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UK Domestic Energy Contracts:
the 28-day rule and experience in Sweden

Stephen Littlechild

The Cambridge-MIT Institute

Massachusetts Institute of Technology
Center for Energy and
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UK domestic energy contracts, the 28 day rule, and experience in Sweden

Stephen Littlechild[1]
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Abstract

In the UK, domestic customers must be able to terminate energy contracts at 28 days' notice. This has been seen as a transitional protection for customers and for competition. This paper reviews the arguments for and against the 28 day rule, and examines the extent to which UK suppliers have offered fixed-price fixed-term contracts. It also looks at experience in Sweden, where there is no such restriction and where there is greater use of fixed-price fixed-term contracts. The paper concludes that there is no longer a need for the 28 day rule to protect customers, and that it is more likely to restrict than to protect competition.

Key words: competition, electricity, regulation

JEL classifications: L94 electric utilities, L51 economics of regulation

1. Introduction

In the UK, all energy supply contracts to domestic customers are required to be terminable by the customer on 28 days' notice. Ofgem has recently consulted on whether to suspend this 28 day rule for a trial period for the supply of energy efficiency packages,[2] and has since decided to do so.[3]

Ofgem sees the 28 day rule and associated restrictions on termination charges as protecting customers and competition. The industry widely regards these provisions as preventing or discouraging beneficial developments, including longer-term fixed-price contracts. Ofgem's stated intention is "to continue to withdraw from regulating the energy industry where we believe this is in the best interests of customers, for example by removing certain licence conditions". On this basis, would it be more appropriate to remove the 28 day rule completely, rather than suspend it for a trial period for certain

[1] Honorary Professor, University of Birmingham Business School, and Principal Research Fellow, Judge Institute of Management, University of Cambridge. I am grateful for comments and information from Tony Boorman, Eileen Marshall and Iain Osborne (formerly or now of Offer, Ofgas and Ofgem); John Lang, Denis Linford, Rob MacDonald, Laurence Poel, Simon Skillings and Stephanie Tobyn (UK supply companies); Margareta Bergstrom and Hakan Heden (Swedish Energy Agency), Kaj Forsberg and Peter Fritz (EME Analysis), Jan-Erik Moreau (LO), Johan Ohnell (TE) and Christina Svalstedt (Vattenfall); Mike Boxall, Nigel Cornwall and an anonymous referee. None of these is responsible for the views expressed herein.

[2] *Testing domestic consumer take-up of energy services: trial suspension of 28 day rule*, Ofgem Consultation document, January 2004. Unless otherwise indicated, page references after quotations refer to this document

[3] *Testing domestic consumer take-up of energy services: trial suspension of 28 day rule*, Ofgem Decision document, March 2004, 73/04.

services? Does the rule still provide a necessary protection for customers and facilitate a competitive retail market? Or is the protection no longer needed, and does the rule restrict the kinds of terms and services that can be offered and thereby tend to limit retail competition?

Part One of this paper looks at the historical background to the 28 day rule, and compares the present thinking of Ofgem with the previous thinking of OFFER. Parts Two and Three discuss in turn the potential advantages and disadvantages of removing the rule. Part Four summarises the experience in Sweden, where there is no such restriction on contracts and there is an active market for fixed-price fixed-term contracts. Part Five concludes.

PART ONE: BACKGROUND TO THE 28 DAY RULE

2. Initial thinking and consultation: gas

The 28 day rule was developed in the context of discussions preceding the opening of the retail market for residential customers. Since this happened in gas before electricity, the first formulation of the condition is in the standard condition of the gas suppliers' licences. However, the most explicit discussion of the thinking behind such a rule is in electricity.

OFGAS and DTI jointly launched a consultation process in May 1994.[4] There was little discussion of contract terms, since it seemed to be envisaged that domestic customers would be supplied on a tariff basis and that a contract would be exceptional.[5] But the paper suggested that, in such latter cases, "some form of regulatory oversight over contract terms may be appropriate. Such regulation, for example, may require all contracts to contain a 'cooling-off' period for the consumer before any binding commitment takes effect".

In March 1995 DTI published its Draft Standard Conditions of Gas Suppliers' Licences as part of the Gas Bill. This now seemed to assume that supply under contract would be the norm, subject to standard licence conditions. Condition 11, Termination of contracts, provided inter alia that

> "… the licensee shall not enter into a contract for the supply of gas to any domestic customer at any premises unless
> (a) If it is a contract for a specific period exceeding 12 months, whether or not followed by an indefinite period, it provides that the customer shall have the

[4] "In December 1993, responding to recommendations by the Monopolies and Mergers Commission (MMC) on the gas industry, the President of the Board of Trade announced the Government's intention to introduce competition in a phased and orderly way from 1996 into the domestic gas supply market. Mr Heseltine stated that a joint consultation paper would be issued by OFGAS and the DTI." *Competition and Choice in the Gas Market: a joint consultation document*, London: dti Ofgas, May 1994, p. 1.

[5] "It is for consideration whether domestic consumers should have a right to be supplied on a contract basis if they wish. We envisage two circumstances in particular where this might be appropriate: New Connections … and Energy Efficient Investment." *Ibid*. p. 28

right to terminate the contract within 7 days of the date on which it was executed …;

(b) If it is a contract for a specified period, whether or not followed by an indefinite period, it provides that the customer may terminate it at any time during the specified period by giving 28 days' notice of termination … subject, however, to his paying such cancellation fee as may be reasonable in the circumstances; …"

The next version of the draft licence conditions, in June 1995, contained a reordering of the clause to put the 28 day notice requirement before the 7 day cooling off period. It also embodied two modifications presumably suggested by suppliers. First, the concept of reasonable termination fee was augmented by the parenthetical clause "having regard, in particular, to the supplier's marketing and administrative costs in relation to the customer". Second, there was now a provision that "no [28 day] notice … shall be considered to have been effectively given unless and until any payment required [ie the termination fee] … is made".

In the final draft of the standard conditions on dated 2 January 1996 the parenthesis about marketing and administrative costs was deleted. There were no further changes in these clauses before the final version issued in February 1996.[6]

3. Initial thinking and consultation: electricity

In June 1995 OFFER proposed a Competitive Supply Code to deal with the practical arrangements associated with the interface between suppliers, customers and the distribution businesses. To advise it in developing the Code it established a Competitive Supply Code Executive comprising a cross-section of Pool members and customer representatives. OFFER's consultation paper in January 1996 commented on its own thinking and on the recommendations of this Executive and its Working Groups.[7]

The consultation paper recognised that most smaller customers were then supplied on tariff terms but that, "increasingly, however, the relationship between customers and suppliers will be a contractual one". It noted that this had some advantages:

> "In particular, where the supplier and customer are able to agree a long term contract, the supplier may be able to achieve savings in the costs of electricity purchases and in other costs which can be shared with the customer."

It went on to say that

> "The form of contracts is best determined by the interaction of suppliers and customers in a competitive market to ensure that the interests of both suppliers and customers are served. However, in considering customer protection issues

[6] Gas Act 1995. Determination of the Standard Conditions of Gas Suppliers' Licences, DTI, London: HMSO, 21 February 1996.

[7] *The Competitive Electricity Market from 1998: Supply Code, Trading Arrangements and Costs*, OFFER, January 1996, esp. pp. 3-9.

during the transitional period after 1998 it may be necessary to impose some restrictions on the form of contracts."

After suggesting that it would be reasonable to expect the terms of any supply to be set out in writing after any verbal agreement, the paper went on to discuss contract terms. It said:

> "3.7 In general customers and suppliers should be free to enter such contractual arrangements as they see fit. Given that present tariff customers have little experience of contractual relationships in electricity there is a concern that customers may be persuaded to enter into contracts which are not in their best interests. There is also a concern that dominant suppliers may seek to pre-empt competition by asking customers to sign long term contracts or contracts where the provisions for termination are unclear.
>
> 3.8 Electricity supply contracts with domestic customers will be subject to the Unfair Contract Terms Act, 1977, and the Unfair Terms in Consumer Contract Regulation, 1994. These provisions, which apply throughout the economy, are aimed at protecting customers from unreasonable terms being imposed upon them. In the circumstances of domestic electricity customers it may be appropriate to consider, perhaps for a transitional period, some further explicit restrictions on the form of contracts that suppliers ask customers to agree to. …"

The paper then raised four issues. First, it asked whether there should be a seven day 'cooling-off' period after signing a contract, and concluded that this "would seem appropriate to enhance customer protection in a new market". The next two issues concerned contract duration and the provisions for termination.

> "3.10 The second issue is whether some obligations should be placed on suppliers in relation to the duration of contracts. I have noted the concern that dominant suppliers could offer their customers, as the only alternative to a tariff, a contract which tied in those customers for a long period. To protect customers and new suppliers it may be appropriate to provide for all suppliers to offer (amongst such other contractual arrangements that they may wish to provide) contracts for domestic customers which enable the customer to change the arrangement (or their supplier) after 12 months. This could be achieved either by a 12 month contract or by an evergreen contract which gave the customer the right to terminate the contract after 12 months.
>
> 3.11 Third, it is necessary to consider whether there should be minimum provisions enabling customers to terminate contracts. In the case of evergreen contracts this might include circumstances where the customer wishes to enter into another contract (whether or not with the same supplier) and has given the supplier reasonable notice (say 28 days). Where the contract provides for terms to be varied at the supplier's discretion, it would seem appropriate to ensure that the customer is able to terminate the contract if the supplier proposes a significant variation to the contract, including a variation in price, which is unacceptable to the customer."

The fourth issue concerned a customer's responsibilities to pay when the customer has quit the premises. A final comment is also of interest in the context of Ofgem's present consultation.

> In considering these issues, it will be important to take into account cases where the supplier is providing other goods and services under the contract in addition to electricity supply. For example this might include energy efficiency services where a long term contractual relationship may need to be maintained in order to spread the cost of energy efficiency measures over a reasonable period of time."

4. The 28 day rule in electricity licence conditions

The licence conditions subsequently adopted differed in some respects from those considered in the consultation paper. In formulating electricity licence conditions, OFFER sought to mirror as far as possible the conditions in the gas supply licences. The formulation became identical in both sectors, as it appears in the Standard Licence Conditions (SLCs) in the licenses of domestic gas and electricity suppliers. In the event, therefore, the restrictions on contracts embodied in these SLCs have so far proved to be permanent rather than transitional.

