

Addressing undue discrimination

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Target Audience: Energy suppliers, consumers, consumer organisations and representatives, academics and other interested parties

Overview:

In the light of responses to consultation, the Authority has decided to introduce two new licence conditions: one requiring cost reflective payment methods; and the other prohibiting undue discrimination. The drafting of these licence conditions (and associated guidelines) has been amended slightly from proposals set out for consultation in April.

This document sets out the rationale for the Authority's decision, the statutory consultation notices required to implement the new licence conditions, and guidance on the new conditions. We invite any final representations on the new licence conditions and seek the consent of suppliers to implement the new licence conditions. Subject to responses, we intend to introduce the new licence conditions in August.

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Context

Ofgem's principal objective is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. In keeping with this objective, we launched a study of the state of GB energy supply markets ('the Probe') in February 2008. In October 2008, we set out our initial findings on the operation of the GB retail energy markets and set out for consultation a package of measures to tackle the issues raised. In January 2009, we consulted on a range of proposals in relation to one of the key action areas identified - addressing unfair price differentials. In April 2009, we consulted on final proposals for two new licence conditions designed to address undue discrimination. In the light of responses to that consultation, this document sets out Ofgem's proposed way forward.

Associated Documents

- Energy Supply Probe – Initial Findings Report, October 2008 (Ref: 140/08)
- Addressing unfair price differentials (01/09), 8 January 2009
- Energy Supply Probe – proposed retail market remedies (41/09), 15 April 2009
- Addressing undue discrimination – final proposals (42/09), 15 April 2009
- Addressing undue discrimination – impact assessment (43/09), 15 April 2009
- Addressing undue discrimination - final impact assessment (73/09), 26 June 2009

The above documents are available via the Ofgem website at the following location:

<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx>

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1. Overview

Background

1.1. In October 2008, Ofgem set out the initial findings of its investigation into the operation of the GB retail energy markets. This identified a number of areas where we are keen to further improve the functioning of the retail energy supply markets.

1.2. Our Initial Findings Report found a number of significant pricing differentials that could not be explained readily by differences in costs. Our key areas of concern centred on the differentials between payment methods, between regions and between fuels (gas and electricity). We identified that unjustified price differentials and discriminatory pricing structures have had a significant detrimental impact on the consumers affected and a disproportionate impact on vulnerable groups.

1.3. In responding to these concerns, we remain convinced that consumers benefit most from a vibrant, competitive market: markets work best when consumers make active choices based on good quality information. We are therefore proposing a package of measures designed to improve the functioning of the market for all consumers, particularly vulnerable households. Our proposals were set out for consultation in April and our aim is to implement the package ahead of the winter.¹

1.4. Over time, we anticipate that these remedies - through the operation of the market - will address instances of undue discrimination. However, we expect that this process will take time to have the effect envisaged. In the meantime, competitive pressures alone may not be sufficient to protect consumers from undue discrimination and this may disproportionately harm vulnerable consumers.

1.5. Following an earlier consultation on a range of proposals², the Authority announced in March 2009 that it was minded to introduce two new licence conditions for domestic gas and electricity suppliers as follows:

- Licence Condition A: a requirement for any difference in the terms and conditions offered in respect of different payment methods to be cost reflective; and
- Licence Condition B: a prohibition of undue discrimination in any terms and conditions offered to customers.

1.6. The proposed licence conditions and draft guidelines for these conditions were published for consultation in April 2009.³ These guidelines outlined the principles Ofgem intends to take into account when interpreting and applying the licence conditions and, in particular, set out the factors that we intend to take into account in deciding whether there is any "objective justification" for practices that might otherwise be viewed as discriminatory.

¹ *Energy Supply Probe – proposed retail market remedies* (41/09), 15 April 2009

² *Addressing unfair price differentials* (01/09), 8 January 2009

³ *Addressing undue discrimination – final proposals* (42/09), 15 April 2009

Consultation responses

1.7. We received 18 responses to our consultation on the proposed licence conditions and guidelines, and on the impact assessment.⁴ A list of all those that responded and a summary of their views is contained in Appendix 1.

1.8. Respondents expressed a wide range of views on the proposed licence conditions and associated guidelines, and on our impact assessment:

- Suppliers expressed mixed views on the proposals: some were broadly supportive, while others expressed concerns about the potential for the licence conditions to weaken competition. Several suppliers recognised that the proposed guidelines help to mitigate these risks, although there were numerous suggestions for how the licence conditions and guidelines could be improved and clarified in this respect.
- Consumer groups were strongly in favour of Ofgem's intention to address undue discrimination and supported the proposed licence conditions and guidelines. Some argued that the proposals did not go far enough to protect vulnerable consumers.
- The three academics that responded were strongly opposed to the proposed licence conditions on the basis that they believe that the rules are likely to stifle competition and, as such, could have harmful consequences for consumers.

Ofgem's view

1.9. Following consideration of these responses to consultation, the Authority has decided to introduce Licence Conditions A and B, amended only slightly from the drafting of the licence conditions and the associated guidelines set out in April. These amendments are discussed in the next section. This document sets out the statutory notices required under the Gas and Electricity Acts for licence modifications.

1.10. We acknowledge the concerns expressed about risks to the intensity of competition between suppliers as a result of a prohibition on undue discrimination. However, as set out in the final impact assessment published alongside this document, we believe that the potential impact on competition is ambiguous, especially in the presence of obstacles to effective consumer engagement and effective switching, particularly among vulnerable consumers.

1.11. Given our statutory duty to protect consumers, and to have regard to the interests of vulnerable consumers, we continue to believe that it is appropriate to introduce a licence condition prohibiting undue discrimination. We consider that this measure will have significant benefits for many vulnerable consumers in the form of lower prices and we have attached particular weight to this consideration.

⁴ Addressing undue discrimination – impact assessment (43/09), 15 April 2009

1.12. It is also important to recognise that we have drafted the guidelines in a way which we believe will minimise the risks of any negative impact on competition and innovation, particularly through our approaches to materiality and enforcement, and the sunset clause. In the light of consultation responses, we intend to amend the guidelines to further reduce uncertainty and risks to competition.

Policy developments

1.13. This section sets out our policy position in the light of responses to the April consultation exercise. In particular, we discuss:

- the status of the guidelines;
- the details of the enforcement procedure;
- the concept of objective justification;
- the drafting of Licence Condition A; and
- the scope of application of Licence Condition B.

1.14. Our revised proposals are reflected in the licence conditions set out in the statutory notices in appendices 2 to 5 and in the revised guidelines set out in appendix 6.

Status of the guidelines

1.15. In our final proposals document in April, we set out our aim to produce guidelines on the proposed licence conditions - in order to reduce uncertainty around the application of the measures and, through their content, to mitigate some of the risks identified to competition and innovation. Draft guidelines were published for consultation as part of the April document.

Respondents' views

1.16. Several respondents welcomed the proposed guidelines and recognised their potential to mitigate the risks to competition and innovation (although there were numerous suggestions for how the guidelines could be improved in this respect).

1.17. Most of the Big 6 suppliers argued that the guidelines should be provided for explicitly on the face of the licence conditions, to provide greater certainty about how Ofgem will interpret and enforce the new licence requirements. In particular, respondents were keen for certainty that Ofgem would issue guidelines on the new conditions and that procedural and consultative requirements would be established in relation to any revising of the guidelines.⁵

⁵ For the avoidance of doubt, the guidelines revision process set out in Licence Condition B applies only to the revision of the guidelines and not to their initial promulgation. The guidelines as published in this document are the ones we intend to refer to.

Ofgem's view

1.18. As set out in April, our intention was always to issue guidelines to accompany both of the new licence conditions - and to consult widely before making any revisions to the guidelines. This was particularly in recognition of the special circumstances of Licence Condition B, which is broadly drafted, and our desire to reduce uncertainty around application of the prohibition on undue discrimination.

1.19. In the light of responses to consultation, we propose to provide in Licence Condition B that the licence condition will be interpreted and enforced in accordance with the published guidelines and that any subsequent revision will be subject to formal consultation process. Although the guidelines set out the approach that Ofgem will expect to take, we will consider each case on its own merits.

Enforcement procedure

1.20. In April, we noted that Ofgem will enforce Licence Conditions A and B in accordance with our existing enforcement guidelines⁶ and that in respect of Licence Condition B only, we would normally follow a "multi-stage" enforcement process.

1.21. At stage 2 of this process, we noted that where a supplier is unable to justify a pricing differential, the payment of compensation to any customers who had suffered detriment as a result of the pricing structure in question would reduce the likelihood of Ofgem proceeding to exercise its formal enforcement powers in respect of the identified concern. Furthermore, at stage 3 we noted that where Ofgem proceeded to use its formal enforcement powers, failure to pay compensation in mitigation of a breach of Licence Condition B would be considered an exacerbating factor in assessing any possible penalty imposed.

