CEER Position paper on early termination fees

17 May 2016

1 Introduction

European energy laws require that a customer should be able to switch their energy supplier within three weeks. Furthermore, EU legislation clearly states that switching should be at zero cost for the customer (see the 3rd Package).

Could this provision be interpreted in a way that no cost can be charged to a customer who unilaterally ends an energy contract before the end of the contract term?

The costs charged to customers who unilaterally end their energy contract earlier than the agreed termination date are mostly known as 'exit fees', 'early cancellation fees', 'termination fees', etc. The focus of this CEER paper is on ***'termination fees'***, namely general costs that are charged to customers at the end of the contract and on ***'early termination fees'***, namely specific costs that are charged to customers who unilaterally end an ongoing contract with an energy supplier before the contract's end date.

The 3rd Energy Package Directives clearly state that switching should be completely free for the customer. Therefore, it should not be possible for energy suppliers to charge a *termination fee* to customers who respect the end date of their energy contract. These termination fees are to be considered a switching cost.

However, CEER considers *early termination fees* not to be a switching cost but rather separate and legitimate charges covered under the contract between the supplier and the customer. CEER accepts that, from a customer's perspective, all termination fees can act as a barrier to switching.

Energy retail markets are characterised by the existence of contracts with fundamentally different properties, such as fixed and variable price contracts, which can be linked to the wholesale markets for electricity and gas. Furthermore, certain contracts are of a fixed term nature (e.g. 1 year contracts) whilst others are of an undetermined end date.

Arguably the prices of fixed term, fixed price contracts might rise if the costs of early termination of such contracts cannot be charged to the customer by their current supplier through an early termination fee. However, this view ignores the potential benefits of a switching-friendly environment without early termination fees, which could outweigh the effect of rising costs at individual customer level. If customers switch more freely knowing they will not be sanctioned by an early termination fee, the competitive pressure on suppliers increases, thus compensating for the rising risk of the fee being passed onto customers. Yet, certain risks remain as some costs may be placed on inactive customers.

CEER recommends that analysis on the effects of abolishing barriers to switching on market dynamics is carried out at national level, given that much of the effects depend on the situation and contractual contexts that exist at national level. It depends on national circumstances whether creating an environment where customers are encouraged to switch more freely can result in lower overall prices through higher competitive pressure on prices due to significantly increased switching levels.

2 The customer – supplier relationship

As a background, wholesale electricity costs vary significantly over a year and even hour-by-hour, driven by volatile underlying international fuel prices and varying demand for electricity. These wholesale costs typically represent around 50% of suppliers' costs of supplying electricity to their household customers.

In order to have greater certainty over their electricity bill, some household electricity customers, however, value fixed price contracts over a fixed period (e.g. one year). Fixed term and fixed price contract give consumers the certainty of fixed energy costs. Allowing consumer to break this contract free of charge changes the nature of the product. From the suppliers' perspective, the fixed term and the fixed price are correlated. The offered fixed price is set in combination with the duration of the contract (e.g. a 1 year fixed price contract might be less expensive than a 3 year fixed price contract). When suppliers offer fixed term / fixed price contracts, they typically need to hedge the volatile wholesale costs, incurring additional costs to do so.

In cases where a customer on a fixed term / fixed price contract terminates the contract early, early termination fees may therefore be justified to enable the supplier recoup its hedging cost, which is not recovered from the customer during the agreed term of the contract.

Early termination fees are therefore justifiable when a supplier contracted the energy to be supplied for the full duration of the contract and was charged to do so. In this case, the supplier passes on the risk of accruing extra costs to the customer in the form of an early termination fee. If early termination fees were not allowed in these circumstances, the supplier may be forced to pass on the risk of such costs being incurred to all customers. The end result could be higher electricity prices and less consumer choice.

Early termination fees also present advantages to customers, as without early termination fees for fixed tariffs, customers can be forced to stay in contracts even if this is against their interest (e.g. having signed a 3 year fixed price contract and then realising the market price has dropped significantly). A key question is whether the contractual clarity (discussed below) provides enough protection for consumers and supports the goal of improving competition in emerging energy markets.

For contracts with *variable* pricing, the validity of early termination fees is much harder to argue, as the supplier will most likely not contract the full amount of energy that is expected to be needed to cover the customer's needs from the start.

For non-fixed term contracts, the same holds true. As both parties can end the contract according to the agreed terms, there is little argument that there is a cost for the supplier associated with the customer ending the contract.

CEER acknowledges that early termination fees are possible for fixed term, fixed price contracts, provided the customer is fully and clearly informed about the existence of the early termination fee before entering into the contract and that the rest of the contract terms are balanced and do not lock-in the customer, locking the market for new suppliers.

