

**July 2000**

**Gas and Electricity Supply Licences**

**Proposals for Standard Non-  
discrimination Licence Conditions**

## Executive summary

This document reviews the non-discrimination conditions in the gas and electricity suppliers' licences. It proposes that the best way to better co-ordinate gas and electricity regulation, to protect the interests of consumers and promote effective competition in gas and electricity retail supply markets is through the removal of the non-discrimination licence conditions, and reliance on the provisions of the Competition Act 1998 to address anti-competitive behaviour.

### Background

Since the non-discrimination conditions were originally developed there have been a number of changes to the regulatory environment. These include the introduction of competition to the domestic gas and electricity supply markets; the de-facto creation of a single regulatory body for gas and electricity ('Ofgem'); the implementation of the Competition Act 1998, which came into effect on 1 March 2000 and in respect of which Ofgem has concurrent powers with the OFT; and the introduction of the Utilities Bill, which is presently passing through Parliament. One of the government's main objectives of the Utilities Bill is to formally join gas and electricity regulation to better co-ordinate gas and electricity regulation.

### Options

Ofgem has considered three options as part of its review of the non-discrimination conditions. These are:

- ◆ the retention of the current non-discrimination conditions, unamended;
- ◆ amending the current non-discrimination conditions, to take account of recent market developments and differences between the current gas and electricity conditions; and
- ◆ removing the current non-discrimination conditions and using the Competition Act 1998 to address anti-competitive behaviour in the gas and electricity supply markets.

### Approach

In assessing these options, Ofgem has considered its primary duty under the Utilities Bill to protect the interests of consumers, where possible by promoting effective competition

and the government's objective to improve the co-ordination of the regulation of the gas and electricity industries.

As the removal of price controls indicates, Ofgem believes that, as competition develops, the most effective way to regulate the gas and electricity supply markets to secure effective competition and to protect consumers is to move from reliance on specific, *ex ante* constraints on behaviour to an approach based upon the general prohibition of conduct that has damaging effects. More specifically, since effective competition is likely to be the best means of protecting consumers' interests, Ofgem is of the view that what should be prohibited is conduct that prevents, restricts or distorts competition.

Ofgem believes that, once competition has developed to an extent sufficient to justify the removal of price controls, an *ex post* approach to regulating supply markets, targeted only on anti-competitive behaviour, is the best way of fulfilling its statutory duties, particularly since it is likely to minimise the extent of any regulatory distortion to the development of competition.

Following from this, Ofgem has assessed each of the three options against the following factors:

- ◆ the best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets;
- ◆ the most efficient use of Ofgem's resources to address anti-competitive behaviour in the gas and electricity supply markets;
- ◆ minimising the regulatory burden on gas and electricity suppliers; and
- ◆ ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development.

### **Proposal**

Ofgem's proposal to remove the non-discrimination conditions from the gas and electricity supply licences reflects Ofgem's view that as competition develops, regulation should move from ex-ante requirements to ex-post regulation, where action is only

taken against the behaviour of market participants that has harmful effects on customers and/or competition. This approach is reflected in Ofgem's intention to remove all remaining supply price controls in the gas and electricity supply markets, subject to satisfactory progress in removing the remaining barriers to entry in these markets. Ofgem's approach should lead to customers benefiting more quickly from suppliers' innovations and allow Ofgem to focus its resource on market developments that have anti-competitive effects.

Ofgem believes that the Competition Act 1998 can address anti-competitive behaviour that will cause appreciable harm to customers and competitors in the gas and electricity supply markets. Under the Competition Act 1998, suppliers will have the option of seeking ex-ante approval of innovations, allowing them to avoid financial penalties under the Act. However, the fees for ex-ante approval should ensure that only innovations with a serious risk of being considered anti-competitive and/or those requiring a large initial investment, will be brought to Ofgem for consideration. The table below summarises the advantages and disadvantages of each of the options considered by Ofgem.

Ofgem will consider responses to this consultation and publish, in the document that sets out its final proposals for the gas and electricity standard licence conditions in the autumn, a summary of responses to this consultation and its final proposals for the future gas and electricity supply non-discrimination conditions.

*Table – A summary of the advantages and disadvantages of Ofgem’s options for the non-discrimination conditions*

<b>Option</b>	<b>Advantages</b>	<b>Disadvantages</b>
<p>Option 1 – The retention of the current non-discrimination conditions, unamended.</p>	<ul style="list-style-type: none"> <li>◆ Retention of the advance notice requirement in the electricity condition may allow Ofgem to prevent some behaviour, which may have an anti-competitive effect, from being implemented.</li> <li>◆ Ofgem could use the conditional order powers under its sector specific powers to quickly address anti-competitive behaviour having an adverse effect on customers and competition.</li> </ul>	<ul style="list-style-type: none"> <li>◆ The existing conditions are unlikely to allow Ofgem to address all behaviour by dominant suppliers, which would cause appreciable harm to consumers and competition, e.g. ‘dual fuel’ offers and customer tie-ins.</li> <li>◆ Ofgem may occasionally use the condition to stop the introduction of an offer that it believed would adversely affect competition, but that in practice would not have adversely affected competition.</li> <li>◆ Ofgem would be required to use resources to consider pro-competitive offers from dominant electricity suppliers.</li> <li>◆ Suppliers’ compliance costs may increase due to the duplication of Ofgem’s powers under the licence conditions and the Competition Act 1998.</li> <li>◆ The advance notice requirement in the electricity condition can delay pro-competitive offers coming to market to the detriment of customers and the development of competition.</li> </ul>

