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Dear Andrew,

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**Retail Market Review – Findings and initial proposals**

1. At this time of rising commodity prices, and against a challenging economic backdrop, we recognise the need for Ofgem to maintain its scrutiny of the energy market to ensure customers continue to receive a fair deal. Overall, we agree with the principles and objectives that underlie the Retail Market Review (RMR), such as the need to increase tariff simplicity and transparency across the energy market, and to ensure full compliance with both the letter and spirit of the 2008 Probe remedies. We also agree with many of the suggested proposals (e.g. the need to address the patchy implementation of the Probe remedies, and improvements to segmental reporting).
2. However, the proposals relating to the regulation of energy tariffs set out in this consultation, if implemented, would result in the most fundamental change to the regulatory framework for energy retail since liberalisation. We do not believe a sufficiently clear or compelling case has been made which demonstrates ineffective competition and a level of consumer harm to justify the extent of new regulation proposed. We also have concerns that, rather than promoting competition and benefiting consumers, the proposed measures will have detrimental effects on both, outweighing the harm they are designed to address.
3. We agree that simpler energy tariffs would be beneficial to consumers, and recognise improvements can be made in this area. We are also open to further development of a charging model in which customers pay a pass-through / standing charge, combined with a single tier p/kWh energy charge. However, Ofgem's proposed way of achieving this looks overly complex, and too reliant on intrusive regulation. Instead, we suggest a more proportionate approach would be for Ofgem to work with suppliers and consumer groups to develop and implement a new Code of Practice for retail tariffs.
4. We also have concerns that the proposals may be in conflict with important areas of Government policy (such as smart metering and the Green Deal). Customer choice would be significantly restricted as a direct consequence of these proposals, as they would place a major restriction on suppliers' freedom to market tariff propositions to their customers. It is ironic that, at the very time suppliers need to be developing and marketing innovative propositions to promote Green Deal, smart meters and the growth of home technologies, Ofgem is proposing removing the ability for suppliers to innovate in the largest part of the retail market.
5. It is crucial that Ofgem sets out its measures of success clearly before detailed remedies are developed. For example, is Ofgem seeking a further increase in switching, increased levels of new entry, higher reported levels of customer satisfaction, or a mixture of all of these? This is particularly relevant given that the focus of the review has now changed substantially since its launch (away from an initial focus on supplier profitability), and that

the industry has already undergone an extensive process of change in the past two years in response to the 2008 supply market Probe. Measures of success for the review should be agreed between Ofgem, consumer groups and suppliers before detailed remedies are defined. It is important to avoid the risk that suppliers (and ultimately our customers) are required to incur significant additional disruption and costs in complying with the latest RMR proposals, only to find that Ofgem's objectives change once again. The resulting level of customer and regulatory uncertainty and incurred cost will only serve to deter further new entry to the retail energy market, and damage the trust of our customers.

6. We have set out our views on each of the questions posed in the consultation in Annex 1 to this letter (and confidential Annex 2). In the remainder of this letter, we draw out some of the most important views from these responses.
7. This response is submitted on behalf of the Centrica group of companies excluding Centrica Storage, is not confidential (aside from Annex 2), and we are happy for it to be placed on the Ofgem website.

#### Effectiveness of competition in the retail market

8. While the Review has raised a number of issues that are important for customers, we do not agree with Ofgem's findings on either persistent consumer harm, or reduced competition (including barriers to entry) in the retail energy market. The GB market is amongst the most competitive in the world – we currently enjoy the lowest average domestic gas prices of the EU15 and the highest level of switching. Increased customer choice and innovation is a direct benefit of this competition.
9. While there is room for improvement in some areas, we do not believe that the extent of any consumer harm that may exist – particularly from tariff complexity – is as severe as Ofgem suggests<sup>1</sup>. We also have concerns that Ofgem's use of research in some areas is both methodologically flawed and out of date. Research from 2008, for example, does not reflect the strong growth in tariff comparison websites over the last three years. It also fails to reflect the benefits from the Probe remedies, such as the introduction of Annual Statements, point of sale accurate price comparisons (where implemented) and clearer billing. An independent report commissioned from Frontier Economics by the Energy Retail Association (ERA) concludes that Ofgem has overstated the extent of customer confusion arising from tariff complexity and that the evidence that this confusion is causing customers to disengage from the market is not persuasive.
10. We strongly dispute Ofgem's assertion that retail prices rise quickly when wholesale prices rise, but fall slowly when wholesale prices fall. Ofgem's own analysis shows that these conclusions are highly sensitive to assumptions on the hedging strategy adopted by suppliers, and the analytical method used to estimate the relationship between wholesale and retail prices. In reality, suppliers are reluctant to increase retail prices when wholesale costs increase, because of the risk of losing customers. We have already shared our own hedging and pricing analysis with you that supports this view<sup>2</sup>.
11. Independent analysis commissioned from NERA by the Energy Retail Association (ERA) identifies several problems with Ofgem's statistical analysis of pricing, which together mean that Ofgem cannot claim to have proven that prices respond asymmetrically. Furthermore, both the NERA and the Ofgem reports note that an asymmetric response to cost increases does not provide evidence of competition problems or of any harm to consumers. The NERA report also comments on the stark contrast between the qualified

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<sup>1</sup> Ofgem's own engagement survey from 2009 showed that only 14% of customers disagreed with the statement "I found it easy to decide which deal to switch my gas to."

<sup>2</sup> This analysis is included in (confidential) Annex 2 for reference.

conclusion of the Ofgem analysis, and the unqualified announcement made as part of the RMR press release.

12. Ofgem's focus on "sticky" customers as a barrier to entry in the domestic retail market is also misplaced. In our view the most important barrier to entry in energy retail is low profitability. Ofgem analysis has shown that energy retail margins have averaged only 1.6% since 2005<sup>3</sup>. This analysis also fails to reflect the costs incurred by suppliers from the collateral requirements resulting from volatility in underlying commodity prices.
13. Regulatory uncertainty and network charging volatility, both of which are within Ofgem's remit to address, have also been highlighted as impediments to entry and growth particularly for small suppliers.
14. In spite of these barriers there have been a number of successful "niche" entrants into the business and residential markets in recent years. This includes the recent launch of Co-operative Energy, which suggests there remains scope for entry into the domestic market.
15. Lastly, we believe Ofgem has understated the level of switching in the market, and has been selective in its choice of evidence. The document relies on the results of Ofgem's latest consumer engagement survey, which reportedly shows that "around 60% of energy consumers report never having switched supplier." However, independent research from 2011 has shown that between 71% and 79% of customers have actually switched (depending on supplier)<sup>4</sup>.

#### Tariff reform

16. We do not agree with Ofgem's view that tariff complexity represents a significant barrier to competition and consumer engagement at present. However, we recognise that improving the simplicity of energy tariffs would be beneficial for our customers. Multiple tariff tiers in particular can be difficult to understand, and there are good arguments for suppliers to change the way they structure their tariffs (possibly moving towards a charging model in which customers pay a pass-through / standing charge, combined with a single tier p/kWh energy charge). In developing this structure further, it will be important to recognise that the pass-through / standing charge element should fully recover the fixed costs of supplying energy. If set at too low a level, then lower consuming customers will tend to become loss making (resulting in significant market distortions), and will create a disincentive for suppliers to help their customers reduce energy consumption.
17. While the proposals on tariff structuring in the consultation are set out at a relatively high level, they look to be an overly prescriptive way of addressing the issue of tariff complexity. They also involve a significant and disproportionate increase in the regulation of the (competitive) retail market.
18. Rather than introduce a regulated standardised tariff, a more proportionate approach would be for Ofgem to work with suppliers and consumer groups to develop and implement a new Code of Practice. This could set out best practice in tariff structures, such as requiring all suppliers to include a cost reflective pass-through / standing charge, combined with a single tier p/kWh. It could also be combined with a requirement for suppliers to specify an APR-type measure for all tariffs (similar to that used in the finance industry) that customers could use to compare different offers.
19. A formal accreditation system for comparison websites would also be a positive step forward, since as Ofgem itself acknowledges these are a valuable way of stripping out tariff complexity and streamlining the switching process for consumers. These options

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<sup>3</sup> See Appendix 9 of the Retail Market Review – Findings and initial proposals.

<sup>4</sup> Morgan Stanley Research Energy Survey 2011

would deliver tangible improvements in tariff transparency without introducing unnecessary restrictions on the way suppliers meet the needs of their customers.

20. Requiring customers to agree to move on to FTCs to enjoy the full benefits of competition is a highly interventionist proposal. We do not believe this level of intervention is consistent with the principle of proportionate regulation in the absence of any clear evidence of material consumer harm caused by the current market arrangements, the existence of alternative solutions, and the potential detriment to competition and consumer choice. Fixed term contracts (FTCs) are not appropriate for all customers. Many customers, for example, prefer the flexibility that tariffs offer, and prefer not to commit to a longer term deal.
21. If customers who wish to remain on tariffs are denied benefits such as dual fuel discounts, discounts for using online services and a range of other innovative offers, it is difficult to see how this could be in the public interest. It is also unclear that FTCs are simpler than tariff propositions, and that this proposal will address any of the issues highlighted by Ofgem.
22. FTCs by nature also increase the cost to serve our customers. Compared to tariff propositions, suppliers offering FTCs incur additional costs through increased engagement with customers caused by the renewal dates that are a feature of such contracts. Fixed price propositions are also more costly, as they require more hedging than tariff products, and lead to further cost whenever customers break contracts (which often occurs when customers move home). Overall, we estimate that FTCs incur additional costs of up to 3% compared to tariff propositions<sup>5</sup>. These costs will ultimately be passed on to consumers through higher prices. We are therefore sceptical that the high levels of take-up of FTCs envisaged by Ofgem can be realised.
23. Ofgem's intention to grow the market for FTCs may also increase barriers to new entry to the energy retail market. Market participants all face substantial capital requirements for credit risk as a cost of participation in volatile energy commodity markets. These requirements are likely to be particularly onerous for smaller or less well-capitalised companies. As FTCs tend to be based on back-to-back market hedges, they have higher hedging costs than tariff products. Therefore new entrants will face increased capital requirements to enter the sector and provide a range of products to customers. This issue will become even more severe should proposed EU financial regulations be approved (which will further increase the capital requirements associated for credit risk in the energy sector).
24. We are also concerned that the proposals could result in the failure to deliver the benefits of Government's Smart Metering agenda, as well as its wider environmental objectives. Restrictions on the range of tariffs that suppliers are able to offer (e.g. no separate time of use tariff) will make the roll-out of smart meters far more challenging. A key driver of the necessary change in customer behaviour underpinning the Government's benefits case is that customers will save money if they choose to consume energy at (cheaper) off-peak times, rather than at peak. To be able to pass these savings on to customers, we need to be able to offer tariffs that vary according to time of use. However, as Ofgem's proposals stand, time of use tariffs will not be permitted. Instead, customers will have to sign up to an FTC, which many customers may not find attractive. This problem will be exacerbated if customers are required to roll onto an evergreen tariff, each time their FTC expires.
25. The proposals will also restrict customer choice. Customers value having a range of tariffs from which to choose, for example being able to select a level of tariff to match the level of customer service they require. Customers who opt for a purely online service

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<sup>5</sup> We estimate additional costs to range from 1% for a 6 month product to 3% for a 3 year product.

offering, or are happy with a less extensive level of customer service would typically expect to pay a lower price. In contrast, some customers are willing to pay a premium to receive an enhanced level of service delivery. Under these proposals, this form of tariff differentiation will be prohibited, severely limiting the potential for innovation in the market.

