‘Regulating for current and future consumers’

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- Are We Approaching Critical Limits?’

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Introduction

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, while at the same time combating the very serious long-term threat of climate change. Perhaps these challenges will foreshadow the end of utility regulation as we know it. But 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 very short.

There are three themes to address in the regulatory scope*:*

- *consumer welfare and 'light touch' regulation;*
- *structure, performance and conduct of the energy market after 10 years of competition; and*
- *promises, progress and problems.*

I will discuss these points but in a different order as it strikes me that the first presupposes a view of the second and suggests a line of argument in addressing the third. It is also the last time I will be addressing this forum representing energywatch as—in a very good example of the changing regulatory landscape—energywatch is in the process of being abolished. We will finally close our doors in the autumn.

A decade is an age in the energy sector

Before we evaluate how the regulatory regime has performed over the last decade, it's worth casting our minds back to the priorities of 1998 and a number of landmarks around that time:

- we were comfortably self sufficient in gas, and world commodity prices were low—Brent crude oil prices in February 1998 averaged just $15/bl. Indeed the interconnector was not to start exporting our surplus away until later that year, and mainland energy markets, with a couple of exceptions, were only just beginning to be opened in the wake of the 1996 directives;
- the commitment to household competition had been confirmed after the 1997 change of government and we were midway through a complex market opening process that would not complete for another year;
- we had decided that the wholesale power trading arrangements of the Pool were not fit for purpose and were embarking on a four-year process that would culminate in the 2001 New Electricity Trading Arrangements. In the meantime, the government had imposed a moratorium on building new gas-fired power stations; and last but by no means least
- agreement had just been reached at Kyoto on an international framework to reduce greenhouse gases over the coming 15 years.

The energy policy focus was primary domestic: commodity fuel prices were low, we were an island built on coal and surrounded by oil and gas, but we were worried that domestic power generators were taking rentals from a wholesale trading regime they had been able to manage to their own benefit. We thought new wholesale and retail arrangements would change all that, and we also recognised that in the longer-term concerted international action would be necessary to

reduce emissions. The regulatory focus that followed from that was wholly domestic and wholly fixed on making competitive markets work properly.

10 years on our markets exhibit some markedly different characteristics:

- we are Europe's marginal gas market at a time when Brent crude oil prices are breaking new records on their way over the psychological $100/bl barrier, which was breached twice last week;
- nearly a decade on most householders know they can switch supplier. Many have, but there is also real concern about the prices being generated to the extent that one household in six suffers fuel poverty. In 2006 households spent £21.9bn on their gas and electricity bills. That's 60% more than the £13.6bn they spent in 1998;
- we have had wholesale power markets based on the principles of the New Electricity Trading Arrangements for seven years, and increases are now being allowed in regulated charges to fund significant new assets to cope with the twins shifts of low carbon investment and with becoming Europe's marginal gas market;
- novel policy mechanisms have been introduced that mean a rising proportion of bills—currently 7% or so of the average household electricity bill—now covers extra funding for renewables and home energy efficiency; and, again last but no means least
- work is well underway to establish a replacement for the Kyoto international framework from 2012 to reduce greenhouse gas emissions.

The scale of the political challenge these developments have presented can be measured by the fact that there have been three energy white papers in the last ten years and two—soon to become three—specific pieces of important legislation: the Utilities Act 2000, the Energy Act 2004 and what should become the Energy Act 2008. These political changes have had significant impacts across the energy sector not least on the regulatory framework. One specific example is my own organisation, which was created through the 2000 Act but is to be abolished by another piece of legislation, the Consumers Estate Agents and Redress Act 2007.

All this leads me to my first point - What we can learn from the last ten years is that, in contrast to its first decade which began in the late 1980s, the regulatory framework has had to evolve to face some very significant external challenges. We are now Europe's marginal gas market and want to retain leadership of international policy to combat climate change, we can expect those challenges to intensify. These drivers suggest an ability to adapt for regulation and the companies subject to regulation, and not an end to an existing framework as we know it — I believe we are in and will remain in a much more fluid environment.