<p>Option 2 – Amending the current non-discrimination conditions, to take account of recent market developments and differences between the current gas and electricity conditions.</p>	<ul style="list-style-type: none"> <li>◆ Amended conditions could take account of recent market developments, including 'dual fuel' offers and customer tie-ins.</li> <li>◆ Removing the advance notice requirement from the electricity condition would allow Ofgem to focus on behaviour that it, and customers and competitors, believed was having an appreciable anti-competitive effect. Suppliers could still approach Ofgem for guidance or a decision under the Competition Act 1998.</li> <li>◆ Amended conditions could remove any unjustifiable differences between the gas and electricity conditions, which would reduce distortions to competition.</li> <li>◆ The removal of the advance notice requirement would allow electricity suppliers to bring new offers to market more quickly and allow customers to obtain the benefits of those offers earlier.</li> <li>◆ Ofgem could use the conditional order powers under its sector specific powers to quickly address anti-competitive behaviour having an adverse effect on customers and competition.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Even with amendments, it is unlikely that the conditions would cover any behaviour that harms consumers and competitors that would not be covered by the Competition Act 1998.</li> <li>◆ The licence conditions would require amendment to take account of future market developments, whereas the Competition Act 1998 should evolve to take account of such developments and developments in EC and UK competition law.</li> </ul>
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<p>Option 3 – Removing the current non-discrimination conditions and using the Competition Act 1998 to address anti-competitive behaviour in the gas and electricity supply markets.</p>	<ul style="list-style-type: none"> <li>◆ The Competition Act 1998 could address all behaviour that would cause harm to customers and competition that is currently covered by the non-discrimination conditions, or that would be covered if the conditions were amended.</li> <li>◆ The Competition Act 1998 can evolve, without amendment, to take account of future market developments and developments in EC and UK competition law.</li> <li>◆ Ofgem can better focus its resources on anti-competitive behaviour through reacting to complaints and initiating investigations.</li> <li>◆ The provisions to seek guidance and decisions will allow suppliers, if they believe that it is necessary, to obtain an ex-ante view as to whether a proposal is anti-competitive.</li> <li>◆ Removing the conditions would remove the duplication of powers, which may reduce suppliers compliance costs.</li> <li>◆ Ofgem could use the interim measures powers under the Competition Act 1998 to fairly quickly stop anti-competitive behaviour having a significant adverse effect on competition.</li> </ul>	<ul style="list-style-type: none"> <li>◆ Ofgem would not be able to use the sector specific powers to issue conditional orders to stop anti-competitive behaviour.</li> </ul>
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# 1. Introduction

## *Purpose of this document*

- 1.1 The Utilities Bill, which is currently being considered by Parliament, is expected to be granted Royal Assent this summer. One of the government's main objectives in introducing the Bill is to improve the co-ordination of the regulation of the gas and electricity industries.<sup>1</sup> An important part of Ofgem's work programme to ensure the effective implementation of the Bill and to meet the government's objective is the development of new standard gas and electricity licences. Ofgem has already consulted on proposed new standard licence conditions<sup>2</sup> and there will be a further consultation in the autumn.
- 1.2 This document reviews the role of the 'non-discrimination' licence conditions (Standard Condition 13 of the gas suppliers' licence, Conditions 4A and 4B of the English and Welsh electricity supply licences and Conditions 3A and 3B of the Scottish electricity supply licences) in regulating behaviour in the supply markets.<sup>3</sup>
- 1.3 As well as the Utilities Bill and the government's objective to improve the co-ordination of the regulation of the gas and electricity industries, Ofgem's review of the non-discrimination conditions takes account of a number of changes to the regulatory environment since the non-discrimination licence conditions were originally developed. In particular, these changes include:
- ◆ the introduction and development of competition in the domestic gas and electricity supply markets;
  - ◆ the merging of the gas and electricity industry regulators into a single regulatory body, 'Ofgem' from July 1999. 'The Gas and Electricity Markets Authority' will be formally established by the Utilities Bill; and

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<sup>1</sup> "A Fair Deal for Consumers, Modernising the Framework for Utility Regulation, The Future of Gas and Electricity Regulation - The Government's Proposals for Legislation", DTI, October 1999.

<sup>2</sup> "Initial Proposals on Standard Licence Conditions, A Consultation Paper", Ofgem, November 1999 and "The Utilities Bill Standard Licence Conditions Volumes 1-8: Consultation Paper", Ofgem, February 2000.

<sup>3</sup> References to the electricity non-discrimination condition licence conditions in this document should be taken as covering conditions 4A and 4B. In some electricity supply licences these conditions have different numbers. Again, references to the electricity non-discrimination licence conditions should be taken as covering these conditions.

- ◆ the implementation of the main provisions of the Competition Act 1998 from 1 March 2000.
- 1.4 These developments mean that this review takes place against a background of substantially more competition in the gas and electricity supply markets, a better co-ordinated approach to the regulation of the gas and electricity supply markets and stronger competition law powers than when the conditions were originally developed.
- 1.5 This review only considers the non-discrimination conditions contained in the gas and electricity supply licences. It does not consider the non-discrimination conditions that affect other parts of the gas and electricity supply chains, which are contained within other licences, including the transportation and generation licences, and the proposed new distribution licence.

### ***Structure of Document***

- 1.6 Chapter 2 explains the regulatory framework and recent market developments that affect this review. Chapter 3 explains the factors Ofgem has considered in this review and the approach Ofgem has taken to assess each of the options to change the non-discrimination conditions. Chapters 4 to 6 outline the three options Ofgem has considered in this review and assesses each option against the factors set out in Chapter 3.
- 1.7 Chapter 4 assesses the option to retain, unamended, the current non-discrimination conditions. Chapter 5 assesses the option to amend the current non-discrimination conditions to take account of recent market developments and to remove unjustifiable differences between the current gas and electricity conditions. Chapter 6 assesses the option to remove the current non-discrimination conditions and to use only the Competition Act 1998 to regulate anti-competitive behaviour in the gas and electricity supply markets. Chapter 7 confirms Ofgem's initial proposal and explains the timetable for the rest of this review.
- 1.8 Appendix 1 sets out the Statutory Duties of the Director General of Gas Supply (DGGS) and the Director General of Electricity Supply (DGES) and how these duties will be altered by the Utilities Bill. Appendix 2 sets out Standard

Condition 13 of the gas suppliers' licence. Appendix 3 sets out Conditions 4A and 4B (Conditions 3A and 3B in Scotland) of the electricity supply licence. Appendix 4 summarises the views expressed about the non-discrimination licence conditions in earlier consultations on proposed standard licence conditions.