At the same time, CEER considers that early termination fees are harder to justify for contracts that are not fixed term and fixed price in nature. Early termination fees therefore are not appropriate for energy contracts with variable pricing where the customer carries the full risk of the price variation.

As such, early termination fees for these types of contracts should be limited and clearly associated to certain additional cost borne by the supplier specific to the customer in question; this is typically the case when certain benefits are given to the customer in addition to energy supply, such as energy audits, energy efficiency appliances, insurance. The responsibility would be on suppliers to robustly demonstrate that these additional costs justify early termination fees.

In addition, CEER notes that in setting contracts suppliers must adhere to all their regulatory and legal obligations.

3 How do early termination fees affect the customer?

Exit fees are reported as a problem in the European Commission's "Second Consumer market study on functioning of retail electricity markets for consumers in the EU" presented at the London Forum 2016. In addition, the ACER-CEER Market Monitoring Report 2015 presents the following information:

> Respondents [to ACER Questionnaire] were able to provide information on exit fees, which seem to represent a significant share of the switching costs in their respective countries, thus reducing the final savings made by consumers in switching. Exit fees, which are most often charged to consumers on fixed-price and fixed-term contracts, can be considered a type of product differentiation as their relatively high value compared to the final price of energy usually exceeds any potential costs incurred by suppliers due to consumers' breaking away from the contract within the contractual period (e.g. marketing costs for signing up a 'replacement' consumer, costs of re-selling the pre-purchased energy, discounts on energy included in the contract etc.). These considered costs need to be objectively justified.
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> Exit fees, which can pose a barrier to switching, are more common for electricity consumers than gas consumers. In some countries (e.g. Belgium, Italy), suppliers are not allowed to charge exit fees to consumers who wish to break the existing contract, as exit fees are considered to act against competition, mask the comparability of offers and to tie consumers to their existing contracts.
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> **Where exit fees are imposed on consumers who wish to switch supplier, offers which include exit fees should be fully transparent in price comparison tools** and, for example, **filterable from the rest of the offers** by consumers in search of a different deal. Contractual obligations deriving from such offers should be made available to consumers. While this Report has identified exist fees as a barrier to switching, since they tend to increase the threshold for consumers to switch due to the perceived diminished potential savings available, **in fully competitive markets, exit fees are set up to cover the costs incurred by suppliers due to early contract termination**.
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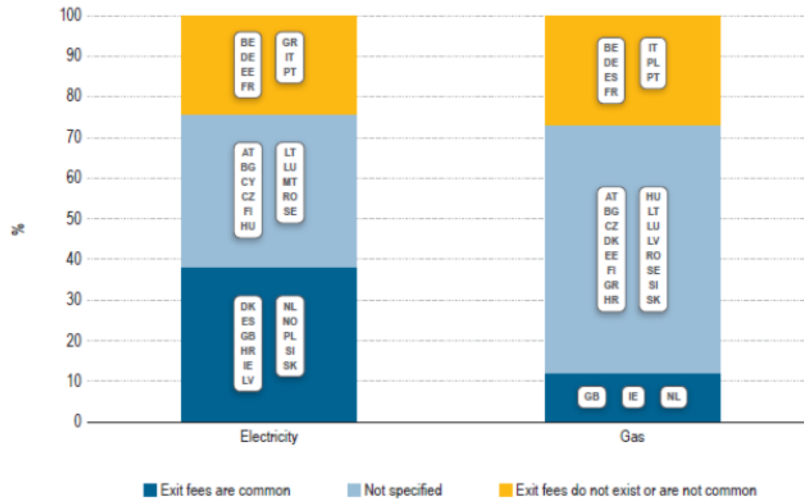
> Source: ACER-CEER Annual Report on Monitoring the Internal Electricity and Natural Gas Markets in 2014

Annex 8: Consumer switching behaviour

Figure A-20: Existence of exit fees imposed by suppliers when switching offers – 2014 (%)



Source: ACER Questionnaire (February–April 2015) and ACER Database (November–December 2014).

Notes: Based on the offer data shown or as indicated by the respondents in the Questionnaire. Although MSs are listed in the Figure, the information drawn from the offer data may refer only to the capital city.

Source: ACER-CEER Annual Report on Monitoring the Internal Electricity and Natural Gas Markets in 2014

From the consumer perspective, the risk of being charged an early termination fee is both a *real* and a *psychological* barrier to engage in supplier switching. It is a real barrier, as the early termination fee will reduce the potential gain that can be expected from switching. Early termination fees also present a potential behavioural barrier, since consumers do not want to be exposed to any risk as a consequence of their actions. This is a bias identified by behavioural economics, where the consumer is seen as not being fully informed and not making purely rational decisions due to behavioural biases. However, it is noted that early termination fees can exist in markets alongside high switching rates – for example in Ireland, where the switching rate was 14% in electricity and 17% in gas in 2014.