The most relevant part of the SLCs is Condition 46 entitled Termination of Contracts on Notice, which provides as follows:

1. The licensee shall not enter into a domestic supply contract unless the domestic supply contract contains a term allowing the customer to terminate such domestic supply contract at any time by -
    a) giving to the licensee a valid notice of termination; and
    b) subject to paragraphs 6 and 7, paying to the licensee on demand a termination fee.

2. A notice of termination is valid where it is given at least 28 days in advance of the date on which it is to take effect ….

7. Where a termination fee is payable, it shall be of an amount not greater than that which the licensee may in all the circumstances reasonably require.

Section 6 provides that a termination fee may not be demanded in specified circumstances: where the customer is moving house, or within 5 days of signing a contract for over 12 months supply (the cooling-off period), or where the supplier has unilaterally changed the terms of the contract, or where the supplier did not tell the customer about the cooling-off period. There is one additional provision.

6. A termination fee may not be demanded of a domestic consumer where

…

> b) the domestic supply contract was a domestic supply contract of indefinite length and was terminated other than during a fixed term period;

The meaning of section 6 b) is partly clarified by Condition 31, which defines "fixed term period" as "a specified period of more than 12 months during which the principal terms of that contract may not be varied by the licensee other than by agreement with the customer". Thus, if the contract is of indefinite length - a "rolling contract" or an evergreen contract that provides for continuation of supply after the end of an agreed fixed-price period - then a termination fee may not be demanded if the fixed period is 12 month or less. A termination fee may be demanded for a domestic supply contract of definite length, however long that is.

In sum, as Ofgem explains, Condition 46 requires that "all energy supply contracts (whether fixed-term or rolling) must contain provisions for them to be terminated [by the customer] on no more than 28 days' notice. … If the contract is for a fixed term that is more than 12 months a reasonable termination fee can also be demanded." But a termination fee, whether reasonable or not, may not be demanded in fixed-term contracts of 12 months or less.[8]

In practice, suppliers seem to have preferred to leave domestic customers on evergreen contracts. They have not sought to specify a finite length to the contract, which might lead the customer to question whether to continue as a customer at the end of a contract.[9]

5. Comment on initial and present thinking

It has been conjectured that OFGAS and DTI envisaged that the 28 day rule was originally intended for consumer protection only, and was not envisaged as transitional.

> "I am sure the issue was customer protection, not worries about anti-competitive behaviour, since the conditions were applied to all suppliers. Nor do I suspect they were intended to be transitional, since they were incorporated as a hard to change standard condition, not as part of the suppliers Code. I think the simple point was that domestic customers were moving from tariffs to contracts which could specify a period of time for supply or be rolling. But since the customer's supplier had an obligation to supply, from the customer's perspective it was an evergreen contract. The idea of a 28 day notice period with a termination payment if appropriate seemed reasonable."[10]

The 1994 consultation document drew no association between the 28 day rule and preventing potential anti-competitive behaviour of BG in locking up the market. Indeed, one of the main concerns was to protect BG from excessive loss of market share. Whether or not the 28 day rule was envisaged as transitional is less clear. Certainly it was a licence condition rather than a Code provision. But so too was the obligation to publish

[8] It is not entirely clear why a termination fee may not be demanded for contracts under 12 months. The original provision in the gas licence, that a 7 day cooling off period was not needed for contracts under 12 months, seems more understandable.

[9] There are also practical issues. An energised supply point must have a registered supplier, so in reality a fixed duration contract has to be open ended, and terms specified beyond the initial fixed period in the event that the customer does not change supplier.

[10] Dr Eileen Marshall, personal communication, 22 March 2004.

tariff schedules, which was explicitly transitional.[11] And it appeared in one of three chapters said to deal with "the extent to which other transitional measures may be necessary".

OFFER's 1996 consultation paper clearly assumed:

- that long term contracts would be a normal component of the market for the supply of electricity – at least, they would be available for customer choice as well as shorter term contracts
- that long term contracts could be in the interests of customers insofar as they could provide cost and price reductions or other services that it would otherwise not be possible to provide
- that the terms of such contracts were best left to customers and suppliers to agree between themselves
- that any restrictions on the terms of such contracts should be approached with caution and should be of a minimal nature
- that there was nevertheless a case for considering some such restrictions "during the transitional period after 1998".

The main justification for such transitional restrictions was the inexperience of domestic customers at that time with contractual relationships in electricity, which might lead them to sign contracts not in their best interests. The possibility that dominant suppliers might seek to pre-empt competition by asking customers to sign up to long-term or unclear contracts was an additional concern. However, my reading of the paragraph is that this second concern was predicated on the same premise as the first concern, namely "that present tariff customers have little experience of contractual relationships in electricity". In other words, the concern was not about long-term contracts per se, and not so much that there were dominant suppliers who might offer these long-term contracts. Rather, the concern was that the initial inexperience of the customers might lead them to accept commitments that were undue or inappropriate or overly extensive. These ill-judged commitments in turn might pre-empt competition. In other words, both concerns were predicated on customer inexperience that was considered to obtain at the time of market opening in 1998 and likely to obtain for some transitional period thereafter, but by no means forever.

It is worth recalling the context of OFFER's discussion of "the concern that dominant suppliers could offer their customers, as the only alternative to a tariff, a contract which tied in those customers for a long period." At that time (January 1996) most customers knew of no supplier in electricity or gas other than the incumbent that had supplied them for the whole of their lifetimes.[12] The very concept of an alternative competitive supplier was unknown and would no doubt be alien at first. Moreover, there was no guarantee that

[11] "In a fully competitive market, there would be no regulatory requirement to publish tariff schedules … Ministers have determined that for a transitional period after 1996 all suppliers should be required to publish tariffs and supply on the basis of them. The length of such a transitional period would be determined by the DGGS. We do not currently expect it to extend beyond 1998 …" *Competition and Choice in the Gas Market*, p. 27

[12] Some would have remembered a pre-nationalisation supplier, but it was still a monopoly.

any other credible domestic supplier would even emerge in each area. It was entirely possible that domestic customers would have no alternative offers against which to compare a long-term contract offered by the incumbent.

OFFER's discussion provides some further insight into what at that time it considered appropriate in terms of contract duration and cancellation conditions. The suggestion (not adopted as it happens) was that all suppliers should have to offer at least a contract that the customer could change after 12 months. A 28 day cancellation period was indeed proposed, but this was limited to evergreen contracts[13] and contracts where the supplier was able to, and did, propose a significant variation in terms. There was no suggestion that the 12 month contracts - or indeed fixed-price fixed-term contracts of any other duration - should be subject to a 28 day notice period.

Ofgem's recent consultation paper describes the thinking behind these licence conditions as follows:

> "The provisions of these SLCs were drafted to embody a compromise between two desirable goals. On the one hand it is desirable that, in the short term, customers have choices between a range of contract types. On the other, it is essential for the long term interest of customers to prevent incumbents from hampering new market entry by locking up large sections of the market, and to ensure that customers are not locked into arrangements that are to their detriment (even though exiting them may be at a price)." (para 3.7)

Perhaps inadvertently, this wording puts a slightly different emphasis on short term and long term considerations compared to the policy underlying the 1996 consultation paper. It is certainly desirable that customers have choices between a range of contract types. But this is true in the long term, not just in the short term. It describes the kind of consumer choice at which regulatory policy should always aim. On the other hand, it is only in the short term or temporary interest of customers, and not in their long-term interest, to restrict their choice. That is, only for a transitional period are consumers assumed vulnerable to locking themselves into detrimental long term contractual arrangements, and must be prevented from doing so. This as a result of not having the information and experience, and availability of competitive opportunities, necessary to judge whether their own interests are best served by a long term contract, and what the terms of that contract should be. But that is a purely short-term situation.

The suggestion that "it is essential for the long term interest of customers to prevent incumbents from hampering new market entry by locking up large sections of the market" is not dissimilar to a provision in the 1996 paper. However, in the absence of reference to customer inexperience and a transitional period, this seems to become a suggestion that the 28 day rule might actively promote rather than restrict competition, which seems to go beyond the 1996 document. This argument is discussed further below.

[13] An evergreen contract was "one which has an indefinite period, but where key terms including price can be varied by the supplier generally subject to a notification in advance". (para 3.5 p. 7)

PART TWO ARGUMENTS FOR REMOVING THE 28 DAY RULE

6. Energy efficiency

Energy efficiency may be mentioned as a first potential benefit of removing the 28 day rule because that was the topic of Ofgem's recent consultation. Suppliers, energywatch and numerous interested parties have argued that suppliers could and would provide energy services under the right conditions, but are presently precluded from doing so. The Energy White Paper explained that "Energy suppliers have little incentive to offer energy service contracts if customers can switch at short notice." (cited in para 1.8)

Ofgem disagrees.

> "A range of stakeholders consider that the 28 day rule is a key barrier to increased marketing of energy services packages, and hence to domestic takeup of energy efficiency measures. Ofgem does not share this view." (para 4.2, also para 1.10)

Ofgem also sees numerous disadvantages of removing the 28 day rule, as discussed below.

Ofgem accepts that customers could see lower bills from greater take-up of energy services, not necessarily during the term of the contract but thereafter, when consumption is lower and the initial cost is paid off. It notes that "for the average consumer a 15 per cent reduction in energy bills would represent around £90 per participating household" (para 1.5).[14] It also notes that "innovation in energy services might see the integration of previously separate measures, and the bringing of new measures to the market. It is not possible to quantify this effect, but it should not be ignored."

Ofgem's scepticism is thus not about the benefits of energy efficiency, but about claims that the 28 day rule is a barrier to the emergence of energy services offerings. Nevertheless, to the extent that the rule does constitute a barrier, removing it would bring corresponding benefits.

