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Consultation Response

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Ofgem's Retail Market Review – Updated domestic proposals

About Which?

Which? is an independent, not-for-profit consumer organisation with around one million members 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?'s mission is to make individuals as powerful as the organisations they have to deal with in their daily lives by empowering them to make informed decisions and by campaigning to make people's lives fairer, simpler and safer.

1. Introduction

There is much to welcome in the latest RMR package. Which? fully supports the proposals to simplify bills and other communications, improve the switching process, provide better reporting of complaints data and monitor the development of competition in a more sophisticated and meaningful way. It is regrettable in a liberalised market that there appears to be a need for a 'regulatory guarantee' for better service and treatment of customers. However, we understand why Ofgem has taken this approach to the Standards of Conduct, as Which? has long maintained that the competitive pressure on suppliers is not sufficient to deliver these outcomes without it. Finally, we also welcome Ofgem's parallel focus on increasing wholesale market liquidity and transparency. Competition will only be effective if existing independent suppliers and new entrants are able to mount a credible and sustainable challenge to the dominance of the six major suppliers.[1]

However, the combination of Ofgem's RMR proposals and the Prime Minister's recent announcement to ensure consumers get the 'lowest tariff'[2] still contain a serious risk of allowing competition to remain weak. We do not believe the proposals will materially improve the comparability of energy tariffs, and so prices that can't be compared at a glance (or even with a calculator by the vast majority of consumers) will continue to deliver little competitive pressure on bills. Furthermore, segmentation of suppliers' customer bases based

[1] Wholesale power market liquidity: consultation on a 'Secure and Promote' licence condition, Ofgem, December 2012.
[2] DECC proposes limiting suppliers to 4 'core tariffs' per fuel, requiring that these tariffs contain one standard variable rate tariff and one fixed term fixed price tariff that are comparable like with like across the market, and prohibiting poor value 'dead' tariffs by transferring consumers to the cheapest tariff. Ensuring a better deal for energy consumers, DECC discussion document, November 2012.

on payment method or online account management (or both) will still be possible, limiting the ability of competition to deliver benefits to all consumers.

As such, while we agree with Ofgem's analysis of the causes and outcomes of tariff complexity, we do not believe that the proposed solutions are sufficient. By going a little further and implementing Recommendations 1-6 from our recently published report, The Imbalance of Power: The Retail Market,[3] Ofgem can not only resolve some of the practical issues with delivering the current proposals – such as frustrating consumers by highlighting through the Supplier and Market Cheapest Deal initiatives tariffs that may no longer be available or are unsuitable for another reason – but also deliver a framework that finally enables consumers to play their designated role and drive genuine, effective competition that keeps prices in check for everyone.

Given that Which? has now published its full package of recommendations for reform of the retail market in our own report we have elected to use this consultation response as an opportunity to demonstrate to Ofgem where our recommendations – which we genuinely believe are aligned with Ofgem's direction of travel – intersect with the key areas of the RMR. Accordingly, we have not directly answered the questions set out in the consultation document, but set out our views under section headings that correspond to the relevant chapters. However, in doing this we have sought to respond to the main issues highlighted in each chapter's questions.

2. Why the market needs reform (chapter 2)

The 'market' is essentially an oligopoly of six large, vertically-integrated suppliers who demonstrate little interest in genuinely competing with each other. In a system where consumers are supposed to be the 'engine of competition', seeking out the cheapest deals, it is unacceptable that people cannot understand and compare prices. It is therefore little wonder that three-quarters are on expensive standard tariffs[4] and the vast majority are considered disengaged from the market, demonstrating little evidence of behaviour that is conducive to effective competition.

Yet, even if straightforward comparisons were possible, consumers would likely find themselves thwarted by an industry structure that – in the absence of independents' ability to achieve serious scale – leads dominant companies to adopt strategies of comfortable co-existence rather than dynamic and aggressive rivalry.[5] We recognise that this issue is the focus of a separate piece of work by Ofgem on increasing wholesale market liquidity and transparency; nonetheless, it is important to acknowledge its fundamental importance to a properly functioning retail market.

The limited competition that does exist is played out in a small segment of the market where the six major suppliers and a few of the independents vie for the most determined and engaged consumers with attractive fixed term deals. This is little more than an illusion of a competitive market, propped up by the ultimately flawed measures of switching numbers, large numbers of tariffs and international price comparisons.[6] And, as Ofgem's research has found, even those who have attempted to engage with the market may not get the outcome they sought. Many consumers say they are confused by the options they are presented with,

[3] Full report available at www.which.co.uk/documents/pdf/the-imbalance-of-power---which-report-306453.pdf
[4] Variation in Tariff Types and Energy Bills, DECC, March 2010, p 48.
[5] The Imbalance of Power, Which?, 2012, pp 34-36.
[6] The Imbalance of Power, Which?, 2012, pp 10-15.

increasing the probability of them giving up their search or making a poor switching decision.[7] These outcomes are not only likely to reduce incentives to engage with the market again in future, they will also contribute to the profound lack of trust consumers have in energy suppliers and the industry. On this latter point, we agree with Ofgem's view that recent efforts to 'rebuild trust' through, for example, some reductions in tariff numbers, improvements to bills and other communications, transparency in complaints reporting and changes to sales and marketing practices are largely being driven not by competition but greater regulatory interest and pressure from consumer groups.

