



Suppliers, consumer groups and
any other interested parties

*Promoting choice and value for
all gas and electricity customers*

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Dear colleague,

Consultation on the Undue Discrimination Prohibition standard licence condition

This consultation presents our 'minded to' position to retain the existing Undue Discrimination Prohibition Standard Licence Condition ('SLC 25A') until 31 July 2014. Responses to this consultation are invited by 10 April 2012 and should be sent to:

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Background

In October 2008 we published 'The Energy Supply Probe (the 'Probe')'¹ which looked at the competitive functioning of the GB energy supply markets. We identified a number of areas needed to improve the functioning of the retail energy supply markets. Alongside a wide range of concerns, the Probe found a specific issue, a range of differences in the prices of tariffs which could not be justified by cost. This included former electricity incumbents² charging a higher price for their home regions ("in-area") compared to their entrant regions ("out-of-area"). These findings were set against a backdrop of encouraging, but underdeveloped, levels of consumer engagement. It was noted that consumers' reluctance to switch creates market conditions in which suppliers face lighter competitive constraints on their pricing strategies. As a consequence, we were concerned these consumers may not be able to benefit from effective competition to the same extent that more active switchers would.

In order to address our concerns that particular groups of consumers could face unjustified price differentials dependent on region, we introduced Standard Licence Condition 25A ('SLC 25A') in September 2009. SLC 25A requires the domestic supplier to 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. The grounds for objective justification and our approach to the

¹ 'Energy Supply Probe – Initial Finding Report', October 2008, Reference: (140/08)

² The former incumbent electricity suppliers are the five vertically-integrated supply companies. They are: EDF Energy, E.ON, RWE npower, ScottishPower and SSE.

enforcement process are set out in our Guidelines³ for the condition. This licence condition does not apply to suppliers with fewer than 50,000 domestic customers per fuel.

SLC 25A includes a "sunset clause", to allow the condition to lapse three years after its implementation on 1 September 2009. The introduction of this clause reflected our original expectation that the full implementation of the Probe remedies would ensure retail competition is sufficiently effective to protect consumers from undue discrimination. This provision is due to expire on the 31 July 2012. Please see Annex 1 for the requirements of SLC 25A.

In the decision to introduce SLC 25A and in future publications, Ofgem committed to review the operation of the condition and the functioning of the retail markets. In line with this commitment, in March 2011, we published 'The Retail Market Review (RMR) – Findings and initial proposals'⁴. This publication included an assessment of the progress of the Probe remedies. We found since the introduction of SLC 25A the average difference between a suppliers' in-area standard tariff and out-of-area tariffs reduced from over £30 to around £13 in January 2011, per customer, per year⁵. We therefore consider that the prohibition was successful in removing or significantly lessening the in and out of area price differentials.

Whilst this is the case, overall, our monitoring activities suggested at the time the RMR was launched the overarching issues identified during the Probe had not materially improved. The RMR Findings and Initial Proposals document confirmed that there still are a significant number of consumers that are not active switchers and continue to be disengaged from the market. As such, these consumers are not benefiting fully from effective competition in the same way as those who have engaged in the market and switched supplier. We therefore outlined our initial proposals aimed at addressing these concerns and making competition in the retail energy market more effective for consumers.

The Wider Context

We recently published more detailed proposals in The Retail Market Review: Domestic Proposals⁶. These proposals interact with, and in some cases build on, our previous Probe remedies. In particular, in December 2011, we outlined our proposals to improve tariff comparability, which included:

- all standard tariffs would be structured to consist of a compulsory regional standing charge plus a national unit rate set by suppliers (day / night rates for Economy 7 (E7) tariffs); and
- Ofgem would set the compulsory regional standing charge, and possibly a regional adjuster to the unit rate to account for regional differences in network costs that vary with consumption.

