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Ofgem - Retail Market Review - Findings & Initial Proposals

Please find below Which?'s response to the findings and initial proposals of Ofgem's Retail Market Review.

Our response broadly follows the structure of the Review. However, in the interest of a more coherent narrative, we felt that Q28 (impact of measures to address tariff complexity on price discrimination) is most relevant to the section on tariff complexity and, accordingly, have moved it to this part of the response, where it follows Q4. We have not responded to Q19-24 as these relate to non-domestic users of energy who are not part of our core constituency.

To aid navigation and provide structure we have interspersed our responses to the questions with the following section headers and sub-headers. Due to the length of this response, at the beginning of each section we have provided bullet points detailing the key observations and recommendations in our response.

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INTRODUCTION

- *Ofgem has provided a well-evidenced and persuasive analysis of why high levels of disengagement and frequency of poor switching decisions, coupled with an absence of a significant challenge to the dominance of the Big 6 from smaller suppliers, are important factors in the failure of the energy market to deliver the benefits of competition to consumers.*

- *The findings of the Review are a damning indictment of the effectiveness of Ofgem's 2008 Energy Supply Probe to increase engagement and enhance competition. Not only have most areas of the market demonstrated no improvement, but some have seen marked deterioration.*

- *The Review fails to set out in any detail what a well-functioning energy retail market would actually look like beyond high-level concepts like 'increased consumer engagement'. This is essential in being able to judge the success of any measures implemented as a result of this process.*

- *Some of Ofgem's proposals are radical yet still depend on level of engagement with a market that has thus far been characterised by persistently high levels of disengagement. It is a concern that there has been no consideration of whether there are other factors that present barriers to engagement that are not present in other markets, particularly the very nature of energy as a utility.*

- *It is now more than a decade since liberalisation. The vast majority of consumers know they can switch their supplier yet most do not - despite the substantial savings available. As such, if the proposed remedies fail to improve outcomes for consumers, Ofgem should consider whether there are alternative ways of structuring the energy market that would better protect and promote consumer welfare.*

Which? and energy

1. Which? is an independent, not-for-profit consumer organisation with around 1 million subscribers and is the largest consumer organisation in Europe. Which? is independent of Government and industry, and is funded through the sale of Which? consumer magazines, online services and books. Which? is a consumer champion working to make things better for consumers. Our campaigns make people's lives fairer, simpler and safer.

2. Through frequent and ongoing dialogue with consumers, including regular surveys, Which? has identified low levels of satisfaction and trust in the energy sector. The cost of energy ranks as consumers' number one financial concern, with 86 per cent saying they are worried about it. Yet, just 23 per cent of consumers trust energy suppliers to sell them the right tariff and services to meet their needs, and only 16 per cent believe that suppliers try to keep their prices at a reasonable level. Overall, just one in five consumers considers energy suppliers to be trustworthy[1].

Agreement with the findings of the Retail Market Review

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.

3. Which? generally agrees with the central finding of the Review that product and price complexity, combined with the absence of a significant competitive fringe of small and independent suppliers, represent impediments to the development of a level of competition that benefits consumers.

4. It is encouraging to see the depth of research and analysis that supports Ofgem's conclusions on the causes of consumer harm and barriers to entry and informs its proposed remedies. Particularly positive is the comprehensive analysis of the consumer experience in relation to tariff complexity in the context of the increasingly influential field of behavioural economics, and the use of the Consumer First Panel to appraise the various options for addressing tariff complexity.

5. That said, it is extremely disappointing that the Review's effective indictment of the energy market comes not only after more than a decade of retail market competition, but a full two and a half years after Ofgem published the findings of its Energy Supply Probe in 2008. While

[1] Which? surveyed a sample of 2,000 UK adults between 30th April and 7th May 2010. Results were weighted to reflect the UK adult population.

many of the Probe remedies were designed to increase consumer engagement and enhance competition, by Ofgem's own analysis only a minority of the key findings of the Review are indicative of any kind of improvement for consumers. In most areas there has been no change at all, or – in the cases of the volume and complexity or tariffs, evidence of less timely price adjustments when wholesale prices fall than when they rise, and the number of disengaged 'passive consumers' – marked deterioration[2].

6. It is clear from the Review that any consumer benefits to be gained from the proposals are largely predicated on an effective demand-side (consumer) response. This would manifest itself in a level of engagement with a market that has thus far been characterised by persistently low levels of engagement. This is despite over a decade of retail market competition and a high level of awareness among consumers of the ability to switch supplier and/or tariff[3].

7. The most radical proposals in the Review are those aimed at making products (tariffs) easier to understand and compare and reducing barriers to market entry by new suppliers. While Which? generally supports these proposals, we also recognise that this is the second wide-ranging review of the retail market that Ofgem has conducted in the last three years – a process that cannot continue *ad infinitum*. As such, we ask Ofgem to clarify the following:

- How Ofgem intends to assess the success of the measures implemented in improving consumer welfare and the how long it will allow before making this determination; and

- The course of action Ofgem intends to take if the measures do not achieve their intended objective, specifically whether this will include consideration of whether there are alternative ways of structuring the energy market that may better serve the interests of consumers. This should also acknowledge that, as a *utility*, energy has particular characteristics that may impact on consumers' propensity and ability to engage with the market. We discuss this issue in the following section.

Competition in the energy retail market

8. As a general principle, Which? supports the view that any well-functioning market depends on efficient interactions on both the demand (consumer) side and the supply (firm) side. This fosters a so-called 'virtuous circle' where engaged consumers play a key role in driving vigorous competition between firms, who respond by delivering competitive prices, better customer

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[2] RMR, 2.91.

[3] Among those who have never switched either energy supplier, 87% are now aware it is possible to switch supplier (*Customer Engagement with the Energy Market - Tracking Survey*, Ipsos Mori, 2011, p24).

service, and innovation. We understand these benefits as the underlying rationale for market liberalisation.

9. However, it is difficult to detect the aforementioned positive effects of competition in the energy retail market. Instead, the Review presents a picture of a market characterised by worryingly high levels of consumer disengagement and frequency of poor switching decisions, coupled with the absence of a significant ‘competitive fringe’ that represents a material threat to the dominance of the Big 6.

10. Which? agrees that consumers’ interests will be protected and promoted by outcomes like competitive pricing and innovation. However, these are high-level, somewhat abstract concepts and substantially more detail is required on how Ofgem intends to judge the success of any measures that are implemented as a result of the Review in order to improve competition and secure these outcomes. Fundamentally, we feel that while the Review effectively describes the existing problems in the market, it is less impressive in setting out what Ofgem believes an ‘ideal’ market would look like and what it should achieve. Although not necessarily attainable, without such a benchmark it is difficult to comment on whether the proposals are sufficient or not.

Energy – a consumer product or a utility?

11. In the Review, Ofgem proposes to address the structural issues – product complexity and barriers to market entry and consolidation for non-vertically-integrated suppliers - it identifies as impediments to the development of a market that promotes the interests of consumers. In their interventionist nature the proposals to simplify tariffs and increase wholesale market liquidity are somewhat radical to the extent that they represent a clear change in direction from the Energy Supply Probe. In the Probe remedies, Ofgem introduced a set of overarching ‘principles’ (the Standards of Conduct) as a mechanism to foster a well-functioning competitive market by ‘guiding’ supplier behaviour.

12. However, intervention to reduce product complexity and remove barriers to market entry for smaller and independent suppliers will only be effective if consumers respond proactively to these improvements. It may be overly optimistic to assume that, as long as consumers can easily understand and compare products in a market that includes firms with markedly different business models, they will respond by switching to the supplier that offers the best deal. As we point out below, there may be other factors, principally the nature of energy as a utility, that present a barrier to consumer engagement in this market that may not exist in markets for other consumer products.

13. In Which?'s view, energy is not a consumer product in itself but a utility. As core products, gas and electricity are 'derived demands' – bought incidental to some other need or purpose (in the case of energy, at the most basic level this 'need' is the ability to participate in modern economic and social life). They are also homogenous, being identical in quality and reliability irrespective of the firm and/or tariff through which they are supplied. Furthermore, because energy is supplied to the majority of consumers on a credit basis with no effective limit on demand consumers do not have to 'go to the market' to source more of the product when it runs out.

