

# **Who really cares for the customer in regulated industries?**

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## Introduction

At a time when the consumer advocacy and representation framework<sup>1</sup> is being truncated it is entirely right to take stock and ask the question “who really cares for the customer in regulated industries?”

As we look to the future—one without energywatch—our best guide is recent experience. The last decade has too often seen market failures identified but left to fester for far too long. This period has also shown that there is a gulf between regulated utility market theory and practice. Where practice strays from theory, it is usually the consumer who ends paying, quite literally, the cost.

## Lessons learned to improve the regulatory process

There are many issues policy makers and regulators need to address as we adjust to increased dependency on turbulent world markets for our physical energy supplies. These include ensuring the most vulnerable in our society are not excluded from the market and the very serious long-term threat of climate change. The central issue though, especially in this time of high prices, is to ensure that consumers as a whole are not left to pay more than is necessary to deliver a truly sustainable energy market and that they have the opportunity to register their concerns in a way which is listened to and delivers improvements.

As we look to the challenges of the here, now and future, we should not forget what we can learn from our experiences, even though, in the case of utility regulation, that history may be relatively short. At times during the last 10 years there have been some important debates on the nature of the regulatory structures that we wanted.

For instance, the 1997 change of government brought about a different view of regulation—previously seen as a “light hand” to curb abuse of monopoly power in former nationalised industries released from the “dead hand of government”. This change first became evident formally in the 1998 *Fair deal for consumers* consultation paper, which set out some key points that still resonate today.

The green paper:

- sought to ensure all consumers had access to competitive supply as a mechanism to help keep costs as low as possible;
- suggested consumer representation be provided by a statutory body—which became energywatch—independent from the economic regulator; and
- asked the regulator to develop a Social Action Plan to set out how it could contribute to reducing fuel poverty.

Overall, the consultation paper was an important statement of commitment to the competitive regime by the new government and one that was written through the subsequent Utilities Act 2000. Importantly it also empowered ministers with an ability to give Ofgem guidance on environmental and social matters, an issue that continues to be actively debated today.

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<sup>1</sup> BERR Strengthen and streamline consumer advocacy <http://www.berr.gov.uk/consultations/page29878.html>

Outside of specific energy legislation there have been some important developments in the regulatory world that concentrate on the how rather than the why of regulation. The Better Regulation Task Force has made a number of pertinent recommendations, four of which are worth highlighting. It said regulators should:

- include a clear explanation of how they will prioritise their different objectives in their annual business plans;
- produce quantified assessments of costs and benefits for proposals with a significant impact;
- make sure they engage as fully as possible when consulting with stakeholders; and
- take measures to reduce unnecessary regulation, including the lifting of price controls from sectors that no longer require them.

Last autumn the House of Lords select committee on economic regulators produced a very timely report<sup>2</sup> that made a number of useful points in a constructive manner. They were keen to see a clear distinction between the spheres of politics and regulation—a very important point in a sector like energy where so many areas of policy from social to environment are important to voters. They made a particular point of this in reference to Ofgem saying the “government will need to be careful to ensure that Ofgem is not sent mixed messages.” They also said regulators should be given a clear statutory steer on how their duties should be prioritised.

More practically, the committee also made some sensible commitments about improving impact assessments especially with regard to measuring the impact of specific proposals after their implementation. It also said regulators and competition authorities needed to improve “the timing and content of their investigations of particular markets.” They specifically said “where possible, utility regulators should look to bring more cases to the competition authorities and that the regulators should work to ensure that the cases most likely to establish useful precedents are brought to the Competition Commission.”

Most recently, the government through the Better Regulation Executive (BRE) has also launched a review of the consumer protection regime<sup>3</sup> looking at where legislation can be simplified, while ensuring the public gets a fair deal and high-quality products.

### ***The dangers of insufficient regulatory oversight***

Perhaps if Ofgem had received this advice a number of years ago the heavily regionalised nature of household energy supply competition would have been given greater attention than it has to date. Although the government is fond of portraying the British energy markets as one of the most competitive in the world, this glib assertion masks the reality that it is in reality a highly concentrated collection of regional markets.

