Promoting choice and value
**for all gas and electricity customers**

# The Retail Market Review - Findings and initial proposals

## Consultation

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**Overview:**

Building on the findings of our 2008 Energy Supply Probe, Ofgem's Retail Market Review has demonstrated that further action is needed to make energy retail markets in Great Britain work more effectively in the interests of consumers. Consumers are at risk from a number of features in the market which reduce the effectiveness of competition. We now have three investigations relating to our Probe remedies in progress. In addition to enforcing existing obligations, we believe that further radical actions are now required.

In this document we outline a range of initial proposals for consultation designed to make it much easier for consumers to identify who is offering the cheapest tariff; make it easier for new suppliers to enter the market; enforce and strengthen Probe remedies in both the domestic and non-domestic market; and increase the transparency of company accounting practices.

We would prefer to implement reform wherever appropriate with the cooperation of the supply companies. This would ensure quicker implementation to the benefit of consumers and would limit uncertainty for the industry. If, following consultation, we consider that reforms do not have a realistic chance of addressing the concerns identified due to industry opposition or otherwise, we will consider a referral to the Competition Commission.

# Context

Ofgem's principal objective is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. In accordance with this objective, on 26 November 2010, we launched a review into the state of the GB energy retail market.

The EU Third Package entered into force on 3 March 2011. It recognises the importance of a fully functioning market for consumers. The market is changing, notably with increasing concerns over rising energy prices and consequent impacts on vulnerable customers; the roll-out of smart meters and increasing role for demand side response; the Government's Electricity Market Reform; and the need for investment to move to a secure, low carbon energy future.

The initial proposals set out in this document are aimed at making competition work more effectively so that the benefits can be realised by consumers. They are in line with our principal objective, and uphold our EU duties. We regard effective consumer activity as a key driver of competition among suppliers and a stimulant to new entry. We have found a number of market features that reduce consumer engagement and may permit suppliers to make higher margins from some customer groups. Our initial proposals are aimed at addressing the behavioural and structural features of concern. To inform them we have conducted extensive research and analysis in a number of areas.

In addition to the supplementary appendices to this document (numbered 6 – 10), we are publishing a number of papers covering our research and analysis. These are available on our website on the Retail Market Review webpage. We will also shortly publish our review of the companies' 2009 segmental accounts.

# Associated documents

- The Electricity and Gas Supply Market Report, March 2011, Reference: 36/11

- Update on Probe Monitoring: tariff differentials and consumer switching, July 2010, Reference: 79/10
  http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Update%20on%20Probe%20Monitoring_FINAL.pdf

- Liquidity Proposals for the GB wholesale electricity market, 22 February 2010, Reference: 22/10
  http://www.ofgem.gov.uk/Markets/WhlMkts/CompandEff/Documents1/Liquidity%20Proposals%20for%20the%20GB%20wholesale%20electricity%20market.pdf

- Energy Supply Probe — Initial Findings Report, October 2008, Reference:140/08
  http://www.ofgem.gov.uk/MARKETS/RETMKTS/ENSUPPRO/Documents1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf

# Contents

| | Retail Market Review: summary of key findings | Probe Development |
|---|---|---|
| Market Structure | • One new entrant and a small rise in the market share of small suppliers | Slightly Improved |
| | • High regional market shares of incumbent electricity suppliers and British Gas nationally | No Change |
| | • Independent and small market participants find the wholesale market does not meet their needs to compete effectively | No Change |
| Supplier Behaviour | • Evidence of the removal of large unjustified price differences between some payment types | Improved |
| | • Some suppliers have shown improvements in their communications with their customers, but shortfalls remain | Slightly Improved |
| | • No evidence of a cartel among the Big 6 energy suppliers | No Change |
| | • A lower price premium for incumbent customers but evidence suggests that the Big 6 are benefiting from sticky customers | No Change |
| | • Evidence that competition continues to be targeted at online market; large discounts to offline standard tariffs are available | No Change |
| | • Complex pricing structures are contributing to lower consumer engagement | Deteriorated |
| | • An increase in the number of tariffs available may also be contributing to lower consumer engagement | Deteriorated |
| | • Evidence that energy prices have tended to rise in response to wholesale cost increases more quickly than they fall with decreases | Deteriorated |
| Consumer Engagement | • A significant proportion of consumers are disengaged from the energy market | No Change |
| | • Quality of switching remains a concern with a large proportion of consumers not sure if they have saved money from their switch | No Change |
| | • An increase in the number of passive consumers and fall in the number of active consumers | Deteriorated |
| Non -domestic | • Some improvement in the clarity of information for micro business customers, however many suppliers are still falling short in this area | Slightly Improved |
| | • Concerns that business customers not being dealt with in the spirit of the Standards of Conduct, particularly when switching and using third party intermediaries | Deteriorated |

# Executive Summary

1.1. This Retail Market Review has demonstrated that further action is needed to make sure energy retail markets in Great Britain work in the interests of consumers. Consumers are at risk from a number of features in the market that serve to reduce the effectiveness of competition.

1.2. Of particular concern is the growing complexity of pricing information and the high number of sticky consumers[1]. Consumers find it difficult to make a well-informed choice of supplier, and many customers are on standard evergreen products[2] which lack any obvious decision or trigger points for engagement with the market.

1.3. Our Review has also confirmed the evidence in our 2008 Energy Supply Probe that there are structural features in the industry that are likely to have the cumulative effect of weakening competition:

- regional markets in GB remain very highly concentrated, with the former gas and electricity incumbent suppliers[3] typically still supplying around two thirds of customers in each region;
- segmentation of customers may permit suppliers to make higher margins from sticky customers. This, combined with large incumbent market shares, may confer an advantage to the Big 6 (see footnote 3), raising barriers to entry to the energy retail market;
- a lack of wholesale products and wholesale market transparency combine to frustrate the trading activities of non-vertically integrated suppliers and may protect any advantaged position of the Big 6; and
- there is further evidence of companies pursuing similar pricing strategies.

1.4. These structural features are likely to lead to consumer harm by weakening the intensity of competition among suppliers. For example, our latest Supply Market Report shows that our estimates of dual fuel margins have risen sharply over the last few years and are now near their highest point over the last seven years. We now have evidence that energy prices have tended to rise in response to wholesale cost increases more quickly than they have fallen with decreases.

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[1] Sticky consumers are those customers that choose not to switch, cannot switch due to their circumstances, or are put off switching due to other features of the market such as tariff complexity. We estimate that around 40-60% of customers in the energy sector are currently sticky (although we recognise they may have switched in the past) and that vulnerable customers are likely to be disproportionately represented in this group.
[2] Standard evergreen products are those that have no termination date.
[3] The former incumbent suppliers are the six vertically-integrated supply companies that supply over 99% of GB domestic customers. They are: British Gas, EDF Energy, E.ON, RWE npower, ScottishPower and SSE (also known as the Big 6). References to the Big 6 in this document (and associated documents) are necessarily generalised and the situations of individual companies within that group will vary.

1.5. Many of the remedies following the 2008 Probe were designed to increase consumer engagement and enhance competition. There has been notable progress (eg our Probe remedies removed unjustified differentials from prepayment meter and off-gas-grid tariffs worth around £300 million), but we are disappointed with the reaction of suppliers to many of these measures. Investigations to examine whether suppliers are complying with our Probe remedies are underway and we have announced a further investigation today.

1.6. The key findings from the Review and how they have developed since the Probe are summarised in the table at the start of this section.

1.7. Given these findings and our concerns over how the companies have responded to the Probe remedies, we do not consider that enforcing existing obligations will be sufficient. **We consider that further action is needed in order to protect the interests of consumers.** We summarise our initial proposals below:

**Proposal 1: Improve tariff comparability** To address the complexity of tariff information provided by suppliers we propose to make it simple for domestic consumers to compare prices and choose a better deal.

**Proposal 2: Enhance liquidity** To address continued concerns on low electricity wholesale market liquidity and new entry we propose improving access to wholesale market products for new entrants and independent suppliers and generators.

**Proposal 3: Strengthen Probe remedies – domestic** To address the continued poor performance by the companies to our Probe remedies we propose to make sure the Probe remedies are strengthened, and where necessary enforced, so that they achieve their original objectives.

**Proposal 4: Strengthen Probe remedies – non-domestic** To address continued concerns we have found in the non-domestic sector we propose to take further action to prevent unfair contracting practices in the non-domestic sector.

**Proposal 5: Improve reporting transparency** To address concerns on suppliers' financial reporting we will investigate how to improve reporting requirements for vertically integrated utilities.

1.8. Each of these initial proposals is described in more detail below.

1.9. Such reforms will bring real benefits to consumers. Our initial proposals would make it simple for domestic customers to compare suppliers' prices, while still allowing choice and flexibility for those customers that want them. Customers should find it easier to identify how to save money, whether by switching supplier or moving to a cheaper tariff with their current supplier. New suppliers with new products and ideas should find it less difficult to enter the market to compete with the incumbents. With more competition and empowered consumers holding suppliers to account we would expect more effective competition, which we would expect to bring benefits through keener prices, better customer service and greater innovation.

1.10. **We are seeking views on these initial proposals by 1 June 2011.** If, following consultation, we consider that appropriate reforms do not have a realistic chance of addressing the consumer harm identified, either due to industry opposition or feedback as to the suitability of the initial proposals, we will consider alternative options. Such options would include a referral to the Competition Commission by way of a Market Investigation, or by way of an open licence reference. We are also exploring whether or not additional powers should be sought from Government in a number of areas.

## Proposal 1 – Improve tariff comparability

### Make it far easier for domestic consumers to compare prices and choose a better deal

1.11. We intend to address confusion in the domestic market by a proposal to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single "per unit" price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75%[4] of customers currently on standard evergreen products.

1.12. Suppliers would still be free to offer an unrestricted number of fixed-term products in order for suppliers to continue to innovate and give their customers genuine choice. However, we would seek to ensure that customers only buy into these products with full knowledge and assent to their terms and conditions. Contract terms that allow adverse unilateral variations and automatic rollovers to a new fixed term product at the end of the period would not be permitted. This means that customers would default back to the suppliers' standard evergreen product, unless they make a positive choice for a further fixed term product.

1.13. We propose to require suppliers to quote prices for all fixed-term products on a basis that is readily comparable to the unit price for their standard evergreen products[5]. We would also require regular disclosure of average fixed term product prices on the same basis, so that any differential between standard evergreen and fixed term product prices is transparent to both consumers and Ofgem.

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[4] DECC (2010) Energy Trends, p. 48 and 49. This figure is the simple average of the percentage of GB gas and electricity customers on standard tariffs.

[5] We are proposing that this metric be on p/kWh basis of the net annual bill of the fixed term product, at average consumption levels, minus standardised charges. We are consulting on the contents of the standardised charge, see Chapter 3.

1.14. We consider our initial proposals to be in line with the consumer protection provisions of the Third Package, which relate to the transparency[6] and comparability[7] of prices.

1.15. We are confident, based on evidence from consumer research, that reforms along the lines of those proposed here would be likely to have a material positive effect on both the level and effectiveness of household engagement in the energy market. However, we remain concerned that, despite these proposed reforms, there may be many consumers, including vulnerable consumers, who still do not engage in the competitive market and may remain at risk from higher prices.

1.16. Therefore, we shall continue to investigate whether more needs to be done to protect those consumers that remain persistently disengaged, or find engagement in the market difficult - particularly if these consumers fall into vulnerable groups. This is an area that may warrant consideration of additional consumer protection powers or Government intervention.

## Proposal 2 - Enhance liquidity

### Improve access to wholesale market products for new entrants and independent suppliers and generators

1.17. We consider that strong intervention by Ofgem is needed to provide the electricity market liquidity that market participants, in particular independent and small market participants, require to compete against existing players and to encourage competition between vertically integrated players. This would improve competition and contestability in the energy retail markets to the benefit of consumers. It is also in line with Government's thinking as outlined in their Electricity Market Reform.

1.18. Subject to consultation and the outcome of our assessment of the wholesale power market (referenced in our open letter on liquidity published in December 2010[8]) we propose to intervene with two distinct, complementary initiatives.

1.19. First, we propose a new licence condition that would require the Big 6 to make available between 10% and 20% of their power generation into the market through a regular Mandatory Auction (MA). This should help to drive reference prices and support the ability of independent market participants - including potential supply market entrants - to access the bulk of the wholesale products they need.

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[6] See paragraph 1(c) of annex 1 to Directive 2009/72/EC (electricity) and Directive 2009/73/EC (gas)

[7] See article 3(3) of Directive 2009/72/EC (electricity)

[8] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=163&refer=Markets/WhlMkts/CompandEff

1.20. Second, we propose a new licence condition to require the establishment of Mandatory Market Making (MMM) arrangements, to ensure that market participants are able to trade continuously and mitigate imbalance risks. We expect that MMM would particularly benefit participants who have difficulties accessing the market at present.

1.21. These proposals should be seen against a broader and evolving context, notably with the UK being part of an integrated European energy market. An integrated wholesale electricity market is being affected by 'market coupling'[9]. However, given the specific nature of our concerns (eg product availability and forward trading) and the timescale for large scale coupling, we believe that our additional measures remain necessary.

1.22. These proposals are aligned with the requirements for greater transparency of trading which could result from other European legislative changes[10]. Clearly, as these market and regulatory changes continue to develop, we will monitor the problem to make sure that our proposals are required and consistent with the developments.

1.23. Our approach has been to secure an industry solution to the problem of liquidity. Whilst some initiatives have been taken forward, we do not consider they are likely to prove sufficient to address the concerns identified. We are now setting a deadline of 1 June 2011 before which we hope industry will engage with us and develop our proposed interventions or to propose alternative arrangements satisfactorily to address our liquidity and contestability concerns. During this time we will complete the planned assessment of industry initiatives in line with our previously proposed criteria[11]. We will also use this time to discuss our proposals with the European Commission. We recognise developments in the European single market and we will ensure these are carefully considered as we develop our own proposals.

## Proposal 3 - Strengthen Probe remedies – domestic

**Make sure the Probe remedies are strengthened, and where necessary enforced, so that they achieve their original objectives**

1.24. The performance against our 2008 Probe reforms has been patchy. There is therefore scope for strengthening a number of the licence conditions (including those

[9] Whereby at the day-ahead stage, interconnector operators make available unused (or a particular proportion of) capacity to power exchanges, who determine cross-border electricity flows based on trades at the exchanges.
[10] Relevant initiatives could include: Review of the Markets in Financial Instruments Directive (MiFID); Energy Markets Integrity Regulation (REMIT) and Transparency of European Markets Integrity Regulation (EMIR).
[11] GB wholesale electricity market liquidity: Summer 2010 assessment, 29/07/2010, Ref 95/10 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=130&refer=Markets/WhlMkts/CompandEff

put in place or amended as part of the Probe) to give suppliers less freedom in how they interpret these obligations. This is necessary in order to ensure suppliers abide with both the spirit and intention of the measures as well as complying with the letter of the licence conditions.

1.25. We also have concerns over whether one supplier is complying with standard licence condition 27.2A on cost reflectivity between payment methods[12]. ScottishPower's tariff differential between its dual fuel standard credit and direct debit offerings seems well above our understanding of the difference in the costs to serve these two types of customer. We are therefore announcing today that we have launched a formal investigation into ScottishPower's compliance with the relevant licence condition[13].

1.26. We also recognise that more can be done to improve the switching process itself and consumers' access to tariff information. This could come through enhanced obligations on suppliers either when dealing with switching sites or on their own marketing activities. We are also considering how switching site accreditations can best be used to ensure consumers have trust in the tools they use to search alternatives tariffs and suppliers and switch if desired.

1.27. Where we consider modifications to a licence condition are not necessary, we propose enhancing our monitoring. In cases in which we suspect non-compliance, we intend to carry out swift assessments, rapidly moving to appropriate enforcement activity where we find our suspicions are reinforced.

**Possible actions under this option include:**

**New rules**

- Strengthen existing regulations to ensure consumers receive clear and transparent information - possibly requiring more standardised information on bills and Annual Statements
- Introduce one or more of the Standards of Conduct into new or existing licence conditions

**Ofgem actions**

- Directly provide consumers with information/advice regarding the switching process and how they can use available information to assess their options
- Take steps to improve consumer trust in switching sites
- Enhanced monitoring of supplier activities and, where appropriate, take enforcement action

[12] SLC 27.2A of the supply licence stipulates that any difference in terms and conditions between payment methods for paying charges for the supply of electricity or gas shall reflect the costs to the supplier of the different payment methods. The licence condition clarifies that price is included in the definition of "terms".
[13] For the avoidance of doubt, the fact that Ofgem has launched an investigation should not in any way be taken as implying that there has been a breach of a licence condition.

- Publicly name and shame companies that persistently fail to adhere to the spirit of existing regulations and the Standards of Conduct

## Proposal 4 – Strengthen Probe remedies – non-domestic

### Take further action to prevent unfair contracting practices in the non-domestic sector

1.28. Following the Probe, we introduced a range of remedies to address contracting practices that were adversely affecting micro business consumers[14]. We are concerned that performance against these remedies has not been complete. As a result, and as in the domestic sector, we intend to take action to ensure compliance with existing licence conditions and to consider whether further licence amendments are needed.

1.29. Suppliers will need to comply more rigorously with the new supply licence condition on protections for micro business consumers (SLC 7A). On completing our review of compliance, we will contact non-domestic suppliers to point out specific areas that need improvement. We shall consider further action if suppliers do not take prompt steps to resolve any areas of concern. We are also considering extending the reach of the licence condition beyond micro businesses. We want more businesses to get clearer information about when their contracts are ending and what renewal options are open to them.

1.30. We are concerned about the possible use of the objections procedure to frustrate business customer switching. Our evidence shows that some suppliers have a high level of objections and/or a significant number of objections that are subsequently withdrawn. We intend to write to these suppliers to seek explanations for this. We will examine the reasons for objections and assess whether existing licence conditions have been breached. We shall also consider whether new licence conditions might be necessary.

1.31. We shall also examine the role of third party intermediaries (TPIs) in this market and consider whether action is needed. There have been a large number of complaints about the actions of TPIs, some of which act independently and some of which act on behalf of suppliers. This too may be an area that warrants consideration of additional powers from Government.

1.32. We are also considering whether we need to extend some elements of the Standards of Conduct into non-domestic supply licence conditions. However, we have

[14] For a definition of 'micro business' and more information about the protections which apply to such consumers please see Ofgem's factsheet on 'Helping small businesses get the most out of the energy market':
http://www.ofgem.gov.uk/Media/FactSheets/Documents1/helpingmicrobusinextprobeqa.pdf

not proposed to extend tariff simplification to the non-domestic sector, but invite views on whether there is a case for us to consider this.

## Proposal 5 – Improve reporting transparency

### Improve further the transparency in vertically integrated utilities

1.33. Our 2008 Probe required reporting of separate financial information for supply and generation. This has provided greater transparency for consumers and potential competitors. We publish an analysis of this data as part of this Review. We propose to seek incremental improvements to improve cross-company comparability for subsequent years but remain concerned that transparency is limited by company specific policies on transfer pricing and reporting of wholesale energy costs. For example, some of the companies excluded significant profit elements from their 2009 segmental results. As a result, we feel that consumers are not provided with sufficient clarity about how retail prices relate to suppliers' wholesale costs.

1.34. We propose to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated firms in the sector and report to us on the likely impact of these practices on reported profits and transparency. We will also ask them to make recommendations on how to improve reporting in future years, either through amendments to the segmental statements or through additional reports provided to Ofgem.

