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Dear Angelita

**Re: Moving to Reliable Next-day Switching – Target Operating Model and Delivery Approach**

Cornwall Energy welcomes the opportunity to respond to Ofgem's consultation *Moving to Reliable Next-day Switching – Target Operating Model and Delivery Approach*.

Cornwall Energy is an independent advisor and commentator on energy policy, regulation and markets in the United Kingdom. Our customers include suppliers, generators, public bodies, service providers, financial institutions and law firms.

We welcome the move by Ofgem to increase consumer engagement in the market and lower barriers to competition by shortening the switching process. However, we are concerned that there are question marks over whether this move will truly deliver the expected benefits. We also question its compatibility with other recent regulatory initiatives.

Our main concern is that if the cost benefit analysis of next-day switching proves to be attractive for the industry to undertake these changes then the uptake of next-day switching should be optional as we are not convinced the majority of customers are interested in next day switching. Allowing next-day switching to be optional will reduce complexity for dis-interested consumers and minimise industry costs.

We would also like to highlight the lack of justification for the Data and Communications Company's (DCC) nomination as the new Centralised Registration Service provider. We consider that a sufficient explanation has yet to be provided as to why the DCC is best placed to undertake this task or indeed why a CRS is the best way forward for the industry. This is particularly pertinent given the DCC's recent six month delay to go-live and request for a £90mn funding increase.

We set out our general thoughts on next-day switching below taken from our publication *Energy Spectrum*, and specific answers to the consultation questions are included below this.

## A stitch in time—Ofgem prepares for 24-hour switching

On 10 February, Ofgem published its decision on moving to next-day switching, along with the target operating model for achieving this by 2019. This move follows the regulator's June 2014 consultation on *Moving to Reliable Next-Day Switching*, where it proposed to replace the current separate, network-run, gas and electricity registration services with a new Centralised Registration Service (CRS). This would be governed by the Smart Energy Code and managed and operated by the Data and Communications Company (DCC).

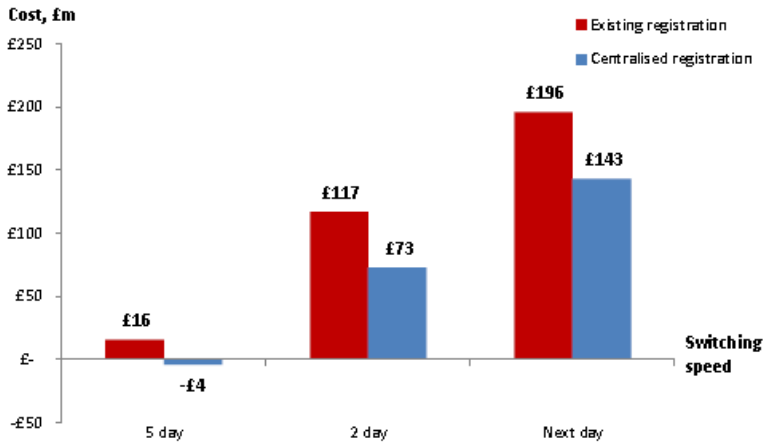
But, in this week's *Energy perspective*, we suggest that there are question marks over whether this move will truly deliver the expected benefits. We also comment on its compatibility with other recent regulatory initiatives. We express these doubts knowing that there is significant industry, consumer, political and regulatory support for next day switching.

### A date with a dream

Under the model currently proposed by Ofgem, consumers would be able to switch so that they were supplied by their new supplier from the day after the contract began. This would mean that the switch would occur during the mandated, and non-waiverable, 14-day cooling-off period. Therefore the system, and suppliers, would be required to offer the consumer the ability to cancel their new contract, and move back to their previous supplier under the previous tariff terms for up to 13 days after the switch had occurred. This will require the CRS to be able to track and reverse all switches on an almost real-time basis—markedly increasing the complexity of the process, relative to the existing arrangements.

Ostensibly, consumers' ability to return to their previous tariff terms would seem to sit uncomfortably with aspects of Ofgem's Retail Market Review (RMR). For example, if a domestic customer terminates their fixed-term tariff with a termination fee, and then subsequently determines to return to the fixed-tariff within the cooling-off period, will they be subject to the termination fee? Or will it be treated as if they had never switched away? It seems likely at present that Ofgem will push for the latter option in order to support competition, but this will result in the charging of termination fees to customers post-14 days from the switch. There is quite clearly the chance that this will increase customer confusion and introduce additional risks for "mis-billing" with regards to termination fees.

