

# Energy market investigation

## Microbusinesses

**5 March 2015**

This is one of a series of consultative working papers which will be published during the course of the investigation. This paper should be read alongside the updated issues statement and the other working papers which accompany it. These papers do not form the inquiry group's provisional findings. The group is carrying forward its information-gathering and analysis work and will proceed to prepare its provisional findings, which are currently scheduled for publication in May 2015, taking into consideration responses to the consultation on the updated issues statement and the working papers. Parties wishing to comment on this paper should send their comments to [energymarket@cma.gsi.gov.uk](mailto:energymarket@cma.gsi.gov.uk) by 18 March 2015.

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The Competition and Markets Authority has excluded from this published version of the working paper information which the Inquiry Group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure).  
The omissions are indicated by [✂].

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## Summary

1. This working paper covers the supply of gas and electricity to microbusinesses in Great Britain. Our analysis is ongoing, so this is an initial paper, which provides information about this segment and describes aspects where we may wish to carry out further work, based on some initial concerns.
2. Ofgem has a specific definition for microbusinesses, which corresponds to the scope of the market reference for non-domestic customers. It uses this definition to impose requirements on the treatment of those customers. In practice, the definition of microbusinesses is less clear-cut. Suppliers tend to apply the additional requirements related to microbusinesses to a wider range of small and medium-sized enterprises (SMEs), and each supplier has a different approach. It is therefore more challenging to isolate microbusinesses and present consistent information.
3. Even within the regulatory definition, there is a range of consumption levels. At the smaller end, some microbusinesses spend similar amounts on gas and electricity as domestic customers. However, the largest microbusinesses use substantially more than domestic customers – for example the upper threshold for electricity consumption in the microbusiness definition is around 30 times typical domestic consumption. We are therefore open to the possibility that market outcomes may differ between microbusinesses depending on their energy usage or other characteristics.
4. There are a number of suppliers serving SMEs. While the Six Large Energy Firms supply electricity to around 90% of SMEs, their combined market share is lower in gas. In non-domestic electricity as a whole, the market share of former incumbents in their own regions is around a third. There are also more suppliers in the non-domestic than in the domestic segment. We have not received suggestions that there are significant barriers to entry in the non-domestic market, so at this stage it appears unlikely that any issues in the microbusiness segment are the result of a lack of supplier entry.
5. The most common tariff type offered to microbusinesses is a fixed-term, fixed-price, single-fuel contract. This type of contract is used for both acquisitions and renewals. There is also a range of other tariff types with variable prices. A microbusiness may end up on some of these other tariffs without making an active decision.
6. There are specific regulations which apply when suppliers are dealing with microbusinesses. These form an intermediate step between the level of regulation for domestic customers and the regulations which apply across all non-domestic customers. These regulations have changed over recent years,

and further changes will come into effect in April 2015. In addition to formal regulatory changes, there have also been industry-led developments, such as many suppliers ending the practice of auto-rollover contracts. We will take these changes into account when considering this segment.

7. Following initial discussions with third parties and our early work, there are several issues we would like to consider further. These issues are potentially interrelated. Low engagement by customers with energy supply, partly due to a lack of transparency, may soften competition and lead to high margins for suppliers. In particular, many microbusinesses have arrived on their current tariffs by default, rather than as a result of an active choice.
8. **Engagement:** the level of engagement in the retail energy markets by microbusinesses appears to be low. The survey evidence we have reviewed suggests that only a small proportion of microbusinesses have switched supplier in the previous year, and a sizeable minority have not switched in the previous five years. We would like to understand whether there are barriers to microbusiness engagement, including any similarities to any issues that may be faced by domestic customers.
9. **Transparency:** in the non-domestic segment, the majority of prices are not published, and final prices are often the result of negotiation between suppliers and customers. This limits microbusinesses' awareness of prices in the retail markets, and may lead to higher search costs – although it may also allow suppliers to offer prices tailored to a customer's situation or to manage their risks. In addition, it is possible that microbusinesses have less ability to use third parties to help them navigate the markets, as they cannot use the price comparison websites (PCWs) available to the domestic segment, and may not benefit much from the third party intermediaries (TPIs) that are more active for larger non-domestic customers. We would like to consider further whether a lack of transparency limits the ability of microbusinesses to find the best deal for them, and whether it is a factor in engagement.
10. **Margins:** the initial findings of our retail profitability working paper indicate that the earnings before interest and taxes (EBIT) margins of the Six Large Energy Firms were over twice as large in the SME segment as in the domestic or industrial and commercial segments. We would like to refine this work and, to the extent possible, we would like to understand whether margins are higher or lower for microbusinesses than for SMEs as a whole.
11. We intend to consider further how effectively competition is working for microbusiness customers in light of the factors above. We would like to understand whether microbusinesses on different types of contract achieve different outcomes, and in particular the outcomes for microbusinesses that

do not make an active decision over their supplier or tariff. Information from suppliers' internal documents suggests that there may be differences in outcomes between tariffs, with apparently much higher prices for some default tariff types. We will seek to understand whether differences in prices are cost-oriented. We will also consider the impact on customers of the decision by many suppliers to end auto-rollover contracts.

12. We are keen to receive comments on this working paper, in order to help us develop our understanding of this segment. (We would also like to know whether there are additional issues we should be considering.) We welcome views from all interested parties. We would be particularly interested in comments from:
  - microbusinesses;
  - independent suppliers that supply microbusinesses (or that have considered entering this segment); and
  - TPIs that provide services to microbusinesses.

## **Introduction**

13. This working paper covers the supply of gas and electricity to microbusinesses. This is an initial paper, which forms the starting point for our work in this area. We are publishing this paper to provide a summary of the evidence we have considered so far, to outline areas where we may wish to carry out further work and to provide an opportunity for parties to comment.
14. There are four sections in this paper. The first two provide background material, while the other two start to outline potential issues in this segment:
  - (a) Describing microbusinesses: This section explains how microbusinesses are defined and notes some characteristics of these customers.
  - (b) Describing the segment: This section provides information about the market structure, covering the suppliers present, the tariffs they offer and the regulatory context.
  - (c) Views from third parties: This section briefly summarises the concerns we have heard from third parties.
  - (d) Potential issues: This section sets out potential issues, along with the evidence available at this stage. It notes areas of interest for further work, based on some initial concerns.

15. This working paper partly relies on existing public documents, including Ofgem’s survey of the non-domestic segment exploring engagement; a review of the role of brokers by Cornwall Energy; and Ofgem consultation documents. We have received submissions from The National Association of Citizens Advice Bureaux (Citizens Advice), the Federation of Small Businesses and Ofgem. We refer to responses to questionnaires sent to the Six Large Energy Firms, as well as some of their internal documents. In addition, we cross-refer to information from the working papers on retail margins, PCWs, and descriptive statistics.

## **Describing microbusinesses**

### ***Microbusiness definition***

16. The terms of reference for this market investigation<sup>1</sup> cover the supply of energy to microbusinesses, following Ofgem’s definition of a microbusiness.
17. Ofgem defines a microbusiness as a non-domestic customer that meets at least one of the following criteria:
  - (a) it employs fewer than ten employees (or their full time equivalent) and has an annual turnover or balance sheet no greater than €2 million;
  - (b) it consumes no more than 100,000 kWh of electricity a year; or
  - (c) it consumes no more than 293,000 kWh of gas a year.<sup>2</sup>
18. These levels of energy consumption would typically cost a business around £10,000 per fuel (before VAT).<sup>3</sup> Microbusinesses now account for an estimated 1.6 million electricity meter points and 0.55 million gas meter points.<sup>4</sup>

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<sup>1</sup> Ofgem (2014) [Decision to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain](#), p30.

<sup>2</sup> If a non-domestic consumer qualifies under only one of the consumption criteria, it is regarded as a micro-business only for that fuel. The definition of microbusinesses has changed over time. It was originally defined by government for the purposes of the complaints handling standards and redress scheme. The definition was then updated following Ofgem’s Energy Supply Probe and again following its Retail Market Review.

<sup>3</sup> As of Q1 2012. . Ofgem (2012) [The Retail Market Review – draft impact assessment for the updated proposals for businesses](#).

<sup>4</sup> Ofgem (2014) [Proposals for non-domestic automatic rollovers and contract renewals](#), pp40–41.

19. However, information is not always specifically available for microbusinesses. This means that the evidence in this working paper may relate to one of the following categories:

- non-domestic customers (all business customers, including those in the industrial and commercial segment);
- SMEs (smaller businesses – although there is no industry standard definition); or
- microbusinesses (as defined by Ofgem).