Furthermore, potentially large numbers of consumers are effectively excluded from the most competitive tariffs, while accusations of loss leading on such tariffs are a common complaint from independent suppliers struggling to gain a foothold in the market. A lack of robust information makes such allegations difficult to substantiate; however, the generally low level of engagement on the part of most consumers at least makes such practices a distinct possibility. What is clear is that those who tend to benefit from competitive prices are likely to be in higher socioeconomic groups, while poorer and vulnerable consumers tend to languish on more expensive tariffs.[8]

Which? believes that these problems are well documented by Ofgem in the RMR and supported by a robust evidence base, comprising analysis of market data and qualitative and quantitative consumer research.

3. Tariff simplification (chapter 4)

We believe that the 'rules-based' approach to tariff simplification set out in our report should address the problems of disengagement and segmentation in a way that is less restrictive and more conducive to innovation than explicitly capping the total number of tariffs a supplier can offer (although, in practice, we would expect this approach to restrict tariff proliferation in a similar way).

Which? recommendation 1: Unit pricing[9]

To provide the straightforward comparability that will make it easy for consumers to compare offers and identify the best, a consistent system of unit pricing is required. This means standardising the structure of tariffs so that all consumers have to do is look at the unit price, whether expressed consistently in kilowatt hours, megawatt hours or any other unit of consumption. The stated purpose of competition is to keep the prices of this essential service in check. It is unacceptable that consumers have to go through such a complex error-prone process in order to compare prices and not surprising that few even attempt it. Energy is not a bespoke product; it is a basic utility and should have clear prices that are highly visible across consumer media. This can be achieved through:

(i) The abolition of standing charges and tiered rates which have served to obscure prices;
(ii) Requiring the unit price to reflect the costs of paying by direct debit (the most common and lowest cost payment method) with any surcharge a supplier chooses

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[7] Customer Engagement with the Energy Market - Tracking Survey 2012, Ipsos MORI for Ofgem, April 2012, p 33.
[8] According to Ofgem, the proportion of consumers who claim they have never switched is 10% higher among those in the lowest social groups than the average. Switching is highest for those in the highest social grades.
[9] The Imbalance of Power, Which?, 2012, p 41.

to levy for other payment methods presented as an annual amount priced in pounds and pence and chargeable on a daily basis. This surcharge must be 'universal', ie the same on all of a supplier's tariffs;

(iii) Requiring dual fuel and online account management discounts also to be presented as a universal amount priced in pounds and pence and available on all tariffs offered by a supplier; and

(iv) Requiring the key features of each tariff to be reflected in its name (eg whether the tariff is fixed or variable price, fixed term or open-ended etc).

These measures would instantly bring full comparability to all single-rate tariffs, which constitute around 80% of energy tariffs currently available. Consumers on Economy 7 could be given an indicative 'weighted' unit rate for the purpose of comparison, calculated using the average 'split' between day-time and night-time use.

With unit pricing, prices should become visible as well as easily comparable. It should be easy to pick up a newspaper, go to a website or digital teletext or even ring around the different suppliers to find out quickly and conveniently what the cheapest deal on the market is. Information about a supplier's cheapest tariff would also be simple to communicate on energy bills in this form, acting as a prompt for consumers to take action.

As well as making prices clear and visible, simple single unit rate tariffs will also pave the way for more effective collective switching initiatives because it will be possible to establish a single 'best deal' for all participants. Current tariff structures mean that a 'winning tariff' that is market-leading for a 'typical' customer will probably not be the cheapest for everyone.

Our proposals for the treatment of surcharges and discounts should also ensure that customers who do not – or cannot – pay by direct debit, manage their accounts online, or get a dual fuel tariff (because they don't have mains gas) are treated fairly because the value of these surcharges and discounts will be transparent and easy for the regulator and consumer bodies to scrutinise. This should limit the scope for suppliers to discriminate against certain groups of consumers and/or soften competition by using surcharges or discounts to significantly distort the presentation of prices.

Finally, we also believe that unit pricing is a fairer way to price energy, given that the majority of the costs that make up a consumers' bill depend on how much energy they use. It should also place greater emphasis on the marginal costs of energy consumption, stopping the current situation of 'the more you use, the less you pay per unit' and providing consumers with greater financial incentives to invest in energy efficiency measures.

Unsurprisingly for a policy that seeks to deliver full price transparency, a number of objections to unit pricing have been raised in our discussions with energy suppliers and others. In our report, we have set out our responses to these, as well as examining the limitations of the Tariff Comparison Rate (TCR). We have included these responses in the appendix to this consultation response.

