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Dear Andrew,

The Retail Market Review: Domestic Proposals

1. The retail energy market faces a period of unprecedented challenge. Commodity and non-commodity elements of household bills are forecast to continue to escalate in coming years. Increases in network charges and the new Energy Company Obligation (ECO) alone are forecast to add £94 to bills by 2014[1]. Against an economic backdrop that continues to prove exceptionally challenging, it is essential that the retail energy market functions effectively - meaning consumers should be able to find an energy deal that they are confident represents the best deal for them.

2. Ofgem's latest Retail Market Review (RMR) proposals are therefore timely, and there is much in the document we welcome. Many of the proposals are likely to significantly improve transparency. Mandating a standing charge and single unit rate structure for tariffs in particular will help customers to more easily compare offers between suppliers, as will many of the proposed information remedies.

3. However, it is also essential that any new regulations introduced through RMR do not unduly constrain the ability of suppliers to offer products that are clearly in the interests of consumers. Innovative energy products can be a highly effective way of engaging customers in the energy market. We have seen this most recently by the success of our "Fix and Fall" tariff, launched this autumn. This capped deal that allows customers to take advantage of future price reductions with no penalty has been well received by customers, with significant numbers[2] of customers taking this tariff up in the last three months.

4. Innovation will also become increasingly critical in the context of the rollout of smart meters. For customers to unlock the true potential of smart meters in a way that allows them to reduce their bills through behaviour change, suppliers will need the ability to launch products that are very different to those available on the market today. Restricting the ability of suppliers to introduce innovative time of use tariffs will not be in consumers' interests, potentially conflicting with Ofgem's primary duty. It is crucial therefore that Ofgem's RMR conclusions strike an appropriate balance between enabling a vibrant and innovative retail energy market, while also ensuring products offered by suppliers are easy to compare.

5. One proposal that fails to achieve this balance is the proposed cap on the number of tariffs. The cap would certainly achieve its objective of promoting transparency by limiting the number of products between which customers have to choose. However, we have concerns that setting this cap at four is overly restrictive, and would prevent some products that customers value from coming to market.

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[1] "The Costs of the Energy Company Obligation", a NERA report for Energy UK, 21st November 2012
[2] Details on the specific number of customers who have signed up for our new "Fix and Fall" tariff are provided in Appendix B to this response.

6. Our detailed views on each of the proposals in the October RMR document are set out below. However, our key views are as follows:

   - A tariff cap that permits six tariffs, rather than four, would be a more acceptable balance between promoting transparency and allowing innovation. A four tariff cap will severely restrict the ability of suppliers to offer products that customers value (such as our "Fix and Fall" tariff, for example), and effectively end the market for differentiated affinity tariffs. Allowing suppliers to offer six tariffs would allow customers to access a set of basic tariffs from each supplier (such as evergreen, short and long term fixed price products), as well as provide scope for a small number of additional innovative tariffs. A six tariff cap would also provide sufficient flexibility for suppliers to offer affinity tariffs, which have proven to be a particularly innovative part of the market, yet which would also need to be included within the cap.
   - A higher tariff cap is needed for customers with smart meters. While we would hope many customers will opt for innovative time of use tariffs when they have a smart meter installed, it is likely that many would want to retain their existing (dumb meter) tariff. This will particularly be the case where the smart meter is installed as a replacement meter. Customers will expect to be able to access all of the tariffs available on "dumb" meters, as well as a reasonable range of additional "smart" tariffs. Restricting smart meters to the same tariff cap as dumb meters – or relying on securing Ofgem approval for each innovative smart tariff through a derogation application process – would severely limit innovation in this crucial part of the market.
   - "Online" should be an allowable discount, and "green energy" an allowable surcharge. Discounts are the primary way in which suppliers incentivise customers to adopt cost saving behaviours. Ofgem has recognised that "dual fuel" is a discount that customers value. However, customers also value online discounts in the same way, and therefore these should also be permitted, without using up a tariff "slot". Similarly, customers should be able to specify they are willing to pay a surcharge, if they want their energy provision to be a "green" form of their favoured tariff (with this "green" surcharge being available on a consistent basis across all tariffs).
   - The "Market Cheapest Deal" trial should not proceed any further, and may be misleading for consumers. We have severe concerns regarding this proposal. An obligation to advertise competitor prices goes well beyond what is reasonable in a competitive market. We are also very concerned that the proposal would be logistically complex, and may mislead some of the most vulnerable customers in the market (e.g. if it was insufficiently clear that by switching to a cheaper deal, customers would no longer be eligible for support that is conditional on being registered with a large supplier, such as the Warm Homes Discount).
   - We would suggest introducing a "sunset clause" on the tariff reform proposals. We welcome Ofgem's proposal to avoid further re-regulation before 2017[3]. We believe that by this point in time the Standards of Conduct proposals will be firmly embedded in all aspects of a supplier's activities. We would therefore encourage Ofgem to consider introducing a sunset clause on the tariff reform proposals, which would enable the market to return to less prescriptive arrangements once standards of conduct were fully in place.