26. Finally, it is worth noting that there is already a regulatory framework in place to protect consumers from unfair and misleading pricing practices (amongst other forms of unfair trading) in the form of the Consumer Protection from Unfair Trading Regulations (CPRs). The Office of Fair Trading (OFT) and Trading Standards have wide-ranging powers to investigate and enforce against breaches of the CPRs, and Ofgem has not presented any compelling evidence that additional, sector-specific regulations are required in the energy retail sector.
27. In summary, we are keen to work with Ofgem and consumer groups to develop ways in which tariff simplicity can be improved. However, to be in the interests of our customers, we believe these should:
- allow customers to retain some choice in their tariff (as a minimum for service/price (e.g. online), time of use (both Economy 7 and Smart), and affinity deals);
  - be compatible with the smart metering, and broader "green" agenda (specifically being consistent with collection of Green Deal payments);
  - enable cost reflective pricing, with any pass through / standing charge covering all reasonable fixed costs;
  - not lead to market distortion;
  - be supported by a rigorous impact analysis, including consumer research (endorsed by consumer groups and suppliers), and detail review of costs and benefits; and
  - include a reasonable transition period.
28. We believe that these principles are best delivered by a supplier Code of Practice (coupled with some form of APR-type comparator), and that a regulated approach would not be proportionate.

#### Supplier conduct

29. The 2008 Probe made a number of recommendations aimed at improving supplier conduct. These included new standards for bills and statements, debt blocking, field sales, financial information reporting, regulatory reporting requirements and new micro business rules.
30. British Gas has been very robust in ensuring that we have implemented solutions which are compliant with both the letter and the spirit of these rule changes, but we have not arrived at this position without considerable cost. We would have preferred for these changes to have had time to embed and mature before further changes were proposed, as the full benefit of these changes are only just being felt in the market.
31. Nevertheless, we recognise that take-up of the Probe remedies across the industry has been patchy, and would therefore support a consistent application of the regulations by all suppliers in this area to maximise benefits to consumers. In light of the very positive feedback we have received from consumer groups to our field sales processes, annual statements and bills, we hope that these will represent the standards which Ofgem will expect all suppliers to meet.
32. In any event, we would suggest awaiting the conclusion of DECC's review of billing before requiring suppliers who already meet the 2008 Probe remedies to undertake

further (interim) changes to bills. Should Ofgem choose to introduce additional requirements on suppliers that result in a material change in system and process requirements, it will also be important to allow a reasonable period of transition (to limit implementation costs, allow for the extensive communication required by the extent of change proposed and prevent any inadvertent breaches to the new regulations).

33. We note that Ofgem has signalled an enhanced monitoring of supplier activities, and a greater appetite to take enforcement action. While we recognise the need to ensure that all suppliers comply with the terms of their licence, it is important that enforcement action is proportionate, and allows for a human element in the way we interact with our customers<sup>6</sup>.

#### Non-domestic proposals

34. We support many of Ofgem's proposals relating to non-domestic customers, in particular the push for additional regulation of Third Party Intermediaries (TPIs), possibly by the OFT. However we question the need to extend the scope of SLC 7A, and in particular do not believe that further restrictions on the auto-renewal of contracts for customers larger than micro businesses would be appropriate.
35. We already apply SLC 7A to all our small enterprise customers. However, medium and large sized non-domestic customers are fundamentally different in nature to small enterprises. They have different requirements and level of sophistication in the way they contract for their energy, and a need for different levels of protection from regulations. We do not believe there will be any benefit from prohibiting these customers selecting contracts that auto-renew, should they prefer them.
36. Instead, we would suggest Ofgem should work with suppliers and consumer groups to understand which non-domestic customers would benefit most from SLC 7A, and only at that point consider whether the current coverage of the licence conditions is appropriate. It is important to recognise that applying these regulations to customers increases supplier costs (which are ultimately reflected in higher prices). It is therefore important only to regulate where there is a clear need to do so.
37. We do not consider additional licence conditions relating to objections are necessary, and we challenge the assertion there is any evidence that the objections process hampers switching. In relation to the Standards of Conduct, more clarity is needed as to how Ofgem intends to extend the current obligations. We do not see an obvious need for greater regulation other than potentially in relation to TPIs.

#### Liquidity proposals

38. The emphasis put by Ofgem on increased liquidity to further stimulate retail competition is misplaced, given the key barrier to new entry is industry profitability. For small suppliers, the biggest issue they face is not so much liquidity but the capital requirements for credit risk. The margin calls required to manage volatile power prices will tend to be very large relative to the operating margins they can expect to earn. Should proposed EU financial regulations be approved, capital requirements for participation in energy commodity markets will increase significantly, reducing hedging and liquidity and damaging competition. Ofgem needs to factor these developments into its market analysis and use its influence in the European policy debate to secure the best outcome for GB customers.
39. Despite these challenges, we note that there still remains scope for new entrants to the retail energy market. For example, very recently, we have seen Cooperative Energy enter the sector (without the backing of generation interests).

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<sup>6</sup> This principle is clearly established in Ofgem's existing enforcement guidelines.

40. Although we consider that current levels of liquidity are sufficient to support competition in generation and supply, we agree that introducing a generator auction could improve power market liquidity further. The auction needs to be designed to work with the grain of the successful competitive GB energy market and to avoid distorting competition in generation. Generators must not be forced to sell at a loss or to accept weak credit support. If participation is to be mandated, all large generators must be included. There is no legal or economic basis to discriminate against one set of generators, who happen to be part of vertically integrated companies. In 2010 Centrica sold 75% of its own generation through the traded market.
41. We do not think Ofgem has made the case for mandating market-making. As with the proposed auction, there is no case to discriminate against vertically integrated players by giving them a special obligation that does not apply to other generators performing identical roles in the market. Other generators or traders may be equally or even better placed to perform this role. It is not acceptable for vertically integrated players to be subject to a bid-offer spread regulated by Ofgem. This represents direct intervention in the pricing of the generator's product. Moreover, Ofgem has provided no evidence that this would be a proportionate or necessary response to the challenges faced by some market participants.
42. Power exchanges have incentives to appoint market-makers where their presence would help to promote liquidity. For instance, since the launch of Ofgem's review, N2EX has announced that EDF and RWE have been appointed as market-makers for UK power futures, helping to create a UK power futures market.

#### Segmental reporting

43. Finally, we remain supportive of the concept of reporting on the financial performance of energy suppliers on an annual basis. This report, which sets out in a transparent and broadly consistent manner the actual profits of energy suppliers is an important step forward towards developing greater trust in the sector.
44. We also believe that these reports (which are based on clear and objective reporting criteria) are the most reliable indicator of profitability in the sector, particularly if reconciled to group reports. In contrast, we would urge Ofgem once again to end its practice of using the wholesale retail price link report to comment on the profitability of suppliers, given this report inaccurately reflects changes in margins of suppliers, and wholesale energy costs only represent around half of household bills.
45. We believe it is important to establish a "level playing field" in financial reporting between suppliers as far as is possible, and we share Ofgem's view that cross-comparability of the report between companies could be improved in a number of important respects.
46. We support the proposed independent review of transfer pricing and hedging practices, and hope that this is used to address some of the most severe causes of comparability problems between supplier accounts (most notably, extensive use of exceptional adjustments). We would be happy to comment on the detailed terms of reference for this review, and hope these are consulted upon.
47. Andrew, we support many of the principles that underpin the retail market review, but do not agree with Ofgem's published findings on consumer harm or reduced competition in the retail energy market. In addition, in a number of areas (particularly tariff reform) more detailed work is needed to deliver proportionate proposals that will be in the interests of our customers. It is important that the proposals in your next RMR publication are accompanied by an impact assessment, backed up by rigorous consumer research, and full assessment of costs and benefits. This will enable all stakeholders to comment directly on the way in which the emerging proposals will affect our customers.

I hope that you find this letter and our more detailed responses to your questions helpful. If you have any questions, please do not hesitate to contact me directly.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Mr. Tim Dehurst". The signature is fluid and cursive, with a long horizontal stroke extending from the end.

Mr Rowlands

General Counsel, British Gas



## **Annex 1: Response to consultation questions (non-confidential)**

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

While the Review has raised a number of issues that are important for customers, we do not agree with Ofgem's findings on either the causes of persistent consumer harm, or barriers to entry in the energy retail markets.

Competition in the retail market is strong, and while there is room for improvement in some areas (e.g. in relation to consistent application of the 2008 probe remedies), we do not believe that any consumer harm that may exist – particularly in relation to tariff complexity – is as severe as Ofgem suggests. Moreover, any issues are likely to be self-correcting as suppliers continually strive to develop offerings that are tailored to the needs of their customers.

Our specific comments on the individual issues highlighted by the Review are set out below.

#### **Complex tariff information**

Ofgem has highlighted both the complexity of individual tariffs ("tariff complexity") and the multiplicity of tariff options available ("tariff diversity") as causes of consumer harm which limit effective engagement in the market.

We agree that tariff complexity is an area where suppliers can make improvements. We set out our views on how this can be delivered later in this response. However, the analysis presented by Ofgem is selective and does not support the conclusions in the report. In particular:

- market research actually suggests that complexity in the GB energy sector is comparable to that found in similar industries (e.g. mobile phones and TV broadband) and in other European countries;
- evidence of consumer harm from complex tariff information and tariff diversity presented by Ofgem is overstated;
- the benefits from tariff diversity are understated; and
- the case has therefore not been made for increased regulation.

#### *Evidence of tariff complexity / diversity*

Ofgem quotes OFT survey research undertaken by Ipsos Mori as the primary source of evidence that complex tariffs are relatively more prevalent in energy than in other sectors. However, the analysis actually suggests that the energy sector does not appear to be greatly different from the mobile telephone sector in this regard. OFT's 2010 advertising of prices survey, for example, found 11% of respondents had experienced complex pricing in gas or electricity, compared to 10% who had experienced complex pricing in mobile phones and 7% in TV broadband.

Ofgem has also presented evidence that the number of tariffs available to domestic customers has increased two-fold since January 2007 (although we note that Frontier Economics was not able to replicate this analysis in its report on tariff standardisation for the ERA). To the extent that the number of tariffs has increased, this appears to have been largely driven by the increase in fixed and capped price deals, demand for which has increased due to escalating commodity prices over this period. Despite this, British Gas currently offers only 7 different types of energy tariff<sup>7</sup>. Moreover, recent work by the European Commission does not support the view that the number of electricity tariffs available in the UK is particularly high<sup>8</sup>.

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<sup>7</sup> As of 27<sup>th</sup> May 2011.

<sup>8</sup> EC DG Sanco (2010), The functioning of retail electricity markets for consumers in the European Union, 2 (Table 2 p32).