Which? recommendation 2: Limiting segmentation[10]

[10] The Imbalance of Power, Which?, 2012, p 44.

Suppliers currently segment the market through practices that increase complexity and restrict availability of certain products to certain customer groups. This means that most consumers – including a disproportionate number of the vulnerable – are found in a part of the market that sees little benefit from competition. In addition to unit pricing, Which? believes that the following moves would start to address this:

(i) Requiring suppliers to offer one open-ended standard variable rate (SVR) 'default' tariff per fuel and no other variable rate products where the price is set entirely by the supplier (as with the RMR proposals, unless better value that the prevailing SVR tariff, 'dead' tariffs[11] would also be eradicated as a result of this measure);

(ii) Requiring that all other tariffs are fixed term contracts and either fixed price or – assuming a sufficiently robust one becomes available in the future – clearly linked to a transparent wholesale market index that suppliers have no direct influence over; and

(iii) Ensuring that all tariffs offered by a supplier are available for all payment methods with suppliers able to levy surcharges for non-direct debit customers (as set out in our unit pricing recommendation);

(iv) Ensure that all tariffs are available through all sales channels and that consumers are clearly informed about the features of tariffs, including exit fees.

There are a number of advantages to limiting suppliers to one standard variable rate (SVR) tariff per fuel and requiring that all other offers are fixed term and fixed price or independent market 'tracker' tariffs. Most importantly, it would ensure that competition for all consumers who do not want to lock themselves into a fixed price contract (which may have an early exit penalty) or be on a tracker product that exposes them to potentially volatile short-term wholesale market movements would be focused on just one tariff. This would be enhanced by our unit pricing recommendation, which would ensure that consumers could easily compare the price of SVR tariffs from all suppliers, bringing greater competition to this part of the market.

Our recommendation that the payment methods other than direct debit should be treated as transparent surcharges on top of the direct debit price, with discounts for online and dual fuel options (the other key 'dimensions' of an energy tariff) applied as a universal amount across all of a supplier's tariffs, will prevent suppliers from segmenting their SVR customer base. This should mean that any price cut to the SVR tariff (eg to acquire new customers) would also be passed onto existing customers.

A single SVR tariff per supplier is also an essential feature of a market where suppliers also offer fixed term tariffs as it provides a clear 'default' for consumers who have come to the end of a fixed term contract and have not sought a further fixed term offer.

These proposals should also curtail the practice of offering only the cheapest tariffs to direct debit customers and/or customers who manage their accounts online. Using direct debit to pay bills and the internet to manage accounts are not typically characteristics of low-income consumers, a significant proportion of whom will be vulnerable. Social inequalities mean that consumers do not always have a 'free' choice between payment and account management methods. However, our understanding is that the price of the energy supplied is largely determined by the cost of the wholesale energy.[12] As such, we do not believe that that part

[11] Open-ended contracts that are closed to new customers and may be uncompetitive.
[12] Updated household energy bills explained, Ofgem, May 2012.

of the cost should be affected by payment or account management method. Therefore, these 'service costs' should be treated as additional costs of lesser or greater amounts on top of the wholesale cost. If suppliers have procured energy at a competitive rate then this benefit should be available to all customers, with the difference in the total price paid by those with lower cost payment methods and those with higher cost payment methods reflecting only the actual cost difference between serving those customers.

Which? recommendation 3: National pricing[13]

National pricing has a number of attractions given its potential to drive competition by making prices more visible. Ofgem should undertake a review of the benefits of national pricing, reporting no later than Autumn 2013.

We believe that the issue of network costs as a factor in regional price differences could be addressed with minimum impact on consumers and network operators through the introduction of a 'clearing house' to standardise these costs – which, in any case, generally vary only by a couple of percent between the regions with the highest and lowest costs – across the country. This idea has already been suggested by EDF Energy in its previous response to the Retail Market Review.

The introduction of national pricing should be seen in conjunction with a package of additional measures, including clear and transparent pricing and enabling existing independent and new entrant suppliers to compete successfully in the retail market. As we set out in our report, without these national pricing could cause unintended consequences that may reduce competition. As such, national pricing should be subjected to a full cost-benefit analysis that also considers the implications for competition, particularly in light of suppliers' responses to earlier regulations banning price discrimination between regions.[14]

Interestingly, in our analysis of the latest round of price rises we found that for standard tariff customers, both direct debit and standard credit, British Gas essentially already has national pricing. The regional differences range from 0.02% to 0.07% across the different consumption levels. EDF Energy also has a very small regional difference of between 1.2% and 1.5% across their standard tariffs, for both direct debit and standard credit customers.[15]

4. Clearer and simpler information (chapter 5)

Ofgem's proposals to ensure consumers receive bills containing information that is easy to access and understand are proportionate and welcome. Which? has been calling for a standardised summary box on bills since 2008 and we are pleased that this is included. The decision to prescribe both the content and format of annual statements is a positive move, and that engagement with annual statements and consumers' trust in the information they provide would be enhanced through Ofgem 'co-branding'. Similarly, requiring price information notices to set out clearly the impact of a price rise on each consumer's own energy costs and include a prominent switching reminder should improve the effectiveness of these essential communications.