[3] The Retail Market Review – Updated domestic proposals, page 10.

- Suppliers should be able to provide customers with relevant information along with the Price Increase Notification. Customers value the fact that suppliers are able to provide them with information on how to mitigate the rising cost of energy at the time of a price rise. Preventing suppliers from providing this information is not in customers' interests. Ofgem should instead seek to prevent the overall message about the price rise being unnecessarily diluted by defining what "relevant" information may be.

7. In the following sections we set out our views on the proposals relating to:
   - tariff simplification;
   - information remedies; and
   - Standards of Conduct.
8. In addition, Appendix A sets out our responses to the specific questions Ofgem has posed. We also include a confidential Appendix B setting out our response to your formal request for information regarding the costs and benefits of the proposals.
9. This response is submitted on behalf of the Centrica group of companies (excluding Centrica Storage), is not confidential (aside from Appendix B), and may be placed on the Ofgem website.

Tariff simplification

10. We set out our views on the tariff simplification proposals below, focusing on each of the following issues in turn:
    - Number of allowed tariffs;
    - Smart tariffs;
    - Discounts and surcharges;
    - Market cheapest deal;
    - Sunset clause;
    - Bundles;
    - Loyalty rewards; and
    - Small supplier exemptions.

Number of allowed tariffs

11. We recognise the need to improve transparency by reducing the range, and simplifying the structure of energy tariffs. Indeed, we have already taken steps to improve our own range of tariffs. The initiatives announced by ourselves and other suppliers over the last two years[4] are evidence of this. However, if the RMR proposals are to provide these improvements whilst maintaining customer engagement in the market, transparency and simplicity must be balanced with choice and innovation.
12. As a direct way of limiting tariff proliferation, we accept that a cap on the number of tariffs a supplier may offer would be very effective at limiting the number of tariffs available. However, to avoid unduly damaging innovation, the level of the cap needs to be sufficient to allow suppliers to offer the core range of tariffs (i.e. standard evergreen, one year fixed, two year fixed), and a number of more innovative tariffs. This will give suppliers scope to design offerings that will engage customers in the market, and adapt to changing customer needs.

[4] Ofgem have published full details of these initiatives on their website. Link.

13. We do not believe that a four tariff cap will strike an appropriate balance between these two needs, and will inevitably see some tariffs removed from the market, damaging customer engagement as a consequence. As currently proposed, the tariff cap would only allow space for one innovative tariff (assuming we continue to offer the standard range of tariffs customers have come to expect, as set out above).

14. A four tariff cap would therefore severely restrict our ability to offer truly innovative products such as "Fix and Fall", as we would be compelled to make a choice between innovative offerings. Under the rules as proposed (assuming we maintain our standard offerings), we would not be able to offer a "Fix and Fall" product alongside another innovative offering – instead having to choose between two products, both of which may be demanded by customers.

15. A four tariff cap would also effectively force differentiated "affinity" products to be removed from the market. For example, given affinity partners would be unlikely to enter into arrangements where they lose their customers at the end of the fixed term period, any fixed term affinity product would be likely to take up two of the four tariff slots; one for the fixed term contract itself and one for an evergreen offering for customers to roll off on to. Even if the affinity product was evergreen and took up one of the four slots, that would not allow suppliers any space for non-core tariffs.

16. Given the dramatic growth in the number of customers choosing such affinity products, (particularly when offered in partnerships with trusted third parties such as M&S and Sainsbury's), a solution must be found to accommodate them. We note that some of these tariffs also allow customers to make donations to charities such as Age UK, National Trust and Cancer Research.