Respondents' views

1.22. Those respondents that commented on the proposed enforcement process were supportive. Indeed, the Big 6 suppliers regarded the multi-stage enforcement process as helpful in reducing the risk and uncertainty associated with Licence Condition B. However, most of the Big 6 expressed concern at the reference to compensation, which they argued would create significant risk and uncertainty for suppliers and undermine the benefits of the proposed enforcement process.

Ofgem's view

1.23. Our intention in including a reference to compensation in the guidance on the enforcement process was to highlight that the option would be open for suppliers to pay compensation to customers where a particular pricing structure was thought to be unduly discriminatory. Our intention was not in any way to mandate the payment of compensation. However, we accept suppliers' concerns about the references to

⁶ *Enforcement guidelines on complaints and investigations (232/07)*, 28 September 2007

compensation and are keen not to add unnecessary risk or uncertainty to the process. As such, we propose to delete the references to compensation in the enforcement process. Nevertheless, the payment of compensation to customers could still be a mitigating factor as explained in our existing guidelines on financial penalties.⁷

Objective justification

1.24. In April, we proposed that, in respect of Licence Condition B only, where a potentially material case of discrimination had been identified, we would consider whether any such differences in terms and conditions could be objectively justified. The proposed guidelines set out a range of factors that might constitute an objective justification for offering different terms and conditions (e.g. cost reflectivity).

Respondents' views

1.25. Respondents broadly approved of the proposed approach to determining whether undue discrimination has arisen. Several of the Big 6 suppliers suggested additional potential objective justifications, in particular to enable them to better determine their competitive position on a regional basis.

Ofgem's view

1.26. We believe that the existing guidance is adequate to enable competitive activity. Furthermore, we believe that including a specific consideration of general competitive intent would risk undermining the key aims of the licence condition and would make enforcement of the condition significantly more difficult.

Drafting of Licence Condition A

1.27. In April, we proposed to adopt a 'copy out' approach to transposing the requirements of the EC Gas and Electricity Directives relating to cost-reflective payment methods. This approach, recognised across Government as a valid one in many circumstances, has both advantages and disadvantages. The primary advantage in this instance is that it avoids any potential over-implementation by way of the licence condition.

Respondents' views

1.28. Suppliers generally accepted the need for this condition to reflect the requirements of the EC Directives and agreed with our proposal not to introduce any additional obligations on suppliers. Several of the Big 6 argued that the Directive

⁷ See GEMA's "Statement of Policy with respect of financial penalties pursuant to section 27B of the Electricity Act and Section 30B of the Gas Act" published in October 2003

wording should be elaborated on in the licence condition, in particular to make the text more consistent with the language used in the standard licence conditions.

1.29. In addition to requesting the insertion of an explicit reference to the guidelines, most of the Big 6 argued that Licence Condition A should contain references to objective justification and, in particular, materiality - as used in Licence Condition B.

Ofgem's view

1.30. We do not propose to amend the drafting of Licence Condition A. While certain responses recommended clarificatory amendments, or alignment of terminology with other parts of the supply licences, we note that principles of EC law would require interpretation by reference to the original text of the Directive in any event. As such, deviating from the Directive text without good reason may confuse, rather than clarify matters.

Scope of application of Licence Condition B

1.31. In April, we proposed that Licence Condition B would be applied to all suppliers active in the domestic supply market. We also proposed to apply a materiality threshold in considering potential infringements, which would include consideration of, among other things, the scale and degree of detriment to consumers and detriment to vulnerable groups.

Respondents' views

1.32. The one respondent to comment specifically on the scope of application of Licence Condition B (a small supplier), accepted the need for Ofgem to retain the option to deal with tariffs that have a significant detriment to individual customers, but argued that we should not consider investigating cases involving less than around 50,000 customers.

Ofgem's view

1.33. The approach to materiality set out in April would effectively mean that small suppliers are very unlikely to be capable of infringing Licence Condition B. Nevertheless, we are persuaded that the application of Licence Condition B to small suppliers would represent an unnecessary administrative burden for those firms. We therefore propose to explicitly limit the scope of application of Licence Condition B to suppliers with more than 50,000 customers. We believe that this is in keeping with better regulation principles and is consistent with the approach proposed for Licence Condition A.

Legal framework for making the modifications

1.34. This section considers the legal issues arising from the modification process and sets out the approach we are taking in proposing modifications to the existing licences.

1.35. We propose to introduce these licence conditions using the collective licence modification process. The licence modifications that are being proposed are identical for both gas and electricity. In each case we are proposing two separate licence modifications:

- to implement Licence Condition A into the gas and electricity supply licences; and
- to implement Licence Condition B into the gas and electricity supply licences.

1.36. Either of the proposed modifications may be blocked by the objections of relevant licence holders⁸ or by the Secretary of State directing the Authority not to make a modification. If licensees do object in sufficient number to block one of the proposed modifications, the Authority may make a reference to the Competition Commission if we still want to proceed with the modification. If the Competition Commission subsequently reports that it is in the public interest for the modification to be made, then the Authority may implement the modification.

1.37. We have separated the changes into separate proposed modifications for each licence condition. This approach means that licensees and the Secretary of State may object to one of the proposed licence modifications.

1.38. The Statutory Notices contained in appendices 2 to 5 propose licence modifications to the standard conditions of the gas and electricity supply licences. The proposed licence modifications are set out in Schedule 1 to each Notice.

1.39. Relevant licence holders under section 23(12) of the Gas Act 1986 and section 11A(10) of the Electricity Act 1989 may register their formal objection to any of the proposed modifications, although it is open to any interested party to make representations.

1.40. We would encourage relevant licence holders to let us know as soon as possible if they propose to object to any of the proposed modifications. This way, we will be able to understand properly the nature of any objection. It should be noted that objections cannot be withdrawn after the final date set out in the Statutory Notices for objections to be submitted (24 July 2009).

⁸ The Authority will not be able to make the modification that is subject to the objection where: 20 per cent or more of the relevant licence holders; or 20 per cent or more of the relevant licence holders weighted according to their market share, have given notice of objection to the Authority (and not withdrawn it) by the relevant date (which cannot be less than 28 days after the date that the notice is published).

Implementation and review

1.41. We have already consulted extensively on these proposals. As set out in April, we propose that the licence conditions will come into force as soon as possible after the end of the statutory consultation period. As such, we hope that the new licence conditions will be in place by August. We have provided that Licence Condition B will expire at the end of July 2012. In the event of significant changes to UK or EU legislation or market developments, it may be appropriate to review Licence Condition B accordingly.

1.42. As part of our ongoing market monitoring work, we will evaluate the impact of the new licence conditions. As part of this, we may need to collect specific cost information (for example on the costs to serve PPM customers) from suppliers on an ad hoc basis.

1.43. Before the termination of Licence Condition B we would expect to undertake a full review of the impact of the new licence conditions and, once it is implemented, our proposed package of retail market remedies. In doing so, we would consider the functioning of the retail energy supply market.

Document structure

In Appendix 1 we summarise the views of respondents to the final proposals on which we consulted in April.

Appendices 2 to 5 present the statutory modification notices together with the final proposed legal text for the modified standard licence conditions.

Appendix 6 contains revised guidelines on the new licence conditions.

Appendices

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Appendix 1 - Consultation Questions

1.1. In our consultation document *Addressing undue discrimination - final proposals* (42/09) and the accompanying impact assessment (43/09), Ofgem sought the views of respondents about the drafting of the proposed licence conditions and guidelines, and on the impact assessment. We received 18 responses. This appendix lists all those that responded and summarises their views.

List of Respondents

| List | Name |
|------|---|
| 1 | Age Concern and Help The Aged |
| 2 | Professor Catherine Waddams |
| 3 | Centrica [<i>Confidential</i>] |
| 4 | Consumer Focus |
| 5 | EDF Energy |
| 6 | Energy Action Scotland |
| 7 | E.ON UK |
| 8 | First Utility |
| 9 | Professor George Yarrow |
| 10 | Good Energy |
| 11 | National Energy Action |
| 12 | National Housing Federation |
| 13 | NAVETAS Energy Management |
| 14 | North Edinburgh Fuel Poverty Action Group |
| 15 | RWE npower |
| 16 | Professor Sir John Vickers |
| 17 | ScottishPower |
| 18 | Scottish & Southern Energy [<i>Part Confidential</i>] |

1.2. Responses received by Ofgem which were not marked as being confidential have been published on Ofgem's website www.ofgem.gov.uk. Copies of non-confidential responses are also available from Ofgem's library.

Summary of Responses

1.3. The following is a summary of the responses received. These are grouped into general comments on the final proposals, comments on the drafting of the licence conditions and the guidelines, and comments on the impact assessment.

Overview

1.4. Respondents expressed a wide range of views on the proposed licence conditions and associated guidelines, and our impact assessment.