20. This issue is partly due to the fact that suppliers do not distinguish between microbusinesses and SMEs. Suppliers we have spoken to apply the additional microbusiness requirements to all SMEs unless they are explicitly identified as not being microbusinesses.<sup>5</sup> Furthermore, as shown in Table 1, each of the Six Large Energy Firms categorises SMEs in a different way, and these differ from the Ofgem microbusiness definition.

**Table 1: Small and medium-sized enterprise definitions**

|                                    | <i>Electricity</i>  | <i>Gas</i>  |
|------------------------------------|---|---|
| Ofgem (microbusiness definition)   | Consumption up to 100,000 kWh a year.   | Consumption up to 293,000 kWh a year.                                     |
| Centrica                           | Consumption up to 5,000,000 kWh a year and <20 sites.   | Consumption up to 10,000,000 kWh a year and <20 sites.                    |
| E.ON                               | Consumption up to 1,000,000 kWh a year, not half-hourly metered and <20 sites.                                    | Consumption up to 1,500,000 kWh a year and <20 sites.                     |
| EDF Energy (EDF)                   | Profile classes 3 and 4, meters that are not part of groups of 50 or more sites and do not have complex metering. | Consumption up to [redacted] a year [redacted] a year for new customers). |
| RWE npower                         | Consumption up to [redacted] a year.  | [redacted].   |
| Scottish Power                     | Profile classes 3 and 4, single sites only.   | Consumption up to 73,268 kWh a year, single sites only.                   |
| Scottish and Southern Energy (SSE) | Profile classes 3 to 8, single sites only.  | Quarterly billed customers, single sites only.                            |

Source: Parties' responses, CMA analysis.

### ***Microbusiness characteristics***

21. At the start of 2014 there were an estimated 5.2 million UK private sector businesses, 96% of which had fewer than ten employees; these accounted for 33% of private sector employment and 19% of private sector turnover.<sup>6</sup>

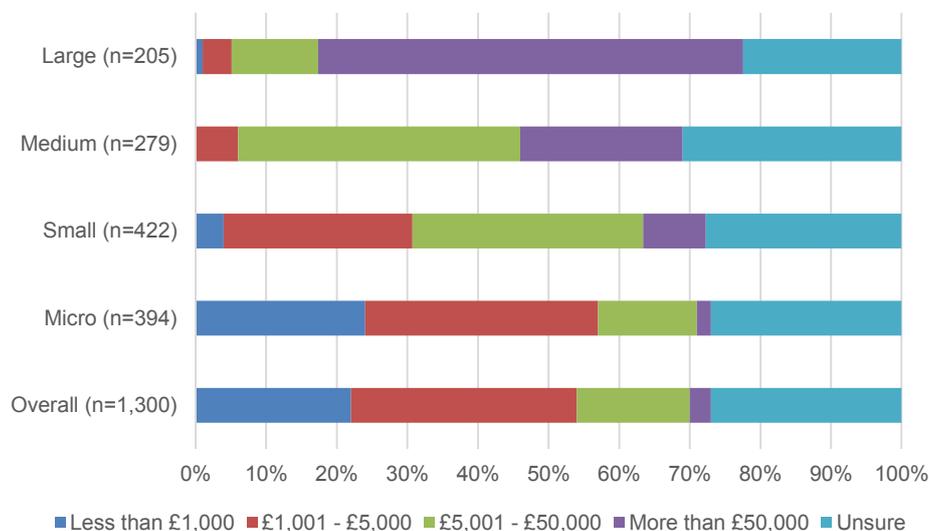
<sup>5</sup> RWE npower told us [redacted].

<sup>6</sup> Department for Business, Innovation and Skills (2014) [Business population estimates for the UK and regions 2014](#), p4.

22. Small businesses, defined by BIS as those with fewer than 50 employees, make up the largest number of businesses across all industry sectors, although they are not spread evenly across all sectors. At the start of 2014 there were 950,000 small businesses operating in the construction sector, 18% of all small businesses. A further 779,000 (15%) were in professional, scientific and technical activities and 538,000 (10%) in the wholesale and retail trade.<sup>7</sup> Small businesses are therefore a diverse group.
23. As part of a 2013 survey conducted on behalf of Ofgem, non-domestic customers were asked to estimate how much they had spent on energy in the previous year (including VAT). As shown in Figures 1 and 2 below, most microbusinesses spend substantially less on their electricity and gas each year than larger businesses. 59% (51%) of large businesses had spent more than £50,000 on their electricity (gas) in the previous year compared with just 2% (2%) of microbusinesses. However, some microbusinesses spend significant amounts on energy: 16% had spent more than £5,000 on their electricity and 13% had spent more than £5,000 on their gas.

FIGURE 1

**Reported annual amount spent on electricity by size of business**

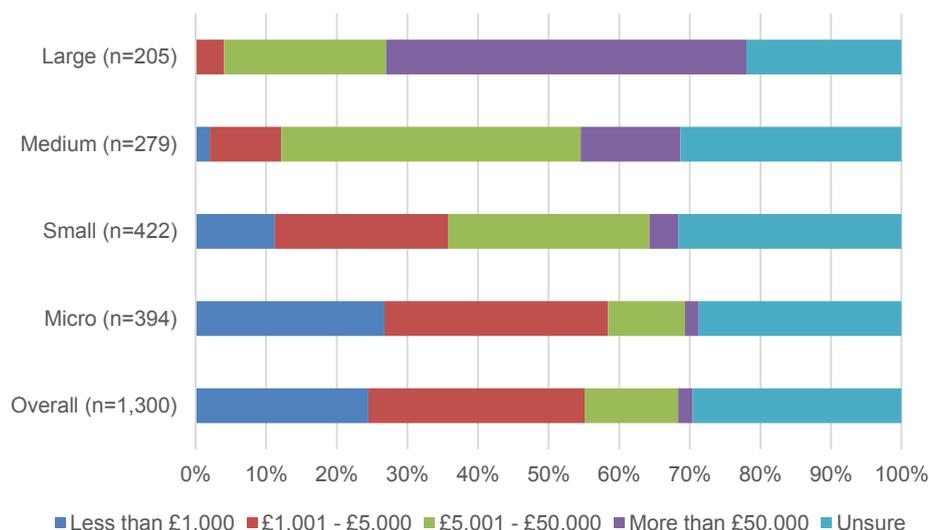


Source: The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p73.

FIGURE 2

**Reported annual amount spent on gas by size of business**

<sup>7</sup> Department for Business, Innovation and Skills (2014) *Business population estimates for the UK and regions 2014*, p12.



Source: The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p74.

24. At the lower end, some microbusinesses spend similar amounts to domestic customers. 24% (27%) of microbusinesses reported that they spent less than £1,000 a year on electricity (gas).<sup>8</sup> This compares with a mean figure for electricity and gas combined of £1,276 for domestic customers.<sup>9</sup> According to a survey for the Federation of Small Businesses, 44% of its members spend under £2,000 a year on energy, and 57% spend under £3,000 a year.<sup>10</sup> However, the largest microbusinesses use substantially more than domestic customers – for example the upper threshold for electricity consumption in Ofgem’s microbusiness definition is around 30 times typical domestic consumption.<sup>11</sup>
25. As shown in Table 2 below, microbusinesses do not spend a greater proportion of their costs on energy than non-domestic customers as a whole. The figures are almost identical for each category.

<sup>8</sup> The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), pp73–74.

<sup>9</sup> TNS BMRB (2014) *Retail Market Review baseline survey: report prepared for Ofgem*, cited in Ofgem, Micro-Business Consumers Memo, p6.

<sup>10</sup> Federation of Small Businesses (2014) *FSB ‘Voice of Small Business’ survey panel – April/May 2014 energy survey*, p10.

<sup>11</sup> 3,200 kWh per year (Ofgem (2013) *Decision: new typical domestic consumption values* (letter to interested parties), p2).

**Table 2: Annual spend on electricity or gas as a percentage of all business costs**

|                               | %               |                  |                 |                  |
|-------------------------------|-----------------|------------------|-----------------|------------------|
|                               | Electricity     |                  | Gas             |                  |
|                               | Microbusinesses | All non-domestic | Microbusinesses | All non-domestic |
| Less than 5%                  | 43              | 43               | 46              | 46               |
| 5% to 10%                     | 13              | 12               | 9               | 9                |
| More than 10%                 | 2               | 2                | 3               | 2                |
| Unable to provide an estimate | 41              | 42               | 42              | 42               |

Source: The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), pp74–75.