### *Evidence of consumer harm from tariff complexity / diversity*

The GB retail energy market has the most competitive retail energy market in the world. Ofgem has confirmed it is confident that energy suppliers are pricing independently and that there is no evidence of collusive activity or excessive profits. Independent studies repeatedly show that levels of switching in the market are amongst the highest of any other retail energy market. In addition, the existence of six major competitors compares favourably with many other markets (fixed and mobile telecommunications, supermarkets, pay television, high street banking, etc.) and switching rates are also high relative to these sectors.

Given this level of competition, it is implausible for Ofgem to conclude that customers experience material and persistent harm from tariff complexity and diversity which must be addressed through regulatory intervention. Competition itself acts as a natural way of limiting the complexity of offerings (as, to the extent this is an issue for consumers, then suppliers can enter the market using simplicity as a way of differentiating their propositions). Indeed, we have seen a new entrant to the retail market (Co-operative Energy) that has decided to compete on exactly this basis in recent weeks.

We also do not believe that Ofgem has presented any compelling evidence that shows tariff complexity and diversity in the energy sector have led to significant consumer harm. A recent OFT (2010) study (referenced by Ofgem) suggests that only 1% of the total sample highlighted “too many options” as an issue of concern in relation to pricing in the energy sector<sup>9</sup>. This indicates that the case for tariff diversity causing consumer harm is overstated.

Ofgem’s older 2008 consumer engagement survey is also quoted as evidence of this harm (which found that 70 per cent of respondents agreed that the number of tariffs on offer was confusing). However, this survey was conducted before substantial changes were made to the buying process that we believe have resulted in major improvements in tariff simplicity and clarity of the sales process.

Specifically, since 2008 the proportion of switching that takes place via online comparison sites (which simplify the process of comparing significantly) has more than doubled from 16% to 35%. In addition, doorstep comparisons have become much simpler with the introduction of Hand Held Terminals for field sales advisors, and Annual Statements have been introduced. Reliance on out-of-date customer research therefore significantly overstates the extent to which tariff complexity deters engagement.

We recognise that some customer groups (particularly the vulnerable) will have a clear preference for simple tariff structures, and place little value on having a wide range of tariffs from which to choose. While it is important to recognise this, it is also important not to understate the preferences of other customer groups who place a much higher value on choice. Any assessment of customer harm underlying the case for regulatory intervention must therefore take account of the needs of all customer groups in the market.

### *Benefits from tariff diversity*

We do not believe that Ofgem places sufficient weight on the benefits to consumers from multiple tariff offerings. Ofgem’s duties set out that consumer interests should be promoted through encouraging competition. The development of tariff offerings tailored to the demands of specific groups of consumers is a key way in which competition manifests itself, and is a source of consumer benefit.

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<sup>9</sup> As noted above, the OFT’s survey found that 56% of customers surveyed had experienced some form of complex pricing, and 39% of those had experienced this in energy. 61% of those who had experienced complex pricing in energy found it difficult to choose a supplier, and 21% of that subset highlighted “too many options” as one of the reasons for this. Table 481 of Annex N of the OFT study shows that only 30 respondents of the original sample of more than 3000 (i.e. 1%) met all of these criteria.

The development of new tariff offerings is also a key enabler for the benefits which can be realised from innovative technologies. In particular, much of the benefit from smart meters and smart grids will only be realised if the price consumers pay for their energy varies by time of use.

#### *Need for regulation*

As set out above, we feel the issues relating to tariff complexity / diversity have been overstated, and the benefits understated. Even without any quantified impact assessment of Ofgem's proposals, it is difficult to see how the highly interventionist proposals set out by Ofgem can be justified as proportionate. This is particularly true, given survey evidence that suggests energy tariffs are actually comparable to other industries in terms of their complexity.

Under a competitive market firms face strong commercial incentives to innovate and address potential sources of consumer detriment without the need for regulation. A prime example is the rapid development of online switching sites which assist customers to make informed choices, as well as the use of hand-held terminals to facilitate price comparisons on the doorstep. By imposing a regulated "one-size-fits-all" solution, Ofgem is undermining incentives for this kind of innovation.

As set out later in our response, there are far less radical ways of addressing this issue – for example the development of a new Code of Practice between suppliers, in which the most confusing aspects of tariff behaviour are prohibited, and more transparent approaches (e.g. use of standing charge / single p/kWh tariff tier) are encouraged.

#### **Poor supplier conduct**

The 2008 Ofgem Probe made a series of recommendations designed to improve supplier conduct across a number of areas. These included new standards for bills and statements, debt blocking, field sales, financial information reporting, regulatory reporting requirements and new micro-business rules. We have been very robust in ensuring that we have implemented solutions which are compliant with both the letter and the spirit of these rule changes. However, we agree with Ofgem that implementation has been patchy across the sector as a whole, and therefore recognise that it may be necessary – in some areas – to be more prescriptive in how remedies should be introduced.

Bills and annual statements are one such area. Our own performance on billing has been exemplary, with both Which? and Consumer Focus having singled us out for the quality and clarity of information on our bills and annual statements. Reaching these standards has been costly for us and has involved extensive investment in new systems, processes and training. It would therefore unfairly penalise us if we were required to change our processes and systems again to meet a different interpretation of the Probe remedies. We therefore strongly suggest that any changes should focus on rolling out our best practice model across the sector, in order to ensure that all customers benefit from improved billing and statements.

We also note that Centrica is currently working with DECC to support a number of billing initiatives to test the Government's proposals for further information on bills (e.g. comparative consumption information). Ofgem must not force further changes to bills until the changes required by DECC have been tested and implemented.

#### **"Sticky" customers**

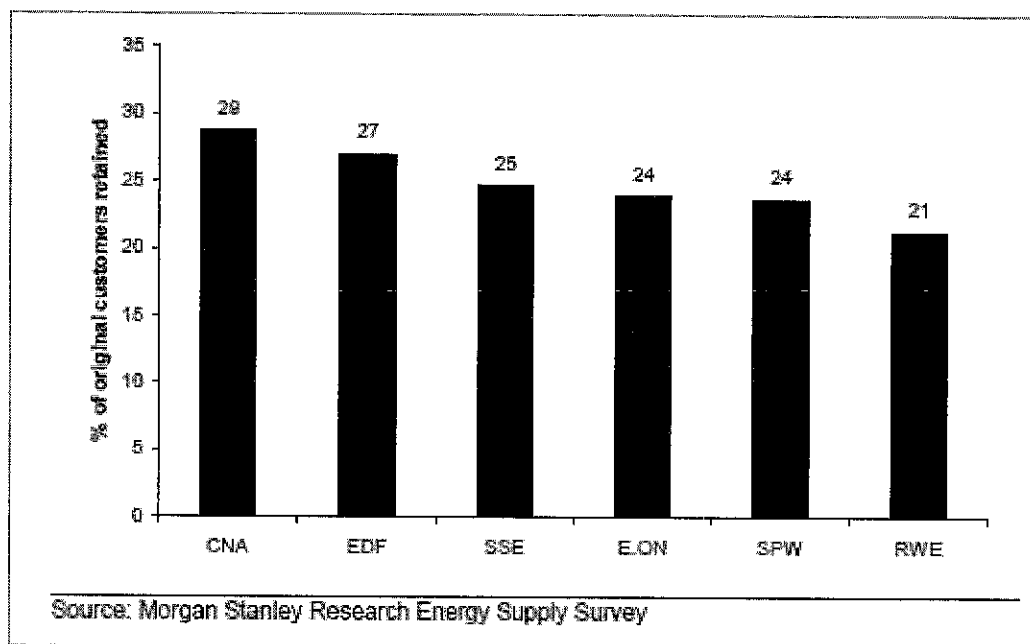
Ofgem argues that the presence of a high number of "sticky" customers in the market reduces competitive pressure on suppliers and confers an advantage to incumbents that is not available to new entrants. We believe Ofgem's analysis of switching behaviour is flawed in a number of respects, meaning that the conclusions drawn from this analysis are not robust. In particular:

- the percentage of customers who have switched supplier is far greater than Ofgem suggests
- Ofgem's claim that switching rates are on a downward trend is misleading
- Ofgem have misrepresented the regional market share picture and confuse high incumbent market shares with lack of competition and switching
- even among customers who have not switched, there is limited evidence of consumer harm and considerable evidence of benefits accruing from competition.

#### *Percentage of customers who have switched supplier*

The document quotes survey data suggesting that only 41% of gas customers and 40% of electricity customers have ever switched supplier. This is difficult to reconcile with the fact that British Gas (as the former monopoly supplier in gas) now has a 42% gas market share. As a minimum, 58% of gas customers must therefore have switched at some point in time (even if British Gas had not won back a single customer since deregulation).

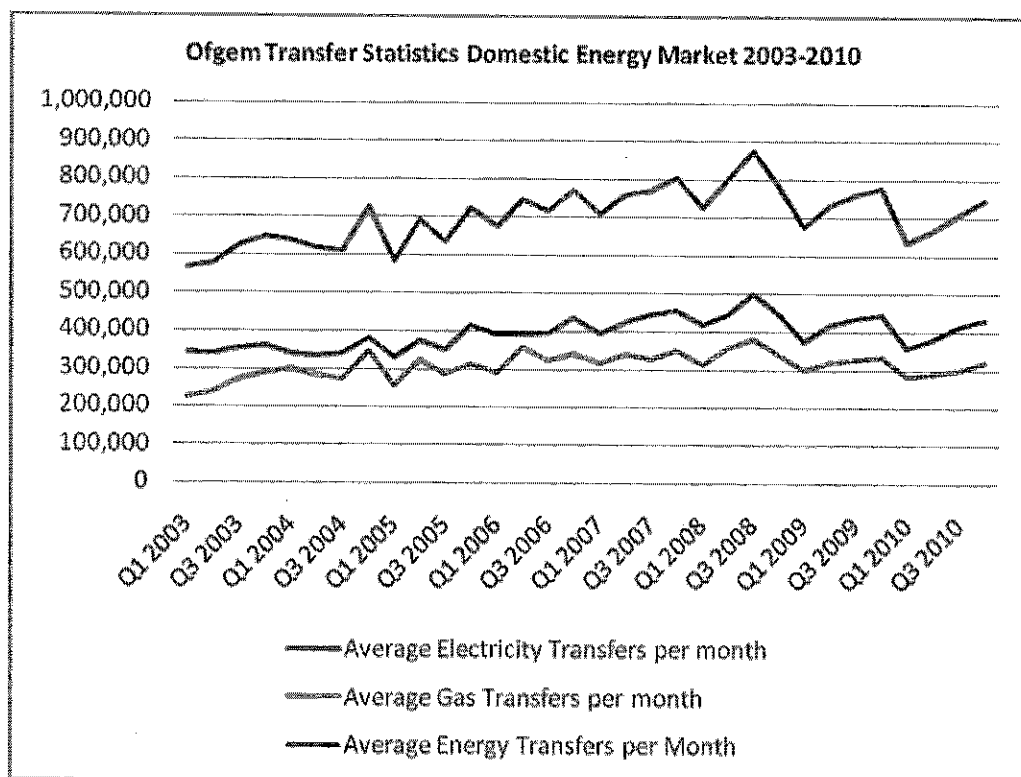
Ofgem's data is also contradicted by independent third party research (Morgan Stanley Energy Survey 2011) that suggests between 71% and 79% of consumers have switched depending on the supplier. This is set out in the chart below.



