ENERGY SERVICES GROUP

OFGEM PAPER ON 28-DAY RULE

ESWG(03)6

Consumer protection in energy supply: the role of the 28 Day Rule

Ofgem submission to the Energy Services Working Group

July 2003

Summary

1. The purpose of this paper is to explain the important role the 28 day rule plays in protecting the UK's 45 million domestic energy consumers[1], and why the rule does not create a significant barrier to suppliers' promotion of energy services.

2. The paper begins by explaining the effect of the 28 day rule. The rule reflects a compromise between short-term customer choice and longer-term imperatives such as preserving market liquidity and consumer protection. This compromise does not prevent suppliers offering consumers long term contracts, or bundling energy efficiency measures with energy supply, and in reality some suppliers are currently offering fixed-term contracts. All the 28 day rule requires is that customers must always have a "back-door" to exit a contract – perhaps after payment of a reasonable termination charge, which can cover costs suppliers incur because of that contract termination.

3. The paper explains why this compromise has been struck, and why it is vital for consumers to have such a "back door". It remains extremely important that consumers can extricate themselves from poor service or contracts into which they have been erroneously transferred, through administrative error or misselling. This right to take advantage of competition will remain important, however competitive the market becomes.

4. The paper then explains how the competitive market is benefiting consumers, and describing the extent of competition. It explains Ofgem's concerns that competitive dynamism and market liquidity may be reduced if lock-in contracts are allowed.

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[1] 25m electricity, 20m gas – naturally, many households have one account for each fuel.

5. The paper concludes by recommending that the Working Group challenge suppliers to exploit the as-yet unexplored flexibilities inherent in the current rules, through market-testing propositions attractive to customers. This would be complementary to the Group's work exploring what are the real barriers that make the business case for investment in energy services currently less than attractive.

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1. What does the 28 day rule do?

1.1. This paper concerns the effect of various contractual arrangements between energy suppliers and their customers. It therefore begins with a description of the range of contractual arrangements currently common, and the regulatory rules which govern them.

A range of contract types

1.2. Customer contracts with energy suppliers fall broadly into three categories:

- "Former tariff scheme" contracts. Schedule 7 of the Utilities Act 2000 has the effect that customers who have never switched away from their incumbent supplier[2] are deemed to have a contract with their supplier under a scheme known as the "former tariff customer" scheme. The former tariff schemes were approved by Ofgem;

- "Deemed contracts." Customers who take energy after they have moved house (but who have not got around to signing up with a supplier for those premises), or in some other circumstances, are deemed to have a contract which is governed by the standard Supply licence (SLC 28). At any time this is a small group of customers, but most customers will be served by a deemed contract at some time or other; and

- "Express contracts." Customers who have entered into a contract with a supplier have accepted the terms of that contract. However, suppliers are regulated by their licences as to what terms they can include in such contracts. The 28 day rule is one such requirement of the licence, and the contracts under discussion in the rest of this paper will be in this group. Most of the customers with express contracts have switched

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[2] A former Public Electricity Supplier, supplying electricity in its home region, or British Gas as a

supplier at least once, although some will have transferred from a former tariff scheme contract to an express contract, for example on moving house.

What does the 28 day rule do?

1.3. The terms of contracts are regulated by the licence in a number of ways. The rules relevant here are contained in Standard Licence Conditions (SLCs) 46 and 47. The provisions of these SLCs embody a compromise between two desirable goals. On the one hand, it is desirable that, in the short term, customers have choices between a range of contract types. On the other, it is essential for the long-term interest of customers to prevent incumbents from hampering new market entry by reducing the liquidity of the market, and to ensure that customers are not definitively locked into arrangements that are to their detriment (even though exiting them may be at a price).

1.4. This compromise is effected by licence rules that set out the following:

- energy supply contracts can be for a fixed term, and if the contract is for a fixed term that is more than 12 months a reasonable termination fee can also be demanded[3];
- whether or not a fee is payable on termination, all energy supply contracts (whether fixed-term or rolling) must contain provision for them to be terminated on no more than 28 days' notice;
- energy suppliers may bundle other goods and services into the same contract with energy supply, and the contractual provisions governing these goods and services may be different. The

gas supplier.

