The Retail Market Review – Findings and Initial Proposals
Response by E.ON

Executive summary

1.1 At the time Ofgem launched its Findings and Initial Proposals of the Retail Market Review (the "Initial Proposals") in March 2011, the rhetoric it used to accompany the launch led to headlines of "profiteering" and "rip-off" across large sections of the press. The published documents themselves present a rather more measured view, with it being clear that, far from ripping off customers, companies have earned energy retail margins averaging only some 1.6% since 2005, well below the benchmark margins that Ofgem presents for other retail businesses and even for a theoretically perfectly integrated utility[1].

1.2 Other areas of the published Initial Proposals equally presented a less extreme and more balanced view than might have been anticipated by someone who had only heard or read the press coverage. Therefore, for example:

- The Ipsos MORI survey carried out by Ofgem showed engagement with the market, with consumers having a good awareness of switching, an appreciation that it was easy to decide which deal to switch to and a full understanding of what they were switching to;

- The evidence of non-compliance with the existing Probe remedies in relation to residential customers was patchy and uneven. There were some examples of failure to comply, which were properly being pursued by Ofgem, but the Initial Proposals in no way revealed a widespread disregard and lack of compliance with those remedies;

- There was some emerging evidence of consumers beginning to feel some of the benefits of those Probe remedies, even though these were at early stages;[2]

- On the business side, the evidence was, if anything, thinner, with Ofgem indicating that it was still investigating this area in relation to compliance and raising only three fairly general issues – one of which

[1] The Retail Market Review, Findings and Initial Proposals, Supplementary Appendices, Appendix 8, pages 42-43

[2] Although the annual statement requirement has only been in place since July 2010, the Ipsos MORI poll revealed that already 42% of customers felt that they had received clearer information from their supplier about the name of the tariff they were on and 45% had received clearer information about any changes to their tariff and the forecast cost of their consumption over the coming year.

was an apparent claim by a third party that had not yet been investigated; and

- In relation to liquidity, Ofgem indicated that its assessment of liquidity was not yet completed[3] and presented what it later described to us in a meeting as a "menu" of options.

1.3 Ofgem's proposals fall into three main areas: Retail market proposals, market liquidity proposals and segmental reporting proposals.

Retail market proposals

1.4 By most measures the retail energy market actually works well:

- It is highly competitive, with no evidence that high margins are being earned or could be sustained, as Ofgem's own evidence shows;

- There are six large competitors, with an emerging competitive fringe, including the entry of a substantial new player recently in the form of Co-Operative Energy;

- The vast majority of customers are aware that they can switch and switching remains at high levels, with the Chief Executive of Ofgem himself recently commenting to the Energy and Climate Change Select Committee that switching in energy was at higher levels than almost any other comparable sector, being higher than fixed line telephony, mobile telephony, mortgages and personal banking and the only other product with higher switching rate is motor insurance[4];

- Suppliers are innovating in their products within the existing market framework and the advent of smart metering is likely to open this up further;

- Companies have responded to the remedies introduced by the previous Probe inquiry and their actions are beginning to have impacts on the market.

1.5 However, we do accept that there are some weaknesses in the market and we are not complacent, particularly about the way that suppliers are viewed by many consumers. We would like the industry's standing to be higher and, whilst it is unlikely by the very nature of energy products (as a grudge purchase that consumers have no option but to take) that

[3] Op cit, fn 1, page 21

[4] Alistair Buchanan CBE, Chief Executive Ofgem and Andrew Wright, Senior Partner Markets, Ofgem, 18 January 2011, in response to Q21

energy suppliers will ever be popular, we would like to increase the trust with which we are regarded. E.ON has been focusing specifically on this "trust" aspect in its advertising and communications with consumers.

1.6 We also accept that, if a number of customers perceive the market to be complex, when this is coupled with the low interest energy has for most consumers, it makes it less likely that they will search for better offers.

1.7 However, Ofgem's reaction to the issue of complexity has been a dramatic attack on consumer choice and on innovation in the market, without any evidence that consumers will be more engaged in the market as a result of the proposed remedies or that the certain detriment to many consumers would be outweighed by the potential benefits to others. Over two million E.ON customers could be adversely affected.

1.8 We do not support Ofgem's approach and show in the body of our response that Ofgem's analysis and hence confidence in its conclusions is quite flawed. Nonetheless we are supportive of taking action to improve consumer choice. We believe improvements could be made to reduce complexity in the market and encourage further consumer engagement, thereby reducing any existing distrust in price comparison sites and telephone advice centres, which will be essential to effective consumer choice when smart meters offer an increased range of products.

1.9 We believe the market needs to get to a situation where consumers are not deterred from looking for an alternative product or supplier by fear that it will require too much effort or be too difficult. Consumers should be able easily to:

- access enough and sufficiently simple information about products;
- to enable them to engage effectively with the market; and
- make an informed choice;
- should they wish to do so.

1.10 We have put forward proposals in our response, which we summarise below, which we believe will help lead to these results. They are as follows:

- A common language for products and product components;

- Exploring the options for a common price element, ranging from simple language and structure to a possible £100/£200/year/fuel standing charge for all products;

- Enhanced product description at sale:
    - Presented in "key facts" format;
    - Identifying risks; and
    - Presenting the action required at the end of the fixed term;

- Internet sales to be subject to the marketing licence condition;

- Advertising to go further than the ASA requirements, through inclusion of a requirement to have regard to the risk of confusion;

- Enhanced information at renewal (at the end of a fixed term), including a comparison to the relevant evergreen product;

- Consultation on conditions to allow the roll-over to a fixed term with an exit fee; and

- The sunset clause on SLC25A (no undue discrimination) to be extended to July 2016.

1.11 We accept that increasing consumer trust is a long term programme. It will require clear understanding of what engages customers, improvements in the information given to customers and a common understanding of the standards of conduct which are required. We are ready to work together with Ofgem on this and will look to Ofgem to lead the process of building consensus.

1.12 However, it will be as important as the actions taken by suppliers and other industry parties that all stakeholders seek by their public comments to support the aim of building trust. If suppliers are to continue to drive the customer engagement that is necessary to achieve energy efficiency and decarbonisation within the home, through programmes such as the Green Deal, the Energy Company Obligation and suppliers' own initiatives, it is essential both that suppliers continue to improve but also that others such as Ofgem and Government seek to change the rhetoric employed.

Wholesale market proposals

1.13 We have looked at the "menu" of proposals put forward by Ofgem in relation to the issue of improving access to wholesale market products for new entrants and independent suppliers and generators and/or building a robust reference price in the market for the purposes of Electricity Market Reform and otherwise. We believe that:

- Participation by all licensed generators who are, or have links to, licensed suppliers, in a day-ahead auction would be helpful in establishing a robust market reference price, which will provide an easily accessible and suitable deep day-ahead market for independent suppliers and generators;

- The recent N2EX developments reducing minimum clip sizes in its day-ahead auction from 1MW to 0.1MW will be helpful to small suppliers and generators. This will help small market participants gain better access to the small volumes they require and reduce the amount of capital they need to meet their trading volume requirements. Consequently, there is no need for regulatory intervention to impose smaller clip sizes;

- Market making for the Great Britain power futures market has recently commenced. With this development the case for intervention to impose mandatory market making seems to have been superseded;

- A robust market reference price derived from a day-ahead auction, coupled with active market making, will help to facilitate better support of trading and hedging in all timeframes. As a result other auctions covering timescales further out are not required;

- Mandatory market making in power is not appropriate for generators. To require it would not be aligned with the European Regulator's (ERGEG) proposals on market makers[5] and would require physical generators to become FSA authorised financial traders;

- Financial regulations being proposed by the European Commission could soon make the provision and use of market making by generators and small suppliers impractical;

- Smaller suppliers and generators would benefit from the presence of volume aggregators in Great Britain, as seen in the German and Nordic power markets. Support from Ofgem in facilitating the development of a volume aggregation service would be very helpful; and

- A greater understanding of the products already available for small suppliers would help reduce some of the perceived barriers to entry for new suppliers. Support by Ofgem in publicising the different initiatives being taken by existing market participants, such as E.ON, would help

[5] ERGEG draft advice on the regulatory oversight of energy exchanges Ref: C10-WMS-13-03 5-APR-2011.

achieve this. In E.ON's case we have recently launched a Wholesale Energy page on the E.ON UK website[6] where we explain how we offer a number of wholesale gas and power products that could be of interest to electricity suppliers.

1.14 We would welcome the opportunity to work with Ofgem to develop ways for encouraging greater participation in the day-ahead auctions.

Proposals on segmental accounts

1.15 Ofgem suggests the appointment of a leading firm of accountants to review the transfer accounting pricing and hedge accounting practices of the vertically integrated firms to ascertain how they impact on reported profits and transparency. However, Ofgem does not explain with what the impact will be compared. Also, a clear distinction between transfer pricing and hedging needs to be drawn. We therefore suggest that the remit for Ofgem's leading firm of accountants be set as:

"to review the transfer pricing and hedging accounting practices of the firms in the sector that prepare Segmental Statements, as required under Generation Licence Condition 16 and Electricity and Gas Supply Licence Conditions 19A and report to Ofgem whether the practices are:

1. *consistent with the OECD's principles on transfer pricing; and, where the practices are not consistent, to identify the minimum adjustments necessary to bring them into compliance and to report to Ofgem the likely impact of these adjustments on reported profits and transparency; and*
2. *fully reflected in the Segmental Statements; and where the practices are not so reflected, to identify the minimum adjustments necessary to bring them into compliance and report to Ofgem the likely impact of these adjustments on reported profits and transparency."*

E.ON

1 June 2011

[6] http://www.eon-uk.com/contactforms/wholesalegasandpower.aspx

CHAPTER: Two

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

2.1 Ofgem's Retail Market Review paints a picture of the market which is quite different from the market in which we compete:

- Our market of six competitors is relatively competitive by most normal benchmarks (Ofgem's benchmark of supermarkets for instance has four major players);

- Our profits have been small or even negative in recent years, quite contrary to the impression that there is a problem of lack of competition in the market;

- Although energy is of low interest to consumers, almost all are prepared to switch. Switching increases at any price increase and there is a continual erosion of market share in our home areas.

- Although less active (described as "sticky") customers may pay more, this is relatively little (c£40) compared to other industries and all are protected by the no undue discrimination licence condition introduced in the Probe;

- Tariff structures are not simple but most prospective switchers do not see the tariff structure, instead being quoted a simple annual bill by a price comparison website or our sales agents using pentablet technology.

We comment below on each individual section of Chapter 2.

Complex tariff information

2.2 It is easy to label energy as complex as there are undoubtedly features which could be simpler and there are characteristics of the energy market which make it seem more complex than other markets, for example:

- The units used, kWh, are not tangible, unlike the units used in, say water or telecoms;

- Whilst a forecast annual quote is simple to understand, it is not "firm", unlike in insurance, for example, (e.g. for most products it will depend on usage, which itself will depend on weather, occupancy and other factors). As such, it is difficult for consumers to confirm and hence to trust;

- Few consumers are as interested in understanding products and prices in energy as, say, with mobile phones. Energy is not "sexy"; it does not facilitate their social life or make their life better – it is a necessity product and a grudge purchase.

2.3 A perception of complexity may therefore be inevitable and some care is required in deducing what the real impacts are, beyond the general, and important, issue that complexity can put consumers off searching for tariffs and contributes to a lack of trust in the energy market.

2.4 The other assertions of Para 2.7 may not be correct[7]:

Assertion	**Our view**
Consumers less aware of their expenditure on energy and so less likely to engage	There is no evidence that complexity rather than attitude is a material cause of lack of interest in bills. Consumer spend is clear from the bill. Moreover, changes to the bill (a high bill, a direct debit increase or a price increase) can trigger switching. It is probably true that complexity in the bill *calculation* reduces engagement with energy efficiency, but that is a quite different issue and is being tackled by the development of simple comparisons.
May lead to consumers abandoning their search for better tariffs	There is no data on how material this is, or clarity over what aspect of complexity might cause abandonment. Price comparison sites and sales agents seek to simplify tariff comparison, by showing annual spend and key features. Few consumers will therefore see tariff complexity, although there are issues of how the range of products is displayed[8] and of a lack of trust in price comparison sites leading to consumers seeking another source to confirm prices.
May result in an increased frequency of poor switching decisions	Given the simplicity of presentation by price comparison sites and by sales agents it is unclear what the causal link between tariff complexity and the switching decision is. Nor is there any recent analysis of the number of customers who do make a poor switching decision (which is quite different from a good decision, which turns out poorly – e.g. if there is

[7] Ofgem's conclusions seem to be driven from anecdotal comment from the Consumer First panel of 100 consumers, rather than any quantitative research. It is not clear what the basis is for the statement in Appendix 6 Para 1.35 that "*consistently* across our research, consumers identified the number and complexity of tariffs as being a barrier to engaging with the market".

[8] E.ON consumer research, consistent with concerns over price comparison sites

	an unanticipated price increase). However, there is evidence from Ofgem's Ipsos MORI poll[9] both that the majority of responders found it easy to decide which deal to switch their gas or electricity to[10] and that they fully understood the key features of the deal they switched to,[11] as well as that the majority believed that they were paying less post switching[12].

2.5 The lack of a robust explanation of the impact of complexity on consumers brings into question the effectiveness of any proposed remedy, other than the potential benefit of a programme to build trust (which itself will require a consistency of purpose which must be based on robust evidence and analysis).

2.6 Ofgem's statement in para 2.8 that consumers need a motivation to change is self-evident, but it is not true that consumers on evergreen products lack any prompt to engage. House moves, price increases, high bills, poor service, media reports and direct marketing all act as prompts, and the effect of the annual key facts statement is yet to be seen. Nor is it necessarily the case that intervention is the best response to this issue – as the Office of Fair Trading (OFT) has commented, where markets would otherwise self-correct, intervention can be unnecessary or even harmful. Moreover, even if markets cannot self-correct (which seems highly unlikely to be the position here), care must be taken when intervening because it is not always clear that interventions will improve outcomes for consumers[13].

Complexity of individual tariffs

2.7 The OFT research is informative, but has a limited sample size. The OFT interviewed 3,015 consumers, of whom 343 had experienced complexity in the energy market and 141 had found it difficult to decide on a supplier or product. The analysis presented in box 2.1 is based only on the feedback from the latter interviewees.

2.8 It is unclear what inferences should be drawn. For example:

- Is "too difficult to calculate amount to pay" a general issue, reducing confidence in the market, or a specific issue for those consumers who want to check prices? If the former, then any potential remedies

[9] Ipsos MORI, Consumer Engagement with the Energy Market – Tracking Survey 28 January 2011
[10] Supra, page 31
[11] Supra, page 32
[12] Supra, page 30
[13] OFT 2010, What does behavioural economics mean for competition policy? OFT 1224, page 34

should encourage, not restrict, products such as our StayWarm product, which has a fixed price to pay regardless of consumption and therefore avoids the need for this calculation. If it is specific to those who want to check prices, how material is this, and would it be more effective to improve trust in price comparison websites?

- If only 21% of responders said "there are too many options" how negative is this? Does it not suggest that 79% did *not* find there to be too many options?

- Is the proportion of customers who really find the market "too confusing and complicated", 40% (of 141), or 16% (of 343) or 2% (of 3015)? The distinction is important as if the proportion who genuinely find the market confusing is relatively low, but a much higher proportion perceive it to be complicated, then any remedies must include a programme to build trust. The remedies must lead to demonstrable improvement – the programme we outline would, albeit over a period of time, whereas Ofgem's proposals may not change the perception that there is too much choice of products.

Switching decisions (para 2.14)

2.9 It is not clear what causal link there is between complex pricing structures and poor switching decisions. The research says that a proportion of consumers do not see the savings they expect, but this seems more likely to be due to a lack of understanding of the risks in a variable priced product. A proportionate remedy could be to improve information about risks.

2.10 Ofgem suggests in para 2.14 that the Ipsos MORI poll shows that 'one-third did not know whether they had saved money'. Actually, it does not show that – the results show that 26% of gas customers and 25% of electricity customers did not know whether they had saved money or not, much closer to a quarter than a third. The others either believed (to the best of their knowledge) that they had (62% and 64%) or that they had not (12% and 11%).

2.11 Nor would the finding "one-third did not know whether they had saved money" *necessarily* be a cause for concern. Although we accept that the base here was specifically customers who switched supplier to save money, looking at this issue more generally, analysis of sales made by our field sales agents[14] shows 67% customers switched to a lower price, 25% switched without a price comparison and 8% switched to a higher price.

[14] This data is captured on the pentablets

Those who switched without a price comparison will normally not have known what product they were on but been attracted by the features of our product. These features will normally have included some promotional benefit and it is unlikely that a consumer on an enduring product (amongst whom would be anyone less engaged with the market) would have made an incorrect decision[15].

