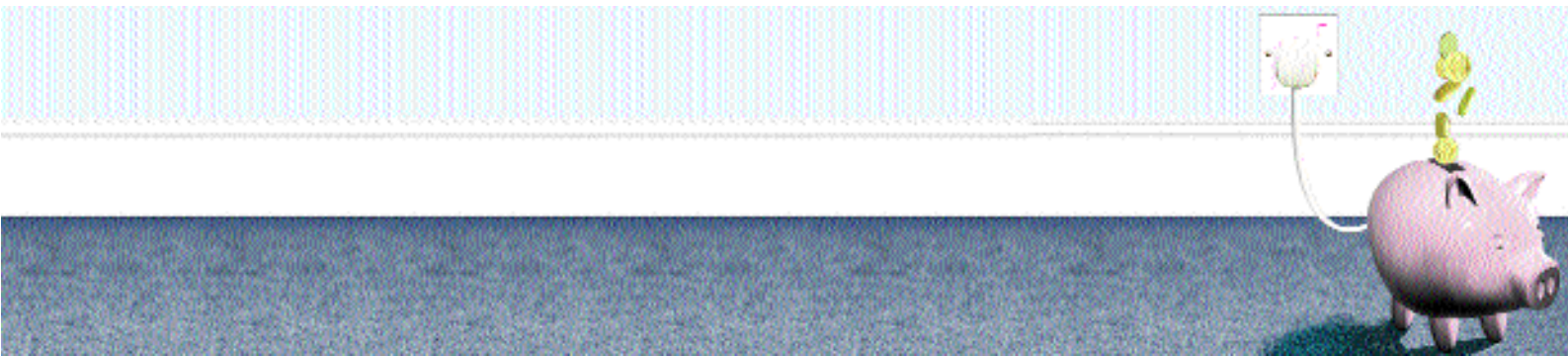


Office of Gas and Electricity Markets

# Giving Domestic Customers a Choice of Electricity Supplier



REPORT BY THE COMPTROLLER AND AUDITOR GENERAL  
HC 85 Session 2000-2001: 5 January 2001

# executive summary

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## This report examines the impact of electricity supply competition on domestic customers

- 1 The 26 million households in Great Britain spend some £8 billion each year on electricity. For most households electricity is a small part of expenditure, but four million low income households spend more than 10 per cent of their income on fuel to heat their homes. Since May 1999 all domestic electricity customers in Great Britain have been able to choose which company supplies their electricity. This represents a major achievement by the Office of Gas and Electricity Markets (Ofgem), the industry's regulator, which has since January 1999 been headed by Mr Callum McCarthy<sup>1</sup>. It would also not have been possible without the co-operation of the companies involved in the supply of electricity. By June 2000, 6.5 million customers, one in four, had exercised their choice to change their electricity supplier and every month some 400,000 customers were changing supplier.
- 2 Successive Governments have taken the view that competition is the best way to protect customers' interests because it increases choice and gives companies an incentive to lower prices and improve customer service. Fourteen regional electricity distribution and supply companies were established at privatisation, in 1990 and 1991, and were initially given a monopoly of supply to domestic and smaller business customers in their areas. The sale prospectuses of these companies stated, however, that the Government were committed to introducing competition in electricity supply for all customers by 1998. Meanwhile, to protect customers from the electricity companies' local monopoly, Ofgem have regulated prices and quality standards.
- 3 In line with Government objectives, Ofgem introduced domestic electricity supply competition during September 1998 to May 1999<sup>2</sup>, following the introduction of competition into the domestic gas market between 1996 and 1998. Ofgem will continue to regulate the prices and quality standards of electricity suppliers until they consider that competition is sufficient to meet their principal statutory objective of protecting the interests of consumers, having regard to their other duties including the protection of vulnerable groups.
- 4 Preparing the systems of the electricity companies for domestic competition cost the companies some £850 million and took five months longer than originally planned. In the absence of statutory powers to require electricity companies to co-operate with the implementation process, Ofgem encountered project management problems, which provide lessons for future

<sup>1</sup> Mr Callum McCarthy was appointed Director General of Gas Supply in November 1998 and Director General of Electricity Supply two months later. The Offices that he headed, the Office of Gas Supply (OFGAS) and the Office of Electricity Regulation (OFFER), have since merged to form Ofgem. The Director General posts will be replaced with a board, the Gas and Electricity Markets Authority. Mr Callum McCarthy is the Chairman-designate of the new Authority.