Following this consultation we released a further publication in February 2012, 'The Standardised Element of Standard Tariffs under the Retail Market Review'⁷. In this document we presented two options for treating regional cost differences in standard tariffs and described the detailed methodology that could be used to set the standing charge and possible regional adjuster for standard tariffs. The two options were:

- **Option 1:** Ofgem sets a national standing charge and regional adjuster to the unit rate. Suppliers set a national unit rate; and

³ See Guidelines on Cost Reflectivity between Payment Methods and the Prohibition of Undue Discrimination in Domestic Gas and Electricity Supply Contracts, 7 August 2009.

⁴ 'Retail Market Review – Findings and initial proposals', March 2011, Reference: (34/11).

⁵ See 'Retail Market Review – Findings and initial proposals', page 24.

⁶ 'Retail Market Review – Domestic Proposals', December 2011, Reference: (166/11).

⁷ See 'The Standardised Element of Standard Tariffs under the Retail Market Review', Feb 2012, Reference: (11/12).

- **Option 2:** Ofgem sets a national standing charge. Suppliers are able to set different unit rates in different regions to reflect cost differences.

We recognise that the scope for suppliers to engage in discriminatory pricing practices would vary under each of the above two options (as well as under other possible alternatives). For this reason, we consider that it would be important to review the extent to which SLC 25A is necessary after any relevant RMR proposals have been properly implemented (assuming, following the consultation process, Ofgem ultimately decided to implement relevant proposals).

We therefore propose taking steps to prevent the sunset clause from lapsing on 31 July 2012. In light of the stage of the consultation on our RMR proposals, we are 'minded to' retain the licence condition for a further two year period. This consultation document provides our rationale for and evaluation of our minded to position.

Our Proposal

The following section outlines our 'minded to' position of re-inserting SLC 25A until 31 July 2014, and incorporates our appraisal of alternative options. It is our view that it is necessary to retain the condition for a further period until the full impact of the RMR proposals is clear and, if appropriate, has taken full effect. We consider this would continue to protect consumers from possible pricing differentials that are not justified by costs until it is appropriate for a full review of the condition to be completed.

Our 'minded-to' position proposes only to amend the sunset clause date and as a result intends to apply the requirements and associated guidelines in the same way as the current licence condition. Consequently, we are proposing SLC 25A would not apply to those suppliers with fewer than 50,000 customers per fuel. However, we note that the licence condition provides us with a power of direction to amend the current 50,000 customer threshold which excludes smaller supplier from the scope of the condition. We would therefore welcome comments from stakeholders on whether it would be appropriate to review the 50,000 customer threshold as part of a separate process, in the event that we decided to reinsert SLC 25A for a further period of time.

In line with our original decision to insert SLC 25A⁸, we would also take this opportunity to remind stakeholders of the materiality considerations that apply to the condition outlined in our Guidelines⁹. This includes the principle that supplier's behaviour will only be considered material if it impacts a significant number of consumers. With this in mind, as we outlined in the decision document in June 2009, smaller suppliers are unlikely to be capable of infringing the requirements of SLC 25A in practice. This remains our position and in light of this we would ask stakeholders to consider these guidelines on materiality in their response to this consultation.

'Minded-to' proposal - Two year extension for SLC 25A extended until 31st July 2014

Our proposal is to extend the existing licence condition for a further two years. We consider it provides the most appropriate balance of preserving existing consumer protections until a full review of the licence condition provides enough evidence that they can be removed or amended. It is our view this will limit additional regulatory burden from

⁸ 'Addressing undue discrimination' Decision document, June 2009, Reference:(72/09)

⁹ See Guidelines on Cost Reflectivity between Payment Methods and the Prohibition of Undue Discrimination in Domestic Gas and Electricity Supply Contracts, August 2009, Reference:(102/09)

having either an extensive review now or a further extension to the condition in due course.

As discussed in our RMR documents, over the three years in which SLC 25A has been implemented, we consider that the dynamics of the market and consumer behaviour have not changed materially since the Probe. Therefore, if the condition lapsed in July 2012, it is our view that it is likely that the supplier behaviour that was prohibited by SLC 25A would return to the market. In this case, consumers, particularly those less engaged with the market, will potentially face higher prices over time.

