TELECOMPLUSPLC

Competition & Markets Authority
Victoria House
Southampton Row
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14th August 2014

FAO: Energy Market Inquiry Project Team

Please find enclosed with this letter our response on the 'Statement of Issues' and scope that the Project Team are proposing to review during the Energy Market Investigation.

Firstly may we take this opportunity to confirm our support for the investigation. Telecom Plus is committed to improving the market in which we operate and where the best interests of the customer are sought through improved engagement and experience of interactions. Improvement begins with clear and transparent communication including pricing, through to enhanced interactions between industry players in order to improve speed of processes.

With this point in mind we urge you to take on board our comments in relation to the theories of harm and in particular our additional items for comment.

While this document does not contain sensitive trading or commercial information we would appreciate discretion being employed when considering if it is to be published to the public domain.

If you require any further information from us please do let us know and we look forward to continuing to support the investigation over the coming months.

Regards,

Ashton Berkhauer

Head of Energy Services
Telecom Plus PLC

1. Theory of harm 1: Access to wholesale markets etc

In our experience, gaining access to the wholesale energy markets has never been a problem, and there is more than sufficient liquidity available from independent gas producers (eg: BP), independent generators (eg: Drax and International Power), from the Big 6 directly, and/or by using various financial instruments for hedging and forward purchase.

In our view it is important that new suppliers should neither expect nor be granted preferential credit terms either for the energy offtake they need or in respect of any collateral required to cover adverse movements in the forward curve related to their hedging arrangements.

The reality is that the financial numbers involved in supplying energy can become extremely large, and loose credit terms will ultimately simply result in the failure of one (or more) suppliers. Indeed, a black swan event that affected one supplier could easily have a domino effect on many others, and the resultant costs would end up being borne in the short term directly by whichever suppliers took over their responsibilities under the supplier of last resort regulations, and in due course indirectly by their customers.

We are aware that a number of independent suppliers (including ourselves) have found ways to access the wholesale markets without the need to fund mark-to-market price movements, although there is invariably a premium charged for such arrangements to reflect the credit risk being assumed by the counterparty. This is however a much better solution than encouraging a marketplace where participants are able to take risks without the means to meet their liabilities if prices move against them.

2. Theory of harm 2: Vertically integrated electricity companies harm the competitive position of non-integrated firms

We have seen no evidence to support this theory. However, we believe there may be a cultural tendency for vertically integrated supply companies to be focussed primarily on their upstream assets, perhaps viewing their customers as simply a captive market to consume the power they generate; the resultant lack of focus on the customer experience may an important contributory factor in the loss of trust between the Big 6 and their customers, and if they were separated, the resultant pure-play retail supply businesses might logically be expected to put greater resources into attracting and looking after their customers.

The recent rapid progress that independent suppliers have made in growing their market share, in our view clearly demonstrates that there is nothing “harming the competitive position of non-integrated firms”, and the fixed term retail energy tariffs they offer have been consistently and substantially cheaper than those offered by the Big 6.

It is important to note that their ability to offer competitive tariffs would remain intact even if the artificial structural pricing advantage available to ‘small’ suppliers (in the form of their exemption from paying certain environmental and social costs) was removed or changed; although they would need to increase their tariffs to reflect this, they would still be cheaper than the Big 6.

This artificial structural advantage, while superficially offering benefits to a small number of consumers, in reality acts as a major distortion to the market, leading to predatory pricing strategies and cross subsidisation by the Big 6, loss of trust in the market as a whole, and acts as a barrier to expansion beyond whatever limit (currently 250,000 households) has been set - we cover these issues in more detail below. In addition, it may encourage manipulation of growth rates by smaller suppliers to keep their size just below any such threshold prior to 31 December when the targets for the next financial year are set.

3. Theory of harm 3: Market power in electricity generation leads to higher prices

We have no comments to make at present in relation to this hypothesis, other than to point out that the cheapest retail prices are offered by those who do not generate their own power, and have seen no evidence of excess profits being made by the vertically integrated suppliers who do.