1.35. Any consideration of future reporting requirements would need to include whether we could build on EU Third Package provisions which require the companies to retain information about their wholesale transactions and to disclose this information to regulators and competition authorities on request.

## Future steps

1.36. The initial proposals set out in this document for consultation are designed to be an appropriate and proportionate response to the findings we have identified in the Review. We consider that Ofgem is able to implement these changes under its powers and that it is in the interest of consumers to develop the initial proposals further and introduce licence amendments to bring them into effect. We believe that this provides the best route to bring benefits to consumers more quickly. For these reasons we do not propose to consult on a Market Investigation Reference to the Competition Commission (CC) at this stage. However, we may do so in the future if our proposals for reform risk being frustrated.

1.37. This document marks the start of a period of substantial consultation between Ofgem, the industry, consumers and their representatives and other stakeholders. At this stage, we are seeking views on our assessment and initial proposals. Following this consultation, we will be conducting additional research, including further behavioural research with consumers. There will be further consultations on the initial proposals contained in this document, including detailed impact assessments.

1.38. Nonetheless, there remains a risk that, even after implementation, our proposals may not do enough to protect the interests of consumers who remain permanently disengaged, including some vulnerable consumers. We would therefore welcome views on whether further consumer protection should be considered (in addition to our five initial proposals) to protect vulnerable consumers.

1.39. We also note that there are possible interactions between our current proposals and our previous Probe remedies. In particular, we note that our initial proposals on tariff simplification may make price discrimination by suppliers between regions very difficult. We would therefore also welcome views on whether our current proposals imply our future review of the undue price discrimination licence condition (which is due to expire on 31 July 2012) should be brought forward.

1.40. We now invite views on the assessment of the energy retail markets and our initial proposals as described in this report. Our deadline for responses to this consultation is 1 June 2011.

# 1. Scope of the Retail Market Review

**Chapter Summary**

In this chapter we set out the background to the Review in the context of our statutory duties, and explain what areas the Review has explored.

## Background

1.1. Ofgem actively monitors the GB energy retail markets. Where we have concerns about aspects of the market we conduct more detailed reviews. These reviews allow us to examine a range of issues in detail and, where appropriate, take action to address the identified problems.

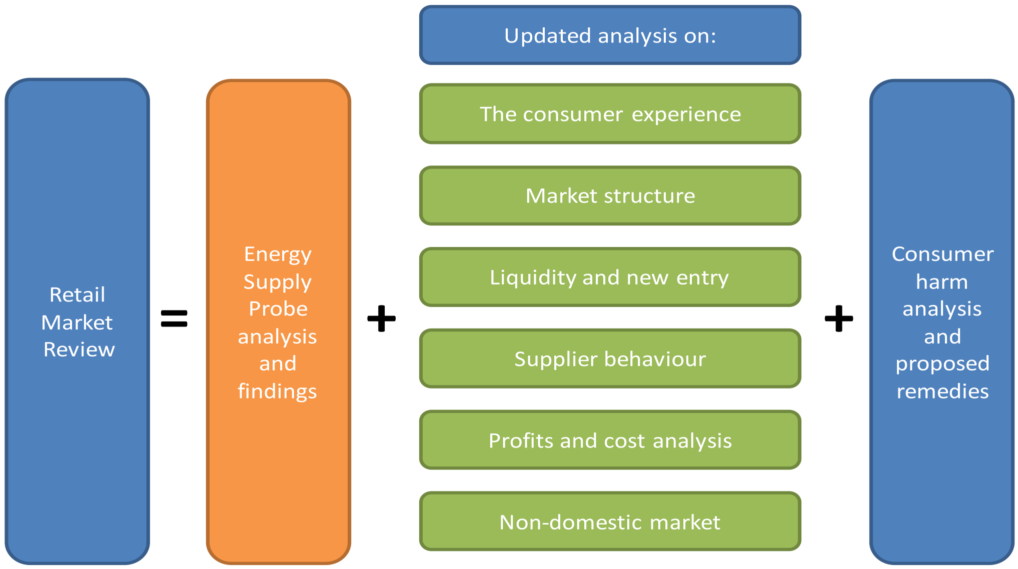
1.2. In November 2010, Ofgem announced its intention to review the effectiveness of the energy retail market (the Review)[15], including a review of the progress companies have made in implementing the reforms introduced as part of our 2008 Energy Supply Probe (the Probe)[16]. The focus of the Review has been the domestic and small non-domestic market.

1.3. We had already undertaken some work to assess suppliers' implementation of the Probe remedies. The majority of these remedies have now been in place for over a year. Based on our assessment we recognise that all suppliers have made changes in response to these licence conditions. However, we see many practices that are not in line with the spirit, and in some cases the letter, of the new rules. The Review has allowed us to take a closer look at supplier activity and commission research to understand better the impact the Probe remedies are having on consumers.

1.4. We announced the Review alongside the publication of the December 2010 Electricity and Gas Supply Market Report. This showed that our estimate of retail margins had increased to £90 per customer per year, for a typical dual fuel tariff. Whilst Ofgem expects efficient firms to make a profit, we initiated the Review against a backdrop of rising energy prices and a number of instances of questionable supplier conduct throughout 2010. In the Review, we have sought to clarify whether the market is transparent and working as effectively as possible. We have used our findings to assess the nature of persistent consumer harm and analyse what further measures may be needed to protect consumers.

[15] Ofgem to review the effectiveness of the energy retail market to see if further action is needed to protect customers http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?file=Retail per cent20Market per cent2026 per cent20November.pdf&refer=Media/PressRel
[16] We include more detail on the findings of the Probe, and the remedies we introduced following it, in Appendix 3 of this document.

1.5. The Review has built on the analysis and findings of the Probe and carried out additional analysis to update our understanding on a wide range of issues to assess the effectiveness of the energy retail markets:




1.6. In parallel with the Review, Ofgem has continued its work on the following separate, but related, projects and investigations:

- mis selling in the domestic market
- non-domestic deemed contracts
- unilateral contract variations

1.7. In addition, we recently published a consultation on practices concerning fixed term offers in the domestic energy retail markets[17], and requested responses by 7 March 2011. The consultation document discusses fixed term offers and automatic contract rollovers in the domestic energy retail markets, sets out our concerns on current practices in these areas and considers how best to address issues identified. In that consultation we noted that we would consider any remedies in light of responses to consultation and in the context of our work on the Retail Market Review. As part of the Review we have put forward proposals regarding automatic rollovers for domestic fixed term offers (these are set out in Chapter 3). These proposals are subject to consultation through this findings and initial proposals document.

1.8. The Review has been, and will continue to be, mindful of the issues raised by all related projects.

[17] This document can be found at the following link: http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=110&refer=Markets/RetMkts/Compet

## Overview of topics explored

1.9. **The consumer experience:** We have analysed consumers' reactions to price changes and the drivers of and barriers to switching. We have also conducted a range of consumer research, which has provided important insights. Through this work we have been able to examine the significance of tariff complexity to those who do not, or only occasionally, engage in the market; changes with consumer engagement since the Probe; and whether vulnerable consumers are still being disproportionately affected. As part of the Review, we have also drawn on behavioural economics help to understand more clearly the choices made by GB consumers.

1.10. **Market structure:** We have used the expanded datasets on customer account numbers, gains and losses; we now receive monthly from suppliers, to provide a granular breakdown of national and regional market concentration.

1.11. **Liquidity and new entry:** Using our ongoing work on GB wholesale electricity liquidity (which arose out of the Probe), we have examined how liquidity and accessibility of products act as barriers to entry to the GB energy markets.

1.12. **Supplier behaviour:** We have examined whether there have been any discernable changes to the pricing and marketing strategies of the Big 6 since the Probe. We have also examined whether the price differentials across payment types, regions and products are still of concern. We have investigated the extent to which suppliers have implemented the Probe remedies in the spirit in which they were intended.

1.13. **Profits and cost analysis:** We have completed detailed analysis on profits and costs. In particular, we have considered the profits earned by the Big 6 supply companies. The Review has also looked at trends in controllable costs. Alongside the Review, Ofgem is publishing a review of the suppliers 2009 segmental statements (Financial Information Reporting: 2009 Results) and a paper updating our analysis on retail pricing asymmetry (Ofgem Discussion Paper: Do energy bills respond faster to rising costs than falling costs?, March 2011).

1.14. **Non-domestic market:** We have assessed compliance with licence conditions relating to the contractual information that suppliers provide to small businesses. The Review has also examined the Standards of Conduct[18] with respect to the interactions between suppliers and non-domestic customers.

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[18] Ofgem introduced overarching Standards of Conduct following the Probe. The Standards of Conduct set out the level of service consumers can expect from energy suppliers, for example on tariff complexity.

# 2. Findings on consumer harm

**Chapter Summary**

In this chapter we set out the key findings of the Review on consumer harm.

**Question 1:** Do stakeholders agree with our findings of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets.

2.1. We regard effective consumer activity as a key driver of competition among suppliers and a stimulant to new entry. The greater the number of engaged consumers, the greater the competitive pressure on suppliers to make efforts to retain or win them. We have identified a number of market features and conduct by suppliers that work against the interests of consumers. We have also confirmed evidence in the Probe that there are a number of structural features in the industry that are likely to have the cumulative effect of weakening competition[19].

## Causes of consumer harm

2.2. This section builds on the findings of our analysis, which are summarised in appendices to this document and in accompanying papers published together with this consultation. In this section, we describe the features of the energy retail market and specific examples of supplier conduct that we believe lead to persistent harm to consumers.

2.3. In each case, we explain how the market feature or supplier conduct results in direct consumer harm (for example, by adversely affecting prices or service quality directly) and/or indirect consumer harm (for example, by reducing the extent of active consumer engagement in the market or lessening the intensity of competition among suppliers). The first two cases below are likely to lead to both direct consumer harm and indirect consumer harm, through lowering consumer engagement, which weakens competitive intensity among suppliers.

- **Complex tariff information:** Limited or complex information and poor comparability between suppliers' tariffs result in many consumers disengaging from the market or making poor switching decisions.
- **Poor supplier conduct:** Questionable supplier behaviour and inadequate response to remedies introduced following the Probe, has contributed to a broad

[19] The findings of the Review and the contents of this document are being published by Ofgem pursuant to its statutory powers under section 35 of the Gas Act 1986, section 48 of the Electricity Act 1989, and section 5(6) of the Utilities Act 2000.

mistrust of suppliers and anxiety amongst consumers. It has also meant that we have not seen the improvement in effective switching that we were hoping for.

2.4. In addition, there are a number of structural features and supplier behaviours that are likely to have a more direct effect on weakening competition in the energy retail markets:

- **Sticky domestic customers and large incumbent market shares:** The presence of sticky consumers in the domestic energy markets decreases the level of competition among suppliers. Segmentation of customers may permit suppliers to make higher margins from sticky customers. This, combined with large incumbent market shares, may confer an advantage to the Big 6[20] over suppliers without a sticky customer base.

- **Vertical integration and low liquidity:** A lack of wholesale products and market transparency combine to frustrate the trading activities of non-vertically integrated suppliers. This acts as a barrier to entry to non-vertically integrated suppliers.

- **Similar pricing and hedging strategies:** Although we are confident that companies price independently and have found no evidence of a cartel, we have seen evidence of companies reducing the risk from competition through adopting similar pricing strategies as well as through similar hedging behaviour and generation portfolios. We also note that many features of the energy retail markets could give rise to a higher risk of coordinated effects.

2.5. These features are likely to lead to consumer harm by weakening the intensity of competition among suppliers. For example, our latest Supply Market Report shows that our estimates of dual fuel margins have risen sharply over the last few years and are now near their highest point over the last seven years. We also now have evidence that energy prices have tended to rise in response to wholesale cost increases more quickly than they have fallen with decreases[21].

2.6. In the following subsections we discuss the consumer harm related to each of the causes listed above, drawing upon the findings of the Review as evidence.

[20] The former incumbent suppliers are the six vertically-integrated supply companies that supply over 99% of GB domestic customers. They are: British Gas, EDF Energy, E.ON, RWE npower, ScottishPower and SSE (also known as the Big 6). References to the Big 6 in this document (and associated documents) are necessarily generalised and the situations of individual companies within that group will vary.

[21] This finding is dependent on both the analysis technique used, as well as how we assume suppliers hedge their energy purchases. Details are provided in the Ofgem Discussion Paper: Do energy bills respond faster to rising costs than falling costs?, March 2011, published with this document.

## Complex tariff information

2.7. Complex information on tariffs has a detrimental effect on consumers as it limits their effective engagement in the energy market:

- It may make consumers less aware of their expenditure on energy and so less likely to engage in the market.
- It may put off consumers from searching for better tariffs.
- It may lead to consumers abandoning their search.
- It may result in an increased frequency of poor switching decisions by consumers.
- It decreases trust in the energy market.

2.8. Our research on behavioural economics, published alongside this document[22], shows that customers exhibit 'status quo bias' and 'limited capacity' when making decisions. Status quo bias refers to the tendency of consumers not to change from what they are currently doing unless they face strong reasons for doing so. For example, our consumer research has shown that many consumers do not think of switching supplier until they experience an instance of bad service. Furthermore, 75%[23] of consumers are on standard evergreen products which lack any obvious decision or trigger points for engagement with the market.

2.9. Limited capacity refers to the range of limitations on consumers to assess the goods and services available to them. These limitations are due to the limited time and attention that consumers have to assess the offers, as well as the range of knowledge and skills of individual consumers.

2.10. We believe there are a number of features of the GB energy markets that are accentuating these consumer biases and acting as deterrents to active participation. We have compiled a large amount of evidence that domestic consumers find both that individual tariffs are complex and difficult to understand, and that the multiplicity of different tariff options in the market is confusing. We discuss these findings in turn below.

### Complexity of individual tariffs

2.11. During conversations with our Consumer First panel[24], many panellists expressed views that they are confused by the number of components of energy tariffs. These include features such as standing charges the number of tiers of

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[22] Ofgem Discussion Paper: What can behavioural economics say about GB energy consumers?, March 2011

[23] DECC (2010) Energy Trends, p. 48 and 49. This figure is the simple average of the percentage of GB gas and electricity customers on standard tariffs

[24] Ofgem's Consumer First Panel is a group of 100 everyday, domestic consumers recruited from five locations across Great Britain. The Panel meets regularly to discuss key issues impacting on their participation in the energy market and panellists change every year.

different price rates, acquisition discounts and cash-back offers. Panellists generally did not fully understand tiered tariffs and the exact meaning of the consumption thresholds between tiers. Panellists also voiced their concerns with the format and presentation of tariff information. When presented with different pricing metrics, panellists preferred simpler formats and became increasingly disengaged the more elaborate and detailed the pricing structure became.

2.12. Complex pricing is not unique to the energy retail markets, but research by the Office of Fair Trading suggests that complex pricing is more prevalent in energy retail than in many other sectors (see Box 2.1 below).

**Box 2.1 Advertising of prices**

As part of its study on advertising of prices, the OFT carried out a survey on consumers' attitudes and responses to different practices by companies to present price information. Complex pricing, where it is difficult for consumers to assess an individual price, was one of the practices examined.

**Relevant findings:**

- Complex pricing was encountered in gas or electricity supply more than in any other sector
- Of these customers, 75 per cent objected to the way in which electricity and gas prices are presented and 61 per cent found it difficult to choose a supplier

Of those who found it difficult to choose an energy supplier:

- 40 per cent thought the market was too confusing and complicated
- 21 per cent thought there were too many options
- 40 per cent thought that it was too difficult to calculate the amount due over the contract period
- 37 per cent thought it was difficult to choose because different suppliers use different terms to describe the same thing
- 16 per cent thought that price comparison sites are too confusing and complicated

*Source: Office of Fair Trading (2010) "Advertising of Prices Annexe N: Consumer survey data tables"*

2.13. The OFT states that firms may have incentives to increase the number of tariffs and thereby the complexity of the choice facing consumers[25]. In this regard, the OFT quotes a strategic marketing consultancy who advises banks to:

> *make use of more complex price systems such as two part pricing, multidimensional pricing or loyalty programs for selected products/services... .the likelihood that banks continually try to undersell one another is greater if their*

[25] OFT 2010, What does Behavioural Economics mean for Competition Policy?, OFT1224

*price structures make it easy for customers to compare offers. In order to prevent easy comparisons, a bank should create price structures that are clearly distinguishable from those of its rivals. Price systems with several price components are especially effective.*

2.14. Complex pricing structures make it more difficult for consumers to make good switching decisions, and so increase the risk that those consumers who do switch supplier fail to realise the savings that they had expected or in some cases switch to a worse deal. Our latest domestic consumer engagement survey found that of those consumers that switched supplier in order to save money, around a third did not know whether or not they had saved money following their switch[26].

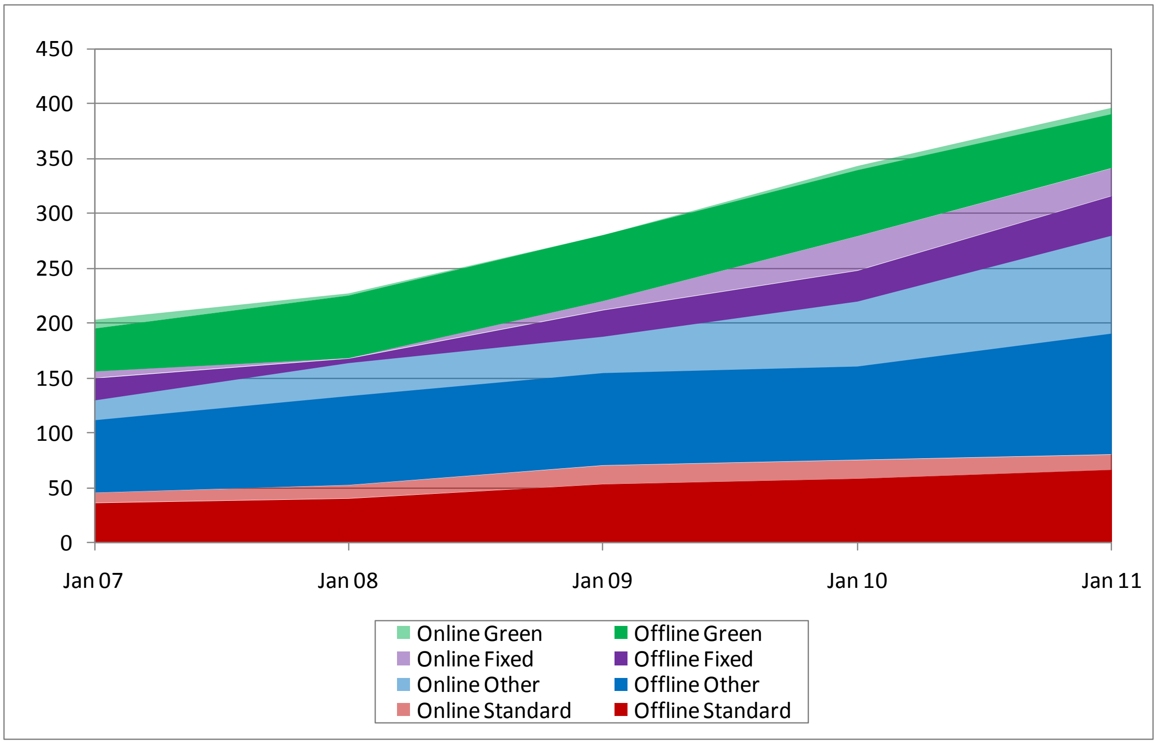
**Multiplicity of tariff options**

2.15. Our research with consumers shows that the large number of tariff options is one of the reasons that many find it hard to decide whether it is worth them switching or not. As a result many do not engage and others will make poor switching decisions. Our 2008 domestic consumer engagement survey reported that 70 per cent of respondents found the number of tariffs on offer confusing. This view is also echoed by our Consumer First panellists. The OFT also identified a large number of tariff options as one of the reasons some consumers find it hard to choose a supplier in the energy market.