26. We will consider in future work whether outcomes differ between microbusinesses depending on their energy usage or other characteristics.

## Describing the segment

### *Non-domestic suppliers*

27. As a simple measure of supplier activity, there are more active suppliers in the non-domestic segment than in the domestic segment. There are 33 active electricity suppliers and 35 active gas suppliers in the non-domestic segment, compared to 24 active electricity suppliers and 24 active gas suppliers in the domestic segment.<sup>12</sup> There are several possible reasons why a supplier might choose to be active in the non-domestic market: for example, lower levels of regulation, or an ability to build scale more quickly.
28. However, some non-domestic suppliers do not serve smaller businesses. We spoke to Haven Power (a non-domestic supplier) as part of the case study interviews. Haven said that it did not supply very low consumption businesses because the volumes involved would be too small to cover its costs. Haven said that the SME segment was as competitive as the industrial and commercial segment. However, Haven told us that the amount of regulatory change made it difficult to operate.<sup>13</sup>
29. This means that it is helpful to look at more focused statistics. For example, Cornwall Energy produced a report in April 2014 that included specific figures for suppliers in the SME segment. Although Figures 3 and 4 below only include suppliers with a share greater than 1%, they still indicate that there were 11 electricity and 13 gas suppliers with at least this share. The combined

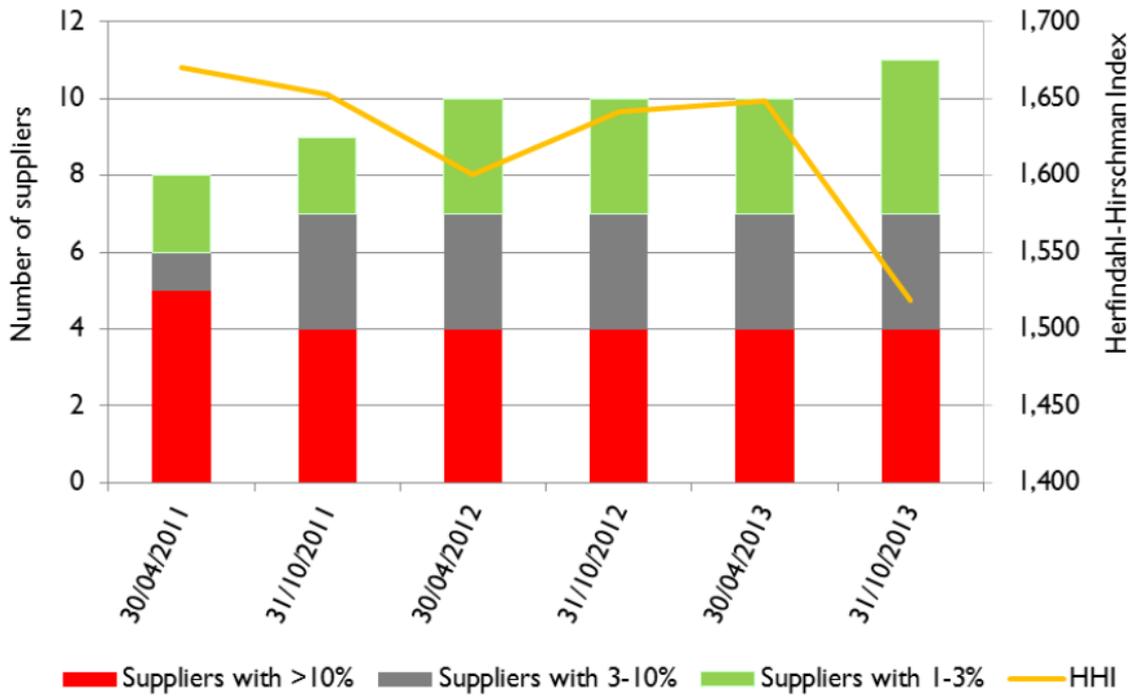
<sup>12</sup> Ofgem (2014) *List of Active Suppliers* (updated September 2014, received 19 December 2014).

<sup>13</sup> Case studies on barriers to entry and expansion in the retail supply of energy working paper.

share by volume of the Six Large Energy Firms was 88.7% in electricity<sup>14</sup> and 66% in gas.<sup>15</sup>

FIGURE 3

**Shares of supply and Herfindahl–Hirschman indices for small and medium-sized enterprise electricity volume**



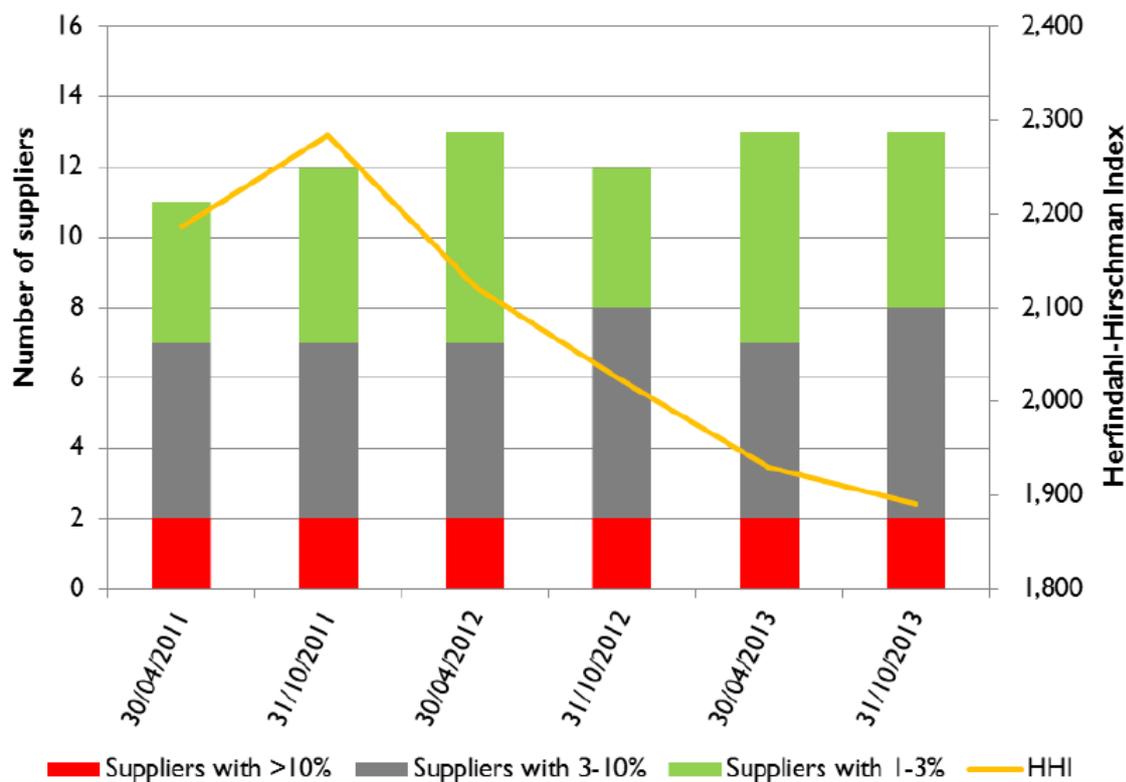
Source: Cornwall Energy (2014) *Competition in British business energy supply markets: an independent assessment for Energy UK*, p13.

<sup>14</sup> Cornwall Energy (2014) *Competition in British business energy supply markets: an independent assessment for Energy UK*, p13.

<sup>15</sup> Cornwall Energy (2014) *Competition in British business energy supply markets: an independent assessment for Energy UK*, p16.

FIGURE 4

**Shares of supply and Herfindahl–Hirschman indices for small and medium-sized enterprise gas volume**



Source: Cornwall Energy (2014) *Competition in British business energy supply markets: an independent assessment for Energy UK*, p16.