1.5. The Big 6 suppliers expressed mixed views on the proposals. Two were broadly supportive of our proposals, while another indicated that they could accept the principle of licence conditions on undue discrimination. Others suggested that we should focus on developing competition and that Ofgem's proposed retail market remedies will go a long way to addressing the concerns we have identified.

1.6. All of the Big 6 expressed some concerns, to a greater or lesser degree, about the potential for the licence conditions to weaken competition and stressed the importance of avoiding undue restrictions on competitive behaviour. Several recognised that the proposed guidelines help to mitigate these risks, although there were numerous suggestions for how the licence conditions and guidelines could be improved and clarified in this respect. Most suppliers highlighted the guidelines, multi-stage enforcement process and sunset clause as crucial to making the licence conditions acceptable to them.

1.7. The two smaller suppliers that responded welcomed the revised proposals. One asked for some additional clarity in the guidelines and suggested that Licence Condition B should not be applied to smaller suppliers. The other asked to see differentials reported by Ofgem on at least an annual basis.

1.8. The six consumer interest groups that responded were strongly in favour of Ofgem's intent to address undue discrimination and supported the proposed licence conditions and the guidelines on their application. However, some expressed concerns about the details and argued that the conditions did not go far enough to protect vulnerable consumers.

1.9. The three academics that responded were opposed to the proposed licence conditions on the basis that they believe that the rules are likely to stifle competition and, as such, could have harmful consequences for consumers.

Licence Conditions

1.10. Five of the Big 6 argued that both Licence Condition A and B should explicitly refer to the guidelines, to provide greater certainty about how Ofgem will interpret and enforce the new licence requirements.

1.11. Consumer groups did not express any specific concerns about the wording of the licence conditions.

Licence Condition A: Cost-reflective payment methods

1.12. The Big 6 generally accepted the need for this condition to reflect the requirements of the EC Gas and Electricity Directives and agreed with our proposal not introduce any additional obligations on suppliers. Several of the Big 6 argued that the Directive wording should be elaborated on in the licence condition, in particular to make the text more consistent with the language used in the standard licence conditions. Two questioned whether the proposed interpretation of 'terms' was consistent with the EC Directives.

1.13. In addition to requesting the insertion of an explicit reference to the guidelines, most of the Big 6 argued that Licence Condition A should contain references to objective justification and, in particular, materiality - as used in Licence Condition B.

1.14. The one consumer group that commented was content with the decision not to apply Licence Condition A to smaller suppliers.

Licence Condition B: Prohibition of undue discrimination

1.15. One of the Big 6 agreed that the purpose of the condition should be to secure that all comparable domestic customers have equal access to the same terms and conditions of supply. Another wondered why the widely-used formulation of "undue discrimination" had not been used.

1.16. One consumer group argued that Ofgem's package of retail market remedies may take longer than anticipated to achieve our objectives and, as such, the sunset clause should be linked to a thorough review after three years to determine the future application of the licence condition.

1.17. As noted earlier, one smaller supplier accepted the need for Ofgem to keep the option to deal with tariffs which have a significant detriment to individual customers, but argued that we should not consider investigating cases involving less than, say, 50,000 customers.

Guidelines

1.18. Most of the Big 6 noted that the guidelines were wide in scope and argued that there were a number of areas where the guidelines would benefit from further clarification. One supplier expressed particular concern around what they saw as vagueness in the guidelines on materiality and what Ofgem might view as objective justification. Two of the Big 6 noted the degree of uncertainty surrounding what groups of customers will be deemed to be comparable. One argued that the concept of making products generally available was potentially problematic and that the objective should be more around ensuring that price differences reflect costs. Another argued that Licence Condition B should aim to ensure equal access among consumers to comparable products rather than to achieve any price equalisation across regions.

1.19. One supplier asked for greater clarity on the meaning of "inability to access" a particular tariff and two others expressed concerns about the subjectivity inherent in the concept of "difficulty in accessing" tariffs.

1.20. One consumer group welcomed the guidelines as a useful way of mitigating the regulatory risk to suppliers and agreed with our proposed general approach. The one small supplier that commented also expressed support for the proposed approaches to objectivity, materiality and cost allocation.

Definition of undue discrimination

1.21. One of the Big 6 agreed with the tests that we proposed to apply, namely that the difference in terms must be material and that the difference cannot be objectively justified. Another welcomed the proposed approach to new products, fixed price and green tariffs and time-limited offers.

Objective justification

1.22. One of the Big 6 felt that the examples given of factors that will be taken into account when assessing objective justification were reasonable (but noted that even initial offers should be reasonably cost reflective and non-discriminatory). Others suggested a range of potential additional objective justifications, including allowing the introduction of time-limited products designed to meet competitor's offers. Two of the Big 6 argued that it was important for them to be able to determine their competitive position regionally and that pricing that is not strictly on a cost-reflective basis by region can be good for consumers and for the dynamics of competition.

1.23. One consumer group agreed with our proposed process of objective justification and the various examples given of potentially legitimate discrimination.

1.24. One academic argued that the potential objective justification for time-limited offers could have unintended consequences - leading to either a reintroduction of the very differentials we are seeking to remove or lead to consumers, particularly the vulnerable, making poor decisions about their energy supply. These concerns were echoed by one of the Big 6. One consumer group also felt that some vulnerable consumers would not benefit from targeted offers.

Materiality

1.25. One of the Big 6 agreed with the proposed tests to apply when judging whether or not there has been a material detriment to customers. Another argued that materiality should be based on the evaluation of the impact on customers' bills, rather than suppliers' margins. Another expressed concern about what it saw as vagueness in terms of the guidance on materiality. Two suggested that 12 months would be a more appropriate period to allow suppliers to effect changes between pricing rounds.

1.26. Two consumer groups agreed with our proposed approach to materiality. Another felt that a lack of clarity around materiality risked suppliers being able to apply incremental price increases without sanctions applying.

Exception for social tariffs

1.27. Two of the Big 6 and four consumer groups welcomed our proposal to exempt social tariffs.

Scope of Licence Condition A

1.28. Two of the Big 6 and four consumer groups welcomed the statement that Ofgem does not intend to pursue discrepancies in the pricing of payment types that result in lower PPM charges. Another of the Big 6 argued that such an approach was not the intended effect of the EC Directives, ignores that more standard credit than PPM customers are vulnerable and leads to an unnecessary market distortion. Three consumer groups argued that the proposals did not go far enough to protect vulnerable consumers as suppliers will still be able to charge PPM customers more than anyone else. Instead, they argued that suppliers should make PPM charges the same as other payment methods.

Cost allocation

1.29. Three of the Big 6 broadly agreed with our proposed approach to cost allocation, while noting the subjectivity involved and the importance of recognising the different approaches taken by different suppliers. Another argued that our guidance was not sufficiently detailed or comprehensive. Three argued that we should allow the cost of advertising aimed at sales of a particular product to be allocated at least in part to that product, while one argued that overheads should be capable of being allocated to different products.

1.30. Several of the Big 6 agreed that a premium for credit risk should constitute a potential objective justification for price differentials between payment methods but asked for clarification around prompt pay discounts. One argued that we should not require a distinction to be made between prompt and tardy payers.

1.31. Two consumer groups agreed with our approach to cost allocation. One stressed the importance of ensuring that suppliers' approaches to working capital and revenue collection costs are appropriate and that bad debt costs are allocated to the correct payment method.

Sunset clause

1.32. The Big 6 agreed that Licence Condition B should be of limited duration. One proposed that we should undertake a review in around 12 months' time.

1.33. As noted earlier, one consumer group argued that the sunset clause should be linked to a thorough review after three years to determine its future application.

Enforcement procedure

1.34. The Big 6 regarded the multi-stage enforcement process as helpful and key to a proportionate approach for Ofgem to adopt in monitoring and enforcing the new conditions. However, most of the Big 6 expressed concern at the reference to compensation, which they argued would create significant risk and uncertainty for suppliers and undermine the benefits of the proposed enforcement process.

1.35. Two of the Big 6 argued that the multi-stage enforcement process should apply to Licence Condition A as well as B, on the basis that both proposed conditions have the potential to restrict competition and innovation in a similar way. Two of the Big 6 argued that Stage 1 and Stage 2 of the process should be a private matter between Ofgem and the supplier concerned, and that Ofgem should only make the matter public if it is taken to Stage 3.

1.36. One consumer group agreed with the proposed multi-stage enforcement process and argued that all evidence related to the enforcement procedure should be made available publicly - to encourage compliance by suppliers and promote consumer confidence.

Impact Assessment

1.37. Three academics and one of the Big 6 believe that our Impact Assessment underestimates the negative impacts on competition of the licence conditions and will have detrimental effects on all consumers. One academic warns against intervention in cases of price discrimination in competitive markets. A consumer organisation agreed that our guidelines will mitigate any potential negative effects on competition and innovation.