2.16. Since the Probe there has been a marked increase in the number of tariffs available. Figure 2.1 shows the number of tariffs available to domestic consumers on 1 January of each year from 2007 to 2011. It shows the number of online and offline tariffs for fixed, green, standard and other tariffs options. The figure combines information on gas-only, electricity-only and dual fuel tariffs.

[26] Ipsos MORI (2011) Consumer Engagement with the Energy market - Tracking Survey, January

**Figure 2.1 Number of tariffs available to domestic consumers on 1 January 2007 to 2011**




Source: Ofgem analysis on data from TheEnergyShop.com

2.17. Since 2008 the total number of available tariffs (online and offline) has increased by over 70%. The figure shows that this increase has been driven by the increase in the number of fixed tariff and "other" options available, both online and offline[27]. The number of offline standard tariffs has increased by over 50% to 66, since 2008. We note this chart does not include payment type options, only the number of offers available.

## Poor supplier conduct

2.18. As part of the Review, we have taken stock of the progress of the measures that were introduced following the Probe. We outline below our assessment of the level of supplier response to a number of licence conditions introduced following the Probe. We also set out our views on how a poor response to licence conditions increases mistrust of suppliers; leads to lower levels of engagement; and in some cases can lead to direct consumer harm. We include a more detailed discussion of supplier response to these licence conditions in Appendix 8 of the supplementary appendices.

[27] Other tariff options include features such as air miles, retail rewards, financial offers, capped prices, energy credits, a tracker energy price or smart metering options.

**Bills and Annual Statements**

2.19. Standard Licence Condition (SLC) 31A is aimed at ensuring domestic consumers have access to the information they need to understand the contract with their supplier, explore alternative offers and switch if desired[28]. All suppliers have now incorporated the new requirements into bills and Annual Statements and we have evidence that half of domestic consumers are aware they have received clearer information on some of these items[29]. However, we have evidence that the quality of implementation varies between suppliers and many improvements could be made to ensure that consumers take notice of and understand the required information.

2.20. We are committed to ensuring consumers get easy access to information about their energy consumption and tariffs to help them engage successfully with the energy market and feel confident in doing so. If they feel unable or unsure about switching, due to lack of information, they may continue to pay higher bills or be put off switching for some time. Inadequate information may also lead consumers to switch unknowingly to a worse deal than the one they are currently on.

**Requirements on suppliers' marketing**

2.21. The objective of SLC 25, relating to suppliers' marketing to domestic gas and electricity consumers, is to improve consumers' ability to make well-informed decisions about energy offers in response to telephone and face-to-face sales activities. These marketing routes continue to account for a significant proportion of the means through which consumers switch.

2.22. We have been monitoring suppliers' compliance with SLC 25 and, on the basis of the information available to us, we are concerned by certain suppliers' efforts to date. In light of our concerns, on 2 September 2010 we launched formal investigations into the sales and marketing practices of EDF Energy, RWE npower ScottishPower, and Scottish and Southern Energy. We will reach a decision later this year as to whether or not any of the suppliers have breached the licence condition[30].

2.23. Given the prominence of telesales and face-to-face sales as a means of switching it is important that consumers are sufficiently well informed that they feel able to take a correct decision when they do elect to switch. Inadequate compliance with SLC 25 could lead to poor switching decisions and undermine consumer

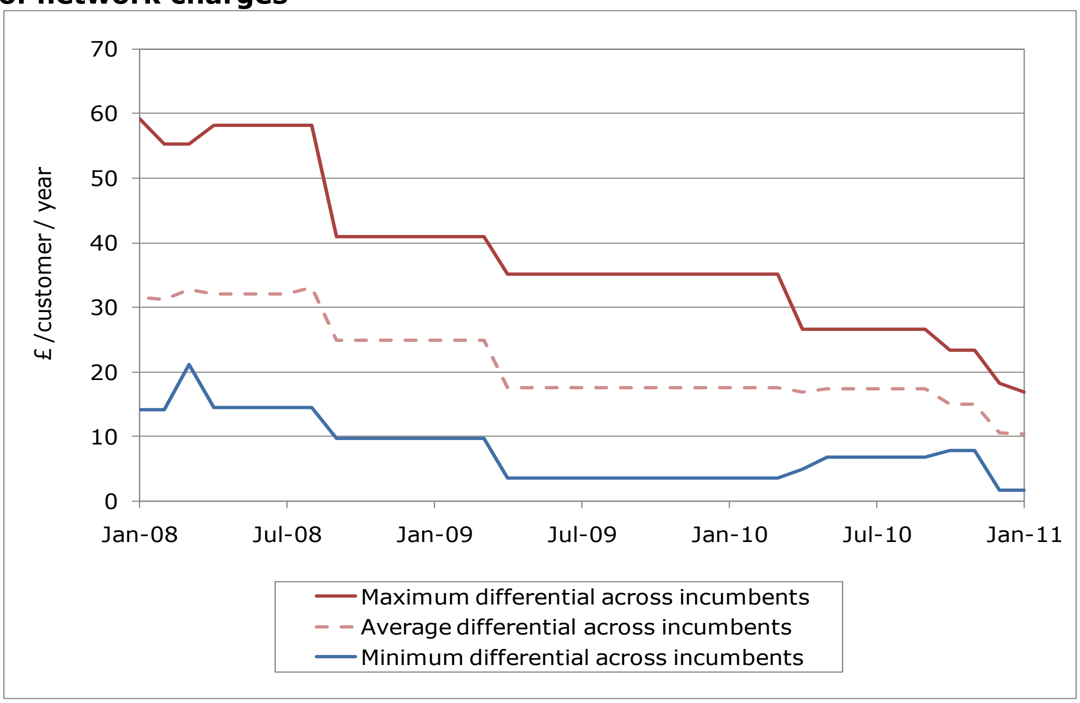
[28] SLC 31A requires suppliers to provide customers with additional information on every bill, and requires that all customers receive this and further information at least once in every 12 month period. This provision came into force in July 2010. Suppliers were required to change their bills from that date. All customers should receive an Annual Statement no later than the end of June 2011.
[29] Almost half of consumers recently surveyed reported awareness of clearer information on the name of their tariff, any changes to it and/or the forecast cost of their energy consumption over the coming year. Source: Ipsos MORI (2011) Customer Engagement with the Energy Market – Tracking Survey, January
[30] For the avoidance of doubt, the fact that Ofgem has launched investigations should not in any way be taken as implying that any supplier has breached SLC 25.

confidence in the energy retail markets. This could lead to higher bills for affected consumers and reduce consumer engagement in the market.

**Prohibition of undue discrimination**

2.24. SLC 25A prohibits discrimination in respect of the key contractual terms (including tariffs/charges) which apply to different groups of customers unless they can be objectively justified. One objective of this licence condition was to remove unjustifiable premiums on the tariffs offered by ex PES[31] suppliers in their incumbent regions (their "in-area" regions) compared with the tariffs offered to customers in regions they were entrants (their "out-of-area" regions). Figure 2.2 compares the average annual bills for standard credit electricity tariffs offered by suppliers to their in-area and out-of-area customers, net of network charges.

**Figure 2.2 Average standard credit in vs. out-of-area tariff differentials, net of network charges**




Source: Ofgem analysis on data from TheEnergyShop.com

2.25. Figure 2.2 shows that from January 2008 to January 2011, the average differential between suppliers' in-area and out-of-area tariffs, net of network charges, decreased from over £30 to around £13 per customer, per year with the maximum differential falling from £55 to £17 per customer.

[31] PES refers to a Pubic Electricity Supplier and were the fourteen regional, monopoly suppliers created at privatisation of the GB electricity market. The following five Big 6 energy suppliers have evolved from the PES companies through consolidations and acquisitions: EDF Energy, E.ON, RWE npower, ScottishPower and Scottish and Southern Energy.

2.26. While this appears to be a compliant response by suppliers to the licence condition, we note that this is in part due to the threat of enforcement activity by Ofgem. In June 2010 we had concerns that two suppliers were charging systematic premiums to their in-area customers which we believed could not be objectively justified. In response, we initiated Stage 1 of our bespoke enforcement procedure for SLC 25A[32]. The decrease in the average in vs. out-of-area differential observed in Figure 2.2 around September 2010 is driven, in part, by these two suppliers reducing their differentials following our Stage 1 enforcement proceedings.

**Cost reflectivity between payment methods**

2.27. SLC 27.2A of the supply licence stipulates that any difference in terms and conditions between payment methods for paying charges for the supply of domestic electricity or gas shall reflect the costs to the supplier of the different payment methods. The licence condition clarifies that price is included in the definition of "terms".

2.28. We have observed a number of positive outcomes resulting from SLC 27.2A. In particular, we note that suppliers have dramatically decreased the premium charged to prepayment meter (PPM) customers with respect to their standard credit customers. Some suppliers now charge less, per year, to their PPM customers. This has had the effect of bringing down the differential between PPM and standard credit, so that, PPM customers now pay, on average, £20 less than standard credit customers for their gas and electricity.

2.29. We have continued to monitor companies' performance against SLC 27.2A. Our analysis shows that ScottishPower's tariff differential between its dual fuel standard credit and direct debit offerings seems very high. As of January 2011, it stood at £114 per annum (excluding any prompt pay discount). This compares with our finding during the Probe that the average difference between the costs to serve a customer on standard credit and one on direct debit was around £37[33].

2.30. Ofgem takes very seriously compliance with all licence conditions. Given these findings, we have today announced that we have launched a formal investigation into ScottishPower's compliance with the relevant licence condition[34].

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[32] SLC 25A has with it a bespoke enforcement procedure. Stage 1 of this three stage process represents the first communication Ofgem has with a supplier following the identification of a concern with a pricing differential.
[33] Ofgem (2008) Energy Supply Probe – Initial Findings Report, October
[34] For the avoidance of doubt, the fact that Ofgem has launched an investigation should not in any way be taken as implying that any supplier has breached a licence condition.

**Standards of Conduct in the domestic sector**

2.31. As part of the Review we have carried out a technical review of supplier communications. This has helped us understand more about how closely suppliers are adhering with Ofgem's Standards of Conduct and, in particular our first Standard: *You must not sell a customer a product or service that he or she does not fully understand or that is inappropriate for their needs and circumstances.* Led by an educational psychologist, the technical review used sample communications from suppliers (such as bills, Annual Statements, terms and conditions and websites) to assess the level of literacy and numeracy required to understand the material.

2.32. The technical review indicated that the literacy requirements to understand suppliers' communications allowed a large majority of the population to access them. However, concerns were raised about the numeracy requirements for information on bills or Annual Statements and on websites. We are concerned that unnecessarily high numeracy requirements could confuse consumers, leading to poor switching decisions, or put them off switching altogether.

2.33. Ofgem regards its Standards of Conduct as important tenets to a well functioning, competitive market. This opinion has been echoed in our consumer groups. Research, carried out through our Consumer First Panel, showed that panellists were generally supportive of the Standards of Conduct. Panellists felt that suppliers should be taking steps to ensure that products are as simple as possible and, ideally, presented in a way that ensures tariffs and features are comparable. Clarity of explanations during the sales process was also seen as key, which was felt to include taking time to fully understand the consumer's situation so that the products offered would match their requirements. However, one criticism made by these consumers, was the lack any mention in the Standards of a compensation scheme if mistakes are not resolved quickly.

**Protections for micro business consumers**

2.34. SLC 7A provides protections to micro business[35] consumers on any type of contract by ensuring they receive clear information about their terms and conditions and, in the case of contracts with a fixed term period, the available options, ahead of the end of their contract. We have also capped the length of contract rollovers to 12 months.

2.35. Customer research has shown that, since coming into force, firms that were not protected under SLC 7A were more dissatisfied with their understanding of contract terms and conditions than the micro business firms captured by the licence

[35] For a definition of 'micro business' and more information about the protections which apply to such consumers please see Ofgem's factsheet on 'Helping small businesses get the most out of the energy market':
http://www.ofgem.gov.uk/Media/FactSheets/Documents1/helpingmicrobusinextprobeqa.pdf

condition[36]. We believe SLC 7A is leading to noticeable improvements in the experience of small non-domestic consumers.

2.36. For example, we have monitored suppliers' compliance with this licence condition. Our initial judgment is that all non-domestic suppliers have taken some steps to comply. While some suppliers appear to be complying well with some elements of the licence conditions, more needs to be done, particularly as regards the clarity of their terms and conditions. These concerns apply to both Big 6 and non-Big 6 suppliers.

**Standards of Conduct in the non-domestic sector**

2.37. As part of the Review we have also examined how well non-domestic suppliers have applied our Standards of Conduct in their interactions with their customers. We have looked into two areas: suppliers' relationship with third party intermediaries (TPIs), and suppliers' objections to customer transfers.

2.38. With regard to the former, we found that non-domestic suppliers have generally incorporated the spirit of the Standards of Conduct into their contracts with TPIs. However, there have been a number of complaints against TPIs and allegations of mis selling. This may be because non-domestic suppliers are less able to police the actions of TPIs working independently. We have passed on complaints to the OFT, who have powers in this area, and have continuing concerns that the actions of some TPIs are having a negative impact on the non-domestic energy market.

2.39. Since the Probe we have also gathered more information about objections made by suppliers to requests to transfer made by non-domestic customers. Non-domestic suppliers are allowed to block a transfer if the contract with their customer allows them to. In these cases, the licence conditions require the supplier to tell their customer that they have objected to the transfer, why they have objected, and what the customer can do to dispute or resolve the objection. Suppliers also have an opportunity to withdraw their objection during this process.

2.40. There are allegations that some suppliers use the objections process to frustrate switching activity to retain non-domestic customers. This would run against the principles of our Standards of Conduct[37]. An early review of our data on this, points to possible concerns in this area.

2.41. Our data shows that it is usual for roughly a third of non-domestic customers wanting to switch supplier to face an objection. However, some suppliers object to more than half of the attempted switches by their customers. In some cases, these objections are legitimate and are upheld, but in other cases they fail. We also have examples of at least one supplier withdrawing a high number of their objections to

[36] Forum of Private Business Utilities Report, December 2010

[37] The third Standard states: *You must not prevent a customer from switching product or supplier without good reason*.

transfer. This may be because the supplier has resolved the reasons for the objection promptly. However, it could also signal unfounded objections. As a result, we believe we need to look into such cases more closely.

**Summary**

2.42. We consider the concerns discussed above would lead to direct and indirect consumer harm if borne out. For example, complex pricing and poor supplier conduct are likely to reduce overall consumer engagement in the energy markets. The remainder of this chapter discusses our findings on structural features of the energy retail markets that we believe continue to weaken competition. These are:

- Sticky consumers and large incumbent market shares;
- vertical integration and low liquidity; and
- coordinated supplier behaviour.

## Sticky domestic customers and large incumbent market shares

2.43. Sticky consumers are those consumers that choose not to switch, cannot switch due to their circumstances, or are put off switching due to other features of the market such as tariff complexity. As many sticky consumers are likely to be vulnerable consumers, we are concerned that these customers are missing out on deals that would save them money.

2.44. The presence of sticky consumers in the energy markets decreases the level of competition among suppliers. We believe that the fewer sticky consumers there are the more that competition among suppliers to offer lower prices and/or better services will be enhanced.

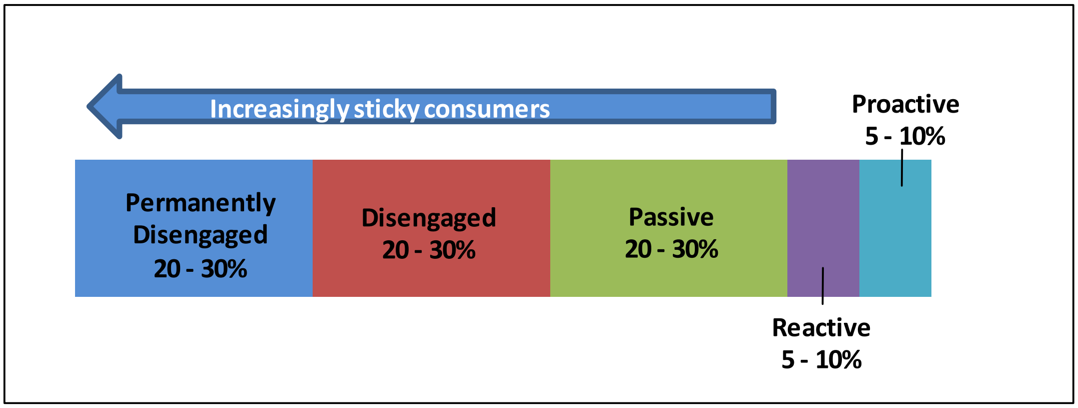
2.45. Sticky consumers may confer an advantage to suppliers that is not accessible to new entrants. A supplier with sticky consumers can pass through reasonably high cost increases to its customers in the knowledge it will not lose a large number of those customers as a result. The advantage of sticky consumers is particularly significant for the Big 6, who each have a large incumbent customer base that contain a sizeable proportion of sticky customers. We recognise that these consumers may have switched in the past, but now show very low levels of engagement.

2.46. Many new or smaller market participants have customer bases that consist almost wholly of active customers who, given that they have already switched, are likely to be more price sensitive. New entrants are therefore less able to pass through cost increases than incumbent suppliers without losing customers. This means that the risk facing new entrants is greater than that facing an incumbent supplier.

**The proportion of sticky consumers**

2.47. Our research suggests that consumers can be categorised by their switching behaviour into five different consumer groups. Consumers in these different groups differ both in terms of awareness and in terms of behaviour. Figure 2.4 presents an estimate of the size of the different consumer groups. We discuss the different consumer types in greater detail below the figure.

**Figure 2.4: Categorisation of consumer groups by switching behaviour**




Source: Ofgem consumer analysis

- **Proactive consumers:** are likely to have switched supplier or tariff within the last year. They research alternative offers themselves and will switch supplier without the need for prompting.

- **Reactive consumers:** are also likely to have switched supplier or tariff within the last year. They do not necessarily shop around or plan to switch, but may switch as a result of an encounter with a sales agent.

- **Passive consumers:** are those who report switching at some time in the past, but have not in the last year. Our research tells us that many of these consumers have switched once, most often to a dual fuel offering either with British Gas or their incumbent electricity supplier. Having made an initial saving with their first switch they are not particularly likely to switch again.

- **Disengaged consumers:** are those consumers who report never having switched but don't rule out switching in the future. Many disengaged consumers may only decide to switch in reaction to poor service from their supplier or following an encounter with a sales agent. They generally have little knowledge (and in some cases little interest) of the energy market.

- **Permanently disengaged consumers:** are those consumers who claim they have never switched and are unlikely to switch in the future. They are the stickiest consumers and many are likely to be vulnerable consumers.

2.48. Our latest domestic consumer engagement survey shows that around 60 per cent of energy consumers report never having switched supplier[38]. This percentage has remained broadly stable since 2007, suggesting that there is a set of consumers who remain disengaged from the energy market (and in some cases permanently disengaged).

2.49. It is important to note that one of the main reasons cited for never switching supplier, continues to be that consumers are happy with their current supplier (77 per cent of consumers who claim they have never switched supplier[39]). This suggests that many sticky consumers are happy to remain so. However, our consumer research has also shown that some sticky consumers assume that their supplier has already put them on the most appropriate tariff.

