ENERGY MARKET INVESTIGATION

Summary of hearing with Which? on 27 October 2014

Opening comments

1. Which? (the brand name of the Consumers' Association) viewed the energy market as a priority and had been engaged in it as an advocacy organisation for several years. The energy market had become a priority because of the very high level of concern expressed by consumers, which was documented in its monthly consumer tracker as the top financial concern for the past several years. Consumers had very little confidence in energy when compared to other markets; just 22% of consumers trusted the energy market, and only 18% trusted energy suppliers to charge a fair price.

2. Which? was pleased that the investigation was taking place and agreed there was a real problem in the market with regards to consumer mistrust and lack of consumer participation; these problems not only worried Which?, but also its members, the general public and the suppliers themselves.

3. Its three key objectives in the energy market were transparent trading, people power and consumer trust. With regards to transparent trading, it said that the opaque arrangements that existed between the wholesale and retail markets meant it was very hard to discover the price of wholesale energy. Which? had not been able to assure consumers that vertical integration had not operated solely to the benefit of suppliers.

4. Despite retail market reforms, consumers were disengaged with the market and assumed all the major suppliers behaved in the same way, and there was herd-like behaviour with regards to pricing. Consumers also struggled to deal with the complexities associated with switching suppliers. People power could, however, be achieved by making it easier for consumers to navigate the market, either through encouraging reform or regulatory interventions.

5. Consumer distrust of the market meant people were less likely to engage, which led to less competitive pressure to keep prices in check, and less pressure for suppliers to innovate and improve customer service. Which? also felt that it was important that DECC and the Treasury dealt with policies that supported vulnerable customers, and the cost of infrastructure investment.

6. The energy market was unique when compared to other essential markets, in that there was a large number of people who were disengaged, consumer protection to price shocks was limited, and the historical structure of the market before privatisation created an assumption, amongst older and vulnerable consumers, that the market was arranged to protect them in order for them to live their daily lives. Consumer behaviour was not rational and so traditional remedies that dealt with adverse effects on competition (AEC) did not apply in the energy market.

Consumption/efficiency

7. Which? agreed that the market was segmented and that average households that stuck with standard variable tariffs could save up to £200 per year if they switched. Which? had no direct evidence of the disengaged segment of the market being used by suppliers to cross-subsidise cheaper tariffs.

8. Around 80% of customers paid a standard variable tariff despite cheaper alternatives. Which? published material that encouraged more efficient management of consumption. A number of schemes including ECO, Green Deal and CERT had been successful to a degree; however, the growing significance of cost drivers such as the wholesale market and government policy on customers' bills meant behavioural change was limited.

9. Consumer consumption adjustments were often misplaced, focusing on electricity rather than heating. CERT assessments had resulted in a reduction in consumption but bills had gone up above inflation. Consequently, consumers often felt that behavioural changes were pointless, and they did not always trust individual suppliers to give accurate advice on energy savings.

10. Government consumption management targets were hard to achieve as delivery of the saving schemes relied solely on the major suppliers without other, more trusted third party involvement. Which? argued that a more community-based approach needed to be adopted, with a bigger role for local authorities and social housing landlords, who understood their housing stock; there had been some success with this approach in Scotland. Which? had also worked with communities on collective-switching schemes.

11. Which? felt that the interest rates on the Green Deal deterred engagement and led to a low take-up. It suggested that Treasury subsidising Green Deal loans, through the Green Investment Bank, could encourage customer engagement.

Research on consumer engagement and consumer trust

12. A monthly consumer tracker was published on Which?'s website, which looked at general consumer issues. Which? also carried out a six-monthly energy tracker, which was established prior to Ofgem's retail market review (RMR). It tested consumers' perception of the market and found that 85% believed that profits drove retail pricing, with policy costs rating low. In separate qualitative research conducted around two and a half years ago, consumers felt that vertical integration made them more open to be taken advantage of and switching rates continued to decline.

13. Rates of distrust and switching peaked in autumn 2013, which coincided with heavy media attention. Which? had not seen any improvements in levels of trust since, and trust in the energy market was significantly lower than in other markets such as retail banking, communications and rail. Consumers felt powerless when dealing with the major suppliers and this collapse in trust represented a severe problem in the market.