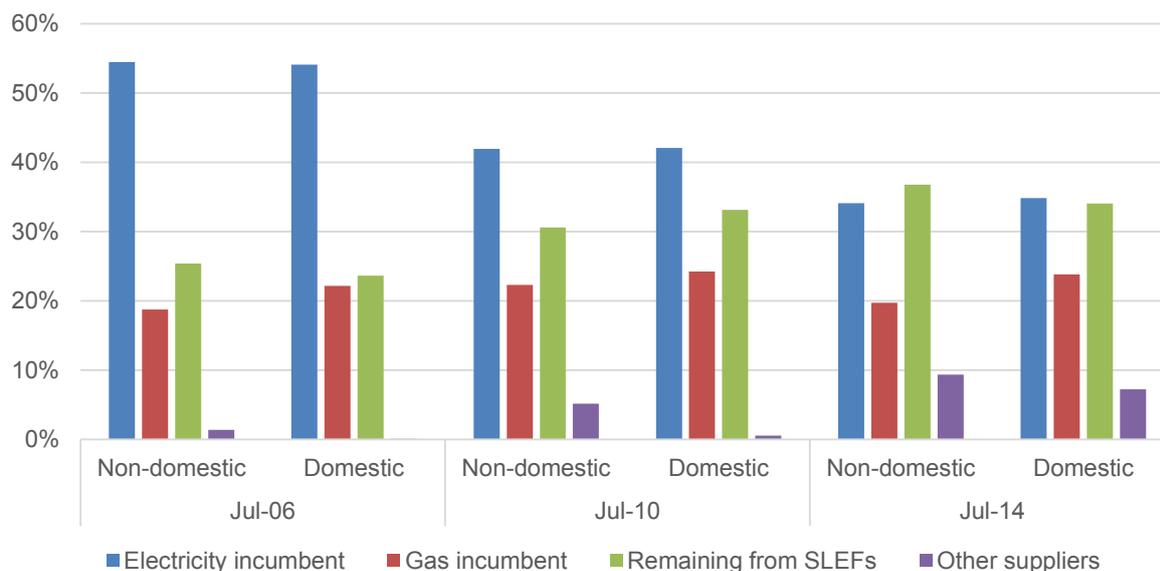
30. Figure 5 shows shares of supply by number of meter points in the non-domestic and domestic electricity segments.<sup>16</sup> The average share of the former regional electricity incumbent in each region<sup>17</sup> fell in the non-domestic segment from 55% in July 2006 to 34% in July 2014. The share of Centrica, the former national gas incumbent, stayed broadly the same (19% in July 2006 and 20% in July 2014). Meanwhile, over the same time period, the share of the non-incumbents among the Six Large Energy Firms increased from 25% to 37% and the share of other suppliers increased from 1.4% to 9.4%. This suggests that since market liberalisation new suppliers have been able to enter non-domestic energy supply and grow their non-domestic customer base over time.

<sup>16</sup> Although this does not split out microbusinesses, they account for the large majority of businesses (see paragraph 21) and so the results should give a good indication of shares among microbusinesses.

<sup>17</sup> The incumbent share is calculated as the total number of meters supplied by the former electricity incumbent in each region divided by the total number of meters in the country. Therefore, this represents the share on a national basis that is still with the regional electricity incumbents.

FIGURE 5

**Non-domestic and domestic electricity supply shares of meter points**



Source: Competition and Markets Authority (CMA) analysis of Distribution Network Operator data on number of meters per supplier by region.

Note: SLEFs = Six Large Energy Firms.

31. Looking at each region separately in the same data, the share of the electricity incumbent in 2014 was generally similar to the national figure of 34%. The difference from the national figure was five percentage points or fewer in all but one region. This was North Scotland, where in July 2014 the electricity incumbent had a share of [✂].
32. For gas, the retail descriptive statistics working paper contains information on SME shares among the Six Large Energy Firms (this data does not cover other suppliers). This information shows that Centrica still has the largest share, as it accounts for around 60% of the SME customers held by the Six Large Energy Firms.<sup>18</sup>

**Tariffs**

33. Unlike the domestic segment, we understand that microbusiness contracts are largely single fuel. This may be due to non-domestic customers using varying proportions of gas and electricity, meaning that a dual-fuel tariff would be less well-suited for many.
34. Another difference from the domestic segment is that electricity is more important than gas for SMEs. An estimate by Cornwall Energy suggested that

<sup>18</sup> Descriptive statistics: retail working paper.

SMEs spend £4.4 billion on electricity, making up three-quarters of total spending across both fuel types (£5.8 billion).

35. The Six Large Energy Firms all told us that all tariffs that they offered to SMEs were also available to microbusinesses (with the exception in some cases of microbusinesses handled under corporate/Industrial and Commercial account management). The broad tariff types available to microbusinesses are:

(a) Tariffs with fixed prices:

- (i) Fixed-term contracts: These contracts have fixed prices which are valid for the whole contract period. Suppliers generally offer fixed-term contracts to new customers (ie acquisition fixed-term contracts) or existing customers at the end of the fixed-term period (ie retention fixed-term contracts). These contracts are typically offered for a duration of one to four years and are generally the cheapest option available to non-domestic customers at acquisition or contract renewal. The majority of non-domestic customers are on these contracts. Unlike a domestic customer, a non-domestic customer does not generally have the option of leaving during a fixed-term contract.
- (ii) Auto-rollover contracts: When a non-domestic customer's existing fixed-term contract comes to an end, in some cases this will automatically be followed by an extension of the duration of the existing fixed-term contract or a new fixed-term contract, if the customer takes no action. The customer will receive a notification of the terms of the new (or extended) fixed-term contract, which is likely to include a different price to the original contract. The Six Large Energy Firms (except EDF<sup>19</sup>) have ceased offering these tariffs in the last year.<sup>20</sup>

(b) Tariffs with variable prices:

- (iii) Evergreen contracts: These contracts have no termination date and the prices are changed periodically.<sup>21</sup> We understand that these tariffs

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<sup>19</sup> EDF still offers a fixed-term rollover contract, but this product allows the consumer to change supplier with 30 days' notice.

<sup>20</sup> Some customers currently remain on these tariffs until their existing contracts expire. RWE npower told us that it no longer enforces auto-rollover terms in existing contracts.

<sup>21</sup> These may also be known as tariff or variable products.

are of limited importance for acquiring new non-domestic customers.<sup>22</sup>

- (iv) Deemed tariffs: These tariffs apply to non-domestic customers that have not signed up to a contract but consume energy. This may occur in two instances: when a non-domestic customer moves into a new property and starts to consume energy without a contract with a supplier or when a fixed-term contract is terminated but the supplier continues to supply the customer. This second possibility can arise if the original contract does not expressly say what will happen after termination and the existing customer continues to consume energy at the premises. A contract is deemed to exist, and a non-domestic customer will remain on this tariff unless it takes action to switch, with price changes being applied automatically. There is a specific licence condition for deemed tariffs, which requires suppliers to ensure that the terms of these tariffs are not unduly onerous.<sup>23</sup>
- (v) Out of contract (OOC): This applies to non-domestic customers that have terminated their contracts, but have not yet switched to a new supplier. Non-domestic customers are defaulted to this type of tariff<sup>24</sup> and will remain on this tariff unless they take action to switch, with price changes being applied automatically.

- 36. Other niche tariffs may also be available to microbusinesses. For example, there are shorter-term fixed-price contracts specifically targeted at new business start-ups and repayment plans for businesses struggling to pay their energy bills. Some suppliers have [X].
- 37. The main channel used by the Six Large Energy Firms to acquire customers was telesales. This accounted for around 50% of sales in 2013. The next most significant channel was TPIs, which were responsible for 30% of sales. Other channels used included suppliers' own websites and face-to-face sales.<sup>25</sup>
- 38. Suppliers have different approaches to payment methods, although the main distinction appears to be between direct debit and standard credit (payment on receipt of a bill). Payment by direct debit can be incentivised – EDF told us that there was a 7% discount for payment by fixed monthly direct debit. Scottish Power said that direct debit was the only payment option it offered to

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<sup>22</sup> For example, Scottish Power told us that its SME acquisition activity was almost entirely based on fixed price contracts, and that it believed this also to be the case for the rest of the market

<sup>23</sup> Standard Licence Condition 7 of the Electricity/Gas Supply Standard Licence Conditions.

<sup>24</sup> This will have been provided for in the original contract.

<sup>25</sup> Descriptive statistics: retail working paper.

new SME customers. Standard credit can involve a range of payment methods, including cash, cheque or bank transfer. Other approaches appear to be of limited importance: SSE said that 'Business customers are not offered pre-payment metering', while E.ON said that other payment methods (pre-payment, standing order and pay as you go) were used by only [X] of its SME customers.

39. Some suppliers require customers with low creditworthiness to provide security deposits. These amounts can be significant. Centrica said that a security deposit was equal [X] (whichever is larger), while Scottish Power said that it asked for a security deposit [X]. However, Scottish Power told us that this applied to only 4% of its customers. E.ON's SME business and EDF do not normally require security deposits.