[13] The Imbalance of Power, Which?, 2012, p 27,45.
[14] The Imbalance of Power, Which?, 2012, p 27.
[15] The Imbalance of Power, Which?, 2012, p 27.

Regarding the effectiveness of online or paperless communications, Ofgem states that, compared to paper documents, online communications are opened and read by a significantly smaller proportion of consumers who receive them. However, it should not be assumed that, even if more consumers could be encouraged to open and read online communications, they would interact with them in a similar way to the way they do with printed material. From our own experiences as a publisher, we know that consumers access and comprehend information differently when using digital and printed media and, accordingly, take a different approaches to the way content is presented in order to maximise its effectiveness. As we expect the number of consumers choosing to receive and read bills and other communications online will continue to increase, we recommend that Ofgem extend its work on supplier communications to cover this area (including consideration of the different ways that information is provided on different types of digital device, eg laptops, tablets, smartphones) in order that all consumers receive clear and meaningful information from their energy supplier.

As part of its commitment to providing clearer and simpler information, Ofgem has also proposed that it will take on the complaints reporting function currently performed by Consumer Focus from 2013. This will bring the energy regulator into line with the Financial Services Authority and Ofcom. Ofgem should use this opportunity to make the following significant improvements to the current arrangements in order to bring real benefits to consumers by driving improvements in supplier performance:

(i) First, the exclusion of complaints made directly to suppliers (as opposed to Citizens Advice, the Consumer Focus Extra Help Unit and the Energy Ombudsman) from the Consumer Focus reporting model is unacceptable. These represent the vast majority of complaints in the sector and Ofgem should include these when it begins to publish complaints data.

(ii) Second, Ofgem should also commit to systematic monitoring of complaints handling practices by conducting consumer research every year. Ofgem’s research so far has already revealed a number of basic customer service issues concerning the way complaints are handled that should be addressed by suppliers immediately. These include failing to call customers back when promised, failing to provide contact details and failing to ensure customers speak to someone who has the ability to make decisions there and then.[16] Suppliers should also put in place processes to ensure consumers are genuinely satisfied with the outcome of their complaint by ensuring that, when consumers are given an explanation of the outcome, they are always asked explicitly if they are happy for their complaint to be closed.

(iii) Third, the FSA has recently determined that complaints processes with a number of stages are ‘inherently prone to misuse’ because they place the onus on consumers to come back to firms if they are dissatisfied with the first response they receive, making it less likely that firms will investigate complaints properly. While the FSA has since abolished multiple-stage complaints processes, they remain in the energy sector and should be reviewed by Ofgem to assess whether they are being misused.[17]

Finally, we support Ofgem’s request that the Energy Ombudsman starts to publish information about complaints received and their outcome at a company level rather than just aggregated

[16] Customer Complaints Handling Research, Harris Interactive for Ofgem, March 2012, p 4.
[17] Consumer complaints: The ombudsman award limit and changes to complaints-handling rules, Financial Ombudsman Service & Financial Services Authority, Consultation Paper 11/10, May 2011, p 18.

figures for the whole industry. This is another area where this sector has lagged behind other regulated markets.

5. Supplier cheapest deal (chapter 6)

While we agree with the principle of the supplier cheapest deal proposal, we believe that Ofgem's current tariff proposals risk undermining its effectiveness. A key issue appears to be the unintended consequences – frustration and/or disappointment leading to even greater disengagement – that may result if consumers are provided with information about a tariff that may not be a practical option for them. In our report we discuss in some detail the effective exclusion of consumers who are unable or unwilling to pay by direct debit (and, in some cases, manage their account online) from many of the most competitive offers.[18]

We believe that this issue could be resolved by implementing the Which? tariff proposals, which would mean that every tariff would be available to every consumer, irrespective of payment method, with surcharges and discounts to reflect different options on top of the core offline direct debit offer. As part of the message, the unit price of the supplier's cheapest deal could be displayed side-by-side with the actual unit price of the consumer's current deal with a 'menu' of surcharges and discounts expressed in pounds and pence per year that would be applicable to both tariffs. The information could be enhanced by providing a personalised projection of the price of the consumer's current tariff and the cheapest version of the supplier's cheapest deal (eg online direct debit). Even if a consumer was unable or unwilling to take up all of the options that 'make up' the cheapest version, the standardised presentation of discounts would enable them to easily see the value of the 'premium'.

We also believe that the Which? tariff proposal would mitigate another unintended consequence of the supplier cheapest deal proposal that is not acknowledged by Ofgem. Many of the most competitive offers are temporary and, as such, are only available to a set 'quota' of customers. As such, it is possible that a consumer contacting their supplier following receipt of a supplier cheapest deal message could be told that the tariff they want is no longer available. However, with unit pricing and standardised surcharges and discounts it would be very easy for consumers to understand the value of other tariffs offered by the supplier and how they compare to their current deal.