17. A restrictive cap would also damage our ability to test innovative offerings, or support trials under the Low Carbon Network Fund such as the Customer Led Network Revolution (CLNR)[5]. At present, we can test tariffs through a "soft launch", allowing us to establish whether a product would have genuine demand across the market as a whole. Under a highly restrictive cap, there would be no freedom to undertake such testing, further limiting the potential for innovation. This would not be in the wider customer interest.

18. These issues could be addressed by increasing the number of tariffs allowed within the proposed tariff cap to six. This would "lock in" some of the best practice the industry has seen to date on tariff simplification, prevent future tariff proliferation, yet allow suppliers sufficient freedom to retain affinity partnerships, whilst testing and launching new products.

19. Finally, we have concerns that the proposal to allow a single additional tariff under the cap in support of collective purchasing schemes will be unworkable in practice. As both the number and variety of collective purchasing schemes rises, so too will the need for suppliers to be able to offer bespoke products which meet the needs of the customers across different schemes. The effect of the proposal, as drafted, will be to restrict suppliers' ability to enter more than one collective purchasing scheme at any one time.

20. We recognise the tension between the need to support the development of collective purchasing schemes, and the wider RMR aim of preventing tariff proliferation. However, if Ofgem is to avoid undermining the future development of such schemes, it is clear this is an aspect of the proposals which requires further thought.

Smart meters

21. As proposed, smart meters would also be subject to the same four tariff cap as "dumb" meters. We have real concerns that such a proposal would not be in the interests of

[5] http://www.networkrevolution.co.uk/default.aspx

consumers – particularly as the smart rollout gathers momentum, and smart meters start to be offered as replacements to existing dumb meters.

22. Our hope is that, when a smart meter is installed in a customer's home, we will be able to offer the customer a compelling time of use tariff that will enable them to get the most benefit from their new meter. However, there are likely to be many customers who will want to retain their previous tariff (at least until they are more familiar with the functionality that a smart meter offers).

23. It is therefore important that customers with smart meters are still able to access the full range of "dumb" tariffs, as well as having the option of a range of time of use tariffs. We therefore suggest that the tariff cap for smart meter tariffs should be offered <u>in addition to</u> the tariffs available on dumb tariffs.

24. Ofgem has suggested that in addition to the cap of four tariffs for smart meters, suppliers could apply for derogation from the cap regulations for particularly innovative time of use propositions. This is a helpful suggestion, in that it acknowledges there is likely to be a need to offer a greater range of innovative tariffs for smart meters. However, derogations from regulations are not granted lightly by Ofgem, and the application process is time and resource intensive. As such, even with a potential for derogation, these proposals are likely to represent a significant barrier to innovation in this crucial part of the market.

Discounts and surcharges

25. We welcome that Ofgem have recognised that customers value being able to access dual fuel discounts, and that this category of discounts is permitted under the proposed new regulations. However, the proposal that online discounts are not to be treated in an identical manner seems inconsistent with this logic.

26. Discounts are the key way in which customers can be given incentives for adopting cost saving behaviours, and adopting paperless billing is one such category where offering a discount is highly effective. Online discounts are an important mechanism for both engaging customers and incentivising cost saving behaviour (allowing suppliers to share the cost benefits of moving online with customers). At present, online discounts save each customer around £80 per annum[6].

27. We would suggest that Ofgem allows online discounts to be overlaid on any tariff as a form of "wrapper" (in a similar way to the treatment of dual fuel discounts). So long as this discount is being applied on a consistent basis across all core tariffs when requested by the customer, then transparency would be unaffected.

28. Similarly, we suggest that the set of surcharges that customers are able to overlay on their tariff should be extended to include a "green" surcharge. As with dual fuel and online discounts, a green surcharge could be applied as a transparent "wrapper", available on a consistent basis across all tariff types. Under the current proposals, "green" tariffs would take up one of the four "slots" – suggesting they are unlikely to be offered by major suppliers were the proposals implemented as drafted (and instead only be offered by "niche" providers).