### **Regulation**

40. There are fewer supply licence conditions for non-domestic supply than for domestic supply. However, there are some additional regulations that apply when a supplier is dealing with microbusinesses, but not when dealing with other non-domestic businesses.
41. The main licence condition applying to microbusinesses is Standard Licence Condition (SLC) 7A. SLC 7A was introduced as part of the Energy Supply Probe in October 2009 with the aim of improving engagement among microbusinesses.<sup>26</sup> It introduced specific requirements for suppliers when dealing with microbusiness customers and on the terms and conditions applicable to contracts between suppliers and microbusinesses. In summary:
- (a) suppliers must try to identify whether a non-domestic customer is a microbusiness;
  - (b) suppliers must provide information to microbusinesses before entering into a contract;
  - (c) within 10 days of entering into a contract or renewing a contract with a microbusiness suppliers must provide contract information;
  - (d) suppliers must provide contractual information to microbusinesses 30 days before renewing a contract;
  - (e) information on bills must be plain and intelligible;

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<sup>26</sup> Ofgem (2009) *Energy Supply Probe - proposed retail market remedies (decision document)*, p30.

- (f) suppliers cannot change contract terms on the grounds that the customer no longer meets the microbusiness definition;
  - (g) the maximum notice microbusinesses have to give to end a contract is 90 days, although this does not prevent a supplier from signing a fixed-term contract with a microbusiness; and
  - (h) the maximum length of an auto-rollover contract is one year.
42. Ofgem made changes to SLC 7A with effect from 31 March 2014 as part of the Retail Market Review. This included requirements to provide additional information on bills, such as the contract end date.
  43. Ofgem made further changes to SLC 7A in November 2014, which will take effect from 30 April 2015. The changes are: to reduce the maximum notice period required at the end of a fixed-term contract to 30 days, to require suppliers to provide current prices and annual consumption details on renewal letters, and to make suppliers acknowledge termination notices from microbusinesses within five working days. At an earlier stage, some stakeholders had put forward the idea of banning auto-rollover contracts.<sup>27</sup> Ofgem decided not to ban auto-rollover contracts, although it said that it would carry out further work in this area.<sup>28</sup>
  44. As well as SLC 7A, some additional pieces of regulation apply to microbusinesses but not to other non-domestic customers. Microbusinesses have the right to raise complaints with the Energy Ombudsman (like domestic customers).<sup>29</sup> Similarly, a version of the Customer Objective and Standards of Conduct applies to microbusinesses, although there are some differences from the equivalent domestic supply requirements.<sup>30</sup>
  45. There have also been voluntary industry developments in recent years. Many suppliers have limited back-billing<sup>31</sup> for microbusinesses to one year.<sup>32</sup> Many suppliers have also ended auto-rollovers.
  46. As noted in paragraph 28 above, Haven said that the amount of regulatory change was problematic. SSE also told us that the requirement to provide a

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<sup>27</sup> Ofgem (2014) [Proposals for non-domestic automatic rollovers and contract renewals](#), p16.

<sup>28</sup> Ofgem (2014) [Decision on automatic rollovers and contract renewals for micro-business consumers \(letter to interested parties\)](#), p5.

<sup>29</sup> Article 2(1) of the Gas and Electricity Regulated Providers (Redress Scheme) Order 2008.

<sup>30</sup> Standard Licence Condition 7B of the Electricity/Gas Supply Standard Licence Conditions.

<sup>31</sup> A back-bill is a delayed request for payment issued to a customer for previously unbilled consumption.

<sup>32</sup> Ofgem (2013) [Micro-business back-billing: publication of supplier data covering April 2012 – March 2013](#), pp1–2.

renewal letter at least 60 days before contract expiry, with a quote valid through the period, affected the risk premium included in the quote.

47. We will take these regulatory developments into account when looking further at this segment. However, we are conscious that many of these changes are recent, and some have yet to come into effect.

## **Views from third parties**

48. Discussions with third parties, including Ofgem, the Federation of Small Business and Citizens Advice, raised the following concerns that warrant further investigation:
- (a) Microbusinesses may face barriers to engaging in the retail energy markets, similar to those faced by domestic customers.
  - (b) The fact that most energy contracts are negotiated and energy prices are generally not published may limit transparency in the non-domestic segment.
  - (c) Brokers may not be operating effectively or fairly.
  - (d) The outcome of concern is that a lack of engagement with the energy supply process can result in businesses being put on tariffs that are not the best deal for them.
49. Ofgem said that a key question was whether competition was working effectively for the very smallest non-domestic customers. In particular, Ofgem said that there was a lack of published prices. It said that ‘For smaller businesses with few resources and limited knowledge of the energy market, it could be difficult and time-consuming to search for the best contract.’<sup>33</sup> Ofgem told us that this could lead to low engagement, and that these customers might end up on more expensive tariffs.
50. The Federation of Small Businesses said that small businesses faced barriers to engaging with energy supply. It said that ‘energy contract terms and conditions are too complicated to understand and compare.’ It told us that the lack of published prices was making it more difficult for small businesses to search and to switch supplier. It said that there was ‘a general lack of trust or confidence’ in TPIs, ‘often based on poor previous customer experience or the

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<sup>33</sup> Ofgem, Micro-Business Consumers Memo, p3. A quarter of microbusinesses and a fifth of small businesses that had not switched in the previous 12 months reported that it was too complex and time-consuming to find a new tariff or supplier to switch to (The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p46).

aggressive sales approach carried out by some'. However, the Federation of Small Businesses said that it welcomed the steps taken by some suppliers to end auto-rollovers.

51. Citizens Advice told us that it had concerns about the behaviour of brokers in the non-domestic segment.

## **Potential issues**

### ***Overview***

52. We now set out some potential issues in the microbusiness segment, based on the views set out above and our own initial analysis. While we are at an early stage of our work, we think that it is helpful to sketch out possible linkages between these issues, in order to consider how they might fit together. As with the rest of this paper, we are seeking comments on all aspects of this section.
53. The potential issues for microbusinesses can be summarised in the following way:
  - (a) Microbusinesses may have lower levels of engagement in the retail energy markets. This may be partly due to innate factors, such as the size of these businesses. (See paragraphs 54 to 74.)
  - (b) In addition, the negotiated nature of supply in the non-domestic segment may reduce transparency and increase search costs. This may be particularly relevant for microbusinesses due to lower levels of engagement, and more limited support from TPIs. (See paragraphs 75 to 89.)
  - (c) Margins appear to be higher for SMEs than for other segments. We do not have specific information on margins for microbusinesses, but it appears that prices may be higher for the default tariffs that will be paid by disengaged non-domestic customers. (See paragraphs 90 to 0.)

### ***Engagement by microbusinesses with energy supply***

54. There is no single way of measuring customers' engagement with the supply of their energy. We therefore consider a range of factors below. These suggest that the level of engagement by microbusinesses appears to be low.
55. We welcome comments on this view, including suggestions for additional sources of evidence. If this impression is confirmed, we would like to

understand the causes, including any similarities to any issues faced by domestic customers.

### *Switching*

56. Switching supplier is one measure of customer engagement, and helps to exert competitive pressure on suppliers. The evidence suggests a significant proportion of businesses are not switching.
57. A survey conducted for Ofgem in 2013 found that 14% of microbusinesses had switched energy supplier in the previous 12 months.<sup>34</sup> This is similar to the level found in the domestic segment.<sup>35</sup> It is also slightly lower than the switching rates reported for other non-domestic customers: 18% of small businesses and 19% of medium-sized and large businesses reported switching supplier in the previous year.<sup>36</sup>
58. We compared this with the proportion of microbusinesses on acquisition tariffs, given that these are contracts with customers that are new to a supplier. Ofgem research has estimated that on 1 April 2013, 23% of microbusinesses were on acquisition tariffs for electricity, and 29% for gas.<sup>37</sup> These figures are somewhat higher than the reported switching rates from the 2013 survey noted above.<sup>38</sup> However, this still suggests that a clear majority of microbusinesses had not switched in the past year.
59. In the survey, 41% of microbusinesses reported that they had not switched supplier over the past five years, while a further 19% were unsure how many times, if at all, they had switched supplier. The percentage of larger businesses reporting that they had not switched over the past five years was lower, falling to 19% for the largest businesses surveyed.<sup>39</sup>
60. The survey also asked for the reasons why customers had not switched during the past 12 months. 69% of microbusinesses that had not switched said that they were satisfied with their current supplier. The next most important reason given was that the level of savings was not sufficient to

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<sup>34</sup> The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p42.

<sup>35</sup> TNS BMRB (2014) [Retail Market Review baseline survey: report prepared for Ofgem](#), p10.

<sup>36</sup> The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p42.