2.50. We are concerned that the proportion of passive customers is growing. Since 2006, the proportion of consumers switching in any one year has been falling steadily. During 2010, 15 per cent of consumers report switching their gas supplier and 17 per cent, report switching their electricity supplier. This compares to 19 and 22 per cent respectively in 2006.

**Do sticky consumers confer an advantage on the Big 6?**

2.51. In this section, we look at how many incumbent area (in-area) customers the Big 6 have and how sticky these customers are. We then discuss two ways in which the Big 6 may benefit from the stickiness of these customers, which may give them an advantage over suppliers without an incumbent customer base.

2.52. Table 2.1 shows the breakdown in the customer base for dual fuel, electricity-only and gas-only distinguishing between customers of the ex PES in their incumbent regions ("in-area" customers), customers of the ex PES in their non-incumbent regions, ie regions in which they are an entrant ("out-of-area" customers) and customers of British Gas.

[38] This figure is subject to inaccuracies due to the nature of the survey they are based on. For example, the survey almost certainly underestimates the number of customers who report never having switched as it is likely a proportion of customers surveyed have either forgotten that they switched in the past, or were unaware it took place.
[39] Ipsos MORI (2011) Customer Engagement with the Energy Market – Tracking Survey, January

**Table 2.1 Number of ex PES and British Gas domestic customer accounts (million), August 2010**

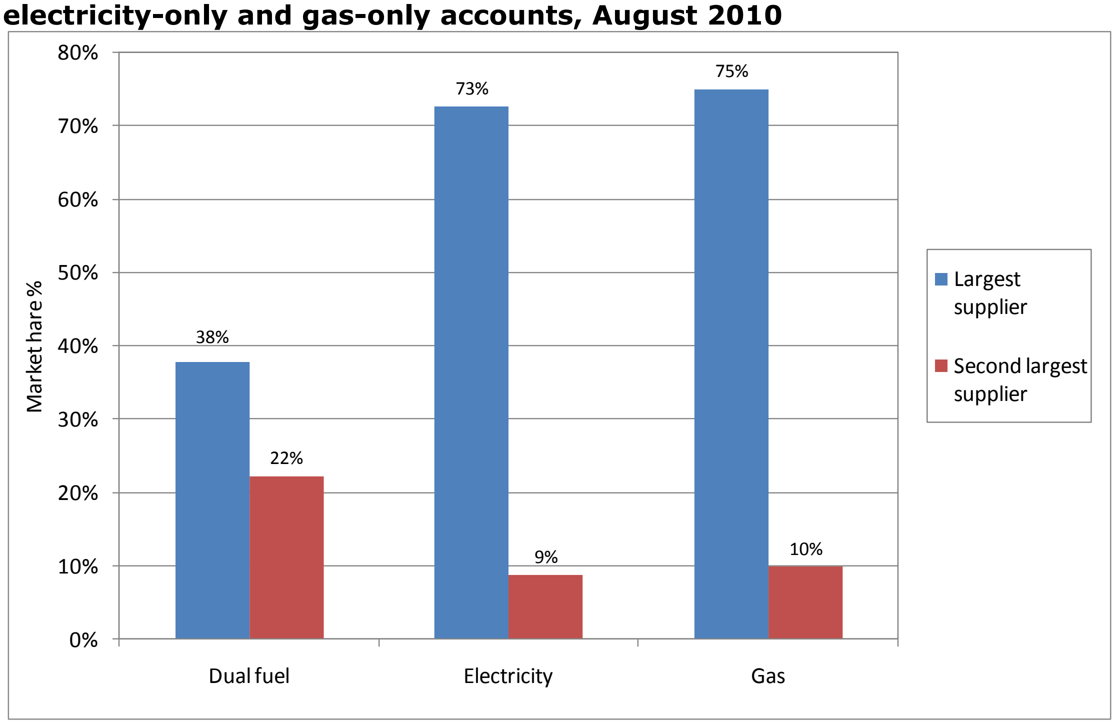
| | Dual fuel | Gas-only | Electricity-only | **Total** |
|---|---|---|---|---|
| ex PES (in-area) | 4.1 | 0.4 | 6.7 | **15.2** |
| ex PES (out-of-area) | 7.0 | 0.7 | 1.7 | **16.5** |
| British Gas | 5.7 | 3.5 | 0.8 | **15.7** |
| **Total** | **16.8** | **4.6** | **9.2** | **47.5**[40] |

Source: Big 6 suppliers, Ofgem analysis

2.53. Almost half, 48 per cent (15.2 out of 31.7 million), of the ex PES customer base is made up of their in-area customers either on a single-fuel or dual fuel basis. Of the 9.2 million electricity-only accounts, the former electricity incumbents supply 73% of them. For gas-only accounts, British Gas has over 75% of these customers.

2.54. Figure 2.5 provides a summary snapshot of the level of concentration at the regional level for each type of fuel account by showing the average share of the largest and the second largest supplier in each region. The figure highlights how small the second largest supplier of gas-only and electricity-only accounts is. For electricity-only accounts the average share of the second largest supplier is 9 per cent, and for gas-only accounts it is 10 per cent.

**Figure 2.5 Average regional share of the two largest suppliers of dual fuel, electricity-only and gas-only accounts, August 2010**



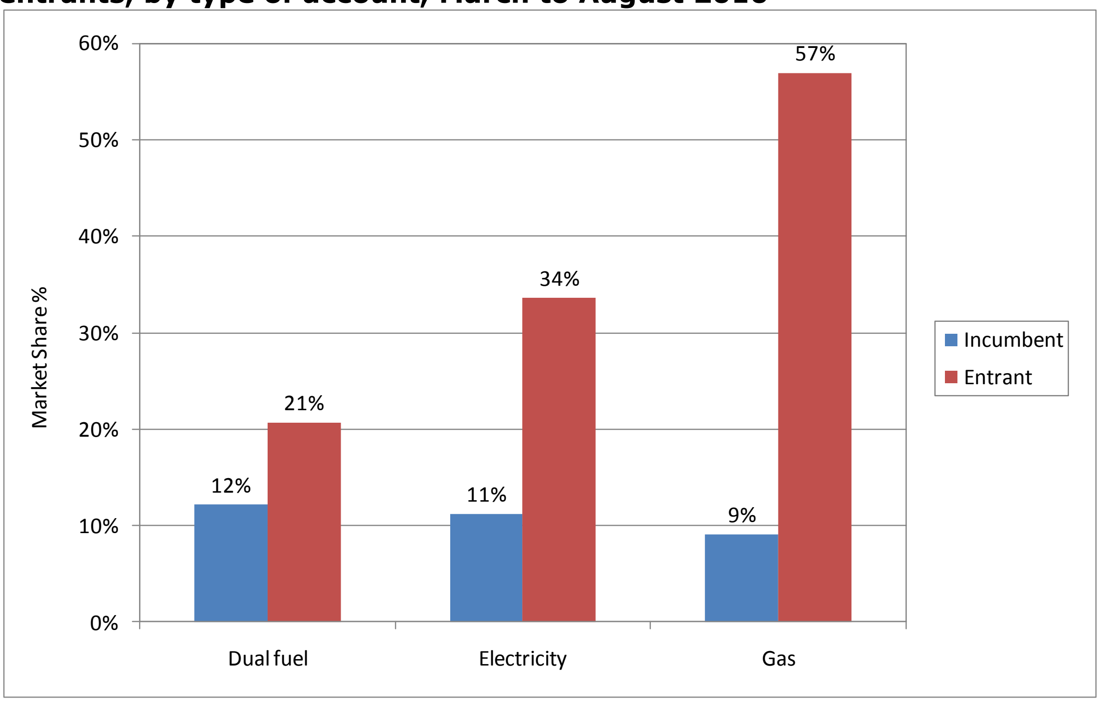

Source: Big 6 suppliers, Ofgem analysis

[40] For comparability, given that dual fuel accounts represent both gas and an electricity account the number of dual fuel accounts has been doubled to calculate the Total column. Differences are the result of rounding to one decimal place.

2.55. The findings above show that the regional market shares of the ex PES incumbent electricity suppliers, in their regions of incumbency, for electricity-only accounts is still very high. This is the same case nationally with British Gas for its gas-only customers. Evidence showing that these customers are more sticky than others is set out below.

2.56. Figure 2.6 shows that there is a marked difference in the average customer churn rates of the regional incumbents and of those suppliers entering a region[41]. The contrast is most striking for gas-only accounts, where the average customer churn rate across all 14 regions for British Gas, the incumbent, is 9 per cent, compared to an average of 57 per cent for the remaining five Big 6 suppliers. For electricity-only accounts, the difference in the average customer churn rate between incumbents and entrants, across regions, is around three-fold: 11 and 34 per cent respectively.

**Figure 2.6 Annualised churn of regional incumbent(s) and of regional entrants, by type of account, March to August 2010**




Source: Big 6 suppliers, Ofgem analysis

2.57. Figure 2.6 indicates that electricity-only and dual fuel customers within the incumbent regions of ex PES electricity suppliers (and gas-only and dual fuel customers with British Gas) are far more likely to be sticky than customers of the same companies in regions in which they are entrants.

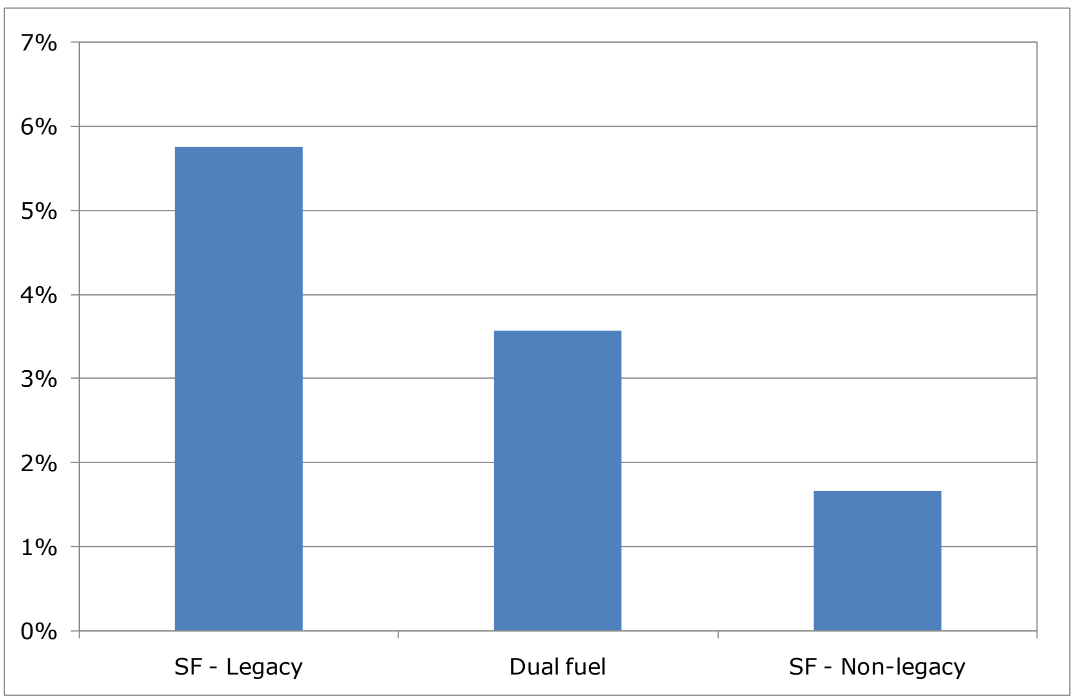
[41] Churn is calculated as the ratio of the number of accounts a supplier loses in a given period, divided by the average number of customers over this period. For periods less than one year, we have annualised the data.

2.58. To understand better how the Big 6 gain from their sticky customers, we have estimated the sales margins made by the ex PESs and British Gas on electricity-only, gas-only and dual fuel customers and looked at ways the Big 6 can segment the market between their more active and inactive customers.

2.59. First, we find that the companies have, on average, earned higher margins on their single fuel customers relating to their legacy business (ie gas in the case of British Gas, and electricity in the case of the ex PES suppliers) than on either their dual fuel customers or on their single fuel customers relating to their non-legacy business. We note this finding varies across the Big 6 suppliers. This finding is reflected in Figure 2.7 which shows our estimated sales margins for the Big 6. The figure is split between:

- legacy single fuel (SF): electricity-only for the ex PES and gas-only for British Gas,
- non-legacy single fuel: electricity-only for British Gas and gas-only for the five ex PES, and
- dual fuel[42].

**Figure 2.7 Estimated sales margins on legacy and non-legacy fuels, 2010**




Source: Big 6 suppliers - request for information, Datamonitor

2.60. This finding suggests that a customer who is still purchasing their electricity and gas separately, as single fuels, from the ex monopoly supplier (eg British Gas for

[42] In this analysis we have not been able to distinguish between the sales margins of the ex PES on electricity in their incumbent regions and in the regions they are entrants.

gas and their ex PES supplier for electricity) is not benefiting from cheaper offers from these suppliers' on their non-legacy fuels or from dual fuel discounts. This is likely to be because our analysis suggests that these customers are more sticky than other customers. This makes them less price sensitive, which is why suppliers are able to make higher margins from them.

2.61. Combining the above with our finding that the ex PES suppliers and British Gas still have large electricity-only and gas-only market shares respectively, suggests that the Big 6 have an advantage over suppliers without a sticky customer base.

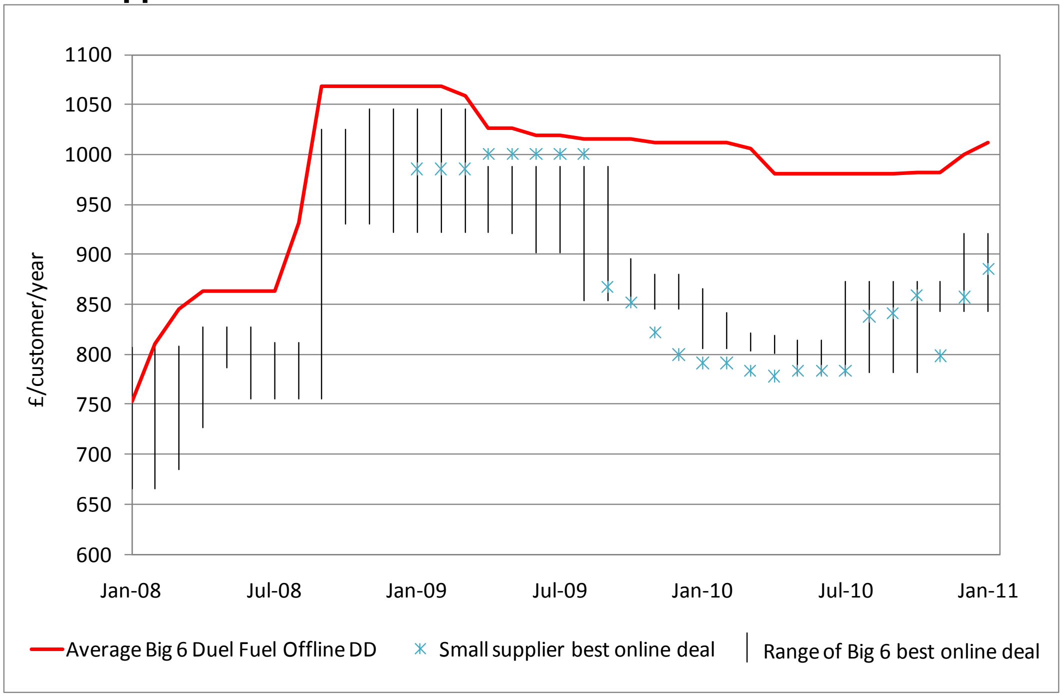
**Online vs. offline segmentation**

2.62. A related finding is that suppliers can segment the market between active and inactive customers through the use of introductory discounts and bespoke tariffs (eg online offers). There are a very large volume of introductory offers available, through switching sites, cash-back sites and suppliers themselves. As a result, we have been unable to gauge the extent to which suppliers use this mechanism to segment the market. Where we have better evidence of market segmentation is in the market for online offers.

2.63. Online tariffs, those that can be accessed online or are made available to customers who manage their accounts online, are an important type of new tariff that have seen a large increase in number. They are particularly relevant for dual fuel accounts, representing, as of August 2010, around 13 per cent of all dual fuel customer accounts of the Big 6.

2.64. Figure 2.8 contrasts the average direct debit, dual fuel offline bill with the average of the online deals available from the Big 6 and the lowest online deal available from small suppliers.

**Figure 2.8: Average dual fuel offline direct debit (DD) vs. best Big 6 and small supplier online deals**




Source: Ofgem analysis on data from TheEnergyShop.com

2.65. Figure 2.8 shows that, since January 2008, the offline dual fuel tariff of the Big 6 has generally been above their online tariffs. This seems to be another way the Big 6 have segmented their more active customers, targeting them with their most competitive offers[43]. Between September 2009 and March 2010, the average online tariff offered by the Big 6 fell by around £100. In contrast, their offline tariffs fell by around £50.

2.66. We note the impact the entry of small suppliers may have had on the pricing behaviour of the Big 6 on online offerings. In the second half of 2009, keen pricing by small suppliers may have been a factor in the decisions by the Big 6 to lower their online prices over this period.

**Distribution of sticky customers**

2.67. The following highlights an additional concern we have regarding sticky customers. We believe sticky consumers are made up of a larger proportion of vulnerable consumers than on average and that they may be missing out on deals that would result in significant savings.

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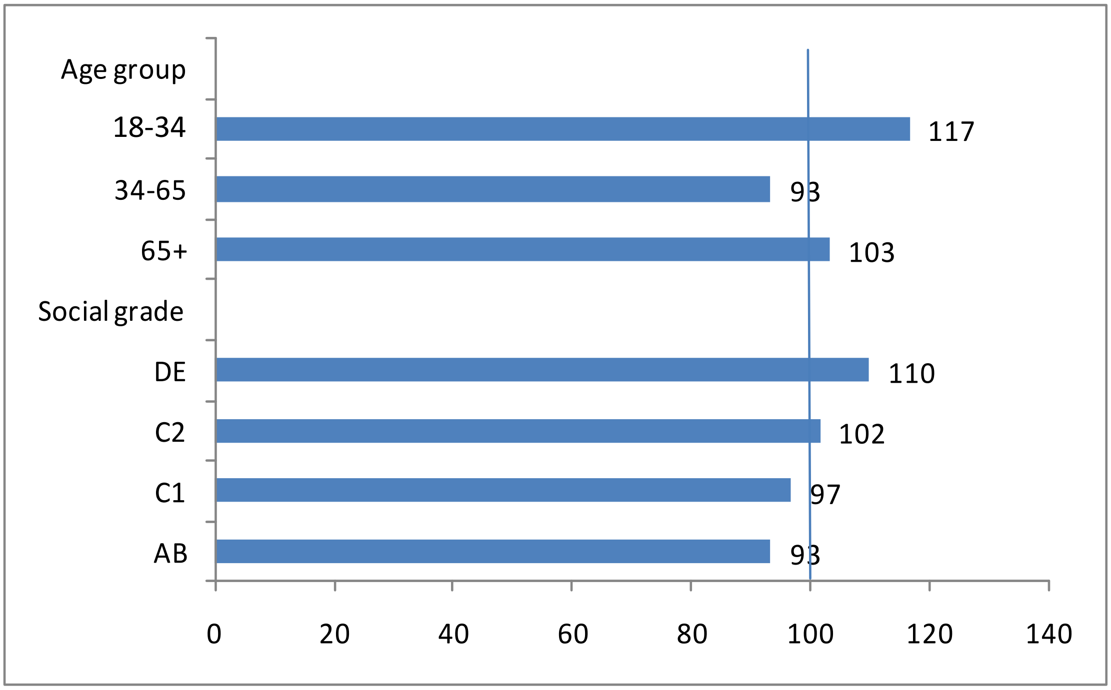
[43] Analysis carried out as part of the Review has shown that annualised churn rates of electricity-only customers taking online tariffs is over double that of customers taking offline tariffs. It is five times greater for gas-only customers taking online tariffs compared with those on offline deals.