[3] Other than where the customer is terminating on moving house, or where the supplier has unilaterally changed its terms, or where the customer was not told about the termination fee.

licence provides that where the energy part of the contract is terminated, the supplier may require "reasonable security" with regard to the goods and services (SLC 47.4).

1.5. Thus, the current rules allow suppliers to create longer-term relationships with customers, through fixed term contracts, and to create a barrier of reasonable size to the customer exiting the relationship. What is not permitted is for the supplier to create an insurmountable barrier – either through an excessive termination charge, or through a non-terminable contract. Contracts including an insurmountable barrier are referred to here as "lock-in" contracts.

1.6. On market opening, most suppliers initially offered rolling contracts, renewed automatically from time to time if neither party is opposed. This remains the most common pattern. However, a number of suppliers are now experimenting with longer-term, fixed-term contracts[4]. For example:

- British Gas has signed up a significant number of customers through a series of offers which offered a guarantee of no increase in electricity prices, against a customer commitment of twelve to eighteen months;
- Npower launched a capped-price offer, in April 2002, with customer prices fixed until March 2003. This was only available to out-of-area customers[5].

See SLCs 46 and 47.

[4] Fixed-term contracts are, of course, already the norm for industrial and commercial customers, but these are outside the scope of this paper.

[5] We hesitate to hold up the Npower offer as an example, since the company has recently been fined £100,000 in the High Court on the grounds that the "price freeze" was not actually applied. However, this does not detract from the points that a) the company recognised consumer interest in a fixed-term contract and b) the licence did not prevent the company rolling out this offer.

2. The 28 day rule is not a barrier to energy services

2.1. The licence rules outlined in chapter 1 contain considerable flexibility. Enlivening the energy services market may involve suppliers building richer, longer-term relationships with customers, through which they can sell a bundled package of services. The 28 day rule is not an obstacle to creating such long-term relationships. As described in chapter 1 above:

- the 28 day rule does not prevent fixed-term contracts;
- it does not prevent suppliers charging a reasonable termination fee, so as to create a disincentive on the customer to terminate the contract;
- the rules do not prevent a single contract covering both goods, nor a single bill (so long as both elements of the contract are itemised);
- in addition, on termination of the energy part of a bundled offer with energy efficiency measures, the supplier can recover reasonable security relating to the bundled goods and services.

2.2. The only step which is not permitted – whether a contract is bundled, or purely for energy - is tying a customer into a non-terminable contract. It is hard to see why suppliers want to take this extra step, unless they do in fact foresee the unit price of the energy part of an energy services bundle being significantly higher than market prices. If, in fact, the energy services bundle were predicated on a cross-subsidy between expensive energy and energy efficiency services, then customers might wish to switch away. From the customer's point of view, such a contract might indeed be less attractive than financing an energy efficiency measure direct from credit providers.

2.3. Taking these factors together, Ofgem does not believe the 28 day rule in itself is a barrier to the development of an effective market for energy services. This view is strengthened by the existence of two "counter-factuals":

- there is no 28 day rule in the industrial and commercial sector, but neither is the energy services market adequately developed in that sector, other than for the largest users;
- until licences were reissued after the 2000 Utilities Act, the gas supply licence allowed a supplier to refuse to release a domestic customer unless reasonable security had been provided for linked goods and services. In other words, the 28 day rule used not to apply to linked contracts in the domestic gas market. However, that market was even less abundant in energy service bundles than is the case today.

2.4. Ofgem suggests the lessons to be drawn from this experience are that the real barriers lie, not so much in regulatory rules, as in supplier or customer attitudes, which may in turn arise from a weak "business case". However, given sufficient impetus, suppliers are coming to the market. Appendix 1 to this paper (already circulated to the Working Group) outlines the range of measures energy suppliers have put in place, to take advantage of the 50% uplift the Energy Efficiency Commitment allows for energy service packages. Innovation is appearing and suppliers have rolled out a variety of options, although it is still too soon to know how many customers will take up these offers.