This unforeseen outcome is a direct function of the evolution of the Big Six through corporate transactions rather than direct competition for consumers. None of the transactions that created the Big Six has been properly scrutinised by the competition authorities even though there has been significant erosion in competition. For example no objections were raised by

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<sup>2</sup> House of Lords select committee on economic regulators report  
[http://www.parliament.uk/parliamentary\\_committees/lordsregulators.cfm](http://www.parliament.uk/parliamentary_committees/lordsregulators.cfm)

<sup>3</sup> BRE Consumer Law Review <http://www.berr.gov.uk/bre/reviewing-regulation/protecting-consumers/page44093.html>

Ofgem as the sectoral regulator when a scale player—TXU—failed in 2002 and its 5.5mn consumers were acquired by E.ON UK.

To compound this lack of oversight Ofgem, the competition authorities and policy makers have not correctly exercised due attention concerning the degree of vertical integration between production and supply that has been allowed without regulatory challenge. Their vertical integration keeps quantities of power traded on wholesale markets low. The relationship between the wholesale sector and the retail is therefore now a major concern, and the similarity in suppliers' prices and pricing structures is alarming. Yet all the companies have quoted different percentage rises in wholesale gas costs, and all have different electricity generation and hedging strategies. Some believe there is a strong case to be answered by the Big Six with regard to collusive pricing.

Almost five years ago the parliamentary Public Accounts Committee warned that Ofgem should take seriously the risk that vertically integrated companies may exploit their position, and that the regulator “should adapt its competition analysis of the wholesale market and the retail markets to reflect the new reality of the market”. Despite this, there have been no studies of the implications of this reintegration, either in terms of the retail market impacts or the state of wholesale trading (or the interactions between the two). The pervading feeling among consumer groups is that our regulators have failed to act for no good reason.

This position has given rise to a situation where large incumbent players enjoy strong market power and where many consumers choose not to switch possibly because the cost and hassle of doing so outweighs the benefits. This situation on the ground by no means reflects the vigorous or effective competition that our policy makers and regulators set out to achieve and whose existence they often invoke.

Prior to 2002, as an important part of the process of setting supply business price controls for each company, Ofgem exercised a thorough—some would say intrusive—supervisory role over both gas and electricity supply businesses. As part of this oversight process the regulator would routinely check the allocation of wholesale purchase contracts against different consumer classes to ensure that consumers with less choice were not treated in a discriminatory manner. In April 2002 Ofgem concluded that retail markets were sufficiently competitive to remove the remaining price controls, despite many questioning this assertion. At that point in time areas of the market were identified as potentially problematic for consumers, especially the treatment of prepayment meters and consumers in Scotland with teleswitching. These issues have not been addressed properly although six years have since passed.

Recently the NAO set out what it thought of Ofgem's decision to remove supply price controls. This included some very sensible advice for the regulator as it cautioned that not all consumers had “been able to apply competitive pressures ... markets through switching.” It then thoroughly debunked the relevance of switching as a measure of consumer benefit because it said “some problems remain” particularly for vulnerable customers who “are still unable to take full advantage of the competitive market for a variety of reasons, including complex tariffs and a lack of easily accessible, trustworthy, relevant, understandable and comparable information.”

The NAO continued in this vein, noting that, with some incumbents continuing to hold strong positions in their original markets, there remained a need for regulators “to continue to use their competition and consumer protection powers to ensure that markets continue to protect the consumer and that consumers can take further advantage of competition.” These comments

on the reality of the most competitive retail markets in Europe if not the world simply do not chime with what often passes for cheerleading that emanates from Ofgem.

So its shopping list for Ofgem is worth attention. It said Ofgem should:

- work more closely together with other sector regulators and the OFT to understand better and engage with consumers, and develop their expertise in behavioural economics;
- understand if gaps in information provision exist and, where necessary, work with others to resolve any shortcomings; and
- ensure suppliers provide key information in a more consumer friendly format and through more accessible channels.

The NAO said Ofgem should push for a memorandum of understanding with Berr, the new National Consumer Council and the Office of Fair Trading on information for energy consumers under the new consumer representation arrangements, including on quality of service. We consider this essential: regular and well-regarded information on suppliers' service to their customers should not be allowed to die with energywatch.

### **Areas for improvement**

Despite what the Public Accounts Committee, the NAO, House of Lords Committee and others have recommended since the removal of price controls, Ofgem has produced only occasional reviews on the state of competition. When analysis is presented it has tended to focus almost exclusively on national switching levels or point to supply limitations and competitive bottlenecks on the continent; and to attribute price excursions to "market sentiment". Its most recent analysis from June 2007 is on the domestic market and based on data as at end March 2007 and is over a year old. It has not issued any analysis on the business markets since summer 2003.