14. Therefore it is legitimate to ask whether the energy market can ever provide sufficient opportunities for product differentiation and enough tangible points of 'market contact' to deliver a level of consumer engagement at which the full benefits of competition can be realised. While the fact that energy was once provided by public bodies may by responsible for a degree of paternalism in the market as a legacy effect that suppresses the level of switching activity, after more than a decade of retail market competition the concept of competitive choice is not exactly new. Indeed, while nine in ten consumers say they are aware they can change their energy supplier only four in ten have actually exercised their right to switch, despite the well-documented savings on offer.

TARIFF COMPLEXITY

- *Which? supports the proposal to make tariffs easier to understand and compare. While suppliers are likely to contest product intervention as detrimental to competition, our view is that particular characteristics of the energy market, such as low frequency of purchasing decisions and the fact that energy is not only a utility but an essential-for-life service, demand that tariffs are easy for consumers to understand and compare.*

- *It is not self-evident that reducing complexity will increase the overall proportion of consumers that are engaged with the market. It should improve the effectiveness of switching among consumers that are already engaged, but understanding it as a mechanism* *to boost participation among a majority of consumers who have consistently failed to engage requires a substantial leap of faith. Again, we recommend that Ofgem should consider other factors that may be driving disengagement.*

- *We seek clarification that Ofgem will require all tariffs offered in the market to be structured in the same way, with a standardised charge covering fixed costs and a single unit charge covering the actual energy used. This means no more complicated 'tiered' pricing, which do not permit straightforward comparison. To permit straightforward comparison and transparency, all discounts should be subsumed into the unit charge.*

- *The proposal to prohibit auto-rollovers without positive assent is welcome. However, where consumers do agree to be switched to a new fixed-term deal when their contract comes to an end, they should be protected by a time-limited price guarantee from any increases in the prices they were quoted when they signed up. Failure to provide this reassurance will erode confidence in the market.*

- *Ofgem should extend its proposal on prohibition of unilateral contract term variations to cover the marketing of tariffs with an advertised 'minimum' discount. Fundamentally, consumers should be made aware of whether there is a difference between the discount offered at the time they sign up and what the discount could be reduced to during the contract term. Ofgem should also consider whether variable discounts are appropriate in the energy market as consumers may be better served by fixed discounts than high initial discounts that reduce to a less attractive level of discount over time.*

- *In the next stages of the Review, Ofgem should assess whether a move to national pricing would help address the issue of segmentation of 'sticky' customers and price discrimination between regions. We also recommend consideration of a naming convention for tariffs to improve consumer choice.*

- *The standardised charge should reflect the fixed costs of providing and maintaining a connection to the energy supply networks. We believe that the most appropriate way to apply this charge would be on a per-connection per-day basis. Further clarification is required on whether environmental and social levies and charges would be included in this charge, and, if so, how these will be applied in an equitable manner that accords with the 'polluter pays' principle. Indeed, we feel that the Review represented a missed opportunity to seek stakeholders' views on the fundamentals of environmental and social levies and charges on energy bills.*

- *In the development of a metric to enable comparison between tariffs, Ofgem should conduct a thorough analysis and assessment, including consumer research, in order to satisfy itself that any metric is not only understood by consumers but also perceived by them as relevant to their own situation and energy consumption habits.*

- *Ofgem is correct to propose measures that restrict opportunities for suppliers to obfuscate prices and exploit consumer inaccuracy. Which? does not believe that this will damage competition as the proposals preserve suppliers' ability to target particular types of customer with different offers or create innovative bundled products. However, Ofgem should be mindful of the unintended consequences of greater price transparency, such as facilitation of tacit collusion, and 'restructuring' of price offers, where firms undercut their competitors 'headline' prices by introducing separate charges for certain services.*

- *We believe that Ofgem should revisit its proposal that there will be no 'dual fuel' evergreen tariffs under the new regime. There are currently around 16.9 million dual fuel accounts, many of which will be standard (evergreen) tariffs. As dual fuel tariffs usually attract a discount, we are concerned that many consumers may lose out financially if they are 'defaulted' onto separate single fuel tariffs. As a general point, the migration of large numbers of accounts that will be required following the proposed changes demands an impact assessment to ensure that no consumer will be left worse off.*

Reducing tariff complexity

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

15. Which? believes that in order for a market to function effectively it is essential that consumers understand the nature and price of the products available to them. However, evidence cited by Ofgem in the Review suggests that consumers find pricing information in the energy market difficult to understand. 70 per cent of respondents to Ofgem's 2008 domestic consumer engagement survey said they found the number of tariffs on offer confusing[4]. While no comparable figure is provided in the most recent (2011) consumer engagement survey, it is unlikely a 70 per cent increase in the total number of available tariffs since 2008[5] will have had any positive effect on the proportion of confused consumers.

[4] RMR, 2.15.
[5] RMR, 2.17.

16. Therefore, Which? believes the principle of making tariffs easier to compare is a sound one. At present there are too many variables – standing charges, tiered rates, discounts expressed as both monetary amounts and percentages (sometimes within the same product offer) – to permit straightforward 'at a glance' comparison between different offers without using a price comparison service. Although product intervention is a radical step and is likely to be presented in suppliers' response to this consultation as detrimental to competition, we recommend that consideration is given to the following factors in assessing this claim:

- Choice is a relatively new concept in the energy market, having only been introduced in 1998, and it should be expected that familiarity with products will generally be lower in newer consumer markets, particularly those without frequent opportunities for interaction, than more mature markets where consumers have become accustomed to acquiring information and making choices;

- Certainly, it has been found that consumers are less likely to object to complexity in the way products are priced when related to products they purchase frequently, suggesting that knowledge and experience of a sector may help them mitigate the effects of complexity. A 2010 OFT study found that just under half (49%) objected when they were making a high frequency purchase, compared to 70 per cent for low frequency[6]; and

- Notably, consumers were particularly likely to object (75%) where they had experienced complex pricing in the gas and electricity sector, suggesting that the combination of a low frequency of purchasing decisions and the nature of energy as an essential-for-life service may elicit an especially negative emotional reaction in consumers when they are faced with products that are difficult to understand and compare[7].

17. In the Review, Ofgem makes a clear link between tariff complexity and the *level* and *effectiveness* of household engagement[8]. Regarding *effectiveness* of engagement, it has been shown that an unacceptably high proportion of consumers who have already engaged with the energy market in order to change their supplier either make switching decisions that leave them paying more than before[9], or are unable to gauge whether they have saved any money[10].

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[6] http://www.oft.gov.uk/shared_oft/market-studies/AoP/OFT1291.pdf (p75)

[7] http://www.oft.gov.uk/shared_oft/market-studies/AoP/OFT1291.pdf (p75)

[8] RMR 1.15.

[9] Wilson and Waddams Price (2007) provide evidence that some consumers in the electricity market actually switched to suppliers with higher tariffs, even though they stated price as the only reason for switching (http://www.google.co.uk/url?sa=t&source=web&cd=10&ved=0CGMQFjAJ&url=http%3A%2F%2Fwww.esrc.ac.uk%2Fmy-esrc%2Fgrants%2FRES-578-28-0001%2Foutputs%2FDownload%2F6c7c07e8-d293-4134-95f3-

Therefore, Which? welcomes measures to reduce complexity insofar as they will reduce the potential for error in the switching decisions of already engaged consumers and drive consumer confidence in switching as a mechanism to potentially reduce energy costs.

18. However, as alluded to above, it is not axiomatic that measures to address complexity will also significantly increase the *level* of engagement with the market and the ability of consumers to realise the substantial savings that are available to first-time switchers[11]. At present, up to 60 per cent of all consumers claim to have never switched supplier. Within this group those with the most to gain from switching - consumers in lower social grades and those more likely to be on lower or fixed incomes - are disproportionately represented[12]. While consumers may *say* that a large number of complex tariffs deters them from engaging with the energy market[13], we reiterate the point made earlier that Ofgem should also consider whether the nature of the energy as a utility is also a factor in the persistently high proportion of consumers who are considered either 'disengaged' or 'permanently disengaged'[14].