CEER underlines that from the customer perspective, clarity is the first consideration. Therefore, before entering in a contract with an energy supplier, the contractual conditions must be made clear to the customer, including whether an early termination fee will be applicable, under which conditions and how high the early termination fee will be.

Furthermore, CEER is of the view that contracts should be balanced and provide proportionate benefits and costs for both consumers and suppliers. An early termination fee must therefore *inter alia* reflect the period of the contract that is not respected and should not lock-in customers against their will or interest.

The **unfair commercial practices Directive**[1] may act to prevent an early termination fee from being too high compared to the value of the contract. In addition, the Directive on unfair terms in consumer contracts[2] introduces a notion of "good faith" in order to prevent significant imbalances in the rights and obligations of consumers on the one hand and sellers and suppliers on the other hand.

[1] Directive 2005/29/EC of the European Parliament and of the Council

[2] Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts

The ***contractual practices*** are very relevant to evaluate whether an early termination fee presents a barrier to consumer switching or not. If the conditions imposed by the contract result in consumer lock-in, such as having a very small window of opportunity to inform the supplier that the contract should be ended in combination with an automatic renewal of the contract if the consumer does not act, the consumer will have to accept the termination fee when switching. In such circumstances, switching will most likely be very low and the abolition of early termination fees might be considered to raise the level of switching and therefore raise the competitive pressure on suppliers and prices.

CEER is of the view that it is not acceptable to lock-in customers by contractual conditions that prevent them from switching, making it too hard for the customer to switch energy suppliers. Therefore, CEER recommends energy suppliers to give customers a sufficiently long fee-free window to switch at the end of the contract.

In light of this, CEER supports the conclusions of the 2016 Citizens' Energy Forum whereby

"The Forum calls for removing barriers to the switching process - including unjustified fees - to further engage consumers in energy markets, foster competition among suppliers, and drive down energy bills."

4 Early termination fees in the context of automatic renewal of fixed term contracts

A specific issue is ***automatic renewal*** of fixed term contracts. If a customer enters into a fixed term contract and does not actively end the contract at the end of the contract term, in many countries, the contract will be automatically renewed for the same term. This can lead to 'customer lock-in', especially if the procedure for contract termination is very complex or the window available to the customer to do so is very short.

In France, this situation led to the 2014 'Loi Hamon' (Law Hamon), which prohibits for automotive and insurance contracts, a termination fee once a fixed term contract has been automatically renewed at the end of the first term. This rule exists in other countries as well, e.g. automatically renewed contracts can be ended free of charge with a month's notice. This practice puts pressure on the supplier to offer the customer a good contract.

CEER recommends not allowing early termination fees to be charged in case of contracts that result from automatic renewal of fixed term energy contracts. To prevent automatic renewal of contracts leading to customer lock-in, it should be prohibited to charge an early termination fee once a fixed term contract has been automatically renewed at the end of the first term.

5 Other contractual provisions can have similar effects as early termination fees

In terms of other contractual provisions which can have similar effects as early termination fees, a lot depends on the initial market practices.

In some countries, a loyalty bonus is paid out to customers who respect the ***full term of their contract***. This bonus is paid out also if the customer decides to switch to another supplier after the contract is ended. This is the case in the Netherlands, where the bonus is not conditioned by a renewal but by the customer serving out the initial contract term (mostly 1 year). To ensure this happens in practice and no money is charged to the consumer, these bonuses are paid at the end of the contract.

There are also contracts that give the customer cashback upfront. Based on the early termination fee legislation in some countries, the supplier is allowed to ask for cash back of up to a maximum of 50 EUR per fuel (in addition to an early termination fee) if the contract is ended before the first year. This also holds for presents (such as iPads), up to 50 EUR per fuel can be charged back to compensate for breaking the contract and keeping the present.

CEER recommends ensuring that loyalty bonuses are paid out before or in connection with the end of the contract, in order to prevent them from having the effect of locking in the customer.

In some markets, there are also **renewal bonuses**, which the customer receives only if the contract is renewed.

CEER points out that renewal bonuses act as a barrier to switching and should therefore be avoided.

CEER wants to remind that work is ongoing on the Benchmarking Report on commercial barriers to supplier switching, which is looking at termination fees in a broader context.

6 List of related documents

- Directive 2005/29/EC of the European Parliament and of the Council
- Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts
- Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity
- Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas
- Electricity and Gas Retail market design, with a focus on supplier switching and billing, Ref: C11-RMF-39-03, 24 January 2012
- ACER-CEER Annual Report on Monitoring the Internal Electricity and Natural Gas Markets in 2014, November 2015
- Conclusions of the 8th meeting of Citizens' Energy Forum, London, 23-24 February 2016