4. Theory of harm 4a: Inactive customers reduce incentives on energy suppliers to compete

We offer the following thoughts on this theory:

i. Switching for the sake of switching is a negative sum game – it simply increases costs for the industry and therefore all consumers.

ii. We believe there will always be a substantial number of customers who have never engaged with the market by switching, or who, having switched, had a negative experience and are unlikely to switch again. The clear risk (in the absence of regulatory intervention) is that these customers will be paying more for their energy than more engaged consumers.

iii. We believe that virtually all energy suppliers (other than ourselves) take advantage of this inertia, and use the extra profits they make from inactive customers to cross-subsidise the introductory fixed-price deals they offer to new customers. This is clearly demonstrated by the preponderance throughout the market of cheap fixed price deals (for the minority) and expensive variable tariffs (for the majority).

iv. We believe it is unfair that the vast majority of consumers, who are inactive, should pay significantly more for their energy, and to the same supplier, than those who have joined more recently.

We believe the impact of these issues can most easily be addressed by introducing a low single digit maximum delta (x%) between the Standard Variable Evergreen tariff and the cheapest fixed term tariff offered by any supplier.

v. We believe that the Big 6 feel under pressure to adopt these tactics in order to offer short term discounted tariffs for new customers, in order to appear competitive on price comparison sites against the artificially low tariffs charged by independent suppliers who benefit from the small supplier exemptions on various environmental charges.

This issue can best be addressed by either:

a) significantly reducing or abolishing these exemptions so that they only apply to the very smallest suppliers (under 10,000 customers); or

b) phasing the obligations in progressively (perhaps between 10,000 and 2m customers), with the rate at which they kick in rising fairly steeply to perhaps 50% of the total obligation at 100,000 customers, before rising more gently to 100% at 2m customers.

Either of these would have the benefit of eliminating the current cliff-edge at 250,000 customers which may distort the market and act as a barrier to growth, as well as reducing the ability of medium sized suppliers to damage market trust by offering unsustainably low prices to new customers.

vi. We do not believe that any form of centralised forced switching mechanism would be beneficial for a number of reasons including:

a) the material costs incurred by the industry in increased levels of switching (which will ultimately be borne by consumers);

b) the difficulties which would be faced by the gaining supplier(s) in obtaining the information they need to bill and collect payment from the customers transferred to them (including meter readings, contact information and bank details).

c) issues around scalability for both the gaining and losing suppliers. On the one hand, the need by the gaining supplier to recruit and train staff to look after an exceptional influx of new customers. On the other, the need to shed staff and other fixed overheads (which may result in a material marginal cost burden) to reflect a significant fall in the size of their business.

d) it makes the assumption that everyone who is inactive is not 'engaged' with the market – in some cases, they may have made a conscious choice to remain with their current supplier for any of a number of rational reasons, including satisfaction with the way they feel they are being treated, the financial strength of their supplier, receipt of a non-financial benefit such as loyalty points, guarantees about the size and/or timing of future price rises, etc.

e) it has the potential to further damage trust in the energy market, as being forced or encouraged to switch to an alternative supplier that might (at that point in time be cheaper), does not necessarily mean a better customer experience or lower costs in either the short, medium or longer term.

Theory of harm 4b: Tacit collusion between suppliers

We do not believe that there is any tacit collusion between suppliers.

The reality is that all energy companies face broadly similar costs in supplying energy to retail customers, notwithstanding any short term anomalies in the wholesale cost of the energy they are supplying caused by different approaches to hedging. They all purchase their energy in the same wholesale markets, and face similar regulatory, distribution,

transmission, balancing, sales, marketing, social, administration and billing costs. In addition, they each need to make an acceptable profit margin from their energy businesses, otherwise there is no incentive to make the necessary investment needed to secure supplies and deliver good customer service in future.

As they face identical cost pressures, generally at the same time, it is only logical that they will announce price changes at a similar time – which to the uninformed clearly creates an impression of collusion. But this is no different to any other market where prices tend to move in tandem across all suppliers, such as Petrol (due to changes in the cost of oil) or bread (due to changes in the cost of wheat).