2.68. Figure 2.9 shows the profile of electricity and gas consumers across a range of subgroups, who in 2010 claim they have never switched supplier. For each subgroup, Figure 2.9 reports the proportion for those consumers that claim they have never switched supplier, compared to all consumers who claim they have never switched (set at 100 in the figure).

**Figure 2.9 Proportion of consumers who claim they have never switched energy supplier, of those who have mains electricity/gas mains**




*Source:* Ipsos MORI (2011) Customer Engagement with the Energy Market – Tracking Survey, January

2.69. The figure shows that the proportion of those consumers who claim they have never switched is 10 per cent higher amongst consumers in social grades DE[44] than the average (which has been indexed at 100). It is lowest for those within social grades AB. Figure 2.9 also shows that the proportion of consumers who claim they have never switched is also higher for young (18 to 34 year olds) and for older (above 65) consumers than average. The profile is broadly similar for gas consumers who claim they have never switched.

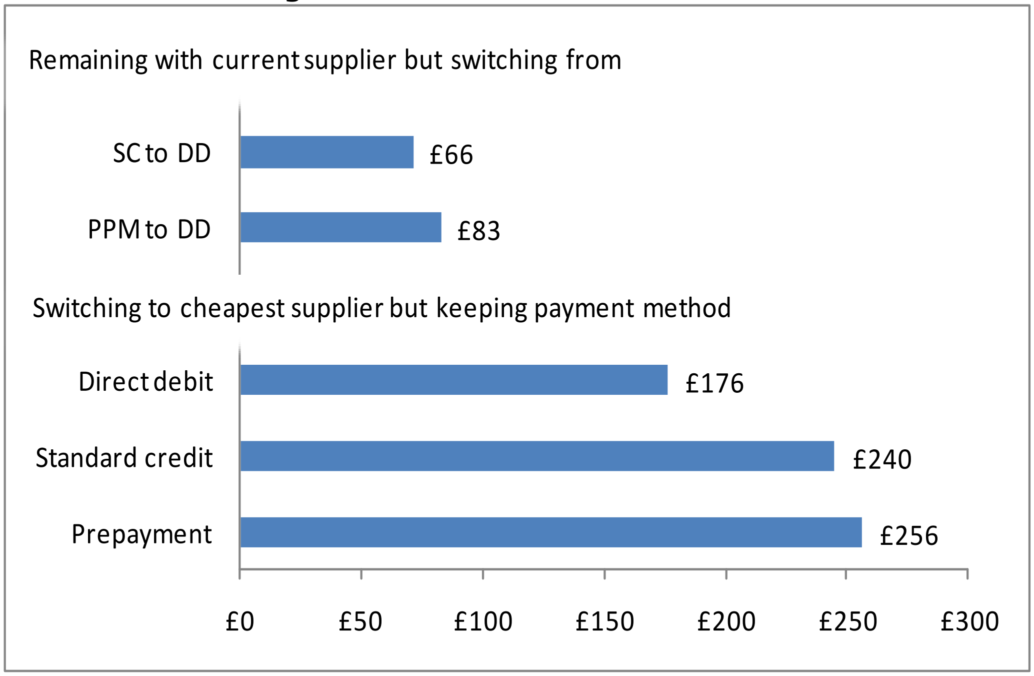
2.70. Our analysis on lost savings, figure 2.10 illustrates the extent to which consumers could save on their energy bills if they were to switch. It sets out the average savings on standard dual fuel bills that consumers of the Big 6 would have made over the course of 2010, if:

[44] DE refers to the social grade that contains both persons who are semi-skilled and unskilled, manual workers (D) and state pensioners, casual and lowest grade workers, unemployed with state benefits only (E). Source: National Readership Survey

(a) at the start of the year, they had remained with their current supplier but had switched payment method, or

(b) they had kept the payment method but had switched supplier to the lowest standard tariff available.

**Figure 2.10 Average savings in 2010 energy bill of standard dual fuel customers of the Big 6**




Note: In the chart SC refers to standard credit, DD refers to direct debit and PPM refers to Prepayment meter tariffs
Source: Ofgem analysis of data from The EnergyShop.com

2.71. Figure 2.10 shows the extent of the savings that are available from switching away from standard credit and from prepayment meters to direct debit: £71 and £83 respectively. As shown in the figure, greater savings can be achieved from switching supplier. These start at £176 a year, for a consumer who stays on an offline direct debit tariff, to as much as £256 for a consumer who stays on an offline prepayment meter tariff[45].

2.72. The finding that there are more consumers who claim they have never switched in lower social grades and certain age groups concerns us when combined with the information above on the savings consumers are missing out on from not switching.

[45] In these calculations we have not taken account of the possible costs of installing or removing prepayment metres, or of other costs involved in the change of payment method.

## Vertical integration and low liquidity

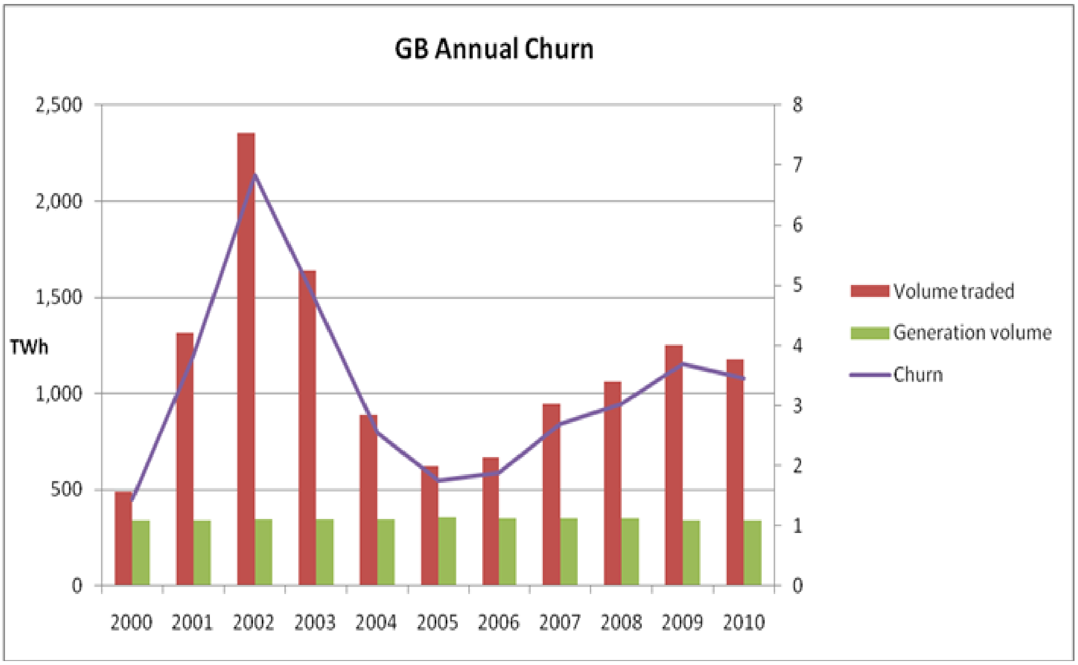
2.73. Vertical integration by incumbent suppliers may be another market feature that increases entry barriers and reduces competition. Vertical integration may confer competitive advantages related to improved risk management and lower collateral requirements. For example, vertically integrated suppliers may be more able to manage medium term volatility in generation and retail margins. Flexible generation also provides a hedge against near term price and demand volatility.

2.74. While it should be possible for non-vertically integrated suppliers to realise these benefits through contractual means, this would require sufficient market depth in a full range of wholesale products. However, our liquidity project has shown that products are often not available of the right size, shape and for the right time period – especially for products further into the future.

2.75. We have previously stated that we would like to see industry deliver liquidity improvements itself, on the basis that greater liquidity should be of benefit to industry. The development of the N2EX exchange is an example of a voluntary industry initiative. However, we have witnessed volatile and only limited increases in traded volumes since it commenced operation early in 2010.

2.76. Further, figure 2.11 shows that churn – a high level measure of overall trading in the power market – is on a downward trajectory. These are not our only measures of liquidity (we explore trends further in Appendix 7). However, overall our latest evidence indicates that the wholesale market is failing to develop greater liquidity on its own. Subject to the results of a further assessment, we therefore remain concerned that there is inadequate liquidity in the GB power market, particularly to meet the needs of independent market participants.

**Figure 2.11: GB traded electricity volume, generation output and churn ratios**




Source: APX, DUKES, ICE, N2EX, E.ON, Ofgem calculations.

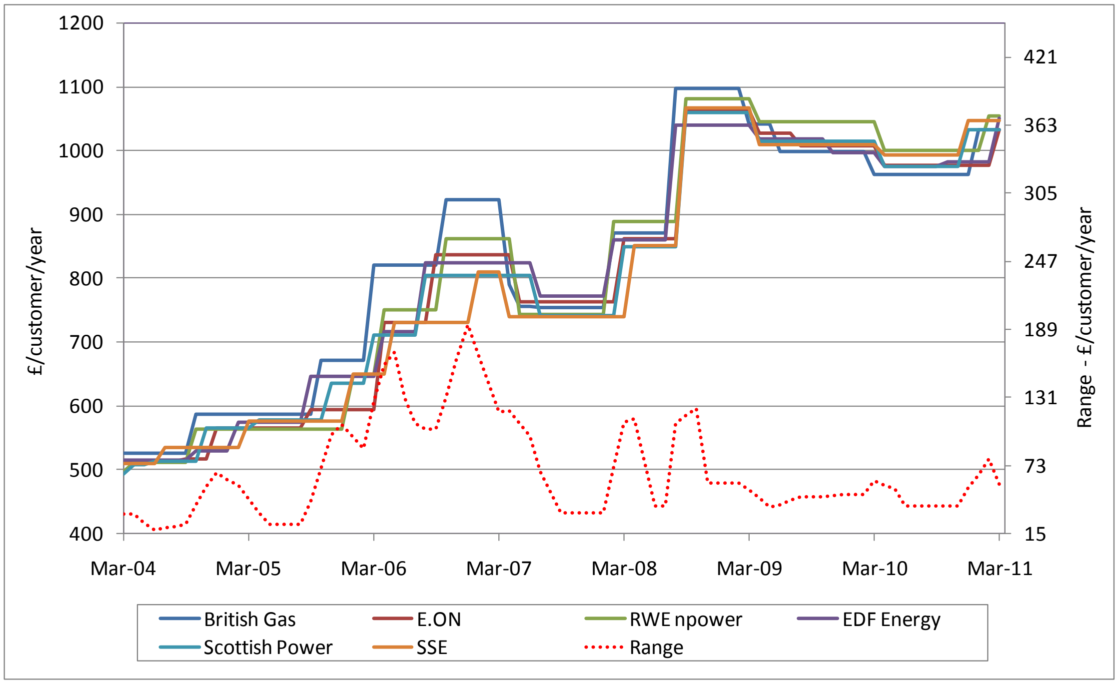
2.77. These factors may mean that to compete against incumbent, vertically integrated suppliers, a new entrant may have to enter both upstream and downstream markets simultaneously. This raises barriers to entry in the energy retail market significantly.

2.78. The observations that there has only been a single instance of entry in the electricity supply market since the Probe, and that the Big 6 still hold over 99 per cent of domestic customer accounts increase our concerns that there are impediments to small suppliers or other new entrants making inroads into the market, and that low liquidity could be one such impediment.

## Similar pricing and hedging strategies

2.79. We have continued to monitor suppliers' pricing behaviour since the Probe. Figure 2.12 presents the average dual fuel, direct debit price, across regions, of each of the Big 6 suppliers over the period 2004 – 2011. The figure shows how closely suppliers continue to follow each other's prices. The red line on the diagram presents the 3-month rolling average of the range of prices. It shows that at the end of 2006, the price of an average, annual dual fuel bill offered by the Big 6, varied by nearly £200 (using typical consumption figures). In the period to early 2009, the difference fell to less than £40 and remained there for the majority of 2009 and 2010. Following the price rise in March by the last Big 6 supplier to raise prices in Winter 2010/11, the range between suppliers' prices has now fallen to £22.

**Figure 2.12: Dual fuel, direct debit annual bills by supplier, March 2004 – March 2011**




Note: The range is based on a three month rolling average
Source: Ofgem analysis on data from TheEnergyShop.com

2.80. Price convergence to this degree is a sign that suppliers are reacting very strongly to decisions made by their competitors. The Probe examined in detail the basis for these price movements and the factors that suppliers take into account in their individual pricing decisions. These included: the overall business context in which companies decide retail prices, the importance that suppliers attach to customer reaction in their retail pricing decisions, and the constraint imposed on a supplier's pricing behaviour by competitor considerations.

2.81. Suppliers pricing strategies are also driven by the need to retain customers. Our review of the business plans of the Big 6 suppliers highlighted the importance to them of maintaining customer numbers, both to ensure future profits from energy supply and to maintain the hedge for the generation business. As a result, pricing decisions by suppliers are considered closely in the context of independent decisions by their competitors. This is to because it is a suppliers' price relative to their competitors that will trigger customers' to switch away.

2.82. In particular, decisions on the timing and the size of any price adjustments are typically determined in relation to the perceived market leaders in each region. Several firms' business plans stated that they wait until competitors have announced their price changes, not just to avoid the adverse publicity of going first with a price rise, but to assess the extent of their own price adjustment.

2.83. We also have concerns that the Big 6 have somewhat similar underlying cost structures, driven off a high level of similarity in hedged-positions and also generation portfolios[46]. This strategy allows the companies to protect themselves from having to price too far out of line with their competitors. However, it also means the underlying price drivers of the Big 6 are likely to be very similar. This may have played a large part in narrowing the range of prices offered by the Big 6 suppliers and may not be to consumers' advantage.

2.84. However, we are also concerned that the vertically-integrated nature of the Big 6 supply companies may affect suppliers' decisions on their customer bases. During the Probe we obtained expectations for customer numbers from all the Big 6 supply companies. Although there were exceptions, most suppliers said their aim was to sustain customer numbers at close to their current levels, at the time, primarily to maintain balance between their upstream and downstream positions[47]. This may suggest that some of the Big 6 suppliers are not interested in vigorously competing for many more customers than their own upstream generation arms can supply. This would lead to customer acquisition strategies that are focused on replacing lost customers as opposed to significantly growing market share.

2.85. Many features of the energy retail markets represent a high risk of coordinated effects. Table 2.2 below summarises the characteristics of the market that may facilitate coordinated effects. These are listed by the Competition Commission as those features the Commission will seek to assess in the circumstances of a Market Investigation. We present in the table our assessment of the applicability of each market feature to the energy retail markets. This shows that many features of the energy retail markets may facilitate coordinated effects.

[46] There are variations in generation portfolios, for example, we note that EDF and Centrica (the parent company of British Gas) have a somewhat different upstream generation portfolio to the other four Big 6 suppliers. This is largely due to the purchase of British Energy, the incumbent nuclear generator, by EDF in 2008. British Gas subsequently purchased a 20% stake in the company.

[47] Ofgem (2008) 'Energy Supply Probe - Initial Findings Report', 6 October 2009, para. 7.13

**Table 2.2 Risk of coordinated effects**

| Relevant factor | Applicability to energy retail |
|---|---|
| A high level of concentration in the market | High |
| The existence and significance of entry barriers | Relatively high |
| Evidence of a long-term commitment to the market by firms | Relatively high |
| A high degree of homogeneity of the firms' products | High |
| A high degree of homogeneity of firms | Relatively high |
| A high degree of market transparency | Relatively high |
| The existence of institutions and practices that may aid coordination | Relatively high |
| The existence of switching costs | Relatively high |
| Excess capacity in the market | Relatively high |
| Stabile demand and costs | Relatively high |
| Stabile market shares over time | Relatively high |
| Lack of short-term financial pressures on firms | Relatively high |
| Few maverick firms | Relatively high |

Note: The line on maverick firms refers to the common assertion that coordination is easiest to sustain among equals. When a market contains a maverick firm, it may be more difficult to establish and sustain coordination. This is because the price and/or market shares that would be necessary for the maverick firm to collude may be very different from other firms in the industry.
Source: Competition Commission (2003) Market Investigation References: Competition Commission Guidelines, June and Ofgem analysis

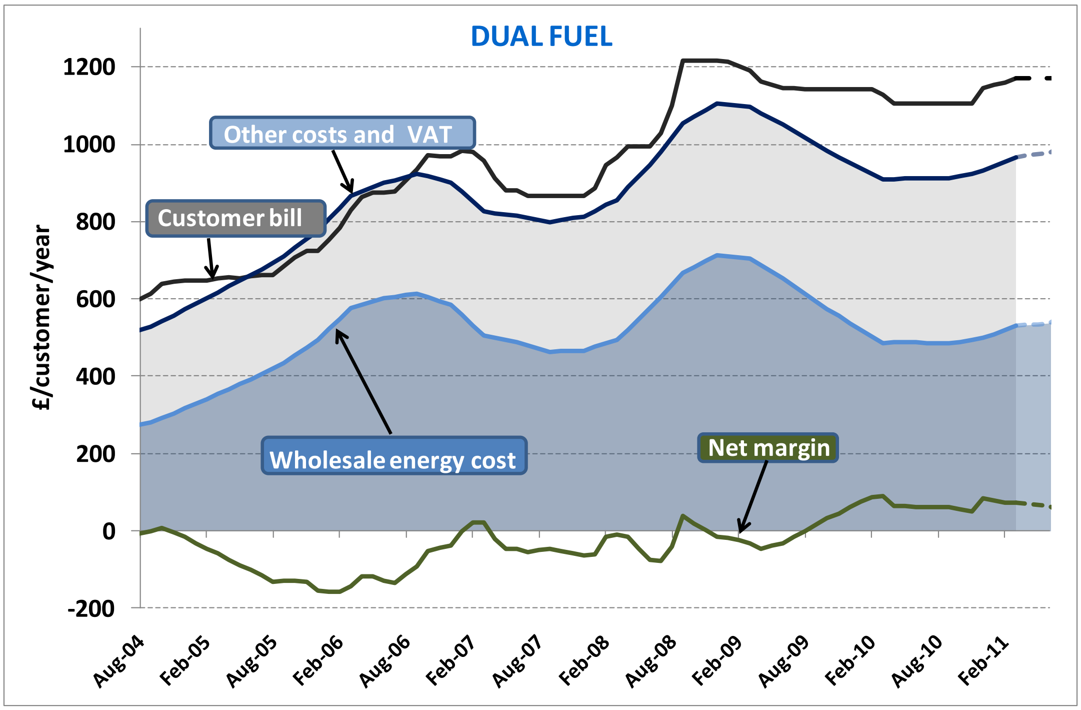
## Impact of weak competitive intensity

2.86. The range of market features discussed in the previous three sections is most likely to cause harm to consumers through reduced competition. Since the Probe we have noted a number of indicators that might suggest the level of competition in the energy retail market has weakened. In addition to the evidence on high tariff complexity and poor supplier conduct, we have also observed increases in gas and dual fuel margins in recent years and changes in suppliers' retail price response to wholesale price movements.

2.87. Since the Probe, Ofgem has been monitoring suppliers' gas, electricity and dual fuel margins through its Electricity and Gas Supply Market Report. In December 2010, following price increases by three of the Big 6 suppliers, the report indicated our estimate of supply margins on a typical dual fuel domestic customer had risen to £90, just below the historic highs seen in early 2010.