6. The tariff comparison rate (chapter 7)

We do not believe that the Tariff Comparison Rate (TCR) will provide the clarity and instant comparability of prices that is needed to drive effective competition in the energy market. While the idea of a 'common currency' for otherwise non-standardised products is intuitively attractive and has been employed with some success in financial services, we consider it a poor alternative to unit pricing that, for the following reasons may confuse or mislead consumers:

(i) Ofgem itself acknowledges that the TCR will not show consumers the price that they will personally pay.[19] Instead, it will be a 'blended price' based on the national average annual price of a tariff at different consumption levels. If consumers fail to recognise – as we believe many will – that the TCR will not

[18] The Imbalance of Power, Which?, 2012, pp 28-29.
[19] The Retail Market Review – Updated domestic proposals, Ofgem, October 2012, p 101.

reliably tell them whether one tariff is cheaper than another for them personally, but is merely a 'prompt' to search further and obtain a 'personalised price' from a switching site or supplier then this creates a risk of mis-buying;

(ii) Simply to make sense of the TCR, consumers will need to know their consumption – or at least whether they are in the low, medium or high usage group. Evidence suggests that consumers do not have a sufficient understanding of their usage to do this, and using bills and annual statements to 'educate' consumers about which usage category they are in is likely to be ineffective given low engagement with these communications. Also, a dual fuel consumer could be in one usage group for one fuel and a different group for the other, creating a risk that they could mix them up and consequently choose the wrong tariffs;

(iii) Furthermore, basing the TCR on a national average price adjusted for suppliers' regional market shares is likely to misrepresent the price of tariffs from suppliers who have large numbers of customers in regions with high distribution costs;

(iv) Consumers are also likely to be confused by the relationship between their tariff's TCR (expressed as p/kWh) and the unit rate that they see on their bills and, increasingly, on in-home display units. Ofgem acknowledges that the TCR is not a 'silver bullet' and that consumers will need to engage further to obtain information about the actual price of the tariffs available to them. It seems highly questionable whether, given historically low levels of engagement, a 'prompt' of this kind will deliver the serious competitive pressure that is needed.

Additionally, the TCR is likely to suffer from a key problem affecting quotations from price comparison sites, which are also based on the total price of a tariff over a 12 month period. In order to obtain a quotation, users of price comparison sites must provide information about their energy consumption (or spend, which is a proxy for consumption). However, previous consumption may not necessarily be a good indicator of future consumption as a consumer's usage may vary from year to year due to changes in the weather, the number of people in their household or the physical features of the property. The industry's own code of practice for accurate billing notes the significant impact that new gas and/or electric appliances and changes in occupancy, such as a new baby, can have on energy consumption.[20]

The implications for the TCR here are clear because, as with price comparison sites, a consumer using the TCR to make the right choice of tariff must assume that their usage over the next 12 months will not be significantly different from their usage in the previous 12 months. However, there are a whole range of reasons (described above) that mean their consumption could vary substantially between the two periods, creating a risk that any purchase decision based on the TCR could be the wrong decision.

Finally, as well as being subject to all the aforementioned factors that can influence how a consumer's energy usage may change over time, this method is only able to provide an estimate of prices on the basis of current unit rates. In the case of variable-price tariffs this is particularly problematic as there is no guarantee that rates won't change during the period the estimate refers to.

7. Standards of Conduct for domestic consumers (chapter 8)

Throughout the RMR we have repeated our view set out in the Energy Supply Probe that there was 'no clear process for enforcement of the Standards [of Conduct] and no clear incentive

[20] Code of Practice for Accurate Bills: Frequently Asked Questions, Energy Retail Association, April 2011, p 2.

for why energy suppliers would comply with the Standards'.[21] This view has not changed and, accordingly, we welcome Ofgem's proposal to make the Standards a legally binding obligation via an overarching licence condition. However, it is extremely disappointing, although not entirely unexpected, that energy suppliers have not voluntarily implemented a set of principles that broadly reflect our minimum expectations of how any company should treat its customers. There are two key reasons why we believe the commercial risks of poor conduct to energy suppliers are, at best, rather minimal:

(i) First, the vast majority of consumers are unable to substitute gas and electricity for other sources of energy and 'opt out' of the retail energy market altogether; and

(ii) Second, difficulty comparing alternative offers and a protracted switching process makes a 'vote with your feet' strategy less immediately harmful to energy suppliers (and therefore less attractive to consumers) as it might be to companies in other sectors.

The main objective of the Standards is to require licensed suppliers to treat consumers fairly and require them to take consumers' needs into account in all their dealings with them. Fairness is critical in a market that provides a service that consumers have no choice but to use. For the following reasons, one of the most obvious areas where this fairness principle is clearly lacking – and should be applied immediately – is tariffs. It is fundamentally unfair that consumers are unable to easily understand and compare the prices of an essential utility. And, as we set out in our report, it is unfair that some consumers are effectively excluded from the most competitive deals due to their socioeconomic circumstances.