We believe it is generally clear within the industry when cost pressures have reached a level at which the Big 6 need to increase their prices to maintain an acceptable return. And the way these industry-wide price increases are implemented demonstrates just how well the competitive market is working. For example, consider the levels of brinkmanship displayed by the Big 6 in trying avoid the hostile media spotlight that falls upon whichever supplier is first to announce, in order to protect their brand - with the result that consumers are often protected from price increases for longer than they would have been in the absence of this extreme competitive pressure.

And most importantly, we have seen no evidence that any supplier is making an excessive level of profits – if anything, the reverse is generally true. Depending on market conditions, the Big 6 tend to have years when their profitability is normal, and years when they make very poor profits – with an overall return below the level considered acceptable in almost any other sector of the economy.

Theory of harm 4c: Regulatory interventions reduce the incentives for energy suppliers to compete

Over the past three years, the cheapest tariffs in the market have been consistently offered by medium-sized independent suppliers – sometimes as much as £200 or more below the prices charged by the Big 6 for their standard variable tariffs.

They are able to offer these highly aggressive tariffs for a number of reasons, but one of the key factors has been that whilst their customer base remains below 250,000 they are exempt from paying certain environmental and social costs which have been running at an underlying level of around £100 per household per year.

Medium sized suppliers (above 250,000 customers) who are growing fast also gain a substantial benefit, because the obligation for each annual period from 1st April is calculated by reference to the size of their customer base on the previous 31st December; this means the average cost per customer can be substantially below the amount being paid by a member of the Big 6.

This exemption is distorting the market, and creating an un-level playing field that has a number of serious detrimental ramifications:

a) Those consumers that are actively engaged in switching via price comparison sites are predominantly the middle classes. They are able to make material savings on their energy bills by avoiding paying their share of the social and environmental levies imposed upon

larger suppliers, by simply moving to a smaller supplier who is exempt from paying these costs (or paying them at a lower effective rate).

Those consumers that are not actively engaged in switching, and hence on the inflated standard variable tariffs (that cross-subsidise the loss-leader tariffs/social obligation free tariffs) tend to be the most vulnerable.

The outcome is that vulnerable consumers, namely those who can least afford it, are subsidising annual savings of over £100 for the middle classes. In our view this is both socially regressive and morally indefensible.

b) We have always worked on the principal that that all our customers should receive our best available prices at all times. This is one of the reasons why, although we are rarely at the top of the 'best buy' tables, we are uniquely trusted by our customers to treat them fairly. The prevalence within the wider market of 'loss leader' introductory deals, in some cases partially funded by the small supplier exemptions, has been responsible for creating a mistaken (albeit widely-held) belief by consumers, politicians and journalists that everyone could save up to £200 by switching.

The outcome is a material decrease in trust between consumers and the energy industry, where customers paying anything other than the cheapest introductory tariff feel they are being overcharged, and where inactive and loyal customers end up cross-subsidising those introductory offers for customers who have switched.

c) Worryingly, more established independent suppliers are starting to adopt the same cross-subsidisation strategy as the Big 6, notwithstanding that they are also benefitting from the material structural pricing advantage of being exempt (or partially exempt) from the social and environmental costs – or face a lower average cost because of the way these are calculated for a growing supplier. They are doing so in order to maintain a significant delta on comparison sites below the subsidised introductory tariffs offered by the Big 6, and with a view to making a positive return over time as their legacy base of (highly profitable) inactive customers grows.

A glance at the websites of the small suppliers who head the price comparison sites demonstrates that in some cases those with the cheapest one year fixed tariffs are also offering the most expensive standard variable tariffs – astonishingly, even more expensive than the Big 6! This means that any customer who fails for any reason to actively re-engage with their supplier at the end of their fixed term (typically 12 months) is automatically transferred to the standard evergreen variable tariff, and therefore simply through inertia are switched from the very cheapest tariff in the market to the most expensive.