Multiplicity of tariff options (paras 2.13, 2.15 -2.17)

2.12 Ofgem does not quote the source of the conclusion that multiple tariff offers are deterring customers from considering switching nor does it offer a hypothesis as to how reducing the choice of tariffs consumers are currently on (as Ofgem proposes) would make it easier to absorb multiple tariff offers.

2.13 Ofgem's research does show that 22% of customers do not switch because they perceive switching to be a hassle. However, it is not clear whether searching is perceived as a hassle or the switching process itself, or whether this is a perception or based on personal experience.

2.14 It is not clear therefore whether consumers are really deterred by the number of tariffs or just have a natural wish for there to be fewer and, if the latter, how strongly this view is held. Our own research suggests that it is the presentation of the number of tariffs which is the issue, coupled with consumers' low interest in energy (for example, there seems to be general acceptance of the much higher number of tariffs in the mobile phone market).

2.15 Ofgem quotes in para. 2.13 from the OFT's paper on behavioural economics[16], from footnote 21 in that document which refers to advice given by a consultancy not to the energy industry but to the banking industry. The fact that a consultancy may advise participants in a different industry to deliberately use complex price systems to make comparison harder does not in any way support a proposition that it is done in energy, whether deliberately or accidentally. Indeed, given that the most usual metric of comparison in energy is the forecast annual bill, as supported by the Probe remedies, this would not seem to be a potentially very successful strategy in energy in any event.

2.16 We reject the implication in para 2.13 that we have developed new products in order to confuse customers, and believe that the range of products we offer is proportionate – giving customers the benefit of

[15] The scenarios where the decision might be incorrect are (a) consumer is on a promotional product with their current supplier, (b) consumer is on an older fixed or capped rate product

[16] Op cit fn 12

choice, without adding minor variants (Annex 1 includes an example key facts presentation).

2.17 We offer three further observations:

- The majority of consumers who switch are guided through the range of tariffs by a sales agent. This process could be improved by the use of common language and a clear key facts presentation, but the number of tariffs is not an issue;

- Part of our own increase in the number of tariffs has been through the desire of our partner, Age UK, to offer a full product range. A partner such as Age UK can act as a trusted adviser, bringing in to the competitive market customers who might otherwise be less engaged; and

- Much of the increase is in the number of online products. Price comparison websites should make it easy for consumers to navigate the range of products and to compare the number of products they want to. A key part of the programme to build trust must be to seek to reform the price comparison website ("PCW") market, improving information provided to allow consumer to make more informed choices.

Conclusion

2.18 We agree that it is beneficial in any market to reduce complexity and that we should look at what could be done in energy to ensure that any complexity does not deter customers from engaging with the market. We are supportive of a programme to reduce complexity and to build consumer trust and we set out some proposals in Annex 1.

2.19 However, a far clearer understanding of the impact of complexity than Ofgem has provided is required (and we do not believe will be substantiated) to conclude that an appropriate remedy is to remove rather than improve customer choice[17]. As the OFT said, quoting John Stuart Mill, in its document on behavioural economics[18], relied on by Ofgem:

[17] Indeed it is not clear how such a case could be made. A Utilitarian argument that more customers would benefit by reduced fear of complexity than disadvantaged by loss of their existing product, or potential choice of product, would need to assess the magnitude or potential benefit and certain loss.

[18] OFT 2010, What does behavioural economics mean for competition policy? OFT 1224, page 34

"All errors which [man] is likely to commit against advice and warning, are far outweighed by the evil of allowing others to constrain him to what they deem his good."[19]

The OFT comments that this quote highlights two overarching issues that often overshadow intervention: first, that we want solutions that solve the problem but we do not want to remove consumer choice and secondly, that there is no guarantee that authorities will necessarily improve the market or not create unforeseen consequences elsewhere[20].

Supplier conduct (para. 2.18 et seq.)

2.20 Ofgem has not provided us with any current issues relating to E.ON[21] in this area. It does mention a number of investigations that it is continuing with other suppliers, which are evidence of the enforcement process working properly as it should. There is some unfortunate damning by association that appears to be resulting.

2.21 We recommended in our response[22] to the consultation on fixed term offers that Ofgem publicise (without necessarily naming the supplier) cases where they have had to intervene. This would accelerate the market moving to best practice. It would also increase the transparency of concerns over market operation, reducing any exaggeration and consequent weakening of consumer confidence in the market.

2.22 Ofgem is not specific in Chapter 2 about its concerns over business market objections although suggests in Chapter 3 (para 3.74) that objections may be deterring customers from engaging with the market. We are not aware of any evidence of this and would have expected the requirement of SLC14.3(b) to explain the reason for the objection to have been sufficient (although perhaps could be strengthened by highlighting to customers what action they should take if they dispute the grounds). We believe objections are more likely to frustrate suppliers than customers; for example, the old supplier can respond to a notice of termination by undercutting[23] the new supplier's contract and then using the fact of the renewed contract as a basis for objection. Further work is required to understand the high proportion of objections from some suppliers. We would be pleased to undertake research to help Ofgem better understand the issues.

[19] John Stuart Mill (1859) on Liberty.
[20] OFT 2010, What does behavioural economics mean for competition policy? OFT 1224, page 34
[21] Ofgem raised two issues with us during 2010, which have been resolved.
[22] E.ON 7 March 2011
[23] Or, as we have experienced, highlighting the risk that delayed switching will lead to high out of contract rates and then offering a price match

Sticky domestic customers

2.23 Using Ofgem's definition, sticky customers are a feature of most markets. For instance, in the mobile phone market, 60% of customers are with their first provider and 74% have no interest in switching[24]. In the energy market 63% of customers are with their original provider (ex-PES electricity or BG gas, including dual-fuel) and 77% of customers who did not switch in the last year did not do so because they were happy[25] with their current supplier.

2.24 However, unlike, for example, insurance renewal, it is not possible in electricity to take advantage of sticky customers through price segmentation. The Probe remedy of a prohibition on undue discrimination prevents any higher prices to less active customer groups.

2.25 The Probe analysis[26] of customer engagement presents a more credible picture than the Review. It identified six segments:

- Disengaged 7%
- Older (happy as they are) 23%
- Loyalists 25%
- Under-confident and nervous 13%
- Unhappy potential switchers 17%
- Confident deal seekers 16%

2.26 This analysis supports the contention that many customers are deterred from switching by previous experience or by perception of complexity, but acknowledges that most customers might switch in the event of a prompt such as a price rise, house move, high bill, poor service or sales agent calling.

2.27 Our own research at the time of the Probe suggests a similar picture to Ofgem's then view. This research examines consumer attitudes towards

[24] 'Mostly Mobile' July 2009 Ofcom

[25] Ipsos MORI's question seems flawed here. Our research suggests that long-standing customers who have had contact with us are happy, but those who have had little contact have a low level of satisfaction. They would more accurately be described as 'having no interest in switching', which is an unstable situation – poor service, a price rise or any other prompt could easily lead to them searching for alternatives.

[26] Initial Findings Report October 2008 Ofgem, from Ipsos MORI Customer Engagement Survey July 2008

switching and suggests that around a quarter of consumers are fully engaged, a third would respond to a cheaper offer, a quarter are deterred by lack of interest (including a belief that switching is not worth it) and a sixth by lack of understanding. Nonetheless, research also shows that all attitudinal categories do switch, suggesting that the potential prompts are strong enough to engage most customers.

2.28 We do not believe that the market has changed materially over the last three years to alter our, or Ofgem's then, picture. The Probe informational remedies have yet to take effect, the reduction in overall market switching is slight and there is a continuing reduction in our electricity market share in the Eastern, East Midlands and North West regions.

2.29 By contrast the Review's finding that 50-60% of customers are disengaged (of whom 20-30% would never switch) is simplistic, providing little insight into how sticky customers might be. It is for instance, impossible for 50-60% of customers to be disengaged and for us to only have retained 20-25% of customers in the Eastern, East Midlands and North West regions as single electricity (plus 10% or so dual-fuel). Ofgem's table 2.1 paints a similar picture to this – at most 10.2 million accounts (21.4%) have never switched.

2.30 The fact that customers are much more likely to become engaged than Ofgem has assumed is also consistent with suppliers' observed caution over pricing, leading to low margins over the last few years and no substantive difference between enduring product prices offered by the six largest players and that offered by Co-op Energy (which has been highlighted as "fair").

2.31 We have also experienced an increase in *product* switching, i.e. within, rather than between suppliers, which may be a contributing factor to Ofgem's observation (para 2.50) that switching between suppliers has reduced (although our own experience has also been that churn has slightly increased over this period). As most larger suppliers do, we offer a full product range and it may be that as much emphasis in understanding why consumers miss out on the most appropriate product should be on switching product as on switching supplier. For example, to understand whether the Ipsos MORI finding that 20% of consumers who hadn't switched because they didn't think there was much difference between suppliers really meant that, or that they didn't think there were potential savings to be had.

2.32 It is clear that much more research is required to understand the differences between groups of customers and the barriers they face to getting the best deal for themselves. We recommend that this research also seeks the background to the results shown in figures 2.5 and 2.6. If customers have a strong preference for dual-fuel , it would be expected that the majority of single fuel customers were those who had not yet switched (and hence were with the incumbent supplier) and that single fuel switchers would be small in number and have a high churn rate.

Online vs. off-line segmentation

2.33 In our Probe response[27] we noted that the online market was not yet mature and that suppliers had yet to develop robust strategies. This in part explained some aggressive pricing which, if Ofgem were right about segmenting the market to target the most active customers, would be a loss making strategy.

2.34 Suppliers' motivation is in fact quite the opposite. Online prices are a means to acquire customers and are only sustainable if successfully targeted at customers who are satisfied with a single promotion and then continue on to an enduring form of their preferred product at the end of a fixed term period. The same strategy is available to new entrants, applies in other sales channels and is normal in other markets. Unlike some other markets, energy promotions are generally available to existing customers also, albeit that some prompt may be required for a customer to call their supplier or search a website.

2.35 If Ofgem believes that intense online competition is not in consumers' overall interest, then a potential remedy would be some restrictions based on the licence condition prohibiting undue discrimination. We would recommend Ofgem initiates any discussion of this by open letter.

Distribution of sticky customers

2.36 Ofgem is almost certainly right that vulnerable customers make up a higher proportion of customers who have never switched, although the fact that the number who report they have never switched is two to three times what is known to be possible suggests that figure 2.9 cannot be relied on[28].

2.37 There are in fact three sources of potential saving open to sticky customers, with quite different barriers and hence potential remedies.

[27] Response to the Call for Evidence. E.ON April 2008 para 4.11

[28] Further analysis is required of the impact of consumers moving property, amongst who may be a higher proportion of younger customers. A customer may correctly recall that they personally have never switched, but by moving premise may have changed supplier several times (albeit that a house move is commonly a strong prompt to change supplier, with up to three suppliers making contact). The customer will of course have secured any dual-fuel benefit from a previous occupant having changed supplier.

- Firstly, a truly sticky customer with electricity and gas supply could make a saving by switching to the cheaper of their current suppliers. There are no real barriers at present to this[29], but Ofgem's proposal could make it more complicated by ruling out any dual-fuel or promotional benefit. A programme to build consumer trust in the market could help, although principally we would hope to attract a gas switch through the evidence of our own service on the electricity account;

- Secondly, switching payment method saves customers a real cost and is strongly encouraged by suppliers. The constraint is not one of complexity, but of customers having a preference for their current payment method (or a supplier requiring prepayment);

- Thirdly, promotions offer a saving, although we cannot replicate the savings shown in figure 2.10. We believe savings to be more of the order of £100 or so[30]. Ofgem should consider what steps can be taken to remove barriers to customers taking up such offers. The proposals we set out in Annex 1 are designed to build consumer trust, to encourage a phone call – either to the customers' current supplier or to a price comparison site's agent – or an online search (although for this an additional barrier is that websites are not well-designed to help customers through a range of tariffs). If there is a barrier of consumer concern that taking up a promotion commits them to continually checking their tariff, then our proposal for greater clarity at the point of sale and for roll-over with safeguards would alleviate this.

Vertical integration and low liquidity

2.38 Ofgem links its suggestion that there is low liquidity in the wholesale market with vertical integration by incumbent suppliers. In fact, as has been made clear to Ofgem in previous responses, E.ON broadly optimises its generation business and its supply business separately, through its European trading house, E.ON Energy Trading ("EET") based in Düsseldorf.

2.39 In 2010 E.ON UK generation generated 29TWh. Our power supply was 48.3TWh, meaning that our supply exceeded our generation by some 19 TWh. EET's trading in 2010, for delivery in 2010 and beyond, saw sales outside of E.ON equal 106 TWh and purchases from outside of E.ON of 122 TWh. The difference reflects the view that our supply activities will be

[29] Assuming credit management is not an issue
[30] Greater savings may be possible when the forward curve has fallen sharply, to well below the typical level of any hedge

larger than our generation activities. This gave a total trading volume of 228 TWh. Therefore, for 2010 our sales through trading exceeded our generation by a ratio of 3.7 to 1.

2.40 This hardly supports the picture that Ofgem is seeking to present under which vertically integrated players are responsible for low liquidity in the market. Indeed, our own experience suggests that vertically integrated players are amongst the most active in the wholesale market. E.ON believes that other vertically integrated players, especially, for example, RWE and SSE, trade similar ratios to E.ON whilst it appears that the independent generators, for example, are much less active in trading (despite, as Ofgem suggests, demand from independent suppliers for trading partners). In 2010, our estimate is the six vertically integrated players together traded some 850TWh, more than double GB national demand in that year.

2.41 As we have said to Ofgem on previous occasions, we believe that there are two separate and largely unrelated issues to be addressed; first, Ofgem's continued concerns about liquidity in the Great Britain electricity wholesale market and secondly, how to better provide support for new suppliers. Thus, taking actions to raise liquidity levels will not be an effective way of helping entry in the domestic retail supply market. However, introducing distortion to the wholesale market specifically to help small suppliers would carry a real threat to confidence in wholesale trading, which could easily result in lower liquidity levels.

2.42 We believe that a pure focus on liquidity levels does not address the main problems facing small suppliers: namely that of trading in wholesale markets with high minimum clip sizes and those suppliers often having inappropriate capital backing for such trading. Action to improve the likelihood of small supplier market entry must focus on providing trading arrangements that facilitate the procuring of volumes that are below the traditional minimum volumes for a wholesale market and also support the efficient use of limited capital strength.

2.43 In this context, N2EX's recent agreement to amend its day-ahead auction to a minimum clip size of 0.1 MW, with the clear intention of helping smaller suppliers, should be very helpful. Further action to help, as we have previously suggested in responses to Ofgem, could be the commercial development of volume aggregating services focused on supporting small players, as seen in Nordpool and Germany.

2.44 We discuss this further in our responses to Questions 8 to 13 in Chapter 3 below.

Similar pricing and hedging strategies

2.45 As we discuss below, the key factors in our pricing policy are competitive positioning, cost movements and customer perception. We do not know the detail of our competitors' hedges – these are commercially sensitive to each of us. Ofgem suggests in this section, paras. 2.79 to 2.85, that companies have similar underlying cost structures, driven off a high level of similarity in hedged positions and also generation structures. As hedging strategies are confidential we cannot know whether this is actually the case. However, we do note that there are internal inconsistencies in Ofgem's case, with it suggesting in this section that hedging strategies are similar, whilst it suggests in Appendix 9 of the Initial Proposals[31] that the data shows "material differences" in the costs of fuel purchasing between suppliers and "evidence of some differences in hedging strategies" as well, apparently, as a "wide range in performance" across profit margins.

2.46 As Ofgem is aware, the classic test of dominance is the ability by a dominant firm to "behave to an appreciable extent independently of its competitors and customers and ultimately of the consumers"[32]. In the case of a company such as E.ON, which is self-evidently not dominant, but rather operates in a highly competitive market, you would expect just the opposite to be the case – that it is *unable* to behave independently of its competitors (or indeed customers and consumers) and has to take their actions into account, whilst itself operating independently on the market. If it did not have to do so, that would be suggestive of a rather different market dynamic.

2.47 Ofgem also considers the tests for coordinated effects, in table 2.2, without giving any evidence or analysis as to how it has reached the conclusions it presents in the table. A number of those conclusions are, at best, questionable, though it is more difficult to assess them without any underlying analysis. However, some clear examples are the assertions that there is a high degree of homogeneity of firms, that there is a high degree of market transparency (there is some transparency but only in one aspect of the market – residential pricing), that institutions and practices exist that may aid coordination, that switching costs are relatively high, that costs are stable, that market shares have been stable over time and that there is a lack of short-term financial pressures on firms. All these assertions could well be challenged. Furthermore, even if all were valid, there is no evidence that suppliers are profiting from the

[31] Para. 1.17, page 45

[32] *Case 85/76 Hoffman-La Roche v Commission [1979] ECR 461, paragraph 38*.

situation and that it is allowing them to "abuse" customers – indeed, quite the contrary from the margin figures that Ofgem presents.