Tariff structure, automatic rollovers and contract term variation

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

19. Which? supports the proposal to make tariffs easier to understand and compare subject to satisfactory clarification of the following:

- It is not explicit in Ofgem's initial proposal that suppliers will be required to structure fixed-term tariffs (as opposed to only 'evergreen'[15] tariffs) in the same way, with a 'standardised element' or 'standing charge' covering certain fixed costs and a single unit charge (p/kWh) covering the actual energy used.

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[10] RMR, 2.14.

[11] RMR, 2.71.

[12] RMR, 2.69.

[13] RMR, 2.14.

[14] RMR, 2.48.

[15] Ofgem uses this term in the Review to describe a variable-price tariff with no contract term. Which? considers this equivalent to the 'standard' tariffs currently offered by suppliers.

- Nor is it clear from that Ofgem intends to retain evergreen contracts for consumers with multiple rate electricity meters (e.g. Economy 7, Economy 10, Dynamic Teleswitching). Which? believes that evergreen contracts should also be available for the tariffs supported by these meters, as 'defaulting' these consumers to evergreen single-rate tariffs would result in substantial increases in bills given their dependence on cheap off-peak electricity for space and water heating purposes.

20. For tariffs to be instantly and directly comparable, Which? believes they should all be structured in the same way. This means that 'no standing charge' tariffs, where pass through costs are simply subsumed into the overall price using complicated 'tiered' pricing models (which, in turn, vary significantly across suppliers in the way that 'tier thresholds' are set), should be phased out in preference for the model Ofgem has proposed for standard evergreen tariffs.

21. In the interests of transparency and reducing price obfuscation, all discounts (e.g. dual fuel, direct debit, paperless billing) should be included in the single unit charge to eliminate the use of complicated discount structures, such as those identified by Consumer Focus on a number of British Gas tariffs[16] that precluded 'at a glance' comparison between different products. Ofgem's proposal to not limit the number or type of fixed-term 'other tariffs' (i.e. non-evergreen tariffs) will only deliver the benefits to consumers of choice and innovation, which the measure seeks to promote, if consumers are able to easily compare the value of competing offers against each other and with evergreen tariffs.

22. A useful analogy to the presentation of prices in the energy market is provided by the regulatory action taken by the European Commission in 2007 requiring that all airline fares are quoted inclusive of all applicable taxes, charges and fees[17]. Although there has been some 'restructuring' of price offers by some operators, with services that were once part of the inclusive headline price, such as hold baggage, becoming a chargeable 'optional extra', airline passengers in the EU now receive more precise upfront information on the actual price of fares, allowing them to compare fares effectively and avoid misleading advertisement. For the vast majority of consumers air travel cannot be considered an essential service. As such, Ofgem should consider that if it is deemed so important that users of a non-essential, discretionary

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[16] Consumer Focus wrote to British Gas in November 2009 and again in January 2010 raising concerns about the discount structure offered to consumers on its Standard, WebSaver 4, Track & Save 2011 and Zero Carbon. This discount structure could not be achieved by typical medium and high users, as the discount was based on Tier 2 consumption usage and capped at a quarterly level. (http://www.consumerfocus.org.uk/files/2010/12/Letter-to-Ofgem-Request-for-investigation-into-energy-tariffs.pdf)

[17] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/1010&format=HTML&aged=1&language=EN&guiLanguage=en#fnB1

service have the ability to easily understand and compare prices then this benefit should also be extended to users of an essential, non-discretionary service like energy.

23. Which? is broadly supportive of Ofgem's proposal to prohibit auto-rollovers without positive assent. Where positive assent is sought ahead of the end of a fixed-term contract, consumers should also be given a guarantee that the unit price they are quoted for the new fixed-term offer (even if it is not a fixed-price product) is not increased for a minimum of six weeks from the date their supply under the new contract commences with any exit fees suspended for the same period. This reflects the average time it would take for a consumer to switch to another supplier or tariff if they found the new increased unit price on the new tariff they had agreed to be unacceptable. This is to ensure that consumers are not penalised as a result of any price changes that they are not made aware of at the time positive assent is granted. Failure to provide these reassurances to consumers will further erode confidence in the market over time.

24. On the issue of prohibition of contract terms for fixed-term offers that allow 'adverse unilateral variations'[18], Which? believes that Ofgem should ensure that this also covers the marketing of fixed-term discount tariffs that are 'pegged' or 'guaranteed' to be X per cent below the supplier's standard prices. Often these tariffs are introduced to the market with a discount that is substantially higher than the advertised minimum discount, usually in order to achieve a high placing in price comparison tables. For example, Consumer Focus recently identified an E.ON discount tariff[19] that offered a 13 per cent saving on E.ON's standard prices, but only stated a 'minimum discount' of 6 per cent[20].

25. Anyone signing up for such a tariff on the assumption that the price quoted reflected the stated minimum discount rather than the higher discount available at the time could see their energy costs rise significantly if the supplier exercised its right at a later date to increase its prices to the level of the stated minimum discount. If the consumer wishes to cancel their contract as a result of any price increase they normally face a substantial exit fee. Consumer Focus is correct to call for suppliers to inform customers of the level of the current discount compared to the minimum discount and how long the current discount will last. However, Ofgem may also want to consider whether marketing tactics like these are appropriate for an essential-

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[18] RMR, 3.18.

[19] SaveOnline v4 (based on a medium user in the Yorkshire region).

[20] http://www.consumerfocus.org.uk/files/2010/12/Letter-to-Ofgem-Request-for-investigation-into-energy-tariffs.pdf

for-life service like energy, and whether consumers may be better served by discount tariffs where the level of discount is fixed for the duration of the contract term[21].

National pricing and naming conventions for tariffs

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?

26. We have included any reservations or requests for clarification in the discussion of the existing proposals. However, there are a couple of further issues that would be appropriate to consider under the banner of other suggestions to reduce complexity and enhance engagement.

27. Firstly, in discussions between Which? and Ofgem since publication of the Review the concept of 'nationwide tariffs' has been raised as an alternative to the current situation whereby suppliers operate different pricing strategies in the 14 electricity distribution regions. As certain costs related to the supply of energy vary across the country – largely due to geographical, population distribution and legacy factors – nationwide tariffs would presumably still result in some variation in the cost of the same tariff in different regions, given identical consumption. However, the proposal to separate these costs into a standardised charge levied on all consumers in a region would mean that the tariff price for the actual energy consumed on a per unit basis should in theory be the same across the whole country. This would bring two distinct improvements on the current arrangement:

- The sizable proportion of 'sticky' customers in the Big 6's incumbent customer bases confers an advantage on the Big 6 that is not available to independent suppliers or new market entrants[22]. Without the ability to segment 'in-area' customers (many of whom are sticky) from 'out-of-area' customers (many of whom, by definition, are not), suppliers will be prevented from passing through disproportionately high cost increases to in-area customers because of the risk of losing customers acquired in other regions on the same tariff.

- National pricing strategies will make the presentation of prices to consumers much simpler. Suppliers will be able to run transparent national marketing campaigns and providers of energy price information to consumers, including Which?, will be able to analyse the market and provide tariff information and commentary in a clearer and more meaningful way.

[21] Fixing the level of discount is not the same as fixing the unit price. A tariff with a fixed discount would be definition be indexed to something else (usually the supplier's standard tariff) and, as such, prices could rise and fall over the contract period.
[22] RMR, 2.45.