<sup>37</sup> Ofgem (2014) [Proposals for non-domestic automatic rollovers and contract renewals](#), p41.

<sup>38</sup> Contributing reasons could be that some customers will be new businesses, and that some acquisition products will have a term longer than one year, both meaning that a consumer could be on its first contract with a supplier while not having switched during the past year.

<sup>39</sup> However, the proportion of large businesses that were unsure about their number of switches in the past five years was higher than for microbusinesses, at 32%. (The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p41).

justify switching (43% of microbusinesses).<sup>40</sup> This is a reminder that choosing not to switch may be a positive decision by a customer rather than a sign of disengagement.

### *Familiarity with contracts*

61. Given that the majority of businesses are on fixed-term contracts, it is important for them to know their contract expiry date. Knowledge of the expiry date of a supply contract may be a sign of engagement.
62. A survey conducted by Cornwall Energy in 2013 estimated that among all business respondents, over a fifth of respondents (22%) did not know their contract expiry date. Slightly more microbusinesses were unaware of the date than larger businesses.<sup>41</sup>
63. However, the 2013 survey carried out for Ofgem found that only 13% of microbusinesses on fixed-term contracts did not know or were unsure of their contract end date. This was identical to the proportion across all non-domestic customers.<sup>42</sup>

### *Time with current supplier*

64. We have data on the length of time that SME customers have been with their current supplier, for five of the Six Large Energy Firms. A customer that stays with a supplier for a long time could be satisfied with the tariff offering and service provided. This customer may also have actively switched between tariffs from the same supplier. However, it is also possible that this customer has remained with the same firm due to inertia.
65. Drawing on information provided by suppliers, we look at customers that have been with one of the Six Large Energy Firms for six years or more.<sup>43</sup> In electricity, the proportion of SME customers that have not switched supplier in at least the past five years is up to around 50% (EDF, SSE).<sup>44</sup> In gas, only

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<sup>40</sup> The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p46.

<sup>41</sup> Cornwall Energy (2013) *Business and broker interaction in the energy market*, pp7–8.

<sup>42</sup> The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p35.

<sup>43</sup> Not all parties were able to report the equivalent statistic for longer periods than six years.

<sup>44</sup> Note that the figure for one of these suppliers was based on a simple average across the 14 regions. The weighted figure for GB will be requested from the supplier and may differ from this simple average.

16% of EDF's SME customers have been with it for six or more years, compared with around half of Centrica's SME customer base.<sup>45</sup>

### *Internal documents*

66. Internal documents from a couple of suppliers recognise a lack of engagement among some customers, and note that this is particularly the case for smaller/lower consumption businesses.

67. [✂]

### FIGURE 6

[✂]

Source: [✂]

68. [✂]

### FIGURE 7

[✂]

Source: [✂]

69. Another E.ON document from 2012 said that one characteristic of the SME segment in 2012 was 'High proportion of customer base inert and choose not to shop around for the best price on a regular basis'.

### *Reasons for limited engagement*

70. There are several possible reasons for low engagement by microbusinesses. We discuss one of these (lack of transparency) in more detail in the section below, and we consider some other potential factors in this section. The points in paragraphs 71 to 73 were identified in a report for the Federation of Small Businesses looking at small business customers across markets.<sup>46</sup>

71. As noted in paragraph 23, microbusinesses spend less on energy in absolute terms than larger businesses. Energy represents a similar *proportion* of total business costs for microbusinesses compared to that for other non-domestic customers (paragraph 25). Microbusinesses may therefore have a lower

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<sup>45</sup> These figures can be higher for individual regions. In electricity, the highest proportion not switching supplier in at least the past five years was around 85% (SSE in South Wales). The equivalent for gas was around 60% (Centrica in London).

<sup>46</sup> Amelia Fletcher, Antony Karatzas and Antje Kreutzmann-Gallasch (2014) *Small businesses as consumers: are they sufficiently well protected? A report for the Federation of Small Businesses*, p7.

incentive to engage in the energy markets than larger businesses, given that the absolute benefits from engagement are smaller.

72. The opportunity costs of engaging with the purchase of energy may also be higher for microbusinesses than for larger businesses. A microbusiness may not have spare staff time to use on non-core activities.
73. Microbusinesses, like domestic customers, may also have limited knowledge about the energy markets. In comparison, a larger non-domestic customer is more likely to have staff with specialist knowledge or procurement skills. In a survey conducted on behalf of Ofgem, more microbusinesses were dissatisfied with the ease of understanding offers available compared with larger businesses (24% of microbusinesses, compared with 17% of medium-sized businesses and 21% of large businesses).<sup>47</sup>
74. Another possible reason for low engagement could be the change of supply process. (This sits between a customer signing a contract with a new supplier and being transferred over to the new supplier.) A bad experience at this stage of the switching process may be a deterrent to future engagement. However, research has shown that microbusinesses and small businesses tend to be more concerned about earlier stages of the switching process such as choosing a contract, rather than the change of supply process itself.<sup>48</sup>

## ***Transparency***

### *Approach to pricing*

75. In general, prices for business customers are negotiated and rarely published by energy suppliers. Many suppliers publish their deemed contract prices and some publish other variable contracts, but we understand these are unlikely to be the best deals in the market. Overall, this creates a lack of transparency. (In an internal document from 2014, E.ON described the SME segment as a whole as 'increasingly complex & opaque'.)
76. There are a number of potential consequences from a lack of transparency. Customers with less visibility of market prices may be less likely to try to switch supplier or tariff, as they may not be aware that there are better deals available. For customers that do decide to investigate their options, a lack of transparency may increase their search costs. If a customer ends up in a negotiation with a supplier, it may be in a weak position if it has limited

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<sup>47</sup> The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p53.

<sup>48</sup> Collaborate Research (2013) *Non-domestic consumers and the Change of Supply (CoS) process: qualitative research findings* (report for Ofgem), p5.

knowledge of its other options.<sup>49</sup> For example, a new business may begin its energy supply with a deemed tariff – which tends to be high, reflecting the risk to suppliers – and use that as a starting point for its expectation of an agreed tariff. With greater transparency, the business would expect an agreed tariff to be substantially lower than the deemed tariff.

77. The lack of transparency of pricing applies across the non-domestic segment, and is therefore not specific to microbusinesses. However, when coupled with lower levels of engagement and possible barriers to engagement for microbusinesses, there may be a larger effect on microbusinesses.
78. It is possible that there are some advantages to a system that develops quotes for each customer. For example, this may allow a supplier to factor in the credit risks associated with supplying a customer and thus avoid adverse selection issues.<sup>50</sup> It may also allow the supplier to vary different contract aspects which might have mutually beneficial outcomes. EDF told us:

The customer will then be able to negotiate this price if they are willing to fulfil requirements that reduce cost or risk to EDF, with the most relevant factors including clearing outstanding debt, signing up for online billing and service, providing up to date contact information, as well as product type, contract length and payment method.

#### *Use of third party intermediaries*

79. One way of overcoming a lack of transparency is to receive assistance from an intermediary. PCWs help domestic customers to compare offers from different suppliers. Other TPIs (brokers) are important for larger businesses participating in the retail energy markets. However, microbusinesses may fall between these two models, leaving them less well served by intermediaries.

#### *Price comparison websites*

80. As discussed in the price comparison websites working paper, the use of PCWs can reduce search costs for domestic customers by providing a one-stop shop for personalised quotes.<sup>51</sup> PCWs are widely used in the domestic segment. For example, the CMA customer survey reported that, of those that

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<sup>49</sup> Several suppliers noted that competitor quotes could play a role in negotiations. For example, Centrica told us that 'During discussions with the sales agent the customer can negotiate a lower price, factors we will consider are competitor prices...' RWE npower said that [§].

<sup>50</sup> If a supplier set prices without reference to a consumer's credit risk, its offer might be attractive to consumers with high credit risks. This could lead it to gain a disproportionately large number of these consumers, which would have a consequential impact on the supplier's costs.

<sup>51</sup> Price comparison websites working paper.

had switched energy supplier in the past three years, around two-thirds of respondents used a PCW to find information.<sup>52</sup> As prices are not generally published in the non-domestic segments, this model of online searching does not apply. Some PCWs do offer services to non-domestic customers but in most cases, only through their call centres.