2.88. As part of the Review we have received updated information from the Big 6 on their costs of supply. We have used this information to update our analysis on our estimate of supply margins for a typical dual fuel customer (see figure 2.13). This has lowered the estimated margin published in our December report to £85. However, since December, the remaining three Big 6 suppliers have raised their electricity and gas prices. The estimated margin on a typical dual fuel customer is now £75. We recognise that suppliers may use different hedging strategies and their operating costs may vary, so actual margins for individual suppliers will differ from our indicator.

**Figure 2.13 Typical dual fuel customer bill, costs and net margin**




Source: Ofgem (2011) Electricity and Gas Supply Market Report, March

2.89. We also now have evidence that suggests suppliers' retail prices have tended to rise in response to increases in wholesale costs more quickly than they have fallen, when wholesales costs decline. We have used two approaches to analyse this. First, we carried out a simple comparison of what happened to bills, depending on whether wholesale costs were rising or falling. Secondly, we constructed an econometric model. These tests found evidence that energy bills follow an asymmetric trajectory. The findings are sensitive to both the technique used as well as the assumption we make on how suppliers purchase their energy in advance[48]. While there are a range of explanations for this observed pattern, it does raise further concerns about the level of competitive intensity in the industry. We are keen to get feedback on these findings and further details are provided in the Ofgem Discussion Paper: Do energy bills respond faster to rising costs than falling costs?, March 2011, published alongside this document.

[48] Suppliers typically purchase energy in advance to hedge against volatile wholesale energy costs. The econometric analysis assumes an 18 month hedging strategy.

2.90. In addition to these two concerns regarding the level of competitive intensity among suppliers, we highlight that many consumers believe there to be inadequate evidence of innovation by suppliers from which they are benefitting. This may suggest that many suppliers are not finding ways to improve the consumer experience in the energy market. We continue to regard an effectively competitive market as one in which competition is working in the interests of consumers. Innovation by suppliers is a key part of this.

2.91. We summarise the key findings discussed in this chapter and how they have developed since the Probe in the table on the following page.

| | Retail Market Review: summary of key findings | Probe Development |
|---|---|---|
| Market Structure | • One new entrant and a small rise in the market share of small suppliers | Slightly Improved |
| | • High regional market shares of incumbent electricity suppliers and British Gas nationally | No Change |
| | • Independent and small market participants find the wholesale market does not meet their needs to compete effectively | No Change |
| Supplier Behaviour | • Evidence of the removal of large unjustified price differences between some payment types | Improved |
| | • Some suppliers have shown improvements in their communications with their customers, but shortfalls remain | Slightly Improved |
| | • No evidence of a cartel among the Big 6 energy suppliers | No Change |
| | • A lower price premium for incumbent customers but evidence suggests that the Big 6 are benefiting from sticky customers | No Change |
| | • Evidence that competition continues to be targeted at online market; large discounts to offline standard tariffs are available | No Change |
| | • Complex pricing structures are contributing to lower consumer engagement | Deteriorated |
| | • An increase in the number of tariffs available may also be contributing to lower consumer engagement | Deteriorated |
| | • Evidence that energy prices have tended to rise in response to wholesale cost increases more quickly than they fall with decreases | Deteriorated |
| Consumer Engagement | • A significant proportion of consumers are disengaged from the energy market | No Change |
| | • Quality of switching remains a concern with a large proportion of consumers not sure if they have saved money from their switch | No Change |
| | • An increase in the number of passive consumers and fall in the number of active consumers | Deteriorated |
| Non -domestic | • Some improvement in the clarity of information for micro business customers, however many suppliers are still falling short in this area | Slightly Improved |
| | • Concerns that business customers not being dealt with in the spirit of the Standards of Conduct, particularly when switching and using third party intermediaries | Deteriorated |

# 3. Initial proposals

**Chapter Summary**

Building on the findings of the Review and the evidence of persistent consumer harm in the GB energy retail markets, we present our initial proposals for intervention.

3.1. The Review has shown that whilst there have been some improvements resulting from the Probe, many of the issues identified have not materially improved and some new concerns have emerged.

3.2. Ofgem's principal objective is to protect the interests of existing and future energy consumers. Wherever appropriate, Ofgem exercises its functions in a manner which it considers would further the principal objective by promoting effective competition. However, before exercising its functions in this manner, Ofgem must consider whether the interests of consumers would be better protected by exercising its functions in any other manner. In performing its duties, Ofgem must also have regard to the interests of vulnerable individuals[49].

3.3. Our analysis indicates that continuing to promote effective competition is appropriate as the main way to protect the interests of energy consumers, such that existing companies and potential new entrants should compete to win the business of customers who are making choices based on accurate information. However, at this stage, we have not ruled out using other means to protect the interests of energy consumers, including those of vulnerable individuals.

3.4. We regard consumer activity as a key driver of competition among suppliers and to stimulate new entry. The greater the number of engaged consumers, the greater the competitive pressure on suppliers to make efforts to retain them. We have found a number of market features that lower consumer engagement, the most significant being complex tariff information and the prevalence of sticky customers.

3.5. We also recognise that competition among suppliers would be enhanced if barriers to market entry and expansion in the energy retail market were lower. The threat of new entry, or new entry itself, keeps pressure on incumbents to meet the needs of consumers.

3.6. We have learnt from our experience following the Probe and, in particular, how the industry has reacted to our Probe remedies. These remedies were aimed at improving consumer engagement, through improving the information available to

[49] The Authority must have regard to the interests of: individuals who are disabled or chronically sick; individuals of pensionable age; individuals with low incomes, and individuals residing in rural areas.

consumers about their tariff, usage and ability to switch and reducing the ability for suppliers to mislead. We are generally disappointed with the reaction of suppliers to these measures.

3.7. We have already launched a number of investigations to examine whether suppliers are complying with our Probe remedies. In particular, we are currently investigating four of the supply companies (EDF Energy, RWE npower, ScottishPower and Scottish and Southern Energy) in relation to concerns over mis selling. We are also pursuing investigations with three companies (British Gas, EDF Energy and RWE npower) in relation to their customer complaint handling procedures[50].

3.8. We intend to continue with these investigations. However, given our concerns over how the companies have responded to the Probe remedies and our other findings from the Review we do not consider that merely enforcing their existing obligations will be sufficient to address the consumer harm identified.

3.9. We believe there are important ways in which competition needs to be enhanced in the energy retail markets in order to protect the interests of consumers. In this chapter we present our initial proposals for intervention. In each case, we discuss the justification for action, what we would expect our intervention to achieve and present an example of how we consider the proposal should work. We follow this with a discussion on how our proposals tackle the causes of consumer harm identified in this Review. We conclude with a discussion of the future actions available to Ofgem if our intentions or the outcome of our actions were to fall below our aspirations.

## Our initial proposals

3.10. Our initial proposals indicate the types of intervention that we believe are necessary to make the energy retail market work more effectively in the interests of consumers.

3.11. The proposals are high-level and preliminary. They will be subject to further rounds of consultation in which details of the proposals will be discussed and evaluated. They are presented in this document to help stakeholders understand Ofgem's current thinking on the necessary interventions going forward. At this stage, we believe Ofgem should pursue all five of the proposals set out below.

3.12. We are seeking views on these proposals by 1 June 2011. We will closely review all responses to this consultation and look to reflect any concerns and suggestions from stakeholders in subsequent consultation documents.

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[50] For the avoidance of doubt, the fact that Ofgem has launched an investigation should not in any way be taken as implying that there has been a breach of a licence condition.

**Proposal 1: Make it far easier for domestic consumers to compare prices and choose a better deal**

3.13. The findings from the Review that contribute most to low consumer engagement are that a large number of customers remain persistently disengaged and that the high complexity of energy tariffs is deterring many consumers from active participation in the competitive market. Furthermore, the prevalence of standard evergreen products mean that many consumers are on tariffs without any obvious decision points (such as the end of a contract) to prompt a decision on whether or not to switch supplier.

3.14. As a result of these findings, we are proposing to introduce measures to reduce the complexity of tariff offerings, improving their comparability and decrease the number of standard evergreen products available. We note that the consumer protection provisions of the Third Package include requirements for consumers to receive transparent information about energy prices[51] and are supplied with electricity at clearly comparable prices[52], we therefore consider that further action would be consistent with our EU duties to ensure that there are effective consumer protection measures for energy consumers[53].

3.15. We intend to address confusion in the domestic market by a proposal to restrict the number of tariffs for standard evergreen products from each supplier to only one per payment method. We also propose to standardise the format of these tariffs across suppliers, with suppliers allowed to compete on a single "per unit" price. Consumers would then be able to tell at a glance whether they can save money either by switching supplier or by moving to a new deal. This would be a major reform impacting the 75%[54] of customers currently on standard evergreen products.

3.16. Suppliers would still be free to offer an unrestricted number of fixed-term products in order for suppliers to continue to innovate and give their customers genuine choice. However, we would seek to ensure that customers only buy into these products with full knowledge and assent to their terms and conditions. Contract terms that allow adverse unilateral variations and automatic rollovers to a new fixed term product at the end of the period would not be permitted. This means that customers would default back to the suppliers' standard evergreen product, unless they make a positive choice for a further fixed term product.

3.17. We propose to require suppliers to quote prices for all fixed-term products on an "evergreen equivalent" basis that is readily comparable to the unit price for their

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[51] See paragraph 1(c) of annex 1 to Directive 2009/72/EC (electricity) and Directive 2009/73/EC (gas)

[52] See article 3(3) of Directive 2009/72/EC (electricity)

[53] See article 37(1)(n) of Directive 2009/72/EC (electricity) and article 41(1)(o) of Directive 2009/73/EC (gas)

[54] DECC (2010) Energy Trends, p. 48 and 49. This figure is the simple average of the percentage of GB gas and electricity customers on standard tariffs.

standard evergreen products[55]. We would also require regular disclosure of suppliers' weighted average fixed term product price on the same basis, so that any differential between standard evergreen and fixed term product prices is transparent to both consumers and Ofgem.

3.18. We set out some high level features of our initial proposal on improving tariff comparability in the box below.

**Our initial proposal:**

**For evergreen contracts:**
- All suppliers limited to one evergreen product per payment method.
- Compulsory standardised element set annually by Ofgem and identified separately on consumers' bills.
- Standardised element designed to cover pass through costs, such as T&D charges and some environmental and social charges.
- All consumers in each region to have the same standardised element.
- All other revenue recovered through a single unit charge, set on a p/kWh format.

**For all other contracts**
- No limitation on number or type, but must all be fixed term, with clear end date and clear switching windows. Exit penalties allowed.
- Price information presented in an "evergreen equivalent" format for comparison purposes with evergreen contracts. One approach to do this would be by subtracting from the annual estimated bill of the fixed term contract, the annual cost of the relevant standardised element for a consumer in a particular region. This residual could then be presented on a p/kWh format to compare with the 'price' of suppliers' evergreen contracts.
- All penalties and contract terms must be clear.
- No auto-rollovers: customers would default to evergreen contract terms if no positive assent given.
- No terms that allow adverse unilateral variations.
- Customer to receive statement ahead of switching date with rollover offer (to another fixed contract) and all switching prompts. Adequate switching window provided without penalty.
- Regular disclosure of suppliers' weighted average fixed term product price on an "evergreen equivalent" basis to aid transparency between suppliers' fixed term and standard evergreen product prices.

3.19. We continue to recognise the importance of bills and Annual Statements as a highly effective and regular means of communicating information to customers. We are therefore considering how best to use bills and Annual Statements for this purpose. For example, we will consider whether price metric details of a range of a suppliers' alternative tariffs, should be included in the information on bills as a reminder to customers that there may be better tariffs available.

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[55] We are proposing that this metric be on p/kWh basis of the net annual bill of the fixed term product, at average consumption levels, minus standardised charges. We are consulting on the contents of the standardised charge, see question 6.

3.20. We are confident, based on evidence from consumer research, that reforms along the lines of those proposed here would be likely to have a material positive effect on both the level and effectiveness of household engagement in the energy market. However, we remain concerned that, despite these proposed reforms, there may be many consumers, including vulnerable consumers, who still do not engage in the competitive market and may remain at risk from higher prices.

3.21. Therefore, an important part of our thinking going forward will be to investigate what more can be done to increase engagement by, or protect, suppliers' most vulnerable customer groups. We are particularly concerned about those that have either been persistently disengaged, or find engagement in the current market difficult - particularly if these customers fall into vulnerable groups. This is an area that may warrant consideration of additional consumer protection powers or Government intervention.

3.22. Following this consultation and taking account of the responses that we receive, we will consult separately on a range of options to reduce tariff complexity and increase comparability. We set out our consultation questions in the box below:

**Question 2:** Do stakeholders consider that Ofgem should take action to reduce the complexity consumers face and enhance engagement with the energy market?

**Question 3:** Do stakeholders agree with our initial proposal for intervention to reduce the complexity consumers face and enhance engagement in the energy market?

**Question 4:** If not, then do stakeholders have alternative suggestions for proposals to reduce the complexity consumers face and enhance engagement in the energy market?

**Question 5:** We are proposing to standardise evergreen contracts across suppliers. Do stakeholders agree with the proposed contents of the standardised charge?

**Question 6:** We are proposing to create a standardised metric to allow consumers to compare evergreen and fixed term contracts across suppliers. Do stakeholders agree with our proposal for a standardised metric?

**Question 7:** Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to reduce the complexity consumer face and enhance engagement in the energy market?

**Proposal 2: Improve access to wholesale market products for new entrants and independent suppliers and generators**

3.23. We continue to observe little market entry and exit. At the same time, we continue to observe that liquidity in the wholesale electricity market is failing to develop to meet the needs of independent market participants. While we recognise that liquidity is only one factor in an organisation's decision to enter or exit the market, we consider that it is very important.

3.24. We are committed to improving liquidity in the GB wholesale electricity market. It is also important that independent and small market participants have access to the products they need to manage their risk effectively. As outlined in Appendix 7, we believe voluntary market developments have been insufficient to date. We have also continued to develop the options for intervention that we put forward in February 2010[56].

3.25. We consider that strong intervention by Ofgem is needed to provide the electricity market liquidity that market participants, in particular independent and small market participants, require to compete against existing players and to encourage competition between vertically integrated players. This would improve competition and contestability in the energy retail markets to the benefit of consumers. It is also in line with Government's thinking as outlined in their Electricity Market Reform.

3.26. Subject to consultation and the outcome of our assessment of the wholesale power market (referenced in our open letter on liquidity published in December 2010[57]) we propose to intervene with two distinct, complementary initiatives.

3.27. First, we propose a new licence condition that would require the Big 6 to make available between 10% and 20% of their power generation into the market through a regular Mandatory Auction (MA). This should help to drive reference prices and support the ability of independent market participants - including potential supply market entrants - to access the bulk of the wholesale products they need.

3.28. Second, we propose a new licence condition to require the establishment of Mandatory Market Making (MMM) arrangements, to ensure that market participants are able to trade continuously and mitigate imbalance risks. We expect that MMM would particularly benefit participants who have difficulties accessing the market at present.

3.29. These proposals should be seen against a broader and evolving context, notably with the UK being part of an integrated European energy market. An integrated wholesale electricity market is being affected by 'market coupling'[58]. In April 2011, market coupling for GB commences over the BritNed cable which links GB

[56] Liquidity Proposals for the GB Wholesale Power Market, 22 February 2010, Ref. 22/10, http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=95&refer=MARKETS/WHLMKTS/COMPANDEFF

[57] http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=163&refer=Markets/WhlMkts/CompandEff

[58] Whereby at the day-ahead stage, interconnector operators make available unused (or a particular proportion of) capacity to power exchanges, who determine cross-border electricity flows based on trades at the exchanges.

and the Netherlands. This is the first step towards wider coupling[59] and in time, should have an important positive effect on liquidity day-ahead as market participants are required to use exchanges for cross-border trades. However, it has been estimated that initially 10GWh[60] of day-ahead trading will take place on BritNed each day and thus, given the limited scale of BritNed, the specific nature of our concerns (eg product availability and forward trading) and the timescale for large scale coupling, we believe that our additional measures remain necessary.

3.30. These proposals are aligned with the requirements for greater transparency of trading which could result from other European legislative changes[61]. Clearly, as these market and regulatory changes continue to develop, we will monitor the problem to make sure that our proposals are required and consistent with the developments.

3.31. Our approach has been to secure an industry solution to the problem of liquidity. Whilst some initiatives have been taken forward, we do not consider they are likely to prove sufficient to address the concerns identified. We are now setting a deadline of 1 June 2011 before which we hope industry will engage with us and develop our proposed interventions or to propose alternative arrangements satisfactorily to address our liquidity and contestability concerns. During this time we will complete the planned assessment of industry initiatives in line with our previously proposed criteria[62]. We will also use this time to discuss our proposals with the European Commission. We recognise developments in the European single market and we will ensure these are carefully considered as we develop our own proposals.

3.32. We are giving industry until 1 June 2011 to engage with us and develop our proposed interventions or to propose alternative arrangements to address our liquidity and contestability concerns. During this time we will conduct a further market assessment in line with our previously proposed criteria[63]. We set out our consultation questions in the box below:

**Question 8:** Do stakeholders consider that low electricity market liquidity constitutes a barrier to entry in the domestic retail supply market?

**Question 9:** Do stakeholders consider that our two proposed interventions (the MA and the MMM) could improve the ability of the wholesale electricity market to meet

[59] By 2020, around 6-8GW of interconnection could be realised between GB, Ireland and the rest of Europe. A proportion of all planned and new interconnector capacity will be reserved for market coupling.
[60] By APX-ENDEX, the providers of the market coupling solution for the BritNed cable
[61] Relevant initiatives could include: Review of the Markets in Financial Instruments Directive (MiFID); Energy Markets Integrity Regulation (REMIT) and Transparency of European Markets Integrity Regulation (EMIR).
[62] GB wholesale electricity market liquidity: Summer 2010 assessment, 29/07/2010, Ref 95/10 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=130&refer=Markets/WhlMkts/CompandEff
[63] Ibid.

independent participants' needs, and will ultimately improve the likelihood of retail supply market entry?

**Question 10:** Subject to the results of our further wholesale market assessment, do stakeholders consider that both interventions could be necessary to meet the objectives stated in questions 8 and 9?

**Question 11:** Do stakeholders consider that there are other intervention options we should be developing?

**Question 12:** On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:

- Volume requirements
- Product requirements
- Frequency
- Governance arrangements
- Participation
- Platform

**Question 13:** Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to take action to improve wholesale electricity market liquidity?

**Proposal 3: Make sure the Probe remedies are strengthened, and where necessary enforced, so that they achieve their original objectives**

3.33. While we recognise the Probe has led to benefits for consumers, significant shortcomings remain. During 2010, Ofgem has had reason to suspect that a number of suppliers may not have been operating in a manner that is in full compliance with Probe licence conditions. In a number of cases, these suspicions have been escalated to both formal and informal investigations to establish compliance. Our current mis selling investigations are such examples. In addition, we have been presented with evidence that a number of suppliers could be doing more to apply the Probe licence conditions and the Standards of Conduct in ways that would enhance the experience for their customers.

3.34. We are disappointed by these events and findings as they suggest that in a number of important ways suppliers are not acting in their customers' interests. Suppliers have had over two years since the Probe Initial Findings Report, in which we highlighted the features of the market that we thought were restricting the effectiveness of competition, to make changes to their behaviour.