7. Costs of the trial suspension

It is not the purpose of this paper to assess the merits of the energy services case and of the trial suspension of the 28 day rule, but rather to look more generally at the potential advantages and disadvantages of removing the rule entirely. However, among the benefits of removing rather than suspending the rule would be the cost savings from not having to go through at least some of the proposed required procedures for the trial suspension. It is also possible that removal rather than suspension would lead to the provision of additional energy services that would otherwise have failed to clear the hurdle of the proposed regulatory requirements. Third, removal might allow other or more services that might have cleared the hurdle but that might be precluded by the restrictions on size or focus (for example) associated with the concept of a trial

[14] Given the average household gas bill of around £340 pa and the average electricity bill around £250.

In order to appreciate the possible magnitude of the proposed costs and barriers, it is worth summarising what Ofgem's consultation paper envisaged. Amongst other things, it proposes the following procedures and restrictions on an allowable contract package:

- Such contracts should be limited to 4 per cent of a supplier's customers or 50,000 customers if higher
- but "Ofgem would regard it as potentially anti-competitive for a former Public Electricity Supplier to focus its energy services marketing disproportionately on regions where it is the former monopolist"
- the package must be bespoke, designed after a personal energy efficiency audit of the consumer's home
- it must provide advice based on the audit, listing energy efficiency measures that are suitable to install and advice on other ways of saving energy
- it must reduce the household's estimated energy demanded by at least 15 per cent, with the means of assessing this prescribed in some detail, and with the reduction in supplied energy measured in terms of kWh avoided, both in terms of increased comfort and energy saving, with energy saving weighted according to the carbon intensity of the fuels
- it must be expected to save the consumer money, where "this should be assessed over a reasonable period … and by a discounted cash-flow approach using a discount rate that approximates to an average consumer's cost of capital" and "Ofgem expects each supplier would be able to demonstrate on request that it has in place procedures to verify that each customer is in fact saving money".
- up-front deposits by the consumer must not cover more than one-third of the initial cost (including the cost of the installed energy efficiency measures but not including the cost of credit)
- only contracts lasting up to five years would be permitted
- the contract must not lock in the consumer if the supplier is only providing advice or arranging installation
- it must provide price certainty, defined as fixed prices, prices capped to fall but not rise above a specified price, or prices indexed to wider price changes, but any increases should not exceed increases in the DTI's quarterly energy index
- it must state separately the charges for energy, energy efficiency measures and finance charges
- the supplier must provide a written quote in advance which should include information on eight specified items, and access to an independent second opinion from a reputable and independent source at no up-front cost to the customer
- the contract must have fair termination arrangements (e.g. on a house move) and the consumer should have the right to pay off outstanding debts on the contract plus a reasonable charge to cover administration and the costs of a supplier's hedging arrangements, and so terminate the contract and switch supplier.

Not surprisingly, regulatory monitoring of all this surfaced as a concern.

> "Ofgem maintains a standing capability to monitor suppliers' compliance with regulatory obligations. However, we have some concerns that the complexity of energy services may mean such routine monitoring would be inadequate. Each energy services package is itself complex, and each will be somewhat different.

> Therefore Ofgem and energywatch cannot necessarily expect to spot systematic problems from individual consumer cases."

To deal with this, more obligations on suppliers were envisaged. They would be required to make regular data returns to Ofgem as to how many contracts have been signed, of what nature, what measures are being installed, and how much energy is being saved, etc. In addition, six-monthly board-level statements of compliance would be required.

Ofgem and no doubt many suppliers wish to avoid the possibility that a customer who had signed an energy services contract could switch to another supplier without proper contract termination. But this raised additional problems and necessitated further obligations on suppliers.

> "Ofgem proposes to continue … the right to object for non-termination of a non-terminable contract. // This proposal raises a number of complex practicable practical questions about how the industry is going to manage the objections process in this area. …. Ofgem expects the industry to have developed the necessary protocols on treatment of objections, communications between suppliers, communications with customers, etc before the trial begins. Ofgem will also expect suppliers' arrangements to include creation of an audit trail that will enable verification that customer transfers have only been blocked in appropriate circumstances … Ofgem will wish to be satisfied that suppliers are going to be able to manage the objections process without consumer detriment before we will put into effect the derogation that will begin the trial."

Finally, Ofgem "proposes to carry out a substantial programme of evaluation work". This would cover consumer benefits, additional energy savings, consumer problems, and benefits to suppliers. The work programme would include data returns from suppliers, supplier interviews, customer surveys and before-and-after meter reads from a sample of homes.

What would all this cost? How would it impact on the incentives of suppliers? To what extent would energy service offerings be abandoned because Ofgem was not convinced that they met all the prescribed requirements? "Ofgem does not yet have sufficient information about the impact of its proposed parameters to assess their costs and benefits in detail." (Appendix para 1.16) However, it seems an onerous set of obligations to impose on suppliers (and on Ofgem).

It is fair to say that some of these proposed obligations would be inherent in any energy services package as normally understood, including the idea of designing packages around an audit of the consumer's home, offering credit and a written quote and the right to pay off the loan. Other obligations associated with objections to switching may be helpful to some suppliers. Ofgem has also modified some of these obligations in the light of replies to the consultation.[15]

[15] The main modifications appear to be reduction from 15% to 9% in the threshold demand reduction but associated with three year rather than five year lock-in periods, replacement of the obligation to provide credit by an obligation to offer to provide credit, removal of the requirement that consumers should save money, inclusion of an additional option for providing price certainty, and replacement of the requirement

Nevertheless, the conditions of the trial would put additional obligations on suppliers beyond what they themselves might choose to do, and it would put obligations on Ofgem to monitor these.

Are these remaining obligations and costs proportionate to the issue, do they represent a sensible use of Ofgem's resources, how well do they sit with Ofgem's self-imposed undertaking to reduce the annual costs of regulation? [16] All these are interesting questions that lie beyond the present paper. For present purposes, the point is that some of this bureaucracy would not be necessary if the 28 day rule were simply removed. Suppliers and Ofgem would save costs, and suppliers of energy services would not be subject to possibly overwhelming restrictions. Suppliers would decide what energy services to offer to customers, the most attractive forms of contract would emerge in the market, and Ofgem need not be involved at all.

8. Other advantages

Other potential advantages of removing the 28 day rule may be noted more succinctly. In each case, it is not argued that the rule prevents all kinds of contracts or associated benefits, but rather that the rule restricts the scope for offering them.

a) Breadth of choice

Allowing suppliers to offer contracts without provisions for cancellation at 28 days' notice (but perhaps with other mutually acceptable provisions for cancellation) would increase the breadth of choice in the market. For example, as noted earlier, it would make it possible or easier for suppliers to offer contracts that required some initial cost or some continuing commitment, where this would be at risk if premature cancellation were possible. Greater breadth of choice means that there is greater likelihood of more consumers, who have different tastes, finding something that suits them better than the presently available range of products.

b) Price security

An obvious type of contract that might be offered, apart from energy services, would provide security on price for a period of, say, one to three years. The simplest contract would be a fixed price. Ofgem's consultation paper suggests various additional ways in which security might be provided – for example, a price adjustment facility with specified and limited price changes, or a price related to an index such as the retail price index RPI or an index of oil or gas prices. There may not have been as much demand for such a product over the last decade, when retail energy prices have been largely stable or declining, as there might be now, after numerous price increases have been recently

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that a second opinion be provided by a requirement to inform consumers where a second opinion might be obtained.

[16] Ofgem has announced a budget cut of 6 per cent in 2004/05 and an RPI-X control for subsequent years with a view to "maintaining year-on-year downward pressure on costs". (Press release 5 February 2004).

announced. Even so, those suppliers that have offered price guarantees have reported positive responses from customers. This suggests that consumers might value price security more highly in future than they have done in the past. Indeed, it is arguable that if suppliers had been less restricted in their ability to offer fixed-price fixed-term contracts over the past few years, if Ofgem had encouraged rather than discouraged such contracts, then domestic customers would have been better protected against present price increases.

c) Lower risks and prices

If suppliers could more easily sign back-to-back fixed-term retail contracts against a fixed-term wholesale contract, they would reduce the risks of being short or long of hedging contracts. Lower risk means lower cost, and therefore greater ability to compete by offering lower prices, which would be a benefit to customers.

A longer and fixed-term contract also means that the initial costs of attracting a customer (and of incorporating the customer into the supplier's data base to provide a full range of services) can be spread over a longer and more certain period of time. To illustrate, suppose it costs an average of £50 to attract and install a new customer whose annual bill might be £250. If the customer were expected to stay for only six months on average, that cost would represent about 40% of that customer's total bill with that supplier. But if the customer guaranteed to stay for a full year the cost would represent only 20% of the total bill, and if the customer guaranteed to stay for 3 years the proportion would fall to 7%.

In practice, most customers do not move every few months, and the value to a supplier of a fixed term contract will relate to the reduced uncertainty and risk as well as to any increased duration of stay. Nevertheless, both attributes have a value.

d) More effective competition

The less restricted ability to offer new kinds of contracts would enhance competition. The wider the range of alternatives open to competitors, the more scope there is for new entrants to find a niche where they can operate successfully, and the less chance there is that incumbents can dominate the scene in all available respects.