<sup>2</sup> Competition was introduced into the small business market at the same time. Larger users of electricity could already choose their supplier by September 1998.

projects of this nature. Ofgem have allowed companies to recover an additional £121 million a year from customers on average between 1998-99 and 2004-05 to meet the additional costs they incurred<sup>3</sup>.

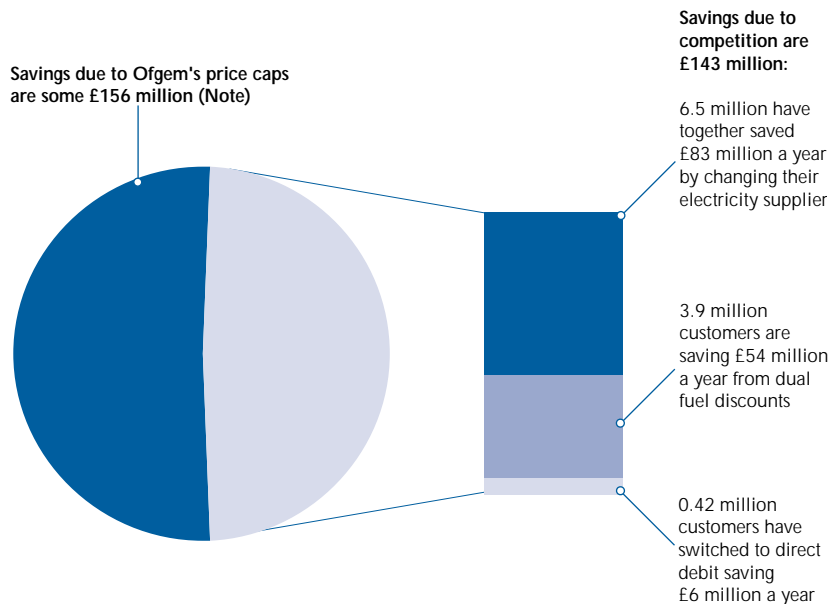
- 5 This report examines the extent to which domestic customers have benefited from electricity supply competition, through reduced prices and improved services, and what more Ofgem could do to sustain and extend the benefits. In doing so we have considered the impact on customers of changes made to the price controls that Ofgem apply to electricity distribution and supply companies. We have also compared the impact of competition with other countries and sectors of the British economy, and taken account of our previous report, and the subsequent report of the Committee of Public Accounts, on the introduction of competition into gas supply<sup>4</sup>.

## Main Findings

### Competition has reduced electricity bills for many customers although some have experienced problems

- 6 The 6.5 million customers who had changed their electricity supplier by June 2000 have together seen their bills fall by £299 million since the start of competition. This is a 15 per cent reduction in real terms, an average of £45 per customer<sup>5</sup>. About half of this reduction is attributable to competition (Figure 1).

- 1 The 6.5 million domestic customers who have changed their supplier have saved 15 per cent of the electricity bills in real terms since the start of competition, half of which is due to competition and half due to price cuts



Note: These savings are due to Ofgem's controls over the prices transmission and distribution businesses charge suppliers for their network services.

Source: NAO analysis

3 Ofgem had initially allowed the companies to recover £726 million over five years and gave this figure to the House of Commons Trade and Industry Select Committee in 1997. Ofgem increased the amount the companies were allowed to recover, and extended the period of recovery to seven years, after companies supplied new information on the costs they had incurred.

4 Office of Gas Supply: Giving Customers A Choice – The Introduction of Competition into the Domestic Gas Market (HC 403 (1998-99) 12 May 1999) and the Committee of Public Accounts' 8th Report, HC 171 (1999-2000) 3 February 2000. The Committee's recommendations are set out in Appendix 1.

5 The range of tariffs offered by domestic suppliers, and variations in consumption, mean that customer savings vary substantially and few customers have saved precisely this amount.