Whilst we recognise it is likely that if the RMR proposals are implemented it would make it more difficult for suppliers to discriminate unduly, we are still in the process of consulting industry and stakeholders on these proposals. As a consequence, the form of these proposals is still under development and if they are implemented, the timelines for the proposals to become effective are currently uncertain.

We therefore do not consider that it is prudent to conduct a full review of SLC 25A at this point in time given the market is likely to change significantly if the RMR package is implemented. SLC 25A was implemented on a temporary basis with the expectation being that it would be fully reviewed in the future. We are still of the view that this should occur. However, as explained above, we consider that it is vital for a detailed review of SLC 25A to be conducted at a time when there is certainty as to whether and how any relevant RMR proposals would be implemented. We also consider that, depending on its outcome, a review of SLC 25A could potentially identify a need to consider extensive alterations to the condition. For this reason, a full review is likely to require greater resources and take some time in order to conduct the appropriate level of analysis and stakeholder engagement

Therefore, we consider that to ensure consumers remain protected from unduly discriminatory practices, SLC 25A should remain until such time as we can fully understand the impact of its removal. Retaining the condition until July 2014 would help to ensure that there is no gap in consumer protection before we have a clear picture on relevant RMR proposals before the condition lapsed again.

At the same time, it would not preclude us from conducting a review and removing or amending the condition before the end of July 2014, depending on developments with the RMR. If regional pricing by suppliers was likely to remain a feature of the market we may wish to conduct a full review of the licence condition within a shorter timeframe to provide an assessment on whether we wished to retain SLC 25A for a further period. We do not recommend this option at this stage. However, we propose to keep this under review as we finalise our proposals on tariff comparability.

We welcome views from stakeholders on our 'minded to' proposals and any other considerations in this consultation.

Questions for Stakeholders

1. We welcome views from stakeholders on our 'minded to' proposals and any other considerations in this consultation.
2. We welcome comments from stakeholders on whether it would be appropriate to review the 50,000 customer threshold as part of a separate process, in the event that we decided to reinsert SLC 25A for a further period of time.
3. We welcome comments from stakeholders on whether there are alternative suggestions or views on the Undue Discrimination Prohibition Standard Licence Condition ('SLC 25A').

Next steps

We welcome views from stakeholders on our 'minded to' proposal and the alternative options. Responses to this consultation are invited by 10 April 2012 and should be sent to:

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Following consideration of these responses, and relevant responses from our December 2011 publication on 'The Retail Market Review: Domestic Proposals', we intend to publish a decision document.

We are happy to accept responses by post or email. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website at www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to compatibility with Ofgem's principal objective and duties, and any obligations to disclose information, for example, under the Freedom of Information Act 2000. Respondents who wish to have their responses remain confidential should clearly mark the document(s) to that effect and include the reasons for confidentiality. Respondents are asked to put any confidential material in the appendices to their responses.

Yours faithfully,

Ian Marlee

Partner, GB Markets

Annex 1 – SLC 25A - Prohibition of Undue Discrimination

25A.1 This condition applies in relation to the supply of [electricity/gas] by the licensee under a Domestic Supply Contract or a Deemed Contract for the supply of [electricity/gas] to Domestic Premises.

25A.2 Subject to paragraph 25A.3, the licensee must ensure that in supplying or offering to supply [electricity/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.

25A.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

25A.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.

25A.5 The Authority may from time to time revise the guidance referred to in paragraph 25A.4 with a view to:

(b) Removing or reducing inconsistencies between [Electricity/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.

25A.6 Before revising guidance under paragraph 25A.5, the Authority shall give Notice that it proposes to do so to:

(a) [Electricity/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.

25A.7 A Notice given by the Authority under paragraph 25A.6 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 the Authority must consider any representations or objections which are duly made and not withdrawn.

25A.8 The licensee is not required to comply with this condition if it supplies [electricity/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

25A.9 This condition will cease to have effect on 31 July 2012.