14. The perception of distrust was driven by doorstep mis-selling scandals, a sense of price coordination amongst major suppliers, Energy UK's defence of the industry, and the general political and media climate. Customer services differed very little amongst the major suppliers, and customer satisfaction worsened every year. There was no correlation between excellent customer service and size of market share.

15. Distrust adversely affected competition in the market, as the lack of engagement reduced demand-side pressure in terms of pricing, innovation and service standards, as well as switching and participation in energy efficiency schemes.

16. Which? believed that doorstep selling should not be reintroduced, despite it representing direct engagement with customers. The lack of transparency was the underlying reason for consumer mistrust and, ultimately, lack of engagement. These issues would not be solved by putting more information on bills and there needed to be a greater role for third-party intermediaries such as Which? that consumers trusted.

17. Which? had encouraged Ofgem and suppliers to simplify bills for several years. There had been recent steps in the right direction, but these changes had not proved sufficient and consumers still found certain terms in the bills confusing and key information difficult to find.

18. Which? believed that bills must include the key pieces of information that customers needed to make informed decisions. Consumer testing should be

carried out before changes to bills are mandated or licence conditions imposed.

19. Which? said that statistics on consumer satisfaction for retail banks, communication and rail companies demonstrated a healthy degree of scepticism about these providers, but there was not anywhere near the level of distrust and poor treatment experienced by energy customers.

20. There was very little differentiation in terms of customer service amongst the larger suppliers. Which? rated suppliers for customer service and the performance of the bigger suppliers consistently worsened each year.

21. Customers believed that they were powerless in their dealings with the very large energy companies that were supplying an essential product or service. Which? believed that this lack of consumer trust was to the detriment of a competitive market. It deterred consumer engagement and reduced demand-side pressure in terms of pricing, innovation and service standards. This in part explained why so many people did not switch despite evidence of concerns about energy costs. This distrust had affected the take-up of energy efficiency schemes and smart-metering, a fact that was acknowledged during Which?'s discussions with suppliers.

22. Which? did not believe that consumer disengagement could be addressed through the reintroduction of doorstep selling, as had been suggested by the largest suppliers.

23. Third-party intermediaries were a potential solution to addressing issues of mistrust, but ultimately Which? had told the boards of all the major suppliers that they needed to improve transparency and address the underlying reasons why people did not believe the price that they were charged. Putting more information on bills would not solve this problem.

24. One consequence of the lack of competitive pressure on the demand side for the largest suppliers was that there was less pressure on them to improve their customer service. Which? met regularly with the chief executives of the major suppliers and there was a growing realisation that customer service needed to be given a higher priority. Suppliers had to invest in training customer service advisers so that they could adequately respond to customer queries and reverse the perception that customer service was poor.

Price comparison websites

25. Which? operated its own price comparison website (PCW), which provided a full market comparison. It believed PCWs had an important role to play in the

energy sector and it was important that they offered a straightforward way to engage with the market and provided customers with the best, most accurate results. They needed to be transparent with regard to commissions and offer a full market comparison.

26. Which? believed it was reasonable for PCWs to charge a commission, but customers should be aware of this and the customer journey should encourage switching and engage customers. Which? was sure Ofgem would clarify and put in place rules for PCWs.

27. In its role as an advocate of consumer right, Which? had been challenged by the larger suppliers over this role. Which? believed its members and the public wanted a switching site provided by a not-for-profit organisation that would use the revenues for the good of consumers.

28. Which? negotiated commissions on an individual basis with each supplier. Some suppliers had refused to engage in a contract with Which? and Which? now outsourced its contract negotiations to Energylinx, who also managed Which?'s white-label energy site.

29. Which? had been approached about offering a single PCW for energy, but it believed that it was better that competition existed in the provision of PCWs, provided they were properly regulated and operated in the consumer interest.

People power (prices, switching and vulnerable customers)

30. Which? did not believe that price regulation was the best solution for consumers. It believed consumers should be able to compare prices much more easily and that mechanisms should be in place to give people confidence that the price they paid was fair. One way of achieving this was for Ofgem to publish a price across a range of tariffs and regularly update it so that people would have a benchmark against which to compare prices.