2.48 In paragraph 2.84 Ofgem suggests that the vertically integrated nature of the six largest companies may affect suppliers' decisions on their customer bases, with an intention to sustain them at their current levels to maintain balance between upstream and downstream positions. However, as we point out above, in 2010 our supply exceeded our generation by some 19TWh and the activities of our trading business reflect the fact that our supply business is larger than our generation business.

Competitive intensity (paras 2.86 – 2.91)

2.49 We are surprised that Ofgem has drawn any conclusions from recent price increases when retail margins have historically been low or negative.

2.50 As we noted in our response to the Probe Call for Evidence[33] the key factors in our pricing policy are competitive positioning, cost movements and customer perception. This remains the case and was a significant factor in our delaying our price increase earlier this year until February 2011, some two months after some competitors. These principles also explain why it is also not surprising, given the previous low retail margins, that Ofgem's report[34] should show a relatively greater, albeit small (£8), response to rising wholesale costs compared to falling wholesale costs. However, NERA has also shown[35] that asymmetry may follow from other causes, including just the pressures on suppliers not to increase prices.

2.51 We reject Ofgem's assertion in para 2.90 that suppliers are not seeking to innovate or to improve customers' experience of the market. The largest savings customers are able to make from engagement with the energy retail market, greater than those highlighted in paragraph 2.37 above, are from reducing their energy usage. Products such as E.ON's Energy Fit enable customers to better understand their energy usage, whilst building relationships and securing take-up of CERT measures, or in future the Green Deal, offer potentially larger savings still. We have also improved our service standards, seeing a significant improvement in customer satisfaction, albeit from an admittedly low start in terms of regard in which the industry is held.

[33] E.ON April 2008 Para 4.1
[34] Do energy bills respond faster to rising costs than falling costs? March 2011 Ofgem. Figure 2
[35] Asymmetrical Price Response in Energy Supply: A Review of Ofgem's Analysis. May 2011. NERA.

Summary

2.52 Ofgem has conducted extensive, but incomplete, research and analysis. Complexity may well be an issue in the energy market, but it is quite unclear how it actually affects consumers. Some customers are disengaged and more may be sticky, but again, it is unclear what the causes are, or whether there is any more consumer harm than would be the case in any other competitive market.

2.53 Nor is it clear that complexity and stickiness are actually reducing competitive intensity. Indicators such as switching behaviour, including product switches as well as supplier switches, product innovation and promotions and, above all, suppliers' actual margins are all indicative of a highly competitive market.

2.54 Ofgem has, however, shown that there are certain issues which should be addressed and although, as we show in the next section, Ofgem's initial proposals are not justified, there is a need for a programme to build consumer trust in the market so that customers do not fear complexity, or switching.

2.55 Ofgem's analysis of suppliers pricing and hedging strategies is also inconclusive, suggesting both that they are similar between suppliers and also different. However, with the key fact being that suppliers have not made sustained margins, there cannot be a material concern over competitive intensity.

CHAPTER: Three

Proposal 1

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

3.1 We believe that there is always value in seeking to reduce complexity in the market. This is especially so against the background of an expectation that prices are likely to rise in the future because of movements in wholesale costs, the impact of the costs of decarbonisation and a greater proportion of renewables on the system and other increasing burdens that Government policy is placing upon energy suppliers, for example in relation to fuel poverty. Consumers do not like paying energy bills, as these are unavoidable costs upon them (they are not a choice product, like mobile phones, for example) and if they do not understand them, or find them more complex than they need to be, this will not help in building trust in the energy system as a whole. Therefore, we should all seek to do what we can to assist consumers' understanding. In that context, we have put forward proposals later in this paper and in Annex 1. These proposals build on the Probe remedies and address areas which were not dealt with under the previous Probe remedies and therefore cannot be expected to resolve themselves as those remedies take effect.

3.2 However, Ofgem's summary of the reasons for action (para 3.13) is flawed and not supported by the evidence.

3.3 At the time of the Energy Probe in 2008 Ofgem commissioned qualitative research, using focus groups and individual interviews with a range of domestic vulnerable and non-vulnerable consumers, to understand consumers' attitudes and experiences of GB domestic energy supply markets. This confirmed that a number of conditions needed to be met for consumers to engage successfully in the energy markets, as follows. Consumers must:

- be aware that they can switch energy supplier;
- know how to switch, or be willing to have the process explained to them;
- be convinced that there are benefits to switching; and

- be confident that the switching process itself is not difficult or risky, and that they are unlikely to encounter problems (particularly billing errors, subsequent price increases or poor service) after the switch has been completed.[36]

3.4 Testing these premises against Ofgem's results, the Ipsos MORI poll carried out for Ofgem in January 2011 revealed that, among those who have never switched supplier, the overwhelming majority (87%) are now aware that it is possible to switch supplier, which Ipsos MORI comments, is a "significant" increase on the previous year and since 2008[37]. Of those who have not switched, the vast majority (77%) have not done so because they are happy with their current supplier, i.e. because they are satisfied rather than because they are disengaged[38]. There are those who are concerned that switching is a hassle (22%) – though it is unclear whether complexity is a major contributor in this. Importantly, very few – just 4% - indicate that they are unsure where to get information to help them make a good choice (note: this question did not refer purely to a "choice" but a "good choice" so the fact that this number is so low suggests a very high degree of confidence amongst non-switchers that they would be able to make a good choice.) Equally, an even smaller number, just 2%, indicate that they would not know how to go about switching[39].

3.5 In addition, of those who did switch, a significant majority – 77% for gas and 77% for electricity – said that they found it easy to decide which deal to switch their gas or electricity to. Only 12% (gas) or 13% (electricity) disagreed that it was easy[40]. Moreover, 76% (gas) and 77% (electricity) felt they fully understood the key features of the deal they switched to – note again the wording of the this question – this was not just "mere" understanding, it was "full" understanding[41]. This would hardly support a suggestion of excess complexity in the market.

3.6 There is also a suggestion by Ofgem under Proposal 1 that it needs to be easier for domestic consumers to compare prices and choose a better deal. Of those who did switch to another deal, Ipsos MORI reveals that only 12% in gas and 11% in electricity did not feel that they were paying less with by far the majority, 62% in gas and 64% in electricity, believing that they were paying less[42], a result that Ipsos MORI describes as follows: "customers' evaluations of their switching experience continue to

[36] Source: Ofgem Probe, Initial Findings October 2008, para. 5.2
[37] Ipsos MORI, Consumer Engagement with the Energy Market – Tracking Survey 28 January 2011, page 19
[38] See also footnote 25
[39] Supra, page 20
[40] Supra, page 31
[41] Supra, page 32
[42] Supra, page 30

be *very positive* (emphasis added)". It is of course also the case that price changes since the switch can blur the picture.

3.7 There admittedly does seem to be some confusion around one aspect of switching – that of whether customers have ever switched. At the time of the Probe, Ofgem indicated that[43] at least 75% of GB consumers who take both gas and electricity had switched energy supplier at least once since the market opened to competition in the late 1990s, equivalent to just under 20 million households. It is difficult to reconcile that with the latest Ipsos MORI results that only 41% of gas customers and 40% of electricity customers believe that they have ever switched supplier. Switching levels in 2010 were a little down on 2009, to 15% for gas and 17% for electricity but this may reflect the very static general price levels in 2010, until the very end of the year, given that it is often price changes that trigger switching and most, but not all customers (see discussion above), switch for price reasons[44].

3.8 All in all, the results of the Ipsos MORI survey are, at best, inconclusive in supporting Ofgem's premise of undue complexity, with a number of indicators pointing in quite the other direction. A much greater understanding of the nature of complexity is required to be confident that proposals which reduce consumer choice could be effective in alleviating consumers' perception of complexity. The OFT study to which Ofgem refers was of a relatively small number of customers and is as consistent with general disquiet and a fear of complexity as of any specific issue. Our own research suggests that complexity arises not from the range of products but from the way consumers have to get information about the range.

3.9 That said, as we point out above, we are always willing to address complexity in the market, hence our own suggestions in this area. Smart meters will create new options, for example on time of use tariffs and on choice of payment method. Customers will need to be helped through this complexity; it cannot be wished away. A key element of this will be to build trust in comparison tools such as websites and even the pentablets we provide to our sales agents. Building trust requires a consistency of purpose over some years and it is essential that proposals are well considered, evidence based and are consistent in their evolutionary path.

3.10 Ofgem also suggests that the prevalence of standard evergreen products means that many customers are on tariffs with no obvious decision points. This is just not the case – for customers on evergreen products there are

[43] Source: Ofgem Probe, Initial Findings October 2008, para. 4.1
[44] Other prompts have also changed; supplier customer service is improving and the recession has led to fewer house moves

numerous potential decision points – house moves, price increases, high bills, poor service, media reports and direct marketing all act as prompts, and the full effect of the annual key facts statement is yet to be seen. It is also extremely hard to see how (and Ofgem does not even consider or suggest how) customers on a standard evergreen product, amongst whom will tend to be the least active customers, could actually be given a stronger prompt.

3.11 Ofgem's analysis also identifies potential detriments from the asymmetry in gas and electricity pricing by the Big Six and from customers not fully understanding the risks in variable priced products. Our proposals suggest actions Ofgem could take to tackle these issues.

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

3.12 As already discussed above, we do not believe that the evidence presented supports the case for intervention along the lines proposed by Ofgem in any event. The proposals themselves appear to us to be disproportionate in their impact and inappropriate.

3.13 Ofgem suggests that confusion in the domestic market could be addressed by a proposal to restrict the number of tariffs for standard evergreen products to only one per supplier per payment method. Frankly, this seems like rather a "baby out with the bathwater" response to the issues that Ofgem perceives exist in the market.

3.14 The existing range of products have emerged in response to customer demand, to provide a choice depending on what is important to the customer, for example if they are looking for price protection, or are elderly and possibly on a fixed income and therefore want a guaranteed charge no matter how much energy they use, or the benefit of additional cold weather payments or green electricity. Propositions are generally tested on consumer focus groups before introduction, reinforcing the view that they are responding to need. We have a reasonable number of tariffs[45], but accept that there might be better ways of grouping tariffs – fixed, variable etc. – which might help make them more accessible to consumers and more comparable with similar groupings for other suppliers.

[45] See Annex 1 for a summary of E.ON tariffs. We also have tariffs offered jointly with Age UK.

3.15 Ofgem says that it will still be possible to provide a variety of products, but that they must be offered on a fixed term basis, with no adverse unilateral variation and no automatic roll-over. This seems a somewhat strange compromise, since it still allows the complexity in terms of number of tariffs, about which Ofgem has expressed concerns but forces customers to have to *opt-in* to remain on a product with which they are happy.

3.16 The present proposals, therefore, would lead to an unfair and disproportionate reduction in consumer choice, affecting over two million E.ON customers and with other adverse side-effects (see Question 7), without any argument being presented by Ofgem as to how they would be effective or which customers would be expected to benefit[46].

3.17 It appears to us that:

- Consumers who have never switched, or have switched once to take a dual-fuel offering, would not have any greater prompt as a result of these proposals to consider switching, nor would they see any simplification in the range of products to which they might switch; and

- Most consumers who acted on a prompt would not gain; they would still be guided through the range of products on offer by a price comparison website or sales agent. Indeed they would face an added complication, of having to understand the implications of a forced change of product at renewal.

3.18 We support the aspiration to simplify tariff structures, if this can be applied to all products and not just enduring products. This would reduce the perception of complexity, which may deter consumers from starting to search. It would also make it easier for less sophisticated customers who want to make their own product comparison, albeit these are relatively few in number[47].

3.19 We comment on the proposals in detail below.

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[46] Nor has Ofgem shown how the certain detriment to many consumers is outweighed by the supposed benefits to others. New techniques would be required to make such an assessment and we suggest could be an example case, as proposed by BIS [A Competition Regime for Growth: A Consultation on Options for Reform] of when Ofgem should use its competition powers and when it should use the expertise of the Competition Commission.

[47] Research has not identified how many customers fall into this category, but the “customer engagement with the energy market – tracking survey. January 2011 Ipsos Mori” shows at pages 24 and 25 that only around 10% of switchers are unassisted and at page 20 that only 22% believe switching to be a hassle (of which complexity in making a product comparison may only be part of the cause).

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

3.20 We believe that there are alternative and better proposals that can be presented that will assist consumers. We discuss the details in response to Questions 5 and 6 and in Annex 1, and compare the effect with Ofgem's proposals in Annex 2. In summary:

Our proposal	**Benefits**
Common language for products and product components	Easier to compare products Reduce product mystique
Explore the options for a common price element. For example, a possible £100/£200/year/fuel standing charge for all products	Potential to make it easier to compare products and to check forecast annual cost, although each option has downsides
Enhanced product description at sale: • Present in "key facts" format • Identify risks • Present action required at end of fixed term	Easier to compare products Should deter overly complex products, as they will require greater disclosure Will increase consumer understanding of risks of price change Would increase consumer horizon, beyond the initial forecast annual cost
Internet sales to be subject to marketing licence condition	Presents clear information, helping customers identify the appropriate product for their needs Suppliers would seek to raise standards, as required by confidence code
Advertising to go further than ASA requirements, through inclusion of requirement to have regard to the risk of confusion	Consumers less likely to see "multiple claims of best value" (contributor to complexity[48])
Enhanced information at renewal (end of fixed term), including comparison to relevant evergreen product	Clearer presentation "Moment of decision" encouraged, without a risk that customers are forced off their preferred products
Consult on conditions to allow the roll-over to a fixed term with an exit fee	Ensure that customers clearly understand the risks of taking the benefit of an exit fee product (if allowed – further assessment required)

[48] OFT 2010 Advertising of Prices Survey Table C16

Sunset clause on SLC25A (no undue discrimination) extended to July 2016	Shows industry commitment to fair pricing (increasing consumer trust). Allows time to assess implications for smart meters

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

3.21 Ofgem refers to the proposed contents of the standardised charge but it is an illusion that the standardised charge has a content. The standardised charge is no more than an element of price and the purpose of standardising it is to make it easier for consumers to compare products. There is no explicit need for it to relate to costs which are common between suppliers (and in any case many environmental costs are no more common than metering or customer service costs). Furthermore, there is no benefit at all in it covering unit related costs (as these do not impact on the competitive positioning of unit rate charges).

3.22 There are several options for simplification, as we discuss in Annex 1. Each option has advantages and disadvantages but we believe that the most promising for further analysis are (a) simple presentation without standardising any charge; and (b) a very simple, uniform standing charge (£100/year for electricity; £200/year for gas) or the equivalent as a premium on the first kWh. In the latter proposal the standing charge would only notionally cover fixed costs, although we would also recommend restructuring of the Energy Company Obligation (ECO) and networks charges to allow the uniform standing charge to be lower.

3.23 We reject options which have a more sophisticated standardised charge on three grounds:

- A regular review process would inevitably force a round of price changes at the same date irrespective of wholesale cost changes;

- Networks charges are not published sufficiently far in advance of when they change to allow Ofgem to complete a review process and for suppliers to meet the advance notification requirements for this date. A risk premium would need to be added (this would also be needed to cover potential changes in costs between review periods);

- The benefits of this level of simplification would primarily fall to those consumers who wish to calculate their own bills but it would not be sufficient for them if charges changed from year to year and the customer wished to compare a forecast amount to their current bill.

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

3.24 This proposal seems to us to be unduly complex, given most customers' preferred way of comparing offerings from competing suppliers, which is to focus on the annual bill[49]. The Probe remedy was for an estimated annual bill, as part of the annual statement, as the standardised metric. We believe customers can easily relate to this and it provides a robust base for better informing customers of the risks in any product.

3.25 We believe that there is some cause for optimism in relation to the Probe annual bill/annual statement remedy, which can be gleaned from the Ipsos MORI poll results. Although the annual statement requirement has only been in place since July 2010 – therefore barely six months at the time of the Ipsos MORI poll - already 42% of customers felt that they had received clearer information from their supplier about the name of the tariff they were on and 45% had received clearer information about any changes to their tariff and the forecast cost of their consumption over the coming year. These results are not perfect – but in each case the "yeses" were greater than the "nos" and this was at a relatively early stage in the remedy.

3.26 Ofgem does not provide details of what the metric would look like, but we do not believe any simple unit rate metric can capture the differences between products with different structures, for example, time of use tariffs or promotional products with different standing charges. The many resultant caveats to cover customers with quite different usage from average would add to complexity and undermine the confidence of customers in the validity and helpfulness of the standardised metric.