28. Secondly, Which? is keen to examine whether standard terminology or a cross-industry 'naming convention' for tariffs could be agreed to convey the 'pricing principle' (e.g. fixed, variable) behind each tariff to consumers. Research carried out by the OFT finds that almost four in ten energy consumers have difficulty choosing a tariff because different suppliers use different terms to describe the same thing[23]. In contrast, in the financial services industry, for example, the terms 'tracker', 'fixed' and 'standard variable' are readily understood by mortgage and investment products' customers and, accordingly, widely used by companies to describe their products. The rail industry also recently developed a naming convention for ticket types in response to demands from consumer groups and government to make products in this market easier for consumers to understand[24]. A naming convention would not prevent suppliers branding their tariffs however they wished to – an important dimension of product differentiation - but would require that an agreed term describing the type of tariff be included in the tariff name. Which? recommends that Ofgem conducts consumer research to further explore the concept of a naming convention for energy tariffs.

Undue price discrimination

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?

29. Ofgem notes that the introduction of SLC 25A (prohibition of undue discrimination) and SLC 27.2A (cost reflectivity between payment methods) have, respectively, coincided with a reduction in unfair tariff differentials between 'in area' and 'out of area' customers, and – with the exception of one supplier[25] - between different payment methods.

30. However, that Ofgem felt it necessary to address what are essentially pricing practices in a competitive market through the licence conditions effectively lays bare the hitherto failure of consumer engagement as a mechanism to impose sufficient discipline on energy suppliers. The effect of this appears to be the overcharging of certain groups of consumers in the apparent knowledge that suppliers will not lose a large number of customers as a result. It is reasonable

[23] RMR, Box 2.1.

[24] In 2008 the Association of Train Operating Companies (ATOC) simplified the range of tickets sold by the 24 train operators to just three types – Anytime, Off-Peak, and Advance (http://www.atoc.org/media-centre/previous-press-releases/simpler-rail-fares-for-all-journeys-100107).

[25] Scottish Power's compliance with SLC 27.2A is currently under investigation.

to expect that more engaged consumers with the capacity to easily identify tariffs[26] offering better value would have 'voted with their feet' and taken their business elsewhere.

31. As a general point, it may be the case that regulatory intervention better serves the objective of increasing consumer engagement (e.g. through measures to address tariff complexity) rather than *ex post* correction of the outcomes of ineffective consumer engagement. A move to nationwide pricing, as discussed under Q4, would also restrict suppliers' ability to segment – and discriminate against – sticky in-area customers, because any discriminatory practices would also impact on out-of-area customers on the same tariff that had been acquired at some point and, by definition, are more likely to switch in the event of what they perceive to be poor treatment. Additionally, recovery of certain costs through a standardised charge that would be the same for every household would reduce the scope of costs that could be transferred to sticky customers in order to cross-subsidise the acquisition of more active consumers.

Contents of the standardised charge

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

32. It makes sense to separate certain regulated pass-through costs, which are relatively stable and suppliers have no control over, from the cost of energy, which is more volatile and controlled by suppliers. As we understand that these charges vary by region, separating them from the cost of energy consumed would remove the most significant barriers to the introduction of national pricing (see Q4). Standing charges are already commonplace on some existing tariffs; they are also familiar to consumers with fixed line telephone services, who pay (and generally accept as a concept[27]) 'line rental' charges.

33. Which? notes that Ofgem also proposes including 'some environmental and social charges' in the standardised charge[28]. If this is the case, Ofgem must make clear, and provide a justification for, which ones will be included. This means accounting for all charges that are passed through to consumers in energy bills (whether or not they are defined by government as a 'levy'). These are: the Carbon Emissions Reduction Target scheme (CERT); the Community Energy Saving Programme (CESP); the Renewables Obligation (RO); the EU Energy Trading Scheme; and the Feed in Tariff (FIT).

[26] Following the arguments made above, the latter is a precondition of the former.
[27] Regular dialogue with consumers has not provided Which? with any evidence to the contrary.
[28] RMR, 3.18.

34. Which? asks for clarification as to how DECC and Ofgem intend to ensure that these charges are levied on consumers in an equitable way. It is our understanding that some environmental charges are currently levied on a per-unit basis (i.e. the more units you consume, the more you pay) and, as such, are consistent with the 'polluter pays' principle. Including these charges in the standardised charge (i.e. every bill payer pays the same amount) may result in lower users paying a disproportionate share and therefore may not be equitable. We consider that it would be fairer, if possible, for these charges to be apportioned to energy consumption (e.g. on a per kWh basis) and not included in the standardised charge, as this would mean all households make the same contribution irrespective of consumption.

35. If it is not possible to factor social and environmental costs into the standardised charge in an equitable manner, Which? believes that the standardised charge should only include those fixed costs that relate to providing and maintaining a physical connection to the gas and electricity networks. These costs are fixed to the extent that they do not vary with consumption and including them in the standardised charge is equitable because it is our understanding that the cost of providing and maintaining a domestic connection does not vary by property type, size or number of occupants. It is reasonable to consider that these costs are present wherever there is an active gas or electricity connection, even when no energy is being consumed.

36. Which? recommends that the most straightforward way to apply the charge is on a per-day basis, with the actual energy consumed charged for on a per-unit basis. A daily charge would also be appropriate and transparent way to recover fixed costs following the transition to a smart metering 'world', where recovery of fixed costs through unit prices may be less straightforward and transparent for consumers who choose 'smart' tariffs with 'dynamic' or 'real time' pricing.

Environmental and social levies/charges – additional points

37. Although happy to comment on the standardised charge proposal, Which? feels that the Review should have been used as an opportunity to collect stakeholders' views on the fundamentals of funding environmental and social programmes through levies or other charges on energy bills. A complete lack of transparency means it is not possible to know how charges are currently levied, nor which tariffs from which suppliers incur what charges. The key for consumers is whether these costs are passed on to them in their bills, and, if they are, they must be able to determine this clearly from their bills/annual statements.

38. The cumulative impact of these charges is significant[29], yet there is at present no mechanism to monitor and report on the amount of costs passed through to consumers by suppliers. Which? has for some time asked DECC to empower Ofgem to put in place a proper system to enable this. It is not currently possible for individual consumers to know how much they are paying for CERT or FIT, for example.

39. A relevant consideration here is that the Government committed in the 2011 Budget to introduce a new framework to cap the impact of levy-funded support on energy bills[30]. Which? welcomes this framework but believes strongly that *all* charges passed through to bills must be included in this framework. The amount of these charges must be shown on energy bills. Otherwise consumers cannot tell how much they are paying: the fact that some policies are statistically defined as levy-funded (e.g. FIT) and others are not (e.g. CERT) is not relevant to them.

40. Which? research shows that 87% of consumers would like more details of the costs in their bills that are not directly related to energy consumption; 51% said they would like a detailed breakdown on each bill of how much goes towards these; while 36% would like to know roughly how much they pay[32]. There is no way of knowing if suppliers pass costs on in full, in part, or in excess of the actual cost of the programmes funded, nor whether they pass on a relatively higher proportion of costs to certain types of tariff or customer (e.g. sticky customers in order to cross-subsidise acquisition of more active consumers). This is unacceptable for consumers, and even more so when considered in the context of rising energy bills and with a large number of households already in fuel poverty. Much greater transparency is needed around these charges and Which? therefore asks that Ofgem/DECC establishes not only how charges are currently passed on, but also an appropriate system to monitor and report on them in the future.

41. A discussion is then needed on how this information be presented on bills/annual statements – bearing in mind consumer needs and the imperative not to confuse consumers further – as well as exploring any alternative payment collection options, and their practicalities and administration costs. We recommend that these could be important issues for discussion and evaluation in the further rounds of consultation. We welcome the opportunity to participate in

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[29] In 2009 Ofgem estimated that CERT costs each domestic customer using gas and electricity £45 per year, the EU ETS around £24 for a typical domestic consumer with an annual electricity consumption of 3,300 kWh, the RO around £12 on the annual electricity bill, and CESP around £3 for a customer using gas and electricity. Ofgem Factsheet 81: Household energy bills explained, August 2009 http://www.ofgem.gov.uk/MEDIA/FACTSHEETS/Documents1/updatedhouseholdbills09.pdf

[30] http://www.hm-treasury.gov.uk/d/control_framework_decc250311.pdf

[32] Which? general public survey of 2,004 adults (the 'energy omnibus') using an online access panel. Adults aged 16+ who pay energy bills (2,350 adults in total), Fieldwork took place in October 2010 and results were weighted to reflect the UK adult population. Unpublished.

these discussions but we reiterate our view that the Review could usefully have included consideration of this issue in its initial findings and proposals document.