2.5. For these reasons, Ofgem believes the Working Group has an important role to play in challenging the energy supply industry to take full advantage of the freedom allowed by regulatory rules. For example:

- Ofgem would be happy to work with suppliers to clarify further what would be a "reasonable" termination fee relating to the energy component of a fixed-term contract. This would build

on the guidance Ofgem has already issued, which discussed in greater detail the issues surrounding security for goods and services; and

- Suppliers should begin actively experimenting with fixed-term contracts extending to longer periods, and including energy efficiency measures. This could be within the programme of customer research suggested by energywatch at the first meeting.

2.6. Ofgem thinks the present compromise works well for customers. The case for such change at present seems purely hypothetical. While we recognise the validity of the customer choice arguments, on one side of the balance, we see continuing strength to the consumer-protection arguments on the other side of the scales. These are explored in the next section.

3. Are fixed-term contracts in consumers' interests?

3.1. It seems clear that fixed-term offers are attractive to some customers. We understand that this has been the experience of those suppliers who have experimented with them. *Prima facie* it seems desirable for customers to have more choice, not less.

3.2. From the supplier's point of view, building a book of customers on fixed-term contracts would enable the supplier to buy a hedging contract covering the consumption of that group of customers. This can reduce suppliers' risks and costs, which might lead to lower prices for these customers.

3.3. However, Ofgem's analysis has also identified some potential customer detriments in fixed term contracts:

- Quality of service may fail to live up to the customer's expectations at the time of signing the contract;
- Misselling remains a danger, and might be more detrimental to the consumer if the contract is not terminable on 28 days' notice; and
- We also have some concerns about competitive effects of widespread use of fixed-term contracts – these are covered in chapter 4 below in more detail.

3.4. A number of suppliers have demonstrated difficulty in maintaining adequate customer service standards. Energywatch's case-load evidences many thousands of cases each year of: failure to bill at all, perhaps for some years (which can lead to accrued debts of thousands of pounds); inaccurate billing; poor customer communications, and a general lack of flexibility in customer service. It is perhaps disappointing that after five years of

competition this remains the case, but arguments that "the market ought to be more mature" are beside the point.

3.5. Ofgem and energywatch have intervened in a few egregious cases, but in general we believe formal regulation is a very poor instrument for managing provisioning and customer service. Competition is a much better means for driving up standards in this area. Above all, given that problems of this nature do and will arise, it is essential that a customer can protect himself by switching supplier. The customers' ability to switch away from a supplier when dissatisfied therefore remains an essential safeguard. Use of lock-in contracts would remove this protection.

3.6. These arguments carry all the more weight with regard to "erroneously transferred" customers. Over 2% customer transfers are in this group – at current rates (150,000 plus transfers each week), this will represent around 160,000 customers over the coming year. These cases arise, among other reasons, through mistaken identity (owing to poor industry data), or through misselling or forgery. In many cases the customer cannot be returned, because his meter has already been registered to the new supplier. One of the few saving graces is that such a customer can immediately (on 28 days' notice) transfer back to his chosen supplier. However, if the 28 day rule were modified so that lock-in contracts were allowed on the market, there is no reason why it would not be a lock-in contract on which the customer's signature had been forged. The removal of the customer's right to switch away quickly would greatly exacerbate this already unfortunate situation, and it would be difficult for both Ofgem and Ministers to explain to a customer thus affected why their protection had been removed.

3.7. Allowing customers to be locked in, with no right of exit even on payment of a termination charge, would expose them to the range of abuses described above. This aspect of the 28 day rule's customer protection role will remain important however

competitive the market becomes, since its purpose is to ensure a customer can take advantage of that competition.

4. Competitive effects

4.1. The last section explained why the 28 day rule provides important protections for individual customers. Ofgem is also concerned that removing the rule could have a damaging effect on the development of competition.

A competitive but not mature market

4.2. The domestic gas market was opened to competition in regional stages, with full competition from May 1998. However, the most potent competitors have proven to be the electricity incumbents, who were not allowed to compete in gas in their home areas until they were themselves exposed to competition; domestic electricity competition was fully open from May 1999.

4.3. Customer switching has progressed at a faster rate than was envisaged before market opening, and faster than in most equivalent markets (e.g., fixed telephone services or household insurance). Over 150,000 customers switch supplier each week – although many of these are switching back to their historic supplier, so net erosion of incumbent share is slower, at around 5% during 2002-2003. Incumbents now have around 63% of the national market in both electricity and gas.