The outcome once again is a material breakdown in trust between consumer and supplier, where loyal customers who believe they are on the lowest tariff in the market are in fact on the most expensive. This is exacerbated by the fact that they may continue to see their chosen supplier named at the head of the Best Buy tables, and therefore make the false assumption that they will still be getting the benefit of these attractive prices, wholly

failing to appreciate that they (and many other customers with that supplier) are now getting an uncompetitive deal.

d) The pricing strategies being adopted by many energy suppliers in relation to fixed term contracts appear designed to enable them to pay lip service to competition, whilst enabling them to maximize their profits from inactive customers.

In other similar markets where future costs are uncertain (such as the mortgage market), consumers typically pay a premium in order to fix their rates and therefore gain certainty over the price they will pay. This stands to reason as the supplier is factoring in both an expectation of future prices and the risk that costs will rise more than expected.

Over the past few years, consumers have been rewarded in the energy markets with a significant price discount when they switch, in return for entering into a fixed term contract - notwithstanding the inflationary backdrop to energy costs and significant supplier risk.

Whilst there is clearly some commercial value to a supplier from tying a customer in contractually for an extended period, this is almost completely obliterated if the customer has the right to leave at any time upon payment of a negligible early termination fee ('ETF'). A two year fix with a £15 ETF at a discount of over £100pa from the evergreen standard variable tariff, makes little commercial sense unless the supplier believes a significant proportion can be successfully migrated in due course onto a much more expensive (and profitable) tariff.

And while it would logical for the cost of fixed term tariffs to rise as the length of the contract increases, in the energy markets the opposite is frequently the case, with the 'zero term' evergreen variable tariff generally the most expensive available!

In contrast, our cheapest tariffs are our standard evergreen variable tariffs, and these apply to all our customers (except those who have chosen a long term fix at a higher current price). This is because they give us the flexibility to increase our prices to reflect any changes to our costs at relatively short notice, and we don't need to factor any pricing or other regulatory risks into the rates we charge.

An analogy with the mortgage market is instructive. The cheapest rates are a one or two year fixed (or discounted variable) tariff, reverting thereafter onto the lenders standard variable rate at a significant premium. Five year and ten year fixed rates (where available) are progressively more expensive, and in most cases more expensive than the current variable rate.

The problem with extrapolating across to the energy markets is that it is much more complicated, and customers are much less likely to realize at the end of their introductory period that they have been switched to a significantly more expensive tariff.
A further indication that energy markets are not behaving in the interests of consumers, is that at a time when the press are speculating about likely short-term falls in the cost of

energy (due to the significant recent fall in wholesale gas prices), virtually all switching continues to be onto short-term fixed price tariffs – with the result that consumers will not benefit from any reduction in market pricing if/when such price reductions happen.

The outcome is further collateral damage to the trust between consumer and supplier, with the vast majority of customers paying significantly higher prices than those who have switched recently.

Customers are encouraged to commit to contracts for fixed term tariffs that may not be to their benefit, and then rolled over onto inflated standard evergreen variable tariffs.
We believe the solution is that instead of customers being switched at the end of a fixed term tariff to the suppliers more expensive evergreen standard variable tariff, they should instead be switched to the suppliers cheapest Fixed Term tariff (if cheaper) - but with the important caveat that any Early Termination Fees applicable to that new fixed tariff will be subject to a limit of £10 per fuel if the customer subsequently decides to switch, and waived completely if they switch within 30 days of receiving their first bill on their new fixed tariff.

e) We are similarly concerned by a further consequence of the small supplier exemptions, and the way that competition has largely become restricted to the fixed price tariff segment of the market.

It is clear that there are large numbers of consumers who are unable or unwilling to participate in this growing Fixed Price tariff segment due to their length of tenure (eg: short term assured tenancies), method of payment (eg: prepayment meters), concern over the risks associated with fixed term contracts (as is clearly visible in the mortgage marketplace), and/or who simply won't engage in the complexities of this market (as evidenced by the substantial legacy bases of the 'Big 6' after 10+ years of competition).

The outcome is that a large segment of UK consumers will continue paying over the odds for their energy, effectively subsidising those who have the time and motivation to switch on a regular basis.