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

3.27 It ought first to be repeated here that, as set out in response to Question 3 above, the Ipsos MORI poll results on switching actually make

[49] Ofgem's Consumer First panel in March 2009 concluded that 'the view of many consumers was that they should not be the ones having to make the calculations'. A metric of "the annual bill" meets this, in a way which a unit rate metric cannot. Moreover, a unit rate metric would be quite complicated even with just two rates – gas and electricity or day and night.

encouraging reading and do not support Ofgem's basic premise. It found that:

- Among those who have never switched supplier, the overwhelming majority (87%) are now aware that it is possible to switch supplier[50];
- In addition, 85% found switching to be very or fairly easy, with 46% judging it to be very easy and only 4% finding it fairly or very difficult[51];
- Of those who have not switched, the vast majority (77%) have not done so because they are happy with their current supplier, i.e. because they are satisfied rather than because they are disengaged[52];
- Of those who did switch, a significant majority – 77% for gas and 77% for electricity – said that they found it easy to decide which deal to switch their gas or electricity to[53];
- Moreover, 76% (gas) and 77% (electricity) felt they fully understood the key features of the deal they switched to[54];
- Of those who did switch to another deal, only 12% in gas and 11% in electricity did not feel that they were paying less with by far the majority, 62% in gas and 64% in electricity, believing that they were paying less[55].

3.28 Notwithstanding this, we have proposed in Annex 1 a detailed set of remedies to further reduce complexity and increase consumer engagement. We believe these will be more effective in increasing consumer understanding of products and confidence in the benefits of switching than Ofgem's current proposals, and without the downside of removing choice.

3.29 They will be effective in reducing complexity as a barrier to engagement and in prompting a decision point at renewal, but without depriving customers of the choice they have at present. Our proposals will significantly raise the standards and attraction of internet based switching (whether between suppliers or products), providing a solid base for the

[50] Ipsos MORI, Consumer Engagement with the Energy Market – Tracking Survey 28 January 2011, page 19
[51] Supra, page 33
[52] Supra, page 20
[53] Supra, page 31
[54] Supra, page 32
[55] Ipsos MORI, Consumer Engagement with the Energy Market – Tracking Survey 28 January 2011, page 19

evolution of the market to a greater variety of products based on smart meters.

3.30 By contrast, Ofgem's own proposals would:

- Force over 700,000 E.ON customers on our Age UK, StayWarm, Go Green, WarmAssist and Energy Online products to confirm each year that they wished to stay on their preferred product;

- Put over 500,000 E.ON customers on our Fixed, Capped and StayWarm products at risk from surprise price increases if they did not promptly confirm at renewal a desire to stay on their preferred product;

- Potentially cause over 1.5 million E.ON customers to forfeit the benefits of Tesco Clubcard points or of the No Mains Gas Discount, depending on the exact constraints of the evergreen product[56];

- Particularly adversely affect suppliers such as E.ON who have offered customers a simple range of alternative products, whilst having no impact on those suppliers who still have 75% or more of customers on a standard product. By contrast, we only have 53% of customers who are still on a standard product, since many of our customers have exercised their right to choose in response to innovation in products;

- Prevent customers from switching to our Age UK product range, developed with our partner Age UK;

- Prevent customers from a choosing a lower priced variable price product, avoiding the premium of a fixed or capped product;

- Reinforce the benefit to British Gas of its unique asymmetry in gas and electricity pricing (lower electricity unit rates), undermining the Probe remedy of making total annual bills (incorporating gas charges for customers who prefer a dual-fuel product) the appropriate comparative metric; and

- Complicate our efforts to attract customers who have never switched gas supply by preventing a simple reward offer and requiring any substantive saving to be of an unfamiliar type (fixed, capped or tracker).

[56] A genuine single electricity rate would also raise prices to Economy 7 and other time of use tariff customers, but we assume this is not what Ofgem intend.

3.31 The greatest weakness of Ofgem's proposals, apart from the fact that it does not have adequate evidence upon which to justify such a wholesale change to the competitive market, is that the customer detriments of the proposals it makes are definite and irreversible, whilst it is unclear how or whether they will actually lead to greater consumer engagement:

- Consumers who have not switched at all will be on the same, standard evergreen, product as before;

- Consumers will mostly still be prompted to switch by media message, a price change, a high bill, poor service or a contact from a sales agent;

- When following up a prompt consumers will still have a range of products to choose from, and be primarily attracted by a projected saving, very likely based on the product being a promotion;

- Consumers who wish to check the projected saving will still be at risk of getting a different savings message if they have used the wrong information;

- Consumers with, or wanting, dual fuel or time of use products will still have to use their consumption data to get a price comparison[57];

- Consumers will have the additional complication of having to understand a change of product at the end of their fixed term;

- Consumers who come to the end of a promotional period are still likely to see a significant price increase and be prompted to search alternative offers.

3.32 We do not therefore believe that there would be any greater switching under Ofgem's proposals except possibly as a result of withdrawing the benefits of existing products from customers. However, it is surely unacceptable that the greatest effect arises from reducing the proportion of customers who are happy with their current supplier.

3.33 We are quite confused by Ofgem's comments in paragraphs 3.56 and 3.57 of the Consultation Document. These paragraphs refer to "*a set number* of standard evergreen products per supplier (emphasis added)" whereas the initial proposal (para 3.18) allows for only one evergreen tariff per supplier. Paragraph 3.57 suggests that one benefit is in reducing

[57] We also doubt many single electric consumers will really want to compare unit rates (e.g. 10.97 p/kWh v 9.73 p/kWh) and not consider their potential annual bill (£464 v £421)

"suppliers' ability to segment the market between active and inactive customers on these products" yet by virtue of SLC25A such segmentation is already not allowed.

3.34 Moreover, we doubt that fewer (as opposed to simpler) evergreen products would make it any easier for consumers to identify the best deal for them. A dual-fuel customer, for example, may currently be prompted to search by a media story which closes with a ranking of average annual bills. It seems unlikely that tables of electricity and gas unit rates would have the same resonance. On starting to search, a customer will surely be interested in promotional offers, as these will offer more features and greater savings. Under Ofgem's proposals a comparison of suppliers' evergreen products is only relevant for what happens at the end of the fixed term period, but it would be quite misleading to present current rates as relevant to one or more years ahead.

3.35 We also reject the implication of para. 3.61 that the principal objection to these proposals is that there is a cost to industry. The principal objections are that they deprive customers of current benefits and of future choice, that they primarily have effect by forcing customers to work harder or to lose their preferred product and that they are less likely to change customers' fear of complexity than a programme to build trust based on improving not reducing customer choice.

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

3.36 Low electricity market liquidity is capable of constituting a barrier to entry in the domestic retail supply market, although it would only be one factor in an organisation's decision to enter or exit the markets. However, the current levels of liquidity in the wholesale market mean that it is unlikely to be the main factor, as there remain a number of other barriers to entry that could deter new suppliers, particularly domestic supply, namely:

1. "Domestic supply margins were low or negative for several suppliers in 2009"[58];
2. "Small suppliers say they find it difficult to secure adequate access to wholesale electricity supplies. In particular, they find it hard to access contracts of a small quantity, in the right shape, for the long duration that they are seeking, at a price that allows them to compete with the large vertically integrated suppliers"[59];

[58] Ofgem's Financial Information Reporting: 2009 Results page 4
[59] Frontier Economics Competition and entry in the GB electricity retail market A REPORT PREPARED FOR ENERGY UK January 2011 page 12

3. Any trading requires the management of risk such as purchasers being required to post some form of collateral. "While posting collateral has a cost for any potential entrant, it is most likely to be a material barrier for smaller, less well capitalised players that do not have a credit rating" [60];
4. "Government has increasingly used suppliers to deliver policy, both to meet environmental objectives and social obligations" [61];
5. "the level of technical skills needed to participate in the market"[62];
6. "One area that has been increasingly raised by small suppliers as a potential barrier is the uncertainty associated with network charges" [63];
7. "There are a number of costs associated with entering this market, and then expanding to reach scale. These include investment in IT systems and call centres and the costs associated with building a brand and acquiring customers. There is an element of fixed cost to these activities, and therefore they can be expected to act as a barrier to smaller suppliers" [64]; and
8. "Industry arrangements are extraordinarily complex. They also change with remarkable frequency. This is expensive for all suppliers to manage. However, because there is an element of fixed cost associated with dealing with these arrangements and processes, it falls most heavily on small suppliers"[65].

3.37 This suggests that there are two separate and largely unrelated issues to be addressed; firstly, Ofgem's continued concerns about liquidity in the Great Britain electricity wholesale market and, secondly, how to better provide support for new suppliers. Thus, taking actions to raise liquidity levels will not be an effective way of helping entry in the domestic retail supply market. However, introducing distortion to the wholesale market specifically to help small suppliers would carry a real threat to confidence in wholesale trading, which could easily result in lower liquidity levels.

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

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[60] Supra, page 17
[61] Supra, page 11
[62] DECC Energy Market Assessment March 2010 paragraph 2.24
[63] Frontier Economics Competition and entry in the GB electricity retail market A REPORT PREPARED FOR ENERGY UK January 2011 page 19
[64] Frontier Economics Competition and entry in the GB electricity retail market A REPORT PREPARED FOR ENERGY UK January 2011 page 19
[65] Frontier Economics Competition and entry in the GB electricity retail market A REPORT PREPARED FOR ENERGY UK January 2011 page 19

3.38 Ofgem's proposed interventions (the MA and MMM) are focused on supporting liquidity. We believe that this focus does not address the main problem facing small suppliers: namely that of trading in wholesale markets with high minimum clip sizes and such suppliers often having inappropriate capital backing for such trading. Consequently the introduction of MA and MMM, without other initiatives, is unlikely to help improve the likelihood of small supplier market entry.

3.39 Action to improve the likelihood of small supplier market entry must focus on providing trading arrangements that facilitate the procuring of volumes that are below the traditional minimum volumes for a wholesale market and also support the efficient use of limited capital strength. In this context, N2EX's recent agreement to amend its day-ahead auction to a minimum clip size of 0.1 MW, with the clear intention of helping smaller suppliers, should be very helpful. Further action to help, as we have previously suggested in responses to Ofgem, could be the commercial development of volume aggregating services focused on supporting small players, as seen in Nordpool and Germany (for further explanation, see answer to question 11).

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

3.40 As explained in our answers to questions 8 and 9, the current level of liquidity in the wholesale market is only one of a number of barriers to entering the supply market. The introduction of mandatory auctions and mandatory market making, in isolation, is unlikely to help improve the likelihood of retail supply market entry. Regardless of the results of Ofgem's further wholesale market assessment, solutions are required, such as the smaller clip sizes being introduced on the N2EX exchange, that actively facilitate the procuring of volumes that are below traditional volumes for a wholesale market and also are supportive of efficient use of limited capital strength. Neither the introduction of auctions nor market making, in isolation, are efficient ways of delivering such support.

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

3.41 When considering what intervention options Ofgem should be developing, there need to be very clear links between the intervention and its objective.

3.42 We do not see any need for intervention to support wholesale market liquidity *per se*. Recent events have shown that the Great Britain electricity wholesale market has the capability to achieve higher levels of liquidity, as shown in Fig 1 below. However, as shown in Fig 2, short term changes in liquidity in the Great Britain wholesale power market are reflected in similar markets. This suggests that the Great Britain wholesale power market is heavily influenced by external events that affect similar markets. Also, the very strong trend correlation between Great Britain power and Great Britain gas since July 2010 shows that the Great Britain gas market is very probably the primary liquidity influence on the Great Britain power market.

Fig 1: Gas market liquidity and churn, April 2006 to April 2011

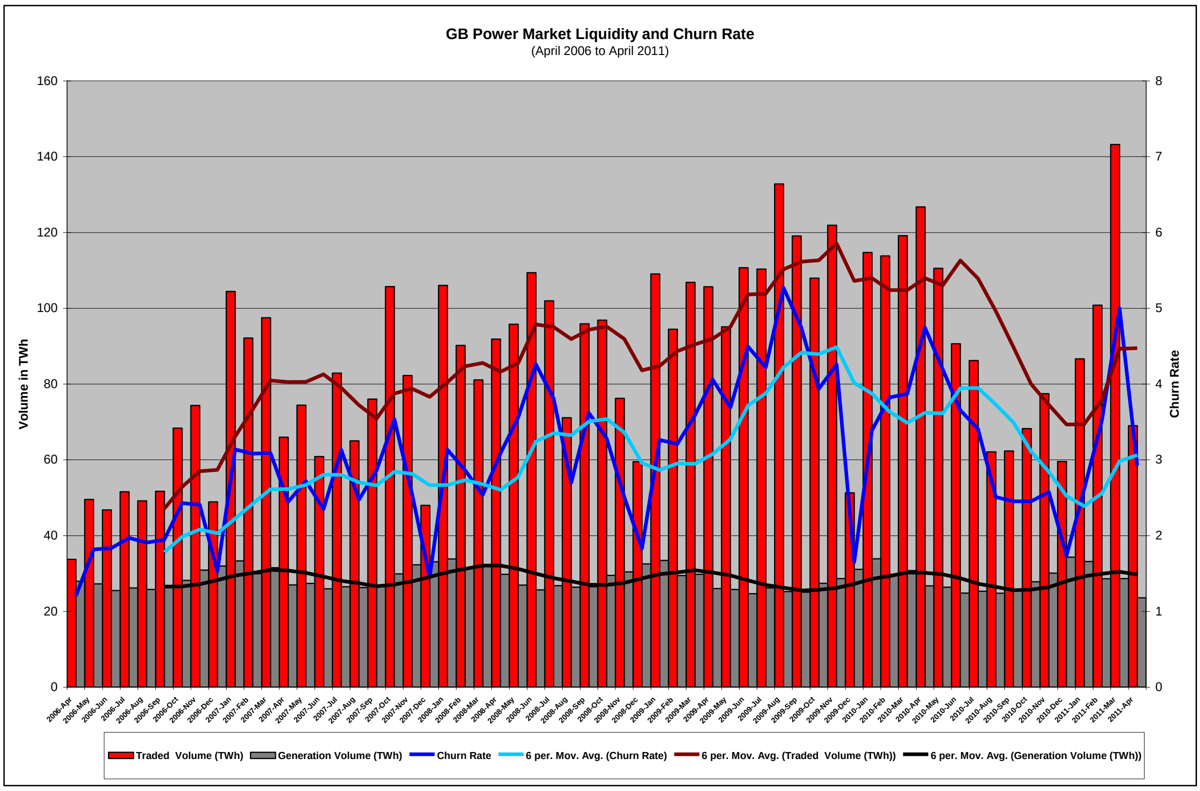
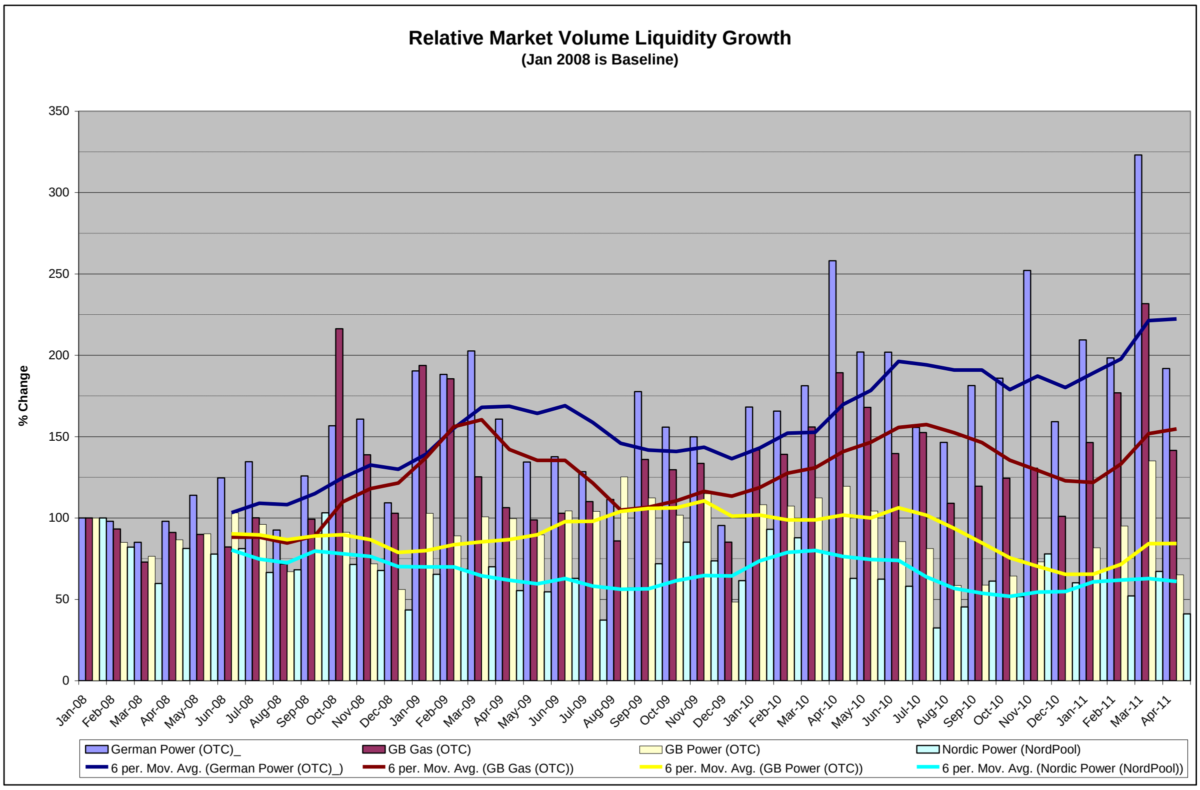


Fig 2: Relative market volume liquidity growth, Jan 2008 to April 2011



3.43 Not only has the Great Britain electricity wholesale market recently shown its ability to achieve higher levels of liquidity, looking forward it has a large variety of participants and is subject to a number of recent supportive developments, such as the commissioning of the BritNed interconnector and the introduction of day-ahead auctions by the APX and N2EX exchanges. Further benefits associated with developments in the N2EX exchange, such as the introduction of market making and adoption of smaller minimum clip sizes for some trading activities, are also now coming forward.