The improved ability to reduce risk is likely to be of greater value to smaller suppliers than to larger ones. The latter might be able to reduce their risks as a result of having a larger portfolio of customers, even without back-to-back contracts. The consequence is that new entrants would find it easier to start up and grow in the market.

e) Price response by incumbents

It is sometimes suggested that retail competition is not fully effective because incumbents have not cut their prices to domestic customers in response to lower prices offered by

entrants. Ofgem is urged to take action, or at least to investigate.[17] The explanation for the observed behaviour by incumbents is presumably that incumbents find it more profitable to accept a small loss of market share at existing prices than to cut their prices to all existing customers.[18]

Fixed-price fixed-term contracts could provide an alternative means by which incumbents could compete with entrants without the cost of reducing prices to all their subscribers. That is, they could offer a lower price to those of their customers willing to sign up for a longer-term contract. Whether they would do this is unclear, and in fact one company was able to charge a premium for a medium-term price guarantee. But this suggests that customers do value longer-term price security, and perhaps that the market for fixed-price fixed-term contracts is as yet undeveloped, by entrants as well as by incumbents. Facilitating more active competition with this type of contract could make price discounts more relevant to incumbents than price premia.

f) Security of supply

Concerns are sometimes expressed as to whether suppliers have sufficient incentive to contract ahead, and hence whether the pattern of contractual relationships is sufficiently strong to provide adequate security of supply. At present suppliers have the incentive to be fully contracted to meet their expected future demand. Under-or over-estimating this demand could lead to incurring higher costs in the balancing mechanism.[19]

With uncertainty about future wholesale costs and retail demand, there may be less incentive to contract a long period ahead if there is flexibility to adjust retail prices before then. In contrast, fixed term commitments at fixed prices seem to provide added opportunity and incentive for suppliers to contract ahead with generators, and to that extent could increase security of supply in the system as a whole.

g) Spreading price increases

If each supplier's customers are on a few tariff types that may be changed at a few weeks' notice, then all or many of its customers have to experience a price increase or decrease at the same time. If all or most suppliers experience cost increases and increase their prices at the same time, attention is focused on this situation. Experience suggests that energy price increases are still politically sensitive. There may be pressure to

[17] "Key priorities to protect consumers' interests should be: looking at the continued failure of electricity suppliers to reduce in-area prices for domestic customers; …" DTI response to Ofgem, *Summary of Responses to the Corporate Plan 2004-7 consultation letter*, January 2004, p. 6.

[18] Whether such a policy is sustainable over a long period of time is another matter. The major generators adopted a similar policy during the 1990s, but as their market shares reduced it became more profitable to cut prices to maintain volume than to concede market share. Similarly, if incumbent suppliers are losing up to 1 per cent of customers per month, and are now down to nearly half of their initial market share, it will gradually become more profitable for incumbents to compete on price as well as other dimensions.

[19] Actually the asymmetry of the dual imbalance prices initially gave an incentive to over-contract, although modifications in the balancing mechanism have reduced this to some extent.

investigate the market, to reduce or stop the price increases, to reintroduce price controls, and so on.

With fixed price fixed-term contracts that have different end-dates, any price increases or reductions are spread over time and over the customers of each supplier. This means that price increases would take effect only at the time such contracts came to an end. Fewer customers would be affected on each occasion, and each would have the option of shopping around before accepting the best offer. (Moreover, as noted above, customers would have the option of protecting themselves against further price increases for a further period of years if they chose to do so.) Political pressures on market participants and on the regulator would be correspondingly reduced.

PART THREE: ARGUMENTS AGAINST REMOVING THE 28 DAY RULE

9. Transitional protection for customers

Does the original rationale for the 28 day rule still obtain? The original rationale in electricity, noted above, was two-fold:

> "Given that present tariff customers have little experience of contractual relationships in electricity there is a concern that customers may be persuaded to enter into contracts which are not in their best interests. There is also a concern that dominant suppliers may seek to pre-empt competition by asking customers to sign long term contracts or contracts where the provisions for termination are unclear."

The domestic electricity market has now been open for over five years, the domestic gas market a couple of years longer. In that period, both customer awareness and the extent of competition have changed significantly, as Ofgem itself has emphasised.[20]

By mid-2003, over 90 per cent of customers were aware that they could purchase gas and electricity from other suppliers. Over a third of customers said it was easy to compare prices between suppliers. Most of the remainder said they did not know, rather than that it was difficult to make comparisons. Around 40 per cent of all domestic customers had actually chosen another supplier. Around 15 per cent said they were likely to switch in the next 12 months. A third of electricity customers and over 40 per cent of gas customers had switched more than once.

Since then, customer experience has continued to increase. There are several easily accessible websites that will make comparisons of alternative offers. By the end of 2003 about half of all customers - 47 per cent of gas customers and 51 per cent of electricity customers - had switched their supplier at least once, and over a third of the switchers had changed their supplier more than once.[21]

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[20] Unless otherwise indicated, data in this sub-section are from *Domestic gas and electricity supply competition, recent developments*, Ofgem, June 2003.

[21] *Domestic Competitive Market Review: A review document*, Ofgem, April 2004, p. 55.

Market structure and products available have also become more competitive. The in-area market shares of incumbents have continued to fall. Many customers have chosen to buy on a 'duel-fuel' basis. Non-price offers have proliferated, including affinity deals with supermarkets and others, green tariffs, and differentiated services including insurance and reductions for self-meter reading. And some medium-term price guarantees have been offered to and accepted by customers, as discussed below.

It is true that competition has made less of an inroad at a local level than at a national level. As of March 2003 there were six major supply groups in the domestic (residential) energy market. None of them had a national market share exceeding 23 per cent.[22] However, on average the incumbent group still supplied 65 per cent of the customers in its own area.[23] This is far from the one hundred per cent dominance obtaining at the time the market opened. And the degree of competition was sufficient to allow Ofgem to remove the transitional price cap on incumbents.

This is evidently no longer a market characterised by customer ignorance and inexperience in the face of overwhelmingly dominant incumbents. It no longer seems necessary or desirable to prevent domestic customers from signing up to long-term contracts on the grounds that these contracts are not in their best interests. Nor are customers any more likely to sign up for energy contracts where the provisions for termination are unclear, than for any other type of service. No doubt some consumers are not able to make sensible choices for themselves, for various reasons, but this is not specific to energy services. In general, domestic consumers are now quite capable of judging energy contract issues for themselves. In fact, with respect to contract duration and termination conditions, there seems no reason to expect a regulator to know better than customers what are in the latter's best interests, and no more reason to expect this in energy than in, say, telecommunications or financial and other services.

10. No obstacle?

Is the 28 day rule really a problem? Does it actually prevent or restrict the development of longer-term contracts, either with or without energy services? Ofgem is not convinced.

> "Suppliers have claimed this [the 28 day rule] is a major obstacle to the development of energy services, although they have not submitted to the Working Group the business case that would support this assertion. // In the absence of such evidence, Ofgem has remained sceptical about this argument. Ofgem has argued that the supply licence already permits fixed-term contracts, backed up by termination fees, which would have the same effect as a bundled lock-in contract. That suppliers are not experimenting with ways to enable energy service contracts (for example using fixed-term contracts with termination fees, or arrangements for the assignment of contracts) tends to suggest that the 28 day rule is not the primary barrier to the provision of such services." (paras 1.9, 1.10)

[22] ScottishPower 10%, SSE Energy 14%, LE Group 15%, Npower 16%, PowerGen 22%, BGT 23%. Ofgem 2003, Chart 6.2 p. 44

[23] Apart from North of Scotland 83%, the range is 57% to 68%. Ofgem 2003, Table 6.4, p. 45.

Ofgem acknowledges that "there is some doubt about how easily and cost-effectively termination fees would be payable." (Appendix 1 para 1.6) But it has yet to form its own view on this.

Looking beyond energy services, the argument that the 28 day rule is not a restriction on the offering of long-term contracts might run as follows. The rule does not prohibit long-term contracts, or indeed contracts of any duration. Nor does it prohibit reasonable termination charges for contracts over 12 months. Contracts of 12 months and under are unlikely to need termination charges. Provisions for termination charges that might be found unreasonable are not likely to appeal to customers. Suppliers in other sectors do not always insist on termination charges, or in practice are not able or willing to enforce them. Customers in other sectors do not object to long-term contracts with reasonable termination charges. In practice, some energy suppliers have offered contracts of over a year, with provision for termination at 28 day notice, and customers have welcomed these contracts. If there is not more competition to provide such contracts, this is not the fault of the 28 day rule, but rather reflects a lack of innovation or interest on the part of suppliers, or a lack of fully developed competition at the retail level.

What happens in other service sectors? In the mobile phone sector suppliers at one time considered a graduated cancellation charge, initially high then declining as the contract elapsed. However, they found this too difficult to explain to customers and settled instead for a flat charge. Consumers found this acceptable and subscribed in large numbers though some complained about being 'locked-in'. In the household and automobile insurance sector, annual contracts are the norm, with full payment often up-front. The terms of the contract spell out the basis of cancellation fees or reimbursement, which may depend on how much of the contract has yet to run. In practice relatively few customers cancel these contracts before the end of the year. 28 day notice periods are also not uncommon, and have been reported in the TV rental and telecommunications sectors. In none of these other sectors is there a regulatory obligation to provide termination at 28 days' notice, nor a regulatory scrutiny or veto over the reasonableness of the termination charge.

This experience may suggest two things. First, that termination charges and 28 day notice periods are not as necessary or as complicated as some would claim, and not a deterrent to customers or suppliers in other sectors. Second, that the 28 day rule is correspondingly unnecessary as a means of protecting customers and ensuring that termination charges and notice periods are reasonable.

11. Experience of contracts in the domestic electricity market

A brief review of the experience of contracts in the electricity sector seems useful, particularly since this has not been an aspect covered by Ofgem's own reviews of retail competition. Of the six present suppliers in the domestic electricity market, most have at one time or another sought to market modest variants of fixed-price fixed-term contracts,

at least to the extent that contracts can be so-described while containing the 28 day cancellation clause. Four suppliers have been more active than others.

Scottish and Southern (SSE) had an affinity deal with a catalogue company whereby SSE gave the customer an up-front discount off catalogue goods in the form of vouchers. This was considered to be more attractive to customers than saving a few pounds a year on their electricity bill. The contract offered was for one or three years (there were a few variants and the size of up-front discount varied accordingly), with a termination payment based on the remaining pro-rata value of the up-front incentive received by the customer. For example, if a customer signed a three-year contract and terminated after two of the three years, the customer would pay back a third of the value of the up-front incentive received. To recoup the costs of the up-front incentive, the energy prices were generally higher than SSE's "normal" tariff offerings at that time. SSE took the risk of early termination and change of tenancy. However, this was a small experimental offer and the number of customers involved was very modest. It is no longer offered.

From time-to-time SSE has offered price promises (e.g. "sign-up now and we will not increase prices until December 2004"). It has not offered any formal fixed price contracts for longer durations.

Scottish Power (SP) originally offered a 3 year Capped Price product to domestic customers that included a small premium (£1 per month) that was refunded to customers at the end of the 3 year period as a "loyalty bonus". If the customer chose to change supplier within the 3 year period then the accumulated loyalty payment was retained by SP and in this way it operated as a form of termination fee. While many customers are still within the lifespan of the original product the current offering has evolved to remove the loyalty payment completely but a premium is still paid by the customer for the security of having prices fixed for a 3 year period. The product is still proving very popular with SP's customers.