A changing domestic agenda

At times during the last 10 years there have been some important debates on the nature of the regulatory structures that we wanted. We can break those developments down into four-year periods connected with the three pieces of legislation I referred to above.

Firstly, 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. But it did not represent unquestioned support for a market from a government that had already decided too many gas-fired power stations were being built. Importantly, we also saw the Act empower ministers with an ability to give Ofgem guidance on environmental and social matters, an issue that continues to be actively debated today.

A good indicator of the increasing environmental challenges is represented by the good report last year from the Sustainable Development Commission, "Lost in translation". This draws out many of the tensions that exist in the system and also highlights why the government needs to clarify the legal duties of the key players, especially Ofgem.

Of course making duties explicit does not always mean they are delivered or delivered as well as they might. Unsurprisingly the SDC's focus is on environmental and sustainability issues; it does not directly address social issues and Ofgem's existing remit to protect vulnerable customers. The two areas are linked, not least because the greater focus is brought on sustainability at least over the short to medium term the higher the likely costs (all other things being equal) to customers. Put another way if the government decides to materially reshape Ofgem's mandate away from economic regulation and onto sustainability, there will need to be much greater concern than hereto that it has the proper toolkit to make sure the industry it regulates acts responsibly in terms of tackling fuel poverty and reducing carbon, and moreover that it uses that toolkit. The present position of excessive profits, high and opaque prices, unsustainable business models and increasing fuel poverty must be addressed urgently.

We must also not use the debate on duties as an excuse for not tackling real structural problems that have become embedded in the market under Ofgem's current brief. We have our own take on these and how they might be addressed, and 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 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.

- Supplier business models are based on selling units of energy and not sustainable energy services, that is optimal packages of energy, energy efficiency and other low carbon measures so that consumers can enjoy the heat, light and power they require at the lowest possible cost.

Another four years on and we had the Energy Act 2004 concluding a process begun by the February 2003 energy white paper. From a regulatory perspective, this imposed a new sustainable development duty on Ofgem, and also introduced the right of appeal of code signatories where sponsoring panels disagreed with code changes decisions reached by the regulator. The first change is an important iteration in the policy process of managing the challenge of climate change. The second change is equally important and reflects the regulator's position as arbiter on changes to the complex contractual frameworks that make our liberalised energy markets work.

Since 2004, we have, as I have already mentioned, seen some very important changes to world and national energy market fundamentals that have culminated in a recently published draft energy bill, the follow-up to last year's energy white paper. But in the regulatory world there have also been some important developments that concentrate on the how rather than the why of regulation:

- the Better Regulation Task Force carried out some important work in 2005;
- the Legislative and Regulatory Reform Act 2006 set out five principles of good regulation, namely that it should be proportionate, accountable, consistent, transparent and targeted; and
- the House of Lords select committee on economic regulators produced a very worthwhile analysis of current themes and issues last autumn.

The Better Regulation Task Force made a number of 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.

The Lords committee produced a very timely report 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. This is to be welcomed as it would provide for a debate about the specific importance of its sustainable development duty in the light of the recent report on this issue by the Sustainable Development Commission.

More practically, the committee 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."

I will touch again later on the very specific concerns energywatch has about the energy markets and how the Competition Commission might have a role to play in addressing them. But for present purposes these various matters of regulatory inter-action and improvement are no less relevant today than previously.

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 (ERA). 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 four such challenges where we have seen reliance on self-regulation, including:

- **Mis-selling and erroneous switching**—there were very many instances 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.
- **Poor billing**—unfortunately this continues to be one of the major problems faced by consumers in retail energy markets, and is by far and above the number one source of complaints to us. 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 and 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. The industry itself has also recognised that it needs to bring billing and metering into the

21st century. Unusually, it has worked closely with energywatch in pressing for the installation of a smart meter plus an effective consumer interface in the home of every gas and electricity consumer in this country. Such a programme would bring benefits to both consumers and suppliers. It would bring an end to estimated bills, allow suppliers to read meters remotely, reduce consumer complaints against suppliers dramatically, improve consumer engagement with their energy consumption, reduce energy consumption and lead to fairer charges for prepayment meter consumers. However, energywatch and the ERA at odds with Ofgem about how a universal metering programme should come about. Ofgem, although supportive of smart metering, wants to leave it to the market. The ERA (again unusually) and energywatch believe that self-regulation is not sufficient and instead call for a Government mandate to introduce smart meters over the next 10 years so that the full economic, social and environmental benefits of smart meters can be realised.