Its supply market probe may address the former—it will probably do nothing for the latter—subject to one proviso. This concerns whether the probe has been launched as a whole-hearted attempt to measure the state of competition in Britain's energy markets. Reading the regulator's comments on launching it back in February does not create that impression. Then Alistair Buchanan, the chief executive of Ofgem, said "We, of course, keep the market under constant surveillance but to date we have seen no clear evidence that the market is failing." Again there was no analysis presented in support of these statements. energywatch finds it extremely disconcerting that the industry regulator—whose primary duty is the protection of consumer interests—seems to be making the case for energy suppliers' price movements.

It is also disingenuous for the regulator (as it has consistently done) to represent prices from the wholesale forward curves as representative of suppliers' costs when the leading players are significantly integrated. It has itself highlighted the ability of upstream electricity producers to earn windfall gains from carbon both in the past and, more recently, going forward. In fact we would say it is mutually inconsistent for the regulator to highlight this practice and then assert retail markets—which are the means of recovering these arbitrary costs from consumers—are properly competitive, as it has done consistently over the past few months.

I believe part of the reason why these issues have arisen highlight the difference between the theory of regulation provided for in the statute and the reality of regulating a sector dominated by a handful of integrated players who are very adept at managing their regulatory relationships.

At energywatch we have our own take on structural problems in the market and how they might be addressed. They include:

- vertical reintegration has gone much too far and is actively deterring the evolution of healthy liquid markets and is possibly distorting retail prices. The problems are not all in mainland Europe, many of them are here. Ofgem should be considering how to stimulate trading and making internal transactions and inflated transfer prices more visible;
- cash-out (where a supplier faces charges for being unable to balance their supply and demand exactly) especially in electricity is penal and creates competitive distortions. Ofgem has admitted as much, and we need to see early reform;
- central traded arrangements are much too complex and expensive and need to be simplified. Market rules are used to deter new entry by the incumbents, who control the rule change assessment processes and deter increased market transparency;
- the centralised markets are remote from the legitimate concerns of environmental groups and representatives of smaller players, and access to them needs to be increased;
- we are Europe's marginal gas market at a time when Brent crude oil prices are breaking new records on a regular basis and forward gas prices have hit the never seen before price of £1 a therm; and
- the regulatory framework is becoming less intrusive for companies, with price controls lifted and "self-regulation" becoming more prevalent despite continuing hardship for many customers.

### ***The growing importance of self-regulation***

I want to pay some attention to an important and growing aspect of energy market regulation. This is the so-called "self-regulation" of certain aspects of the market by the Big Six supplier participants themselves, generally under the auspices of their representative group, the Energy Retail Association. Self-regulation looks set to become a progressively more important area of the energy market and its effectiveness will be an important determinant of how customers perceive it, particularly after the demise of energywatch.

The early days of household competition brought a number of challenges for consumers and the regulatory framework. Many concerned industry operations and practices in a very new competitive market, and these have generally been addressed, although not always as quickly or thoroughly as we would have liked through self-regulation in an increasingly concentrated industry structure.

There are three such challenges where we have seen reliance on self-regulation, including:

- mis-selling and erroneous switching—there were very many instances in the early years of full market deregulation of consumers switching their supplier due to error or misrepresentation and even fraud by suppliers' agents. This practice has been much reduced now, not least thanks to energywatch campaigning, which prompted the major suppliers to introduce a self-policed code of practice in 2003. From a regulatory perspective, it is important because it marked one of the first major instances of an outcome delivered through Ofgem looking to the industry to develop its own solutions. International standards

such as BS ISO 10001- *Quality management – Customer satisfaction – Guidelines on codes of conduct for organizations* can provide a base for reference;