In footnote 38 of the RMR report, Ofgem itself acknowledges that the estimated percentage of non-switchers "is subject to inaccuracies" and "almost certainly underestimates the number of customers who report never having switched", but nevertheless this research is used to support Ofgem's conclusions on the number of disengaged and passive consumers. Ofgem's data on switching is fundamental to its analysis but appears to underestimate switching by 30 to 40 percentage points.

#### *Trends in switching rates*

Ofgem states that switching rates for domestic customers have been on a "downward trend" since 2006, based on Ipsos MORI survey data. However, according to Ofgem's own data on internal transfer statistics, switching rates actually peaked in 2008 following steep increases in wholesale costs. While switching rates in 2009 and 2010 were below the 2008 peak, analysis of data since 2003 does not suggest any discernable downward trend, and transfer volumes in Q4 2010 were higher than in 22 of the previous 32 quarters. This is set out clearly in the chart below.



#### *Regional market shares*

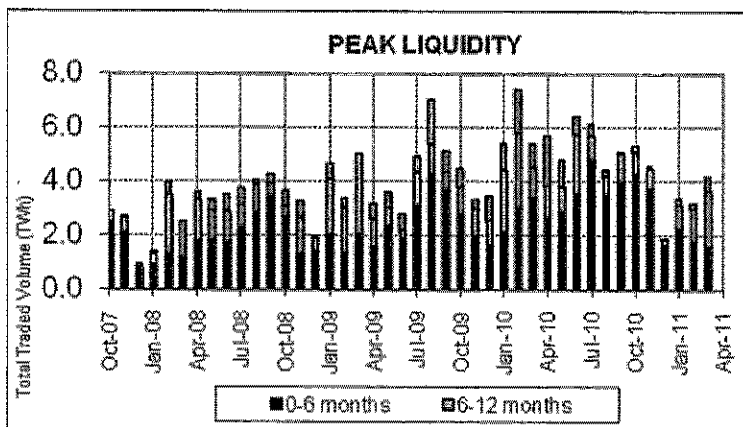
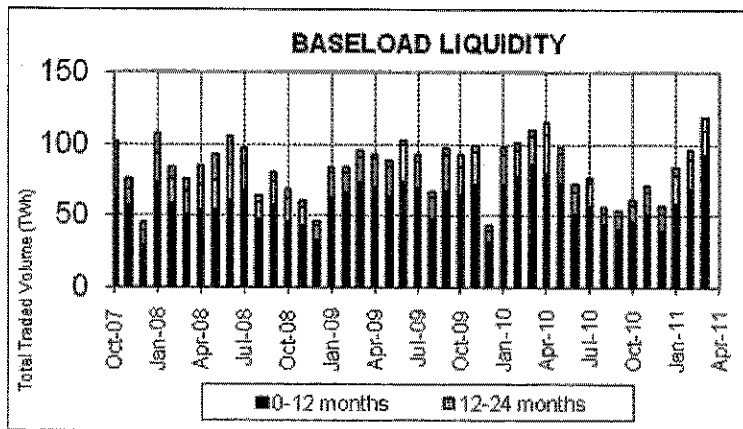
Ofgem categorises regional market share by Dual Fuel, Single Electricity, and Single Gas, and states that 73% of electricity-only customers are held by regional incumbents while 75% of gas-only accounts are held by British Gas. This is used to justify the contention that incumbents have excessive market share. However, as most customers tend to be acquired onto Dual Fuel deals (rather than onto single fuel deals), this gives a distorted impression of numbers of customers actually held by incumbent suppliers.

A more representative view would be to ask what percentage of all gas accounts and all electricity accounts remain with the incumbent supplier (ex-PES for electricity and BG for gas). This gives a much lower figure – 42% of all gas accounts remain with the incumbent (i.e. BG), while 40% of all electricity accounts remain with the incumbent electricity supplier<sup>10</sup>. Moreover, this headline figure masks a high level of underlying churn, with many customers both leaving and returning to former incumbents.

#### **Vertical integration and low liquidity**

Wholesale energy markets are generally working well, exhibiting levels of liquidity that are more than sufficient to sustain effective competition in generation and supply. Ofgem's own evidence does not support the assertion that churn in the wholesale power market is on a "downward trajectory" – churn rates have risen steadily since 2005 as the market recovered from Enron crisis. While Ofgem is right to continue monitoring liquidity levels, it is much too early to determine whether the slight dip in late 2010 relative to 2009 is indicative of a trend. Analysis of traded volumes for baseload and peak power since October 2007 (shown in the charts below) does not support such a conclusion. In addition, the opening of the UK power futures market in January 2011 and the appointment of two market-makers by N2EX in April 2011 is likely to give a further boost to liquidity.

<sup>10</sup> Source: British Gas analysis of Cornwall Energy data



### Similar pricing / hedging strategies

We welcome Ofgem's confirmation that it is confident that energy suppliers price independently. However, we do not share Ofgem's view that competition has weakened and have seen no compelling evidence to support Ofgem's claims of "coordinated supplier behaviour" and companies "reducing the risk of competition" by adopting similar pricing strategies, as well as through similar hedging behaviour and generation portfolios.

The comments cited above overstate Ofgem's own assessment on the point, which concludes (more moderately) that similarities in underlying price drivers "may" have played a large part in narrowing the range of prices offered by the Big 6 and "may" not be to the consumers' advantage.<sup>11</sup>

Ofgem's observations of price convergence are based exclusively on dual fuel direct debit prices rather than suppliers' wider portfolios and therefore do not present a full picture of competitive dynamics. Further, the observation that suppliers continue to follow closely each other's prices in determining their own prices is to be expected in a competitive market. British Gas does not have visibility of the hedging strategies adopted by our competitors. However, we are not aware of any evidence that suggests these strategies are similar or converging over time.<sup>12</sup> To the extent there has been any trend towards convergence in hedging strategies, we are concerned that this may have been driven in part by Ofgem's own actions – in particular, the publication of the quarterly wholesale / retail price report (which could be argued as creating a default "benchmark" strategy for suppliers). We have concerns that the proposals set out in this document could potentially exacerbate this risk further (with a single

<sup>11</sup> Para 2.83

<sup>12</sup> This view is inconsistent with Ofgem's statements elsewhere in the report where it recognises that suppliers may use different hedging strategies and that there are variations in generation portfolios. See para 2.88 and footnote 46

p/kWh tariff across suppliers leading to an increased downside of picking the “wrong” hedging strategy).

Similarly, Ofgem provides no clear evidence to support the suggestion that some of the Big 6 may have customer acquisition strategies focused on replacing lost customers as opposed to significantly growing market share. This inference is drawn from statements from suppliers gathered in the context of the 2008 Probe on sustaining customer numbers to maintain balance between their upstream and downstream positions, which do not support this conclusion.

Ofgem claims that many features of the energy retail markets represent a high risk of coordinated effects however presents no compelling evidence to support that claim. The RMR contains no detailed reasoning on this issue, and is limited to a high level summary of relevant features (Table 2.2). Many of these features are, in our view, overstated. Of the thirteen features listed, Ofgem rates only two as “highly” applicable to energy retail, namely homogeneity of products and level of concentration. However, with six significant players and a fringe of smaller suppliers, the market is not particularly concentrated, in particular relative to other energy markets. We question whether the remaining features have “relatively high” applicability to energy retail, as Ofgem claims. For example, we do not consider there to be a particularly high degree of homogeneity between suppliers and the market is not characterised by significant switching costs.

Evidence of recent new entry (e.g. by Co-op earlier last month) suggests entry barriers can be overcome. Fluctuations in wholesale prices mean that costs are not particularly stable and market shares have changed significantly over time. There is no evidence that suppliers are protected from short-term financial pressures. There are several smaller fringe players offering niche products in addition to the offerings of the six large players, as well as scope for firms to bring new products into the market. Finally, Ofgem fails to take into account further conditions for coordinated effects, including the ability for firms to retaliate if a supplier deviates from any prevailing behaviour. Price changes occur relatively infrequently in the energy sector, which limits the scope for such a response.

### **Barriers to entry**

Ofgem has also asked for views on barriers to entry in the retail energy market, although these do not seem to be set out clearly in any part of Chapter 2. While as set out above all the available evidence indicates that the retail market is highly competitive, there are a number of material barriers to new entrants.

By far the most significant barrier to entry in energy retail is a persistently low level of profitability. Ofgem’s own analysis has shown that energy retail margins have averaged only 1.6% since 2005 – well below returns earned by supermarkets, high street retailers and telecoms companies over that period.

In addition, there are a number of other important barriers to new entrants, including:

- high collateral requirements, incurred when contracting for energy in wholesale markets;
- increasing complexity of Government policy and regulatory intervention, e.g. in relation to environmental and social obligations;
- a high level of volatility in underlying commodity costs and in regulated network charges;
- a high level of regulatory risk, as demonstrated by frequent reviews of the market and strong regulatory criticism and / or intervention whenever margins breach a certain level perceived by Ofgem as “too high”; and
- economies of scale particularly in the domestic supply business meaning that entry by small players is likely to be difficult – although this barrier can be overcome in the case of cross-sector entry by an established player in another market, as demonstrated by the recent launch of Co-operative Energy.

These issues are well summarised in the recent report produced by Frontier Economics on behalf of Energy UK<sup>13</sup>.

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

As set out above, we consider that Ofgem has significantly overstated the extent to which tariff complexity represents a barrier to competition and consumer engagement at present. However, we agree that there is scope for increasing the transparency of tariffs offered by suppliers – for example, by simplifying the way in which tiers of tariffs are specified, and the way discounts are applied.

Ofgem's initial proposals on tariff complexity are set out at a relatively high level. However, as they stand, they look to be a very complex and overly regulated way of achieving simpler tariffs. We have concerns that the far more regulated approach Ofgem seems to favour, combined with a prohibition on tariff offers (some of which are well understood by customers in today's market, such as dual fuel discounts), will not benefit customers.

Rather than mandating a regulated standardised charge, we believe a more proportionate approach to address Ofgem's concerns would be for Ofgem to work with suppliers and consumer groups to develop and implement a new Code of Practice (COP) on tariff structures. This COP could, for example, require all suppliers to include a cost reflective pass-through / standing charge, combined with a single tier p/kWh. If such an approach is adopted, it is critical that the pass-through / standing charge element must reflect the fixed costs of supplying energy. If this is not the case, then significant market distortions will result (as lower consuming customers would tend to become loss making for suppliers).

Another approach which could be adopted, either in addition to or instead of a COP on tariff structures, would be to require suppliers to set out an APR-type measure (similar to that used in the finance industry) that customers could use to compare tariffs. However, the APR would need to be specified carefully to ensure that it accurately reflects the cost structures of suppliers and the price charged to end consumers.