Metrics for price comparison purposes

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?

42. Which? understands the term 'price metric' to refer to a common measure of prices that enables products to be compared easily, such as allowing price offers to be ranked from highest to lowest. Price ranking is useful for homogenous products, such as gas and electricity. However, consumers may need additional information if quality aspects, such as standards of service, of a product matter or differ from product to product.

43. Consumers may face difficulty using a price metric as intended if any of the following conditions apply: purchases are infrequent; a clear explanation of the metric's purpose (and limitations) is not easily available; or the information itself is poorly presented. The Annual Percentage Rate (APR) is perhaps the best-known metric to consumers; however, research by the OFT has found that very few consumers knew the actual meaning of the term or its primary purpose[33]. It is also relevant to cite research conducted by Which? as part of its APR supercomplaint that found wide variation in the cost of products with the same APR, due to differences in the way that interest charges were calculated by different providers (e.g. variation in the balance charges applied to, when interest would start accruing, differences in interest-free periods etc.). Ofgem should consider experiences from the financial services sector where the development of a metric for energy customers is concerned.

44. Ofgem's Review proposes the development of a tariff price metric to help consumers assess and compare tariff offerings in order to identify the most appropriate tariff for them. Which? believes that ensuring that all tariffs are structured in the same way is the best way to develop and provide the basis for an effective and transparent price metric. Where all tariffs are comprised of a standardised element that is the same irrespective of supplier or tariff and a unit charge including all discounts (or multiple unit charges in the case of tariffs using multiple rate meters), the unit charge (e.g. pence per kWh) will serve as a 'ready made' metric for comparing one tariff against another as all other costs will be the same irrespective of supplier or tariff.

[33] Consumers' appreciation of Annual Percentage Rates, 1994, OFT

45. We are aware that there may be concerns about some consumers' ability to differentiate between unit prices where the variation may be a matter of pence or less (although we note that consumers appear to respond effectively to narrow price differences in the market for petrol and diesel) and accept that presenting an aggregate price figure (e.g. annual spend using approved average consumption estimates for different types of user) may be necessary for some consumers to recognise the cost differences and that the perceived 'hassle' of switching would be worthwhile. However, the key point is that any price metric should be transparently based on the underlying unit charge.

46. The importance of including all discounts in the unit charge is underlined by the example provided earlier where the 'capping' of discounts at uniform quarterly level of consumption by British Gas meant that typical medium and high users could not achieve the advertised discount because their consumption in the warmer, lighter months would not be high enough[34]. An 'average annual consumption' metric that assumes equal consumption throughout the year would return a figure that included this unachievable discount in full and would, therefore, be misleading.

47. Before introducing a metric to enable more effective tariff choices, we would strongly recommend that Ofgem conduct a thorough analysis and assessment – including qualitative and quantitative research with consumers and stakeholder engagement - of any prospective price metrics before pursuing the concept further. Fundamentally, Ofgem should be able to satisfy itself that any metric is not only understood by consumers but also perceived by them as relevant to their own situation and energy consumption habits.

Costs and risks of proposals to reduce tariff complexity

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 consumers face and enhance engagement in the energy market?

48. In consideration of stakeholders' responses – particularly from energy suppliers – to its proposals, Ofgem should recognise that suppliers and consumers are likely to differ in their ability to understand the market in which they interact. It is reasonable to infer that the incentive to maximise profits (or be forced to exit a competitive market) means suppliers will analyse the market more vigorously than consumers, who face no such pressures. In markets where consumers only interact intermittently - as in the case of gas and electricity which is

[34] http://www.consumerfocus.org.uk/files/2010/12/Letter-to-Ofgem-Request-for-investigation-into-energy-tariffs.pdf

supplied irrespective of whether an 'active' choice of tariff has been made – their understanding of that market is limited further. As such, suppliers may have incentives to exploit consumer inaccuracy or 'naivety' and attempt to increase consumer error by obfuscating product information to limit price competition.

49. Academic research has also concluded that a high degree of product complexity can allow firms to raise prices[35]. High cost and inefficient firms are therefore more likely to rely on product complexity to disguise their inefficiency and relying on the fact that their products will be mis-evaluated by consumers. In this way product complexity can be seen as a method employed by firms to reduce effective competition. Such practices are brought into especially sharp focus where the supply of energy is concerned, given the fact that it is an essential-for-life service with effectively no choice not to choose.

50. Which? believes it should be both feasible and costless for suppliers to fully inform consumers of product information. However, we anticipate that suppliers will argue that simplification of the way that product information is presented to enhance understanding and comparability will have a detrimental impact on competition. To this end, we note that Ofgem has proposed not to restrict the number or type of tariffs that suppliers can offer in the fixed-term tariff market. As Which? believes that ensuring consumers can easily understand and compare products is, as a general principle, preferable to limiting the number or type of products in a market, we do not object to this measure to the extent that it preserves meaningful choice.

51. Which? appreciates that competition requires that suppliers are able to differentiate by targeting specific customer groups or demographics and/or creating products that represent a genuine alternative to a 'straight' gas or electricity tariff. These could, for example, include 'bundled' offers where ancillary energy or non-energy related services, such as boiler servicing, insurance, or car breakdown cover, are provided in addition to the core service of gas or electricity. It may be that suppliers subsume the cost of these value-added services into the unit price. However, given our understanding that this is a market where consumers are primarily motivated by cost and choice of product by its position in price ranking tables, we feel it more likely that the cost of these services would be recovered through a fixed monthly or annual charge determined by the supplier, similar to 'packaged' or 'premier' bank accounts[36].

[35] "Pricing and product design with boundedly rational consumers", Gabaix, Laibson, February 2003.

[36] Some bank accounts offer extra benefits in return for a monthly fee – typically between £5 and £25 a month depending on the account. Commonly known as 'packaged' accounts, the extras they offer range from travel insurance and preferential savings rates to will-writing and share-dealing services.

52. While Which? believes that making tariffs easier to understand and compare will deliver significant benefits to consumers, we urge Ofgem to be mindful of the following issues:

- In any market, greater price transparency – the intended outcome of Ofgem's proposals to reduce complexity - can lead to *less* competitive outcomes. Where prices are 'public' and rivals easily able to observe each other's prices – particularly any attempts to defect from a collusive agreement - this can facilitate tacit collusion. Ofgem should be vigilant in this respect. As it is generally agreed that collusion depends on the ability for rival firms to make implicit or explicit agreements on pricing strategies, and maintaining agreements may be more difficult in markets with large numbers of firms, Ofgem's proposals to ease market entry barriers for new suppliers are particularly pertinent here.

- One unintended effect of efforts to increase price transparency in the European short-haul airline market (see Q3) has been a 'restructuring' of price offers. Services once included in the ticket price, such as hold baggage and food and drink, have become chargeable 'optional extras' as airlines attempt to differentiate their headline price from their competitors. While unhelpful for price comparison purposes, Which? accepts that as long as these fees are *avoidable* to the extent that consumers can make alternative arrangements (in the example above, by taking carry-on baggage and bringing food and drink from elsewhere) firms are justified in separating the cost of these services from the headline price. However, *conditional* or *contingent* fees (payable only if a certain event occurs) are a greater cause for concern. We do not rule out the possibility that when faced with requirements to present prices more transparently, energy suppliers may attempt to compensate for undercutting their rivals' headline prices by introducing an array of conditional 'administrative' charges. These could include fees to update account details following a house move or change of name, or the introduction of revenue sharing telephone number prefixes such as 0844 for customer service functions.

