

Insight is a new, occasional feature of *Energy Spectrum*. In it we provide the floor to colleagues, collaborators and customers to provide an informed view on a matter of topical concern to policy makers or regulators. We do not have to agree with the point of view, but it must be reasoned and likely provide interest to our readers. The only rule is that we have a right of reply.

In this second *Insight* former electricity regulator Professor Stephen Littlechild comments on Ofgem's major supply licence review, with the consultation on the conclusions and proposals about to close out.

Comments on Ofgem Supply Licence Review

Stephen Littlechild¹

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British domestic gas and electricity markets have now been open for at least eight years. A review of the existing supply licence conditions is timely. Ofgem is therefore to be congratulated on establishing this review and on proposing numerous removals and simplifications of the licence conditions.

Many of the existing licence conditions were put in place when nationalised industry monopolies were still the prevalent form of supply. They were drafted at a time when we really had no idea whether there would be retail competition at all and if so what form it would take. We had to be rather cautious. Now, however, it is apparent that there is competition – in fact relatively vigorous competition compared to most other countries – and we have a better idea of how competition works. On the whole competition has worked well: customers are aware they can change supplier and have done so, a range of competing suppliers offers new and innovative products, and Ofgem surveys report consumer satisfaction.

Ofgem of course has to strike a balance, but there is surely scope to go further than the present initial proposals. Some of the proposed licence conditions will retain unnecessary and unhelpful restrictions on competition and on suppliers, particularly new entrants. Such restrictions will be against the interests of the majority of customers.

Experience in Norway and Sweden

Experience in Norway and Sweden is very relevant. They too opened their domestic markets to retail competition at about the same time as the UK. In some respects their background is different, with more municipal ownership there. However, mergers and international takeovers have gradually brought about similar market structures and ownership as in the UK.

These Nordic countries do not require suppliers to have licences at all. Virtually none of the restrictions in the UK supply licences apply to suppliers there. Yet the provision of service to customers of all types is generally considered to be no less satisfactory than in the UK. These markets are characterised by considerable switching between suppliers, and more innovative terms of supply. Licence obligations like those in the UK have proved simply unnecessary.²

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² For further information on Nordic experience see my paper "Competition and contracts in the Nordic residential electricity markets", *Utilities Policy* 14 (3) August 2006, 135-147.

It is therefore possible to consider removing most of the restrictions that the UK has previously considered necessary. Let me focus on a few main areas.

Duty to supply

Section 2 proposes to retain the duty to supply and the obligation to offer a whole range of payment methods, and envisages a role for Ofgem in resolving disputes about security deposits.

The paper points out that “in a competitive market one would expect to see a range of payment methods being offered to meet customer needs, although not necessarily by all suppliers.” This is absolutely correct. Although incumbent suppliers have been keen to retain and attract customers of all types, smaller entrants have tended to concentrate on particular types of domestic customer. They have done so at different parts of the socio-economic spectrum.

There is thus no need for a licence condition forcing every supplier to offer all types of terms to all types of customer. It makes no more sense than requiring all grocers to offer both corned beef and caviar, explaining that this is not a problem for grocers because they can each decide what prices to charge.

The focus of the obligation is said to be protecting vulnerable customers. It belongs more naturally in that section, on which I comment below.

Domestic supply contracts

Section 3 proposes where possible to rely on general customer protection legislation and contract law. This is a sensible and justified stance. Yet the proposed restrictions go beyond that.

For example:

- 3.4 would require the energy part of a contract to be clearly distinguishable. This is perhaps a hangover from the days when electricity Area Boards also had supply showrooms and used the electricity bill as a means of recovering debts on appliances. The restriction might be problematic if a supplier offered to install a smart meter as part of a contract, as indeed happened when competition started in Sweden. Is it proposed to split the contract price into an energy part and a meter part? Is this a helpful complication when an aim is to facilitate smart metering?
- 3.6 would require a supplier to provide copies of a supply contract on request and within five days of entering the contract, to draw attention to principal terms, and to provide information on continuation terms 30 days before expiry. But to the extent that customer protection legislation and contract law do not consider it reasonable to provide for these actions, why should the electricity licence do so? Successful suppliers will continue to want to meet customers' wishes in these respects. Domestic customers are no longer tied to a supplier for life, they can and do move if their suppliers do not behave responsibly.
- Suppliers may charge a termination fee for fixed term contracts, and 3.9 rightly proposes to remove the licence requirement that such a charge must not be unreasonable, on the grounds that Unfair Contracts legislation already provides sufficient protection. It is unclear whether 3.10 would prohibit the levying of termination fees for indefinite term contracts or allow them in circumstances defined by the Authority. This is apparently on the grounds that Unfair Contracts legislation provides a lack of certainty. Prohibition of termination fees for indefinite term contracts seems a draconian response to that situation, and further detailed involvement by the Authority should surely be avoided. Is there still a need for such restrictions on indefinite term contracts other than deemed contracts?