We also note that Ofgem has already made extensive changes to the regulatory framework for the energy retail market as part of the 2008 Ofgem Probe. While in the main the Probe measures were not specifically targeted at addressing tariff complexity, they did have the overall goal of improving customer engagement and trust in the energy market. It would be sensible to allow these changes to embed and mature, and their impacts to be assessed, before implementing a further suite of licence changes.

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

No. As set out above, while we recognise tariff complexity is an issue where there is scope for improvement within the industry, we do not believe Ofgem has made a case for the degree of intervention proposed in this consultation. We support the overall goal of enhancing customer engagement in the market (although as noted previously the GB retail market is already highly competitive), but do not believe that any compelling evidence has been tabled that would support the view that Ofgem's proposals are proportionate.

In particular, we have significant concerns regarding Ofgem's requirement that customers will be forced to sign up to fixed term contracts (FTCs) in order to take advantage of the range of offers and discounts currently available to our tariff customers. While many customers do find fixed rate tariffs appealing, contracts such as these are not appropriate for all customers. Indeed, our market analysis indicates that the majority of customers are happy on their existing tariffs, and will not want to switch to FTCs. It is difficult to see how denying such

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<sup>13</sup> See: <http://www.frontier-economics.com/library/publications/frontier%20report%20-%20competition%20and%20entry%20in%20the%20gb%20electricity%20retail%20market.pdf>



customers access to discounts and incentives from which they currently benefit can be in their interests.

FTCs also tend to be more expensive than tariff offerings, particularly for contracts with duration of 12 months or less. FTCs place a range of additional costs on suppliers, for example increasing costs of more customer interaction through letters / call centres around time of renewal. FTCs also by nature require suppliers to increase the level of hedging they undertake in the market. Our analysis suggests that the combined effect of increased hedging costs and costs associated with fixed renewal date result in additional costs ranging from 1% for a 6 month product to 3% for a 3 year product.

We also have concerns that some customers may not be willing or able to take on the commitment of a fixed term contract (we have particular concerns about take-up of FTCs amongst the most vulnerable). Many customers value the flexibility that tariffs offer, and are unwilling to make a commitment to agree to a contract for a given duration.

Finally, recent evidence from the telecommunications sector suggests that fixed term contract markets are no guarantee of achieving the best outcome in terms of consumer welfare<sup>14</sup>. We therefore believe it is misleading for Ofgem to suggest that, by moving customers to the FTC market, consumers will unambiguously be better off. We would expect Ofgem to include detailed analysis of the disadvantages and additional costs to customers of FTCs in its forthcoming impact assessment.

Choice is one of the cornerstones of competitive markets and we believe that all customers must retain a large degree of choice over their energy tariff. Our feedback shows that consumers benefit significantly from having a range of tariffs available to them, from which they are able to choose the product that most suits their preferences and consumption level. This benefit would be drastically reduced were Ofgem to insist on a "one size fits all" regulatory policy for evergreen tariffs.

The development of new tariff offerings is also a key enabler to the benefits which can be realised from innovative technologies. For example, much of the benefit from smart meters and smart grids will only be realised if the price consumers pay for their energy varies by time of use. We have real concerns that restrictions on time of use, green tariffs and other structures which incentivise energy suppliers to help consumers reduce consumption may be detrimental to a number of environmental initiatives, including Government plans to roll out the Green Deal, and the public interest / economic business case which underpins the Government's mandation of smart metering. It seems ironic that, at the very time suppliers need to be developing and marketing innovative propositions to promote smart meters and the Green Deal, that Ofgem is proposing removing the ability for suppliers to innovate in the largest part of the retail market.

While some of these issues could potentially be addressed through the detailed design of the standardised tariff, we strongly believe that regulated retail tariffs should not be part of one of the most competitive energy supply markets in the world. Principles of better regulation, which have recently been reinforced through the publication of BIS's Principles for Economic Regulation, require that policy interventions must be proportionate and that the costs imposed by regulation must be outweighed by the benefits achieved for consumers. Ofgem's tariff simplification proposals contravene these principles – and are likely to result in a less efficient market, that delivers less innovation and choice for customer, and at higher cost.

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

We consider a far more proportionate way of promoting tariff simplicity will be for Ofgem to work with suppliers and consumer bodies to develop a new industry COP setting out best

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<sup>14</sup> Recent Billmonitor research on mobile contracts showed 76% of consumers were on the "wrong contract" wasting an average of £194.71 each per year. <http://www.billmonitor.com/national-billmonitor-mobile-report>.

practice in tariff structures. This would discourage (or even prohibit) those aspects of current tariff structures that empirical research suggests customers find most confusing. We would be happy to work with Ofgem, Consumer Focus, CAB and Which? on developing such a code. Another possibility which could be implemented alongside this would be to develop an APR (Annual Percentage Rate) measure similar to that used in the finance industry that customers could use to compare tariffs. Either of these suggestions could deliver tangible improvements in tariff transparency, without the need to introduce unnecessary restrictions on the way suppliers meet the needs of their customers.

A complementary measure would be to further improve the accessibility and accuracy of comparison websites, which as Ofgem rightly points out are a valuable way of reducing confusion over energy tariffs. The availability of these websites reduces the risk of any consumer harm, as consumers will tend to use these sites more frequently if they perceive complexity to be a problem. We therefore would be supportive of Ofgem's proposals to accredit comparison websites.

Finally, it is worth noting that there is already a regulatory framework in place to protect consumers from unfair and misleading pricing practices (amongst other forms of unfair trading) in the form of the Consumer Protection from Unfair Trading Regulations (CPRs). The Office of Fair Trading (OFT) and Trading Standards have wide-ranging powers to investigate and enforce against breaches of the CPRs, and Ofgem has not presented any compelling evidence that additional, sector-specific regulations are required in the energy retail sector.

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

As set out above, we do not believe that evidence of consumer harm supports the concept of introducing regulated standardised evergreen contracts. Instead, we would favour a voluntary supplier commitment to develop tariff structures that are simpler for consumers to understand. One potential tariff structure that we believe warrants further development is a pass-through / standing charge combined with a single p/kWh energy tariff.

A structure such as this would need to be carefully specified, as to be cost reflective, the pass-through / standing charge would need to recover all of those costs that are "fixed" in nature. If this were not the case, then suppliers would be required to recover fixed costs through the variable element of the charge. This would tend to make low consuming households less profitable (most likely loss making), and high consuming households more profitable.

This would result in a material distortion to the retail market, with suppliers naturally focusing resource on attracting higher consuming households. Lower consuming households would in contrast become far less attractive. This distortion could result in a number of undesirable developments in the market, an obvious one being that suppliers will have a reduced incentive to win lower consuming households (tending to reduce levels of switching in this market segment).

To avoid this, the pass-through / standing charge should include a reasonable level of those costs that are "fixed". This would need to include social and environmental costs and fixed elements of T&D costs. However, it would also need to include fixed elements of opex (e.g. cost of providing call centres etc.) and metering costs. Under Ofgem's more regulated model, determining an appropriate cost allowance for the standardised charge would be complex, adding significantly to regulatory burden for both Ofgem and the industry. We believe a less regulated approach –which would deliver similar benefits in terms of improved tariff simplicity – would therefore be a far more proportionate and appropriate approach.

**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?**

We think there is merit to developing ways in which contract and tariff offerings can be more accurately compared. As set out in our response to question 4 above, we believe improved comparator metrics could be a useful way in which tariff simplicity and comparability could be promoted. Such metrics could be introduced without the other more interventionist proposals set out in this section that could have unintended consequences for the market.

We would favour developing a standardised comparison metric similar to the "APR" model used in financial services. If used by all suppliers, then customers would find it far easier to compare both tariff and FTC propositions offered by suppliers. More work is needed to develop such a model, however we would suggest a combination of variable per unit charge alongside a standing charge metric would be able to capture most supplier offerings.

While this model would capture the price elements of propositions, it would not capture the non-price components of such deals. However, so long as such offers are clearly set out (and possibly evaluated), and stated separately to the price comparison, this would enable consumers to make an informed comparison between supplier offerings.

**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?**

A number of comments on the costs and risks of Ofgem's proposal are contained in our responses to Questions 3 and 4 above. To summarise, the key costs and risks we see from the proposals are as follows:

- Detrimental impacts on choice and competition – the proposals will restrict consumer choice and, if poorly designed, could undermine incentives on existing suppliers to seek out new customers. By setting prescriptive terms on how suppliers can compete the proposals may further increase barriers to new entry.
- Reduced incentives to innovate – the proposals will directly restrict tariff innovation and, in their current form, could have significant adverse impacts on the benefits that can be realised from innovative technologies such as smart metering.
- Increased administrative costs and regulatory burden – forcing a widespread shift to fixed-term contracts will add an additional layer of cost to the industry, since such contracts are much more expensive to administer than evergreen tariffs. Indicative estimates suggest that the combined effect of increased hedging costs and costs associated with fixed renewal date result in additional costs ranging from 1% for a 6 month product to 3% for a 3 year product. The introduction of a standardised charge will add significantly to regulatory burden by effectively requiring an annual price control review of suppliers' costs of provision. These additional costs are likely to ultimately fall on customers.
- Potential market distortions arising from non-cost reflective tariff structures – if Ofgem introduces a standardised tariff as proposed that does not fully reflect industry costs, this could create a structurally loss-making and disengaged group of low consuming customers who are not profitable for suppliers to serve.
- Undermining consumer trust – by introducing further radical changes to the market so soon after a sweeping set of remedies under the 2008 Probe, Ofgem's proposals send a strong signal to consumers and other stakeholders that the energy retail market is not functioning properly. This undermines trust in the sector and is completely at odds with the evidence of vibrant competition in the GB market.
- Regulatory risk and unintended consequences – all regulatory interventions introduce a risk of adverse unintended consequences, which by definition cannot be completely foreseen in advance. This is particularly the case when introducing such sweeping changes to a competitive market which is already functioning well in many respects. We note that the OFT's report on the implications of behavioural economics for competition

policy, which Ofgem references in its report, concludes that despite the existence of behavioural biases on the part of consumers, "in most circumstances, the pricing, marketing, and advertising practices of firms can still be viewed as benign with no need for action", and "[m]ore generally, markets can be self-correcting and interventions can potentially do more harm than good."

In contrast, the alternative proposals we have put forward – such as the development of a "best practice" code on pricing practices and an accreditation system for switching sites – are much lower risk, since they would complement the current competitive market arrangements rather than working against them. They are also less costly in terms of administration and regulatory burden, and in our view would be equally (and quite possibly more) effective in reducing complexity and increasing consumer engagement than Ofgem's proposals.

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

The emphasis put by Ofgem on increased liquidity to further stimulate retail competition is misplaced, given that new entry is unlikely to be commercially attractive at current levels of industry profitability. Ofgem itself recognises that retail profitability has been relatively low over a number of years.<sup>15</sup> Furthermore, there are clearly other barriers that are at least as significant such as the highly regulated nature of the energy market, including the range of social and environmental obligations imposed on suppliers. For small suppliers, the biggest issue they face is not so much liquidity but the capital requirements for credit risk.