#### *Role of third party intermediaries*

81. TPIs act as intermediaries between non-domestic customers and energy suppliers. Ofgem estimates that there are over 1,000 TPIs operating in the non-domestic energy segments, from large organisations to individual advisers, receiving around £200 million of revenue a year from fees and commissions. TPIs operate a range of business models. For example, they may present offers from a range of suppliers, represent one particular supplier or multiple suppliers and/or offer energy advice to customers.<sup>53</sup>
82. The available evidence suggests that microbusinesses are less likely to have used TPIs than larger businesses. In a 2013 survey, 11% of microbusinesses said they had chosen their current energy contract with the help of a broker, compared with 21% of medium-sized businesses and 23% of large businesses.<sup>54</sup> Microbusinesses are more likely to use information from suppliers.

#### *Reasons for different usage of third party intermediaries among non-domestic customers*

83. It appears that brokers are more likely to contact larger businesses:
  - (a) On being asked what best described the switching process (either to a new supplier or a new contract with their existing supplier) 25% of larger businesses reported having been approached by a broker or a switching site, while just 13% of microbusinesses were contacted.<sup>55</sup>
  - (b) Larger businesses were also more frequently contacted by brokers. Among businesses that had been approached by brokers, larger businesses recalled on average 15 approaches in the last year, compared

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<sup>52</sup> Price comparison websites working paper.

<sup>53</sup> Ofgem (2014) *Proposals for regulating non-domestic third party intermediaries (TPIs)*, p9.

<sup>54</sup> The Research Perspective and Element Energy (2013) *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), p31.

<sup>55</sup> Cornwall Energy (2013) *Business and broker interaction in the energy market*, p9.

with small businesses and microbusinesses that recalled an average of nine to 12 approaches respectively.<sup>56</sup>

84. TPIs may prefer to focus on larger business customers because they can earn more commission. This may be proportional to consumption or spend, rather than a flat rate per switch. For example, Centrica told us that commission could be in the form of pence per day (as part of the standing charge), pence per kWh (unit rates) or as a percentage of standing charge and unit rates. E.ON said that 'The unit rate charged to the customer is then the base price plus the commission rate.'
85. The lower use of brokers among microbusinesses may also be explained by the less positive views about brokers among microbusinesses compared with larger businesses. In 2013, 32% of microbusinesses held a broadly positive view of energy brokers, compared with 43% of small businesses, 53% of medium businesses and 55% of large businesses.<sup>57</sup> (14% of microbusinesses responded 'Don't know'.)
86. These less positive perceptions may be the result of the sales approaches of certain brokers. Of businesses that had been approached by a broker in the last year, microbusinesses were more likely than larger businesses to disagree that the broker had a professional tone, clearly identified themselves and provided accurate information about the services offered. However, of businesses that had used brokers, 80% were satisfied with the overall service provided.<sup>58</sup>
87. Other evidence from a survey by Cornwall Energy supports this, showing differing attitudes towards brokers between businesses of different sizes. It found that microbusinesses were less likely to agree that 'energy brokers make me better informed and able to make better choices in this area' than larger businesses (40% compared with 56%) and more likely to disagree with the statement (29% compared with 14%).<sup>59</sup>

#### *Ofgem's proposals for third party intermediaries*

88. Due to concerns about poor customer experience of using TPIs and the potential negative impact on future engagement that this may have, Ofgem

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<sup>56</sup> The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p57.

<sup>57</sup> The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p56.

<sup>58</sup> The Research Perspective and Element Energy (2013) [Quantitative research into non-domestic consumer engagement in, and experience of, the energy market](#) (report for Ofgem), p61. (Note that the last statistic did not segment businesses by size.)

<sup>59</sup> Cornwall Energy (2013) [Business and broker interaction in the energy market](#), p12.

has developed a draft code of practice for non-domestic TPIs. The purpose is to build consumer trust and confidence when using TPIs. The draft code of practice sets out standards for TPIs when dealing with customers, such as, including clearer information, fair marketing tactics and effective monitoring and complaints redress.<sup>60</sup>

89. In August 2014, Ofgem proposed that the code should be underpinned by a licence condition on suppliers to work only with code-accredited TPIs.<sup>61</sup> Ofgem has published a further open letter on the project's next steps. It intends to take into account the CMA's findings on TPIs in general and any specific effects on microbusinesses and SMEs.<sup>62</sup>

## **Margins**

### *Our profit margin analysis*

90. The initial analysis reported in our analysis of retail profit margins<sup>63</sup> found that there were substantial differences in EBIT margins between segments for the Six Large Energy Firms. Over the years<sup>64</sup> 2009–13, EBIT margins were over twice as large in the SME segment as in the domestic or industrial and commercial segments:
- (a) The combined EBIT margin for the Six Large Energy Firms in the SME segment was 8.6%, compared with 3.3% in the domestic segment.
  - (b) The combined EBIT margin was lowest in the industrial and commercial segment at 2.1%.
91. We also looked at combined EBIT margins by fuel. The margin was slightly larger for SME gas supply (10.1%) than for SME electricity supply (8.1%).
92. The SME category used in this analysis does not correspond to the definition of a microbusiness. This means that we do not have a specific figure for the margin on microbusiness supply. To the extent possible, we would like to understand whether margins are higher or lower for microbusinesses than for SMEs as a whole.

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<sup>60</sup> Ofgem (2013) *Code of practice for non-domestic third party intermediaries* (draft).

<sup>61</sup> Ofgem (2014) *Proposals for regulating non-domestic third party intermediaries (TPIs)*, p4.

<sup>62</sup> Ofgem (2015) *Next steps on our project for a code of practice for the non-domestic third party intermediary (TPI) sector*.

<sup>63</sup> Profitability of retail energy supply: profit margin analysis working paper.

<sup>64</sup> These years are the financial reporting years for each firm, which differ in some cases from the calendar year.

93. Taken in isolation, this initial analysis does not prove that there is a competition problem. However, it suggests that we should carry out further work on competition to supply microbusinesses.

*Indicators of customer detriment from non-engagement*

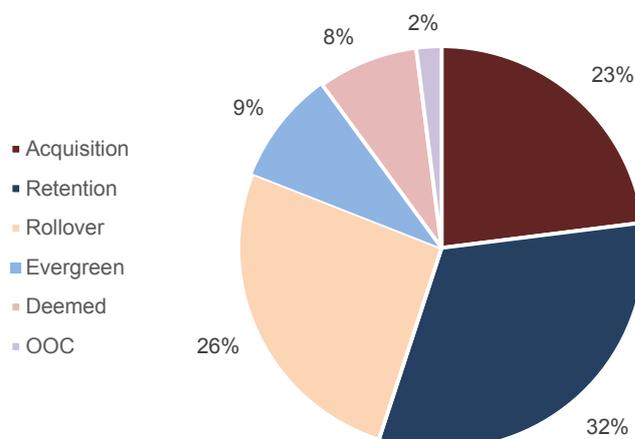
94. There are reasons to believe that customer outcomes are worse on the default tariffs which disengaged non-domestic customers are likely to pay either immediately, or after any initially negotiated period (for example, see paragraphs 98 and 101 below). As it appears that microbusinesses may have lower levels of engagement in the retail energy markets, this could suggest that many microbusinesses pay higher prices than other businesses.

*Tariff types*

95. Disengaged microbusinesses may end up with one of several types of tariff. For the purposes of this section, we refer to these as default tariffs. (However, customers on these tariffs are not necessarily disengaged – for example a customer may prefer the flexibility of an evergreen contract.) These tariff types (defined at paragraph 35 above) are:
- (a) auto-rollover tariffs;
  - (b) evergreen tariffs;
  - (c) deemed tariffs; and
  - (d) OOC.
96. Figures 8 and 9 below show the tariff types for microbusinesses in 2013. In electricity, 45% of microbusinesses were on default tariffs. The largest proportion of these were on rollover contracts (26% of microbusinesses). The picture was similar in gas – 49% of microbusinesses were on default tariffs. Again, the largest default tariff category was rollover contracts (23% of microbusinesses).

FIGURE 8

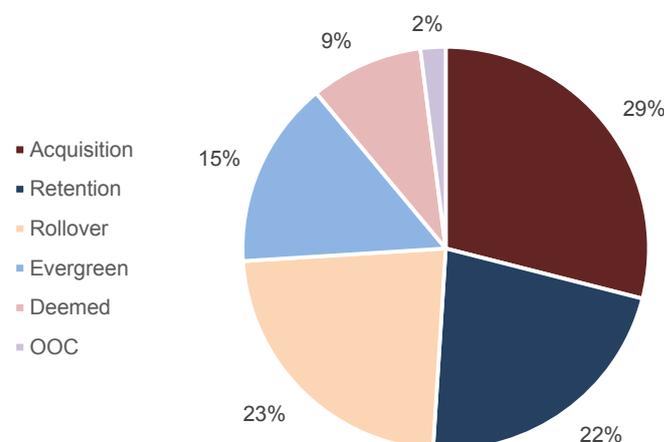
**Tariff types for microbusinesses on 1 April 2013 – electricity**



Source: Ofgem (2014) *Proposals for non-domestic automatic rollovers and contract renewals*, p41.