Powergen inherited the Staywarm product from Eastern/TXU and continues to offer it. The monthly charge is fixed for 12 months and customers can use as much energy as they need. Customers can leave without termination fee, but in practice they tend not to. Powergen regards the product as very keenly priced and it has proved very popular with customers (the take-up is in the hundreds of thousands). It is attractive from the social and fuel poverty perspective, though more problematic from a commercial and environmental perspective.

Powergen also offered a Capped Product from July 2002 at its standard price with a guaranteed price reduction in October 2003 that would obtain until September 2004. This product was available to new customers if they switched and signed up before October 2002, and to existing customers. Customers could leave under standard 28 day conditions, with an additional, but hard to enforce, contractual requirement for the customer to telephone Powergen before leaving. This product attracted many tens of thousands of customers.

British Gas originally offered some fixed period contracts with a minimum term of 12 months in Trial Areas 2 and 3 about a year after the gas market first opened. (This was the Valueplus product, which offered a small discount in return for the customer agreeing to pay by direct debit and making a commitment to remain with British Gas for at least 12 months.) British Gas has now offered three rounds of Capped Electricity Products with durations ranging from 15 to 24 months. These contracts provide that the price will not go up during the specified period, but may go down. Cap 1 was offered in two waves from May 2002 onwards, with a cap until 1 January 2004 (hence maximum duration 20 months). There was a termination charge of £20, considered at the time to be a necessary incentive to stay on the contract but there were very few terminations. Cap 2 was offered in 2003 with a fixed end date of April 2005 and duration from 17 to 22 months. There was no termination charge. Cap 3 was introduced at the beginning of March 2004 with an end date at the end of April 2006, hence has a maximum duration of just over 2 years. There is again no termination fee. All these contracts may be terminated at 28 days notice.

There was a limited window of acceptance for each wave of offering, typically 2 to 3 months. British Gas specified a maximum number of acceptances in order to facilitate hedging. The first offering nearly sold out, the second did, at which time British Gas stated that some 1.2 million customers were on a capped arrangement. These terms were available to new or existing customers, alongside the British Gas standard offering, hence represented an added incentive for new customers to sign.

This experience shows that it is indeed possible to offer fixed price contracts for up to two years duration in the electricity market, consistent with the 28 day rule, and some suppliers have done so. A rough calculation suggests that the contracts mentioned above perhaps account, in aggregate, for somewhat over a million customers at present, or around 5 per cent of the market as a whole. They perhaps account for around 10 per cent of the customers of those suppliers most active in this approach. There is a general feeling among suppliers that customers would welcome more options for fixed-price fixed-term contracts.

Some suppliers have set termination charges, but the general conclusion seems to be that they are too difficult to enforce for this kind and duration of contract. (One supplier reports a similar experience in the SME (Small and Medium Enterprises) market, where attempting to enforce an early termination fee merely increased the incidence of bad debt.) Customers seem to have welcomed the fixed price contracts or assurances that have been offered, and seem to have treated them as fixed-term contracts even though there is technically the right to leave at 28 days notice. Whether all this means that the 28 day rule has had no effect at all is another matter, however.

12. Possible obstacles

Most suppliers would argue that, despite this evidence, the 28 day rule does represent an obstacle to the offering of certain kinds of contract, and therefore to certain kinds of competition. There seem to be three relatively concrete concerns.

First, there is evidence that the 28 day rule has prevented at least one supplier from offering a fixed-price fixed-term contract for under one year. At one point Npower offered a fixed-term capped price offer that ran until a named date that was some 10 months away from the launch date, and the offer included a termination fee. Ofgem required the offer to be withdrawn on the grounds that the 28 day rule prohibited a termination fee for a contract of 12 months or less.[24]

Second, some suppliers are concerned that Ofgem would interpret a "reasonable" termination fee to mean an unduly low fee that would not reflect costs or represent a barrier to customers leaving a longer-term contract. For example, if a supplier signed up a customer on a 5-year deal and locked in power contracts at a fixed price to back off the sale, the supplier would be exposed if the customer switched before the end of the period and the wholesale market moved against the supplier. As with fixed rate mortgages, the supplier's risk is that the customer sticks with the fixed price whenever wholesale prices are higher than the fixed price offer, but will leave whenever the opposite is the case. However, unlike fixed rate mortgages, the supplier might fear that the regulator would not allow sufficient termination payments to dissuade customers from breaking the contract in this way. Moreover, the allowed termination charge might not make it worthwhile for the supplier to pursue the defaulting customer through the courts.[25]

Against this, Ofgem would argue that it has repeatedly told suppliers that it would be happy to give them more certainty on this point. If they were really concerned about this matter they would take up the offer.

If Ofgem's offer has been made and not taken up, and there is no evidence of Ofgem insisting on "unreasonable" termination fees, it is difficult to attach much weight to the concern. On the other hand the requirement that a termination fee be "reasonable" does necessitate a discretionary role and judgement for the regulator that introduces at least some element of uncertainty, cost and delay for suppliers – and a cost for Ofgem - that would not otherwise be there.

The third concern is that the 28 day notice requirement is itself a barrier to the presentation of long-term contracts to customers, and hence to the development and

[24] A second example was a Seeboard green tariff that provided low energy light bulbs. The company wanted to charge a termination fee equal to the cost if the customer left within a certain time, but since the contract was for less than 12 months all it could do was ask for the bulbs to be returned, which was not practicable.

[25] What "a reasonable charge to cover administration and the costs of a supplier's hedging arrangements" would amount to is unclear. As noted above, a figure of the order of £50 is sometimes mentioned for acquisition and administration costs (in Sweden too, see below). The cost of hedging would depend on the circumstances, but in some circumstances could perhaps be of the same order of magnitude. (E.g. Assume an energy bill of £250 p.a. x 5 years contract x 1/2 generation cost = £625. Assume the contract is cancelled half-way through after a 15% fall in wholesale market prices. Then the supplier is left with a loss on the remaining contracted generation of £625 x ½ x 15% = £46.875.) Would a cancellation charge of about £100 (= £50 + £47) be attractive to potential customers and acceptable to Ofgem as the arbiter of what is a reasonable termination fee? Would the cancellation fee depend on the movement of prices since the time the contract was taken out?

offering of such contracts. Although some suppliers have not found this a barrier to at least some contracts, they and other suppliers argue that having to include the provision over-complicates the message when the majority of customers want a simple product. If the main message to consumers is the attraction to both parties of committing to a fixed price for a fixed period of time - of not having to think about electricity price for three years, say - then this might be undermined by a series of clauses explaining the options for changing ones mind during that period and the consequences if one or other party were to breach these conditions during the period of the contract, depending on the time at which this happened and the circumstances obtaining at that time.

Related licence conditions accentuate the situation. SLC 44 requires that "Before entering into any domestic supply contract the licensee shall take all reasonable steps to draw the attention of the customer to the principal terms of the domestic supply contract". As noted earlier, SLC 46.6 (d) provides that a termination fee may not be demanded where the supplier has not drawn the attention of the customer to the cooling–off period. The Authority now has an ability to fine companies up to 10 per cent of turnover for breaching licence conditions. All this means that a supplier has no alternative but to emphasise the ability to cancel a contract at 28 days' notice, when the message that the supplier wishes to convey is that the contract represents a medium- to long-term commitment that neither side should consider revoking.

Whether or not they have offered fixed-price fixed-term contracts to date, most suppliers claim that that the 28 day rule is restrictive. One supplier that has not so far offered fixed contracts says that if the 28 day rule were lifted, it certainly would. Others seem to take a similar view. As always, it is difficult to judge the significance of these claims. However, Ofgem has hitherto been actively concerned to maintain and enforce the 28 day rule. There would be no point in doing this if it had no effect. The maintenance and enforcement of the rule must therefore be presumed to have prevented or restricted the development of certain kinds of contractual behaviour.

It would seem unfortunate if potential competitors are denied the ability to compete in particular ways unless they can demonstrate the reality of the obstacles that they claim to exist. This is uncomfortably reminiscent of pre-reform airline regulation in the UK and US, where the onus was on potential entrants to prove that there was a demand for their services that was not already met by existing incumbents. If a regulator's principal objective is to protect the interests of customers "wherever appropriate by promoting effective competition", should it not seek to remove all alleged obstacles to effective competition, itself bearing the onus of proof to demonstrate convincingly why an alleged obstacle should *not* be removed?

13. Switching when unhappy with price or service

Ofgem argues that "the 28 day rule serves the important consumer-protection role of allowing customers, when unhappy with the price or service from their current supplier, to switch suppliers." (para 1.10)

The 28 day rule enables customers to switch suppliers at a month's notice. Removing the rule would by no means preclude customers from switching suppliers if they are unhappy with price or service: they would be able to switch supplier on the expiry of the chosen term of their contract. Customers could therefore still express their dissatisfaction with a supplier by switching, and they would decide for themselves whether the price of a fixed term contract is sufficiently attractive to warrant committing themselves to not switching for a specified period of time.

Is a 28 day rule necessary to deal with the most severe quality of service problems? If quality had deteriorated to such an extent that changing supplier was a serious option, this suggests that the supplier had breached an implicit term of the agreement. It might then be open to the customer to claim breach of contract, and change supplier. Or Ofgem could take steps to make that possible, without the need to invoke a 28 day rule.

An appropriate comparison is again with other consumer service sectors. Suppliers of automobile insurance and home insurance services, for example, typically offer contracts for a year. It is equally important in those sectors that customers be able to show their displeasure at unattractive prices or poor service. Yet as mentioned there is no regulatory requirement in those sectors that suppliers should limit themselves to agreements that can be cancelled at 28 days' notice. It is not argued there that such a restriction would better enable customers to switch supplier, and would thereby constitute more effective protection for customers. Contracts of a year's duration have emerged as most convenient and economic for suppliers and customers. The ability to switch suppliers when renewing such a contract is considered adequate and appropriate to protect customers from unsatisfactory service. Another comparison is with the financial sector, where investors commit funds for periods ranging from a day to tens of years: there is no suggestion that investors would be better protected by a regulatory requirement that all such investments should be subject to cancellation at 28 days' notice, with regulatory approval of the cancellation charges.