1.38. One academic believes that allowing introductory offers could be harmful. Either it could either have the effect of allowing some price differentials and therefore undermining the intent of the licence conditions, or if differentials do not develop, reducing the effectiveness of consumers' decisions.

1.39. A consumer organisation welcomed our consideration of small suppliers in the Impact Assessment. However, one big 6 supplier did not agree that the impact of the licence conditions on small suppliers would be insignificant, but believes the impact would be to reduce the attractiveness of entry through lower margins in some market segments and through increased economies of scale. We did not receive any responses from small suppliers which supported this view.

1.40. One consumer organisation agreed with our view that the impact on vulnerable customers should be given greater weight. One big 6 supplier believes that differences in consumer engagement between market segments are relatively small

and another does not agree that vulnerable customers have been targeted by the licence condition. Another consumer organisation believes that we underplayed the negative impacts on vulnerable customers and the fuel poor throughout the Impact Assessment and one academic believes it will cause detriment to vulnerable consumers.

Other issues

1.41. One consumer group called for Ofgem to report periodically on its findings on the functioning of the retail energy market and to undertake an analysis of the efficient costs to serve of different payment methods.

Appendix 2 - Notice of Proposed Modification to Electricity Supply Licence Standard Conditions (A)

To: All holders of an electricity supply licence

NOTICE OF MODIFICATION OF THE STANDARD CONDITIONS OF ELECTRICITY SUPPLY LICENCES UNDER SECTION 11A OF THE ELECTRICITY ACT 1989

Whereas:

1. Each of the companies to whom this notice is addressed holds an electricity supply licence granted, or treated as granted, pursuant to section 6(1)(d) of the Electricity Act 1989 (the "Act").
2. In accordance with section 11A(3) and (4) of the Act, the Gas and Electricity Markets Authority (the "Authority") gives notice ("Notice") that it proposes to modify the standard conditions of the electricity supply licence.
3. The proposed licence modification is set out in Schedule 1 to this Notice.
4. The reasons why the Authority proposes to make this modification have been published by the Authority in the following documents:
 - (a) Addressing undue discrimination - decision document, June 2009 (Ref: 72/09)
 - (b) Addressing undue discrimination - final proposals, 15 April 2009 (42/09)
 - (c) Addressing unfair price differentials, 8 January 2009 (01/09)
 - (d) Energy Supply Probe - Initial Findings Report, October 2008 (140/08)

These documents are available free of charge from the Ofgem library, 9 Millbank, London SW1P 3GE (0207 901 7003) or from the Ofgem website www.ofgem.gov.uk.

5. In summary, the proposed licence modification aims to ensure that any differences in the terms and conditions suppliers offer in respect of different payment methods are cost reflective.
6. Any representations or objections to the proposed modification may be made before 24 July 2009 (the "relevant date") and sent to:

Neil Barnes
Senior Economist, GB Markets
Ofgem
9 Millbank
London SW1P 3GE

or by e-mail to neil.barnes@ofgem.gov.uk.

7. Although any person may make representations, only those licensees who are "relevant licence holders" under section 11A(10) of the Act may register a formal objection to any proposed modification.



Andrew Wright
Managing Director, Markets
Ofgem
Authorised on behalf of the Authority

26 June 2009

SCHEDULE 1**MODIFICATION OF THE STANDARD CONDITIONS OF ELECTRICITY SUPPLY LICENCES UNDER SECTION 11A OF THE ELECTRICITY ACT 1989****Licence Condition A: Cost reflective payment methods**

Insert into existing Standard licence Condition 27 'Payment methods under Domestic Supply Contract':

"27.1. Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Electricity shall reflect the costs to the supplier of the different payment methods.

27.2. In this Condition "terms" means all terms on which a supply of electricity is offered or provided, including terms as to price, which significantly affect the evaluation of that supply."

Appendix 3 - Notice of Proposed Modification to Electricity Supply Licence Standard Conditions (B)

To: All holders of an electricity supply licence

NOTICE OF MODIFICATION OF THE STANDARD CONDITIONS OF ELECTRICITY SUPPLY LICENCES UNDER SECTION 11A OF THE ELECTRICITY ACT 1989

Whereas:

1. Each of the companies to whom this notice is addressed holds an electricity supply licence granted, or treated as granted, pursuant to section 6(1)(d) of the Electricity Act 1989 (the "Act").
2. In accordance with section 11A(3) and (4) of the Act, the Gas and Electricity Markets Authority (the "Authority") gives notice ("Notice") that it proposes to modify the standard conditions of the electricity supply licence.
3. The proposed licence modification is set out in Schedule 1 to this Notice.
4. The reasons why the Authority proposes to make this modification have been published by the Authority in the following documents:
 - (a) Addressing undue discrimination - decision document, June 2009 (Ref: 72/09)
 - (b) Addressing undue discrimination – final proposals, 15 April 2009 (42/09)
 - (c) Addressing unfair price differentials, 8 January 2009 (01/09)
 - (d) Energy Supply Probe - Initial Findings Report, October 2008 (140/08)
5. These documents are available free of charge from the Ofgem library, 9 Millbank, London SW1P 3GE (0207 901 7003) or from the Ofgem website www.ofgem.gov.uk.
6. In summary, the proposed licence modification aims to ensure that any terms and conditions suppliers offer to customers are not unduly discriminatory.
7. Any representations or objections to the proposed modification may be made before 24 July 2009 (the "relevant date") and sent to:

Neil Barnes
Senior Economist, GB Markets
Ofgem
9 Millbank
London SW1P 3GE

or by e-mail to neil.barnes@ofgem.gov.uk.

8. Although any person may make representations, only those licensees who are "relevant licence holders" under section 11A(10) of the Act may register a formal objection to any proposed modification.



Andrew Wright
Managing Director, Markets
Ofgem
Authorised on behalf of the Authority

26 June 2009

SCHEDULE 1**MODIFICATION OF THE STANDARD CONDITIONS OF ELECTRICITY
SUPPLY LICENCES UNDER SECTION 11A OF THE ELECTRICITY ACT 1989****Licence Condition B: Prohibition of undue discrimination**

Insert as Standard Licence Condition 29 'Prohibition of undue discrimination in supply licences':

Prohibition on undue discrimination

"29.1 This condition applies in relation to the supply of electricity by the licensee under a Domestic Supply Contract or a Deemed Contract for the supply of electricity to Domestic Premises.

29.2 Subject to paragraph 29.3 the licensee must ensure that in supplying or offering to supply electricity, the Principal Terms on which it does so do not discriminate without objective justification between one group of Domestic Customers and any other such group. For the purposes of this condition it shall be for the Authority to decide whether there is any such objective justification.

29.3 The licensee shall only be in breach of this condition if and to the extent that the nature of the discriminatory terms offered and/or their impact on any Domestic Customers is material in any respect.

Compliance with this condition

29.4 This licence condition shall be interpreted and enforced in accordance with guidance issued by the Authority and until such guidance is published this licence condition shall not be enforceable.

29.5 The Authority may from time to time revise the guidance referred to in paragraph 29.4 with a view to:

- (a) removing or reducing inconsistencies between Electricity Suppliers in their interpretation and application of its provisions; and
- (b) clarifying how the licensees' compliance with the obligations imposed by this condition will be monitored and enforced.

29.6 Before revising guidance under paragraph 29.4, the Authority shall give Notice that it proposes to do so to:

- (a) Electricity Suppliers in whose licences Section B of the standard conditions is effective;
- (b) the National Consumer Council; and
- (c) such other persons as the Authority considers it appropriate to consult in relation to the proposal.

29.7 A Notice given by the Authority under paragraph 29.4 must:

- (a) state that the Authority proposes to issue the revised guidance and specify the date on which it intends that this should take effect;
- (b) set out the text of the guidance and the Authority's reasons for proposing to revise it; and
- (c) specify the time (which must not be less than a period of 28 days from the date of the Notice) within which representations or objections with respect to the proposal may be made.

and must consider any representations or objections which are duly made and not withdrawn.

29.8 The licensee is not required to comply with this condition if it supplies electricity to fewer than 50,000 Domestic Customers or such other number as may from time to time be directed by the Authority.