### ***Contact Details***

- 1.9 Ofgem wishes to conduct this review in as open a way as possible and to take account of the views of interested parties. If you wish to express a view on the issues raised in this document and Ofgem's initial proposals, it would be helpful to receive your comments by no later than 4 September 2000. Responses should be addressed to:

Nick Fincham  
Director, Competition  
Office of Gas and Electricity Markets  
Stockley House  
London  
SW1V 1LQ  
Fax: 020 7828 3154

- 1.10 It is open to respondents to mark all, or part, of their responses as confidential. However, Ofgem would prefer that, as far as possible, responses are provided in a form that can be placed in Ofgem's library.
- 1.11 If you have any queries concerning issues raised in this document, you can contact Colin Garland on 020-7932-1671 or e-mail [colin.garland@ofgem.gov.uk](mailto:colin.garland@ofgem.gov.uk), who will be pleased to help.

## 2. Background

### *Introduction*

2.1 This chapter explains the regulatory framework and recent market developments that are relevant to this review. The regulatory framework covers:

- ◆ the Gas Act 1986 (as amended by the Gas Act 1995);
- ◆ the Electricity Act 1989;
- ◆ Standard Condition 13 of the gas suppliers' licence and Conditions 4A and 4B (Conditions 3A and 3B in Scotland) of the PES electricity licence;
- ◆ the Competition Act 1998; and
- ◆ the Utilities Bill.

2.2 Relevant recent market developments discusses the:

- ◆ development of gas and electricity supply competition;
- ◆ British Gas Trading's (BGT's) supply price control; and
- ◆ the Public Electricity Suppliers' (PESs') supply price controls.

### *Regulatory Framework*

#### **Gas Act 1986 (as amended 1995)**

2.3 Section 4 of the Act sets out the statutory duties of the DGGS. The Utilities Bill will alter these duties. The duties and how they will change are explained in appendix 1.

2.4 Section 28(5)(c) of the Act states that the Director shall not make a final order, or make or confirm a provisional order, if he is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.

## **Electricity Act 1989**

- 2.5 Section 3 of the Act sets out the statutory duties of the DGES. The introduction of the Utilities Bill will alter these duties. The duties and how they will change are set out in appendix 1.
- 2.6 Section 18(4) of the Act states that PESs shall not show undue preference or exercise undue discrimination when fixing tariffs. The introduction of the Utilities Bill will repeal this section of the Act.
- 2.7 Section 25(5)(d) of the Act states that the Director shall not make a final order, or make or confirm a provisional order, in relation to a licence holder if he is satisfied that the most appropriate way of proceeding is under the Competition Act 1998

## **Standard Condition 13 of the gas suppliers' licence and Conditions 4A and 4B (Conditions 3A and 3B in Scotland) of the electricity supply licence**

- 2.8 The gas and electricity non-discrimination conditions explain certain types of behaviour that dominant suppliers in both the industrial and commercial, and domestic sectors of the gas and electricity supply markets, are prohibited from engaging in. The prohibited behaviour is:
- ◆ showing undue preference;
  - ◆ exercising undue discrimination;
  - ◆ setting unduly onerous prices; and
  - ◆ predatory pricing.
- 2.9 The prohibition on dominant companies showing undue preference and exercising undue discrimination becomes less restrictive as competition develops. For example, Standard Condition 13(2) of the gas suppliers' licence allows a dominant supplier to set terms that are reasonable to meet established competition, but not terms that are predatory or unduly onerous.
- 2.10 The electricity licence condition requires dominant electricity suppliers to give Ofgem 28 days notice of any changes to their terms of supply, which are likely

to significantly affect customers' evaluation of the suppliers' offer. Ofgem has 28 days within which to issue a 'counter-notice' to prevent the new terms being introduced. There is no similar requirement in the gas licence condition.

2.11 In considering the three options set out in chapters 4 to 6, Ofgem has considered the drafting of the current non-discrimination conditions, taking particular account of:

- ◆ the recent market developments that are not captured by the current conditions; and
- ◆ the differences between the current gas and electricity conditions.

*Recent developments that are not addressed by the current conditions*

2.12 One of the main developments since competition was introduced into the domestic gas and electricity supply markets has been the offering of 'dual fuel' contracts by suppliers. Under a 'dual fuel' contract, a supplier of gas and electricity offers customers a discount reflecting the cost savings associated with supplying both fuels, e.g. joint meter reading. Ofgem's December 1999 review of competition in the domestic gas supply market estimated that about 5 million households in Great Britain were supplied under 'dual fuel' contracts.

2.13 BGT and a number of PESs offer 'dual fuel' contracts. Being dominant suppliers in relevant markets, Ofgem has assessed all of these offers against the provisions of the non-discrimination licence conditions. In July 1999, Ofgem published the conclusions of its investigation into BGT's 'dual fuel' offer.<sup>4</sup>

2.14 BGT's 'dual fuel' offer consisted of a discount to its customers of around £14 a year on their electricity bill, if the customer was also supplied with gas by BGT. BGT was, and still is a dominant supplier of gas, but was not, and still is not, a dominant supplier of electricity. Therefore, when assessing BGT's 'dual fuel' offer, Ofgem could only assess the offer against Standard Condition 13 of BGT's gas suppliers' licence. Ofgem considered the supply of electricity to be a principal term of gas supply because BGT's discount was only offered to customers who took both fuels. Therefore, Ofgem assessed the whole of BGT's

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<sup>4</sup> "Review of British Gas Trading's Behaviour in the Domestic Gas Market: A Follow-up Document", Ofgem, July 1999.

'dual fuel' offer, including the electricity terms, against Standard Condition 13 of the gas suppliers' licence.