4.4. Price competition has been healthy, with discounts higher than expected before liberalisation, and a growing gap between incumbent prices and prices paid by switchers. This is part of the great benefit to customers of competition: those customers who have entered the market have seen (on average) 17% reductions in their electricity price, 14% in gas since 1998. Around half of the reduction in fuel poverty since then has arisen from price reductions. Clearly, both price and the volume of energy consumed go to make up the customer's bill, and competition has borne down hard on the price part of this equation. Ofgem's primary objective is customer protection, and in the supply market

we are clear that competition is the best means we have to fulfil this objective.

4.5. Although these indicators all suggest that competition is developing well (and contributed to Ofgem's decision to cease controls on retail prices), the market is far from mature. Incumbent market share remains substantially above the thresholds normally used by competition authorities to indicate the possible presence of market power. Although all large supply companies are pricing aggressively outside their "home" area or fuel, they are not pricing equally aggressively to retain "in-area" customers. Although price competition is vigorous, non-price competition (e.g., by service differentiation) is still much weaker.

4.6. It appears to Ofgem that this young market continues to evolve rapidly towards mature competition. The current healthy level of discounting is a reflection of competitive intensity, and the key mechanism by which suppliers experience that competitive intensity is that their customers are persuaded to switch away. The number of consumers switching supplier remains high, and those switchers are leading to an erosion of incumbents' market shares.

4.7. In short, suppliers have to run fast so as to stand still – that is, they need to keep winning new customers so as to replace those lost to others. It would be naïve to believe suppliers find this process comfortable. The industry refers to competitive intensity as "churn", and would derive significant benefits from reducing it. Fortunately, each individual supplier is in a prisoner's dilemma, and cannot initiate a reduction in sales, for fear of a sharp reduction in market share (which would be profitable to the predators). What must be avoided is a regulatory action which would upset this dynamic equilibrium.

4.8. We are concerned that a rapid extension in the use of non-terminable contracts could create such an equilibrium-breaking shock. Specifically, we fear that it would undermine the economics of direct selling.

4.9. Direct selling has been the key means by which customers have been induced to switch energy supplier. 40-70% of switches now arise from doorstep selling, most of the rest from cold-call telesales. Ofgem has been careful in regulating direct sales not to render doorstep selling uneconomic or impossible. Nevertheless, the economics of direct selling are fragile, in large part because of the extent of churn.

4.10. Most customers do not bear in mind the nature of their current contract, and it seems likely that, if approached in this way, many would sign up even if they are not permitted to break their current contract. The gaining supplier would discover later (during the provisioning process) that the customer is not eligible to switch. Sorting this situation out would create substantial cost. (The cost of unpicking an erroneous transfer might be used as a proxy; this is typically several hundred pounds – i.e., the net margin from that customer for a decade or more.) If this sequence of events became at all common, the extra costs created could render direct selling altogether uneconomic.

Potential longer-term anti-competitive effects

4.11. In the longer term, if lock-in contracts became widely used, they could prevent innovative companies from entering the market. The economies of scale in energy supply are such that a new entrant would need to achieve a large customer base within a few years in order to be viable. The new entrant will likely accept low margins during this initial period, offering attractive prices and potentially helping customers who wish to switch out of a fixed-term contract pay any termination charges. (We have seen the latter on the industrial and commercial market.) However, if a significant proportion of customers are locked-in, so they cannot switch even by paying such a fee, this will make market entry proportionately more difficult.

5. Conclusion

5.1. The rules governing contract structure in SLCs 46 and 47 represent a finely-tuned compromise between short-term customer choice and the importance to the long-term customer interest of market liquidity and customer protection. This compromise contains enormous flexibility, which at present is not being exploited, let alone exhausted. The arguments for upsetting the present compromise are therefore hypothetical, and Ofgem does not find them compelling.

5.2. Ofgem believes the Working Group is most likely to achieve real change in the market by addressing the following points:

- Challenging suppliers to begin exploring market propositions that utilise the flexibility available to them;
- This may include market-testing customer-friendly propositions, as proposed by energywatch;
- Ofgem is also very willing to work with suppliers to explore what would be "reasonable" termination arrangements; and
- Focusing on the real economic barriers (e.g., fiscal barriers, lack of consumer interest) that make it hard to construct a business case for energy services.