Termination of this provision

29.9 This condition will cease to have effect on 31 July 2012."

Appendix 4 - Notice of Proposed Modification to Gas Supply Licence Standard Conditions (A)

To: All holders of a gas supply licence

NOTICE OF MODIFICATION OF THE STANDARD CONDITIONS OF GAS SUPPLY LICENCES UNDER SECTION 23(1)(b) OF THE GAS ACT 1986

Whereas:

1. Each of the companies to whom this notice is addressed holds a gas supply licence granted, or treated as granted, pursuant to section 7A(1) of the Gas Act 1986 (the "Act").
2. In accordance with section 23 (3) and (4) of the Act, the Gas and Electricity Markets Authority (the "Authority") gives notice ("Notice") that it proposes to modify the standard conditions of the gas supply licence.
3. The proposed licence modification is set out in Schedule 1 to this Notice.
4. The reasons why the Authority proposes to make these modifications have been published by the Authority in the following documents:
 - (a) Addressing undue discrimination - decision document, June 2009 (Ref: 72/09)
 - (b) Addressing undue discrimination – final proposals, 15 April 2009 (42/09)
 - (c) Addressing unfair price differentials, 8 January 2009 (01/09)
 - (d) Energy Supply Probe - Initial Findings Report, October 2008 (140/08)
5. These documents are available free of charge from the Ofgem library, 9 Millbank, London SW1P 3GE (0207 901 7003) or from the Ofgem website www.ofgem.gov.uk.
6. In summary, the proposed licence modification aims to ensure that any differences in the terms and conditions suppliers offer in respect of different payment methods are cost reflective.
7. Any representations or objections to the proposed modification may be made before 24 July 2009 (the "relevant date") and sent to:

Neil Barnes
Senior Economist, GB Markets
Ofgem
9 Millbank
London SW1P 3GE

or by e-mail to neil.barnes@ofgem.gov.uk.

8. Although any person may make representations, only those licensees who are "relevant licence holders" under section 23(12) of the Act may register a formal objection to any proposed modification.



Andrew Wright
Managing Director, Markets
Ofgem
Authorised on behalf of the Authority

26 June 2009

SCHEDULE 1**MODIFICATION OF THE STANDARD CONDITIONS OF GAS SUPPLY LICENCES UNDER SECTION 23(1)(b) OF THE GAS ACT 1986****Licence Condition A: Cost reflective payment methods**

Insert into existing Standard licence Condition 27 'Payment methods under Domestic Supply Contract':

"27.1. Any difference in terms and conditions as between payment methods for paying Charges for the Supply of Gas shall reflect the costs to the supplier of the different payment methods.

27.2. In this Condition "terms" means all terms on which a supply of gas is offered or provided, including terms as to price, which significantly affect the evaluation of that supply."

Appendix 5 - Notice of Proposed Modification to Gas Supply Licence Standard Conditions (B)

To: All holders of a gas supply licence

NOTICE OF MODIFICATION OF THE STANDARD CONDITIONS OF GAS SUPPLY LICENCES UNDER SECTION 23(1)(b) OF THE GAS ACT 1986

Whereas:

1. Each of the companies to whom this notice is addressed holds a gas supply licence granted, or treated as granted, pursuant to section 7A(1) of the Gas Act 1986 (the "Act").
2. In accordance with section 23(3) and (4) of the Act, the Gas and Electricity Markets Authority (the "Authority") gives notice ("Notice") that it proposes to modify the standard conditions of the gas supply licence.
3. The proposed licence modification is set out in Schedule 1 to this Notice.
4. The reasons why the Authority proposes to make these modifications have been published by the Authority in the following documents:
 - (a) Addressing undue discrimination - decision document, June 2009 (Ref: 72/09)
 - (b) Addressing undue discrimination – final proposals, 15 April 2009 (42/09)
 - (c) Addressing unfair price differentials, 8 January 2009 (01/09)
 - (d) Energy Supply Probe - Initial Findings Report, October 2008 (140/08)
5. These documents are available free of charge from the Ofgem library, 9 Millbank, London SW1P 3GE (0207 901 7003) or from the Ofgem website www.ofgem.gov.uk.
6. In summary, the proposed licence modification aims to ensure that any differences in the terms and conditions suppliers offer in respect of different payment methods are cost reflective.
7. Any representations or objections to the proposed modification may be made before 24 July 2009 (the "relevant date") and sent to:

Neil Barnes
Senior Economist, GB Markets
Ofgem
9 Millbank
London SW1P 3GE

or by e-mail to neil.barnes@ofgem.gov.uk.

8. Although any person may make representations, only those licensees who are "relevant licence holders" under section 23(12) of the Act may register a formal objection to any proposed modification.



Andrew Wright
Managing Director, Markets
Ofgem
Authorised on behalf of the Authority

26 June 2009

SCHEDULE 1**MODIFICATION OF THE STANDARD CONDITIONS OF GAS SUPPLY LICENCES UNDER SECTION 23(1)(b) OF THE GAS ACT 1986****Licence Condition B: Prohibition of undue discrimination**

Insert as Standard Licence Condition 29 'Prohibition of undue discrimination in supply licences':

Prohibition on undue discrimination

"29.1 This condition applies in relation to the supply of gas by the licensee under a Domestic Supply Contract or a Deemed Contract for the supply of gas to Domestic Premises.

29.2 Subject to paragraph 29.3 the licensee must ensure that in supplying or offering to supply gas, the Principal Terms on which it does so do not discriminate without objective justification between one group of Domestic Customers and any other such group. For the purposes of this condition it shall be for the Authority to decide whether there is any such objective justification.

29.3 The licensee shall only be in breach of this condition if and to the extent that the nature of the discriminatory terms offered and/or their impact on any Domestic Customers is material in any respect.

Compliance with this condition

29.4 This licence condition shall be interpreted and enforced in accordance with guidance issued by the Authority and until such guidance is published this licence condition shall not be enforceable.

29.5 The Authority may from time to time revise the guidance referred to in paragraph 29.4 with a view to:

- (a) removing or reducing inconsistencies between Gas Suppliers in their interpretation and application of its provisions; and
- (b) clarifying how the licensees' compliance with the obligations imposed by this condition will be monitored and enforced.

29.6 Before revising guidance under paragraph 29.4, the Authority shall give Notice that it proposes to do so to:

- (a) Gas Suppliers in whose licences Section B of the standard conditions is effective;
- (b) the National Consumer Council; and
- (c) such other persons as the Authority considers it appropriate to consult in relation to the proposal.

29.7 A Notice given by the Authority under paragraph 29.4 must:

- (a) state that the Authority proposes to issue the revised guidance and specify the date on which it intends that this should take effect;
- (b) set out the text of the guidance and the Authority's reasons for proposing to revise it; and
- (c) specify the time (which must not be less than a period of 28 days from the date of the Notice) within which representations or objections with respect to the proposal may be made.

and must consider any representations or objections which are duly made and not withdrawn.

29.8 The licensee is not required to comply with this condition if it supplies gas to fewer than 50,000 Domestic Customers or such other number as may from time to time be directed by the Authority.

Termination of this provision

29.9 This condition will cease to have effect on 31 July 2012."

Appendix 6 - Proposed Ofgem Guidelines

PROPOSED GUIDELINES ON COST REFLECTIVE PAYMENT METHODS AND THE PROHIBITION OF UNDUE DISCRIMINATION IN DOMESTIC GAS AND ELECTRICITY SUPPLY CONTRACTS

1. INTRODUCTION

BACKGROUND, PURPOSE AND STATUS OF GUIDELINES

(i) Background

1.1 Ofgem launched a study into the state of the GB energy supply markets ('the Probe') in February 2008. The Probe focused on the functioning of competition in the electricity and gas retail markets for domestic and small and medium enterprise (SME) consumers ('Consumers').

1.2 On 8 January 2009, OFGEM published its consultation paper "Addressing unfair price differentials" as part of the Probe. Following consideration of the responses to that consultation document, Ofgem proposes to introduce two new supply licence conditions as follows:

- Licence Condition A: A new supply licence condition into both the Standard Gas and the Standard Electricity Supply Conditions (amending existing Standard Supply Condition 27) reflecting the requirements of EC Directives 54/2003 and 55/2003⁹ by requiring any difference in the terms and conditions offered in respect of different payment methods to be cost reflective and;
- Licence Condition B: A new supply licence condition into both the Standard Gas and the Standard Electricity Supply Conditions prohibiting undue discrimination in any terms and conditions offered to customers.

(ii) Purpose

1.3 These Guidelines set out the principles Ofgem intends to take into account when interpreting and applying Licence Conditions A and B and they should be read in conjunction with those conditions. These Guidelines also set out the approach which Ofgem's Authority intends to take in deciding whether there is any "objective justification" when applying sub-section 29.2 of Licence Condition B.

1.4 Ofgem's purpose in introducing Licence Condition A is to better reflect the contents of Annex A(d) of EC Directives 54/2003 and 55/2003¹⁰ ('the EC Directives')

⁹ EC Directive 2003/54 concerning common rules for the internal market in electricity and EC Directive 2003/55 concerning common rules for the internal market in natural gas.