Customer information

Section 4.1 proposes that customers should be informed individually and within a reasonable timescale of a unilateral variation of a contract term that raises price.

Members of the Energy Retail Association reportedly consider that this would be unnecessary and costly. That is an entirely plausible view. Norway and Sweden have no such restriction. Finland, which has had such a restriction, is in process of removing it.

The obligation may have been reasonable when price changes were typically scheduled in advance, once per year, to reflect annual budget decisions by Ministers, and when customers had no choice about whether to accept these terms. Some suppliers may continue to offer terms that change only infrequently, and may find this a sensible way to proceed, and one that their customers value. They should be free to do this. But it is no longer appropriate to impose this obligation on all suppliers and on all types of contract. This is particularly the case when suppliers need to respond to unpredictable changes in wholesale market prices, and when customers do have a choice as to whether or not to accept the terms offered to them.

The problem arises particularly with terms that (for contractual or competitive reasons) reflect the movement in spot market prices, and may need to be adjusted several times in a year, perhaps unpredictably. For example, the main suppliers in Norway have been changing their variable tariffs at least once a month on average since 2001. About 60 per cent of domestic customers have chosen a variable tariff of this form. The cost and hassle of individual notification would probably make it uneconomic to offer such variable tariff terms in the UK. This would be a serious distortion of competition. It would prevent the development of a potentially popular form of contract, and would impose an unnecessary barrier to a development that could offer customers real benefits.

Vulnerable customers and codes of practice

A significant number of restrictions are for the benefit of vulnerable customers. For example

- 5.6 requires a supplier to accept Fuel Direct payments and not to disconnect such customers
- 5.8 requires debt repayment arrangements to take into account ability to pay
- 5.11 requires suppliers to avoid disconnections of vulnerable customers in winter
- 5.13 requires provision of information about PPMs.

Some restrictions to protect vulnerable customers are understandable. But do they need to be imposed on all suppliers?

A significant proportion of vulnerable customers are likely still to be with the incumbent supplier. Almost all the remainder are likely to be with another of the incumbent suppliers rather than with a new entrant supplier. Those major suppliers that have a significant proportion of vulnerable customers presumably accept and are used to these obligations and do not find them an undue burden. But is that a reason to impose these obligations on all suppliers and prospective new entrants?

The proposal to simplify, consolidate and focus the seven detailed codes of practice is an understandable one. However, is it helpful to put the resulting obligations directly into the licence? This seems a backward step, which introduces less flexibility rather than more.

Would it not be better to put the obligations into a simplified and consolidated Code of Practice? It could be made obligatory on incumbent suppliers to comply with that Code. The Code would be voluntary for other suppliers. They could then decide whether or not they wished to focus on vulnerable customers. Consumer groups would take that into account in deciding whether to recommend such suppliers. Perhaps suppliers would need to accept compliance with relevant parts of the Code if they decided to serve particular types of customer (for example, via prepayment meters). The Code could be reviewed at periodic intervals by the suppliers, customer groups and Ofgem. It would be modified as necessary to suit the evolving circumstances without the trouble of a licence amendment.

A similar approach might be adopted for some of the other proposed requirements, including those related to duty to supply and offering a full range of payment methods. At the moment, the perceived needs of a minority of customers are dictating the provision of services to the majority. This is no longer necessary or appropriate. Customers and suppliers are now significantly more experienced than they were when the market opened. There is evidence that the competitive market can, does and will meet the needs of vulnerable customers without exploiting them. Concerns about more vulnerable customers can be addressed in less onerous ways. And if problems do arise in future, it is straightforward to introduce or reintroduce licence conditions to address them.

Vulnerable customers and codes of practice

For all these reasons, it seems unnecessary to continue to impose uniform and detailed restrictions on all suppliers. Ofgem has made a good start in the process of rationalisation. However, it has yet more scope for simplifying the licence restrictions, reducing the burden of regulation and promoting more effective competition.

Cornwall Energy comment:

We support the sentiment behind these comments. Licences generally are over-long, wordy and in many cases the basic rationale behind the conditions is not obvious and anachronistic. Some of us expected a similar “back to basics” review during the passage of the Utilities Act 2000 when the standard licence condition framework was implemented. But with hindsight, given that domestic competition was nascent at that time, it probably has been beneficial to delay review until now.

A lighter touch from Ofgem across the breadth of the supply licence clearly has merit in terms of reducing compliance requirements and costs, and there will be benefits from reducing these for new entrants. But the economics of scale operations in domestic supply are such now that it must be doubted whether this sector will see any entry other than in niche market segments. There will be strong pressures without the threat of new entry into the mass market for incumbent suppliers to cut corners and subordinate non-economic activities especially with regard to less profitable customers. It will be important that a reduction in licence requirements is not matched by any lesser surveillance of the market. Further Ofgem should give careful thought to how it measures competitive activity and reports it to provide stakeholders and customers more generally with routine information on competitive activity, especially for vulnerable customer classes.