- 2.15 BGT did not agree that electricity supply was a principal term of gas supply. BGT argued that in assessing the terms of the 'dual fuel' offer against Standard Condition 13, Ofgem could only assess the terms of gas supply.
- 2.16 Ofgem's investigation into BGT's 'dual fuel' offer concluded that it did not breach Standard Condition 13. However, if the conclusion had been that the offer had breached the condition, BGT might have contested any action Ofgem sought to take on the grounds that the terms of electricity supply were not a principal term of gas supply.
- 2.17 Ofgem is concerned that the present non-discrimination conditions do not adequately provide for the regulation of the gas and electricity supply markets as they are currently developing, because they may not allow Ofgem to consider the effect of behaviour in one market on competition in the other. This is inconsistent with the governments' objective to better co-ordinate regulation of the gas and electricity industries and the Utilities Bill, which allows the Authority to have regard to the interests of electricity consumers when acting under the Gas Act 1986 (as amended 1995) and vice versa.
- 2.18 A feature of a number of recent innovations in the domestic gas and electricity supply markets has been the imposition of costs, over and above any individual switching costs, that a customer may incur, if they chose to switch supplier. This could be in the form of a termination fee payable when the customer transfers or the loss of complementary benefits on transfer. BGT was asked in Ofgas' conclusions of its review of BGT's 'Goldfish' credit card offer to make it clear to customers that outstanding 'Goldfish' points could be redeemed against final BGT bills on transferring supplier.<sup>5</sup> It is not clear to Ofgem that customer tie-ins with an anti-competitive effect are prohibited under the non-discrimination licence conditions. Such tie-ins would have to be addressed under competition law.

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<sup>5</sup> "Goldfish: British Gas Trading's Credit Card Joint Venture: A Decision Document", Ofgas, October 1997.



*The main differences between the current gas and electricity conditions*

2.19 There are a number of aspects of the drafting of the non-discrimination conditions in gas and electricity that differ between the two. The differences of substance are set out below:

- ◆ Dominance. In the gas condition, a dominant supplier is prohibited from predatory pricing or setting unduly onerous prices in any geographic market. In the electricity condition, a dominant supplier is prohibited from predatory pricing or setting unduly onerous prices only in the geographic markets in which it is dominant;
- ◆ Public interest. The gas condition allows a dominant supplier to make an offer that may be in breach of the condition, but that would be allowed because it is in the “public interest”. There is no such provision in the electricity condition;
- ◆ Cross-subsidy. The electricity condition prohibits cross-subsidy of a supply business from another business. Such cross-subsidy is not explicitly prohibited by the gas condition;
- ◆ Disapplication procedure. The electricity condition includes a disapplication procedure in Condition 4B. This sets out the procedure that suppliers should follow when it requests that the DGES notifies it that it is no longer a ‘dominant’ supplier. There is no similar disapplication procedure in the gas condition;
- ◆ Notice. As explained above, the electricity condition requires the supplier to give Ofgem at least 28 days notice of any changed or new offers that significantly affect the customer’s evaluation of the suppliers’ offers, and it allows Ofgem to issue a counter-notice to stop such offers being introduced if they breach or are likely to breach the condition. The gas condition does not require a dominant supplier to give Ofgem advance notice of offers; and
- ◆ The minimum number of customers in a market. In the electricity condition, a class of customers must include at least 50,000 customers to

be covered by the licence condition. In gas, the minimum number is 100,000 customers.

- 2.20 Given the government's objective of aligning the regulation of the gas and electricity industries, as far as possible, Ofgem does not consider that the first four differences can be justified by the different characteristics of the gas and electricity markets. The existence of 14 incumbent PESs in electricity as compared to only 1 incumbent supplier in gas, which implies a larger monitoring burden for Ofgem, and the consequent smaller geographic areas of dominance in electricity, may justify the other two differences.
- 2.21 The full text of Standard Condition 13 of the gas suppliers' licence is set out in Appendix 2 and the full text of Conditions 4A and 4B (Conditions 3A and 3B in Scotland) of the electricity supply licence is set out in Appendix 3.

### **Competition Act 1998**

- 2.22 The main provisions of the Competition Act 1998 came into force on 1 March 2000. The Act replaced or amended the Fair Trading Act 1973; the Restrictive Trade Practices Act 1976; the Resale Prices Act 1976; and the Competition Act 1980.
- 2.23 The Act introduced two prohibitions. The Chapter I prohibition prohibits agreements between undertakings, concerted practices and decisions by associations that have the object or effect of preventing, restricting or distorting competition in the United Kingdom. The Chapter II prohibition prohibits the abuse of a dominant position by an undertaking in the United Kingdom. Section 60 of the Act seeks to ensure that as far as possible, the Act is applied in a manner consistent with EC competition law. Undertakings can be fined up to 10% of their UK turnover for each year or part year, up to a maximum of three years, in which they breach either prohibition. A statutory instrument providing guidance from the Director General of Fair Trading (DGFT) as to how penalties will be calculated under the Act has been passed by Parliament.<sup>6</sup>
- 2.24 Ofgem has concurrent powers with the Office of Fair Trading (OFT) to apply the Act to the gas and electricity industries. Ofgem has recently formally consulted

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<sup>6</sup> "Guidance as to the appropriate amount of a penalty", Office of Fair Trading, February 2000.

on its energy guideline, which provides advice and information under Section 52 of the Act as to how the Act will be applied to the energy sector.<sup>7</sup> A final version of this guideline will be published in the last quarter of this calendar year. This, along with other guidelines issued by the OFT and sector regulators (including Ofgem), provide advice and information under section 52 of the Act on how the Act will be applied. All guidelines are available on the OFT website at [www.ofg.gov.uk](http://www.ofg.gov.uk).

- 2.25 The other major provisions of the Act which are relevant to this review, including undertakings' ability to seek guidance or decisions<sup>8</sup> as to whether agreements or conduct would breach one of the prohibitions, the powers to obtain information, the power to issue interim measures and the provisions to allow undertakings to appeal findings of a breach of the prohibitions to the Competition Commission, are explained in the guideline entitled, "The Major Provisions", which is available from the OFT.<sup>9</sup>

### **Utilities Bill**

- 2.26 One of the reasons the government introduced the Utilities Bill was to improve the co-ordination of gas and electricity regulation as much as possible. This objective was set out in the government's proposal for legislation, published in October 1999.<sup>10</sup>
- 2.27 *"At present there are many differences of detail between the regulation of electricity and gas, as well as some differences of substance: often the same effect is achieved but via different mechanisms. The Government proposes to align the two regulatory systems, except where genuine differences between the two sources of energy or the structure of the two markets exist."*
- 2.28 In addition, the government's proposal stated *"...The Government...has decided that the licensing regimes in gas and electricity should be aligned as far as possible."*

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<sup>7</sup> "Competition Act 1998, Application to the Energy Sector, Formal Consultation Draft", Ofgem, May 2000.