¹⁰ Annex A(d) of the EC Directives provides: "Any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems."

and to address the detriment caused to consumers as a result of non-cost reflective differentials in payment methods applied by gas and electricity suppliers in the GB retail market ('Suppliers'). Licence Condition A is not intended to introduce any additional obligations going beyond those imposed by the EC Directives. In Licence Condition A, for consistency Ofgem retains the term "payment methods" as referred to in the existing Standard Electricity Supply Conditions and the Standard Gas Supply Conditions. For the purposes of interpreting and applying Licence Condition A only, Ofgem considers the term "payment methods" to be interchangeable with the term "payment systems" as referred to in Annex A(d) of the EC Directives.

1.5 Ofgem is introducing Licence Condition B to address other situations in which certain consumers may be losing out by reason of their inability to access (or difficulty in accessing)¹¹ the same supply terms and conditions as other comparable consumers. Licence Condition B is intended to operate during a fixed interim period only to allow the rest of the Probe Remedies Package to take effect.

1.6 Licence Condition B is not intended to diminish in any way the ability of Suppliers to innovate, roll-out or test new products, improve their efficiency or competitive advantage over other Suppliers and/or to introduce initial or 'incentive' offers in a legitimate attempt to penetrate certain markets, segment, or acquire new customers. Further guidance on the recognised importance of such market activity is set out below at Section 4 on Objective Justification.

1.7 Assuming any apparently discriminatory terms and conditions offered by a Supplier cannot be objectively justified then insofar as it is practicable, efficient and reasonable to do so, the intended purpose of the prohibition on undue discrimination in Licence Condition B is to ensure equal access to the same terms and conditions of supply for all comparable Consumers.

1.8 For instance, if and insofar as certain considerations may render universal access for all Consumers to all terms and conditions offered impossible or impractical,¹² Suppliers must instead ensure that comparable terms and conditions (ensuring any price differential is cost reflective) are offered to comparable Consumers who cannot by reason of relevant personal circumstances, avail of certain terms and conditions offered. For the avoidance of doubt in this context, it shall lie within the Ofgem's discretion to decide on whether any given Consumers and/or their personal circumstances are sufficiently "comparable".

(iii) Status

1.9 Unless any particular guidance below is expressly stated to apply to only one of Licence Condition A or B specifically, these Guidelines are intended to illustrate how Ofgem will investigate potential contraventions of both Licence Condition A (cost reflective payment methods) and Licence Condition B (prohibition of undue discrimination).

¹¹ Ofgem includes the existence of significant switching costs including search and transaction costs and consumer perception of the difficulties.

¹² For example Consumers without a bank account are unable to pay by direct debit.

1.10 These Guidelines are without prejudice to Ofgem's powers and duties under the Competition Act 1998 and any guidance issued in respect of those powers and duties.

2. CONSUMER DETRIMENT

2.1 For the avoidance of doubt, both Licence Condition A and Licence Condition B seek to prevent material detriment caused to Consumers by Suppliers and, in particular, detriment to vulnerable groups.¹³ Unless there is evidence of consumer detriment having resulted from any alleged contravention of either Licence Condition A or B, then any such breach is likely to be trivial and in such circumstances, Ofgem is very unlikely to enforce either Licence Condition. In assessing whether any such detriment has resulted, Ofgem will be guided by the Guidelines on 'Materiality' set out below at Section 5.

3. DEFINITION OF UNDUE DISCRIMINATION IN SUPPLY CONTRACTS UNDER LICENCE CONDITION B

3.1 In respect of Licence Condition B only, Ofgem intends to apply the following test in determining whether undue discrimination has arisen in a particular case:

- (i) If a Supplier offers terms and/or conditions of supply to one group of customers which are materially¹⁴ different from the terms and/or conditions of supply offered to any other group of customers and;
- (ii) if Ofgem considers that any such difference or differences in the terms and/or conditions offered cannot be objectively justified;¹⁵
- (iii) If both of the above conditions are satisfied, Ofgem will consider that Supplier to be engaging in undue discrimination for the purposes of Licence Condition B.

3.2 For the purposes of the above approach and the remainder of these Guidelines, the term 'customer' will be interpreted in accordance with the definition of that term as set out and applied under the existing Electricity Supply Licence Standard Conditions and the existing Gas Supply Licence Standard Conditions.

3.3 The terms and conditions of supply of an electricity or gas product which Ofgem will assess when applying Licence Condition B, include all the elements of that product, including price, contracted for service features and the terms upon which a product or service may be offered in conjunction with another product or service e.g. dual fuel offerings.

3.4 In respect of dual-fuel offerings, Ofgem will assess whether the inclusion or exclusion of other products or services offered by a Supplier in conjunction with another product leads to one or other product (whether gas or electricity) being

¹³ For definition and discussion of 'Vulnerable Groups' see Section 6 below

¹⁴ For guidance on 'materiality' see Section 5 of the Guidelines.

¹⁵ Relevant circumstances would include the costs of supply to a group of customer. For guidance on 'objective justification' see Section 4 of the Guidelines.

offered at below cost price.¹⁶ For the avoidance of doubt provision by any Supplier of a product with another product (whether gas or electricity) at below cost is very likely to be treated as undue discriminatory conduct in respect of those customers not offered, or not able to access, the second product in addition to the first product e.g. customers who are "off grid" and unable to access mains gas.

3.5 Ofgem is concerned that these Guidelines should not restrict Suppliers' ability to innovate in the retail market.¹⁷ For the avoidance of doubt, time limited or "initial" offers innovative offers or new-customer acquisition targeted offers are likely to be objectively justified as explained below.

3.6 Similarly if Suppliers offer innovative tariff structures on a non-discriminatory basis Ofgem would not expect to challenge the principles of such tariffs, examples of which are set out below.

(i) Fixed price tariffs

3.7 Fixed price tariffs are by their nature only offered on specific terms for a certain period of time. Provided any fixed price tariff (which is not a time-limited or customer acquisition targeted offer as discussed separately below under objective justification) were to be made available on a non-discriminatory basis to all comparable Consumers at the time of offering, any difference between fixed tariffs and other tariffs, shall not fall to be assessed for objective justification as the conduct in question would not be discriminatory.

(ii) Green Tariffs

3.8 Similarly, provided any green tariffs offered by a Supplier are made available to all Consumers on a non-discriminatory basis at the time of offering, Licence Condition B will not be engaged. Any difference between green tariffs and other tariffs shall not fall to be assessed for objective justification as the conduct in question would not be considered discriminatory under the above approach.

4. OBJECTIVE JUSTIFICATION

4.1 In respect of Licence Condition B, Ofgem considers that any alleged objective justification relied upon by a Supplier for offering two groups of customers different terms and conditions can only be assessed on a case-by-case basis. The Guidelines set out below are intended to assist in such an assessment although they are not intended to constitute the exclusive basis upon which any alleged objective justification will be assessed.

4.2 In assessing any potential contravention of Licence Condition B, Ofgem will first consider whether any differences in transaction conditions offered to two groups of customers reflect differences in those customers' circumstances; or whether any relevant similarities in customers' circumstances are reflected in transaction

¹⁶ The relevant costs to be assessed are Suppliers' forward looking avoidable costs which are not covered by the relevant below cost price charged for a sustained period. See further guidance on Materiality at Section 5 below and Section 8 on cost allocation.

¹⁷ See Guidelines on 'innovation' under Section 4 on Objective Justification.

conditions offered to two groups of customers. Differences between customers' circumstances may constitute an objective justification for offering different terms and conditions.

Cost Reflectivity

4.3 For the avoidance of doubt, the following Guidelines in respect of Cost Reflectivity are relevant to both Licence Condition A and Licence Condition B.

4.4 Ofgem is likely to consider discriminatory conduct to be objectively justified when the difference in the treatment reflects the differences in the costs of supplying a particular customer or group of customers.¹⁸ As such an assessment of the objective justification of any price differential will usually involve an assessment of the relevant costs involved and the degree to which these costs are reflected in the respective prices charged by a Supplier.

4.5 Ofgem intends to assess the relevant terms and conditions offered by a Supplier on a forward looking basis i.e. relative to costs at the date at which prices were first made available to a group or groups of customers and will not generally assess any differences in terms and conditions offered to customers on an ex post basis.

4.6 Ofgem will take the following factors into account when assessing cost reflectivity under Licence Condition A and any alleged objective justification in respect of Licence Condition B:

(i) Geographical considerations:

- Ofgem recognises that there can be geographic cost differences related for example to different network charges.
- As transmission and distribution charges can vary by region it would be objectively justified to reflect these in prices charged to customers.

(ii) Payment Methods:

- Differences in prices which reflect the differences in costs associated with operating different payment methods would be objectively justified e.g. any difference in Suppliers' costs associated with processing a direct debit payment as opposed to processing a quarterly standard credit payment method.