3.44 We do recognise however that, despite the recent introduction of day-ahead auctions by the APX and N2EX exchanges, there has yet to be established a day-ahead reference price that is sufficiently robust for supporting the development of contracts for differences (CFDs). Encouragement could include requiring greater participation in the N2EX day-ahead auction to support the development of CFDs and hedging further out along the trading curve. Such developments would provide a solution for addressing the concerns that have been raised about the relatively lower levels of liquidity for timeframes further out. However, auctions, like market making, would not necessarily be the most focused way of supporting small suppliers.

3.45 In both the German and Nordic markets procurement of small volumes has been addressed through the development of volume aggregating arrangements (known as "Client Clearing" in Nordpool). The actual detailed arrangements for volume aggregation vary between the German and Nordic markets, and between the various arrangements within each market. However, the common model is that groups of players working with small volumes (small volume suppliers, small volume generators, small volume vertically integrated players and large consumers) come together to aggregate their demand requirements into volume sizes that allow their aggregated needs to be met through trading in the wholesale market using standard products of standard sizes.

3.46 Looking more closely at the arrangements in Nordpool there are 147 exchange members and a further 222 clearing clients[66]. Clearing clients are small participants that use some form of aggregation service. This means that 60% of the Nordpool users do not directly participate in the Nordpool market, but do so through forms of volume aggregating services. In our experience the majority of clearing clients have annualised trading volumes of 100-500GWh, but there are some clients below 100GWh, others in excess of 500GWh and a small number in excess of 1,000GWh. Many of these clients are not 'small' participants, but

[66] Nordpool Member list as at 11-05-2011, http://www.nasdaqomxcommodities.com/membership/memberlist/

choose not to directly participate in the Nordpool market for various commercial reasons. In Germany similar results have been achieved by several Stadtwerkes or similar companies founding common subsidiaries that are engaged in trading, e.g. Trianel and Syneco.

3.47 This evidence from more liquid power markets clearly shows that small participants (including small suppliers) do not require explicit direct participation in the market in order to be successful; rather they require appropriate market access arrangements.

3.48 We strongly believe that such arrangements could be adapted to meet Ofgem's objective of supporting small players and we would be happy to discuss with Ofgem our experiences of these services and how they could potentially be applied in the Great Britain market.

3.49 Having volume aggregation services not only allows access to small clip sizes, but also provides help in managing limited capital strength. Having access to the small clip sizes would reduce the level of capital needed to balance volumes purchased. The required credit cover needed could also be more efficiently used through concentrating it in one place to meet the volume aggregator's requirements.

3.50 We understand that the provision of such a service linked to existing exchanges has been considered for the Great Britain power market by some Nordic providers. However, costs, in particular, the Balancing and Settlement Code (BSC) signatory cost for the aggregator, appear to have prevented this developing. Some work to see if the barriers to entry for services such as volume aggregation could be reduced would hold a real prospect of effective support for small players. The recent announcement by N2EX that its members now have an option to allocate energy volumes relating to one or more of their clearing accounts to a third party for energy notification and delivery purposes under the BSC is a very helpful step towards realising volume aggregation in Great Britain.

3.51 Another way to help small suppliers is to secure a greater understanding of the products already available for them. This would help reduce some of the perceived barriers to entry for new suppliers. Support by Ofgem in publicising the different initiatives being taken by existing market participants, such as E.ON, would help achieve this.

3.52 In E.ON's case we have responded to Ofgem's view that small suppliers want to see greater clarity as to who they should contact in the large companies for the purchasing of appropriate products. We have launched a Wholesale Energy page on the E.ON UK website[67].

3.53 On the website we explain how we offer a number of wholesale gas and power products for signatories to the GB gas Unified Network Code (UNC) and the GB electricity Balancing and Settlement Code, such as licensed gas and electricity suppliers, and that, besides trading, we can also help other suppliers meet their customers' needs through the provision of non-standard products, including:

- *Bespoke products*, which in power include non-standard shaped volume products, can help suppliers meet their customers' predicted load profiles. E.ON Energy Trading already provides fully shaped products to a supplier, its affiliate E.ON Energy Solutions. This product is available to all suppliers who are prepared to procure economic volumes and have the appropriate capital strength. However, while we are willing to offer such a product, none have yet been taken forward for supply in Great Britain, (other than by E.ON Energy Solutions) because counterparties could not pass our credit checks. E.ON Energy Trading will continue to consider any future requirements for this type of product from counterparts with sufficient credit. To ensure that the offering is financially viable, the offering will continue to be subject to minimum and maximum volumes and the supplier having an appropriate credit rating. We would expect that this product would interest suppliers who have established a customer base, which is of sufficient size that they can carry out the upstream activities of supply, but have yet to have sufficient volume to fully participate in wholesale trading. This arrangement would probably be of interest to the type of supplier that would also find voluntary volume aggregating arrangements operating outside of the main wholesale market helpful;

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- *Hedging options,* which can help suppliers balance unexpected changes in their customers' demand. Although there has been little interest from the market in the past, E.ON Energy Trading will continue to consider any future requirements for the provision of option contracts to suppliers. To ensure that the offering is financially viable, the options offered are subject to minimum and maximum volumes and the supplier having an appropriate credit rating. Further, as these are options, there will be charges to reflect the cost of uncertainty that E.ON will be taking on;

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- *Managing upstream power supply activities for other suppliers*: because E.ON Energy Solutions is continually managing power

[67] http://www.eon-uk.com/contactforms/wholesalegasandpower.aspx

procurement for our ever changing demand portfolio, it can use these skills to manage the power procurement needs of other suppliers. This new tailoring of products to meet different customers', and in particular small suppliers', needs reflects our recent experience of some small suppliers wishing to procure products from us as if we were supplying them under multisite contracts. While we have concerns about supplying other suppliers as if they were a single customer with a number of sites, we can offer a product for small suppliers to act as virtual suppliers. This means that E.ON can offer all the upstream supply activities, including hedging, demand forecasting and registration of the customer's meter. The small supplier handles the downstream supply activities. The arrangement provides smaller suppliers with a platform for entry into electricity supply, and supports the small supplier while it is growing to a sufficient size that it could undertake the upstream activities of electricity supply, such as wholesale trading.

3.54 Our new Wholesale Energy page on the E.ON UK website has attracted interest. However, greater explicit recognition by Ofgem of the steps being taken by existing market participants, such as E.ON, would be very helpful in ensuring that existing and potential small suppliers are fully aware of the increasing levels of support that is available for them.

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

3.55 If Ofgem were to decide to take forward the two interventions of MA and MMM it would need clearly to identify the key purpose of each, such as MA being to secure a robust day-ahead market with stronger reference price for supporting the development of CFDs. This would help ensure that the detailed design of any measures were both targeted and proportionate. Broadening the objectives of either MA or MMM would risk unintended consequences that could be damage the efficiency of the wholesale market.

Mandatory auctions (MA)

3.56 We support day-ahead auctions and, with some modifications to the detail as currently presented by Ofgem, mandatory participation in day-ahead auctions may be one of the better ways of assisting in increasing market participation in this form of trading. We do not support any development of auctions that go beyond the day-ahead stage. If such auctions were to be imposed they would be very likely to reduce the overall level of liquidity down the curve.

3.57 Greater participation in a day-ahead auction is likely to help wholesale market liquidity and in establishing better reference prices. However, without addressing the issue of minimum clip sizes in particular, as has been done by N2EX in recently agreeing to amend its day-ahead auction to a minimum clip size of 0.1 MW with the clear intention of helping smaller suppliers, a mandatory auction would do little to help small suppliers access the shape they require at the wholesale market level.

3.58 From the limited information provided by Ofgem, it is not clear which parts of the market (timeframes) Ofgem is proposing that auctions cover, although the scope seems to go much wider than is necessary for driving wholesale market liquidity and for establishing better reference prices. Having more than a day-ahead auction risks fragmenting the market, which would be detrimental to overall market liquidity.

3.59 We would recommend that any mandatory auction intervention is a day-ahead auction with the objective of supporting a reference price through the use of licence requirements, supported if necessary by changes to code rules based on the following licence framework. A proposed formulation is as follows:

> *To the extent that a day-ahead auction approved by the Authority exists, all licensed generators who are, or have any affiliate or associated company that is, a licensed supplier must trade, or secure the trade on their behalf, a minimum volume equivalent to 10% of their accredited energy (i.e. QACE) in their BSC production account, for the current calendar year through a day-ahead auction approved by the Authority.*
>
> *An arrangement for trading shall only be a "day-ahead auction approved by the Authority" if;*
>
> 1. *The auction produces and publishes a reference price; and*
> 2. *The Authority has confirmed in writing that the day-ahead auction is approved.*

Volume requirements

3.60 Such a licence requirement would mean that groups that had generation would be trading a prescribed volume of electricity in the day-ahead auctions across the year. Our estimate is that this would be in excess of 20TWh per annum, equivalent to some 55GWh per day. The volume would have to be calculated on an annualised basis. To set volumes for each auction round would raise a large number of issues. These issues include:

- competitors having different expected load profiles across the year;
- rules to allow for managing generation outages, breakdowns and test runs;
- rules for adjusting generation to meet requirements of system constraints and developments in demand side load management;
- rules for taking into account the effect of contracts with National Grid; and
- changes in planned generation in response to requirements of the balancing market.

3.61 However, because the auctions, based on annualised targets, would have participation by all groups that had interest in generation and supply, all with a vested interest in achieving compliance with the requirements, competitive forces would be expected to secure sufficient trading in each round to provide a robust market price and availability of product.

3.62 Whilst there can be a collective annual volume target, obligations would have to be set for individual licensees as shown above. It is difficult to see how a group of competitors can be expected to coordinate their actions to deliver a collective obligation without entering into anti-competitive, and thus illegal, cooperation.

3.63 By requiring the volume to be measured as gross trades (i.e. selling or buying), rather than just sales of generation, sufficient flexibility is secured so that the fundamentals of any successful auction are preserved, namely that in each round there are sufficient numbers of willing buyers and sellers. It would also provide the flexibility to better accommodate any trading that was carried out in earlier timeframes, or on other platforms.

3.64 Because a large number of competitors would be involved, the obligation on an individual licensee could be quite small. The smaller the commitment, the less of an adverse effect there would be on other wholesale market trading. This is particularly relevant for the eight large generators, who could find that they have to withdraw product they currently trade elsewhere to meet any mandatory auction obligations. We would thus recommend Ofgem's lowest option of 10 per cent for individual generation licensees; not a collective total of electricity supplied in Great Britain over a given year, although a figure of less than 10 per cent would probably be less harmful for the market as a whole.

Product requirements

3.65 We recommend the auction of hourly slots as currently carried out by the APX and N2EX day-ahead auctions. Hourly slots would also help facilitate opportunities for future market coupling. As has been witnessed with the N2EX exchange, as a day-ahead auction is established and with support from the platform operator, market makers will enter the market. Such market makers can support futures in power products (CFDs, financial and physical) based on the day-ahead auction reference price covering the time periods suppliers and generators wish to hedge their positions. Thus, the need for different auctions to cover both near term products and products for further out is not required. Also, by concentrating on regular day-ahead auctions, which naturally are focused on the day-ahead's load shape and size, the need for different auctions for different product types (baseload, peak and shaped products) is also removed.

Frequency

3.66 Frequency for a day-ahead auction needs to be one for every day of the year. Ideally this would be every day, to aid coupling with other European markets, but as a minimum to be held every business day[68].

Governance arrangements

3.67 Ofgem needs to be very clear as to what its "desired objectives" are for those licensees mandated to participate in an auction. Those desired objectives need to be set out in the generation licence conditions that mandate participation in the auctions. Combining the mandatory participation aspect through generation licence conditions and having the operation controlled through the auction's rules would ensure that the whole process was set out clearly and transparently.

[68] This would mean that, typically, the auctions would carried out Monday to Thursday for the following day, with Saturday's, Sunday's and Monday's auctions being carried out on the Friday.

Reserve price

3.68 Reserve prices are only an issue if mandatory participation is imposed on one side of the trade. If there is a requirement on many suppliers and generators to participate, then normal market forces can prevail and there is no need for reserve prices. However, if Ofgem were to impose a reserve price, in order for it not to distort and interrupt the market, it would have to be a price that is related to the relevant market price at that time. Having a requirement that sellers can only set reserve prices at levels which do not frustrate the objectives of the auction, combined with a role for an independent trustee in securing what would be "reasonable reserve prices", would be tantamount to price control of the reference price. Any interference with the method of deriving a market reference price risks that reference price losing all credibility with the rest of the market.

Participation

3.69 Participation by representatives of both generators and suppliers aligns with the natural needs of a successful auction; namely, the need for willing buyers and willing sellers. Participation needs to be wide if a robust reference price is to be achieved. Thus, all companies with interests in both generation and supply need mandating to participate, with all other generators and suppliers encouraged to participate. To only mandate the Big Six, or the eight main generators[69], even though they all currently have interests in licensed suppliers, would be discriminatory and limit the benefit the auction could have delivered.

Platform

3.70 We do not believe it is practical to have more than one reference price that is sufficiently robust to support a broad range of trading in CFDs, financial and physical futures. There are already two platforms supporting day-ahead auctions; the introduction of a third would at best be unhelpful and at worst be very counterproductive.

3.71 Rather than create a third platform, we recommend that Ofgem first works with the two existing exchanges to co-mingle, at the input of the auction algorithm, their auctions so as to output a single reference price expressed at hourly granularity, which would better support market coupling with other European markets. Having more than one exchange contribute to the reference price not only gives greater strength to the

[69] Centrica, Drax Power, EdF, E.ON, GDF Suez, Iberdrola, RWE and Scottish and Southern all have both generation and supply activities.

reference price itself, but also allows competition between the exchanges to continue based on their costs to serve.

3.72 If the two existing exchanges failed to combine their auctions to output a single reference price, then Ofgem would need to identify the single auction that generators and suppliers must participate in. In selecting the one exchange available to generators and suppliers, Ofgem would have to ensure that the exchange had a recognised and acceptable clearing system and an appropriate credit rating. This would suggest that N2EX would be the most appropriate exchange. It would also reflect the fact that N2EX's setting up was done working with the industry and that this was under a controlled process, of which OFGEM was appraised and was guided independently by the Futures and Options Association.

Trading arrangements

3.73 Taking steps to increase participation in the existing day-ahead auctions would require minimal change to the current trading arrangements.

Mandatory market making (MMM)

3.74 We do not support the Mandatory Market Making proposals presented by Ofgem. The proposals are not aligned with the European Regulators Group for Electricity and Gas (ERGEG) proposals on market makers and fail to recognise that the financial regulations being proposed by the European Commission could soon make the provision and use of market making by generators and small suppliers impractical.

3.75 ERGEG has stated in draft advice on the regulatory oversight of energy exchanges that:

> "Market makers play an important role in ensuring liquidity at exchanges. Market making is usually done by market participants with a high market share. Thus, the selection process and the rules for market making are very important. This is particularly true in view of potential conflicts of interests possibly arising if a market maker (or its ancillary company) is also a producer."[70]

3.76 ERGEG also noted that, whilst there are market makers at many exchanges (both financial and energy), this is not the case everywhere, (notable exceptions being Nordpool Spot, EPEX Spot and the Italian IPEX), and even where market makers exist, most were not officially appointed.

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[70] ERGEG draft advice on the regulatory oversight of energy exchanges Ref: C10-WMS-13-03 5-APR-2011 page 32.

3.77 Ofgem's proposals to require generators (i.e. producers) to be market makers seems to be at odds with ERGEG. While ERGEG is expressing concern about potential conflicts of interest if generators are permitted to be market makers, Ofgem is seeking to create such potential conflicts of interest by forcing some generators to be market makers.