**Net Present Value costs of moving to different switching regimes**




*Source: Ofgem*

The other RMR-related risk that next-day switching presents is in the proliferation of dead tariffs. If a customer on a variable tariff switches away

from a supplier, and the supplier raises its variable prices, then the customer should be able to return to their previous contract terms; that is, the lower prices. This may lead to the creation of dead tariffs for single customers, increasing the administration cost and complexity both for suppliers and the CRS.

There is also some reasonable concern about the impact on erroneous transfers (ETs). The switching of customers on the next day sharply increases the risk of ETs, as there is no opportunity for the supplier to contact the customer prior to the switch. ETs would, therefore, only be identified after the switch had occurred, and in many cases likely after the 14-day cooling-off period had expired.

Ofgem has, in its recent work, strongly signalled its desire to reduce the number of ETs, as it views them as having a harmful effect on consumer perceptions of the industry. This work culminated in July 2014 (*ES435, p15 28/07/14*) with licence modifications to strengthen the requirements to prevent ETs. These included requiring suppliers to take all reasonable steps to ensure that they have a Valid Contract when applying to take over the supply at a customer's premises: an act that will be almost impossible under next-day switching.

## One good turn

The regulator estimates that the cost of moving to a CRS for next-day switching will be £143mn, with ongoing costs of £0.27/ year per customer. These costs are not extreme given the size of the GB market, and when compared to the other costs being imposed on the industry are relatively cheap (for perspective, the smart meter roll-out will cost the industry £10.9bn). However, while the focus has been to drive the costs of other programmes down as far as possible in order to minimise the consumer impact, the regulator has chosen the second most expensive option available to it in the case of reforming the switching process.

Ofgem's own decision shows that the move to five-day switching under a centralised system—a decrease of 16 days from the licence mandated speed and 12 days from the industry's own reduced timescale—would save £4mn and reduce customer costs by £0.33/year. This cost-effective option is overlooked in the decision, with Ofgem simply noting that it "thinks that faster switching will deliver greater net benefits for consumers". Given that the five-day option offers significant reductions in switching timescales compared to the existing arrangements, it is surprising that it was not investigated further.

## What's good for the goose

Since the concept of a CRS was first put forward, Ofgem has consistently indicated that the DCC is its preferred choice to operate the system. This is presumably because of the perceived synergies between the DCC's current role in the centre of the smart meter environment and the CRS. However, the regulator is yet to explain, at length, why the DCC is best placed to undertake this task or indeed why a CRS is the best way forward for the

industry. Instead, the argument appears to be that the DCC is already running one smart centralised system so it is therefore the logical choice for the centralised switching system.

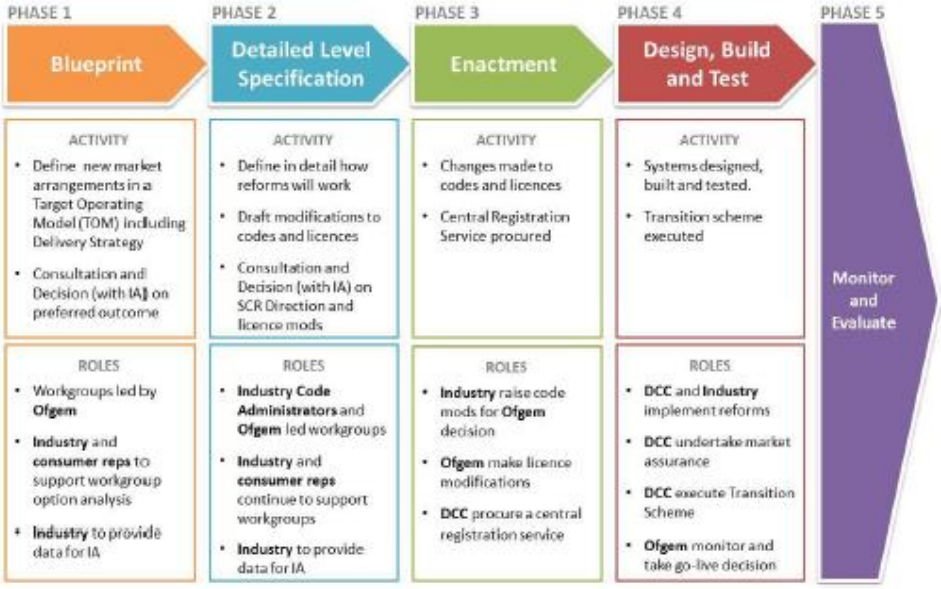
This argument does carry some weight, but should be presented as part of a full reasoned analysis by the regulator, as opposed to being put forward as the only option with no alternatives considered. But this lack of a solid justification is stark given the DCC's recent consultation on delaying the go-live of its systems (*ES452, p14, 1/12/14*). The DCC has also asked for an increase in funding of £90mn.