- poor billing—poor accounting and information management systems led to billing mistakes: customers received bills from old and new suppliers; bills did not arrive for six months, a year or—in one case—seven years; and customers were asked to pay accumulated debt immediately. In 2003 we estimated that up to 5mn consumers may have received inaccurate, estimated bills. Even now, roughly 35% of bills sent to consumers are based on estimated meter readings. In other words, they’re wrong. The solution, in which energywatch under powers we got from the Enterprise Act 2002 played a key part, was to make a “super-complaint” on an issue that we felt was significantly harming consumer interests. The outcome of the super-complaint was that the regulator outlawed back-billing beyond one year. energywatch also initiated and took part in the development of a national standard on billing - BS 8463: 2005 *Specification for customer billing practice*, which can be applied by various industries;
- Redress - the super-complaint also stimulated the development of the Energy Ombudsman redress scheme to resolve deadlocked consumer complaints by the Big Six domestic suppliers, and this scheme went live in July 2006. Due to energywatch’s continual lobbying efforts there has been a recent departure in Ofgem’s traditional approach to the market. The CEAR Act<sup>4</sup> required the regulator to put a new complaint handling standard in place – this reflected concerns that liberalisation had not delivered sufficient investment in and high standards of customer service. International standards BS ISO 10002:2004 *Quality management - Customer satisfaction – Guidelines for complaints handling in organizations* and BS ISO 10003: 2007 *Quality management - Customer satisfaction - Guidelines for dispute resolution external to organizations* have been applied in the process. The new standard represents a back to basics approach which will ensure that companies put new and robust complaint handling processes in place. Whilst it is a positive development, it is also unfortunate that this approach is having to be taken over 10 years after market opening. The next challenge for energywatch’s successor body will be to ensure the new regulations delivers a sea change in the companies’ attitude to complaints and their overall performance standards; and
- bringing the benefits of competition to all consumers, including the vulnerable—these consumers may be elderly, have a disability or a long-term illness; they may have young children, or they may simply be poor. There are presently 4.5mn households in Great Britain that suffer from fuel poverty as they spend more than 10% of their income on heat and light. Unfortunately, recent price increases mean that more people face the “heat or eat” choice despite the voluntary efforts by at least some of the Big Six to offset the worst of the increases for their most vulnerable customers. Earlier these companies had learnt the hard way that disconnection can bring bad publicity even if it “solves” problems with individual consumers. But, alongside a self-regulatory protocol on disconnection, their solution was a shift to much higher-priced prepayment supply terms for many vulnerable users that effectively forces the consumer to “self-disconnect.” There is increasing political pressure on suppliers to do more in this area, and use carbon windfalls to mitigate hardship rather than further reward shareholders. While the regulator has benchmarked social

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<sup>4</sup> The Consumers, Estate Agents and Redress (CEARA) Act 2007 <http://www.berr.gov.uk/consumers/consumersbill/index.html>

measures presently offered by suppliers, many, including energywatch, believe this is an inadequate response.

### ***Future challenges***

Stimulated by the perceived success of some of these measures, the Consumers Estate Agents and Redress Act 2007 provides that the complaint handling function currently undertaken by energywatch will in the future be delivered by a combination of a mandatory redress scheme and complaint handling standards prescribed by the regulator.

The theory sounds good, but many of the advances in dealing with customer service challenges faced to date have been secured purely because of the efforts of energywatch exposing poor practice and escalating consumer grievances. Without proper investment in comparable resource in future, there are real risks that the streamlined structure going forward has been set up to fail at a time when the policy framework will inexorably become more challenging and much more will be expected by the industry.

energywatch's role will be replaced by increased expectations on energy companies to take direct responsibility for resolving their own customers' complaints. Our concern is that these arrangements have never been put to the test, and energywatch has always at hand to assist the millions of consumers whom these companies have failed. It is therefore vital that the statutory redress scheme is capable of effectively resolving individual consumer disputes and delivering the necessary performance incentives on industry.

But increasing policy complexity means the role of the economic regulator becomes all the more important as the guardian of the consumer's interests. It will need to ensure that the investments that are needed to meet policy imperatives of increased security of supply and low carbon—and consumers have shown themselves very willing to pay for—are delivered at a price that is reasonable and does not unnecessarily further aggravate the position of the vulnerable. This imperative means, for example, that big incumbents are not able to hide behind high barriers to entry to competitive markets and earn excessive returns, for instance by delaying investment and pushing up prices. It also means that monopoly asset owners and operators are given tough but fair price controls so they can deliver the infrastructure enhancements that are needed to keep supplies flowing.

### ***Development, promotion and protection of consumer rights:***

Liberalisation of European markets won't work unless consumer interests and not energy companies' interests are protected. As the bitter experience in GB has shown, opening markets to competition is pointless unless consumers are the beneficiaries. The European Commission is set on a course of failure unless effective consumer protection and safeguards against energy poverty are built in to the liberalisation project at the start. The currently proposed 'European Energy Consumer Checklist' and annual 'European Citizens' Energy Forum' alone will not be sufficient protection mechanisms and will not be sufficient substitutes for the complete energy consumer rights.