- **Raising consumer awareness of the carbon and renewable content of their electricity supply** – there is considerable consumer confusion about suppliers' green marketing, not just with respect to so-called 'green tariffs' but more generally to claims about investment in renewable generation, energy efficiency and other environmental initiatives. Most consumers are not aware that most of this activity has come about as a result of Government legislation, for example the Renewables Obligation and Energy Efficiency Commitment (now Carbon Emissions Reduction Target) programmes, rather than suppliers' voluntary efforts. energywatch and the National Consumer Council exposed suppliers' claims on green tariffs by commissioning research on this topic and our subsequent advocacy. As a result of our campaign, Ofgem is currently updating its green tariff guidelines to suppliers and is working with the industry to introduce an accreditation scheme to monitor and vet suppliers' claims. However, we are concerned that such 'self regulatory' efforts will go to waste if consumers are not convinced that the accreditation scheme is truly independent of the industry. We also believe that consumer concern goes much wider than the small number who chose to buy a green tariff. We are therefore pressing for a mandate on suppliers to reveal the renewable and carbon content of every electricity tariff offered to consumers in the hope that consumers will help drive the market to increase the renewable content of their supply.
- **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 4mn households in Great Britain that suffer from fuel poverty as they spend more than 10% of their income on heat and light. Unfortunately, recent prices 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, and use carbon windfalls from the EU ETS to mitigate hardship rather than further reward shareholders. While the regulator has benchmarked social measures presently offered by suppliers, many, including energywatch, believe this is an inadequate response. It looks increasingly likely that the companies are going to have to offer substantially more to pre-empt a windfall tax or to avoid hard-wired obligations to offer social tariffs.

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 proscribed 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 anyway 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 companies have never been put to the test, as we have always been there 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.

Self-regulation only goes so far

The GB energy market and in turn the regulator, through a lack of effective oversight and intervention, is failing to meet the needs of GB energy consumers. We need to apply the lessons we have learned from the failings of the Financial Services Authority in its supervision of Northern Rock to the energy sector. We believe there needs to be a step change in the way the energy regulator engages and intervenes in the market to ensure consumers both now and in the future benefit from a competitive market that functions efficiently and effectively and there is adequate protection in place for vulnerable consumers.

The consumer experience

Although we have seen energy bills double over the past five year, service levels have been deteriorating rather than improving. There is distrust in the way prices are set as they are not being determined on the basis of effective competition. We are continually told that we have the most competitive market in Europe yet our electricity prices remain amongst the highest in Europe. Some of our most vulnerable consumers are unable to access the cheapest tariffs in the market as they pay by prepayment meter. The price increases we have seen in 2008 alone have pushed an estimated extra half a million households into fuel poverty. Small businesses find themselves locked into higher priced contracts due to complex contractual arrangements and business consumers more generally are concerned about their lack of choice due to the low number and type of contract offers. Our international competitiveness has deteriorated and we have seen significant job losses.

The view from the regulator – whose primary duty is the protection of consumer interests – has tended to be that all is well and there is no evidence that the market is failing. The regulator assured the Chancellor on 16 January 2008 that 'Britain's competitive market in energy is working' yet since then we have seen the regulator initiate a range of actions following public and political

pressure including a Business and Enterprise Committee inquiry into possible anti-competitive behaviour in the energy markets, allegations of market abuse and rising prices.

Fuel poverty

The round of price rises seen early in 2008 will have pushed another half a million homes into fuel poverty, putting 2008 levels at around 4.5 million households. With consumers now paying energy bills in excess of £1000 a year, affordable energy has become a thing of the past. So much so the Energy Minister, Malcolm Wicks saw fit to predict last year that "the era of cheap energy is over".