14. Quantifying the detriments

Ofgem's Regulatory Impact Assessment suggests that "Individual customers might find themselves wishing to switch away from their energy supplier as a result of poor customer service, or if they become aware of substantially better offers" and that this would not be possible in the absence of the 28 day rule. It then makes an assessment of the magnitude of these detriments.

a) price disadvantage

Ofgem comments that "In terms of the price disadvantage that might arise from being unable to switch, customers can currently save an average of £70 - £120 (depending on locality) from switching both fuels for the first time." (Appendix 1 para 1.5)

The saving cited is explicitly from switching for the first time, from an incumbent to another competing supplier. However, this is not the relevant benchmark for customers

who sign such a contract. Some customers will have already received such a saving from switching away from the incumbent's standard tariff to another supplier. The price disadvantage that they would forego is the saving from a subsequent switching. But the saving from switching from one non-incumbent supplier to another is accepted to be an order of magnitude less than the above range for first-time switching.

Other customers that have not switched before will obtain a saving from a first move, the amount of which will depend on the price of the contract, which might in turn depend on whether it is offered by the incumbent or by a competing supplier. The price disadvantage such customers forego will then be the remaining difference between that saving and the figure cited above for first time switching.

Whether the savings from moving to and between contracts are greater or less than the savings from moving to and between short-term tariffs remains to be seen. It is possible that customers might attach so much value to the increased assurance on price that little or no discount might need to be offered (and as noted, in one case a premium has been charged). But if so, this indicates that the comparison is not 'like for like': the fixed price contract offers a benefit that the variable price tariff does not. Either way, the alleged "price disadvantage that might arise from being unable to switch" is less than that cited.

b) poor service disadvantage

What contribution does the 28 day rule make to protecting customers from poor service? Ofgem says

> "The detriment to the customer of staying with a supplier with which he or she is dissatisfied is hard to estimate. Resolving customer service problems can take up an inordinate amount of customer time (especially where supplier call centres are not responsive). On any reasonable estimate of the cost of a customer's time, this detriment can therefore amount to many tens of pounds. In addition, some consumers experience disputes with energy suppliers as upsetting, a factor that is hard to quantify." (Appendix 1 para 1.5)

It may well be true that resolving customer service problems can take up an inordinate amount of customer time and that some consumers find disputes upsetting. However, the incidence of poor quality service needs to be put into context. MORI surveys in 2001 suggested that under 5 per cent of gas customers and 3 per cent of electricity customers were dissatisfied with their supplier. J D Power surveys for 2002 and 2003 put the proportion of "disappointed" customers at 5 to 8 per cent for gas and 10 per cent for electricity. Whether this really represents dissatisfaction, or an increase in dissatisfaction, is debateable.[26] Ofgem acknowledges that "most customers do not experience serious customer service problems: customer satisfaction with energy suppliers remains high." (Appendix 1 para 1.5)

[26] Data from *Domestic Competitive Market Review*, April 2004, pp. 25, 30. In 2002 and 2003 customers were asked to rate their supplier on a scale of 1 to 10, and those giving a score in the range 1 to 5 were classified as 'Disappointed'. To classify a score of 5 out of 10 as 'disappointed' (and 7 out of 10 as 'indifferent') suggests an inclination to find customer dissatisfaction.

Moreover, customers themselves do not rank quality of service as a major factor in their decisions to switch suppliers. In 2003 only 6 per cent of gas and electricity customers cited better customer service as a reason for switching supplier.[27]

Since about half of all customers actually switch, this suggests that the proportion of all customers for whom switching to avoid poor service is important might be of the order of (6 x ½ =) 3 per cent. Even if one wished to preserve the option for all 'disappointed' customers to switch, it would still be at most 10 per cent of all customers. It is for consideration whether the remaining 97 or even 90 per cent of customers should be prohibited from signing fixed term contracts if they wish to do so, in order to preserve the ability of this 3 or 10 per cent to change supplier at 28 days' notice.

There is, however, a further question. Should even this 3 or 10 per cent of customers be prohibited from making their own decisions to sign a fixed term contract if they consider that on balance it is beneficial to them? Customers would not be forced to accept what Ofgem calls a "non-terminable contract". In deciding whether to commit to a fixed term contract, customers would consciously decide whether to take 'the bird in hand' of security on price and to forego 'the bird in the bush' of possible "substantially better offers", or of switching to improve customer service, during the course of that contract. Consequently, for all customers who decide to sign a fixed term contract, this decision would imply a judgement that, *for them*, the benefits outweigh the detriments of the restriction. Should this choice be prohibited? Put another way, should customers themselves be allowed to decide the contract durations on which they purchase energy supplies, or should the regulator decide for them?

15. The effect on competition

A final argument in favour of the 28 day rule – perhaps increasingly the most important one - is that abolishing it would reduce competition.

> "Competition relies on companies believing that customers can and will switch suppliers. Both the 'termination fee' or 'non-terminable contracts' options reduce this willingness and ability, and to that extent have potentially negative implications for competition." (Appendix 1 para 1.7)

It is true that suppliers (incumbents, existing competitors and potential entrants) develop and market new and better products on the assumption that this can make a difference to consumer behaviour – some consumers will be attracted to a new supplier, others will be persuaded not to leave an existing one. But surely the extent of competition does not depend on the ability of all customers in the UK to change supplier immediately, but rather on the ability of customers to change supplier at times of their own choosing. This may be at one month's notice, but it may alternatively be at the termination of a fixed-

[27] *Domestic Competition Market Review*, April 2004, pp. 42, 45. Previously the figure cited was 5 per cent. *Domestic gas and electricity supply competition, recent developments*, Ofgem, June 2003, Tables 4.7 and 4.8, and para 4.19

term contract. The automobile insurance and house insurance sectors are no less competitive because customers typically sign twelve-month contracts, and would not be more competitive if agreements there were required to be terminable at 28 days' notice.

Moreover, an important aspect of competition is the incentive on suppliers to develop and offer better products to their existing customers. Important among these are products that customers find so attractive that they are willing to commit themselves for a period of years, consciously foregoing the option of changing to another supplier in the interim. The extent of competition is not to be measured solely in terms of the number of customers that switch supplier.[28]

The 'termination fee' or 'non-terminable contracts' options thus influence the timing of the willingness and ability of customers to switch suppliers, rather than reduce it them. And they have potentially positive implications for competition, in the sense that they represent possibly more attractive choices to some customers.

Ofgem continues

> "The prevalence of 'non-switching' customers is also important for the willingness of new entrants to address the market. … The economics of direct selling are heavily influenced by the 'hit rate', and if sales agents were to begin finding that a significant proportion of their potential targets were unable to switch, a proportion of marketing activity would become uneconomic." (Appendix 1 para 1.8)

Ofgem is right to look at the implications of the rule for potential new entrants. This is particularly the case when the market seems to have consolidated at present into six quite large and regionally important suppliers.

Nevertheless, there is surely an important distinction to be made between competition and new entry in general and the use of a particular selling method. Direct selling has indeed been widely practiced in the new domestic energy market to date. It has been successful in many respects but some variants have had some problems. Whether it will remain the method of choice in future, and precisely what form it will take, is unclear, and will also depend on the contractual forms in common use. But there is no reason to believe that market activity itself would cease. Similarly, the absence of the rule would condition the form of new entry, not render it impossible. In other sectors the absence of a 28 day rule does not seem to have precluded the development of marketing activities suited to the economics of those services and in particular to the widespread use of annual or other fixed term contracts.

[28] But in any case, are the two in conflict? Suppose that incumbent suppliers offered existing customers two-year contracts that were so attractive - against all that competitors could counter-offer - that half of these customers signed up. Would this be so undesirable or harmful to subsequent competition or new entry? If half the 60% of customers still with the incumbents sign up, this still leaves the other 30% to compete for, which does not preclude a continuation of the historic (but now declining) net switching rate of about 1% per month for that 24-month period (quite apart from the scope to compete for the 40% of customers already with non-incumbent suppliers).

To illustrate, if suppliers know that all customers are required to be able to change supplier at 28 days' notice, it may be economic to put costs and effort into a direct sales pitch, whether on the doorstep or over the phone. If the 28 day rule did not apply, and many customers were signed up to annual contracts, then it is indeed quite possible that a proportion of this type of direct marketing activity would become uneconomic. Suppliers would instead find it more economic to develop marketing activities where less of the cost and effort is incurred up-front, and more of it is contingent upon an expression of interest by the customer. Thus in Sweden, for example, there is less direct selling and more reliance on following up responses to mail shots.

It is understandable that some potential new entrants into a market might prefer a restriction on contracts to ensure that all existing customers were immediately available to them, even though at some later time, when they have acquired new customers, they might begin to find it against their interests. Some might even argue that this is just a small restriction because it does not stop existing suppliers from offering long-term contracts, it simply requires them to enable cancellation and allows them to set a reasonable 'buy-out price' in the form of a termination charge. So if incumbents are compensated and new entrant competitors choose to pay the buyout price in order to attract new customers, where is the harm to anyone?

Apart from the practical difficulty of setting and enforcing reasonable termination charges, the counter-argument is that the 28 day rule nevertheless seems to be a restriction and distortion of competition. It favours certain (potential) market participants at the expense of other (existing) participants. It operates in favour of certain (direct) selling techniques and makes more difficult the emergence of other contractual forms and other selling methods – not least those that might be developed by new entrants. Even though it does not make it impossible to offer fixed-price fixed-term contracts, it does seem likely to hinder their development, or at least make their development conditional on specified cancellation provisions that most suppliers regard as an obstacle.

Ofgem rightly acknowledges that "It is, however, possible that competition could benefit from the trial, should it be proven that a wider range of contract structures are possible, consistent with high levels of consumer satisfaction." (Appendix 1 para 1.11). An even wider range of possible contract structures is likely to emerge from the unrestricted removal of the 28 day rule than from the trial suspension, with greater benefits for competition and customer satisfaction.