31. Consumers did not trust suppliers and Which? saw a role for Ofgem as a notional, independent supplier. Which? believed that consumers would welcome an independent, officially sanctioned benchmark price and this would give consumers confidence to engage with the smaller suppliers.

32. Which? recognised that having an agency set an administrative price was challenging, particularly as, when attempted in the past, prices were not always particularly efficient. Some states in Australia offered regulated prices and consumers had the option to switch to the government agency. Northern Ireland also had a price-setting process, which involved a reconciliation of prices on an annual basis to adjust energy prices.

33. Which? was not against suppliers making a profit, particularly where a supplier was efficient, offered a good service and treated its customers well. Which? was aware that Energy UK, which represented the largest suppliers, had suggested that 5% was a fair profit in retail.

34. Which? believed that Ofgem had erred in its assumption that fewer tariffs was the solution to ensuring prices were easily comparable. Which? thought that the way prices were presented and simplification of the price itself, rather than the absolute number of tariffs, was key.

35. Which? had argued this point with Ofgem and Which?'s own consumer research had shown that if the price was presented more simply, rather than that there were fewer tariffs to choose between, consumers were more able to spot the best price for them and suppliers would advertise their prices in a much more straightforward way. Which? believed that this change was potentially the game-changer that would allow many more consumers to realise that they were on a poor deal.

36. Which? did not believe that standardisation and simplicity in the way that prices were presented would decrease the incentive for innovation. It believed that the presumption that there was a large demand for innovative pricing was exaggerated and led to the proliferation of complex tariffs in the past. Going forward, innovation would be witnessed in the time-of-use space and smart-meter programmes.

37. Single unit pricing would be an important bridge in the move from a market where there were very low levels of understanding about energy pricing to what would, potentially, be even more complex pricing in the time-of-use world. The move to single-unit pricing would assist those on time-of-use tariffs as they could focus on the unit rate over each time period and not have to consider the standing charge for a particular time period, as well as the unit rate and how that varied over time.

38. Which? believed that the majority of households were missing out on the best energy deals. 80% of households were on standard tariffs and paid up to £200 more per annum than was necessary. Ofgem had also identified people in privately rented accommodation as not engaging in the energy market as they were unaware of their options.

39. During Which?'s discussions with the major suppliers, the presence of independent suppliers was never portrayed as a driver for keener pricing or improvements in service standards. The independents did not pose a threat to the big suppliers as the big suppliers were very confident in retaining their

existing customer bases. Though the customer base might be eroded, it did not challenge the business strategies of the largest suppliers.

40. Small suppliers tended to be in relationships with the larger suppliers because of their need to access the wholesale market. Small suppliers also struggled with growing their business and dealing with licence conditions. Until recently, the majority of small suppliers were niche players that pursued pre-payment-meter customers or people looking for renewables.

41. The largest suppliers had incredibly stable customer bases. The customer bases of the smaller suppliers were more engaged and this enabled smaller suppliers to put competitive pressure on some of the best fixed-term deals in the market, but Which? had not seen this same constraint on standard-variable tariffs. Which's own calculations had shown that it would take around 15 years to move from a 'big six' to a 'big seven'.

42. It was difficult to compare switching rates across markets. When Which? compared energy with telecoms and personal current accounts, switching in the energy market was at a comparatively poor level, and across markets offering essential products, many of the same features existed – for example, complex pricing and difficulty in switching.

Cost control

43. Which? was keen that unnecessary costs arising from government programmes were not added to energy bills. Which? wanted external scrutiny of these programmes and their impact on bills and believed the National Audit Office or the Major Projects Authority should have more rigorous oversight.

Transparent trading

44. Which? said that there were a number of features of the interaction of the wholesale market with the retail market in the context of vertical integration that prevented it from being transparent and competitive.

45. Some of the vertically integrated suppliers had started to ring-fence their retail and wholesale operations and many of the bigger suppliers had recognised that people questioned their vertical integration. Many of the larger suppliers recognised the lack of transparency in relation to over-the-counter trading and in the forward markets.