Ofgem's analysis of the impact of liquidity and vertical integration on competition is weak, and continues to overlook the capital requirements for credit risk and the prospect of EU financial regulation (notably EMIR and MiFID) significantly increasing these requirements, threatening to make markets less, not more, liquid. In the wake of the financial crisis the G20 committed to central clearing of OTC derivatives. While this is designed to address credit risk, the unintended consequence for the GB energy market could be to make it more (not less) difficult for market participants to use markets to manage risk, as a result of lower liquidity.

The application of bank-style regulation to energy companies is not appropriate for a number of reasons. In particular energy companies naturally have long or short positions in the underlying physical markets, and so their use of derivatives is primarily to hedge and limit price risk (i.e. it is risk reducing, not risk increasing). Unless there are changes to the proposed MiFID exemption deletions, even creditworthy companies will face huge increases in their margin requirements. These increases will take the form of billions of pounds of cash and collateral that companies will be required to hold on their balance sheet to meet possible margin calls, above and beyond what they already hold.

The effect will be to discourage hedging and liquidity, reduce the use of the market to provide risk management options for customers and increase price volatility. Less well capitalised companies will be particularly vulnerable and others may look to become more vertically integrated. Ofgem therefore needs to use its influence to ensure European policy outcomes are in the best interests of GB customers, recognising that the capital requirements required to be in the business of energy trading and supply are otherwise about to get more, not less, demanding.

Ofgem's analysis on liquidity concludes that intervention designed to discriminate against vertically integrated participants (and not large independent generators) is an appropriate response. It is disappointing that Ofgem does not make a case to explain why discriminatory treatment against one set of large generators might be justified. For instance, Ofgem should consider why measures targeting six particular companies are justified, when another vertically integrated company, GDF/International Power, is excluded from the measures. The discussion about the link between vertical integration and liquidity has a long history, and

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<sup>15</sup> "Looking at the industry average over a number of years, the average retail energy margin has been below that earned in other retail sectors, and this result holds after making adjustments for key differences between sectors". (Retail Market Review, March 2010, Appendix 9, p.47.)

analysis from Ofgem and the European Commission<sup>16</sup> in the past has helped to demonstrate why vertical integration should not be seen as a competition problem.

Ofgem notes that to compete against an incumbent, a new entrant may have to enter both upstream and downstream markets, raising barriers to entry. To the extent that low liquidity is a factor in this assessment, it does not follow that vertical integration by existing participants is the cause. The barriers independent suppliers typically face are rather the capital requirements for credit risk. Credit and collateral requirements have increased over time, and are set to increase further, given the direction of European financial regulation. These requirements reflect the real costs of participating in energy markets.

Wholesale price volatility has recently been driven by frequent and sometimes significant shifts in fundamental supply and demand conditions which – paired with the essentially non-storable nature of electricity and the presence of transmission constraints/losses – result in volatile prices. In reflecting these underlying supply and demand conditions, price volatility plays an important role in the market in transmitting signals of tight or lax market conditions to participants and thereby inducing the supply and demand responses needed to keep the market in balance.

In this market environment, if players wish to hedge their market exposures by locking in prices in advance of real time, this does have a real cost and one that should be paid, to ensure that the level of forward contracting is efficient. In order to commit to market positions that may become significantly out of the money by the time of delivery, as in any financial market, market participants will put in place margin requirements to minimise the risk in the case of counterparty default.

Companies can seek to mitigate these requirements by securing a high credit rating or making investments that will reduce their contingent capital requirements, but clearly this may be more challenging for smaller or less well capitalised companies. There is nothing in the structure or conduct of existing vertically integrated players that raises the barriers that this operation of the market presents for other participants.

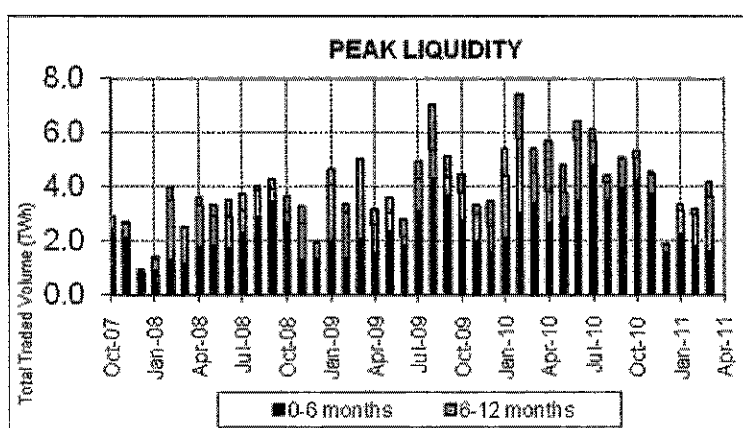
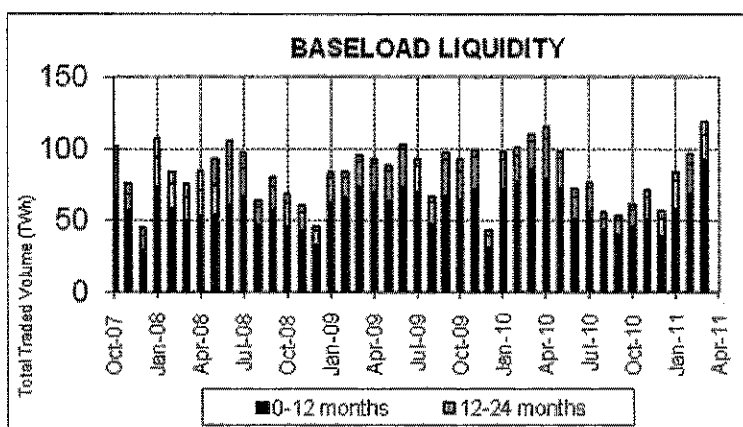
In fact, it is important to recognise that vertical integration is an efficient market response to input price volatility and it provides downstream firms with an efficient financial hedge. Integrated players still face incentives to trade to match the shapes of their generation and load positions, and to ensure that their generation assets are dispatched economically. There is no incentive for vertically integrated companies not to trade as it is not necessary to internalise own generation to achieve the benefits of vertical integration, since a financial hedge against volatile wholesale prices can also be achieved by trading generation in the market place. (In Centrica's case, for instance, 75% of our generation was traded on the market in 2010.) This explains why vertical integration and market liquidity are not generally correlated to one another.

Vertical integration can only raise competition concerns in the presence of significant market power at either the upstream or downstream level. However, the electricity market is unconcentrated both upstream and downstream. Accordingly, to the extent that there may be a liquidity problem in the GB wholesale electricity market (which Centrica does not think is the case) it is not due to vertical integration.

As regards the current state of liquidity, Ofgem has previously recognised that improved liquidity will take some time to develop, as industry initiatives such as N2EX gain momentum and as interconnection with neighbouring markets increases (notably to the Netherlands, through BritNed). However, it asserts that 2010 marked a decline in liquidity. This is not supported by the evidence.

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<sup>16</sup> Paragraph 460 of the *EU Energy Sector Inquiry*, paragraph 40 of the *EDF/British Energy* decision, M.5224.



While base and peak volumes do vary across the year, year-on-year trends do not suggest that there was any sustained downturn in 2010. By most measures liquidity was at least as high as in previous years and more recent evidence from early 2011 is consistent with this trend. Meanwhile, some of the structural changes to the market are moving ahead as promised. Market coupling on Britnred was successfully launched in April and in the same month N2EX appointed two market makers to its new UK power futures market. There continues therefore to be evidence of the industry responding to encourage the development of more liquidity.

**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?**

A well-designed auction could help to improve liquidity. However, the emphasis put by Ofgem on increased liquidity to further stimulate retail competition is misplaced, as discussed in the previous section. Therefore in setting objectives for the auction Ofgem needs to be clear about what objectives it can realistically achieve. Promotion of liquidity is a reasonable objective, but Ofgem should not assume a successful auction will necessarily lead to major new developments in retail competition.

Similarly the benefits for the government's electricity market reform project should not be overstated. While more liquidity would be positive, it is not true to suggest that future generation investment hinges on the development of a reliable reference price. Generation investments depend more on clarity on the regulatory framework through which investments will be remunerated. If government elects to introduce CFDs, generators covered by those CFDs will have an incentive to ensure their output is sold into the index against which their CFD is written and that they therefore receive the full strike price when the difference payment is made. This in itself will stimulate additional liquidity in the prices chosen to form the relevant index (all the indices relevant for EMR are only for baseload products). So the

regulatory risk investors face and the design of the wholesale market are more fundamental factors for potential investors than the future levels of power liquidity.

We do not think Ofgem has made the case for mandating market-making and we do not support this proposal. As with the proposed auction, there is again no case to discriminate against the six vertically integrated players by giving them a special obligation. This proposed discrimination will have economically damaging effects for the vertically-integrated companies since Ofgem plans to regulate the proposed bid-offer spread. To the extent this forces generators such as Centrica to trade on terms that are not based solely on our normal commercial principles, this potentially forces us to transfer value to competing generators and traders, who are not bound by similar requirements.

Ofgem has provided no evidence that this would be a proportionate response to the challenges faced by some market participants, and particularly why such detailed regulation should apply to some generators and not to other large generators or traders operating in the same market. Other generators or traders may be equally or even better placed to perform this role.

In indicating its desire to regulate the bid-offer spread, Ofgem should consider that this may discourage, not encourage, participation in the market. It amounts to direct intervention in the pricing of generation, leaving the generator further exposed to the regulatory risk and loss of value associated with possible ongoing Ofgem intervention to tighten the spread, should Ofgem deem that the initial permitted spread turns out, in its view, to be inadequate.

**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?**

No, for the reasons set out above we do not consider that both proposed interventions are required to meet the stated objectives. Our strong recommendation is that Ofgem and the industry should focus on the design of an appropriate MA mechanism and that this could potentially provide a solution which is both effective and proportionate.

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

Not at this stage. We believe the auction is a sufficient measure given the desire to accelerate improvements in market liquidity.

**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**

On the basis that Ofgem takes forward the auction proposal, it needs to develop and amend the terms of reference it presented in March. The overriding consideration in terms of auction design is that it should work with the grain of the competitive market and be designed so as to avoid distorting competition in generation. Given the GB generation market in which this auction will operate is competitive (unlike many of the markets in which generator auctions have been imposed), this is a serious consideration. The obligation will need to balance the requirement to place an "equal" obligation on all generators whilst avoiding distorting the normal market process of ensuring economic dispatch. (In France, for instance, given EDF's dominance, these considerations were almost entirely irrelevant in the design of the VPP.)

The definition of the volume obligation on generators will determine if this is achieved. We suggest that 10-15% of dispatchable generation should be required to be made available each year. This will ensure economic dispatch provided generators are able to set reserve prices that reflect market prices plus their hedging costs (and that generators are not required to accept weak credit support).

It must also be a requirement that all large generators are required to participate in the auction, not just the six big integrated players, since generators such as Drax and International Power are just as important in providing liquidity as integrated players. Centrica does not support an auction where the obligation to participate is restricted to vertically-integrated participants. Indeed we see no legal or economic basis for Ofgem to discriminate against a certain number of generators in this way.