It is also inequitable that current tariff structures allow suppliers to recover social and environmental policy costs as a fixed amount irrespective of usage or income. Recovering the costs of social schemes as a fixed amount is a very regressive way to fund such programmes as low-income consumers spend a much higher proportion of their income on their energy bills. Funding these programmes through taxation would be the most progressive approach as it would allow contributions to be linked directly to income. However, if costs have to be recovered through bills then doing this on a per-unit (consumption) basis would be fairer given the broadly positive correlation between income and energy usage. Similarly, the lesser environmental impact of lower energy may not be rewarded with a lower rate of contribution to carbon reduction programmes if suppliers are able to recover these costs as a fixed amount per household.

We do not believe that Ofgem's tariff proposals are likely to address these unfair outcomes adequately and, instead, believe that Ofgem should implement the Which? tariff proposals.

8. Protecting consumers on fixed term offers (chapter 9)

As set out in section 3, we propose that suppliers be restricted to one SVR tariff with universal (ie applicable to all tariffs offered by a supplier) surcharges for payment methods other than direct debit and discounts for dual fuel and online account management. All other tariffs should be fixed-term and fixed price, or - assuming a sufficiently robust one becomes available in the future – that directly 'track' a transparent wholesale market index that suppliers have no direct influence over. With this framework in place, there is no need for

[21] Consultation response – Energy Supply Probe: Proposed retail market remedies, Which?, June 2009, p 4.

suppliers to offer more than one open-ended variable price tariff. Furthermore, we support Ofgem's proposal to ban automatic rollovers to fixed term contracts, ensuring that consumers are not locked into potentially uncompetitive contracts without their consent, and believe that a single SVR tariff will enhance this measure by guaranteeing there is a clear 'default' for consumers who have not sought a new fixed term offer or switched to another supplier.

Regarding Ofgem's proposal to allow suppliers to offer variable price tariffs on a fixed-term basis as long as variations in the price of those tariffs are 'set out in advance and scheduled to occur automatically by a precise amount (or amounts) and on a precise date (or dates)'[22], we believe this is flawed on at least two counts.

(i) First, we believe there is a risk that consumers will either not read or understand the terms and conditions of such an agreement, leaving scope for such tariff structures to be abused, for example by setting an attractive low introductory rate during the summer period when consumption is low and a higher rate for the rest of the year. Such a practice would be particularly harmful if there was an early cancellation fee on the tariff.

(ii) Second, it is difficult to envisage how the TCR (which is based on annual consumption) would be calculated for a tariff where, for example, the rate changes on a particular date but there is no way of predicting how much energy will be used either side of that point in time. We also consider that it would be difficult, if not impossible, to present the price of this kind of tariff as a unit rate, were our proposal for unit pricing to be introduced.

Although we believe that all fixed-term offers should be fixed price or tracker products, we accept Ofgem's view that there may be exceptional circumstances (eg significant or unforeseen increases in network costs) that mean the price of a fixed-term contract needs to be changed. We agree that where derogations are granted by Ofgem, consumers should receive 30 calendar days advance notice of adverse changes to their terms and conditions. We also support Ofgem's proposal to remove the requirement that consumers will only be protected from adverse changes if they notify their supplier of their intention to switch on or before the date the changes take place. We assume that this new 'grace period' during which consumers will remain protected will be 20 working days, as per the proposals for the 'switching window'.

We support the introduction of a switching window that would start several weeks before the end of every fixed term contract, with no early exit fees to pay if the transfer goes through early. We also welcome the related proposal that will see consumers who initiate a switch within 20 days of their fixed term contract coming to an end continue to pay their fixed term prices until their switch has completed. Together these measures will reduce the number of people who are unnecessarily transferred to their supplier's (usually expensive) default tariff during the switching process. They should also help limit the financial losses people may incur as a result of the overly long time it takes to switch supplier.

To complement this, two further changes should be made to the switching process. First, the time it takes to switch should be reduced from around five weeks to three weeks, including any cooling off period. This would bring the process in to line with the expectations set out in the Third Energy Package. Not only would this improve the gains and feedback from

[22] The Retail Market Review – Updated domestic proposals, Ofgem, October 2012, p 114.

switching, it would also bring the retail energy market in line with the current account market, where making a switch is a considerably more complicated undertaking. Second, suppliers should write to all new customers within three days of the consumer initiating a switch outlining the process, including when the rates will be switched from the old tariff to the new one.

9. Market cheapest deal (chapter 10)

The market cheapest deal initiative will address one of the main issues with the supplier cheapest deal proposal, which is that consumers may simply be encouraged to switch to another tariff with their current supplier, and not look further for better deals. As Ofgem points out, this may lead to fairer outcomes for individual consumers, but will have little impact on improving the overall competitiveness of the market.

However, as with the supplier cheapest deal proposal, we believe that the effectiveness of market cheapest deal messaging will be undermined by Ofgem's tariff proposals. For the same reasons set out in section 5, we believe this could be addressed by implementing the Which? tariff proposals.