This acceptance from government that energy bills will remain high and that the situation is beyond their control is a misleading notion; the government have the tools at their disposal to deliver a tangible difference for fuel poor consumers. They could use the Energy Bill, currently in Parliament, to direct all energy suppliers to offer social tariffs based on minimum standards.

The government used this year's Budget to fire a warning shot at energy companies about prices. Reports of windfall taxes were wide of the mark, with the government instead opting to call on suppliers to increase their social programmes from a current level of £56 million to £150 million a year. Further details on this show that suppliers spending will not reach £150 million a year until 2010/11 with the increase phased on over the next three years (£100m in 2008/09, £125m in 2009/10 and £150m in 2010/11). BERR estimates that this increased spending will remove 100,000 households from fuel poverty but gives no details of how the money will be spent or how it will be targeted to the most vulnerable homes. It will provide little comfort to the other 4.4 million homes unable to affordably heat their homes.

Ofgem has avoided its regulatory responsibilities on this issue choosing to let the energy suppliers follow a voluntary path on their social initiatives. Despite being asked by government in the Energy White Paper to assess the effectiveness and proportionality of suppliers social programmes Ofgem chose to don its rose tinted glasses and acknowledge every offering from suppliers, no matter how inadequate, as evidence of a commitment to tackle fuel poverty. In doing so they have done a disservice to those suppliers with effective social tariffs in place and ineffective as a regulator to expose which suppliers are falling short.

Over-reliance on switching

The regulator continually refers to switching figures as direct evidence of competition. We do not agree that switching is a sufficiently good barometer for healthy competition and is not a theoretically sound basis for a regulator to determine whether there is effective competition.

There have always been problems with the switching data as it can be inflated by involuntary and mis-selling transfers and fails to identify multiple switchers. Switching to new entrants has been moderate and the seemingly high gross levels of switching reflect the introduction of dual fuel offers. What the regulator often fails to recognise is that some consumers are unable to switch for example due to debt blocking or because other suppliers do not offer terms that support their particular metering arrangements. Many consumers state that they are very unlikely to switch whilst others state that they will never switch. Further survey evidence shows that switching is often ill-advised and up to one third of consumers have switched to a deal that left them worse off. What is perhaps most telling is that after 10 years of liberalisation around 50% of consumers have never switched.

In its press release of 2 April 2008 on switching, the regulator stated that suppliers who do not offer competitive prices and good service will lose customers. Whilst this should be the case in a market where there is vigorous and healthy competition, in practice, we continue to see suppliers winning customers even where they are the most expensive supplier and have the poorest performance record.

Consolidation by default

The energy market is dominated by six vertically integrated firms – the 'Big Six' - with interests across the supply chain. This has a negative effect on competition by reducing liquidity in the wholesale markets and creating barriers to entry.

The regionalised nature of household energy supply competition 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 were properly scrutinised by the competition authorities even though there was significant erosion in competition. For example no objections were raised by the regulator when a scale player - TXU - failed in 2002 and its 5.5 million consumers were acquired by E.ON UK. More recently Scottish Power was acquired by Iberdrola, and rumours suggesting that further takeovers or mergers are in the offing are commonplace within the sector. What happens with British Energy one of the few independent generators will be key.

The Public Accounts Committee warned back in 2003 that the regulator 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 and repeated concerns being raised with the regulator, it has failed to undertake any open or comprehensive review of the effects of vertical integration on the retail market, the state of wholesale trading or the interaction between the two. There is a strong sense that the regulator failed to act.

Now the market is characterised by large incumbent players who enjoy strong market power and where many consumers choose not to switch possibly because of search and switching costs and a sense that there is not much choice out there. It enables suppliers to price tactically at premium rates for certain domestic groups of consumers in the full knowledge that they will retain many of them. In business markets, particularly for those consumers with non-standard load and/or multiple sites, it is frequently difficult even after complex and costly approaches to suppliers for consumers to see aggressive offers. Multi-site consumers with non half hourly meters can find it particularly difficult. The situation on the ground by no means reflects the vigorous or effective competition that our policy makers and regulator set out to achieve and whose existence they often invoke.