The 3<sup>rd</sup> energy package is currently being progressed through the European Parliament and Council. We believe the 3<sup>rd</sup> package provides a real opportunity for developing, promoting and protecting the rights of energy consumers in the liberalised markets. A number of the key

rights<sup>5</sup> that should underpin energy consumers' experience of and engagement in the energy market are already set out in existing European legislation for example protection against unfair commercial practices for domestic energy consumers and the right to universal service in electricity. However, we believe a number of significant improvements could be made to both the gas and electricity directives through the 3<sup>rd</sup> package negotiations for example consumers to receive a final bill from their old supplier within a month of changing to a new supplier, a requirement to inform consumers about their rights and dispute procedures, access to a complaints process where disputes must be settled fairly within 3 months, a requirement for smart meters to be rolled out within 10 years and measures to protect the fuel poor. The key principles that should underpin consumer engagement in the liberalised markets are summarised at appendix A. It is worth noting that it is not enough for consumers to have their rights enshrined in legislation, they must be informed about their rights and have the confidence to exert these rights. In addition these rights must be actively enforced by the regulators and competition authorities.

### **Summing up**

In conclusion I hope my brief remarks have been able to show how:

- economic energy regulation as we currently understand it is a relatively new concept and one where we are still very much in learning mode;
- economic energy regulation has also evolved through learning-by-doing. Given the scale of new policy challenges—including combating climate change and securing long-term energy supplies—we can expect this characteristic to continue;
- politicians are never far away from the energy sector and its regulator whatever the legislation might say. As a market for essential products and where extra-market subsidies already exceed £1bn/year, this is hardly surprising;
- there has been a trend to self-regulation in Britain which has delivered some initial— though we would argue limited— successes and the signs are this is to be developed significantly in the coming years; and
- the success of the regulatory framework depends on a large part on the ability and willingness of the delegated body to fulfil its remit. I have suggested energywatch believes Ofgem could be doing more to ensure the competitive energy markets continue to deliver benefits to all British energy consumers.

All in all, there are many challenges that need to be addressed as we evaluate the future for the regulatory regime. We are at a critical junction now—not least through the replacement of energywatch by Consumer Voice— and many of the issues we are debating have been well-honed over the past decade and will continue to require attention. But I hope I have shown there are some sensible learning points out there to be taken forward and some as well as some areas where we may need to look for real pitfalls.

Thank you for your attention.

Allan Asher

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<sup>5</sup> Energy Consumer Rights – See Appendix A

## **Appendix A: Key principles**

### **Principle 1 ACCESS**

All energy consumers have a right to security of supply and each energy consumer has the right to receive energy services to meet their basic needs without impediment or discrimination, unless there is wilful refusal to pay for supply.

### **Principle 2 CHOICE**

Each energy consumer has a choice of fair and competitive pricing and safe and high quality services, is free to choose or switch a supplier and has the information or support needed for making a choice.

### **Principle 3 FAIRNESS**

Each energy consumer is treated fairly, protected against unfair commercial practices and is able to enter a fair arrangement for supply.

### **Principle 4 CUSTOMER CARE**

Each energy consumer has a right to services to ensure the safety of installed supply; a minimum level of customer support and quality of care; and sufficient accurate, easy-to-understand, visible and accessible information to enable them to make decisions about consumption, services and supply.

### **Principle 5 CUSTOMER SUPPORT**

Each energy consumer is given clear guidance on their rights and responsibilities, how to resolve problems and free and fair assistance with resolving problems where required.

### **Principle 6 MEDIATION & REDRESS**

Each energy consumer has access to free and fair alternative dispute resolution, speedy resolution and compensation for loss or infringement of rights. Vulnerable consumers receive assistance for mediation.

### **Principle 7 PROTECTION**

Energy consumers are protected against disconnection from supply and recovery of debt is flexible and based on ability to pay and takes full account of an individual's circumstances

### **Principle 8 SPECIAL ASSISTANCE**

The existence of consumer vulnerability is identified and special help is given to energy consumers who are in vulnerable circumstances

### **Principle 9 INFLUENCE**

Energy consumers are individually and collectively able to exercise real influence on policies, regulations and practices that affect their interests and welfare

### **Principle 10 SUSTAINABILITY**

Energy and services are delivered in a way consistent with sustainable development and the interests of future consumers and consumers understand their responsibility for sustainable consumption.