In fact, one might go further. Some might argue that the 28 day rule should not be removed until competition is fully effective. A similar argument was once advanced with respect to the residential price cap. But in my view, retaining the price cap was itself a discouragement to competition, that tended to thwart the state of affairs it was hoped to bring about. Ofgem rightly abolished it in 2002. If the analysis in this paper is correct, the 28 day rule similarly tends to limit the further development of competition. Removing it could help to bring about a wider set of competitive options in the market.

PART FOUR EXPERIENCE IN SWEDEN [29]

16. Retail competition in Sweden

The electricity market has been open to all customers in Sweden since 1996, although initially customers wanting competitive supply had to pay for new meters. Retail competition at the domestic level was not effective until profiling was introduced in November 1999. There are about 160 suppliers with associated local networks, although the Big Three companies (Vattenfall, Fortum, Sydkraft) and their associates (minority ownership and partnerships) account for about three-quarters of the total number of customers.

Suppliers typically offer:

- a standard tariff for existing customers that have not signed a contract, which can be varied at 15 days notice (traditionally once or twice a year, later 3-4 times a year, now even monthly as market prices have become more volatile)
- a fixed price contract for one, two or three years
- a spot price contract (with fixed margin added to cover costs) [30]
- some other variants of the above.

A customer wishing to transfer supplier, including a move from a standard tariff to a contract with another supplier, must give one month's notice to the distribution company (in practice about 45 days). A change from the standard tariff to a contract with the same supplier may be completed by the next day.

As of mid-2002, 43% of households were "active", of whom

- 21% have changed supplier
- 22% have signed a contract with their local supplier.

Only about 1% of customers are thought to be on spot price contracts.[31] Almost all the customers that have changed supplier or have signed a contract with their local supplier have signed fixed-price fixed-term contracts for one to three years. It follows that over 40 per cent of the residential customers in Sweden have voluntarily chosen to buy electricity without the equivalent of a 28 days' notice period. Agreements with 28 days' notice have not even made an appearance, let alone survived, in the competitive market.

The degree of activity in the retail market is highly related to size of electricity bill:

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[29] The material in this section was gathered on a visit to Sweden in June 2003. I am grateful to the Swedish Energy Agency and to many parties involved in the industry for informative interviews, and to Ofgem for supporting the inquiry.

[30] Interestingly, the calculation of spot price and its reflection in spot price contracts is not standard for all suppliers. Each supplier determines its own method: most suppliers invoice customers on the average for each month in arrears, but some do it in other ways. (In Norway, where average household consumption is even higher at about 13,000 kWh, the difference in methods left scope for customers to gain from switching between spot prices of different suppliers.)

[31] Customers in Sweden are said to be more risk-averse than in Norway where the proportion on spot contracts is much higher.

- 72% are active in houses with electric heating (usage 20,000 kWh/yr, comprising 1/5 of all customers)
- 52% are active in houses without electric heating (usage 5000 kWh/yr)
- 22% are active in flats (usage 2000 kWh/yr) and other consumer categories.

The typical electricity bill comprises about 1/3 energy charges, 1/3 grid charges, 1/3 taxes. (In the UK the proportion of energy charges would be higher and the proportion of taxes would be lower.)

Table 1 indicates in a rather stylised way the typical pattern of energy charges over the last few years. They increased gradually from mid-1999 to mid-2002, rather severely in winter 2002/03, then reduced somewhat by spring 2003. Contract prices generally lie between spot prices and standard tariff prices. Initially contract prices were about a third higher than spot prices and standard tariff prices were about two-thirds higher. By spring 2003 contract prices were about nearly two-thirds higher than spot prices and standard tariffs were about twice the level of spot price.

Table 1 Typical energy charges in Sweden over time (ore/kWh)

	Mid-1999 to early 2001	Late 2001 to 2002	Winter 2002/03	May 2003
Standard tariff	25	33	65	50
Fixed price contract	20	27	52	40
Spot price	15	20	70	25

Margins over cost (that is, price relative to an estimate of efficient cost) have increased over time for all types of contract and all types of customer. This partly reflects the higher and increasingly recognised customer costs of switching and providing information.[32] It may also reflect a reduction in competition as new suppliers (e.g. Statoil) left the market and the larger suppliers took over the smaller ones, though the larger suppliers would argue that the smaller ones failed to appreciate and handle the costs and risks involved.

17. Range of prices in mid-2003

At least one consumer agency maintains a website search organisation for electricity prices. (It provides the site and invites suppliers to enter terms; it does not check those terms.) A sample examination in June 2003 of the quotes for a 3-year contract for a

[32] Experience gradually revealed that it was costly to handle small customers. Telge Energi (TE, see below) estimates that the administrative costs of changing a supplier (including invoicing and associated telephone time) are around 600kr (£50). From January 2002 onwards, many suppliers introduced significant fixed charges into their energy contracts to reflect the problems and costs of exchanging information consequent on a change of supplier. This made their offers more attractive to larger customers than to smaller ones. (The fixed charge could be of the order of 10% of the annual energy charge, which in turn is about one third of the total residential bill.)

20,000 kWh house with electric heating revealed 62 bids listed. The site can rank the quotes according to total price excluding grid charges. The highest price was offered by one of the Big Three companies. The saving of the best contract compared to the contract of the incumbent (another of the Big Three) was about 5% of total price. The main savings are in moving from a Standard tariff to a contract, rather than in finding the best contract (as with moving from incumbent to competing supplier versus moving between competing suppliers in the UK).

Table 2 shows some tariff and contract prices on offer in early June 2003 for a small consumption household. The original table contains data for the 20 largest companies that account for some 80 per cent of electricity supply in Sweden. The average energy charge for a 1-year contract is nearly 20 per cent lower than in the Standard tariff. The average energy charge for a 3-year contract is about 6 per cent less than for a 1-year contract. The first four companies in Table 2 – the largest suppliers - have energy charges that are around 5 percent above the average. The last four suppliers in Table 2 - the smaller suppliers ranked 8th to 12th in the original table — have charges around 5 per cent lower than the average.

Table 2 Energy charges in Sweden (ore/kWh) with effect from 1 August 2003
(for household consumption 5,000 kWh/yr)

	Standard tariff	1 year contract	3 year contract
Average	47.11	37.77	35.53
Vattenfall	55.94	40.80	35.80
Fortum	55.80	40.66	38.66
Sydkraft	53.30	38.30	37.80
Plusenergi	41.54	39.80	39.50
Telge Energi	45.02	38.52	36.22
Elbolaget i Norden	47.88	38.40	35.30
Malarenergi	40.40	36.60	34.60
Skelleftea Kraft	41.00	35.12	31.82

Source: montel powernews vecka 24, 2003

18. Comparison with UK

Is the competitive market in Sweden better or worse than in the UK? The picture is mixed.

a) In some respects it seems better. There is a greater variety of terms on offer to domestic customers (e.g.standard tariff at 15 days notice, 1-3 year fixed price contracts, spot price contracts). There is a deeper market (more suppliers) for the popular types of contract. The incumbent suppliers offer the whole range of terms so it is possible for customers to exercise choice and get better terms without the worry of changing supplier.

b) In some respects it seems about the same. The extent of price reductions offered by competitive suppliers relative to incumbent suppliers seems similar to the UK. The proportion of 'active' customers - that have either changed supplier or signed contracts with their existing supplier – seems about the same as the proportion that have switched in the UK. Hence the proportion of customers still on original high priced terms with the incumbent is about the same (somewhat under 60%). Supplier margins have in general increased.

c) A higher proportion of larger domestic customers is active in Sweden, but these are more akin in size to small commercial customers in the UK (who are also active). Fewer smaller domestic customers seem to be active in Sweden than in the UK, so there are the same concerns about inactive customers paying higher prices. The smallest consumers (e.g. in flats) may question whether it is worth the bother to switch or contract, as in the UK. But there is no pressure in Sweden for further involvement by government or regulation, other than a determination to make competition more effective.

d) In some respects the Swedish market is said to be less satisfactory than the UK. The provision of customer information is limited and the mechanism for dealing with complaints (the 'customer watchdog') is undeveloped. The arrangements for changing supplier seem to vary greatly from one network company to another, are not uniform or uniformly enforced, and have generally worked poorly, though it is said that they have begun to improve. Customer complaints have been very high and have discouraged switching. Regulatory input has been severely limited by shortage of resources and other priorities. [33] There has been more concentration in the market than in the UK, so that three large suppliers now supply (directly or indirectly) three-quarters of all customers.

19. The origin of contracts

[33] Although not the topic of this paper, some aspects of the switching experience may be of interest. There has been great concern about the problems, costs and delays of switching in Sweden. There has been no significant mis-selling (the main selling tactic is direct mail rather than doorstep selling), but there have been serious problems with the change of supplier procedure. It is difficult to pin the blame (as always) but it is said that many networks are not skilled in these matters and have no incentive to get it right. If anything they have a loyalty to previous or present associate supply companies rather than to competitors generally. If a supplier change fails to meet a specified time deadline, the switching of that customer is delayed by a month or even several months. Reportedly the situation was improving by June 2003, and only 10% of supplier changes failed to meet the deadline, but this was still regarded as high.

Some have suggested that the UK spent too much on switching arrangements including IT, and have suggested Scandinavia as model. However, Swedish arrangements were considered to be in a very poor state, with great variations between 160 networks. There was much talk of the need for centralised procedures and uniform IT systems as in the UK.

Customer information and assistance seemed poor compared to the UK. The Government had not been willing to fund a consumer body, and the regulator had limited resources. The industry funded a new Electricity Advice Body in May 2003, which was understaffed and overwhelmed by enquiries. There was little information available to customers about changing supplier. In consequence, active suppliers were also overburdened with questions, which increased their costs of competing.

How did contracts and spot price terms originate in Sweden?

Telge Energi (TE), the electricity company from Sodertaljie, a municipality just outside Stockholm, was the first competitor in the field and is now the most active residential supplier outside of the Big 3 suppliers. It had only 1 per cent of the Swedish market and wished to expand in order to secure economies from greater size. Its strategy was to aim at households using electricity for domestic heating, about 20% of all households. Its initial contract offering was a response to what customers needed at the time. Before the competitive market opened customers were accustomed to uncertain and generally rising electricity prices. They wanted both lower and more certain prices. TE initially offered fixed-price fixed-term contracts to its own customers at no reduction in prices, and got a very good response. Then it made offers outside its own area, of a 2-3 year fixed price contract at a 20% price reduction. There was a very good response from customers: 20-30% of electric heating households in Stockholm signed up within the first six months. This encouraged TE to offer the same types of contract at lower prices in other areas.