<sup>8</sup> Decisions given under the provisions in the Act have the effect of exempting the agreement or conduct from the prohibitions of the Act. Ofgem can only reopen a case if it has reasonable grounds for believing that there has been a material change in circumstances or it has a reasonable suspicion that materially incomplete, misleading or false information had been given.

<sup>9</sup> "The Competition Act 1998: The Major Provisions", OFT, March 1999.

<sup>10</sup> "A Fair Deal for Consumers, Modernising the Framework for Utility Regulation, The Future of Gas and Electricity Regulation - The Government's Proposals for Legislation", DTI, October 1999.

- 2.29 The Utilities Bill, which is currently being considered by Parliament, will replace the DGGS and the DGES with the 'Gas and Electricity Markets Authority'. The Authority will have a primary objective, '...to protect the interests of customers, where possible by promoting effective competition'.
- 2.30 Under the Bill, the Secretary of State for Trade and Industry will have the power to issue guidance to the Authority on social and environmental issues, to which the Authority is required to have regard when exercising its powers and functions under the Gas Act 1986 (as amended 1995) and the Electricity Act 1989. The Department of Trade and Industry is currently consulting on drafts of this guidance.<sup>11</sup>
- 2.31 The Bill will change the licensing structure in electricity to replace the current first tier electricity licence which covers distribution and supply activities, and the current second tier electricity licence which covers supply activities, with separate licences for distribution and supply activities. The Bill also introduces standard licence conditions for all types of electricity licence and amends the standard licence conditions in the gas licences.
- 2.32 The Bill gives the Authority the power to levy monetary penalties on licensees for past or present breaches of a licence condition, a relevant requirement or for failing to meet a guaranteed standard of service. This extends the power to levy penalties on final order for present or future breaches of a licence condition that is available under the Gas Act 1986 (as amended 1995).
- 2.33 The Authority cannot levy a penalty under the sector specific legislation if a penalty has already been levied under the Competition Act 1998 for the same offence. The Authority will be required to calculate a penalty that is, *"...reasonable in the circumstances of the case"* and does not exceed 10% of the licensee's turnover. A Statutory Instrument explaining how turnover is to be calculated is to be laid before Parliament. Ofgem will be consulting in due course on the approach that it will take to calculate penalties when using these powers. The Bill does not place any time limit on Ofgem's investigations of suspected licence breaches. However, Ofgem will be required, within 12

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<sup>11</sup> "A Fair Deal for Consumers, Modernising the Framework for Utility Regulation: Draft Statutory Social and Environmental Guidance to the Gas and Electricity Markets Authority" DTI, February 2000.

months of a suspected licence breach, to issue a notice that it intends to investigate the suspected breach.

### ***Recent market developments***

#### **The development of gas and electricity supply competition**

2.34 Below is a summary of the development of competition so far in the:

- ◆ industrial and commercial gas and electricity supply markets; and
- ◆ domestic gas and electricity supply markets.

#### ***Industrial and commercial market competition***

2.35 Competition in the industrial and commercial gas and electricity supply markets has been open since the late 1980s and the early 1990s respectively. Ofgem is currently reviewing the development of competition in both markets. Following the survey of gas shippers and suppliers, and customer representatives in January<sup>12</sup>, Ofgem expects to publish the conclusions of its review in the near future. The survey of electricity distribution companies, suppliers and customer representatives was issued in April<sup>13</sup> and Ofgem expects to publish the conclusions of its review at the end of August.

2.36 Ofgas' last review of the industrial and commercial gas supply market<sup>14</sup> concluded that competition was developing well, with a lower level of complaints than in previous reviews and little evidence that BGT's activities in the market were causing any problems.

2.37 OFFER's last review of competition in the over 100 kW market found that over two thirds of sites consuming more than 1MW took supply from a second tier supplier. This accounted for over 80% of output supplied to that market. Nearly half of the sites consuming between 100kW and 1MW took their supply from a second tier supplier. This accounted for about 60% of output supplied to that market.

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<sup>12</sup> "1999 Industrial and Commercial Gas Market Survey", Ofgem, January 2000.

<sup>13</sup> "1999 Industrial and Commercial Electricity Market Survey", Ofgem, April 2000.

<sup>14</sup> "1997 Competitive Market Review, Part 1: above 2,500 therms a year", Ofgas, May 1998.

### *Domestic market competition*

- 2.38 Competition in the domestic gas supply market was phased in between April 1996 and May 1998. In the domestic and small business electricity supply market, competition was phased in between September 1998 and May 1999. The Gas Act 1986 (as amended 1995) and the Electricity Act 1989 require Ofgem to review annually the development of competition in the domestic gas and electricity supply markets. In June 1999, Ofgem published its assessment of the development of competition in the domestic and small business electricity market.<sup>15</sup> In December 1999, the assessment of the development of competition in the domestic gas market was published.<sup>16</sup>
- 2.39 The review of electricity supply competition was published only about 10 months after competition had opened in some areas and about a month after competition had opened in all areas. Nevertheless, the review concluded that the prospects for the future development of competition were good, subject to appropriate monitoring of PESs' behaviour, and in particular, their complementary products and 'dual fuel' offers.
- 2.40 The review of gas supply competition concluded that competition was developing well. 96% of customers were aware of their ability to choose an alternative gas supplier; 25% of customers had switched gas supplier; the level of customer switching was continuing at about 32,000 per week; the number of rival suppliers to BGT was well in excess of that required for competition; and most customers were able to obtain competitive offers, with discounts available of up to 20% compared to BGT's tariffs. Ofgem noted that the gas and electricity supply markets were increasingly being characterised by 'dual fuel' offers, with almost half of electricity and gas switchers supplied on 'dual fuel' contracts. Ofgem was concerned about barriers to entry in the electricity market, many of which it intended to address over the next 18 months.
- 2.41 Later this month, Ofgem will be issuing a survey to all gas suppliers and shippers, to all electricity suppliers, and to customer representatives, to obtain quantitative and qualitative information for its 2000 assessment of competition

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<sup>15</sup> "A Review of the Development of Competition in the Designated Electricity Market", Ofgem, June 1999.