29. We accept the proposal to require discounts to be common across all tariffs, which would prohibit customer-specific discounts and payments currently used by most suppliers as "acquisition" and "winback" offers. Although one-off discounts to specific customers are a useful way of engaging customers in the domestic market (i.e. through a one-off payment, credit or payment in kind to encourage switching from their current supplier), we accept that this can make the comparison of products available across the market as a whole

[6] When compared to our standard evergreen tariff.

more difficult. We also recognise that discounts for specific customers tend to benefit the "most engaged" in the market.

30. Their removal could therefore be argued to create a fairer and more transparent market, with all discounts included in tariffs available on the market. However, it is important to note that the risk of this proposal is that switching amongst the most engaged and/or those customers that value specific discounts most highly may fall. We would hope that this effect is quantified in Ofgem's final impact assessment.

31. We are conscious that the RMR proposals as drafted would not necessarily prevent suppliers from offering these one-off discounts through third party intermediaries, such as switching sites. If the benefits of this proposal are to be realised, we would therefore suggest that Ofgem addresses this potential loophole (e.g. through amendment of the Confidence Code).

32. We are also concerned at the proposal to restrict the way in which discounts must be structured. Expressing discounts in either a pounds per annum or pence per unit format will prevent suppliers from accurately sharing cost savings which are revenue and not volume based, for example when customers pay by direct debit. This could be resolved by allowing suppliers to express discounts using both a pounds per annum *and* pence per unit format, or allowing a percentage off the annual bill where appropriate.

33. As the proposals currently stand however, they will force suppliers to apply the direct debit discount to the unit rate (meaning that customers with low consumption will be over charged and high consuming customers under charged). A flat, per unit, discount will also distort the way in which customers with Time of Use meters are rewarded for paying by direct debit, and force suppliers into offering different direct debit discounts for gas and electricity unit rates. This is likely to create confusion at a time when Ofgem and the industry are seeking clarity.

34. Finally, some of the benefits to consumers of these proposals may be put at risk if suppliers, restricted in the way in which they use discounts and offers, divert that funding in to deeply discounted fixed term offers (i.e. below cost). This is something British Gas opposes, and we do not believe the resulting cross-subsidisation between market segments would be in the long term interests of either consumers, or competition.

Market cheapest deal

35. We fully accept the benefits to consumers of providing information about the best deal they can get with their existing supplier. This is an important way in which customers can understanding the savings they can make by changing to alternative tariffs, changing payment methods, or adopting behaviours that produce savings (e.g. moving to paperless billing).

36. However, we strongly object to the proposal to trial messaging on energy bills that advertise the tariffs of other suppliers. On a point of principle, we believe that a decision to implement this proposal would be unreasonable, and would be without precedent in any other competitive industry.

37. Logistically, we also have real concerns that, in a market as dynamic as the retail energy market, information sent out quarterly to consumers would quickly become inaccurate, and misleading as consequence. Were consumers to switch on the basis of this information, there is a significant risk prices could have moved in the intervening period.

38. The proposal also fails to consider the overall impact on consumers from switching. For example, larger suppliers could be required to advertise a small supplier's tariff as the "cheapest in the market". However, customers eligible for the Warm Homes Discount could miss out on a payment worth up to £140 per annum if they move to an exempt

supplier. This proposal therefore has the potential to mislead vulnerable customers, and cause them to make poor switching decisions.

39. It is also notable that this proposal does not feature in DECC's recent tariff reform discussion document[7], published after this consultation was launched. Suppliers are therefore left in the difficult position of not knowing which set of proposals take precedence.

Sunset clause

40. Many of the tariff proposals set out in the consultation represent a significant increase in the amount of regulation applicable to energy suppliers. Accordingly, there is a significant risk that they may cause a number of unintended consequences (for example, we have already flagged that the proposal to remove some forms of discounts could damage switching, and these and other proposals may have unanticipated implications for the pricing / availability of energy tariffs).

41. We would therefore suggest that the tariff proposals are introduced with a "sunset clause", with the conditions falling away in 2017 unless modified. This would be consistent with the way in which the undue discrimination licence condition was introduced – and which was subsequently removed (partly due to concerns regarding the detrimental impact this condition had on competition). A sunset clause would also be more consistent with the proposal that the retail energy market will be predominantly regulated through standards of conduct in the long term (which should mean that highly prescriptive regulations such as these become redundant over time).