Fixed-price fixed-term contracts had two additional advantages. First, TE considered that they would be similar to contracts in the mortgage market, with which customers would be familiar. Second, before profiling was introduced, customers choosing competitive supply had to install hourly metering. TE decided to give away the meters for free, with the fixed-price, fixed-term contract recovering the initial metering cost over a predictable period of time.

Other companies followed TE. The incumbent suppliers now began to offer fixed-price contracts about 2-3 ore above the level offered by TE. Many customers accepted fixed-price contracts with their own suppliers rather than switch supplier. The incentives to do this were a) they would continue to get a single bill whereas if the distribution and supply companies were different they would get two bills, and b) they avoided the inconvenience of changing supplier with its possibility of misread bills, inaccurate billing or missed bills, etc., which was and still is a problem.

In March 1998, about ten months after it had offered fixed price contracts in Stockholm, TE began to offer spot price terms (actually spot price plus 2.9 ore to cover its costs) as part of its last offer to provide free meters. On this basis it initially required a minimum agreement period of 2 years in order to cover metering costs. TE saw Pool price as a way of offering innovative new deals and good prices to customers. Customers had some concerns that incumbents were trying to lock them into long contracts at high prices at a time when spot prices were very low. Developments in the electricity market at this time also followed the recent liberalisation of the home mortgage market, where customers were beginning to explore new choices of spot versus term rates.

Again, some other suppliers followed suit. In the event - as with mortgages – relatively few customers accepted spot price terms. They preferred fixed price contracts in the expectation that electricity prices would normally go up each year.

20. Differences between Sweden and UK

Why did such a range of terms not emerge in the UK? As explained above, the general industry view (although Ofgem is sceptical) is that the 28 day rule effectively prevented the use of fixed-price fixed-term contracts, and effectively required a tariff like the standard Swedish incumbent tariff with 15 days' notice. It is fair to say, however, that some other factors may also be relevant.

a) Although UK domestic customers may well have felt the same in the early 1990s as Swedish customers did in the late 1990s (i.e. concerned about uncertain and rising prices), by the time the UK domestic market opened in 1998 customers had had at least six years of falling prices (in real terms), there was no great fear of increased prices, and if anything there was an expectation of further falls in prices. Fixed price fixed term contracts were not a particular need for UK domestic customers at that time.
b) In contrast to the situation in Sweden, the situation in the UK did not really change in this respect even in the few years after the market opened. Whereas the frequency of price changes on the standard tariff increased to 3 to 4 times a year (or in one case monthly) in Sweden, there were no significant price variations in UK retail prices (until recently).
c) UK suppliers did not have to pay for the installation of new meters, and other 1998 costs were spread amongst all users. A longer-term contract thus had no particular advantage from this perspective.
d) As regards the absence of Pool price terms in the UK, such terms had never commanded great support among large UK users, Pool price was not seen as particularly low in 1998, and there was increasing dissatisfaction with the Pool that led to pressure to reform the Pool and eventually to its abolition in favour of NETA.

As noted above, circumstances may now be changing in the UK. Apart from the energy efficiency issue, the main change is that there have recently been numerous retail price increases, so customers may now attach greater value to fixed price contracts than they previously did. Certainly several UK suppliers have found considerable interest in the fixed-price terms they have offered. It is also possible that customer acquisition costs have proved higher than expected, and increasingly difficult to cover as the switching rate diminishes. So customers and suppliers may each see greater advantages from fixed-price fixed-term contracts than was previously the case.

21. Two illustrative companies

It may be of interest to look in a little more detail at the portfolios and policies of two different companies in the Swedish electricity market.

a) Telge Energi (TE)

TE has already been mentioned as the initiator of competition and as the most active new supplier in the domestic market. As of spring 2003 its portfolio of customers was as follows.

	Within area	Outside area	Total
Number of customers	45,000	95,000	140,000
On Standard tariff	30,000	0	30,000
On individual agreements	15,000	95,000	110,000
Spot price terms			11,000
Fixed price 1-3 year contracts			99,000
Total individual agreements			110,000

The preferences of customers as to duration of contract vary over time. Formerly, most chose the 1-year contract. In early 2003 the 3-year contract was considered the best deal and about half of the customers chose that, with about one quarter each choosing the 1-year and 2-year contracts. Interestingly, TE's website indicates the proportions of customers choosing each type of contract.

b) Vattenfall

Vattenfall is one of the Big Three companies, with a 13% share of the residential market under its own brand, much higher with associates. As of June 2003 its focus was to keep these customers rather than to attract others (but see note below on its present focus). It had explored attracting new customers, but considered that electricity was an immature market where households were not yet ready to choose or did not care sufficiently about their supplier and the possible cost savings.

Traditionally Vattenfall's Standard tariff was changed once or twice a year, an important decision taken at Board level. Since deregulation in 1999 that tariff has been changed 3-4 times a year, and the decision is now taken at a lower level with a view to maintaining the margin. The decision takes into account recent and predicted Nordpool prices for the next 2-3 months, customer movements between suppliers, competitive price levels, and predicted reactions of customers to price changes (both leaving and arriving). Other companies tend to look to Vattenfall as the price leader in terms of content and timing.

Other companies have also learned how Vattenfall sets its contract prices. There is a significant volume risk as well as price risk in this market, if customers use more or less energy than forecast or than average. Vattenfall considers that it has good competence here whereas some other energy companies did not have. In winter 2002/3 several small companies had problems and a few went bankrupt because they had not properly calculated their volume risks.

Vattenfall offers a spot price contract with a small fixed margin that is revised from time to time. The company does not promote it because it is not suitable for most domestic

customers.[34] Only about 1% of their customers choose it. Vattenfall continues to offer a spot price contract because its philosophy is to be a full service company and to meet all customer needs in an efficient way. If Nordpool prices had been less volatile, the company would have promoted spot price more. It is also difficult to discuss 'risks' with customers, and the company does not want to focus on the negative aspects of deregulation at this stage

99% of Vattenfall's new customers choose the fixed price contract offers, the other 1% choose spot price terms. They do not choose the Standard tariff, which is only relevant if they have moved into an area in which Vattenfall is assigned supplier (supplier of last resort) and if they do not actively choose another supplier or ask for a fixed price contract from Vattenfall. The company promotes contracts, and wants its customers to be active and to make a choice of preferred contract, which should increase customer satisfaction. However, there is a dilemma here. The company wants to move its customers on to contracts, and its own survival depends on customers choosing its contracts, but its existing lower consumption customers are less interested in this, and its Standard tariff is profitable.

Nonetheless, the situation is changing: in mid-2002 about 50% by volume of its customers were on the Standard tariff but by April 2003 this had fallen to about 40%. The company expected that by the end of 2003 there would be a bigger customer movement (more contract signings) than in previous years, reflecting responses to the winter price increases.

In its business plan for 2004, Vattenfall changed its focus and is now more active in the market, focusing on attracting new customers in the domestic market. Its project "Number One for the Customer" launched in 2002 is described as "a fresh approach to our customers [which] means electricity consumption on the customer's terms". This includes offering new electricity price products in stages during 2003. One of these launched in autumn 2003 was the 'Convenient electricity price'. Customers that choose a fixed price contract can now also buy a 'chance guarantee' that enables the customer to transfer to a new contract at a lower price before the original contract ends. Many customers have bought these guarantees because of the volatile market situation.

PART FIVE CONCLUSIONS

22. Conclusions

Ofgem is presently considering whether to introduce a trial suspension of the 28 day rule for energy efficiency contracts. It also has a stated intention "to continue to withdraw from regulating the energy industry where we believe this is in the best interests of customers, for example by removing certain licence conditions". This paper has suggested that there is a case for removing the 28 day rule completely.

[34] Household customers are very vulnerable to spot prices, especially those with electric central heating. The average annual consumption per household is 7-8000 kWh, more than twice that in the UK.

The rule was introduced as a transitional measure when the domestic market was first opened, to protect domestic customers who at that time had no experience of a competitive energy market. That situation no longer obtains: domestic customers have been choosing energy suppliers for nearly seven years, and about half have changed supplier at least once. Claims that the 28 day rule protects competition or customers in terms of price or quality of supply do not seem persuasive. Such arguments do not determine policy in other competitive sectors. These arguments also imply that customers should not be allowed to decide for themselves whether to sign energy contracts for a fixed period, even of one year. It seems questionable whether such restrictions are justified in order to ensure that there is a 100 per cent 'pool' of customers available to be signed up by competing suppliers.

The 28 day rule has not prevented suppliers from offering fixed-price contracts for periods of up to two years, and some have done so. It is not clear how strong is the frustrated demand to offer such contracts. Nevertheless, it seems unlikely that the rule has had no effect, and that it has not restricted the development and wider availability of such contracts. It may also have unduly favoured a particular kind of selling method. If energy services are economic, and attractive in the market despite the availability of subsidised offerings, then abolishing the rule could facilitate their development, as Ofgem's consultation suggests, but at lower cost and with less risk of deterring such developments through undue bureaucracy. More generally, contracts could provide wider choice, lower and more secure prices, more retail competition, and greater security of supply in generation.

Experience in Sweden, where there is no equivalent of the 28 day rule, seems relevant. Fixed-price contracts for 1 to 3 year periods account for over 40 per cent of the domestic market there. In fact, these are the types of contract that suppliers predominantly offer, and almost all the customers that have actively exercised choice have chosen such contracts. This preference may have been influenced by previous experience of uncertain and increasing energy prices, but that is now the context in the UK too.

Swedish experience and the more limited UK experience both suggest that UK customers and suppliers would be interested in fixed-term fixed-price contracts. The time therefore seems ripe to consider removing the 28 day rule, to take this opportunity to reduce unnecessary regulation in a competitive market, and to let domestic customers decide for themselves on what terms they would prefer to be supplied with electricity and gas.