Against this backdrop we also see that levels of transparency and regulatory reporting are minimal and inadequate.

Minimalist oversight of supply

Traditionally, as an important part of the process of setting supply business price controls for each company, the regulator exercised a supervisory role over both gas and electricity supply businesses. It routinely gathered information on costs, performance and returns for a period of more than three years after the remaining supply franchises were removed and after the sector

was opened to full competition. 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.

The regulator lifted the final supply price controls in April 2002 despite concerns that the retail markets were not sufficiently competitive to permit this. Problems identified at that time, particularly the treatment of consumers paying by prepayment meter and consumers in Scotland with dynamic teleswitching, have not been addressed by the regulator even though six years have passed.

Since 2002, the regulator has produced occasional reviews on the state of competition, but as I indicated earlier they focus almost exclusively on national switching levels. Its most recent analysis of the domestic market was published in June 2007 but the regulator has failed to undertake any analysis on the business markets since summer 2003.

Defending the incumbents

The regulator has periodically addressed aspects of market operations, for example the wholesale price spikes that have been a recurring feature of the British markets since October 2004. The main thrust of its analysis has been:

- To point to supply limitations and competitive bottlenecks on the continent.
- To attribute price excursions to 'market sentiment'.

In response to dissatisfaction among some politicians and stakeholders over suppliers' resistance to curbing prices after the collapse in oil prices from mid 2006, the regulator maintained that it was examining supplier behaviour but that competition was fundamentally vigorous and effective. No hard analysis was presented to substantiate these claims beyond generalised, high-level switching data.

On 8 February 2007, the regulator described the British Gas decision to cut prices in March that year as 'the first shot in what Ofgem expects will be the start of another battle for consumers'. It also went to some lengths to explain what it described as the lag between wholesale and retail price falls as being helpful to suppliers in delivering supply security. It also introduced the concept of 'full cycle' costs, which seemed to be short-hand term for allowing suppliers to over-recover from consumers at times of lower wholesale prices.

At the time there was plenty of independent comment that contradicted the regulator's view, as the following examples illustrate:

- 'Press reports of a price war among UK energy suppliers are, in our view, misleading. While the industry no doubt welcomes the publicity the price cuts actually announced so far by Powergen [initial new online offers] and Npower are the minimal reaction we would expect to see in response to Centrica's new tariffs' - Citigroup comment 19 February 2007.
- 'In our view, the recent price cuts do not constitute a price war. The magnitude of competitor reductions across all tariffs will depend largely upon each company's forward hedge position in wholesale gas and power, and the assumed desire to repair retail margins, particularly in gas' - Merrill Lynch comment 19 February 2007.
- 'The reductions result in Npower being marginally cheaper than British Gas (Centrica) on average, although in their original franchise areas, we believe they will be marginally more expensive. Although this has been trailed as an intensification of a price war, we disagree. We see it as further evidence of the disciplined nature of the market, given that Npower has

moved prices to almost in line with Centrica. We would expect others to follow suit over the next few weeks' - UBS comment 19 February 2007.

It is extremely disconcerting that the industry regulator should be making the case for energy suppliers' price movements. We also find it disingenuous for the regulator, as it often does, 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 both in the past and, more recently, going forward. In fact we would say its 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 four months.

We fear there is a significant gap between the reality of the market and the regulator's rhetoric.

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. The actual difference between the direct debit, dual fuel prices of the suppliers who have raised prices is just £26 (Table 1). 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.