FIGURE 9

**Tariff types for microbusinesses on 1 April 2013 – gas**



Source: Ofgem (2014) *Proposals for non-domestic automatic rollovers and contract renewals*, p41.

97. We note that this data was from almost two years ago. However, we have also received updated information from the Six Large Energy Firms on the split of tariff types, across SMEs as a whole rather than microbusinesses specifically. As Figures 10 and 11 show, this suggests that the pattern above is still broadly correct: default tariffs represent just under half the SME segment (although proportions vary between suppliers).

FIGURE 10

**Tariff types for small and medium-sized enterprises – electricity**



Source: Parties' data, CMA analysis.  
Notes: [redacted].

FIGURE 11

**Tariff types for small and medium-sized enterprises – gas**



Source: Parties' data, CMA analysis.  
Notes: see figure above.

*Specific issues – auto-rollover tariffs*

98. Using information obtained from a data request, Ofgem calculated figures for the average annual electricity (gas) bill for a typical microbusiness on different contract types on 1 April 2013. This showed that an auto-rollover contract was 33% (28%) more expensive than a retention (fixed-term) contract. (Some of the Six Large Energy Firms expressed caution about this data, such as the fact that it was only a snapshot, and that it did not use the actual prices at which tariffs were sold.)
99. As noted above, many suppliers have now ended the use of fixed-term auto-rollover contracts. However, six out of 18 respondents to Ofgem's July 2014 consultation on auto-rollovers argued that they should still be banned, despite the voluntary actions by many suppliers to end them. The key concern was that prices could be significantly higher on such contracts. While Ofgem decided not to ban auto-rollovers, it has stated that it will continue to monitor this as changes announced by suppliers and Ofgem's recent reforms (see paragraph 43) take effect.<sup>65</sup>
100. We understand that there may be potential benefits for customers from the end of auto-rollovers by many suppliers. For example, a customer that has not been rolled over onto a new fixed-term contract may have more time to look for a new deal (including after the end of its original fixed-term contract). In contrast, once a customer has been rolled over onto a new fixed-term contract, it will be unable to switch to a different deal during that contract. However, for those customers that do not engage, the end of auto-rollovers may make little difference (as they do not take advantage of the additional

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<sup>65</sup> Ofgem (2014) [Decision on automatic rollovers and contract renewals for micro-business consumers](#) (letter to interested parties), p5.

time to look for a new deal), or may even lead to them paying higher prices. An internal document from SSE showed its proposed tariff changes. The document proposed replacing its auto-rollover tariff type (gross margin of £[redacted]/MWh) with a new variable tariff type (gross margin of £[redacted]/MWh), due to the uncertainty around the length of time a customer would remain with SSE, as customers placed on the proposed new variable tariff type would be free to leave at any time. [redacted]

#### *Specific issues – deemed and OOC tariffs*

101. The Ofgem research referred to above also showed that the average annual electricity (gas) bill for a typical microbusiness on a deemed contract was 75% (58%) higher than on a retention contract.<sup>66</sup> The Ofgem paper also noted that the median duration of customers' stay on deemed and OOC terms was over one year.<sup>67</sup> This means that some microbusinesses are potentially paying high prices for a considerable period.
102. The higher prices for deemed and OOC contracts may be due to additional costs faced by suppliers for customers on these contract types. Suppliers reported to Ofgem that there was a greater risk of non-payment among such customers. Scottish Power noted that the customer was not known to the supplier, that they had no payment history track record and that they could change supplier at any time without the supplier being able to object. In an internal document from 2014, Centrica stated that 'We write off around 37% of our Deemed revenue annually compared to about 5% for the rest of our product range.'
103. Suppliers also appear to face additional costs when serving customers on uncertain contract lengths as they are less able to hedge demand effectively, and as the cost to serve is higher.
104. We note that there is already a specific licence condition in relation to deemed tariffs, which requires suppliers to ensure that the terms of these contracts are not unduly onerous (see paragraph 35). However, this appears to allow some latitude for suppliers to set high prices for these tariffs. For example, an SSE document from 2013 included its rationale for its deemed tariff gross margin. It included a [redacted]p/kWh addition for energy and balancing risk, with the justification that this reflected the premium for buying volumes in cash-out in the most expensive 300 half hours. However, the final deemed risk premium

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<sup>66</sup> All figures from Ofgem (2014) [Proposals for non-domestic automatic rollovers and contract renewals](#), pp42–43.

<sup>67</sup> Ofgem (2014) [Proposals for non-domestic automatic rollovers and contract renewals](#), p43.

was agreed at [REDACTED]/kWh, and covered a wider range of risk than only energy and balancing. This figure was used for subsequent reporting.

### *Comparison between tariffs*

105. There was some information on prices and margins by tariff in the internal documents of most of the Six Large Energy Firms. We report some of this in the section below. The aim is not to compare firms at this stage, given that such comparisons may not be consistent given our current information. The documents are also historical, meaning that the situation may have changed (eg since the end of auto-rollovers).
106. However, we consider that this information is still helpful to illustrate areas for further work. We note that prices are higher for default tariffs, especially deemed and OOC tariffs. Gross margins also appear to be higher on these tariffs, although this may reflect certain additional costs of these tariffs, such as bad debt. Only a couple of firms provided information on EBIT or earnings before interest, taxes, depreciation and amortisation (EBITDA) – but both of these suggested that profit margins were higher for default tariffs.

- *Prices*

107. Figure 12 below is taken from a 2014 Centrica internal document. It shows the annual bill for different tariffs, holding the level of consumption constant. It can be seen that the annual bill was around twice as large for Deemed or OOC tariffs as for acquisition tariffs. The difference appeared to be larger for gas than for electricity.

FIGURE 12

[REDACTED]

Source: [REDACTED]  
Note: [REDACTED]

108. [REDACTED]

FIGURE 13

[REDACTED]

Source: [REDACTED]

109. Similarly, Figure 14 from RWE npower (2014) shows that unit rates for acquisition electricity tariffs (on the left hand side) were [REDACTED] than for other tariffs (on the right hand side). [REDACTED] The price for auto-rollover contracts was

[REDACTED] acquisition tariffs. [REDACTED] for RWE npower's tariff products, which cover customers that have not switched since privatisation. [REDACTED].

#### FIGURE 14

[REDACTED]

Source: [REDACTED]

- *Margins*

110. [REDACTED]

#### FIGURE 15

[REDACTED]

Source: [REDACTED]

111. In an internal document from 2013, SSE stated that over [REDACTED] of its gross margin from non-half-hourly metered customers came from those on auto-rollover or OOC tariffs. This was despite these customers making up only around [REDACTED]% of the volume. SSE noted that this did not take into account indirect costs or possible higher costs of managing OOC customers.
112. An RWE npower internal document from 2014 also suggested that [REDACTED]. The document stated that the 'Average difference between [REDACTED] per customer is [REDACTED].'
113. Internal documents from E.ON also made reference to the size of gross and EBIT margins. A presentation from 2011 on SME strategy said that 'the majority of groups are well above where you'd expect the [gross] margins to sit in a completely rational market.' However, this presentation also said that low volume electricity customers were [REDACTED] of customers, but contributed only [REDACTED] of gross margin and [REDACTED] of EBIT. This statistic does not suggest that higher profits were being earned from low volume customers as a group. In another document from 2012, E.ON stated that 'Our loss making customers are concentrated on low consumption acquisition.'
114. However, [REDACTED]. Figure 16 below shows the number of customers at each consumption level, split by levels of EBITDA margins. [REDACTED]

FIGURE 16



Source: [REDACTED]

115. [REDACTED]

FIGURE 17



Source: [REDACTED]

116. Figure 18 below, from Centrica (2012), [REDACTED].

FIGURE 18



Source: [REDACTED]

117. [REDACTED]

FIGURE 19



Source: [REDACTED]

*Current view on margins*

118. In this section, we have reported information from parties' internal documents. This suggests that prices and (gross, EBITDA or EBIT) margins may be higher for some default tariffs than for tariffs that customers actively choose. As noted above (paragraphs 105 and 106), we are using this information to illustrate areas for further work.