(iii) Initial offers:

- Subject to the above guidance on competitive advantage operating as an objective justification, Ofgem is concerned to prevent discrimination in respect of enduring terms and conditions under which electricity and gas are supplied and not with initial offers made by Suppliers aimed at customer acquisition.
- As such if a Supplier were able to demonstrate that a particular price differential or any additional bonus or incentive was being offered on a time-limited basis only (for example, to assist that Supplier in the acquisition of new customers or

¹⁸ For further guidance on assessing Cost Allocation see Section 8 of the Guidelines.

to penetrate a market in a particular region or to meet a competitor's offer) Ofgem is likely to consider any such 'initial' price differential to be objectively justified.

- However in such circumstances a Supplier must specify expressly in advance in their marketing materials, that any such price differential or bonus incentive is time limited and that the said limited offer will revert, after a reasonable period of time, to the terms and conditions offered to all other Consumers. Failure by a Supplier to adhere to these transparency requirements will lead Ofgem to assume that the price differential offered is intended to operate as an enduring offer for the purposes of Licence Condition B. For the avoidance of doubt "time limited" refers to the actual duration of the tariff and not to a limited period during which the tariff may be made available.

(iv) Competitive advantage

- Licence Condition A and Licence Condition B are not intended to lessen in any way the incentives for Suppliers to improve the efficiency of their operations. The Guidelines on materiality, set out below, are intended to provide flexibility to allow any individual Suppliers, who may be more innovative or efficient than the rest of the market, to benefit from any efficiency improvements they make for a reasonable period before passing that benefit on to Consumers.
- In particular, Ofgem is likely to regard evidence of recent efficiency improvements, combined with competitive price differentials, as a potential objective justification for sustaining price differentials at above costs for a reasonable period of time. However as explained above, Ofgem intends to approach cost assessment on a forward looking basis.
- Following a reasonable period of time it would be expected that any such efficiency benefits would be passed on to customers consistent with an effective competitive market.

(v) Innovation

- Licence Condition A and Licence Condition B are not intended to prevent Suppliers developing new products and charging a market price for such products, provided those products are made available to all Consumers on a non-discriminatory basis.
- However if Ofgem were to require any roll-out of a new development/product to be made available to all customers simultaneously, Ofgem recognises that this could create a potential barrier to innovation.
- Ofgem considers that if a Supplier chooses to limit, for a reasonable period of time, a new product or offering to a group of customers this conduct is likely to be objectively justified if it could be shown to be a necessary part of development, testing or roll-out.
- Similarly, Ofgem is likely to consider barriers arising from technology or capability (e.g. smart meters) to be an objective justification for the limited availability of a product to one particular group of customers.
- It will be within Ofgem's discretion to decide whether any particular offering constitutes a "new" product and whether any such "new" product constitutes a sufficient objective justification for these purposes.

5. MATERIALITY

5.1 Ofgem will not consider any term(s) and/or condition(s) offered by a Supplier to be an infringement of either Licence Condition A or Licence Condition B unless a materiality threshold is met.

5.2 In respect of both Licence Condition A and Licence Condition B, Ofgem recognises that it would be impossible for Suppliers to be precisely non-discriminatory and/or cost reflective at all times and to each individual customer. Costs can vary through time and are not always certain until after the fact. Also Ofgem recognises there are significant costs associated with changing prices and it would be inefficient to require frequent changes to ensure cost reflectivity at all times. However as set out above, Ofgem intends to assess costs on a forward looking basis.

5.3 The relevant considerations which Ofgem will take into account when determining the materiality of any alleged infringement of both Licence Condition A and Licence Condition B include, but are not limited to, the following:

(i) Timing

- Suppliers will be allowed a reasonable period of time to effect changes between pricing rounds. In general, unless Ofgem considers the time between price changes to be exceptionally long Ofgem would not consider taking enforcement action under either Licence Condition A or Licence Condition B as a result of any cost differential movements between pricing rounds, but would expect these to be addressed by the Supplier at the next price change.

(ii) Scale and degree of impact on Consumers

- The conduct of a Supplier will only be material if it impacts on a significant number of Consumers. The financial impact per Consumer will also be relevant. In considering the financial impact Ofgem will judge materiality in the context of the typical margins earned by Suppliers.

(iii) Detriment to Vulnerable Groups

- As noted above, Licence Condition A and Licence Condition B are concerned with the minimisation of detriment caused to Consumers by Suppliers and in particular detriment to vulnerable groups.¹⁹ If the evidence demonstrates that the detriment caused to Consumers by any alleged infringement of Licence Condition A or B is minimal or non-existent Ofgem will not generally seek to enforce Licence Condition A or B against a Supplier. Similarly Ofgem is more likely to enforce Licence Condition A or B if the evidence demonstrates that vulnerable Consumers are particularly affected by the alleged conduct in question.

¹⁹ For definition of vulnerable groups see Section 6 on Social Tariffs.

6. EXCEPTION FOR SOCIAL TARIFFS

6.1 Under the Gas and Electricity Acts, Ofgem is obliged to have regard to the interests of: (a) individuals who are disabled or chronically sick; (b) individuals of pensionable age; (c) individuals with low incomes and (d) individuals residing in rural areas.²⁰ These four groups are referred to in these Guidelines as 'Vulnerable Groups'.²¹

6.2 In December 2004, Ofgem published guidance in which it was made clear that there were no regulatory or legal barriers to suppliers offering social tariffs.²² On 19 December 2008 Ofgem published a report "*Monitoring suppliers' social programmes 2007-08*" in which a social tariff was described as being at least as good as the lowest tariff offered by that Supplier to a customer in that region on an enduring basis ('Social Tariffs'). This is regardless of that customer's payment method and includes online tariffs.²³

6.3 As a result of Ofgem's statutory obligations, in respect of both Licence Condition A and Licence Condition B, if a Supplier chooses to offer more favourable terms and conditions to a relevant Vulnerable Group, any such Social Tariff is very likely to be treated by Ofgem as an exception to the obligations imposed on a Supplier under Licence Condition A and Licence Condition B. In this context the below Guidelines on the scope of Licence Condition A in respect of any below cost payment methods offered are also relevant.

7. SCOPE OF LICENCE CONDITION A

7.1 Directive 2003/54/EC concerning common rules for the internal market in electricity and Directive 2003/55/EC concerning common rules for the internal market in natural gas (together 'the EC Directives'), place obligations on national regulatory authorities such as Ofgem to ensure, amongst other things, that all final Consumers and in particular vulnerable Consumers are protected.²⁴ These obligations are also reflected in the Electricity Act 1989 and the Gas Act 1986.

²⁰ See Section 3A of the Electricity Act 1989 and Section 4AA of the Gas Act 1986 which places the statutory obligation to do so on Ofgem's Authority.

²¹ The relevant sections of the Electricity Act and the Gas Act go on to provide: "*although that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.*"

²² *Supplying low income and vulnerable customer groups*, December 2004 (Ref 272/04)

²³ Para 2.14 of "*Monitoring suppliers' social programmes*" 2007-2008

²⁴ Article 3(5) of *EC Directive 2003/54/EC concerning common rules for the internal market in electricity* and Article 3(3) of *EC Directive 2003/55 EC concerning common rules for the internal market in natural gas* provide:

"Member States shall take appropriate measures to protect final Consumers, and shall in particular ensure that there are adequate safeguards to protect vulnerable Consumers, including measures to help them avoid disconnection. In this context, Member States may take measures to protect final Consumers in remote areas. They shall ensure high levels of consumer protection, particularly with respect to transparency regarding contractual terms and conditions, general information and dispute settlement mechanisms."

7.2 Licence Condition A is designed to reflect Annex A (d) of EC Directive 2003/54 and EC Directive 2003/55 which provide that; “*Any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems.*” For the purposes of interpreting Licence Condition A only, Ofgem regards the terms “payment methods” and “payment systems” as interchangeable.

7.3 Ofgem interprets the EC Directives as intending, amongst other things to protect Consumers who pay by the typically more expensive payment methods such as prepayment meters (‘PPMs’), in particular because those Consumers may not have the choice of other payment methods. As such, and given its statutory obligations under the Gas and Electricity Acts, Ofgem does not intend to pursue discrepancies in pricing of payment types which result in lower PPM charges. Given Ofgem’s administrative priority considerations, it would not be an appropriate use of Ofgem’s resources, nor is it likely to accord with Ofgem’s statutory duties, for Ofgem to target such action under either Licence Condition A or Licence Condition B.²⁵

8. COST ALLOCATION

8.1 Compliance with and enforcement of both Licence Conditions A and B will often require consideration of the costs associated with servicing particular customer groups. In this respect Ofgem intends to take the following approach.

8.2 In broad terms, there are three types of cost:

Those that can be attributed to particular products and services

- Such costs can be used in justification of price differentials. In practical terms these are more likely to be direct costs but they could also include some costs with more indirect characteristics such as charges for customer service. Transmission charges between different areas are one example of a cost that can be attributed to particular products and services as they may vary according to area of supply.