Bundles

42. As with discounts, we accept that requiring bundles to be uniformly offered across the product range may increase the ability for consumers to compare different tariffs. We understand however that, in order to prevent suppliers from circumventing other aspects of the RMR proposals, only "non-energy related" bundles will be allowed.

43. We appreciate the need to protect against suppliers presenting discounts or surcharges as a bundle. It is important however, in defining "non-energy related" bundles, suppliers are not prevented from offering products and services such as Green Deal, boiler cover or new technologies designed to manage energy usage that plainly should be capable of being included in a "bundle".

44. Products and services like these meet specific customer needs, allow suppliers to differentiate themselves in the market, and satisfy a wide variety of customer needs. An effective ban on them will not be in the interests of consumers. It may also hinder the ability of the industry to offer customers truly innovative propositions (as well as potentially making it harder to successfully market Government schemes such as the Green Deal).

Loyalty rewards

45. We welcome that the proposals will still allow suppliers to offer customers loyalty point schemes, for example as a reward for cost saving behaviour (so long as these are applied on a consistent basis across all tariffs). Such products are very popular with customers, and are an effective way in which we can increase engagement.

46. However, we are concerned that, under these proposals, suppliers will no longer be able to offer loyalty points as a reward for tenure (i.e. awarding evergreen tariff customers an amount of loyalty points for staying with us for a certain period of time). Such rewards are the single most common request received from customers when we have discussed our

[7] "Ensuring a better deal for energy customers: DECC discussion document"

service with them. Prohibiting suppliers from meeting that need will only serve to damage customer engagement.

47. Unlike cash rewards, loyalty points have only nominal monetary value and do not therefore act in the same way as a loyalty *discount* could in relation to a termination fee. We therefore ask Ofgem to revisit this proposal and confirm that loyalty points will not be subject to the wider prohibition on loyalty discounts.

Small supplier exemptions

48. Finally, we note that small suppliers have asked to be exempt from any of the tariff reforms that are ultimately introduced as a consequence of RMR. Existing exemptions were granted to give small entrants relief from the high fixed costs of participating in government social and environmental schemes. While innovations such as brokerage in the new Energy Company Obligation mean this argument is harder to sustain today in the context of government schemes, it certainly does not apply in the case of tariff reform. Compliance with the tariff reforms as proposed would not require small suppliers to incur large fixed costs. There is therefore no justification for any form of small supplier exemption from the RMR proposals.

49. We have wider concerns about the exemptions that small suppliers currently enjoy from government environmental and social obligations, which we expect will be worth approximately £97 per household bill in 2013. While we recognise this is the result of Government and not Ofgem policies, it is clear that the operation of small supplier exemptions is already causing a gross market distortion.

<u>Information Remedies</u>

50. We do not agree with the proposal to prevent suppliers from including relevant information which may help customers mitigate the impact of that price rise along with a price increase notification. Ofgem could seek to prevent the overall message about the price rise from being unnecessarily diluted by defining what “relevant” information may be, but customers genuinely value information on other available tariffs, about moving to cheaper payment methods or ways to improve energy efficiency. This is evidenced by the large take up of such offers we see following a price increase notification.

51. We also have real concerns that the proposal to ban the joint mailing of both the annual statement and the price increase notification communication has not been dropped. Whilst we fully understand the concern that customers may not necessarily identify such a communication if it is sent along with a bill – but this must be balanced with the extra cost a separate mailing represents. We estimate this proposal will increase our costs by over £2m per annum in postage costs alone, costs which will inevitably pass through to household bills.

52. Notwithstanding these concerns, we support the intent behind many of Ofgem’s other information remedies. We also agree with the proposals to standardise the format of the annual statement and the price increase notification communications. We recognise that there is scope for some standardisation of the information these communications provide, but are concerned that the level of prescription in the format and language proposed risks creating documents which customers will find hard to engage with.

53. It is important that, even with these communications, suppliers retain at least some flexibility to introduce innovative ways of improving engagement with customers (for example, offering customers ways of managing their bills more effectively through innovative propositions, or taking advantage of energy efficiency offers). Ultimately, we would expect Standards of Conduct to be the key way in which communications such as these are regulated. We would question how the movement towards highly prescriptive

regulation in this area is consistent with the long term intent to shift to principles based regulation.