Regarding other approaches to engaging sticky and/or vulnerable consumers, we believe that our tariff proposals would substantially increase the range of consumer media where transparent and meaningful information about energy prices could be displayed. We believe that digital teletext could have significant potential where the provision of energy market information to consumers is concerned and that low-income consumers, who may not be online but are likely to have a television, may benefit particularly from this.

Box 9 Answering the objections to unit pricing

Ofgem's Tariff Comparison Rate means unit pricing is unnecessary

To get round the problem of prices being dependent on a consumer's consumption, Ofgem has proposed a 'common currency' for energy tariffs, known as the Tariff Comparison Rate (TCR). However, Which? believes that this is a poor alternative to unit pricing and may confuse or mislead consumers for the following reasons:

- The TCR will not show consumers the price that they will personally pay or whether it is definitely cheaper for them than another tariff. Instead, it will be a 'blended price' based on the national average annual price of a tariff at different consumption levels. If consumers fail to recognise – as we believe many will – that the TCR is merely a 'prompt' to search further and obtain a 'personalised price' from a switching site or supplier, then this creates a risk of mis-buying. It seems highly questionable whether, given historically low levels of engagement, a 'prompt' of this kind will deliver the serious competitive pressure that is needed.
- Simply to make sense of the TCR, consumers will need to know their consumption – or at least whether they are a low, medium or high user. Evidence suggests that consumers do not have a sufficient understanding of their usage to do this, and using bills and annual statements to 'educate' consumers about which usage category they are in is likely to be ineffective given low engagement with these communications;
- Furthermore, basing the TCR on a national average price adjusted for suppliers' regional market shares is likely to misrepresent the price of tariffs from suppliers who have large numbers of customers in regions with high distribution costs.
- Consumers are also likely to be confused by the relationship between their tariff's TCR (expressed as p/kWh) and the unit rate that they see on their bills and, increasingly, on in-home display units.

Abolishing standing charges ignores suppliers' need to recover fixed costs

Consumers' bills are broadly made up of five types of cost – the wholesale cost of energy, the cost of transmission and distribution, the cost of government environmental and social policies, tax and suppliers' retail costs and margin. The majority of these costs are inherently variable and/or most appropriately recovered on a consumption basis.

The wholesale energy component is indisputably variable as it depends on the amount used, as does the VAT element. Analysis by Ofgem has also determined that the majority of electricity and gas transmission and distribution costs faced by suppliers are also related to the consumption of individual customers – technically there are no fixed gas distribution charges[135] and, for electricity, there is only one fixed charge, amounting to £13 per household per year.[136] The costs of government environmental and social polices are fixed. The amount of carbon savings each supplier has to deliver through the CERT and the CESP are based on the number of customers it has, while the amount of financial support that suppliers must provide under the much smaller Warm Home Discount scheme is calculated in the same way. However, the ECO, which will replace CERT and CESP in 2013, will be treated as a variable cost as each supplier's target will be set according to the amount of energy it supplies.[137] As well as according with the 'polluter pays' principle, recovering policy costs in this way is, as set out below, more socially progressive due to the positive relationship between energy use and income.

We do not doubt that a large proportion of suppliers' own retail costs are fixed. However, it is also the case that retailers in other sectors face fixed overheads but do not choose to recover them through price structures that include fixed charges. The provision of a petrol station, for example, entails a range of fixed costs – rent, staff, lighting, heating, security, processing payments and so on – but no forecourt operator charges an 'entrance fee' to cover these. Instead, these costs are recovered through unit prices.

Which? understands that unit pricing will probably result in suppliers being unable to recover all of the fixed costs associated with supplying some low users and those customers will become loss making as a result. However, this must be set against the fact that the price structures used by suppliers to ensure they can recover these costs have resulted in a market where consumers are unable to understand and compare prices and drive effective competition. It has also led to discrimination against many groups, including some of the most vulnerable.

One solution that has already been suggested is to set a regulated 'universal' standing charge for all suppliers so consumers are able to compare prices simply by looking at the residual unit rate. However, there are clear problems with the proposal to include costs that are within the control of the supplier in such a charge. First, Ofgem is likely to have difficulties establishing what the charge should be. Second, suppliers may have different fixed costs, meaning that their inclusion in a universal standing charge may result in over-recovery or under-recovery compared with the actual costs incurred. This may deliver advantages to suppliers with lower costs and potentially reduce their incentives to cut costs further.

On balance, therefore, Which? believe that a single unit price incorporating all fixed and variable costs is the most advantageous option. We accept that such a price structure may not be fully cost reflective. However, it would be wrong to assume that the way that energy is currently priced fully reflects costs. There are a number of clear cross-subsidies in the energy market that are not adequately addressed by current price structures. Some of these cross-subsidies are either extremely difficult or even impossible to quantify. These include the extent to which consumers differ in the demands they place on suppliers' customer service functions, the pattern of their consumption (eg those who cook their dinner at 8pm, after the height of the evening peak, cross-subsidise those who cook their dinner at 6pm), and their location (eg within each distribution region there are higher-cost rural consumers and lower-cost urban consumers yet tariffs are not varied to reflect this with the costs of serving each incorrectly assumed to be the same).