<sup>16</sup> "A Review of the Development of Competition in the Domestic Gas Market", Ofgem, December 1999.

in the domestic gas and electricity supply markets. This survey will take account of the views expressed at a public workshop held last month to discuss the factors that Ofgem should take into account when assessing competition in the gas and electricity supply markets. This assessment of competition will inform Ofgem's decision on the future price regulation of BGT's domestic tariffs from April 2001.

### **Supply price controls**

- 2.42 During 1999 and 2000, Ofgem reviewed BGT's gas supply price control and the 14 PES supply price controls. The decisions about the scope, form, level and duration of these price controls were informed by the assessments of competition, discussed above. In addition, Ofgem obtained information to assess companies' expected future costs. Ofgem's price control proposals struck a balance between its duties to secure effective competition in the gas and electricity supply markets, protect the interests of consumers and ensure that companies can finance their licensed activities.
- 2.43 The competition assessments concluded that competition for customers who pay their bills by direct debit was sufficiently developed to remove price controls in both gas and electricity. In addition, small business electricity customers were removed from the price control due to the development of competition for these customers. Small business gas customers had already been removed from price controls. The assessments concluded that competition for customers who paid their bills by other methods (including those paying by cheque and cash or through a prepayment meter) was not sufficiently developed to remove price controls for these customers.

#### *BGT's supply price control<sup>17</sup>*

- 2.44 The price control caps the two tiers of BGT's tariffs until March 2001. The structure of the tariffs reflects BGT's request to Ofgem to remove the standing charge element from its tariffs. The first tier of the tariff cap applies to the first 1143 kWh of consumption per quarter, with the second tier applying to all additional consumption in the quarter. Table 1 shows the effect on customers'

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<sup>17</sup> "Review of British Gas Trading's price regulation, Licence modification", Ofgem, June 2000.

bills of the price reductions introduced by BGT on 1 April 2000, as a result of the price control.

**Table 1 – The change in BGT’s bills at tariff annual average consumption from 1 April 2000**

Tariff	31 March 2000 (£)	1 April 2000 (£)	Reduction (£/ %)
PromptPay (16,441 kWh)	246	239	8/ 3.1
Standard/PrePayment (15,666 kWh)	266	257	10/ 3.6

2.45 Ofgem stated that it was its firm intention to remove price controls from all of BGT’s domestic gas customers from April 2001, subject to satisfactory progress being made in the removal of the remaining barriers to entry in the market.

*PES supply price controls<sup>18</sup>*

2.46 For the domestic tariffs (Standard, Economy 7 and Prepayment), Ofgem maintained price controls for a further two years, until March 2002. Domestic customers who pay their bills by direct debit and small business electricity customers have the protection of a supplementary restriction. This limits any price increase for these tariffs to the rate of inflation. The impact of the price controls on the average bills (based on an annual average consumption of 3,300kWh) for standard tariffs offered by each PES are shown in table 2. PESs’ prepayment tariffs are capped at a maximum of £15 a year more than their standard and Economy 7 tariffs.

<sup>18</sup> “Reviews of Public Electricity Suppliers 1998 to 2000, Supply price control review, Final proposals”, Ofgem, December 1999.



**Table 2 – Impact of Ofgem’s price control on an average standard domestic bill**

<b>PES</b>	<b>31 March 2000 (£)</b>	<b>1 April 2000 (£)</b>	<b>Reduction (%)</b>
Eastern	237	219	8
East Midlands	242	225	7
London	245	235	4
Manweb	265	258	2
Midlands	241	232	4
Northern	260	245	6
NORWEB	244	230	6
SEEBOARD	240	225	6
Southern	243	242	0
SWALEC	276	273	1
SWEB	261	256	2
Yorkshire	243	239	2
Scottish Power	261	261	0
Scottish Hydro-Electric	265	256	3

2.47 Ofgem stated that it was its intention to remove the PES price controls from April 2002, subject to satisfactory progress being made in the removal of the remaining barriers to entry in the market and the adequate development of competition over the next two years.

### 3. Ofgem's approach

#### *Introduction*

- 3.1 When the gas and electricity supply non-discrimination licence conditions were originally developed, competition in the domestic gas and electricity supply markets had not yet been introduced, Ofgem had not been formed, the Utilities Bill had not been developed and the Competition Act 1998 had not been passed. When reviewing what changes, if any, should be made to the non-discrimination conditions in the light of the developments in the gas and electricity industry since the conditions were originally developed, Ofgem has taken particular account of the primary objective that will be placed on the Authority by the Utilities Bill, which is, *"...to protect the interests of consumers, wherever possible by promoting effective competition"*, and the government's objective to better co-ordinate the regulation of the gas and electricity industries.

#### *Promoting effective competition*

- 3.2 As explained in Ofgem's 1999 domestic competitive gas market review, there are a number of important conditions for effective competition, including that:
- ◆ all customers in the market can attract and are aware of a range of competitive offers;
  - ◆ the abuse of market power is prevented; and
  - ◆ the operation of the competitive market promotes innovation in the market and improved economic efficiency.
- 3.3 Ofgem's regulation of the gas and electricity supply markets influences the development of effective competition and the extent to which the conditions set out above are met. As explained in Chapter 2, supply competition is developing well in both the gas and electricity markets. There are no price controls in the industrial and commercial sectors of the markets and the development of competition allowed Ofgem to remove price controls for domestic customers paying by direct debit and to announce its intention, subject to satisfactory progress in addressing the remaining barriers to entry, to remove the remaining

price controls from domestic gas customers in April 2001 and from domestic electricity customers in April 2002. Where there are no longer price controls, Ofgem uses the non-discrimination licence conditions and competition law to protect consumers and competitors from anti-competitive behaviour.

- 3.4 As the removal of price controls indicates, Ofgem believes that, as competition develops, the most effective way to regulate the gas and electricity supply markets to secure effective competition and to protect consumers is to move from reliance on specific, *ex ante* constraints on behaviour to an approach based upon the general prohibition of conduct that has damaging effects. More specifically, since effective competition is likely to be the best means of protecting consumers' interests, Ofgem is of the view that what should be prohibited is conduct that prevents, restricts or distorts competition.
- 3.5 Ofgem believes that, once competition has developed to an extent sufficient to justify the removal of price controls, an *ex post* approach to regulating supply markets, targeted only on anti-competitive behaviour, is the best way of fulfilling its statutory duties, particularly since it is likely to minimise the extent of any regulatory distortion to the development of competition. However, it is necessary to consider whether such a transition is appropriate in the period before full deregulation of supply markets.