Appendix 1 – already circulated to WG

The Development of Energy Services under the Energy Efficiency Commitment

1. The Energy Efficiency Commitment (EEC) places an energy efficiency obligation on electricity and gas suppliers. It requires them to meet an energy saving target between the 1 April 2002 and 31 March 2005. The scheme has been set up by Defra as part of the drive to reduce carbon emissions from households and to promote the social benefits of energy efficiency, with more than half of the energy savings to be targeted at the 'priority group' - households that receive income related benefits or tax credits.

2. Apart from targeting the priority group suppliers have no constraints on the energy efficiency schemes that they set up. However, in setting up the EEC Defra considered it appropriate to incentivise energy service activity. As a consequence, suppliers can receive a 50%-uplift on the energy efficiency measures that are promoted through energy service activity. This uplift, however, is limited to 10% of the overall activity. Energy service activity is defined in the Energy Efficiency Obligations Order as action that:

   a) includes at least two activities that are qualifying action under EEC, of which one:

      i) may reasonably be expected to improve the insulation of the walls or loft of the domestic premises concerned

      ii) may reasonably be expected to improve the efficiency of the principal system for heating those premises

      iii) consists of the supply to those premises of electricity, heat, gas or liquid in circumstances such as from CHP; and

   b) is undertaken in pursuance of an agreement between the supplier or a person acting on its behalf, and a domestic consumer, the terms of which also require the supplier-

      i) to undertake an assessment of the energy efficiency of those premises

      ii) to provide advice to the consumer as to the means by which the energy efficiency of those premises may be improved,

taking into account his circumstances and any other occupant of the premises and

iii) to offer the consumer the option of making an arrangement with the supplier for deferring the whole or any part of the cost to the consumer of the activities for which the agreement provides.

3. Information we have from the suppliers has shown that there is interest in energy service activity that meets the above criteria for the uplift. Of the six major suppliers with an EEC target three have submitted schemes that would take them over the 10% threshold if take up is as forecast. Of the remaining suppliers one has indicated that it intends to make part use of the Energy Service uplift. The others to date have shown no interest in energy service activity. Total proposed energy service activity is nearly 7% of the overall target, with the uplift therefore, this equates to just to just over 10% of the target.

4. The majority of the suppliers' energy service activity will be carried out using either cavity wall, or loft insulation and the provision of low energy lamps. However, the data suggest that two major measures might be provided in some cases. At a very small level, one supplier is promoting an energy efficiency scheme through the energy service route to make a marginal new technology more cost effective. One other supplier has expressed an interest in using the uplift to make other marginal activities more cost effective.

5. To claim the uplift, the suppliers are obliged to offer the consumer a financial package, although the consumer is not required to take it. The nature of the financial package varies according to the suppliers. The longest payback period on offer is for 3 years. This guarantees the consumer, which heats its home in an average way, a lower bill over the pay back period of the measure. One supplier has expressed an interest in bringing the finance in-house, but at present considers it too much of a commercial risk. Other suppliers have set up partnerships with credit unions to help with the financial package. To date we have no data on the numbers of consumers that have taken up the offer of the finance package.

6. The way the suppliers are marketing their energy service activity varies slightly. Most are using leaflets in with bills, while others initially experimented with TV advertising. At present we have little evidence to suggest which method is the more successful, although anecdotal evidence from one of the suppliers has suggested that using leaflets has been quite successful. We do not yet know how successful these schemes have been making consumers more loyal, although one supplier has indicated that these offers are used as a 'reward' for long standing customers. Additionally it is not clear whether the suppliers are using these offers to win new customers.

7. The financial savings that are available from these schemes varies according to the measures that are installed in the home. In a gas-

heated home that had cavity wall insulation and four low energy lamps the consumer could save roughly £100 on the combined gas and electricity bill. Where the consumer takes top up loft insulation and two low energy lamps the savings would be nearer £50.

Conclusion

8. The uplift on energy service activity concentrated the minds of suppliers on delivering energy efficiency measures through this route. It is not yet clear whether these schemes will be successful, although if they are, it is likely that they would be continued because the start up costs will have been covered and any additional measures delivered will be at very little cost to the supplier.