53. We seek clarification from Ofgem on how the proposal to restrict the number of evergreen tariffs to one per payment method (notwithstanding comments made in our response to Q3 concerning multiple-rate tariffs) will affect customers on 'dual fuel' tariffs, where a discount is commonly available for taking both gas and electricity from the same supplier. We understand from Ofgem that there will be no dual fuel evergreen tariff and that dual fuel customers on standard tariffs (defined as without an end date) will most likely be 'defaulted' onto their supplier's separate gas and electricity tariffs when the proposed new tariff regime comes into effect and could end up paying more than previously as a result of losing their discount. If these customers wish to continue to benefit from a dual fuel arrangement then they will have to find an offer in the fixed-term market.

54. Given that there are currently around 16.9 million dual fuel accounts, many of which will be standard tariffs, Which? believes that Ofgem should reconsider whether limiting evergreen tariffs to separate gas and electricity offers is appropriate. Furthermore, the process of comparing a dual fuel offer from the fixed term market with the evergreen market would be better served by there being an equivalent evergreen product to compare with. As such, we feel that evergreen tariffs should be limited to one per payment method for separate gas, separate electricity, and dual fuel.

55. We anticipate that the introduction of a new tariff regime will involve significant numbers of consumers being unilaterally migrated to a different tariff (particularly in the evergreen market where there are currently around 38 standard tariffs (exclusive of payment type options)[37]. Under the proposals these will become a much smaller number of evergreen tariffs. Which? Strongly urges that Ofgem carries out an impact assessment first to ensure that no consumers will be left worse off by the changes. Moreover, all consumers should be made fully aware of the tariff they are being moved to. Not only should consumers be properly informed about any change to their tariff, but this change should be used as an opportunity to inform consumers about their right to switch to a fixed-term tariff and the offers that are available from their supplier in the fixed-term market.

56. Indeed, as a general point, measures to reduce tariff complexity should be accompanied by frequent and consistent messages within supplier communications (e.g. bills and annual statements) reminding consumers of alternative tariffs and their right to switch. Which? believes that the proposal to improve tariff comparability is unlikely to achieve its objective without further activity to both educate and engage the most disengaged consumers.

WHOLESALE MARKET LIQUIDITY

- *We believe that the Mandatory Auction (MA) and Mandatory Market Maker (MMM) proposals are, in principle, appropriate and proportional responses to the issue of how to facilitate new entry and ensure that smaller suppliers can remain competitive.*

- *However, we ask for clarification from Ofgem for its reasoning behind the 20 per cent volume requirement. If the objectives of the MA and MMM are to constrain generator market power and place VI and non-VI suppliers on a more level playing field, in addition to significantly boosting overall liquidity and therefore the potential number of competitors, then we would ask why any limit has been set on this figure.*

[37] RMR, 2.17.

- *Nonetheless, it is not just the absolute volume of energy available to smaller suppliers that is hindering the development of competition and a significant challenge to the dominance of the 'Big 6'. Ofgem should also ensure that suitably sized and shaped power contracts, particularly for longer term delivery of energy are also available to meet the needs of non-vertically-integrated suppliers.*

- *Any argument submitted concerning the costs of the proposed changes should be treated with a degree of caution. Private costs, for example the introduction of new systems or meeting standards for trading arrangements, are often easier to quantify than the wider benefits to consumers and the economy as a whole from reducing entry barriers. At present, these barriers impose an externality on consumers and the economy that results from the weakness in effective competition between energy retailers.*

Wholesale electricity market liquidity issues

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

57. Which? has reviewed the analysis undertaken by Ofgem and discussed the practical difficulties of ensuring a supply of power with small-scale retail energy suppliers. We consider that not only the volume of energy, but also, and in particular, the 'size' and 'shape' of traded energy contracts is insufficient to enable market entry at a scale sufficient to challenge the existing 'Big 6'. Current liquidity and structure of contracts therefore represent a barrier to entry. We also consider that a liquid and transparent wholesale market, accessible to new entrants, is very important for providing a benchmark against which any genuine assessment of retail prices can be made.

58. We understand that the wholesale power markets in the UK are a key method to secure physical delivery of power, in addition to helping to manage price uncertainty. The power markets comprise immediate (spot) and day-ahead (auction) and prompt markets, which allow parties to manage balancing needs. Forward trading, contracts months or years ahead, offer power contracts suitable for price hedging.

59. Energy retailers that do not operate a significant generation portfolio are therefore more dependent upon:

- Their ability to enter into bilateral contact for physical delivery of energy (‘power purchase contracts’); and

- Access to wholesale market products to manage residual demand or secure a sufficiently large volume of energy, far enough in advance, to meet customer needs.

60. We believe that weak liquidity, in particular for forward contracts traded on exchanges, leads to the following competitive constraints:

- Power purchase contacts for smaller suppliers are difficult to secure, due to the limited size and shape of the power product needed, while the lack of liquidity in forward markets risks exposing suppliers to disadvantageous price movements, meaning that small new-entrants are dependent upon wholesale traded power contracts;

- However, the limited availability of suitably sized and shaped power contracts for longer term wholesale energy, whether traded through an exchange or over-the-counter through brokers, directly constrains the competitive threat that small new-entrant suppliers are able to pose.

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?

61. Both Mandatory Auctions (MA) and Mandatory Market Maker (MMM) appear to be appropriate and proportionate responses to reduce or remove the entry barrier for retail energy supply detailed in Q8. Our views on the details of these arrangements are set out in response to Q12.

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?

62. We agree that MA and MMM are necessary; however, the size and shape of energy contracts must also suit small, new entrant suppliers. It is not just the absolute volume of energy available for non-vertically integrated firms that is hindering competition.

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

63. Which? agrees with the objective of creating a more liquid and flexible wholesale market. To implement these proposals may take time. This risks maintaining existing barriers to market entry or expansion. As an interim measure, Ofgem could require VI-suppliers to contract with small or new entrant suppliers as if they are I&C customers. Larger I&C customers may well use contracts of a size and shape that is suitable to support small retailers. The Big 6 already have systems available to meet this type of need at low or no marginal cost. There are risks: such contracting will not be anonymous or help formulate prices, giving VI-firms an advantage unless these contracts or trades are separated from the in-house retail business.

64. Ofgem must also ensure its review is fully aligned with the current Electricity Market Reform where liquidity and new market entrants are concerned. EMR, even as proposed (i.e. tinkering with support mechanisms rather than genuine energy market reform), could have an impact on liquidity levels. For example, smaller suppliers, including First Utilty and Good Energy, and generators, such as Dong Energy, have voiced concerns that aspects of the EMR proposals, particularly the Contract for Difference proposal could actually reduce liquidity in generation[38].

Design of wholesale electricity market liquidity proposals

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

65. It is clear that small market entrants are not able to secure contracts that suit their customer profile or their business planning needs. Our views on the remaining elements are set out below:

- *Volume requirements:* Ultimately, without access to power purchase contracts, the volume that is sold into the market will constrain either the size or number of non-vertically

[38] http://www.publications.parliament.uk/pa/cm201011/cmselect/cmenergy/writev/742/emr.pdf

integrated rivals. However, we would question the figure of 20% of total GB energy that Ofgem proposes should be made available and ask for Ofgem's reasoning. If the objectives are to constrain generator market power and place VI and non-VI suppliers on a more level playing field, in addition to significantly boosting overall liquidity and therefore the potential number of competitors, then we would ask why any limit has been set on this figure. Making 100 per cent of energy available, for example, should not prevent the vertically-integrated suppliers from securing the energy they require to supply their customers if this could be bought back on an anonymous basis through an exchange.

- *Product requirements:* It is clear from Ofgem's work and comments from non-VI suppliers that there is a shortage of suitably sized and shaped product to meet their energy supply or hedging needs. We have no specific views, other than the need for alternative arrangements that will deliver products that meet all market participants' needs.

- *Frequency:* For the MA proposal, our view is the same as product requirements above. The frequency of MMM should be determined by the market needs and nature of trading – see platform below.