Table 1—Costs of current dual fuel offers—GB average, direct debit terms for a medium user

Dual Fuel - Medium User	BG	EDF	NP	E.ON	SP	SSE	Spread
Direct Debit	£968	£965	£972	£967	£959	£946	£26
Standard Credit	£1,055	£1,007	£1,056	£1,063	£1,100	£1,006	£94
Prepayment Meter	£1,144	£1,037	£1,127	£1,097	£1,062	£1,071	£107

Source: energywatch

Dangers of self-regulation

The industry left to its own devices has a very mixed record. The scandal of mis-selling earlier in the decade saw many consumers switched fraudulently and without their knowledge. More recently we have seen problems of mis-selling by npower exposed in the media. Further many consumers have found, as reflected in continuing high levels of consumer contacts with energywatch, the service they receive has deteriorated irrespective of whether they have switched.

Much like the firms it regulates, the regulator is reluctant to take steps to improve the situation for consumers without considerable and sustained pressure from consumer groups, the media and the political arena. For example:

- The regulator failed to take action to put an end to widespread mis-selling until after we launched our 'Stop now' campaign in January 2002. This ultimately led to an industry code of practice which substantially reduced the problem. However, recent reports of npower's conduct in this area highlight the need to be ever vigilant even where there is supposed to be a self regulatory solution in place.

- In June 2003, we were instrumental in creating the customer transfer programme, an energy industry-wide initiative to improve the switching process for consumers.
- In 2003, we also launched a 'Better Billing' campaign to highlight our growing exasperation with the harm such practices were causing consumers, and minimal attempts to address them prompted us to raise a billing super-complaint. This led to the establishment of a billing ombudsman by the industry.

Whilst we acknowledge that significant efforts can be made by the industry to address issues once they have been escalated, a common theme emerges which causes us great concern. It is other organisations that have highlighted these consumer issues and prompted the regulator to become involved in some action. Moreover, and despite it's recently announced 'Consumer first' initiative, we detect in its activities a worrying tendency from the regulator to keep itself distant from real consumer issues and leave them to others. There is also a worrying tendency for it to put the onus on energy suppliers to resolve the issues once they have become fixed in the media spotlight.

Even though the regulator may believe it is practising 'light touch' regulation, we believe this disengagement is creating poorer conditions for consumers and will leave significant legacy issues once energywatch is disbanded. Any arguments that the energy supply ombudsman (ESO) scheme is a good example of self-regulation are also, in our opinion, undermined because it was action by an outside body, in this case energywatch raising the super-complaint, which prompted the scheme to be developed. Furthermore, there have been problems with the ESO scheme. The ESO has a key performance indicator (KPI) to come to a provisional outcome on disputes within 6 weeks. Performance against this KPI has deteriorated significantly over the past 5 months and the ESO is currently taking around 7 or 8 months to resolve disputes referred to it by energywatch. This is not an acceptable timeframe and we believe the majority of complaints should be resolved by the ESO within 6 to 8 weeks.

Recent statements from the regulator have highlighted the merits of increasing self-regulation within the industry, seemingly as a consequence of managing its own costs following the self-imposition of a RPI-X control on its costs. We see this as a worrying tendency given the regulator's track record of reluctant engagement and its readiness to act as an apologist for the Big Six.

Political intervention

Following widespread concern about a lack of effective competition in our markets, the Business and Enterprise Committee rather than the regulator responded by initiating an inquiry into possible anti-competitive behaviour. The terms of reference for this inquiry cover the retail as well as the wholesale markets and fuel poverty. It is much broader in scope that the investigation that the regulator subsequently launched in February this year. By effectively ruling out any close look at the wholesale markets, the regulator has signalled that it is not prepared to get to grips with what is really wrong with the market.

energywatch is firmly of the view that the GB energy market needs to be referred to the Competition Commission for a full and independent investigation. We believe that the Competition Commission is the only body with the necessary powers, competence and resource to determine and remedy what is wrong with our market.

The key features we believe require investigation area:

- The supply markets are highly concentrated and consumers are vulnerable to abuse of market power. The regional supply markets are dominated by two suppliers with British Gas and the incumbent electricity suppliers controlling at least 60% of each of the domestic supply markets.
- The electricity market is dominated by six vertically integrated firms inhibiting competition in the retail and wholesale markets.
- Firms adopt similar supply and trading policies reducing wholesale market liquidity and leaving consumers vulnerable to abuse of dominance.
- There has been no scale new entry in the 10 years since liberalisation due to high barriers to entry including credit policies, complex industry codes and information transparency. This can negatively impact prices, quality, choice and innovation.
- There is a lack of strategic storage inhibiting our ability to store summer priced gas as an alternative to high priced gas during winter.