As previously stated, we believe the simplest (and most appropriate) solution is to impose a maximum discount that can exist between a suppliers evergreen standard variable tariff, and their cheapest fixed term tariff, for each payment type. This would still leave enormous scope for suppliers to compete with different lengths of fixed term tariffs, and would encourage them to focus on offering attractively priced longer term fixed tariffs which deliver real and lasting value to those who are switching.

f) We welcomed the steps Ofgem took to address the problem of cross-subsidisation, most notably by imposing an obligation on all suppliers to notify their customers of their cheapest available tariff on each bill they issue. The hope being that this would encourage those on the standard variable tariffs to take advantage of such cheaper rates, which might logically be expected to lead to a narrowing of the discounts available.

There are however a number of fundamental problems with this approach:

i. some suppliers only issue bills infrequently (for example, on an annual basis). This means that unless the supplier is offering a particular competitive tariff at the time the bill is issued, their customers will not become aware of it. So when a new tariff is launched for a limited period, or bills are only sent quarterly, the majority of their customers will never be made aware of it;

ii. many bills are now sent as e-bills, which customers may be less likely to download and read than a paper bill;

iii. the majority of customers pay the same amount each month on a budget plan; when the amount being charged is not changing, the reality is that many customers will not even open their bill, much less read and understanding a message about cheapest alternative tariffing.

We believe the solution is to mandate that suppliers send a clear and separate communication about their cheapest alternative tariff to all customers on their standard variable tariff, each time they introduce a new fixed term tariff that is cheaper than the evergreen standard variable tariff. This needs to be achieved using a dedicated communication that highlights the savings available, the key terms, and combined with a simple mechanism for customers to take advantage of it. And although 'inertia selling' is generally considered inappropriate, this may be one of those occasions when it should be mandated as long as customers face minimal termination charges.

g) Despite the RMR implementation in April 2014, suppliers are continuing to offer 'below cost' tariffs, earning excess profits from customers on their Standard variable tariff and using these to offer introductory Fixed Price tariffs below cost. Thus pro-active and engaged switchers continue to receive the best deals at the expense of the general population on Standard variable tariffs.

We therefore re-iterate the suggestion we made to Ofgem to address this issue, namely that a maximum differential (x%) should be imposed between the Standard variable tariff and any cheaper fixed term tariffs offered by any individual energy supplier.

h) We are concerned at the successful political lobbying over the last few years that has resulted in a material increase in the threshold for the so-called small supplier exemptions (which was increased from its original level of 50,000 up to a new level of 250,000 customers), and by the further lobbying we understand continues to take place focussed on achieving a further increase. And interestingly, we note that certain prominent members of parliament have recently used this exemption to reduce their personal energy costs.

We believe these exemptions in their current form are one of the primary causes of the current widespread public distrust in the energy industry – after all, if a small supplier can afford to charge £200 less than a member of the Big 6, how can the Big 6 not be profiteering? In order to rebuild trust and encourage genuine and fair competition in the UK energy markets, this structural market distortion needs to be addressed by either:

a) ***significantly reducing or abolishing these exemptions so that they only apply to the very smallest suppliers (under 10,000 customers); or***

b) ***phasing the obligations in progressively (perhaps between 10,000 and 2m customers), with the rate at which they kick in rising fairly steeply to perhaps 50% of the total obligation at 100,000 customers, before rising more gently to 100% at 2m customers.***

Either of these would have the benefit of eliminating the current cliff-edge at 250,000 customers which may distort the market and act as a barrier to growth, as well as reducing the ability of medium sized suppliers (who are starting to achieve reasonable economies of scale) to damage market trust by offering unsustainably low prices to new customers.

From a practical perspective, it would probably be necessary to create a mechanism for smaller suppliers to meet these obligations by a financial payment into a central pool, rather than physically delivering the measures, due to the significant diseconomies of scale and infrastructure required to meet obligations like ECO.

Additional items for comment

1. **Restrictions on the number of tariffs**

The Utility Warehouse differs from all other energy suppliers in the UK in that we span the provision of both energy and communication services on a fully integrated basis. Our customers typically take their energy, broadband, landline and mobile telephony services from us, receiving just a single bill each month covering all their household utilities.