More generally, it is a fact of business that not all customers will be profitable. The considerable overheads incurred by supermarkets, for example, are almost certainly not recovered from those who only spend a small amount on groceries, while credit card providers get little benefit from customers who pay their balance off in full at the end of every month.

Unit pricing will unfairly penalise high users, particularly those in low income groups

Which? analysis suggests that our proposals are actually broadly socially progressive, given the generally positive relationship between energy usage and income. Low users, who are more likely to be in low income groups, currently lose out. We have modelled the impact of moving to unit pricing and calculated that, based on current average standard tariff prices low users would see their annual electricity bills fall by £23 (7%) and their gas bills by £32 (6%). High users would see a £34 (5%) increase for electricity and £37 (4%) increase for gas. However, it is important to note that our modelling is based on current prices and does not account for the increase in competition (and resulting downward pressure on prices) that we would expect in a market with clear and transparent pricing.

Rebalancing tariffs by spreading fixed costs across the whole customer base will also be beneficial from an environmental point of view as it will place greater emphasis on the cost of excessive energy consumption and strengthen incentives to invest in energy efficiency measures.

However, the persuasiveness of this case also depends on how negatively – in terms of their ability to pay – higher users will be affected. It may not be enough simply to state the fact that higher users tend to be in higher income groups, as there is a significant minority of 'high use, low income' consumers who are likely to see their bills rise under single unit rate pricing. According to analysis produced for Ofgem by the Centre for Sustainable Energy there are just fewer than 1.1m households with above average electricity consumption and around 530,000 households with above average gas consumption that are in 'income poverty' (defined as below 60% of median income).[138] The analysis identifies four distinct high user groups for electricity and two distinct groups for gas. All of these groups will see their bills rise under unit pricing, with the size of the increase ranging from £14 to £34 for electricity and £10 to £37 for gas.

However, given the generally socially progressive nature of our proposals, we think that they are justified in terms of the benefits that should arise from a more transparent and therefore competitive market. We also believe that the impact on low income households with high usage should be alleviated in other ways. For example, ensuring that energy efficiency measures delivered through the ECO are targeted effectively at this group, introducing a differential rate for the Warm Home Discount based on energy usage, as well as recognising that some issues – such as health conditions that result in high demand for heat or hot water - are beyond the scope of consumer energy policy and should be addressed through social institutions, such as the welfare state.

Unit pricing will destroy innovation

This objection rests on an assumption that there has already been substantial beneficial innovation in the retail energy market. Which? does not agree with this view. Commonly cited 'innovations' such as offering consumers different payment methods and online account management options have, in fact, been rapidly 'commoditised' due to the ease of replication by all suppliers in the market. Nor is it the case that these services are unique to the energy market – they are found in many other consumer markets, including telecoms and financial services.

In our view, most 'innovation' in the energy market is largely a matter of price presentation. Tiered 'no standing charge' tariffs are regularly held up as a major example of innovation yet for the vast majority of consumers they function in exactly the same way as a tariff with a standing charge. This is because the first tier of units is set at a level well below the annual consumption of most households and is priced at a higher rate which reflects both the cost of energy consumed and any fixed charges (the second tier is priced at a lower rate, reflecting just the cost of the energy consumed). This arrangement is therefore little more than a marketing gimmick.

Smart metering technology does have the potential to deliver innovative tariffs that give consumers a choice of ways to change how they use and pay for energy, as well as reflecting different risk preferences. These include tariffs based on time-of-use pricing and 'real-time' products that are directly linked to wholesale market prices. These types of tariff should also help some consumers save money, but adding them into current tariff structures will create further barriers to consumers ever understanding the true price of one tariff against another. Starting from the basis of the single unit rate would make it easier to construct new tariff types that remain easy to compare.

Finally, we do not believe that unit pricing will prevent suppliers from offering energy-related 'add-ons', such as loyalty points, central heating servicing or remote heading controls. With the price of the tariff clear via the single unit rate, consumers will be better placed to judge the value of such 'added' benefits.

[135] 'Technically fixed' refers to the fact that one of the gas distribution charges is based on historical (from the previous year) rather than current consumption and, as such, may be treated as fixed by suppliers. However, the level of the charge does depend on the amount of energy used and there should be a close correlation between historical and current consumption. As such, we believe that this charge should be treated as a variable charge and recovered through the unit rate.

[136] The Standardised Element of Standard Tariffs under the Retail Market Review, Ofgem, February 2012, pp 10-11. [137] Energy Companies Obligation (ECO) 2012 - 2015: Guidance for Suppliers, Ofgem E-Serve, November 2012, pp 28-30. [138] Understanding 'High Use Low-income' Energy Consumers, Centre for Sustainable Energy final report to Ofgem, November 2010, pp 11-18