***Factors against which Ofgem has assessed the options to change the non-discrimination conditions***

- 3.6 Taking account of this approach and the government's objective to better co-ordinate the regulation of the gas and electricity industries wherever possible, Ofgem has assessed three options for changing the non-discrimination conditions against four factors. These factors allow Ofgem to assess each of the options against its statutory duties, set out in Appendix 1. The factors used to assess the options are:
- ◆ the best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets;

- ◆ the most efficient use of Ofgem's resources to address anti-competitive behaviour in the gas and electricity supply markets;
- ◆ minimising the regulatory burden on gas and electricity suppliers; and
- ◆ ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development.

**The best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets**

3.7 Chapter 2 explained the regulatory framework that affects this review. The Competition Act 1998 changed Ofgem's powers to address anti-competitive behaviour in a number of ways. This Act and the Utilities Bill also change the relative balance between Ofgem's sector specific and competition law powers to address anti-competitive behaviour. These changes included:

- ◆ the range of anti-competitive behaviour that can be addressed;
- ◆ the speed with which anti-competitive behaviour can be addressed; and
- ◆ the penalties that can be levied against undertakings engaged in anti-competitive behaviour.

3.8 The ways in which the relative balance between sector specific and competition law powers has changed is discussed below.

3.9 The Competition Act 1998 can be used to address the types of anti-competitive behaviour described in sections 2 and 18 of the Act, subject to various exemptions and exclusions that are available under the Act. EC jurisprudence partly clarifies the behaviour that is likely to be considered to breach the prohibitions of the Act. The behaviour prohibited by the Act appears likely to include the types of behaviour currently covered by the non-discrimination licence conditions, including dominant suppliers showing undue preference, exercising undue discrimination, predatory pricing and setting unduly onerous prices.

- 3.10 Due to a requirement under the Act to be consistent, as far as possible, with EC jurisprudence and the right of appeal to the Competition Commission for undertakings found to have breached the prohibitions, Ofgem may have less discretion when applying the Act to certain types of behaviour than when applying the non-discrimination licence conditions. Although the licence conditions could be interpreted more widely than the Competition Act 1998 for certain types of behaviour, Ofgem does not believe that as competition develops, such a wider interpretation would be in the consumers' interests.
- 3.11 The Competition Act 1998 also prohibits other abusive behaviour by dominant companies, such as customer tie-ins, that have an anti-competitive effect. Such abusive behaviour does not appear to be covered by the non-discrimination licence conditions. The prohibitions of the Competition Act 1998 should evolve in application to address new types of anti-competitive behaviour that may occur as markets develop.
- 3.12 One of the reasons that the Competition Act 1998 was introduced was that many forms of anti-competitive behaviour could not be addressed under the previous competition law regime. In addition, when the previous regime was capable of addressing abusive behaviour, there was a lengthy process that had to be undertaken to address the behaviour. The Act does not prescribe time scales for investigations. The Act and the Directors' Rules, which set out some of the processes that have to be followed when applying the Act, contain provisions to ensure that the OFT and the sector regulators (including Ofgem) do not cause undue delays when applying the Act. The Act also allows Ofgem to take interim measures if:
- ◆ it has reasonable suspicion that one of the prohibitions has been infringed; and
  - ◆ it considers that it is necessary to act urgently to prevent serious, irreparable damage to a person, or to protect the public interest.
- 3.13 This power is consistent with powers available to the Commission under the EC Treaty. The power to take interim measures may allow Ofgem to act quickly against anti-competitive behaviour that is very significantly affecting competition. Ofgem anticipates that this power is only likely to be used

occasionally because of the conditions that need to be met before the power can be used.

- 3.14 Under the Utilities Bill, Ofgem will be required, within 12 months of a suspected licence breach, to issue a notice that it intends to investigate a suspected breach. There are powers under the Gas Act 1986 (as amended 1995) and the Electricity Act 1989 to issue Conditional Orders against licence holders who are suspected of breaching their licence. Such orders may be a more effective way than interim measures to address quickly anti-competitive behaviour because the conditions that need to be met are less stringent.
- 3.15 The powers to levy penalties under the Competition Act 1998 and the Utilities Bill are explained in Chapter 2. It appears that Ofgem will have similar powers to levy penalties under both sets of legislation.
- 3.16 Both the Utilities Bill and the Competition Act 1998 change, and in some respects increase, Ofgem's powers to address anti-competitive behaviour. Under the Gas Act 1986 (as amended 1995) and the Electricity Act 1989, the Director General shall not make a final order, or confirm a provisional order if he is satisfied that the most appropriate way of proceeding is under the Competition Act 1998.
- 3.17 Ofgem will assess the options for the future non-discrimination conditions to ensure the best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets.

**The most effective use of Ofgem's resources to protect customers from anti-competitive behaviour in supply markets**

- 3.18 Ofgem's plan and budget for the year to March 2001<sup>19</sup> included provision for work to secure effective competition in gas and electricity supply markets, including acting against anti-competitive behaviour. As with the other priorities that Ofgem identified in the plan and budget, Ofgem wants to ensure that its resources to address anti-competitive behaviour in supply markets are used as efficiently and effectively as possible.

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<sup>19</sup> "Office of Gas and Electricity Markets Plan and Budget, April 2000 to March 2001", Ofgem, March 2000.