The government has granted the DCC its requested delay, which may well push back the start of the national roll-out smart meters, and potentially further mis-align the regulator's stated delivery date of next-day switching and the widespread adoption of smart meters. This is hardly an auspicious platform for Ofgem's preferred operator of what promises to be a complicated and wide-reaching new system. Several industry parties have highlighted the need for a full impact assessment, given the scale of the change.

## Up against the clock

The break with the timeframe for the smart meter roll-out will have further consequences. The next-day switching arrangements proposed will require the widespread adoption of smart meters to provide a meaningful level of consumer benefits. However, the national smart meter programme is currently scheduled to be completed by the end of the decade, two years after the regulator wants the new switching arrangements to be in place. Undue haste will impose additional costs for the implementation of a system that will be of limited practical benefit, particularly if the roll-out is back-loaded towards the end of the period, as it was with the non-domestic advanced meter roll-out.

**Switching programme implementation phases**



We should also note the belief of many that the 2020 target date for the smart meter roll-out is unlikely to be achieved. It has already been delayed from 2019, and a plethora of technical problems remain to be resolved.

## Trouble in store

But can we, beyond all these concerns around cost and implementation, be confident that next-day switching will actually deliver meaningful benefits?

The regulator thinks that it will lead to "dynamic competition benefits to consumers" and a saving of £17mn in the first year alone. However, as has been debated endlessly over the past two years, the majority of GB consumers are at present disengaged from the market. Indeed, only around 10-20% of domestic consumers are classed by Ofgem as actively engaged. It is in reality these consumers, already engaged with the market and taking full advantage of competition, who are most likely to benefit from next-day switching. As a consequence, there must be some concern that the move would, not for the first time, increase costs across the entire consumer base, while delivering benefits that would fall almost entirely on a single market segment that is far less disadvantaged than the majority.

Moreover, recent research hardly seems to support the view that the regulator is tackling an issue that is really serving to inhibit consumer engagement. In a report commissioned by the CMA, more than a quarter (27%) of consumers said that they had not considered switching as some aspect of the searching and switching process had discouraged them from doing so. However, this appeared less an issue around timescales, and more one of the effort involved, with many consumers saying that they simply could not be bothered to undertake the process. This might indicate that Ofgem is proceeding with a complicated and expensive workstream in order to address an issue that generally does not act as a hindrance to the majority of consumers. Perhaps the regulator's efforts would be better directed at facilitating the process of shopping, via its TPI workstreams. There are a number of examples of how other markets have tackled this to boost flagging switching rates, and we should have more regard to what our peers are doing.

There has been a general move in the retail market towards fixed-term products in the competitive switching sector. These tariffs now serve as suppliers' main route to new customers. The speed of switching in these cases is even less of an issue, given that many fixed-term tariffs come with termination fees to discourage pre-emptive switches, and customers are provided with ample warning that their tariff is coming to an end.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The indicative savings used for the calculations seem to be based on the belief that customers are currently on a supplier's variable tariff, rather than a competitively priced fixed-term. As the majority of switchers who are likely to take advantage of the

increased switching speed are engaged customers, who already regularly switch, this suggests that the actual savings will be significantly smaller. This lessens the potential benefits of the proposals and adds yet another question mark over the cost of this boondoggle.