3.35. As a result, we consider that there is scope for strengthening a number of the licence conditions (including those put in place or amended as part of the Probe) to give suppliers less freedom in how they interpret these obligations. This is necessary in order to ensure suppliers abide with both the spirit and intention of the measures as well as complying with the letter of the licence conditions.

3.36. An example of one of the measures we are considering is to increase the prescription on suppliers' communications with their customers through bills and Annual Statements.

**An example of concerns with supplier communications**

One of the requirements we introduced following the Probe is that Annual Statements must contain: "a reminder in a prominent position that the Domestic Customer may change their Electricity Supplier"[64]. This element on Annual Statements was intended to prompt the customer's consideration as to whether or not they would consider switching.

SSE's interpretation of this requirement has been to include the following phrase at the end of their Annual Statements: "It's easy to change supplier, so why don't you recommend us to a friend so they can benefit from our great service"[65]. Without prejudice to any further examination of suppliers' compliance, we do not consider that text of this nature is in line with the spirit of the requirements.

3.37. We also have concerns over whether one supplier is complying with standard licence condition 27.2A on cost reflectivity between payment methods[66]. ScottishPower's tariff differential between its dual fuel standard credit and direct debit offerings seems well above our understanding of the difference in the costs to serve these two types of customer. We are therefore announcing today that we have launched a formal investigation into ScottishPower's compliance with the relevant licence condition[67].

3.38. We also recognise that more can be done to improve the switching process itself and consumers' access to tariff information. This could come through enhanced obligations on suppliers either when dealing with switching sites or on their own marketing activities. We are also considering how switching site accreditations can best be used to ensure consumers have trust in the tools they use to search alternatives tariffs and suppliers and switch if desired.

3.39. Where we consider modifications to a licence condition are not necessary, we propose enhancing our monitoring. In these cases we propose to increase our efforts to provide a greater amount of transparency on suppliers' compliance with the licence condition. For example, this may include regularly naming and shaming of companies that we believe consistently perform below a satisfactory level of compliance and publishing more regular reports that place questionable behaviour by suppliers in the public spotlight.

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[64] SLC 31.A.4(e) of the gas and electricity supply licence
[65] Text taken from SSE Annual Statement as at 1 December 2010
[66] SLC 27.2A of the of the gas and electricity supply licence stipulates that any difference in terms and conditions between payment methods for paying charges for the supply of electricity or gas shall reflect the costs to the supplier of the different payment methods. The licence condition clarifies that price is included in the definition of "terms".
[67] For the avoidance of doubt, the fact that Ofgem has launched an investigation should not in any way be taken as implying that there has been a breach of a licence condition.

3.40. We also propose increasing our speed of reactions to concerns. In cases in which we suspect non-compliance, we intend to carry out swift assessments rapidly moving to appropriate enforcement activity where we find our suspicions are reinforced.

3.41. In addition, we would continue to monitor a wide range of indicators on the competitiveness of the energy retail markets. These would include, but would not be limited to, market concentrations, consumer switching rates and supplier profitability. In particular, we would continue to monitor the consumer experience through our Consumer First programme, including discussions with our panel and tracking survey on customer engagement. We propose publishing more regularly on the developments of these competitiveness indicators to provide stakeholders with greater transparency on the state of the energy retail markets.

**Possible actions under this option include:**

**New rules**

- Strengthen existing regulations to ensure consumers receive clear and transparent information - possibly requiring more standardised information on bills and Annual Statements
- Introduce one or more of the Standards of Conduct into new or existing licence conditions

**Ofgem actions**

- Directly provide consumers with information/advice regarding the switching process and how they can use available information to assess their options
- Take steps to improve consumer trust in switching sites
- Enhanced monitoring of supplier activities and, where appropriate, take enforcement action
- Publicly name and shame companies that persistently fail to adhere to the spirit of existing regulations and the Standards of Conduct

3.42. Following this consultation and taking account of responses that we receive, we will consult separately on elements of a package of proposals to enhance the Probe remedies and, where relevant, other licence conditions. We set out our consultation questions in the box below:

**Question 14:** Do stakeholders consider that Ofgem should strengthen licence conditions around suppliers’ communications and interactions with their customers, to give suppliers less freedom in how they interpret these obligations?

**Question 15:** Do stakeholders consider that Ofgem should increase its monitoring and enforcement activity to enhance suppliers’ compliance with licence conditions?

**Question 16:** Would stakeholders welcome the extension of some elements of the Standards of Conduct into domestic supply licence conditions?

**Question 17:** Do stakeholders agree that more needs to be done to improve consumer trust and use of switching sites?

**Question 18:** Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 3?

**Proposal 4: Take further action to prevent unfair contracting practices in the non-domestic sector**

3.43. Following the Probe, we introduced a range of remedies to address contracting practices that were adversely affecting micro business consumers. We are concerned that performance against these remedies has not been complete. As a result, and as in the domestic sector, we intend to take action to ensure compliance with existing licence conditions and to consider whether further licence amendments are needed.

3.44. There are a number of areas where we believe we can take actions to improve the market for non domestic customers. We are doing parallel work outside this Review into deemed contract rates in the non domestic market that also aims to improve the market.

3.45. Suppliers will need to comply more rigorously with the new supply licence condition on protections for micro business consumers (SLC 7A). On completing our review of compliance, we will contact non-domestic suppliers to point out specific areas that need improvement. We shall consider further action if suppliers do not take prompt steps to resolve any areas of concern. We are also considering extending the reach of the licence condition beyond micro businesses. We want more businesses to get clearer information about when their contracts are ending and what renewal options are open to them.

3.46. We are concerned about the possible use of the objections procedure to frustrate business customer switching. Our evidence shows that some suppliers have a high level of objections and/or a significant number of objections that are subsequently withdrawn. We intend to write to these suppliers to seek explanations for this. We will examine the reasons for objections and assess whether existing licence conditions have been breached. We shall also consider whether new licence conditions might be necessary.

3.47. We are also looking into how we can reduce the harm that business customers may face through the actions of some TPIs, who we do not currently regulate. As well as discussing this issue with the relevant bodies, we are considering new licence conditions that regulate the relationship that suppliers have with third parties. We especially want to address the two areas highlighted, namely to make sure customers are aware that they may be paying commission charges for third party services; and to better capture mis selling activity over the phone, such as having full recordings of all telephone conversations. We may need to ask for additional powers from Government to address these concerns fully.

3.48. More generally, discussions with customers and our research show that there are key issues that business customers need to be more aware of. So we will be launching a series of factsheets to empower business customers. We will work with non-domestic consumer representatives, Consumer Focus and suppliers to make sure the main messages are covered, and highlighted to businesses customers.

3.49. We are also considering whether we need to extend some elements of the Standards of Conduct into non-domestic supply licence conditions. However, we have not proposed to extend tariff simplification to the non-domestic sector, but invite views on whether there is a case for us to consider this. We set out our consultation questions in the box below:

**Question 19:** Do stakeholders consider that Ofgem should strengthen licence conditions to prevent unfair contracting practices in the non-domestic sector?

**Question 20:** In particular, would stakeholders welcome additional licence conditions surrounding the objections procedure?

**Question 21:** Would stakeholders welcome the extension of some elements of the Standards of Conduct into non-domestic supply licence conditions?

**Question 22:** Do stakeholders agree with our position, at this stage, not to extend our proposals on tariff simplification into the non-domestic sector?

**Question 23:** Do stakeholders agree that Ofgem needs to look further at the role of third party intermediaries (TPIs) in the non-domestic market?

**Question 24:** Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 4?

**Proposal 5: Improve further the transparency in vertically integrated utilities**

3.50. Our 2008 Probe required reporting of separate financial information for supply and generation. This has provided greater transparency for consumers and potential competitors. We publish an analysis of this data as part of this Review. We propose to seek incremental improvements to improve cross-company comparability for subsequent years but remain concerned that transparency is limited by company specific policies on transfer pricing and reporting of wholesale energy costs. For example, some of the companies excluded significant profit elements from their 2009 segmental results. As a result, we feel that consumers are not provided with sufficient clarity about how retail prices relate to suppliers' wholesale costs.

3.51. We propose to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated firms in the sector and report to us on the likely impact of these practices on reported profits and transparency. We will also ask them to make recommendations on how to improve reporting in future years, either through amendments to the segmental statements or through additional reports provided to Ofgem.

3.52. Any consideration of future reporting requirements would need to include whether we could build on EU Third Package provisions which require the companies to retain information about their wholesale transactions and to disclose this information to regulators and competition authorities on request[68]. We set out our consultation questions in the box below:

**Question 25:** Do stakeholders agree with Ofgem's proposal to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated suppliers?

**Question 26:** Do stakeholders have views on how Ofgem could improve segmental reporting in future years?

## How our initial proposals tackle consumer harm

3.53. We believe such reforms would bring real benefits to consumers. Our proposals would make it simple for domestic customers to compare suppliers' prices, while still allowing choice and flexibility for those customers that want them. Customers should find it easier to identify how to save money, whether by switching supplier or moving to a cheaper tariff. New suppliers with new products and ideas should find it less difficult to enter the market to compete with the incumbents. With more competition and empowered consumers holding suppliers to account we would expect more effective competition, which we would expect to bring benefits through keener prices, better customer service and greater innovation.

3.54. We believe the proposals are a proportionate and balanced response to the level of consumer harm we have observed in the energy retail markets. However, we recognise that interventions of this nature will have related costs associated with them and related risks of unintended consequences. We will carry out detailed impact assessments of these proposals as part of subsequent consultations.

3.55. Subject to the responses we receive to this consultation, at this stage we outline, at a high level, what we believe to be the benefits and potential risks and limitations of our initial proposals.

**Proposal 1**

3.56. Our initial proposals on tariff simplification are aimed at greatly increasing the simplicity and comparability of tariff information. We believe a set number of standard, evergreen products per supplier, will greatly improve comparability between suppliers' evergreen tariff offerings. This will make it clear which supplier is offering the best evergreen deals. Simpler tariff information is aimed at improving

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[68] We note that article 40 of Directive 2009/72/EC (electricity) requires supply undertakings to keep at regulators' disposal the relevant data relating to all transactions in electricity supply contracts and electricity derivatives with wholesale customers and transmission system operators.

consumers' understanding of energy tariffs, enhancing engagement through simpler comparisons between tariffs and reducing poor switching decisions.

3.57. We also note that by setting a limit on the number of standard evergreen products on offer, this will reduce suppliers' ability to segment the market between active and inactive customers on such products. We recognise that switching by active customers between evergreen products should keep prices competitive, thereby resulting in indirect benefits to those inactive customers on standard evergreen products who find it difficult to access the market.

3.58. Suppliers would still be free to offer an unrestricted number of fixed term contracts. This proposal puts no restriction on the range of tariffs that suppliers can offer, only that they should be fixed term. Suppliers will no longer be able to apply adverse unilateral contract variations to or roll-over their customers and consumers will be given a natural decision-point to switch supplier or tariff when their contract ends.

3.59. The quality of information made available to consumers is an important part of this proposal. This is why we would require all suppliers to make their fixed-term deals readily comparable to their standard evergreen products using a standardised "evergreen equivalent" price metric. This will ease comparisons between fixed-term and standard evergreen offers.

3.60. We recognise that there is a risk that prices between standard evergreen products and fixed-term equivalents may diverge, as suppliers use fixed term products to target their more active customers. We predict that this will be mitigated by strong switching activity by customers wanting evergreen contracts. Furthermore, comparability metrics between suppliers' evergreen and fixed term contracts should allow customers (and Ofgem) to very easily tell whether price divergence was taking place. Our proposal that suppliers will also have to regularly publish a weighted average price of all their fixed-term contracts is another way of further increasing transparency between the price of fixed term and standard evergreen deals.

3.61. These proposals will not come about without costs to industry. However, we are committed to improving the accessibility of information that consumers have on the costs of their energy consumption. We believe this will lead to important benefits for consumers. The easier it is for consumers to compare tariff offerings among suppliers, the more suppliers will have to work to retain their customers through more competitive pricing, improvements in service quality and greater innovation in both tariff offerings and measures to reduce costs. Our consumer research has suggested that consumers would welcome simpler tariffs, and/or ways of making tariffs more comparable.

**Proposal 2**

3.62. With regard to our liquidity proposals, we note electricity and gas auctions are a feature of markets in many countries and there are numerous examples of successful auctions in the largest EU countries. These auctions have typically been implemented by regulatory / competition authorities as pro-competitive measures in the electricity and gas markets.

3.63. We believe that a Mandatory Auction could play a strong role in delivering reliable reference prices to the market and help increase the depth and breadth of products available to meet the needs of smaller and independent market participants. Reliable reference prices have the significant benefit that they should facilitate the development of financial products which market participants can use to hedge their exposure to wholesale price volatility.

3.64. Although we believe that a Mandatory Auction could stand as a single solution on its own merits, we also recognise that smaller and independent market participants may desire a transparent and accessible platform that allows for continuous trading, and thereby provides a means of mitigating imbalance risks nearer gate closure. We are therefore consulting on Mandatory Market Maker (MMM) arrangements alongside a Mandatory Auction, in order to provide participants with continuously available products right up to gate closure.

*3.65.* Overall, we believe our liquidity proposals will have the potential to meet independent market participants' needs; support the development of reliable reference prices; facilitate greater competition among suppliers and increase the threat of new entry.

3.66. However, creating obligations on market participants to trade in a particular way may require a diversion from purely commercial trading decisions. It might therefore cause inefficiencies, and ultimately increase costs – which could be passed on to consumers.

3.67. The extent to which the benefit of greater competition will mitigate these costs will depend on how far the interventions are able to support new entrants' trading activities. As outlined above, we consider that by providing transparent and reliable access to key wholesale products, the MA and the MMM would be strongly beneficial in this respect. It is also important that access arrangements and the cost of trading are reasonable. For example, in our February 2010 document[69] we discussed the problem that smaller participants can face when they have to post significant collateral when trading on exchanges. We are seeking consultees' views on how any platform supporting the MA and MMM could minimise unnecessary trading cost and meet the needs of potential entrants.

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[69] Liquidity Proposals for the GB Wholesale Power Market, 22 February 2010, Ref. 22/10, http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=95&refer=MARKETS/WHLMKTS/COMPANDEFF

**Proposal 3**

3.68. On enhancing the Probe remedies (and, where relevant, other licence conditions), we believe stronger licence conditions would lead to a number of important improvements for consumers. Remedies that increase the prescription on suppliers' communications with their customers through bills and Annual Statements, would be aimed at improving consumers' access to important information about their tariff and consumption.

3.69. Further prescription would also reduce the ability for suppliers to interpret our Probe remedies in ways that may not be in the best interest of their customers. Any new obligations on suppliers in their dealings with switching sites would be aimed at making information for consumers more accessible. We hope these measures should improve consumers' ability to access and assess information on suppliers and tariffs, increasing their engagement with the market.

3.70. We also believe that enhancing our monitoring and enforcement activity will lead to benefits for all consumers. By putting suppliers' behaviour under the spotlight, we hope this will make it more difficult for suppliers to get away with questionable conduct and easier for consumers to know whether their supplier is performing well or otherwise. This should improve competition among suppliers, as they attempt to attract customers based on their reputations as well as their prices.

3.71. We recognise that these proposals are not without costs to industry as well as additional burdens on Ofgem. All our proposals will be subject to significant deliberation by Ofgem, as well as an examination of their costs and benefits as part of detailed impact assessments. We would look to only introduce such measures if we were confident that the benefits to consumers outweighed the additional costs to industry and Ofgem.

3.72. However, we also recognise that some of our proposed measures may lead to cost reductions on some of the activities of domestic suppliers. For example, if we decided that all Annual Statements should be based on a simple, pro forma design, we envisage this is likely to reduce some of the marketing and production costs suppliers currently expend. In such cases, any cost savings to their customers should ultimately lead to lower prices than they would otherwise be for consumers.

**Proposal 4**

3.73. We believe any extension of SLC 7A beyond micro business consumers to other small and medium-sized firms would be widely welcomed. Customer research has found that firms that were not protected under SLC7A were more dissatisfied with their understanding of contract terms and conditions than firms captured by the licence condition[70].

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[70] Forum of Private Business Utilities Report, December 2010

3.74. On objections we believe a closer analysis of the process is needed at this stage. The objections process was intended to allow valid issues with the process of changing supplier to be resolved without the need for parties to resort to legal action. However, we are concerned it may be putting some customers off engaging in the market and/or frustrating their ability to engage. We believe a solid objections process is a key part of a well functioning non-domestic market and an important aspect of building trust between suppliers and their customers.

3.75. We believe any efforts to improve the actions of TPIs in the non-domestic market will lead to a wide range of benefits. Good TPIs can help time-constrained business customers find the best deal for their business. They also support the competitive market by making customers aware of offers from less well known suppliers. A reduction in mis selling activities and an improvement in transparency requirements will also reduce the risk that non-domestic customers will make poor switching decisions or be misled about the actual costs of their TPI service.

3.76. As with proposal 3, we recognise that additional obligations for non-domestic suppliers will not come about without the possibility of additional regulatory burdens and costs to suppliers. However, as above we will look to examine the costs and benefits of all our proposals as part of detailed impact assessments. We would look to only introduce such measures if we were confident that the benefits to consumers outweighed the additional costs to industry and Ofgem.

**Proposal 5**

3.77. Our proposals to improve the segmental statements and to seek further clarity on how companies report their wholesale costs are aimed at further improving transparency and consumer trust in the market.

3.78. The segmental statements provided by the companies have improved transparency and do allow a degree of comparison between the companies. However, it is possible for them to be improved and for there to be an enhanced degree of cross-company comparability. The changes that we propose to the guidelines governing how the companies prepare their segmental statements will improve the usefulness of the information.

3.79. However, even with the new guidelines, how companies report their wholesale costs and how this impacts segmental profits will remain an area where there is limited information and clarity, and this is an area of consumer concern. Our proposal to investigate this more deeply and consider how we can improve reporting (both publicly and on a confidential basis to Ofgem) are aimed at underpinning and improving consumer trust in the energy market.

3.80. We recognise that the companies do have different business models and are free to employ accounting conventions which reflect the way that they operate. We also recognise that providing detailed public information about each company’s cost structure could be unhelpful in promoting competition if it leads to a higher risk of suppliers adopting similar pricing strategies. Our remedies will take into account these factors, and where necessary, require that information is provided on a confidential basis to Ofgem.

## Future actions

3.81. The initial proposals set out in this document for consultation are designed to be an appropriate and proportionate response to the findings we have identified in the Review. We consider that Ofgem is able to implement these changes under its powers and that it is in the interest of consumers to develop the initial proposals further and introduce licence amendments to bring them into effect. We believe that this provides the best route to bring benefits to consumers more quickly. For these reasons we do not propose to consult on a Market Investigation Reference to the Competition Commission (CC) at this stage. However, we may do so in the future if our proposals for reform risk being frustrated.

3.82. This document marks the start of a period of substantial consultation between Ofgem, the industry, consumers and their representatives and other stakeholders. At this stage, we are seeking views on our assessment and initial proposals. Following this consultation, we will be conducting additional research, including further behavioural research with consumers. There will be further consultations on the initial proposals contained in this document, including detailed impact assessments.

3.83. Nonetheless, there remains a risk that, even after implementation, our proposals may not do enough to protect the interests of consumers who remain permanently disengaged, including some vulnerable consumers. We would therefore welcome views on whether further consumer protection should be considered (in addition to our five initial proposals) to protect vulnerable consumers.

**Question 27:** Do stakeholders consider that our proposals will be sufficient to protect the interests of consumers, including vulnerable consumers, or are additional consumer protections measures warranted?