We have a number of other important changes that we think need to be made to Ofgem's terms of references which we describe in the table below.

Issue	Ofgem MA (March 2011)	Centrica MA
Volume	10%, 15% or 20% collective annual volume obligation of total volume of electricity supplied in GB in a given year.	10-15% of dispatchable generation <u>capacity</u> to be <u>made available</u> each year. Volume should be defined by economic supply. Need to avoid distorting competition in generation.
Sellers	Big 6 mandated, others voluntary	All large generators (above a defined capacity threshold) mandated
Seller obligation	Big 6 mandated to sell	Generators should be required to make a given volume of generation available over the year.
Buyers	All, subject to approval	All, subject to meeting contract requirements including credit.
Products	Range of near and long term products, including potentially shaped products (e.g. standard domestic load profile)	Base and peak, season, year and 2 year ahead, including small clip sizes (1 MW).
Timing	Monthly, "with guaranteed availability of prescribed products and volume in each round".	Quarterly. Annual process needs to be defined to determine how generators meets annual auction availability requirement.
Reserve prices	Allowed provided not set at level which frustrates objectives of the auction. Role for independent trustee in securing reasonable reserve prices.	Prevailing market price plus transaction costs including slippage cost for hedging the fuel and carbon legs where appropriate (auction should not be a means to transfer value away from generators)
Contract	Unspecified.	Buyers sign up to GTMA terms and conditions
Credit	Fair and reasonable trading arrangements, including credit and collateral, that do not frustrate the objectives of MA.	Appropriate credit support for all transactions. No obligation to accept weak credit support.



Issue	Ofgem MA (March 2011)	Centrica MA
Duration	Unspecified.	Time-limited, in line with precedents from mandatory auctions in other markets.
Platform	Selection by competitive tender, established by parties in accordance with Ofgem's objectives.	Selection by competitive tender, or established by parties in accordance with Ofgem's objectives.
Governance	Independent trustee appointed to ensure MA is run in accordance with Ofgem's objectives	Independent trustee appointed to ensure MA is run in accordance with Ofgem's objectives

Ofgem should consider how it can use a competitive process to encourage the most appropriate platform to develop the required solutions. Ofgem calls for the industry to help provide a solution. However, Ofgem needs to provide guidance on the process it wishes to see evolve from here. For instance, given the concerns of small suppliers, Ofgem needs to indicate what process it will regard as adequate for taking into account all stakeholder concerns. If it fails to do this, large generators may be sceptical about the merits of pursuing joint initiatives with competitors, and of course, regardless of any Ofgem process, every participant has to be cognisant of its own obligations under competition law, and the potential risk of creating structures that may subsequently be seen as anti-competitive.

It is clear however that Ofgem should be looking for the most cost effective solution for customers. Existing power exchanges, notably APX and N2EX, are likely to be well-placed to build on their existing platforms and products to provide solutions that meet Ofgem and industry requirements.

**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?**

Power exchanges have incentives to appoint market-makers where their presence would help to promote liquidity. For instance, since the launch of Ofgem's review, N2EX has announced that EDF and RWE have been appointed as market-makers for UK power futures, helping to create a non-physical cash settled power futures market. Even on EEX, a multi-commodity platform covering various geographic zones, there are only 3 market makers for spot markets covering gas, electricity, emissions and coal and 5 for derivative markets. Nord Pool has one market-maker for each of its zone.

Instead of proposing a uniform requirement on six generators, Ofgem should therefore seek to better understand the demand for new market-makers and the costs of providing the service. Market-makers are more exposed to the costs of managing open positions. Depending on their generation portfolio and approach to trading and portfolio optimisation, some market participants will be better-placed and more willing to provide market-making services than other participants. Where Ofgem believes more market-making activities are required, it should seek to work with the power exchanges to encourage more market-makers to come forward. Exchanges have the experience in structuring contracts to incentivise participants to sign market-making contracts. Ofgem should draw on this experience.

This proposal also risks triggering a need for companies to comply with the Markets in Financial Instruments Directive (MiFID) by virtue of being market-makers. This would be extremely unfortunate given the concerns we have about the costs likely to be imposed by the full application of MiFID to the energy sector.

**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?**

We consider that British Gas's response to these Probe Remedies has been exemplary. We responded positively to the changes introduced by Ofgem by taking proactive steps to gain external input, including meeting with consumer groups, including Consumer Focus. We also conducted consumer research with our own Customer Panel to help guide and shape the final design of our bills and annual statements. We therefore committed significant resources to meeting both the spirit and the letter of the new licence conditions. This was a key reason why we were the only supplier to have our annual statement rated as "Very Good" by Consumer Focus in July 2010, with particular praise reserved for:

- The clear, customer-friendly language used;
- The well-designed graphs and illustrations;
- The frequently asked questions section; and
- The overall design of the annual statement, which is thoughtful and allows consumers to clearly access and understand all the information they need about their energy usage

At the same time, we outperformed all the other suppliers in a survey of energy bills conducted by Which? in July 2010.<sup>17</sup>

We note that Ofgem reports that it is "disappointed" with how some suppliers have responded to aspects of the Probe. However, rather than strengthen the current licence conditions around suppliers' communications and interactions with their customers, we suggest that Ofgem focuses on attaining a "level playing field" of supplier compliance with the existing Probe Remedies. Those suppliers who have failed to meet these standards should therefore be the target of greater prescription/enforcement action.

If this is not the case, and all suppliers are forced to revisit their communications and interactions with customers then this may mean that, in effect, those suppliers that acted in good faith in implementing changes brought in by the Probe Remedies are penalised since they will have to revisit this area, having already committed to significant spend, complied with the new licence condition and gained approval for doing so in a positive manner. As such, they will incur additional expenditure as a direct consequence of seeking to engage fully with Ofgem's Probe Remedies.

Ofgem's primary concern with the failure of some suppliers to respond positively to the implementation of the Probe Remedies is the customer detriment that such failure has caused. It is important, however, to make a distinction between customers of those suppliers that actively engaged and achieved positive comments from consumer groups about their actions in implementing Probe Remedies, and customers of those suppliers that have failed to engage. It is the latter's customers that have lost out. Ofgem's actions should therefore focus on spreading the benefits engendered by the full implementation of the Probe Remedies to those customers that have so far been denied them.

The one area where we believe there may be a case for further regulation is doorstep selling. It is clear from recent events that self regulation of energy selling practices has not been universally effective across the industry. Despite attempts by British Gas to put checks and balances in place, underpinned by substantial investment in technology and training, to eradicate mis-selling (including investment in state-of-the-art handheld terminals), the investigation by Ofgem into four other energy suppliers continues to undermine customers' trust in the energy sector. We therefore suggest Ofgem considers measures to ensure the relevant Probe remedies are implemented, and we would also support stricter enforcement/prohibition of selling (i) within No Cold Calling Zones (i.e. those zones which meet the OFT criteria) and (ii) at properties which clearly display Do Not Knock Stickers.

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<sup>17</sup> Energy Bills Report Card, Which?, July 2010 – available at: <http://www.which.co.uk/documents/pdf/the-which-energy-bills-report-card-218526.pdf>

Finally, we ask Ofgem to be mindful of the work which DECC is currently undertaking with suppliers on billing format change trials. Any further review in this area should be undertaken in a coordinated manner with the ongoing work with DECC.

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

Ofgem's principal statutory objective is to protect the interests of gas and electricity customers, present and future, wherever appropriate by promoting effective competition. It does so primarily through the supply licence conditions and it is therefore right and proper that it monitors suppliers' compliance with these and takes enforcement action where appropriate. While we recognise the need to ensure that all suppliers comply with the terms of their licence, it is important that enforcement action is proportionate, and allows for a human element in the way we interact with our customers.

In carrying out its monitoring and enforcement activities we expect Ofgem to act in accordance with regulatory best practice, as formulated and propounded by the Better Regulation Executive (BRE) and the Department for Business, Innovation and Skills (BIS). The BRE sets out five principles of good regulation which state that any regulation should be:

- transparent
- accountable
- proportionate
- consistent; and
- targeted only at cases where action is needed.<sup>18</sup>

We note that Ofgem itself makes reference to these principles in its Corporate Strategy and Plan 2009-2014, also stating that "Ofgem has a long standing commitment to better regulation in all our activities. We apply better regulation principles to the policies that we develop and the way in which we develop them."<sup>19</sup>

In addition, the recently published document from BIS on 'The Principles of Economic Regulation' sets out an overarching set of principles, the purpose of which is to:

- reaffirm the importance of stable and predictable regulatory frameworks to facilitate efficient investment and sustainable growth;
- set the framework for delivering greater clarity about the respective roles of Government regulators and producers; and
- set out the characteristics of a successful framework for economic regulation to guide policy makers in assessing future developments.

We would expect Ofgem's enforcement activity to continue to be in line with both these principles, as well as its own *Enforcement Guidelines on Complaints and Investigations* (which lists the criteria which Ofgem will generally apply when considering whether to proceed with an investigation).

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

Until we fully understand Ofgem's intentions in this area, it is very difficult to give a definitive view on whether we would welcome the extension of some elements of the Standards of Conduct into domestic supply licence conditions, since it is not clear which elements of the Standards of Conduct are referred to. Also, it is unclear whether Ofgem proposes merely to 'lift and shift' the Standards in their current form into the licence or to seek to amend them as part of the move, given its dissatisfaction with how some suppliers have responded to both the Standards of Conduct and licence conditions introduced as a result of the Probe.

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<sup>18</sup><http://www.bis.gov.uk/bre>

<sup>19</sup>Corporate Strategy and Plan 2009-2014, Ofgem, p.36

We would remind Ofgem that many of the Probe Remedies have only been introduced relatively recently so it may be prudent to reserve judgement on whether they have been successful or not. In our opinion, it would be sensible to give the Probe Remedies the opportunity to 'bed down' before leaping to unsubstantiated conclusions. Certainly, in some areas, for example the provision of annual statements, it would seem likely that their impact may take time to filter through and be able to be evidenced by increase awareness among consumers.

Notwithstanding the points above, our initial view is that we are confident in our ability to respond positively should elements of the Standards of Conduct be moved into the licence itself since they already form part of our everyday operations. For example, in meeting the overarching standard which states "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" we have transformed our field sales, demonstrating that we are market leaders in this area by investing in technologically advanced hand-held terminals and rigorously testing our processes with consumers and consumer groups in order to enhance them further. We are therefore confident that we would meet the Standards of Conduct should they be moved into the domestic supply licence itself.

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

We agree with Ofgem that more could to be done to improve consumer trust in the use of switching sites, and support Ofgem's proposal to introduce some form of accreditation for price comparison websites. This should include efforts to improve the operation of such sites and, for example, how they are monitored, updated, as well as how they display the choices open to a consumer. Once this is done, switching sites could be seen to deserve consumers' trust, making it easier and simpler to promote their usage.

This work should clearly also link to wider suggestions made in the Department for Business, Innovation and Skills' (BIS) recent strategy document on consumer empowerment, *Better Choices: Better Deals - Consumers Powering Growth*, to support the development of a self-regulatory quality mark for web and comparison sites, which might include a commitment to transparency on financial interests.