- *Governance arrangements:* We consider that an option to allow an existing regulated investment exchange should be developed. This would allow an existing energy exchange, or another commodity / derivatives exchange to bid – perhaps for a limited period (5 or more years) – to operate the auction. This has several significant benefits: it allows the exchange to develop and govern the rules for the MA and MMM, given specific principles and an obligation on the Big 6 to obtain and maintain membership, within its existing regulatory process; the rules can be developed over time in response to users' experience; the exchange would be better able to design and introduce new standardised products that meet users' needs; greater liquidity – from that required by the MA alone – may be concentrated in the exchange from its existing trading volumes; price reporting would be more robust, aiding efficiency and reference pricing; cost efficiencies, from a greater number of competing brokers using the exchange to make contracts for their clients needs; and exchanges have existing processes to detect and report market abuse.

- *Participation:* The exchange model, outlined above, would have the advantage of established rules to determine membership and conduct. The Big 6, based on a generation share threshold, could be required to meet the membership requirements of the exchange, with the exchange rules requiring them to act as market makers for the smaller, less liquid forward contracts.

- *Platform:* Open to any regulated investment exchange, either an existing energy exchange or another exchange that wishes to expand into energy contracts.

Costs and risks of proposals to improve wholesale electricity market liquidity

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?

66. Which? urge Ofgem to be circumspect in its appraisal of any argument submitted by existing incumbents of the costs of the proposed changes. Private costs, incurred for example by introducing systems or meeting standards for trading arrangements, are often easier to quantify than the wider benefits to the economy as a whole from reducing entry barriers. At present, these barriers impose an externality on consumers and the economy that results from the weakness in effective competition between energy retailers.

67. A regulated investment exchange, that hosts trading, establishes the contracts and enforces the rules of trading, should offer a more cost efficient way of establishing greater wholesale liquidity and flexibility.

68. In addition, we are sceptical that significant costs should, or would, be incurred as the scale of trading is analogous to supplying larger I&C customers. The Big 6 already have significant experience of providing contracts that meet the needs of I&C customers, with the necessary infrastructure to meet these needs that could be adapted to the MA and MMM remedies. Further, an established exchange may well have IT systems and platforms that can quickly be adopted or contracted-for from brokers or other specialists.

<u>OTHER KEY CONSUMER ISSUES</u>

- *In light of the variable quality of suppliers' implementation of the licence condition setting out requirements for information on bills an annual statements, we reiterate that Ofgem consider not only the type of information provided to consumers through these communications but also the format of that information. At a minimum, all bills and annual statements should contain a standardised summary box on bills providing itemised key information at a glance.*

- *Low levels of consumer trust in suppliers, underlined by the recent prosecution of Scottish & Southern Energy for misleading sales practices and separate ongoing investigations into* *four suppliers' (including SSE) activities by Ofgem, reinforces the importance of effective monitoring of compliance with regulatory obligations.*

- *Ofgem's monitoring activity should also be extended into the area of suppliers' reporting of direct complaints. The current requirements are inadequate and provide information that is of little use in understanding what consumers are complaining about and how long suppliers take to resolve complaints. We recommend that Ofgem look to the progress made on complaints reporting in the financial services industry as an example of how to develop of a complaints reporting regime that permits effective monitoring of supplier performance.*

- *In our response to the Probe remedies, Which? stated that there was 'no clear process for enforcement of the Standards of Conduct and no clear incentive for why energy suppliers would comply with the Standards'. The behaviour of suppliers since has done nothing to change our view. As such, we question whether 'principles' can deliver improvements for consumers in this market, and welcome proposals to make the Standards enforceable through their extension into the licence conditions.*

Provision of information to consumers

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?

69. Which? agrees with Ofgem's assessment that performance against its Probe reforms has been 'patchy' and that 'significant shortcomings'[39] remain. Regarding SLC 31A (information on energy bills and annual statements), Ofgem's concerns about the variable quality of implementation between suppliers and the need for improvements merely adds weight to the argument made by Which? in its response to the Probe that Ofgem should consider not only the type of information provided on bills and annual statements but also the format in which that information is provided to consumers. As energy is a homogenous product often consumed on a credit basis, bills form the main and most tangible point of 'market contact'. Accordingly, Which? maintains that at a minimum all bills and annual statements should contain a standardised summary box on bills providing itemised key information at a glance.

Monitoring and enforcement of compliance with licence conditions

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[39] *The Retail Market Review - Findings and Initial Proposals*, p53

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

70. On SLC 25 (requirements on suppliers' marketing), Which? continues to receive anecdotal evidence from members of the public regarding potentially misleading marketing practices. Since publication of the Review, Scottish & Southern Energy has been successfully prosecuted by Surrey Trading Standards for misleading customers in an attempt to sign them up to their services by doorstep cold calling - the first prosecution of its kind against one of the Big 6 energy firms and a test case under the Consumer Protection from Unfair Trading Practices Regulations 2008.

71. While reforming the structure of tariffs and improving comparability should improve the transparency of suppliers' marketing, the fact that four of the Big Six are currently under investigation for potential breaches of SLC 25, and that energy suppliers are considered trustworthy by just one in five consumers[40], effective monitoring of suppliers' marketing activities, and, where appropriate, naming and shaming of those that do not comply with their obligations, remains a necessary part of building consumer confidence in the energy market.

Supplier complaints handling

72. We also consider that Ofgem's monitoring and reporting activity should also be enhanced in the area of complaints handling. We note that Ofgem is currently investigating the complaints handling practices of three suppliers, but feel that a more proactive approach is required concerning how complaints data is reported by suppliers.

73. With the exception of price, consumers have very little information on suppliers' other attributes or qualities that can only be used to inform choice. Providing consumers with information about how quickly and effectively suppliers deal with dissatisfaction and complaints is one way to address this information asymmetry between sellers and buyers. However, Which? considers that the current requirements for reporting of complaints handling performance by suppliers are inadequate.

74. At present, suppliers are required to produce a report once a year containing the number of complaints that were not resolved at Day+1 (48 hours after the complaint was registered). This seems a fairly minimal requirement for such an important indicator of customer service -

[40] Which? surveyed a sample of 2,000 UK adults between 30th April and 7th May 2010. Results were weighted to reflect the UK adult population.

particularly as there are very few indicators other than price that consumers can use when choosing an energy supplier. Reporting on an annual basis the number of complaints that exist at Day+1 reveals nothing about how long suppliers are actually taking to resolve these complaints, nor the issues that customers are complaining about, making this information of little use to consumers. We understand that one obstacle to providing more meaningful information is variation in the way that suppliers define and record complaints; however, the experience of the financial services sector (see below) shows that this should not be considered a major issue.

75. Arguably, the requirements as they stand could also act as a disincentive to deal with complaints expediently as the next stage at which complaints are routinely monitored is when they reach the Energy Ombudsman (eight weeks later). To enable consumers and consumer representatives, such as Which? and Consumer Focus, to better judge supplier performance a wider range of quantitative data on resolution performance could and should be collected and made available by suppliers at more frequent intervals (e.g. as a 12 month rolling averages, updated every six months).

76. Which? recommends that Ofgem looks to the work of the Financial Services Authority in developing a more effective complaints reporting regime. Firms are required to report certain information to the FSA every six months on the number of complaints they receive and how they handle them. Data is submitted via the FSA's online regulatory reporting system for the collection, validation and storage of regulatory data (GABRIEL[41]), and covers the following three areas[42]:

- Volume of complaints received according to product, type of firm and cause of the complaint. Firms currently report the volumes according to 25 different product categories (e.g. credit cards). These product categories can be combined into five different product groups (e.g. Banking).

- Complaints-handling – including the proportion of complaints resolved within eight weeks and the proportion of complaints upheld by firms.

- Redress paid - this shows the redress paid in respect of complaints reported during the stated half year[43].

[41] Acronym for 'GAthering Better Regulatory Information Electronically'

[42] http://www.fsa.gov.uk/pages/Library/Other_publications/commentary/aggregate_com/index.shtml

[43] This figure only covers cases where a cash value can be readily identified. It does not include other types of redress, for example extending the cover provided by an insurance policy, nor does it include redress paid which does not relate to complaints, for example redress paid as a result of enforcement action or where the firm has undertaken a review of past business.