Those that cannot be attributed to a particular product but are clearly attributable to the energy supply business

- If these costs have identifiable drivers (e.g. overall revenues or unit sales), then these costs can be allocated on that basis and used to justify any cost allocation. Otherwise they should not be used in justification of price differentials. For instance billboard advertising, even if it is say focused on Direct Debit customers, may contain multiple corporate measures and hence not be attributable only to Direct Debit customers but to Standard Credit customers as well.

Overheads not attributable to the supply business

- These should not be used in justification of price differentials. For instance a group charge for intellectual property such as branding or risk should not be used as justification.

²⁵ Given that vulnerable groups are over-represented in the consumer group who choose to pay by prepayment meter method.

8.3 With regard to the following elements of cost:

Working capital and revenue collection costs

- Ofgem is likely to view differences in working capital costs as being an appropriate justification for price differentials between prices changes to different groups of customers (for instance between advance payment plans and standard credit accounts). Ofgem would not view any such charges as discriminatory but will monitor Suppliers' approaches to the use of such charges as part of its debt and disconnection work.

Bad debt and credit risks

- Where Suppliers offer credit terms as a part of their gas and electricity they are likely to incur some bad debt costs. Ofgem would view a reasonable level of premium for this credit risk as representing a potential objective justification for price differentials between payment methods.

9. SUNSET CLAUSE IN RESPECT OF LICENCE CONDITION B

9.1 Licence Condition B includes a "sunset clause" so that the proposed new licence condition prohibiting undue discrimination lapses after 3 years.

9.2 Licence Condition A does not include any such provision given that it reflects existing obligations under EC Directives 2003/54 and 2003/55 and no more than those obligations.

9.3 The inclusion of a sunset clause provision in Licence Condition B is intended to reflect Ofgem's expectation that the full package of measures proposed in the "Energy Supply Probe- Proposed Retail Market Remedies" document published in April 2009, will accelerate the transition of energy supply markets to fully effective competition and that, over time, those measures alone will be sufficient to guard against undue discrimination.

9.4 Ofgem is of the view that a period of less than three years would not allow sufficient time for the reforms identified in the Probe to have taken effect fully. However Ofgem intends to keep this situation under review and proposes to carry out regular reviews in accordance with the procedure set out in the text of the licence condition itself.

9.5 Once Licence Condition B has lapsed, Ofgem will continue to interpret cost reflectivity, for the purposes of applying Licence Condition A, in line with relevant European Commission and European Court of Justice jurisprudence.

10. LICENCE CONDITION B ENFORCEMENT PROCEDURE

10.1 Ofgem will, as a matter of policy, prioritise its resources to focus on systemic issues in its monitoring of the application of both Licence Conditions A and B.

10.2 Ofgem will enforce Licence Conditions A and B in accordance with its existing '*Enforcement guidelines on complaints and investigations*' ('the Enforcement

Guidelines') published on 28 September 2007 as amended from time to time. Consistent with the Enforcement Guidelines, in deciding on priorities for investigation, Ofgem will give weight to the level of Consumer detriment arising.

10.3 In addition in respect of Licence Condition B only, Ofgem will normally employ a three stage process of escalation in dealing with possible breaches giving weight to the level of Consumer detriment arising:

Stage 1

- If, on its own initiative or following a complaint, Ofgem identifies a concern with a pricing differential, which satisfies its prioritisation criteria, it will write to the Supplier concerned giving it an opportunity to respond and to provide objective justification for the pricing differential. At this stage, Ofgem may expect the Supplier to provide cost data supporting the existing structure and justifying any subsequent change.

Stage 2

- If Ofgem is not satisfied with the response, it will write to the Supplier and explain why it is not satisfied. It will allow the Supplier a reasonable period within which to respond. If, at this stage, the Supplier revises its pricing structure, Ofgem is unlikely to take further action, unless there is evidence of a persistent failure to comply with the relevant condition.

Stage 3

- If the Supplier does not revise its pricing differential, Ofgem will make the case for a licence breach. It will send the Supplier a statement of the case for a breach and will give it the opportunity to make written and/or oral representations to the decision maker(s) established to decide on the case, in line with the existing Enforcement Guidelines.
- If the Supplier is subsequently found to be in breach, it may face a financial penalty and/ or an enforcement order requiring it to remedy the breach. The amount of any penalty imposed will be determined by Ofgem's Authority ('GEMA') in accordance with its published policy.²⁶

²⁶ The Gas and Electricity Market Authority established under section 1 of the Utilities Act 2000 ('GEMA'). See GEMA's "*Statement of Policy with respect of financial penalties pursuant to section 27B of the Electricity Act and Section 30B of the Gas Act*" published in October 2003.

GLOSSARY

| | |
|---------------------------------------|---|
| Authority | The Gas and Electricity Markets Authority ('GEMA') established under section 1 of the Utilities Act 2000 |
| Direct debit | A method of payment where a fixed or variable amount is taken from a bank account each month, quarter or year |
| Dual-fuel offering | A type of energy contract where a customer takes gas and electricity from the same supplier |
| Fixed price tariff | A tariff that guarantees that the price paid per unit of gas or electricity used will not change for a given period of time |
| Green tariff | An energy tariff which is marketed as having environmental benefits and is consistent with Ofgem's published Guidelines on Green tariffs |
| Price differential | The difference between two sets of prices. For example the difference in the price charged by one electricity supplier to Consumers using different payment methods. |
| Prepayment meter | These are meters that require payment for energy to be made in advance of use or they will prevent the supply of gas or electricity. A PPM customer pays for energy by inserting electronic tokens, keys or cards into the meter. |
| Probe | The Energy Supply Probe Initial Findings Report (Ref 140/08) published by Ofgem on 6 October 2008 |
| Probe remedies package | The package of proposals put forward by Ofgem for consultation following publication of the 'Energy Supply Probe – proposed retail market remedies dated 15 April 2009. |
| Smart meter | A generic term for innovative forms of metering that provide increased levels of functionality above that of a basic meter. It usually includes at a minimum the ability to read the meter remotely via a communication channel. |
| Standard Credit | A payment method where Consumers pay on receipt of the bill. This typically covers a wide range of payment mechanisms including cash, cheque, credit card and standing order. |
| Standard Gas Supply Conditions | Gas Supply Licence Standard Conditions issued by GEMA as at April 1 2009 |
| Standard Electricity Supply Condition | Electricity Supply Licence Standard Conditions issued by GEMA as at April 1 2009 |

Appendix 7 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ("the Authority"), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.²⁷

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly.²⁸

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them²⁹;
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.³⁰

²⁷ Entitled "Gas Supply" and "Electricity Supply" respectively.

²⁸ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

²⁹ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

³⁰ The Authority may have regard to other descriptions of consumers.

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

- promote efficiency and economy on the part of those licensed³¹ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation³² and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

³¹ Or persons authorised by exemptions to carry on any activity.

³² Council Regulation (EC) 1/2003.

Appendix 8 - Glossary

A

Authority

The Gas and Electricity Markets Authority ('GEMA') established under section 1 of the Utilities Act 2000.

D

Direct debit

A method of payment where a fixed or variable amount is taken from a bank account each month, quarter or year.

Dual-fuel offering

A type of energy contract where a customer takes gas and electricity from the same supplier.

F

Fixed price tariff

A tariff that guarantees that the price paid per unit of gas or electricity used will not change for a given period of time

G

Green tariff

An energy tariff which is marketed as having environmental benefits and is consistent with Ofgem's published Guidelines on Green tariffs.

P

Price differential

The difference between two sets of prices. For example the difference in the price charged by one electricity supplier to Consumers using different payment methods.

Prepayment meter (PPM)

These are meters that require payment for energy to be made in advance of use or they will prevent the supply of gas or electricity. A PPM customer pays for energy by inserting electronic tokens, keys or cards into the meter.

Probe

The Energy Supply Probe Initial Findings Report (Ref 140/08) published by Ofgem on 6 October 2008.

Probe remedies package

The package of proposals put forward by Ofgem for consultation following publication of the 'Energy Supply Probe Initial Findings Report' and the consultation document 'Addressing Unfair price differentials' dated 8 January 2009.

S

Standard credit

A payment method where Consumers pay on receipt of the bill. This typically covers a wide range of payment mechanisms including cash, cheque, credit card and standing order.

Standard Gas Supply Conditions

Gas Supply Licence Standard Conditions issued by GEMA as at 1 April 2009.

Standard Electricity Supply Conditions

Electricity Supply Licence Standard Conditions issued by GEMA as at 1 April 2009.

Appendix 9 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Do you have any comments about the overall process, which was adopted for this consultation?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- To what extent did the report's conclusions provide a balanced view?
- To what extent did the report make reasoned recommendations for improvement?
- Do you have any further comments?

1.2. Please send your comments to:

Andrew MacFaul

Consultation Co-ordinator

Ofgem

9 Millbank

London

SW1P 3GE

andrew.macfaul@ofgem.gov.uk