This is hugely valued by our customers for a number of reasons: they like the simplicity of a single, easy to understand bill for all their domestic utilities; they like the single point of contact that we offer them for any queries relating to any of their services; they like the ease of budgeting for their domestic utility costs that a single monthly bill provides; they appreciate the extra savings they enjoy as a result of our ability to spread the cost of our central overheads across all their services; and they value the consistently high quality of service they receive from our UK based customer service teams.

During the RMR process, we were concerned by Ofgem's initial lack of recognition of the value of innovation and bundling in driving competition in the energy markets, through their very narrow focus on "energy only" suppliers.

Having steadily built a customer base of over 500,000 households over the last 17 years, supplying around two million services, we have clearly demonstrated that the bundled strategy we have developed is one that is meeting a real consumer need, and we believe such bundled propositions have a vital role to play in stimulating competition in the market place (see, for example, Flow Energy).

While we have successfully managed to restructure our business to comply with the new restrictions on the number of tariffs we are able to offer, this has had a number of ramifications both for ourselves and others. For example, it is no longer practical to design and launch tariffs targeted at specific groups (eg: the elderly, or 'low-users'), or to offer a wider range of bundles giving customers greater flexibility and more choice.

2. **Supplying energy is about more than just price!**

We note that the media, politicians and Ofgem are principally focused on price, yet consumers manifestly take other factors into account when choosing their supplier. The reality is that price is simply one amongst a number of factors which are important to consumers, which also include the level and quality of customer service they receive, the flexibility and choice available, the accuracy of the billing, whether they are treated fairly, and other benefits which may be provided by their supplier.

3. **Accuracy of pricing projections given to consumers**

We are concerned at the continuing requirement for new customers to be given a price projection showing how much they will save based on two assumptions that are highly unlikely to hold true (namely that there is no change in the amount of energy a customer uses, and no change in prices by either the gaining or losing supplier), and where the historic consumption on which such savings are calculated is often not available at the time the projection is provided.

We have been lobbying for some time for a change in the regulations to enable licensed suppliers to obtain accurate historic consumption data at the time of providing these projections, and believe this would improve customer engagement and reduce distrust in energy suppliers by significantly increasing the accuracy of any projected savings quoted.

4. **Smart Metering**

Whilst recognising that it is not for the CMA to take a view on the ultimate costs and benefits of the policy decision that has been taken to replace existing meters with Smart Meters, we have a number of major concerns with the design of the Smart Meter Program which was strongly influenced by the Big 6:

i. There are many legacy meters which have been installed over recent years, and which therefore have a remaining useful working life of up to 30 years. Replacing these with Smart Meters before they have completed their normal life cycle is creating significant 'stranded asset' costs, which will be borne by consumers.

ii. The decision to roll out the replacement of meters by suppliers, rather than distribution companies, is also manifestly inefficient, and again this will lead to significant extra costs being borne by consumers. It means for example that instead of all the meters in a road or building being replaced at the same time, multiple visits will be required by different suppliers at different times.

iii. A tight deadline has been set for completing the replacement program. To achieve this will be more expensive than a more gradual program, where each old meter is replaced by a Smart Meter at the end of its useful working life.

The technical specification for Smart Meters keeps changing, and there are a number of technical challenges which are still unresolved; logically, the project should be delayed pending resolution of all outstanding issues, but as any additional costs will be passed onto consumers, there seems little focus within the industry in achieving the end goal at the lowest possible cost.

5. **Gas Storage**

Whilst you have stated that you are not minded to investigate the Gas storage market, we believe that Centrica may enjoy a significant competitive advantage through the dominant position it holds in this market, and the difficulties potentially faced by independent suppliers in renting capacity on reasonable commercial terms. A high cost of storage paid by British Gas to its parent has zero impact at a group level, but a similar price paid by third parties is a real cost to them.

Although we have not looked at this since 2005, at that time the costs of renting capacity made doing so uneconomic, and we effectively had no choice but to pay penal prices to balance in the spot markets which were obviously ultimately borne by our customers through higher retail prices.