Remedies that would help ensure there is effective competition in the GB energy markets include:

- Requirements for firms to trade minimum gas and electricity volumes through the 'over the counter' markets to enhance liquidity and address concerns about the move towards long term 'off market' contracting and self supply.
- Enhanced reporting and disclosure requirements for firms to aid transparency and price discovery.
- Greater transparency on gas flows from Europe and the North Sea including flows from outside of our current jurisdiction.
- Creating incentives for investment in strategic storage to ensure GB can benefit from access to lower priced gas.
- Measures to reduce search and switching costs for consumers particularly for domestic consumers paying by prepayment meter and small businesses.
- Where other measures are considered insufficient, separation of vertically integrated firms through divestment of plant or function.

Regulatory authorities overseas

As well as learning lessons from other regulatory bodies in the UK, it is useful to consider the powers and effectiveness of the bodies regulating energy markets overseas. Analysis shows that the political influence of energy companies can have a direct and marked impact on the powers and effectiveness of the regulatory bodies.

- In Germany, the energy companies were able to delay the introduction of effective regulation until forced by European legislation and to obstruct the introduction of effective competition for both wholesale and retail markets by discriminatory practice including making switching slow and not using standard protocols for switching and settlement.
- The French Parliament established a regulator in 2000. Its powers however are limited and it is the government that sets the retail tariffs and the Energy Act 2006 prohibits it from commenting on energy policy issues.
- Instead of legislating to provide a framework of regulation and an industry regulator, New Zealand initially relied on its existing Commerce Act which mandates the Commerce Commission to oversee trade practices in all competitive sectors. Self

regulation failed and in response to growing concerns about prices and hydro shortages, the government created an industry-specific regulator. The regulator has a wide range of responsibilities for regulating both wholesale and retail markets and for contracting service providers to undertake key roles within the market including the system operation and market settlement.

- In Alberta the regulator sets the standard for how utilities should conduct themselves when engaged in transactions with affiliates. When a utility buys or sells an affiliate the transfer price must be and must shown to be at a fair market value.
- Under political pressures from the electricity companies the Austrian government adopted a minimalist approach to incorporating the unbundling requirements from European legislation into Austrian legislation.
- The Dutch authorities have tried hard to promote a competitive wholesale market but are limited by the small size of the market and the influence of its German and Belgium neighbours

Future challenges

There is an issue to be addressed now regarding the structure of the market. There will also be many challenges in the longer term as we adapt our energy system to the challenges of combating climate change and import dependency. Long-life assets such as power stations and networks need a consistent, stable regulatory framework to attract investment. This key principle is well-understood, but the practice is and will continue to be much more challenging as the companies who will provide the bulk of the investment negotiate with the regulator and other stakeholders what constitutes an acceptable level of profitability.

But increasing policy complexity means the role of 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—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 and revised systems for charging distributed generators so that they can both deliver the infrastructure enhancements that are needed to keep supplies flowing and open up access to networks by smaller, generally low carbon players.

The regulator's role going forward

To ensure the protection of consumer interest going forward there needs to be a step change in regulatory oversight and intervention including:

- Ensure the regulator's primary objective, the protection of consumers, remains just that and other competing objectives, such as the delivery of the better regulation agenda, do not take precedence.
- Greater commitment to the protection of business as well as domestic consumers.
- Prompt and effective action where there is clear evidence of consumer detriment even where the number of consumers affected may be small but the detriment to the individual is material.

- Improve the quality and resourcing of market surveillance and competition analysis in both the wholesale and the retail markets.

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 the twin challenges of 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.

Conclusion

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 watershed. Indeed, although there is imminent institutional change—not least through our replacement by Consumer Voice—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 as well as some areas where we may need to look for pitfalls.

Thank you for your attention.

Allan Asher

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