3.78 Aside from the issue associated with producers being market makers as ERGEG indicated, the presence of market makers and intermediaries should help drive further liquidity. NASDAQ OMX has recently announced formal market making status for both EDF Trading Ltd and RWE Supply and Trading GmbH on their UK Power Futures contracts. This development does suggest that the wholesale market has now got to a point where market making can develop without forced participation. Both EDF Trading Ltd and RWE Supply and Trading GmbH are ancillary companies to generators, and therefore bring the issue of potential conflicts of interest. However, these two companies have not been officially appointed, but have agreed terms with NASDAQ OMX in an environment where all parties have a common vested interest in maintaining the integrity of the market and its associated market making, which includes ensuring that any conflicts of interest are addressed. Such a situation cannot be achieved if one or more of the parties forced to participate does not have a vested commercial interest in the success of the market making.

3.79 Given that market making has commenced, the case for intervention through mandatory market making, seems to have been superseded. Instead, Ofgem should be supporting the exchanges as they make arrangements to support greater levels of market making and to minimise potential conflicts of interest.

3.80 Notwithstanding the above issues, care needs to be taken to avoid imposing mechanisms that could have negative effects on market liquidity, such as mandatory requirements on physical players to undertake the role of market maker for financial products. Forcing parties to undertake commercial transactions that they would not ordinarily wish to enter into will expose them to greater levels of financial risk than they believe are appropriate. Assuming that efficient financial markets tend to allocate risks to those best able to manage those risks, any misallocation of risk by Ofgem will reduce market efficiency. Therefore, parties need to be free to use financial products to match their portfolio needs and the level of risk that they are comfortable with.

3.81 Carrying out market making could move a generator from physical trading to financial trading. Market making is defined under the existing Markets in Financial Instruments Directive (MiFID), enacted in the UK by the FSA regulatory regime, as a financial market activity, which means that UK registered businesses can only undertake market making if they are MiFID authorised entities. Affected generation licence holders would therefore have to become MiFID authorised, which would result in them having to meet a number of potentially onerous requirements. MiFID authorised entities are subject to the requirements of both the Capital Adequacy Directive (CAD) and the Capital Requirements Directive (CRD), which require authorised entities to hold sufficient capital (normally in the form of cash) to cover their trading activity, regardless of whether they may be able to produce the product themselves.

3.82 In simple terms, this could result in a market maker generator having to hold capital to the value of a significant proportion of its sales to the market which, for a large generator, could equate to many millions of pounds. Generators that are not market makers are likely to be considered non-financial entities, and so able to avoid this requirement.

3.83 Other financial regulations being proposed by the European Commission could affect trading in the power markets, in particular the ability of small suppliers to use the services of market makers. As a result of the global financial crisis, the European Commission is reviewing and tightening the existing framework for financial regulation in the EU, and is proposing a number of additional pieces of legislation. The Commission's proposals include the European Market Infrastructure Regulation (EMIR), which will require mandatory clearing of standardised OTC derivatives and mandatory exchange trading of standardised contracts for financial counterparties. MiFID authorised entities (and therefore market maker generators) are likely to be fully subject to EMIR. The resulting cost implications of central clearing are potentially very large, both for the market makers and their clients, with both parties having to deposit large amounts of capital with the central clearing agent.

3.84 The proposals would make trading with market makers a very capital intensive option for all market participants, especially small suppliers with limited capital. Generators who are not required to act as market makers may be able to avoid the costs of central clearing if their traded volumes are below a yet to be defined level. However, there is a real risk that the threshold will become the limit that non-market makers are prepared to trade to, as the cost implications to the business of exceeding the threshold and becoming subject to central clearing are very large. This would clearly limit liquidity in the market and create a situation where companies that currently market make, in power or any other commodity, may find that they can no longer afford to continue offering market making services in the new EU financial regulatory environment.

3.85 Considering the number of market makers required, Ofgem's proposal for six market makers is very questionable as, for example, the Nordpool Futures Market only has two market makers. Examples from other markets show that it is sufficient to have one or two market makers per product. An exchange listing six market makers does not mean that each of the market makers is active in all products. Again, the responsibility for selecting and then agreeing terms with market makers should be between an exchange and its respective members. Ofgem could recommend that the exchange provides a given number of market makers, but the final decision, as with selection of market makers, needs to be with the exchange.

3.86 Ofgem's proposals suggested that mandatory market making should be continuous right up until gate closure. We cannot see how market makers can operate right up until gate closure without restricting their overall levels of trading and thus acting to the detriment of overall market liquidity. There are too many risks involved for a market maker always to be offering to buy and sell product continuously right up to gate closure. In practice, most intraday activity is not for suppliers, but between generators trying to cover breakdowns, or react to fluctuations in gas price - it is not a market area where suppliers are particularly active. In addition, if a number of generators have each to hold back 20-50MW for intraday trading to meet these requirements, then this will reduce the liquidity of the day-ahead market by this volume. As the small parties, for whom this measure would be targeted, are apparently interested in the sub 1MW market, having 120-300MW of intraday product would seem disproportionate and excessive.

3.87 Further, at the times of system stress, through very high or very low demand relative to generation, the market makers need the right to stop trading; they cannot be expected to continue selling product when they know there is no product available for them to buy regardless of price. Also, it is not clear as to what having 20-50MW in total volumes available for the market to buy and sell on a continuous basis actually means. As written, it suggests 20 to 50MW have to be continuously available regardless of volumes traded earlier or the collective net position of the market makers. The volumes made available, and the times they are made available, need to be freely negotiated between the exchanges and the potential market makers. Having to impose rules for volumes is an example of the problems that would be encountered if mandatory market making was imposed.

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

3.88 As explained in question 11, the Great Britain electricity wholesale market has the capability to achieve higher levels of liquidity, although it must be recognised that it has limitations caused by the very strong price linkage with the Great Britain gas market. Liquidity will be helped by the N2EX exchange continuing to develop, the recent commencement of market making and the BritNed interconnector and its associated day-ahead auction becoming established. In this situation any interventions to 'help' carry the real risk of unintended consequences; now is not the time for unwarranted intervention for the supposed purpose of increasing wholesale electricity market liquidity.

3.89 If MMM or MA for products down the curve were introduced, it would come at a cost. Companies having to provide this service would require additional staff and there would be the cost of system changes. However, these costs would be dwarfed by the disruption to liquidity that would result from having monthly auctions, or a variety of auctions across different timeframes that fragmented liquidity.

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

3.90 Where Ofgem believes that suppliers are not complying with the obligations on them under licence conditions it should commence an investigation and proceed to enforcement as necessary. For example, we share Ofgem's surprise that SSE should think that the phrase Ofgem quotes at page 55 of the Initial Proposals document is in any way adequate to meet the requirement of a prominent reminder of the right to switch. It is clearly not. However, Ofgem's first action in such circumstances should be to raise concerns with suppliers, here specifically with SSE, to make them change it.

3.91 Clearly it is the responsibility of suppliers to comply with licence conditions – they should not have to wait for Ofgem to make them do so – but there will sometimes be genuine situations where Ofgem's interpretation of particular requirement and that of the supplier will diverge. In those cases, a dialogue between Ofgem and the supplier and even the possibility of enforcement action has value in resolving the issue. Our experience is that this has been effective with the business market Probe remedies where, following contact from Ofgem, we amended our renewal process and our terms and conditions. Such a process of dialogue with suppliers, and with other stakeholders, would also have the benefit of clarifying any issues with interpretation of the obligations and support Ofgem's proposal for greater transparency on suppliers' compliance with licence conditions (para 3.39).

3.92 We do not believe any supplier would ignore a proposal from Ofgem; rather the supplier would act on the suggestions it agreed with (giving an immediate customer benefit) and consider how to raise the standard further. Obviously, if a supplier was obstructive, Ofgem could then take formal enforcement action or, ultimately, propose a new licence condition, with the benefit of the detailed consideration already given to the arguments.

3.93 It has to be said that the evidence Ofgem presents is pretty weak to justify the introduction of more prescriptive conditions in this area. It provides one sole example on suppliers' communications and interactions with their customers. It also refers to its current misselling enforcement activities regarding a number of suppliers. This latter example is actually one of the system working as it should – strengthening the conditions would not have changed the fact that Ofgem is taking enforcement action against the suppliers in question.

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

3.94 As already stated above, it is the responsibility of suppliers to comply with licence conditions – they should not have to wait for Ofgem to make them do so. However, Ofgem should challenge suppliers on any suspected material error in applying obligations. We would welcome early feedback on any suspected infringement by E.ON and would seek to remedy any shortcomings promptly if it transpired that we were at fault. Clearly, we would hope that enforcement action would never be warranted but we accept that that also could be part of the process if circumstances justified it.

3.95 We support greater transparency on suppliers' compliance with licence conditions; this can help give all suppliers insight into Ofgem's interpretation of the requirements in question.

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

3.96 In order for domestic supply licence conditions to be properly complied with by suppliers and enforced by Ofgem, it needs to be clear what they are requiring suppliers to do. We do not believe that this level of certainty is reached with the Standards of Conduct – which is a point we discussed with Ofgem at the time they were being originally drawn up and put in place. There is insufficient understanding of what the Standards of Conduct mean and how they apply for them to be turned into licence conditions. Fundamentally they currently lack sufficient certainty to carry with them potential legal consequences. As noted in response to question 14, Ofgem needs to challenge suppliers on any concerns and this process will help develop a common understanding of how the standards of conduct can best be applied.

3.97 We would also prefer the Standards of Conduct to be turned into a positive statement of expected outcomes for consumers (as with the FSA's 'treating customers fairly' programme) rather than prescriptive behaviours for suppliers[71].

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

3.98 Yes. It is highly desirable that customers have a more informed choice of products and, with smart meters, an increased choice of time of use and risk management products. Switching sites will be essential to support this and even now the most glaring market failure is that only 16% of consumers switch by this, most convenient, method[72] when over 75% of consumers have access.

3.99 Although Ofgem has no direct control over switching websites, extending the marketing licence condition (SLC25) to internet sales would lead to suppliers requiring higher standards. Ofgem should be ambitious and set a demanding goal of price comparison websites ("PCWs") being the first and trusted port of call of less sophisticated customers seeking to engage with the market. Suppliers will of course seek to make PCWs a second option after their own websites, but the raised standards of all websites will greatly benefit customers, and is essential to maximise the benefits of

[71] See also "Probe Remedies. Response by E.ON. August 2009

[72] Customer Engagement with the Energy Market – Tracking Survey. Ipsos Mori. January 2011. Only a slightly higher proportion, 24%, use PCWs to find information, and it is equally telling that 1/3 of users (as well as any who dropped-out) then seek another route to actually switch.

smart meters in increasing consumer choice. PCWs with a phone service would enable all consumers to benefit from easier and improved choice.

3.100 The proposal we make in Annex 1 is that suppliers should be made accountable for internet sales meeting the requirements of the marketing licence condition (SLC25.1 & 25.2), including that, amongst other requirements, products are appropriate to the consumer.

3.101 We believe websites will then, to get suppliers' business, have to help consumers through the range of products, narrowing the choice to a limited number which meet the consumer's needs and displaying a key facts comparison.

3.102 We acknowledge that there would be a difficult transition period as suppliers and PCWs sought to determine what standards were required, to renegotiate existing contracts and to implement changes but the end result would be greater consumer confidence, better service and a robust and settled platform by the time smart meters became prevalent.

3.103 PCWs would lead the change, as they would each want to develop their own format to which all, or the majority, of suppliers would sign-up. Suppliers would need to be flexible – accepting or rejecting PCWs' formats rather than hoping to impose their individual preferences. Suppliers would also need to be cautious - being the sixth supplier to sign up would not guarantee that a site's procedures ensured compliance, so that in practice PCWs would likely aim for higher standards, to win over the most cautious supplier. Suppliers and PCWs would need to agree a standard for consumer research to confirm the effectiveness of the measures in securing customer understanding.

3.104 PCWs may give customers an option – quick for the customer who knows what they want; a few minutes extra for those who want to be guided. The latter, and hence the product comparison service, might be restricted to those products covered by the PCW's contract with the supplier (but, as now with the Confidence Code, the comparison could not be affected by the level of commission).

3.105 Suppliers would not be accountable for PCWs which were advisory.

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

3.106 Ofgem is not specific in its proposals for clearer and more transparent information for consumers or for steps to improve consumer trust in switching sites, but we support the principle and have set out our own proposals in Annex 1. Nonetheless, we would urge Ofgem to consult fully on even relatively simple further licence changes and not to rush into implementation. Continual change adds to cost, but more importantly, also adds to customer confusion.

3.107 We have shown why it would be premature to introduce the Standards of Conduct into licence conditions, noting that they are too imprecise. The costs could include a stifling of all sales activity, for fear of the potential interpretation, or of quite different perceptions between suppliers leading to greater freedom for those best able to walk the line.

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

3.108 Ofgem's presentation of evidence to justify its proposals in this area is very tentative and lacking specificity. It indicates that it is carrying out a review of compliance and will contact non-domestic suppliers to point out specific areas that need improvement. Despite asking Ofgem specifically to let us have details of any areas where E.ON falls short of the standard it would expect on compliance with licence conditions in this area, we have received nothing.

3.109 Ofgem highlights three areas of concern in Appendix 8, around incomplete information on contract duration, on unclear language in drafting terms and conditions where suppliers' drafting is apparently "poor" and, as Ofgem puts it, a small number of cases where suppliers "were acting in direct conflict" with SLC7A. However, in this latter case, Ofgem appear to be relaying on hearsay in relation only to a single supplier: "it has been claimed one supplier is continuing to use roll-overs in excess of 12 months" and in any case, if it is a suspected breach of SLC7A, it is an issue of enforcement.

3.110 Ofgem concludes that "these current findings do raise *some concerns* that *on balance* suppliers are not *fully responding as we had hoped* (emphasis added)*"*, but it indicates that even this is only an initial view. This really does not provide sufficient concrete evidence to justify further intervention in this area.

3.111 That said, and in the spirit of being constructive, we agree that SLC7A could be broadened in scope, beyond micro-businesses, without adverse effect. This is what we as a company do anyway – BUT in relation to our definition of SME businesses. A line has to be drawn somewhere and, with the advent of smart meters, even the traditional boundaries of halfhourly electricity and daily gas metering may not be helpful. There is also an argument for focusing on the customer, using an employee or turnover definition rather than usage. If the scope is to be changed, therefore, it is particularly important that there should be full consultation on its extent.

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

3.112 It is too soon to ask the question whether there should be additional conditions around objections. Ofgem has yet to start the investigation required to understand the nature of current objections and the potential consumer detriment. In the example we give in paragraph 2.22 the customer who signs up to a price-matched offer has no detriment, but is exposed to a claim from the new supplier for breach of contract.

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

3.113 As we note in response to question 16 there is insufficient understanding of what the Standards of Conduct mean and how they apply for them to be turned into licence conditions. Fundamentally, they currently lack sufficient certainty to carry with them potential legal consequences.

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

3.114 There first needs to be an appropriate set of proposals on simplification for the domestic market, but we would expect certain elements, such as a common language for products and product components, to be applicable. Even if there is no requirement to apply these proposals, there should be a commitment not to contradict them (for example, if VARIABLE has a specific meaning in the domestic sector, suppliers should not use it in a different context in the business sector).

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

3.115 We have previously argued that introducing an independent code of practice for TPIs would ensure a more consistent level of service and increase consumers' confidence in using TPIs. The key requirement is for consumer bodies to have confidence in the code and to actively promote it to business consumers (supported by suppliers, Ofgem and any broker trade association). We previously recommended that Consumer Focus should take the lead in developing the code, and should ensure consistency between the business market code and the code for residential market switching sites. We believed that the key emphasis in the code should be on clear presentation of information to users, meaning that it should therefore be relatively easy to police.

3.116 Suppliers, under the auspices of the ERA, are now working with TPIs to develop a code of practice for TPIs. The work is at an early stage, but we would hope that Ofgem will support this initiative when it is further advanced.

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

3.117 Given the need for further research, notably on objections, it will be several months before there are substantive proposals. A further period must then be allowed for consultation and for implementation of any changes. It may reduce the side-effects of uncertainty in the business market if Ofgem confirmed that no changes would take effect before April 2013. This would allow all suppliers to plan their IT programmes and focus resource on any changes in the domestic market or to implement the Green Deal.

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

3.118 Our first observation is the potential cost of a leading firm of accountants to carry out such a review. To ensure the recovery of the leading firm of accountants' costs were not discriminatory, we assume Ofgem expects initially to cover the leading firm of accountants' costs itself and that the cost would then be passed to the end customer in the normal way through increases in the distribution licence fees.

3.119 Ofgem's reasoning for considering appointing a leading firm of accountants is to review the transfer pricing and hedge accounting practices of the vertically integrated firms to ascertain how they impact on reported profits and transparency. However, Ofgem does not explain against what the impact will be compared.