46. Which? believed that if more trading was done through exchanges, if better rules existed around price benchmarking and if there were more rigorous rules about the separation of the different arms of vertically integrated

businesses, it would be able to tell consumers that measures existed to ensure that vertical integration was not done in a way that was misaligned with good consumer outcomes and unnecessarily high prices.

47. If these arrangements were put in place, Which? envisaged that:

- smaller suppliers would find it easier to engage with the wholesale market and could therefore pass on the benefits to their customers;
- more transparency would put more pressure on the major suppliers to keep their prices and the wholesale dimension of their prices in check; and
- more consumers would have increased confidence in the operation of the market.

48. Which? was aware that details of over-the-counter trades that were undertaken in real time were available for a fee, but believed this provided only a partial picture of the way the wholesale market operated. Purchasing data did not give smaller operators confidence in the operation of the wholesale market, particularly as pricing data for very large over-the-counter trades was not available.

49. Which? was also keen on the use of exchanges as they provided the opportunity to have independent market-making, which, if available along different parts of the curve, would encourage more trading and produce more reliable prices as there would be more trading around these prices.

50. Exchanges relied on transactional data, whereas some price reporters would speak with traders, which Which? felt left the trading system open to manipulation and in receipt of inaccurate data. The larger suppliers had recently flagged concerns about the robustness of data of price-reporting agencies. The larger suppliers would not allow their own traders to provide information to the price reporters, which meant that the price reporters did not see a full picture of the market.

51. Which? believed that the introduction of clearing could help transactionalise a lot of over-the-counter trading, which it viewed as a helpful development. Initial conversations about exchange-based or cleared over-the-counter trading had seen the larger suppliers cite higher costs for smaller suppliers. However, one of the largest of the smaller suppliers was very keen on exchange-based trading.

Self-supply of electricity, hedging

52. Which?'s research had shown that among firms, generation had greater operating margins than retail operations and the vertically integrated companies reported significantly bigger margins. Yet the vertically integrated suppliers always referred to their domestic-supply margin as if it referred to the whole group – there was an eliding of those different numbers in the way they were presented to the public.

53. Which? undertook further investigation and published data going back several years that showed the different operating margins and the differences between supply and generation. Which? had never received a good explanation from the suppliers as to why the margins were different. It had proved difficult for Which? to make robust comparisons between supply and generation margins due to a lack of data.

54. The major suppliers had only recently declared what proportion of their trades were self-supply (the presumption in the marketplace was that it had been a significant proportion of the volumes that were traded). As with the levels of profit margins for supply and generation businesses, without greater transparency around self-supply, the suspicion would persist that significant trades were done that otherwise might have taken place in the open market, and that supply was not undertaken at a price that was the optimum for the retail operation and therefore for consumers. Suppliers had offered reassurance that self-supply did not have a significant impact on the market, but Which? had no means of challenging this.

55. There was a huge challenge for suppliers to demonstrate to people that the wholesale prices translated through to fair retail prices. Which? did not expect the larger suppliers to publish their hedging strategies, but it would like to understand how the underlying mechanics worked and that the incentive existed to deliver to customers as well as shareholders.

56. The existing market arrangements did not enable the major suppliers to credibly rebut that suggestion that they made excessive profits and the subject was very much a live, public concern.

57. It was difficult to compare one supplier with another, and auditing and greater comparability across the suppliers was a step in the right direction. Which? would like to see suppliers provide more data on profits and some of the dimensions of vertically integrated companies.

58. The lack of information on trading and tolling functions was a concern for Which?. Ofgem's consolidated segmental statements would not address this,

particularly the challenge about how best to capture profitability for generation. Traditionally an ‘Earnings before interest and taxes’ margin was used, but a more realistic comparison was sought to reflect the amount of capital that was invested in generation.

Concluding remarks

59. In the event that the Competition and Markets Authority (CMA) made recommendations or proposed remedies, Which? asked that the CMA ensured that recommendations or remedies passed a credibility test with consumers, even if they involved sectors of the energy market that were quite complex and hidden from sight as far as consumers were concerned. The opportunity existed to put in place assurances to people that they could manage their energy consumption better and switch with more confidence.