- 7 Customers who have not changed supplier have also seen their bills reduced since competition was introduced. Ofgem's reduction of price caps for the distribution and supply companies since competition began means that customers who have not switched are paying lower prices overall by some £450 million a year (eight per cent), an average of £23 per customer. Competition has allowed Ofgem to develop a clearer view of costs and available price reductions, and Ofgem believe that competition may also have helped force down the prices paid to electricity generators for the electricity they supplied. It may be therefore that supply price caps from April 2000 were lower than would have been the case in the absence of competition.
- 8 Of about 19 million customers who have remained with their existing supplier, four-fifths (15.4 million customers) have not yet, however, made any financial savings, beyond those arising from the reduced price caps, on account of supply competition. This is because most of the 'incumbent' electricity companies that supply their electricity have not reduced their prices below Ofgem's price caps in response to competition. The remaining 4.2 million customers have made savings due to competition in that their existing suppliers have reduced their tariffs a little below Ofgem's price caps. The savings to such customers have been mostly no more than £2 a year<sup>6</sup>.
- 9 All customers are paying an extra £4 each year on average to meet the costs companies incurred in introducing competition, which means that customers who have not switched have not benefited financially to any significant extent since competition was introduced, and some may have lost out slightly. Customers who have not switched have, however, been able to benefit from a greater range of tariffs and complementary products (such as gas) offered by their existing suppliers.
- 10 By June 2000, some 25 per cent of domestic customers had changed their electricity supplier – a slightly higher proportion of customers than had changed gas supplier one year after gas competition was introduced (23 per cent). The rate of switching in the gas and electricity markets is higher than in many other British markets and overseas electricity markets. Most customers who change supplier do so in response to direct contact from a supplier, often home visits by suppliers' sales agents and the relatively high level of switching in the electricity market is attributable to the effectiveness of this marketing technique. Doorstep selling has, however, given rise to complaints from customers, for example that sales agents had misled them about the savings they would achieve if they switched or they had been switched without giving their consent. In the first year of electricity supply competition there were some 4,900 complaints. This represented 1.06 complaints per thousand electricity switchers, a similar position as in the first year of domestic gas competition.
- 11 Although most customers who changed supplier found switching easy, there is a large variation in how long it takes to complete transfers to new suppliers. In the first two years of domestic electricity supply competition, some 18,800 customers experienced problems with the switching process. Complaint statistics suggest that the customers of some of the new suppliers are much more likely to have received a poor service after they have switched, for example inaccurate and delayed bills. The standard of service provided by the incumbent suppliers to those who have not changed their supplier has remained at a high level during the transition to competition and since.

Customers who have remained with their existing supplier are better off due to changes to price controls, but have not otherwise benefited financially to any significant extent

Switching levels in the domestic electricity market are relatively high

Customers who have switched supplier are more likely to have complaints about the service they receive

<sup>6</sup> An exception is 250,000 customers who have not switched electricity supplier but are nonetheless benefitting from dual fuel discounts worth £2.9 million a year, or over £11 a year each, because they now buy gas from their local electricity company.

Although there have been problems, most customers find changing supplier easy

12 Although problems in changing supplier reported by customers are likely to understate the number of customers experiencing problems, surveys nevertheless suggest that those experiencing problems are a relatively small proportion. Responsibility for maintaining supply to customers rests with distribution businesses and has not, therefore, been directly affected by competition among suppliers. In September 2000, Independent Energy, a new supplier with 240,000 electricity customers, went into receivership but these customers continued to receive a supply of electricity on the same terms, because another company agreed to take them on.

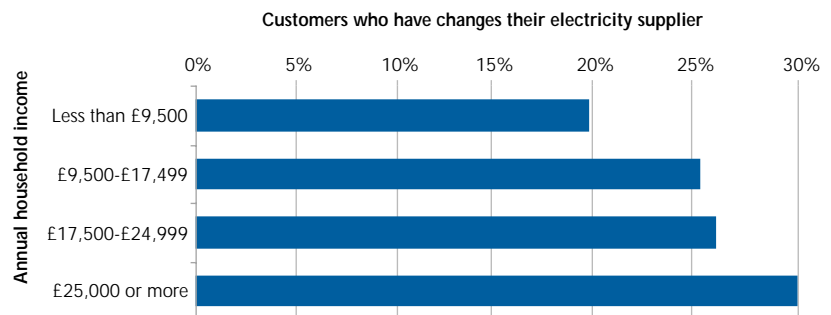
There are variations in the proportion of customers who have benefited financially from competition between different parts of the community

How customers pay for their electricity and where they live has a significant effect on the likelihood that they will change their electricity supplier

13 A survey in May/June 2000, which we commissioned in association with Ofgem, disclosed significant variations in the proportion of customers who had switched electricity supplier:

- a) Rural customers are less than half as likely to have changed their electricity supplier than those who live in urban areas. This is probably because many customers change their electricity supplier in response to a visit from a sales agent, and direct marketing of electricity has so far been less intensive in rural areas.
- b) The proportion of domestic customers switching supplier, and hence paying lower bills, is lower than average amongst poorer households (Figure 2). A major reason for this disparity is that a higher than average proportion of poorer households use a prepayment meter. Customers who use a prepayment meter cost more to serve (even allowing for the greater certainty of income), and few companies compete with the incumbents' tariffs. Ofgem allow the incumbents to recover some of the additional costs of supporting such meters by charging up to £15 a year more to the customers concerned<sup>7</sup>.
- c) Scotland has relatively more rural customers and customers using a prepayment meter than the rest of Britain. Even after allowing for this, a smaller proportion of customers in Scotland have changed their supplier than in England and Wales. This may be because fewer electricity suppliers have actively marketed electricity in Scotland, which reflects the smaller size of the market, the high degree of customer loyalty to the two incumbent suppliers and the more limited scope to offer dual fuel deals due

2 Fewer customers on low incomes have changed their electricity supplier than others have



Source: NAO/Ofgem survey May/June 2000

7 In October 2000, the average additional charge was £12, ranging from £0 in one case to £15 in six cases.

to the lower penetration of gas in northern Scotland. The different market structure whereby the incumbent suppliers also own the generation, transmission and distribution businesses in Scotland may also have had an effect.

## Ofgem are acting to help more customers benefit from competition

- 14** The 19 million customers who have not switched supplier could save up to £674 million, or 13 per cent of their annual bills were they to switch. Before that happens there should come a point when incumbent suppliers' reduce prices in their home regions to stem the loss of customers, as has already happened in the domestic gas market. Ofgem have therefore sought to help domestic customers benefit from electricity supply competition:
- a) They have sought media coverage for the savings available to domestic customers in the electricity market. Most customers are aware that they can choose their electricity supplier. Research commissioned by the Department of Trade and Industry has shown, however, that many do not know the level of savings available or the names of alternative suppliers, and hence few customers shop around for the best deal and switchers have tended not to obtain the largest savings available in the market.
 

Ofgem have sought to alert customers through the media to the savings available by changing supplier
  - b) They have made increasing amounts of comparative price and service information available to the public via a freephone helpline and website. These services reach relatively few customers, but Ofgem are investigating whether requiring suppliers to disclose prices in a standard format would make it easier to draw comparisons, a task many customers find difficult. Information on quality of service is, however, still hard to obtain.
 

Ofgem are seeking to help customers identify the best deal
  - c) They introduced new licence conditions governing selling practices in September 1998 following earlier complaints about the doorstep selling of gas. Complaints about unfair selling practices in the first year of electricity competition were at a similar level to the first year of gas competition and Ofgem therefore continue to monitor and take action on such problems.
 

Ofgem have sought to combat high pressure and misleading selling practices
  - d) They are considering, in a fundamental review of the transfer process, how far aligning the different gas and electricity transfer processes could reduce the delays experienced by some customers.
 

Ofgem are seeking to streamline the transfer process
- 15** Domestic electricity suppliers have so far competed mainly on price rather than on service, but Ofgem believe supply competition should eventually remove the need for specific regulation of customer service. Meanwhile, Ofgem regulate the quality and range of services suppliers provide. Ofgem recognise the need to improve their monitoring of customer service, and will be working with the new Gas and Electricity Consumer Council<sup>8</sup>, known as energywatch, to develop appropriate mechanisms.
 

Ofgem are seeking to improve their monitoring of customer service
- 16** The market is less well developed for prepayment meters and fewer prepayment customers have switched. Many suppliers consider prepayment meter customers to be unprofitable at current price levels and competition should tend to make tariffs more closely reflect costs. If Ofgem lift price controls over the incumbents' prepayment meter tariffs they may, therefore, need to develop other ways of protecting such customers if they wish to avoid increases in the relative prices they pay. Ofgem are already taking or considering several actions to help protect prepayment meter customers:
 

Ofgem will need to continue to protect customers who pay by prepayment meter until the market is competitive

<sup>8</sup> The Gas and Electricity Consumer Council was established under the Utilities Act 2000. The Council, also known as energywatch, will take over from Ofgem the handling of complaints from electricity consumers, advising and informing them, and representing their views.