3.120 It would be difficult for the leading firm of accountants to undertake this work without establishing 'reference' criteria. However, both transfer pricing and hedging methodologies are specific to an individual organisation's structure, management principles and strategy. Therefore, reference criteria would need to recognise the various legitimate ways that companies can operate best practice in dealing with interactions between different sections of an organisation and thus the different segments used in the Segmental Statements. It would also need to recognise that transfer pricing and hedging are two separate issues that need different criteria for ascertaining how they impact on reported profits and transparency.

Transfer pricing

3.121 We would argue that reference to any transfer pricing arrangements should be judged by whether commercial activity between companies within the same group is on the "arm's length principle", i.e. it is conducted as if the two companies were completely separate. Where the leading firm of accountants confirms that the arm's length principle is being appropriately applied, then that should meet Ofgem's requirements. However, if the leading firm of accountants found that the arm's length principle was not being appropriately applied, then it should identify the minimum adjustments necessary to make the arrangements appropriate and report to Ofgem the likely impact of these adjustments on reported profits and transparency.

3.122 The OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2010[73] would seem to provide the reference criteria against which the leading firm of accountants could ascertain how any transfer pricing associated with the preparing of the Segmental Statements was appropriate.

3.123 The OECD's Transfer Pricing Guidelines provide guidance on the application of the arm's length principle, which is the international consensus on transfer pricing, in relation to the valuation, for tax purposes, of cross-border transactions between associated enterprises. The arm's length principle is that commercial activity between two companies within the same group should be conducted as if they were completely separate. Here, a 'controlled' internal transaction satisfies the arm's length principle if it is sufficiently comparable to an 'uncontrolled' transaction between independent enterprises. To establish this, comparison is made of the economically relevant characteristics of a controlled internal transaction against the economically relevant

[73] http://www.oecd-ilibrary.org/taxation/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-2010_tpg-2010-en

characteristics of uncontrolled transactions between independent enterprises. To analyse any transfer pricing activities within the Segmental Statements we would suggest that the OECD's guidance is adopted to cover commercial activity between two businesses within the same company or companies within the same group. We would therefore suggest that the remit for a leading firm of accountants in relation to transfer pricing should be:

> *"to review the transfer pricing accounting practices of the firms in the sector that prepare Segmental Statements, as required under Generation Licence Condition 16 and Electricity and Gas Supply Licence Conditions 19A and report to Ofgem whether the practices are consistent with the OECD's principles on transfer pricing; and, where the practices are not consistent, to identify the minimum adjustments necessary to bring them into compliance and to report to Ofgem the likely impact of these adjustments on reported profits and transparency".*

3.124 Having a two part approach would help to keep costs to a minimum, although they will still be significant.

3.125 The leading firm of accountants should not be tasked with reporting to Ofgem the likely impact on reported profits against a transfer pricing model developed specifically for the exercise, nor should the affected companies be tasked to reconcile their actual practices against a theoretical model.

3.126 Our own transfer pricing arrangements, which are fully explained in our Segmental Statement, are based on our generation fleet selling all of its power output from registered balancing mechanism units to E.ON Energy Trading SE ("EET SE"), a fellow subsidiary of E.ON AG. This arrangement has transferred the associated commodity price risk out of the E.ON UK Group. Similarly, our supply business buys its required supply of power and gas from EET SE under a market based transfer pricing agreement. These arrangements operate across country boundaries. As a consequence, our arrangements are subject to examination by the tax authorities in Germany and the UK.

3.127 The agreement for the disposal of our trading business ("E.ON Energy Trading") to EET SE on 1 January 2009 has been given to HMRC, as have the agreements relating to ongoing trading arrangements. HMRC can review the agreement relating to the transfer of business, and the ongoing trading arrangements when it reviews our corporation tax return for the year ended 31 December 2009. HMRC will also be able to review the ongoing trading arrangements for each year that they are in place. The agreements were negotiated between representatives of the legal entities on the basis of arm's length principles to ensure the transfer pricing meets the expectations of the two tax authorities concerned and that profit is correctly realised in the appropriate companies. Having achieved this we would not be in a position to change our arrangements if the work by the leading firm of accountants were to conclude that transfer pricing should not be on an arm's length basis using market based pricing, or that it was not appropriate to account for profit where it was correctly realised. However, admittedly, this would seem a rather bizarre conclusion for the accountants to reach.

Hedging

3.128 Hedging is the process by which a company manages the risk it becomes exposed to in committing to future sales or purchases. In a competitive market, companies need to be free to adopt different hedging strategies, which are many and varied. They can range from no hedging, with all sales and purchases settled via the balancing mechanism, through to all sales and purchases being hedged through long term contracts. The choice of hedging strategy is one way in which firms differentiate themselves in a competitive market. Imposing a standard hedging strategy would reduce trading strategy/activity diversification and thus the overall level of competition.

3.129 Given the wide range of hedging strategies available, the leading firm of accountants should not be tasked with reporting to Ofgem on the likely impact on reported profits against some perceived standard hedging strategy. It should just confirm that the reporting arrangements for any hedging strategies used by the generation businesses and supply businesses, as reported in the Segmental Statements, ensure that the full effects of the particular hedging strategy are fully recognised in the Segmental Statements. If the effect of the company's generation or supply hedging strategy had not been fully recognised in the Segmental Statements, then the leading firm of accountants should ascertain and report to Ofgem how this impacted on reported profits and transparency.

3.130 For E.ON, our transfer pricing arrangements ensure that the full effects of the generation business's hedging activities are fully realised within each generation business and therefore fully reflected in the Segmental Statement. Likewise, for our supply business, the transfer pricing arrangements ensure that the full effects of its hedging activities are fully realised within that business and are therefore fully reflected in the Segmental Statement.

3.131 If independent generators or suppliers are to be able to use the data in the Segmental Statements for comparison, it is important that the Segmental Statements reflect generation and supply activities and that any activities that do not form part of generation or supply segments are not included. For example, while procurement, sales and hedging are integral activities of both generation and supply, and therefore should be reported in those segments of the Segmental Statements, any wholesale market trading activity, which is based on a company actively using additional risk capital to undertake additional commodity price and volume risk, for speculative purposes, should not. This is a similar contrast to that between purely speculative traders, who require large amounts of risk capital, because they are fully exposed to commodity price fluctuations as against purely merchant generators, who operate as an O&M business and sell under a toll processing agreement, who require lower amounts of risk capital because they have no exposure to commodity price fluctuations.

3.132 This is demonstrated by the fact that:

- a company does not have to be an electricity generator or a supplier in order to trade in power. There are a number of active traders in the wholesale power markets that are neither generators nor suppliers, e.g. Deutsche Bank and Macquarie Bank; and

- a company does not have to be a wholesale trader in power in order to be a power plant operator or a supplier, e.g. Alcan UK Limited, Barking Power Limited and the large number of suppliers in the Nordpool and German power markets who do not actively participate in wholesale market trading.

3.133 Clearly additional risk capital backed trading is not an integral part of either generation or supply.

3.134 As noted above, E.ON's commodity price risk that is associated with generation and supply (fuel procurement and power sales by generation and power and gas procurement by supply) has been transferred out of the E.ON UK Group. This means that the effects of our hedging strategies in both generation and supply are transparent and can be clearly seen and that they do not include any speculative trading that might be done elsewhere in the E.ON group.

3.135 We therefore suggest that the remit for the leading firm of accountants in relation to hedging should be:

"to review the hedging accounting practices of the firms in the sector that prepare Segmental Statements, as required under Generation Licence Condition 16 and Electricity and Gas Supply Licence Conditions 19A and report to Ofgem on whether those practices are fully reflected in the Segmental Statements; and where the practices are not so reflected, to identify the minimum adjustments necessary to bring them into compliance and report to Ofgem the likely impact of these adjustments on reported profits and transparency".

3.136 The phrase "off-shoring" has been used to describe the way that some companies have set up their activities, with the implication that this restricts transparency of their overall generation and supply activities. Whilst E.ON does operate a single Europe-wide trading operation, EET SE, from Germany it operates transfer pricing that meets the requirements of the OECD's Transfer Pricing Guidelines and is subject to the scrutiny of two tax authorities, as well as the use of Segmental Statements. In light of this, we are actually delivering very high levels of transparency. Our arrangements mean that:

- all the E.ON UK Group's revenue and costs associated with licensed generation are reported in the generation segment of the Segmental Statement;
- all the E.ON UK Group's revenue and costs associated with licensed supply are reported in the supply segment of the Segmental Statement; and
- The activities not forming part of E.ON UK Group's licensed generation or licensed supply activities are kept out of those Statements.

3.137 As a result of operating across national boundaries, we believe that we have to adopt standards that deliver significantly higher levels of transparency than would be required if we were only operating within the UK.

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

3.138 We are very supportive of moves to additional disclosure to aid customers' understanding and confidence in the market. The E.ON UK plc Annual Report and Statements have had segmental reporting on our different business activities for over ten years. This segmental reporting has given details of the Group's different activities, including generation and supply.

3.139 Ofgem could improve the way that segmental reporting is accessed by stakeholders by developing the way it conducts and presents its analysis of the companies' segmental statements. We have already recommended to Ofgem that it works with the industry to establish the best way of presenting reconciliations. The output from that work should then be reflected in the guidelines.

3.140 Customers need to have confidence in Ofgem's findings. To help this confidence, Ofgem needs to include in its guidance an explicit commitment that, if Ofgem is to adjust any of the figures presented by the companies, it will discuss those adjustments and findings with the companies and, where agreement cannot be secured on Ofgem's interpretation, any publication by Ofgem will carry a record of that fact and of the companies' positions.

3.141 Once Ofgem has drafted its changes to the guidelines, we would ask to be provided with a draft of the complete document so that, should there be any areas that are not clear to us, the user, they can be resolved before final publication.

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

3.142 We do not believe that the evidence presented by Ofgem supports the case for intervention along the lines proposed by Ofgem, whilst the proposals themselves appear to us to be unlikely to be effective in reducing customers' fear of complexity. They are disproportionate in their impact and inappropriate, adversely affecting over two million E.ON customers, including elderly customers on our Age UK and StayWarm products, and weakening partnerships such as with Age UK and Tesco which can help to engage consumers with the market.

3.143 We believe that Ofgem should have mind to the caution expressed by the OFT, referred to above, before intervening yet again into the market, before its previous interventions have had time to bed in and take full effect. The OFT warns in relation to interventions that "*first, we want solutions that solve the problem but we do not want to remove consumer choice and secondly, that there is no guarantee that authorities will necessarily improve the market or not create unforeseen consequences elsewhere*"[74].

[74] OFT 2010, What does behavioural economics mean for competition policy? OFT 1224, page 34

3.144 We have suggested proposals that we believe can reduce complexity in the market and encourage further consumer engagement. These appear in Annex 1.

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

3.145 We do not believe that Ofgem's proposals would be effective in encouraging consumers to switch directly to non-promotional products and hence do not believe they will reduce suppliers' ability to discriminate. Moreover, the consequences of removing SLC25A are quite unpredictable – if competition is focussed on fixed term/fixed price offers, the evergreen tariff could become the highest priced tariff and fixed term renewal offers could be priced to reflect consumers' propensity to switch.

3.146 Amongst our proposals to reduce complexity in the market and encourage further consumer engagement, we suggest that the sunset clause on SLC25A (no undue discrimination) should be extended to July 2016. As it was designed to do, the no undue discrimination condition protects those customers who do not choose to engage with the competitive market.

E.ON
1 June 2011

E.ON proposals Annex 1

Common language for products and product components

Proposal

Products have a clear label, for the category of a product (standard variants: VARIABLE, FIXED, CAPPED, TRACKER, or NON-STANDARD) and, if applicable, as PROMOTION or TIME OF USE. There is a common definition of what these terms mean. Consumers are clear what type a product is from "key facts" presented at point of sale and in the annual statement.

An example definition would be:

Category	**Example E.ON products**	**Definition**
VARIABLE	Energy Plan Energy Online Age UK Standard	Price can change with 30 days notice. Either the majority product or related[75] to the majority product
FIXED	Fixed Price	Price cannot change[76]
CAPPED	Price Protection	Price cannot be above the initial level, but reduces with the majority product [by the same amount]
TRACKER	Track & Save	Price follows[77] another supplier or group of suppliers' majority products [exceptions[78] to be less than [20%] of customers and clearly caveated]
NON-STANDARD	StayWarm SaveOnline Go Green	Any other type of product
PROMOTION	Age UK with Reward Track & Save SaveOnline	Lower price for a fixed term at the end of which roll-over is to another product, which is not a promotion
TIME OF USE	Economy 7 variants of products Economy 10 Heatwise	Electricity price varies by time of day

A library is built up of common terms to use for basic product components. The terms are in plain English. For instance, rather than primary unit rates, say "first kWh"; "exit fee", rather than termination fee or cancellation charge.

[75] Defined difference or moves with (or later if an increase) than the majority product
[76] With some agreed exceptions e.g. government levies & taxes
[77] Price increase could be discretionary, but not more than the increase in the reference price. A tracker could follow a retail index, such as Energy Trends, but not a wholesale index (OFT guidance – this would be unfair to consumers, who would not appreciate the risks or be aware of a low base point)
[78] Almost certain to be some e.g. for very low usage – although if there was a uniform standing charge it may be possible to have very few, say under 5%, exceptions.

Consumer benefits

- Easier to compare products;
- Increases familiarity with product language, and over time reduces perception of complexity;
- Highlights that a product is a PROMOTION and hence raises interest in what happens at end of the fixed term period;
- PROMOTION label may help customers understand the nature of competition and why they are not automatically offered a 'cheapest tariff', reducing the feeling of unfairness;
- Highlights VARIABLE and hence awareness of risk;
- NON-STANDARD encourages a consumer to examine features further;
- If the label NON-STANDARD may be seen as unattractive it may deter minor product variations;
- Price comparison sites do a quick filter on a consumer's current product category and reduce the length of the drop-down menu: as significant simplification for consumers who are not on a PROMOTION.

Risks

- Deters innovation, if customers are averse to NON-STANDARD;
- Flawed choice of terms.

What else is needed to be fully effective?

- Key facts format agreed for point of sale and annual statement.

Consult on options for common price elements

Two tier unit rates became prevalent due to consumer aversion to standing charges and to supplier concern at loose sales practices taking advantage of comparisons to standing charge products. However, having two tiers contributes to the perception that tariffs are complex and, for those customers who do wish to do their own calculations, makes these harder.

In all cases we would expect the metric introduced by the Probe of the forecast annual bill to be the principal means of consumers comparing products, although in options 8-10 it is possible that solo electric single rate consumers (e.g. off gas grid with oil or LPG heating) could use the unit rate.

Proposal

We assess below ten options. Each has advantages and disadvantages and although some are clearly inferior, several justify further debate and, eventually, consumer research. We have assumed that any rule would normally apply to all products[79]; it will not much help encourage consumers to engage, and search for product alternatives, if the majority of products they encounter are more complex than their current one.

Option	Advantages	Disadvantages
Suppliers set prices	No further licence change (amend SLC25A guidelines to force a change of practice) Cost reflective pricing	
1. Uniform threshold (say, 1000 kWh electricity, 4000 kWh gas)	Easier to compare – one fewer difference (and prices only)	Still have four prices in simplest dual-fuel comparison (plus VAT exclusive prices on bills and VAT inclusive in advertising)
2. As 1, plus rounded first kWh prices[80]	Each option makes easier to calculate Standing charges reduce perception complexity	Calculation requires threshold to be subtracted from usage
3. As 1, plus first kWh are a rounded premium on the (main) unit rate		
4. Standing charge, no two tier unit rates		Customers do not like standing charges Loses familiarity with price components which has built up Perceived unfairness to low users[81] Could be seen as patronising
5. Standing charge, rounded price (multiple £10)		
Ofgem sets and reviews prices	Easier comparison – no difference between suppliers	Premium in unit rates to compensate for risk Common price change on [1st April], includes all price elements Risk of low users being excluded from marketing if the (quasi) standing charge is too low
6. As 3, varies by region	Can compare on unit rates only	
7. As 5, varies by region	Can compare on unit rates only	Stakeholder pressure to set a lower price than costs justify
Simple price, rarely reviewed, and after consultation	Minimum complexity – easiest comparison and price calculation	Increased risk of non cost-reflective pricing distorting marketing
8. As 3, same for all regions, +10p/kWh electricity, +5p/kWh gas	Easy calculation Preserves two tier advantages (customer preference, perceived fairer to low users)	

[79] Option 10 allows for some variation and would allow for innovative products such as StayWarm
[80] Integer p/kWh for electricity; quarter p/kWh increments for gas.
[81] Especially as landlords would be exempt, if there was no usage

Option	Advantages	Disadvantages
9. As 5, same for all regions, £100 electricity, £200 gas	Easy calculation, looks very simple	
10. As 8 or 9, but allow exceptions for fixed term products	Allow innovation, and competition on standing charge elements	Undermines steps to reduce customer fear of complexity Fixed term products biased towards more active/aware consumers Misselling if permitted to have 'no standing charge'

Our initial view is that:

- Same thresholds would help and has minimal downside;
- Ofgem setting prices hardly simplifies and has downsides of increased risk, restricting innovation and of institutionalising a 1st April[82] 'price round';
- It's worth exploring a simple £100/£200 standing charge, although it may be more palatable to structure this is a premium unit rate (Option 8);
- Simplification is unlikely to displace 'forecast annual bill' as the key metric. VAT exclusive and inclusive prices complicate comparison between current bills and potential, advertised, new products. Time of use and dual-fuel tariffs have multiple unit rates.