54. We also support the Supplier Cheapest Deal proposal, something which reflects the significant steps we have already made so as to improve the quality of information provided to customers. This includes the launch of our Better Deal For You initiative where we wrote to all customers advising them how they could check if they were on the best deal, launched our own tariff comparison metric so customers could see which was our cheapest tariff for them and redesigned our bill to make it easier for customers to understand what they were using. We believe this proposal will help large numbers of customers to understand their energy usage, and the options that are available to them to minimise the costs associated with it.

55. We recognise the need to engage customers in the design of customer communications, and welcome the fact that Ofgem have sought this advice as they design the proposed information remedies. This is the approach we recently took when we redesigned our bill, and the strong feedback we received was that the *primary* information customers need from the bill is how much they owe and what action they needed to take. We are therefore concerned that Ofgem are seeking to add additional information to this critical part of the bill, however well intentioned this may be.

56. More generally, we believe that there is an opportunity for Ofgem to further improve the quality of information customers receive, and reduce the confusion some communications create, by launching a wider review of all the information we are required to provide customers with. Items such as the conversion of gas units to kilowatt hours create confusion, whereas others appear to duplicate information provided elsewhere. Some customer communications also create genuine confusion, such as annual statements and price increase notification letters sent to pay-as-you-go energy customers. We would also urge Ofgem to review these communications in the context of any holistic review.

<u>Standards of Conduct</u>

57. We welcome the proposals to introduce Standards of Conduct to licence, and believe they are an important part of the overall RMR package. We recognise the need to improve customer trust in energy suppliers, and believe that putting customer fairness at the heart of everything suppliers do is the single biggest step the industry can take towards achieving this.

58. This will be a considerable, and continuous, undertaking. It is likely to require a review of all processes, policies and procedures, a consultation exercise with our customers, a project to plan and implement changes, and new systems to measure the results and direct repeats of the process. The materiality of these proposals on supplier organisations should not be underestimated.

59. Against that background, and if Ofgem want suppliers to genuinely embrace this proposal, a reasonable time to implement the proposals must be allowed. If this does not happen, suppliers will face significant regulatory risk, potentially being found in breach of licence immediately when the relevant licence conditions are brought into effect. As well as being unreasonable, this is also inconsistent with the Better Regulation principles which say new rules must "*be implemented fairly*"[8]

60. The shift to a "principles based" regulation style system also means that Ofgem will need to take a different approach to enforcement. Subjective assessments of compliance against high level undefined principles create significant regulatory risk, effectively placing

[8] "Better regulation - from design to delivery (annual report) 2005", pages 26-27.

suppliers in a position where they are unable to tell whether they are compliant or not, yet face the subjective judgement of a Regulator.

61. We recognise that Ofgem may not wish to be placed in a situation where it is expected to provide guidance on how to interpret the Standards of Conduct. However, other Regulators have overcome this problem by providing processes which allow for dialogue – for example the mediation and arbitration processes allowed for by the Financial Services Authority.

62. These elements are missing from the RMR proposals and therefore create the possibility that suppliers will face a subjective assessment of their compliance against subjective rules, without the ability to effectively challenge the merits of the decision. This is unacceptable, will inevitably lead to higher costs of regulation as suppliers "gold plate" their processes, and create new barriers to entry. We urge Ofgem to investigate the best practice evident in other regulatory frameworks.

Conclusion

63. Ofgem's latest RMR proposals represent an improvement from the proposals set out in December 2011, and there is much to welcome. There are however a limited number of proposals which do not seem to be in the best interests of consumers and must be revisited as soon as possible.

64. We welcome Ofgem's decision to publish a quantified impact assessment along with their final decision. It is essential that this impact assessment is comprehensive, and properly weighs the benefits of improved transparency with any detrimental impact on choice and innovation that may result (particularly if the proposed tariff cap is implemented in its current format).

65. We would be very happy to work with Ofgem to develop these proposals further if that would be helpful and/or contribute to the development of the quantified impact assessment. Our detailed response to each of the questions Ofgem has asked in the consultation is attached as Appendix A to this letter (alongside confidential Appendix B). We will be in contact shortly to arrange a suitable time to discuss these points in more detail.

Yours sincerely,

Ian Peters

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British Gas