3.84. We also note that there are possible interactions between our current proposals and our previous Probe remedies. In particular, we note that our initial proposals on tariff simplification may make price discrimination by suppliers between regions very difficult. We would therefore also welcome views on whether our current proposals imply our future review of the undue price discrimination licence condition (which is due to expire on 31 July 2012) should be brought forward.

**Question 28:** Do stakeholders consider that our measures to simplify tariffs will reduce the ability for suppliers to price discriminate between regions and so reduce the need for a licence condition prohibiting undue discrimination?

3.85. We now invite views on the assessment of the energy retail markets and our initial proposals as described in this report. Our deadline for responses to this consultation is 1 June 2011.

# Appendices

**Index**

# Appendix 1 – Consultation Response and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. In particular, we would like to hear from licensees, consumers and their representatives and other stakeholders.

1.2. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated below.

1.3. Responses should be received by 1 June 2011 and should be sent to:

Stefan Bojanowski
Retail Markets
9 Millbank
London
SW1P 3GE
020 7901 7068
rmr@ofgem.gov.uk

1.4. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.5. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.6. Next steps: Having considered the responses to this consultation, Ofgem intends to develop further consultations on the initial proposals contained in this document, including detailed impact assessments. Any questions on this document should, in the first instance, be directed to Stefan Bojanowski, whose contact details are given above.

**CHAPTER: Two**

**Question 1:** Do stakeholders agree with our findings of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets.

**CHAPTER: Three**

**Question 2:** Do stakeholders consider that Ofgem should take action to reduce the complexity consumers face and enhance engagement with the energy market?

**Question 3:** Do stakeholders agree with our initial proposal for intervention to reduce the complexity consumers face and enhance engagement in the energy market?

**Question 4:** If not, then do stakeholders have alternative suggestions for proposals to reduce the complexity consumers face and enhance engagement in the energy market?

**Question 5:** We are proposing to standardise evergreen contracts across suppliers. Do stakeholders agree with the proposed contents of the standardised charge?

**Question 6:** We are proposing to create a standardised metric to allow consumers to compare evergreen and fixed term contracts across suppliers. Do stakeholders agree with our proposal for a standardised metric?

**Question 7:** Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to reduce the complexity consumer face and enhance engagement in the energy market?

**Question 8:** Do stakeholders consider that low electricity market liquidity constitutes a barrier to entry in the domestic retail supply market?

**Question 9:** Do stakeholders consider that our two proposed interventions (the MA and the MMM) could improve the ability of the wholesale electricity market to meet independent participants’ needs, and will ultimately improve the likelihood of retail supply market entry?

**Question 10:** Subject to the results of our further wholesale market assessment, do stakeholders consider that both interventions could be necessary to meet the objectives stated in questions 8 and 9?

**Question 11:** Do stakeholders consider that there are other intervention options we should be developing?

**Question 12:** On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:

- Volume requirements
- Product requirements

- Frequency
- Governance arrangements
- Participation
- Platform

**Question 13:** Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to take action to improve wholesale electricity market liquidity?

**Question 14:** Do stakeholders consider that Ofgem should strengthen licence conditions around suppliers' communications and interactions with their customers, to give suppliers less freedom in how they interpret these obligations?

**Question 15:** Do stakeholders consider that Ofgem should increase its monitoring and enforcement activity to enhance suppliers' compliance with licence conditions?

**Question 16:** Would stakeholders welcome the extension of some elements of the Standards of Conduct into domestic supply licence conditions?

**Question 17:** Do stakeholders agree that more needs to be done to improve consumer trust and use of switching sites?

**Question 18:** Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 3?

**Question 19:** Do stakeholders consider that Ofgem should strengthen licence conditions to prevent unfair contracting practices in the non-domestic sector?

**Question 20:** In particular, would stakeholders welcome additional licence conditions surrounding the objections procedure?

**Question 21:** Would stakeholders welcome the extension of some elements of the Standards of Conduct into non-domestic supply licence conditions?

**Question 22:** Do stakeholders agree with our position, at this stage, not to extend our proposals on tariff simplification into the non-domestic sector?

**Question 23:** Do stakeholders agree that Ofgem needs to look further at the role of third party intermediaries (TPIs) in the non-domestic market?

**Question 24:** Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 4?

**Question 25:** Do stakeholders agree with Ofgem's proposal to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated suppliers?

**Question 26:** Do stakeholders have views on how Ofgem could improve segmental reporting in future years?

**Question 27:** Do stakeholders consider that our proposals will be sufficient to protect the interests of consumers, including vulnerable consumers, or are additional consumer protections measures necessary?

**Question 28:** Do stakeholders consider that our measures to simplify tariffs will reduce the ability for suppliers to price discriminate between regions and so reduce the need for a licence condition prohibiting undue discrimination?

# Appendix 2 – Liquidity Proposals

1.1. This appendix sets out indicative design details of our Mandatory Auction (MA) and Mandatory Market Maker (MMM) intervention options, which we are proposing as solutions to the electricity market liquidity problems identified in this document and our previous publications on liquidity.

1.2. As stated in the body of this document, we believe that there are significant links between liquidity and effective retail market competition. It follows that a well targeted liquidity intervention could have significant benefits for retail market competition, and ultimately, consumers.

1.3. We consulted on potential liquidity intervention solutions in February 2010. The document[71] put forward four potential intervention options for consultation:

- Mandatory Auction (MA)
- Mandatory Market Maker (MMM)
- Direct Trading Obligation (DTO)
- Self Supply Restriction (SSR)

1.4. Further to this consultation, and in the light of our further work on liquidity, we believe that the Mandatory Auction (MA) and Mandatory Market Making arrangements (MMM) have the best prospects of achieving our objectives. We discuss the rationale for putting forward MA and/or MMM solutions at greater length in the supplementary appendices published alongside this consultation. In summary, we consider that the MA could provide market participants with a transparent means to access the bulk of their wholesale power product requirements. In addition, the MMM makes sure that ongoing product needs are met, thereby helping to address shaping requirements and helping to mitigate imbalance risk.

1.5. The design details for MA and MMM presented in this appendix are indicative of our intentions. However, as stated in the main body of this document, we are giving industry the duration of this consultation to comment on the proposed interventions or to propose alternative arrangements to address our liquidity and contestability concerns.

1.6. To support this consultation, we set out the indicative design details for the MA and MMM below. These designs have been developed with a view to minimising cost and risk, while achieving our stated objectives. For both the MMM and the MA, the expectation is that Ofgem is involved with identifying or setting up a suitable platform for the activities, and putting in place the obligations on the Big 6 to

[71] Liquidity Proposals for the GB wholesale electricity market, 22/02/10, Ref. 22/10 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=95&refer=Markets/WhlMkts/CompandEff

participate. Ofgem would also support the development of suitable rules and arrangements – specifically the Bid-Offer spread for the MMM and the reserve price for the MA. On an ongoing basis, Ofgem may or may not play a role as a trustee but would require sufficient visibility and monitoring to ensure compliance with the licence obligations.

1.7. We discuss the rationale for our proposals, and the design features presented below, in more detail in Supplementary Appendix 7.

**Table 1: Mandatory Auction (MA) design features**

| ***Design aspect*** | ***Proposal*** |
|---|---|
| **Volumes** | Require Big 6 to collectively provide a prescribed volume of electricity into each auction round.<br>Collective annual volume obligation to be either:<br>10 per cent;<br>15 per cent; or<br>20 per cent;<br>of total electricity supplied in GB over a given year. |
| **Products** | Require Big 6 to collectively offer a range of products into each auction round.<br><br>These would include:<br>Near term products;<br>Products for delivery further out;<br>Baseload products;<br>Peak products;<br>Potentially a smaller number of shaped products (e.g. standard domestic load profile)<br><br>Small clip sizes would be supported. |
| **Frequency** | Monthly auction rounds, with guaranteed availability of prescribed products and volumes in each round. |
| **Governance** | Independent trustee to be appointed to ensure that the MA is run in accordance with Ofgem's desired objectives.<br><br>Auction rules to be set out clearly and transparently. |
| **Reserve Price** | Mandatory sellers to be allowed to set reserve prices for the mandated products, provided reserve prices are not set at levels which frustrate the objectives of the auction.<br><br>Role for independent trustee in securing reasonable reserve prices. |
| **Participation** | Big 6 mandated to sell. Other participants may sell into the MA, subject to approval.<br><br>All market participants, including Big 6, may participate on the buy side, subject to approval. |
| **Platform** | To be selected by competitive tender, or established by parties in accordance with Ofgem's objectives. Accessibility to all participants must be fair and reasonable. |
| **Trading arrangements** | Ofgem wishes to see fair and reasonable trading arrangements (including those regarding credit and collateral arrangements) that do not frustrate the objectives of the MA. |

**Table 2: Mandatory Market Making (MMM) design features**

| ***Design aspect*** | ***Proposal*** |
|---|---|
| **Volumes** | Require each of the Big 6 to provide a bid and offer price for a small volume of power, across a narrow range of frequently traded products.<br><br>We believe the collective market making obligation on the Big Six should be in the order of 20-50MW in total.<br><br>These volumes should be available for the market to buy and sell on a continuous basis. |
| **Products** | Require Big 6 to submit a bid and offer price for a narrow range of widely traded products (e.g. baseload and peak).<br><br>These products should be available for the market to buy and sell on a continuous basis. Small clip sizes would be supported. |
| **Frequency** | Continuous market making by Big 6 required. |
| **Bid Offer Spreads** | Big Six will be permitted a maximum bid offer spread for the prescribed products, to ensure that the objectives of MMM are not frustrated.<br><br>The maximum permissible bid offer spread should be reasonable and broadly reflect the spreads observed elsewhere in the wholesale market. This could be relaxed under volatile market conditions. |
| **Participation** | Big 6 mandated to post bid and offer prices.<br><br>All eligible market participants, including Big 6, may participate on the buy side, subject to approval. |
| **Platform** | Ofgem would support, and may require, the Big 6 to post their continuous bids and offers on a common platform, to increase transparency and accessibility to market participants. |
| **Trading arrangements** | Ofgem wishes to see fair and reasonable accessibility and trading arrangements that do not frustrate the objectives of the MMM. |

# Appendix 3 – The Energy Supply Probe

**Chapter Summary**

This chapter provides a summary of the key findings from our 2008 Energy Supply Probe. It also describes the policies implemented following the Probe and broadly evaluates their impact to date.

1.1. In 2008 Ofgem undertook a wide ranging investigation into the energy retail markets in Great Britain. The Energy Supply Probe[72] (the Probe) found that in the 10 years since market opening, the transition to effective competition in the energy retail markets had advanced well and was continuing. However, the Probe also identified a number of important areas where the transition to fully effective competition needed to be accelerated.

1.2. As a result, Ofgem introduced a number of reforms over 2009 and 2010. There have been many positive impacts from these measures. However, we remain concerned that the impact has been below our expectations. While, we recognise that it may be early to judge the effectiveness of some of the Probe remedies, we have used the opportunity of our current review of the effectiveness of the energy retail market to take stock of how the measures have progressed thus far. We have also assessed whether overall they have resolved (or are likely to resolve) the concerns identified at the time of the Probe.

1.3. We briefly outline the key findings of the Probe and the remedies introduced. We follow this with a brief assessment of the success of these measures to date.

## Summary of Probe key findings

1.4. The Probe consisted of a wide ranging and extensive research programme. It included in-depth analysis of data and information from suppliers, consumers, consumer representatives and others involved with the GB energy retail markets. This also involved consideration of material received as the result of a range of requests for information submitted to suppliers, as well as qualitative and quantitative consumer research commissioned by Ofgem.

1.5. A high level summary of the key findings of the Probe can be found in the text box on the following page.

[72] Ofgem; Energy Supply Probe - Initial Findings Report; 6 October 2009 http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=4&refer=Markets/RetMkts/ensuppro

**Energy Supply Probe: summary of key findings**

**Market structure**

Regional electricity markets remain highly concentrated. British Gas retained around half of all gas accounts in the country.

No evidence of a competitive fringe in energy supply. The Big 6 serviced over 99 per cent of all domestic customer accounts.

**Supplier behaviour**

No evidence of a cartel among the Big 6 energy suppliers.

Competition was targeted at dual fuel customers. At the time, 38 per cent of consumers taking both gas and electricity were on a dual fuel deal.

Evidence of large, unjustified price differences between payment types, incumbent customers and between fuels were of concern.

Online tariffs with heavily discounted introductory rates were available with evidence that these rates rose for the consumer over time.

**Supplier profitability**

Energy supply businesses have low levels of directly invested capital and a very high level of pass-through costs.

Evidence that companies realised higher margins from some customer groups than others. These included sticky, legacy customers, such as those in the ex PES regions of the incumbent electricity suppliers.

**Consumer engagement**

Only 17 per cent of consumers were classed as active (ie they regularly sought out competing price offers and switched based on a good understanding of the range of offers available)

The quality of switching was not always high. As many as 1/3 of consumers who switched reported not achieving a price reduction. Many who did engage did not do so proactively.

**Non-domestic market**

Many of the issues found in the domestic market were equally applicable to small business consumers.

Particular concern around clarity and farness of T&Cs.

1.6. In addition to the key findings in the Probe, we also tested whether rising wholesale costs were passed through into bills more than falling wholesale costs. At the time, our findings were inconclusive – mainly because there were only a few periods where wholesale costs fell, so we could not draw strong conclusions from the data. There was also evidence, from suppliers' business plans, that the Big 6 sought to benchmark their hedging strategies against each other. This was done to minimise the risk of their wholesale costs diverging materially from their competition.

1.7. We also noted a number of wholesale market issues. As part of the Probe we carried out interviews with small suppliers and potential new entrants who highlighted the lack of liquidity in the wholesale electricity markets and raised concerns about the functioning of the wholesale market itself. We have continued to explore this area through our ongoing work on liquidity.

## Outline of Probe remedies

1.8. In light of the findings from the Energy Supply Probe we introduced a range of measures aimed at addressing the issues indentified. The key objectives of the package introduced were to:

- improve the quality and accessibility of information available to consumers so they can make well-informed decisions about their energy supply;
- empower consumers to engage effectively in the market; and
- promote greater transparency of the activities of the major supply and generation businesses.

1.9. In designing the Probe remedies we avoided being overly prescriptive. For example, we stipulated the type and frequency of additional information suppliers should provide their customers, but we allowed for flexibility regarding the presentation and drafting of this information.

1.10. In addition to the new licence conditions, we introduced a set of overarching Standards of Conduct. The Standards were designed to provide a list of Ofgem's expectations for how consumers should be treated by suppliers in a competitive market.

1.11. A list of the licence conditions introduced following the Probe, including the dates they were implemented, is given below.

| SLC | Standard Condition (gas and electricity supply) | Date |
|---|---|---|
| 1 | Definitions for standard conditions (amendment) | 21 Oct 2009 |
| 7A | Supply to micro business consumers (new SLC) | 18 Jan 2010 |
| 14 | Customer transfer blocking (amendment) | 18 Jan 2010 |
| 19A | Financial Reporting (new SLC) | 21 Oct 2009 |
| 23 | Notification of domestic supply contract terms (amendment) | 18 Jan 2010 |
| 25 | Marketing electricity/gas supply to domestic customers (replacement for previous version) | 21 Oct 2009 |
| 25A | Prohibition of undue discrimination in supply (new SLC) | 1 Sep 2009 |
| 27.2A | Cost reflectivity (new SLC) | 1 Sep 2009 |
| 31A | Information about gas/elec consumption (new SLC) | 1 Jul 2010 |
| | Standard Condition (electricity generation) | Date |
| 16B | Financial reporting (new SLC) | 21 Oct 2009 |

## Impact of probe remedies to date

3.87. We actively monitor the energy retail markets. We now receive more detailed datasets from suppliers and we regularly request additional information to facilitate our monitoring activities. We also consult with consumer groups and with industry and carry out our own, regular consumer research.

3.88. We recognise many of the Probe licence conditions have been in force for less than a year and some might need more time to impact fully consumer and supplier behaviour. However, we have used the opportunity of the Review to take stock of how the measures have progressed thus far.

3.89. We note there have been some important improvements since the introduction of the Probe remedies:

- We have seen a substantial reduction in undue price discrimination, particularly in relation to prepayment, in-area electricity and off-gas-grid customers. This has delivered a significant benefit for vulnerable consumers.
- There has been some improvement in the quality of information suppliers provide their customers.
- Recent survey results show that just under half of energy consumers are aware they have received clearer information from their supplier.

3.90. Despite the above many concerns persist**.** We note the following:

- A high proportion of consumers remain disengaged from the energy market.
- The number of consumers switching, whilst healthy compared to other markets, shows a slight downward trend.
- We have observed a large rise in the number of tariffs and the level of complexity associated with many offers.
- Concerns remain over the clarity and transparency of information provided by suppliers to both domestic and small business consumers.
- The concentration of the retail markets has remained largely unchanged, with only one new entrant since the Probe.
- There is now some evidence that suppliers' average prices go up faster when wholesale prices are rising, than they fall when wholesale prices are declining.

3.91. Of additional concern is that we believe many of the findings above are unlikely to improve even with more time for the Probe remedies to take full effect.

# Appendix 4 – The Authority's Powers and Duties

1.1. This description summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below)

1.2. The Authority's powers and duties are largely provided for in statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004, 2008 and 2010) as well as arising from directly effective European Community legislation.

1.3. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of those Acts.[73] Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This description must be read accordingly.[74]

1.4. The Authority's principal objective is to protect the interests of existing and future consumers in relation to gas conveyed through pipes and electricity conveyed by distribution or transmission systems. The interests of such consumers are their interests taken as a whole, including their interests in the reduction of greenhouse gases and in the security of the supply of gas and electricity to them.

1.5. The Authority is generally required to carry out its functions in the manner it considers is best calculated to further the principal objective, wherever appropriate by promoting effective competition between persons engaged in, or commercial activities connected with,

- the shipping, transportation or supply of gas conveyed through pipes
- the generation, transmission, distribution or supply of electricity
- the provision or use of electricity interconnectors

1.6. Before deciding to carry out its functions in a particular manner with a view to promoting competition, the Authority will have to consider the extent to which the interests of consumers would be protected by that manner of carrying out those functions and whether there is any other manner (whether or not it would promote

[73] Entitled "Gas Supply" and "Electricity Supply" respectively.
[74] However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

competition) in which the Authority could carry out those functions which would better protect those interests.

1.7. In performing these duties, the Authority must have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them[75]; and
- the need to contribute to the achievement of sustainable development.

1.8. In performing these duties, the Authority must have regard to the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.[76]

1.9. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed[77] under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply, and shall, in carrying out those functions, have regard to the effect on the environment.

1.10. In carrying out these functions the Authority must also have regard to:

- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and

[75] Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Acts in the case of Electricity Act functions.
[76] The Authority may have regard to other descriptions of consumers.
[77] Or persons authorised by exemptions to carry on any activity.

- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.11. The Authority may, in carrying out a function under the Gas Act and the Electricity Act, have regard to any interests of consumers in relation to communications services and electronic communications apparatus or to water or sewerage services (within the meaning of the Water Industry Act 1991), which are affected by the carrying out of that function.

1.12. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation[78] and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

[78] Council Regulation (EC) 1/2003.

# Appendix 5 – Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

**1.** Do you have any comments about the overall process, which was adopted for this consultation?
**2.** Do you have any comments about the overall tone and content of the report?
**3.** Was the report easy to read and understand, could it have been better written?
**4.** To what extent did the report's conclusions provide a balanced view?
**5.** To what extent did the report make reasoned recommendations for improvement?
**6.** Please add any further comments?

1.2. Please send your comments to:

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