Finally, in a world of more marginal cash-out and next day switching balancing costs will be more volatile and hedging risks increased. It is unlikely that consumers will not see the associated costs. This is before the inevitable optimism bias that is a hallmark of official cost benefit assessments.

## The square peg

There is of course a long way to travel on the development of next-day switching, and it is quite possible that a genuinely positive case can be made. But we do set out here the need to subject the implementation and impact of what, thus far, appears to have been regarded as an inherently beneficial change to far more scrutiny than has been the case until now.

## Consultation questions

***Question 1 –*** *Do you agree with the requirements set out in the TOM?*

As stated above we have concerns regarding the move to next-day switching which we would like to see addressed, and we strongly believe that additional detail must be provided by the regulator. Nonetheless, we consider that the requirements set out in the TOM in general cover the required issues for consideration.

However, we do believe that consideration should be given to allowing next-day switching to be a voluntary rather than mandatory industry wide process. If parties were able to elect if they wished to be subject to next-day switching this would dramatically lower the costs of the program by reducing system requirements, lowering the implementation risks for what promises to be a complex switch over, while ensuring that the full benefits of next-day switching are felt by those to whom the issue is relevant.

***Question 2 –*** *Is our description of the requirements sufficiently comprehensive to progress the design of our reforms during the next phase of the programme?*

We consider that in its current form the TOM is a very high level document that fails to provide the necessary detail needed to progress a workstream that has such potential to impact on the industry. If this workstream is to move forward, particularly to the ambitious timeline proposed by the regulator, then significantly more detail is required for the industry to consider the proposals.

We also believe that a full reasoned analysis must be provided to justify both the centralised registration system and the DCC's role as Ofgem's preferred option to operate this system. The move to a centralised system represents a major undertaking that will involve significant risks in terms of data migration and operation, and the regulator's decision forecasts substantial savings as a result of moving to this option compared to the current baseline under any of the reduced timescales options. This predicted saving is an important part of the presented argument for moving to next-day switching and so the full reasoning behind the argument should be made available.

Further, the selection of the DCC as the preferred scheme operator requires additional justification. The new CRS represents a large investment at a time of increasing cost pressures on customer bills and will sit at the centre of the switching process and so be vital to ensuring consumer trust and engagement in the industry. We therefore consider it necessary for the regulator to provide its reasoning for its preference for the DCC, particularly as to date the DCC has received a six month delay to its go-live date and requested a £90mn funding increase.

***Question 3 –*** *Are there any additional requirements that should be captured in the TOM?*

The treatment of objections and the cooling-off period in a next-day switching environment will be critical, particularly to new entrant suppliers with their smaller customer numbers and increased vulnerability to bad debt. While these issues are identified in the TOM insufficient consideration is given to them and the full range of potential issues they could throw up.

The TOM proposes that in order to manage objections in a next-day switching environment that suppliers will be required to maintain an up-to-date record within the CRS on all sites which they would object to if a switching request was made to allow the CRS to identify in real-time if the switch should proceed. This will place significant resource requirements on suppliers, particularly smaller, fast growing independents to ensure that the record is kept up-to-date. We also note that for many independents the objections process is currently manual and so this will require a significant, disproportionate investment on their behalf to meet this requirement. This we believe creates the risk that suppliers will apply an almost blanket objection process to their customers so as to provide themselves with the necessary time to assess the situation in each switcher's case and so slow the switching process and damage rather than improve the public's perception of the industry.

Under European legalisation customers are entitled to a 14 day cooling-off period, during which they may return to their previous tariff under the same terms and conditions that they were being supplied on before the switch. Under the current switching arrangements this has provided an important consumer safeguard. However, under the next-day switching proposals customers will be able to return to their previous supplier after a potential 13 days of supply with the new supplier. This has the potential to create a cornucopia of issues for the industry, including increased balancing cost volatility and hedging risk. Additionally consumers' ability to return to their previous tariff terms would seem to sit uncomfortably with aspects of Ofgem's Retail Market Review (RMR). These significant issues are not currently addressed in the TOM.

Finally as stated above we wish to see the regulator undertake consideration of voluntary next-day switching which we believe would believe comparable benefits a lower cost with reduced complexity.