In addition, we note that there is a degree of uncertainty over the fate of the Confidence Code, given the planned changes to the consumer landscape which will result in the demise of Consumer Focus, which currently runs the scheme, in 2013. We expect the forthcoming BIS consultation on reform of the consumer landscape to cover this issue but we consider that the opportunity afforded by a transfer of responsibilities to another organisation should be grasped in order to also seek to improve operations.

Currently there are a number of shortcomings with the way switching sites work:

- Switching sites largely provide a price comparison, not a product comparison. Other benefits, such as Nectar points, electricity monitors etc are not included within a comparison;
- The legitimacy of the prices quoted can be questionable as comparisons are based on a time-stamped annual view and don't take into account price events;
- It can be very difficult for customers to understand the value of other non-discounted tariffs (e.g. fixed / price guarantee tariffs or green tariffs);
- Some switching sites only show tariffs from suppliers with whom they have a commercial relationship, in so doing excluding some suppliers and tariffs from a comparison and restricting customers' ability to locate the optimal deal for them;
- Switching site telephony operations are not governed by any controls in terms of the advice given to customers.

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

Our response to this question is confidential and can be found in Annex 2.

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

We do not consider a blanket extension of SLC 7A beyond the reach of micro businesses is necessary. A 'one size fits all' approach to regulating non-domestic contractual relationships is inappropriate – particularly with respect to non-micro business contract roll-overs. Larger enterprises have very different contractual needs and wants to micro business customers. Moreover, these customers have the capacity (including their own procurement teams) to make informed decisions and use the re-negotiation process as an opportunity to ensure their contract is right for them.

Instead, we would suggest Ofgem works with suppliers and consumer groups to ensure that the existing SLC 7A regulations are targeted at those customers that derive most benefit from their application. In principle, we believe it is appropriate to apply SLC 7A to those customers who typically do not have the time or ability to actively manage their energy accounts, or are able to engage with the renewals process (which may mean that, for some of the definitions of Micro Business, too many customers fall within the current definition). We are currently undertaking research into this issue which we hope will be helpful to feed into this process.

We understand Ofgem is also considering further regulation of contract roll-overs, within the micro business sector (including a possible ban on contract extensions for greater than 1 year). We strongly believe this would not be in the interests of customers, as this would:

- increase the number of customers on "out of contract" rates (increasing uncertainty over volume of energy to hedge);
- tend to increase contract lengths to compensate for a ban on automatic renewals (with a consequential increase in cost relating to a higher requirement for contingent capital); and
- increased renewal hedge risks (as greater variance in retention rates would result in higher purchase risks).

We support Ofgem's proposals to develop a series of factsheets, raising issues of interest for non-domestic customers. To maximise the impact of these factsheets, we would suggest that Ofgem works with suppliers and consumer groups to agree the scope and content of these factsheets. We would also be keen to work with Ofgem to agree ways in which these can best be promoted.

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

We believe that additional licence conditions surrounding the objections procedure are not required. The existing arrangements are fit for purpose, and allow suppliers to manage the large hedging and debt risks associated with early switching. The current arrangements afford suppliers the necessary flexibility to do this in the most appropriate way through the contract terms.

Suppliers use objection rights within the contract to resolve change of supply issues – which is preferable for both parties given the alternative is a long and expensive process of litigation/court action. We clearly set out the circumstances when we may prevent the customer switching in our non-domestic supply contract terms. These circumstances are clearly visible from the outset and customers have an opportunity to ensure they are acceptable prior to entering into the contract.

We strongly challenge the assertion that suppliers are deliberately using the objections process to hinder the change of supplier process. However, on a related point we are concerned that some suppliers may be abusing the change of tenancy process to falsely acquire customers. Our evidence suggests that some suppliers may be preventing objections

being raised to their application by indicating on industry flows that the acquisition relates to a new customer, despite there not being a change in tenancy. We would welcome discussions with Ofgem on both of these points when the RMR explores this area further, and will be happy to share our analysis of incidences of objections.

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

We believe the interests of our customers are best served by retaining the existing model where the overarching Standards of Conduct sit above licence rather than within it. The Standards of Conduct are aligned to our business values and ethics, and are regularly reviewed and monitored.

We do not see a clear argument for moving any of the existing Standards of Conduct into licence. Ofgem already gives regard to these standards when considering their priorities for investigating potential licence breaches and when considering consumer detriment in the context of investigations. It is therefore unclear what the benefit to consumers would be of this change. We therefore ask Ofgem to set out more clearly the benefits of any proposals it develops in this area – including presenting a detailed impact assessment.

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

We agree with Ofgem's initial proposal that it would not be appropriate to extend the tariff simplification proposals to the non-domestic sector.

As set out above, we do not believe that the most interventionist aspects of Ofgem's tariff proposals are in the interests of domestic customers. There is even less likelihood of any material consumer harm in the non-domestic sector from tariff confusion, given non-domestic customers tend to be even better equipped to make informed decisions in line with their business needs. These customers also have a higher propensity to satisfy their energy supply needs via a contract – over 80% of business customers are on a contract.

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

We absolutely agree that Ofgem needs to look further at the role of TPIs in the non-domestic market. TPIs play a valuable role in helping businesses understand tariffs and ensuring they get the best deal for them. However, we share Ofgem's concerns that not all brokers are genuinely independent or transparent.

Ideally, TPIs should be directly regulated to ensure there is suitable protection and recourse for businesses that are caught out by rogue brokers. This will be the most effective way of enforcing a change in working practice in the TPI sector. However, we recognise that this will require a step-change in the OFT's engagement in this sector to date, with consequential implications for resourcing. Attempting to fill this 'protection gap' with new licence conditions on suppliers will deliver a far less effective protection for non-domestic customers.

However, we recognise suppliers have a role to play in upholding TPI standards through contractual relationships. We therefore support the development of a Code of Practice designed to ensure TPIs uphold quality standards and principles, including transparency and fairness. Suppliers could agree only to work with TPIs who have signed up to this Code. ERA members have already started initial discussions to develop such a Code of Practice.

In February 2011, Consumer Focus commissioned research into TPI services for micro-business customers. We support most of the recommendations of this report, including:

- The provision of better information to consumers about TPIs, which suppliers can facilitate through website updates.

- A ban on all TPI contracts that preclude non-domestic customers from contacting their suppliers – customers should be free to engage directly with their supplier.
- Mandated accreditation by end of 2011 for TPIs providing services to micro-businesses – micro business customers are most likely to fall foul of unscrupulous TPIs.
- Creation of a Code of Practice through the ERA – conversations between ERA members are already underway.
- Verification of TPI contracts with micro-businesses – call recording of all telephone contracts in full and available to customers on request. We also acknowledge that mis-selling still occurs before the customer reaches this stage, and also support any proposals to address the issue in full.
- Suppliers providing information to the TPI trade body on the number of micro-business contracts not verified and TPIs involved

We also support greater transparency over the level of TPI commissions, and consider this should also be included in the Code of Practice developed through the ERA.

**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?**

We fully support this proposal, and have set out our views in more detail in our separate response to the financial reporting consultation.

In summary, we support the proposed changes to supplier guidance for the segmental statements. However, we have concerns that these are not significant enough to address any of the accounting "adjustments" that have been highlighted by Ofgem in some supplier statements (and which are the root cause of the most severe cross-comparability problems). We would hope that the terms of reference of the accounting review would explicitly include introducing a standardised approach to such adjustments as an explicit objective.

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

Aside from setting out guidance that would address the need for accounting adjustments (as set out above), we think Ofgem has proposed a sensible set of changes to supplier guidance for next year's segmental reports. We fully agree that it would be inappropriate to introduce a requirement to prepare comprehensive set of regulatory accounts. Detailed regulatory reporting is appropriate for industries that are regulated monopolies that are not subject to competitive pressure. Given the competitive nature of the energy retail market, as well as the commercial sensitivity of such data, it would not be appropriate for such accounts to be prepared.

We also agree that mandating compliance with either IFRS or UK GAAP would not make sense, given the ongoing consultation on proposed changes to accounting standards.

**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?**

Significant protection is already in place to protect the most vulnerable customers. In addition to consumer protection legislation which applies to gas and electricity markets as it does to other areas, energy suppliers are also subject to a series of stringent requirements in the form of a range of licence conditions.

There are also a range of additional protections offered to vulnerable consumers through self-regulation. For example, ERA members have signed up to the ERA Safety Net pledging to never knowingly disconnect a vulnerable customer at any time of year, where for reasons of age, health, disability or severe financial insecurity, that customer is unable to safeguard their personal welfare or the personal welfare of other members of the household. We go even

further than this in the protection of our vulnerable customers (for example, we disconnected only two domestic customers for debt in 2010 and have yet to disconnect any in 2011).

In the context of these existing extensive protections, we would question the need for Ofgem to consider the need to introduce additional consumer protections for vulnerable customers.

**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?**

A single evergreen tariff per payment type would preclude any possibility for price differentiation between tariffs on a regional or any other basis. Therefore, the proposals would fully address the concerns on regional price differentiation which prompted the introduction of the undue discrimination condition and indeed go far beyond the scope of that condition.

Suppliers are effectively already prohibited from discriminating between customer groups on price and any other principal terms of supply under SLC 25A. However the current prohibition is subject to two important caveats: (i) objective justification for a differential (i.e. cost reflectivity or in the context of time-limited initial offers) and (ii) a materiality threshold with respect to the size of the differential and consumer detriment. These caveats recognise that there are legitimate reasons for differential pricing in certain circumstances and that this does not automatically result in material detriment to consumers.

The importance of these caveats is recognised in Ofgem's own guidance which states that the undue discrimination prohibition "is not intended to diminish in any way the ability of Suppliers to innovate, roll-out or test new products, improve their efficiency or competitive advantage over other Suppliers or introduce initial or "incentive" offers in a legitimate attempt to penetrate certain markets or acquire new customers".

By contrast, single tariff pricing removes entirely suppliers' ability to innovate and compete for customers via these types of competitive initiatives. Therefore, to the extent the new proposals remove the ability for suppliers to price differentiate, they do so only with respect to differentiation which Ofgem's current guidance recognises to be objectively justifiable or to have no detrimental impact on consumers. There are clear inconsistencies here with Ofgem's proposals for single tariff pricing.

As regards LTCs, Ofgem's current guidance recognises that LTCs are by their nature only offered on specific terms for a period of time (whereas Ofgem is primarily concerned with discrimination arising from enduring terms and conditions). On that basis, under the current regime, differential terms applicable to fixed tariffs are not considered to be discriminatory provided they are offered on a non-discriminatory basis.

Therefore the new proposals would not represent a material change to the current undue discrimination rules with respect to LTCs. Further, under the new proposals, suppliers' ability to apply differential prices between regions would be limited by virtue of the requirement to publish an "evergreen equivalent" price on the LTC, thereby providing complete transparency to the customer of any price differentials between the LTC and applicable tariff price.

On that basis, we consider that Ofgem's proposed measures would effectively remove the need for a licence condition prohibiting undue discrimination.