Ofgem are seeking to protect the interests of prepayment meter customers and help them benefit from competition

- a) They believe that competition would be strengthened if suppliers lost their right to block customers with outstanding debt from changing supplier, and are consulting on removing or curtailing this right, while protecting suppliers' rights to recover debt.
- b) From October 2000, they have required suppliers to inform prepayment meter customers who are not in debt about cheaper ways to pay for their electricity. Many customers begin to use a prepayment meter when they move into a new home already equipped with one. Because suppliers incur costs when customers change their meter there was before then a risk that they might not tell customers about cheaper alternatives.

**17** Ofgem research shows that many customers using prepayment meters prefer this method of payment, and some cannot switch to paying by cheque or direct debit because they do not have a bank account. New technology, however, offers opportunities to reduce the costs of prepayment meters, and Ofgem are exploring alternative payment methods for those without a bank account.

Ofgem are seeking to minimise barriers to entry and ensure all suppliers are able to compete on an equal footing

**18** The possibility that new companies will enter the market places competitive pressure on existing suppliers, but fewer new companies have so far entered the domestic electricity market than the domestic gas market and entry barriers are higher than in the gas market. The Utilities Act 2000 provides Ofgem with powers to reduce barriers to competition and help ensure that suppliers can compete on equal terms. For example:

- a) Ofgem are empowered by the Act to prevent the same company from both supplying electricity and providing electricity distribution services, which should reduce the risk of distribution businesses giving their own supply business preferential treatment.
- b) Ofgem consider that the lower rate of switching in Scotland relative to England and Wales is due in part to the dominance of the two incumbent electricity suppliers in Scotland (paragraph 13c above), and the different wholesale trading arrangements in Scotland. The Act provides for separating the ownership of distribution and supply businesses in Scotland, and for creating separate electricity transmission companies for Scotland. Ofgem plan to align the wholesale trading framework in Scotland with that in England and Wales in 2002.

Ofgem are addressing issues in Scotland, where a smaller proportion of customers have switched supplier than in the rest of Great Britain

Ofgem expect that price reductions arising from competition will be sustainable

**19** Ofgem expect the competitive market to continue to deliver choice and value for customers. They consider that larger savings could be achieved if suppliers seek to build a competitive advantage by driving down the 'wholesale' cost of electricity they buy from generating companies, as wholesale electricity prices are about half of the price of electricity to customers. They believe that the new framework they plan to introduce in 2001 for buying and selling electricity on the 'wholesale' market<sup>9</sup> will aid this process. 'Wholesale' prices are, however, also affected by other factors such as fuel costs and Government encouragement of generators to switch to renewable fuel sources, which could cause prices to rise.

<sup>9</sup> The new framework for trading electricity is known as the New Electricity Trading Arrangements. Ofgem had intended to introduce the new trading framework in November 2000. Following problems with systems testing, in October 2000 they announced a new target date of 27 March 2001 for implementing the new framework.

# Recommendations

## For customers and suppliers

20 The achievement of the Government's objectives for introducing competition into the domestic supply of electricity ultimately relies on customers. We recommend that customers, if they are to benefit fully from electricity supply competition, should review whether their current electricity supplier best meets their needs. They should take into account prices, quality of service and the scope for deals that can provide a range of services, including gas, from a single supplier, especially where the supplier offers a discount for doing so. We recommend suppliers to help by keeping customers informed of the scope for benefits and of the latest developments. Suppliers may also be able to take advantage of changes in the way that electricity generators sell electricity and the availability of new technology, such as the internet, to offer customers better deals.

## For Ofgem

21 Ofgem have an important role to play in helping customers and suppliers make the most of the new market in domestic electricity. While Ofgem have taken many actions to help develop a competitive market for electricity, we consider that there are other actions that might prove worthwhile:



- i **Improve customers' awareness of how to benefit from competition.** If customers are to benefit from competition, they need to be able to make informed decisions as to whether it is worth changing supplier. Although most are aware of competition, many are not aware of the savings available, alternative companies in the market, and the different ways of paying for electricity. Many customers who have switched have relied on doorstep selling for their information, which has meant that switching levels have been lower in rural areas. Ofgem have sought media coverage for the financial savings available and have published comparative price information on their website. Ofgem in 1999 distributed a leaflet, produced jointly with the National Audit Office, to gas customers, and we have recommended that Ofgem should help us to produce a similar leaflet for energywatch to distribute to electricity customers.
- ii **Improve the accessibility of price and service information.** The increasing range of tariffs and services available from suppliers has made it harder for customers to compare prices. Information on quality of service is hard to come by, and competition has largely been on price so far. Ofgem should press ahead with their research on the feasibility of requiring suppliers to disclose prices in a standard format to make comparisons easier, and consider extending this to include customer service information. They and energywatch should also consider raising the profile of the comparative price and service data they continue to produce to the extent that energywatch have not taken on these responsibilities.
- iii **Act to reduce the problems customers experience when they change suppliers.** Some customers have experienced problems when switching supplier such as misleading information from sales agents or delays in the transfer process. Although such problems have so far affected a small proportion of customers, the bad publicity engendered could erode consumer confidence. Ofgem therefore need to be able to quickly identify and remedy problems with the switching process, and should continue developing other sources of information such as mystery



shopping<sup>10</sup>. They should take timely action against suppliers that provide a sub-standard service. Once Ofgem have reviewed the transfer process they should also act to streamline it, possibly by removing any unnecessary differences between the electricity and gas transfer processes.

- iv **Continue to work with the industry to reduce the costs borne by prepayment meter customers.** Prepayment meters are the most expensive payment method both for customers and suppliers, and the limited competition to serve customers using these meters helps to explain why lower income households have so far benefited less from competition than others. Some customers use prepayment meters because they moved into a property already equipped with one, and Ofgem should continue to encourage suppliers to make clear to these customers that they could save money by changing payment method. Research shows, however, that some customers prefer to use a prepayment meter, while some cannot pay in other ways because they do not have a bank account. Obtaining the full benefits of competition for these customers will probably require the development of cheaper ways to serve them. Ofgem should therefore continue to support the development of cheaper payment options, for example by promoting the development of cheaper prepayment metering technology.
- v **Press ahead with measures to strengthen competition in Scotland.** The different market structure in Scotland has contributed to lower rates of customer switching than in the rest of Great Britain. To make the market in Scotland more competitive, Ofgem should press ahead with separating the ownership of distribution, supply and transmission businesses and bringing the framework for trading wholesale electricity into line with that in England and Wales.
- vi **Minimise barriers to entry to the electricity supply market.** The possibility of new companies entering the market is an important source of competitive pressure on existing suppliers and new entrants can be an important source of innovation. Fewer companies have so far entered the domestic electricity market than have entered the domestic gas market. Barriers to entry are higher than in the domestic gas market and Ofgem are aligning the regulation of the two markets so that companies can compete on an equal footing. Ofgem need to continue to monitor the impact of entry barriers, and pay particular attention to the impact of changes such as the new wholesale electricity-trading framework in England and Wales to be introduced in 2001.

<sup>10</sup> Mystery shopping involves seeking first hand experience as a consumer of the services companies are delivering. The mystery shopper does not reveal to the company that they are evaluating the standard of service provided.

## For energywatch

The Utilities Act 2000 has established the Gas and Electricity Consumer Council, which will be known as energywatch. Their focus will be on the needs of electricity and gas consumers. They will have a key educational role to play in raising consumers' awareness of the competitive electricity market, and hence in taking forward some of the actions recommended above. In particular, we recommend that energywatch:



- vii **Improve customer awareness of electricity competition and how to make an informed choice.** There would be a role for energywatch in ensuring that any leaflet produced by the National Audit Office (see recommendation i above) receives wide circulation and publicity. They should also seek to secure greater consumer awareness of the website, currently run by Ofgem, and the helpline for which energywatch are now responsible, and to develop the value for consumers of these and other communication tools.
- viii **Develop clear and consistent processes for monitoring and reviewing the performance of electricity companies.** This will be an important rôle for energywatch working alongside Ofgem. As part of their remit, energywatch should seek to put quality of service information into the public domain in such a way that consumers can better understand it and make choices about different levels of performance.
- ix **Help ensure that all parts of the community take advantage of the competitive market.** Access to a competitive electricity supply market is not consistent across all classes of domestic consumers, and it might be unrealistic to expect this to be the case. There is, however, a role for energywatch to keep under review how the market is developing and whether there are groups of consumers who are being excluded from the full benefits of competition, and to propose remedies.