<u>Consumer benefits</u>

- See above;
- The principal benefit is in reducing the perception of complexity. We believe that relatively few consumers will actually seek to do their own calculations, particularly if confidence in websites is increased.

<u>Risks</u>

- See above;
- May be unfair to consumers with different fixed costs e.g. TIME OF USE tariffs have different metering costs, smart meters reduce prepayment meter costs;
- Reduced ability to compete as a low cost provider, if customers expect lower service costs to show as a lower standing charge;
- Unforeseen side-effects from standardisation, for instance to give an advantage of scale to British Gas or disadvantage to new entrants[83].

[82] Changes in networks charges would be a major influence on the standardised price

[83] This shouldn't be the case – rather it just forces any cost difference or recovery of fixed costs to be reflected into unit rates – but the effects of this are unpredictable

What else is needed to be fully effective?

- Standing charge options could be made quite attractive if the ECO obligation and networks charges were usage based. The latter is within Ofgem's remit. If there is to be a loss of cost-reflectivity doing this within networks charges rather than the retail price would have fewer adverse effects[84]). The charge might then be £60/fuel.

Enhanced product description at sale

Improving consumer information and hence choice will be more effective in encouraging more active engagement than removing consumer choice, and fairer to those who value choice. Improving consumer choice will allow product innovation to continue, without more choice being seen as compounding complexity.

Proposal

- Standardised key facts format (we attach a possible example at the end of this annex, although would normally expect a consumer to only compare two or three products);
- Key facts to include what might lead to a higher annual bill than the forecast, which remains the key metric;
- Clear description of what happens at the end of any fixed term period, including description of the roll-over product and whether there is an alternative of no roll-over[85];
- Highlight if the customer is paying more than currently, or if this is not known.

Consumer benefits

- Increased consumer familiarity with product presentation, reducing perception of complexity;
- Easier comparison of products;
- Increased focus on products with a clear selling point. Deters more complex products with multiple risks to the forecast annual cost;
- Greater awareness of the potential for a price increase in a VARIABLE product, reducing perception that market is unfair;
- Increased confidence in selling.

[84] It is unlikely that cost reflective networks pricing to residential consumers has any material efficiency benefit and indeed higher gas unit rates would help encourage energy efficiency meaures, partway compensating for the lack of a cost of carbon. Consumers would also accept the standing charge more readily if it was smaller and restricted to items which are more easily seen to be property/customer related – connection to the property, metering, environmental taxes, customer service

[85] Additional options would add to administrative costs and may also complicate the sale process, leading to consumer disengagement

Risks

- Key facts and risk description poorly designed – information overload or lacks clarity;
- Additional costs of doorstep selling, although may be offset by the benefits of increased consumer trust and reduced churn.

What else is needed to be fully effective?

- Key facts format agreed for point of sale and annual statement;
- Agreed principles for describing risks.

Internet sales subject to marketing licence condition

Ofgem should be ambitious and set a demanding goal of price comparison websites being the first and trusted port of call of less sophisticated customers seeking to engage with the market. Suppliers will of course seek to make PCWs a second option after their own websites, but the raised standards of all websites will greatly benefit customers, and is essential to maximise the benefits of smart meters in increasing consumer choice. PCWs with a phone service would enable all consumers to benefit from easier and improved choice.

Proposal

- Suppliers are made accountable for internet sales meeting the requirements of the marketing licence condition (SLC25.1 & 25.2) that, amongst other requirements, products are appropriate to the consumer.

We believe websites will then, to get suppliers' business, have to help consumers through the range of products, narrowing the choice to a limited number which meet the consumer's needs and displaying a key facts comparison.

There would be a difficult transition period as suppliers and PCWs sought to determine what standards were required, to renegotiate existing contracts and to implement changes, but the end result would be greater consumer confidence, better service and a robust and settled platform by the time smart meters became prevalent.

PCWs would lead the change, as they would each want to develop their own format which all, or the majority, of suppliers would sign-up to. Suppliers would need to be flexible – accepting, or rejecting, PCWs' formats not hoping to impose their individual preferences. Suppliers would also need to be cautious; being the sixth supplier to sign up would not guarantee that a site's procedures ensured compliance, so that in practice PCWs would likely aim for higher standards, to win over the most cautious supplier. Suppliers and PCWs would need to agree a standard for consumer research to confirm the site was effective in helping customers to understand products.

PCWs may give customers an option – quick for the customer who knows what they want; a few minutes extra for those who want to be guided. The latter, and hence the product comparison service, might be restricted to those products covered by the PCW's contract with the supplier (but, as now with the Confidence Code, the comparison could not be affected by the level of commission).

Suppliers would not be accountable for PCWs which were advisory, but would be accountable for the display of products on commercial PCWs which required the consumer to contact the supplier directly to switch.

It is not a quick win.

Consumer benefits

- Increased confidence in PCWs, increasing engagement with the market (75% of households have internet access and many PCWs also provide a phone service);
- Simpler presentation of products, reduced risk of 'too much choice';
- Clearer presentation of products, with greater awareness of key features and risks;
- Deterrent to more complicated products, both from consumer aversion to the additional explanation and from suppliers' overhead of checking each website;
- Ongoing consumer research to confirm that customers understood products and selecting those appropriate to their needs;
- Reduced perception of complexity in the market.

Risks

- Costs and risk of hiatus in the transition period;
- Costs of consumer research and other monitoring;
- Fewer and less competitive PROMOTIONS;
- Higher sales costs;
- Reduced number of price comparison websites.

What else is needed to be fully effective?

- Key facts format agreed for point of sale and annual statement:
    - Includes clear, prominent annual usage data[86].

[86] This is the key information a consumer requires to get an accurate quote. We believe many consumers input inaccurate data, which may then mean that if they check to a different website or direct to a supplier see an inconsistency, which is perceived as complexity and a barrier to further engagement. It may also help to have a clear, prominent electricity and gas spend. This may be more memorable than usage, and would avoid the problem shown by our research of many consumers just assuming equal electricity and gas spend

Advertising to exceed ASA requirements and have regard to risk of confusion

Consumers have a low interest in energy and many may not appreciate the subtle accuracies of advertising wording. OFT reports that multiple claims which seem to conflict are an aspect of complexity.

Proposal

- Suppliers to have regard to the Standards of Conduct and the risk of confusion from their claims, notably to be the cheapest;
- Sunset clause of July 2013, but with expectation of renewal to July 2016 if there is no substantive adverse side-effect.

Consumer benefits

- Reduce complexity;
- Change industry culture away from 'small print';
- Consumer research by suppliers to understand what presentation is most effective.

Risks

- Ofgem resource required to oversee compliance (although as with ASA complaints the initial process should be supplier to supplier challenge);
- Cost of consumer research inhibits innovative (borderline) advertising.

What else is needed to be fully effective?

- Consumer awareness of common language terms (which would appear on advertising).

Enhance information at renewal (end of fixed term), including comparison to relevant evergreen product

Consumers are protected by SLC25A from unwarranted price increases at renewal, but may miss out on opportunities if they are happy with their current product. Potential prompts could be a key facts comparison to a VARIABLE product or a prompt to get a tariff check at the supplier's website (much as is envisaged on an annual basis by Ministers).

Proposal

- Timely, clear communication of what will happen at renewal:

- Ofgem to challenge weaknesses informally, rather than be prescriptive in a modified licence condition (i.e. as proposed in Option 1 of the consultation on fixed term offers earlier this year[87]);
- Key facts presentation of the roll-over product;
- Key facts presentation of the relevant VARIABLE product[88];
- Signpost to website for further information.

Consumer benefits

- Clearer information;
- Builds confidence in fixed term products – transparent process and premium (if any)[89];
- Prompted to consider alternatives, but in a way which respects the consumers' product preference and is not unduly intrusive[90].

Risks

- Information overload, if the renewal process and the annual statement are not aligned (which may not always be possible);
- Prescription of what to present may not be what consumers' really want and would not readily be able to be changed.

What else is needed to be fully effective?

- Key facts format agreed for point of sale and annual statement.

Consult on conditions to allow roll-over to a fixed term with an exit fee

It is not clear what the balance of customer benefit is between a lower priced product with an exit fee and a higher priced one which allows more time for decision making.

Proposal

- Consultation to consider whether:
    - to allow roll-over with an exit fee, on the grounds that this gives a lower price and customers are informed by the key facts presentation of the exit fee (perhaps also with a requirement to

[87] Ofgem January 2011
[88] e.g. for E.ON customers, Energy Plan for off-line, Energy Online for online
[89] Allaying fears that renewal will see a ratcheting up of prices. The need to justify the premium, particularly if it differs from that at sale or previous renewal should also lead to more transparency over wholesale price expectations
[90] See also our response to the consultation on fixed term offers. E.ON 7 March 2011. We are aware that Ofcom have concluded that automatic roll-over weakens competitive intensity, but, at least for FIXED and CAPPED offers, the form of contract in the energy market is quite different. Ofcom have also conducted extensive research to support their analysis

highlight the risks of a large fee – a reduced benefit of switching in response to falling prices);
    - to require a no exit fee alternative to be given equal prominence; or
    - to require opt-in if there is an exit fee (with default to a no exit fee product).

Consumer benefits

- Resolve outstanding issues, increasing confidence in fixed term products;
- Improved practices;
- Stable regulatory regime supports product innovation.

Risks

- Information overload, if the renewal process and the annual statement are not aligned (which may not always be possible);
- Prescription of what to present may not be what consumers' really want and would not readily be able to be changed.

What else is needed to be fully effective?

- Key facts format agreed for point of sale and annual statement.

Sunset clause on SLC25A (no undue discrimination) extended to July 2016

SLC25A ensures customers who are less active are treated fairly, albeit would need to be more active to take-up the cheapest, promotional, offers. Ofgem has applied the clause wisely, setting out clear guidance and following up issues in a proportionate manner, with a mix of informal and formal investigation. The clause has to date had no clear adverse side-effects.

Proposal

- SLC25A9 is amended so that the prohibition of undue discrimination licence condition ceases to have effect on 31 July 2016.

Consumer benefits

- Stable regulatory regime supports product innovation;
- Avoids further regulatory review in early 2012, undermining the review's programme to build trust.

Risks

- Regulatory burden of justification of smart meter products (this is mitigated by the new sunset date – which should allow an informed review after a few years experience of smart meters);
- Change of approach by Ofgem, so that the clause is applied inflexibly, inhibiting competition, or instrusively, requiring substantial overhead.

What else is needed to be fully effective?

- Nothing.

Example – sales information/product comparison (MDD, dual-fuel, not time of use electricity)

	EnergyPlan (Standard)	**Energy Online**	**Fixed Price**	**Price Protection**	**SaveOnline**	**Track & Save**	**StayWarm**
Key feature	Basic product	Basic online product	No risk price increase, for 18 months	No risk price increase, still benefit prices fall, for 18 months	Promotion, for 12 months. Manage account online	Guarantee cheaper than British Gas, for 12 months	Fixed annual charge – even if usage increases
Product type	VARIABLE	VARIABLE	FIXED	CAPPED	NON-STANDARD PROMOTION	TRACKER PROMOTION	NON-STANDARD
Forecast annual bill (example – average usage)	£1050	£1029	£1092	£1134	£920	£1025	£1080
Can prices change?	Yes – 30 days notice	Yes – 30 days notice	No - fixed	Capped – prices follow EnergyPlan, but can't go above the initial price	Yes – 30 days notice. Guaranteed to be at least 6% below standard	Yes – 30 days notice. Follows British Gas (not E.ON Standard)	No - fixed annual charge
What happens at end of initial period?	n/a	n/a	New fixed price	New capped price	Go to EnergyOnline	Go to EnergyPlan	New fixed annual charge
Exit fee	No	No	Yes, £40 if leave during fixed price period, none if leave at end of period	Yes, £40 if leave during capped price period, none if leave at end of period	Yes, £40, if leave during promotion period	No	No
What could increase the annual bill?	Your usage changes Cost changes leading to a price change.	Your usage changes Cost changes leading to a price change.	Your usage changes	Your usage changes	Your usage changes Cost changes leading to a price change Change in discount	Your usage changes Cost changes leading to BG price change	Nothing
Requirements		Online account servicing			Online account servicing		Notify us if another person moves in to the property
Options	Tesco club card points Online account servicing	Tesco club card points	Tesco club card points Online account servicing	Tesco club card points Online account servicing		Tesco club card points Online account servicing	

Product numbers Annex 2

We believe the principal issue with the number of products is that customers' fear of having to choose from a large number of products deters many from starting to search. This fear is exacerbated by some of the wilder numbers of tariffs quoted, which include regional, time of use and payment method variations, which no customer would ever be exposed to the full range of.

However, it is true that the number of products can genuinely inhibit customers' engagement with the market and that further action, as we have outlined in Annex 1, is appropriate.

In this Annex we discuss the different situations which can arise, where consumers may see a number of tariffs as an example of complexity and the impact of ours and Ofgem's proposals on complexity.

<u>Price comparison websites</u>

The Probe sought to ensure that customers would be able to easily identify their existing tariff, as a basis for comparison, but the drop-down menu is still off-putting, with up to sixty tariffs being displayed (primarily historic variants of promotion, fixed and capped products). A dual-fuel customer may be asked to separately identify their electricity and gas tariffs.

Impact of:

E.ON Proposals	**Ofgem Initial Proposals**
Suppliers work with PCWs to improve ease of understanding. Consumer can exclude many options by inputting category type.	Slight reduction as one instead of six evergreen products, but potential confusion if consumer does not appreciate that their long standing evergreen product has been withdrawn

PCWs typically list all products which a consumer can sign up to online. A consumer who is willing to manage their account online will be able to focus on the first few offers. A consumer who wishes to manage their product off-line or wants specific features may need to work through the full list. They are likely to see five E.ON tariffs and four Age UK/E.ON tariffs[91].

[91] Consumer Focus' open letter of 2 December 2010 reports 13 tariffs, but counts quarterly direct debit as well as monthly direct debit – quite different payment methods appealing to different types of customer, and most websites would not display the two together.

Impact of:

E.ON Proposals	Ofgem Initial Proposals
Suppliers work with PCWs to ensure consumers are helped through choice of product. Key facts presentation to compare when choice narrowed.	Fewer evergreen products to compare, but still need to search mid-table (if fixed and capped non-promotions are highest priced).

Supplier websites

Suppliers continually seek to improve their websites and are at different stages in helping consumers to identify what tariff may be appropriate for them.

A customer looking at eonenergy.com will see six E.ON and three Age UK tariffs, but we accept the presentation needs to be improved to make it easy for a customer to compare products (our phone sales advisers – see below – are able to do this for the customer).

Impact of:

E.ON Proposals	Ofgem Initial Proposals
Requirement to help consumers through choice of product, including key facts presentation.	Reduction to five E.ON[92] and one Age UK tariffs

Telesales and fieldsales

Our agents seek to establish a prospective customer's needs and will aim to present a small choice of products, at most three. If the appropriate product (or our sole product, as with PPM) is variable priced, our agent may offer a promotion to give the customer a material financial incentive to switch.

Impact of:

E.ON Proposals	Ofgem Initial Proposals
Improved clarity at point of sale for fixed term products. Standardised key facts comparison	Choice will either be the single evergreen product, with no additional financial incentive, or a complex offer of a fixed term fixed, capped or tracker product which reverts to a variable product.

Partner outlets

Age UK agents will offer products from the Age UK range. The additional features of these products include cold weather payments and a donation to Age

[92] Two other E.ON products, Go Green and Energy Online, would not be permitted, but are currently not displayed.

UK, although the greatest benefit can be if a customer switches from separate incumbent suppliers to dual-fuel or from standard credit to direct debit.

Impact of:

E.ON Proposals	Ofgem Initial Proposals
Improved clarity at point of sale for fixed term products. Standardised key facts comparison	Restricted to fixed term products

Summary

We have argued in our response that the aim should be to improve customers' choice, not to remove choice. The above analysis shows that the situations in which customer see a choice of tariffs are varied. Each needs to be fully examined to establish the efficacy of any proposal, but our initial assessment shown above suggests that our proposals would benefit customers in each situation whereas Ofgem's would not lead to a material improvement. Even though it is customers' fear of complexity which is the main barrier to engagement, the reality of each situation will determine whether consumers start to believe complexity is not as great as they fear. A programme to build trust, as we advocate, will be more effective than reducing choice.