77. As of September 2010 the FSA publishes aggregate and firm-level complaints data every six months. The most recent firm-level release[44] contained data on 167 firms (including a several large groups of firms). While some of the data could be presented in a more helpful format, for example contextualising figures by scale of the relevant business[45], the FSA's mechanisms demonstrate that it is possible to establish a standardised complaints reporting mechanism in a market with a far greater number of firms than the energy industry.

Extension of the Standards of Conduct into the licence conditions

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

78. Concerning suppliers' adherence with Ofgem's Standards of Conduct, Which? stated in its response to the Probe remedies that there was 'no clear process for enforcement of the Standards and no clear incentive for why energy suppliers would comply with the Standards'[46]. The behaviour of suppliers since has done nothing to change our view. On the issue of tariff complexity, in light of the findings of the Review it is clear to Which? that the two Standards that are of direct relevance to this issue – 'You must not sell a customer a product or service that he or she does not fully understand or that is inappropriate for their needs and circumstances' and 'You must not offer products that are unnecessarily complex or confusing' – have failed to deliver improved performance by suppliers in an area that, by Ofgem's own analysis, presents one of the most significant barriers to consumer engagement.

79. It is difficult to envisage how the Standards of Conduct, as currently constituted, would be incorporated into a new or existing licence condition, as Ofgem has proposed in the Review. However, incorporating the 'spirit' of the Standards into, for example, a new licence condition to ensure that tariffs are easy for consumers to understand and compare would be welcome. Fundamentally, Which? feels that the failure of the Standards to guide supplier behaviour in delivering improved outcomes for consumers reflects the inability of the energy supply industry to respond positively to consumer welfare 'principles' and that it is now appropriate for Ofgem to address market problems through regulatory measures such as the licence conditions. As such, we await to see the detail of the action Ofgem intends to take in later stages of this process before commenting further.

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[44] 1st July to 31st December 2010

[45] This is a recommendation but not compulsory.

[46] Which? consultation response to *Energy Supply Probe - Proposed Retail Market Remedies*, 1 June 2009, p4

Price comparison services

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

80. Which? has no evidence that consumers do not trust price comparison services ('switching sites'), although the findings of Ofgem's most recent Consumer First Panel sessions suggest that some consumers are confused about the impartiality of price comparison services and believe that some may be biased towards one supplier over another[47]. The Consumer Focus Confidence Code struggles to achieve its aim of building trust in these services by ensuring they meet minimum standards as it is not recognised by 98 per cent of consumers[48].

81. However, Ofgem's latest customer engagement tracking survey suggests that price comparison services are used by a minority of switchers to find out about available tariffs (between a fifth and a quarter depending on fuel) and even fewer (16 per cent) to actually make their switch[49]. This may reflect the fact that the ability to switch to a tariff using a price comparison service depends on the service having a commercial relationship with the supplier of that tariff. Having gone through the process of providing tariff and consumption information to a price comparison service only to find that you have to contact the supplier directly to complete your switch is likely to be frustrating for consumers and may cause them to drop out of the process altogether.

FINANCIAL REPORTING

- *We support Ofgem's proposals to increase scrutiny of suppliers' transfer pricing and hedging practices. If low levels of trust and confidence in suppliers are to be improved then consumers must have confidence that prices are fairly determined and reflect the underlying costs of providing the product. Nonetheless, the implication that these practices, despite being a central component of energy supply arrangements, were not already under an adequate scrutiny regime is a matter of some concern.*

- *We repeat the call made in our response to the recent Financial Reporting consultation that segmental reporting requirements should be more comprehensive. It is worrying that, despite damagingly low levels of trust in the industry, Ofgem feels it is acceptable to make*

[47] Consumer First Panel, 7.4.

[48] Which? Omnibus Survey, 2010.

[49] *Customer Engagement with the Energy Market - Tracking Survey*, Ipsos Mori, 2011, p24-25; p28-29

'incremental improvements' to reporting requirements rather than putting in place the reporting requirements that would enable it to undertake this analysis now.

Scrutiny of accounting practices

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?

82. Fundamentally, Which? finds it extraordinary that, as a central component of the current arrangements for energy supply, these accounting practices are not already under scrutiny and review by Ofgem, or other parties on its behalf.

83. Evidence cited by Ofgem in the Review that energy prices have 'tended to rise in response to wholesale price increases more quickly than they have fallen with decreases'[52] is not only an indication of weak competitive intensity, but a real concern given the fundamental importance of consumer confidence in the prices offered by suppliers in any market, particularly that they are determined fairly and relate to the costs incurred in providing the product. Research by Which? has found that 85% of Which? members feel that it is difficult to assess whether price changes are a fair reflection of the underlying cost of energy[53].

84. As an essential-for-life service, it is crucial that the mechanism – whether market or monopoly – used to deliver energy to consumers is scrutinised to ensure that costs are fair. This is not possible without transparency. In the context of the energy sector, improved transparency and scrutiny could also contribute towards an improvement the current low levels of trust and confidence in suppliers. Greater clarity would also enable consumers to make a more informed evaluation of the value for money of supply products generally, and, specifically, of those linked to some index or measure of wholesale prices (e.g. wholesale tracker tariffs).

85. In the general spirit of transparency, Which? would expect that the accountancy firm's review and analysis of transfer pricing is made publicly available, including conclusions as to whether the practices observed misrepresent the value of the product, and, if so, the course of, and timeframe for, remedial action that Ofgem intends to take. In addition, we welcome the proposal for the firm to make recommendations as to future segmental reporting requirements, given the thorough analysis we expect it to undertake.

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[52] Retail Market Review, p18

[53] Which? surveyed 7,883 members between 9th and 30th November 2009.

Improvements to segmental reporting

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

86. In our response to the Financial Reporting consultation (April 2011), Which? stated that segmental reporting requirements should be more comprehensive. We are concerned that Ofgem feels it is acceptable to make 'incremental improvements' to the requirements[54] in order to gradually get to a position where they feel able to undertake a robust analysis, rather than putting in place now the reporting requirements that would enable it to undertake this analysis. As mentioned, already low levels of trust and confidence in suppliers make it imperative that the issue of whether prices are fair is resolved as quickly as possible.

87. As we set out in our response to the Financial Reporting consultation (April 2011) we recommend that Ofgem put in place financial reporting that provides: 'a more comprehensive set of regulatory accounts, supported by prescriptive rules as to exactly how each line item needs to be calculated' (Option B). Which? recognises that energy companies may have concerns with the disclosure of this information as it maybe commercially sensitive. However, we would not expect the information to be available for public consumption but, rather, that the Ofgem would assess and report findings, and, if necessary, take action.

FINAL REMARKS

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

88. Further to the point we make in the introduction, it is difficult for Which? to respond in any depth to this question without understanding what Ofgem sees as the specific indicators of an effective market. We agree that consumers' interests will be protected by competitive pricing, good customer service and innovation. However, these are high-level, somewhat abstract concepts and substantially more detail is required on how Ofgem intends to judge the success of the measures that are implemented as a result of the Review and its various stages. We feel that while the Review effectively describes the existing problems in the market, it is less impressive in setting out what Ofgem believes an 'ideal' market would look like. A benchmark that

[54] RMR, 3.50.

describes what Ofgem sees as an optimum outcome would be a very useful way of assessing whether the proposals are sufficient or not.

89. Concerning the actual *process* of the Review, we are disappointed again by the lack of information about the course of action beyond the initial consultation deadline. It was a notable weakness of the Probe that Ofgem failed to provide a clear administrative timetable for development and implementation of the remedies. This would have allowed stakeholders to monitor reform and focus attention as to when Ofgem will take enforcement action if sufficient progress to resolve the problems identified had not been made.

90. Which? hopes that suppliers will engage constructively with Ofgem's proposals - with the explicit possibility of referral to the Competition Commission before the end of 2011 providing a strong disincentive to efforts to frustrate reform. In spite of this, we believe that Ofgem would still best serve the interests of consumers by setting out a transparent process in which it is clear that energy suppliers are neither able to avoid implementing remedies, nor impose undue influence on the determination of those remedies.