- 3.19 The current non-discrimination conditions in the electricity supply licences require dominant suppliers to give Ofgem 28 days notice of 'new terms'. Currently, Ofgem is required to consider whether each new offer from a PES to domestic and small business electricity customers within its own PES area, is in accordance with the requirements of the non-discrimination condition.
- 3.20 In the last year, Ofgem has been notified of around 40 offers under this condition. In all of the cases where Ofgem has completed its consideration, it has found that the offer is in accordance with the licence condition. In addition, Ofgem has not upheld any complaints from customers or competitors concerning any of the offers that it has found to be in accordance with the condition.
- 3.21 Therefore, Ofgem is currently using resources to consider many PES offers, which are pro-competitive and increase customer choice, when it may be preferable to focus resources on anti-competitive behaviour. This could be achieved through a combination of Ofgem reacting to complaints from competitors and customers (directed through the Gas and Electricity Consumer Council), and starting its own investigations where appropriate. This is because competitors and customers have an incentive to complain about those types of behaviour causing them harm.
- 3.22 There may be cases where suppliers are intending to launch a new offer, which the supplier is concerned may be anti-competitive or for which a large initial investment is required. Ofgem recognises the need for a mechanism to allow such proposals to be considered by Ofgem in advance, although any such process should provide an incentive for suppliers to bring to Ofgem only those offers for which they believe there is a serious risk of an anti-competitive finding, or which involve a large initial investment.
- 3.23 Ofgem will evaluate the options for the future non-discrimination conditions to ensure the best use of Ofgem's resources.

#### **Minimising the regulatory burden on gas and electricity suppliers**

- 3.24 Most regulations and laws give rise to compliance costs on the part of those affected by them. Ofgem's powers to address anti-competitive behaviour in the

gas and electricity supply markets are no exception, and give rise to some compliance costs for suppliers. Regulations and laws can also impose costs on third parties, such as customers, from whom suppliers may seek to recover their compliance costs. Poorly targeted regulation can also give rise to further costs arising from unnecessary distortions of markets, e.g. slower innovation.

3.25 As explained above, Ofgem is currently required to consider a large number of proposed offers from PESs, most of which are pro-competitive. In each case the PES is required to give Ofgem 28 days notice that it intends to introduce the new offer. This can delay the launch of pro-competitive offers on the market, often by more than 28 days when additional information is required by Ofgem. This temporarily denies customers the benefits of these new offers and may slow and distort the development of competition.

3.26 Ofgem would like to ensure that the future regulation of anti-competitive behaviour in the gas and electricity supply markets minimises the compliance costs faced by suppliers and third parties, while still protecting customers against anti-competitive behaviour. A number of measures could be taken to reduce the regulatory burden, including:

- ◆ reducing any duplication of powers to address the same behaviour;
- ◆ eliminating any unjustifiable differences between gas and electricity regulation; and
- ◆ giving suppliers a choice as to whether to seek pre-approval of new offers.

3.27 Ofgem will assess the options to change the non-discrimination conditions against the objective of ensuring that the regulatory burden placed on suppliers and third parties is minimised, while maintaining adequate protection for consumers by preventing and acting against anti-competitive behaviour.



**Ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development**

- 3.28 Before the introduction of competition in the gas and electricity supply markets, suppliers did not have strong incentives to provide offers that met customers' needs. The lack of competitive pressure reduced the extent of innovation in gas and electricity supply markets. As competition has developed suppliers have found new ways to deliver products at lower cost and have also brought to market a range of new offers, including new payment methods, e.g. credit cards, and joint marketing of complementary products, e.g. 'dual fuel' supplies.
- 3.29 Before these markets were opened to competition, it was important that regulation ensured that the monopoly suppliers did not exploit 'captive' customers. As competition develops it remains important that consumers and competitors are protected from the abuse of market power, but it is also important that regulation does not stifle the innovation brought about by the competitive process. For example, by delaying or preventing new offers coming to market.
- 3.30 As competition develops, innovations are introduced by dominant suppliers as well as by new entrants, and the effects of the former on competition have to be considered to distinguish those that are consistent with normal competition, from those that have an adverse effect on competition. By definition, the characteristics and effects of these innovations cannot be known at the time that the relevant prohibitions are developed and introduced. It is important, therefore, that the application of competition regulation can evolve to react to new market developments.
- 3.31 Bearing in mind the development of competition so far in the gas and electricity supply markets, Ofgem wants to ensure that its future regulation of these markets does not distort the development of competition. In particular, Ofgem wants to ensure that:
- ◆ regulation does not cause any unnecessary delays in bringing pro-competitive offers to market;

- ◆ Ofgem is able to act quickly against any anti-competitive behaviour that is causing appreciable harm to consumers and competition; and
  - ◆ regulation of anti-competitive behaviour takes account of recent market developments.
- 3.32 Ofgem will evaluate the options to change the non-discrimination conditions to ensure that they effectively address anti-competitive behaviour, while not stifling the development of competition.
- 3.33 The factors discussed above take account of the issues raised by respondents to earlier Ofgem consultations on proposed new standard licence conditions, following the implementation of the Utilities Bill. These views are summarised in Appendix 4.
- 3.34 Ofgem would welcome views on whether the factors discussed above are the right factors against which to assess the different options to change the non-discrimination conditions. Ofgem would also welcome views on any additional factors that should be taken into account.**

***The options to change the non-discrimination licence conditions***

- 3.35 Ofgem has considered three options for the non-discrimination licence conditions:
- ◆ to retain, unamended, the current licence conditions (chapter 4);
  - ◆ to amend the current conditions to take account of recent market developments and to remove any unjustifiable differences between the gas and electricity conditions (chapter 5); and
  - ◆ the removal of the current conditions, so that Ofgem would use just the Competition Act 1998 to address anti-competitive behaviour in the gas and electricity supply markets (chapter 6)
- 3.36 These options reflect the range of options suggested by respondents to the previous consultations on changes to the licence conditions.

## 4. Option 1 – Retaining the current non-discrimination conditions

### *Introduction*

- 4.1 The first option that Ofgem has considered is the retention of the current non-discrimination conditions, unamended.

### *Assessment against Ofgem's approach*

#### **The best use of Ofgem's powers under sector specific regulation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets**

- 4.2 The retained licence conditions would be unlikely to allow Ofgem to address any behaviour by dominant suppliers which would cause appreciable harm to customers and competition, that could not otherwise be addressed under the Competition Act 1998. Indeed, some behaviour that is prohibited by the Competition Act 1998 would not be prohibited under the non-discrimination conditions, e.g. customer tie-ins by dominant suppliers, which have an anti-competitive effect. In addition, unlike the Competition Act 1998, the licence conditions would not necessarily evolve to take account of new market developments and of developments in UK and EC competition law.
- 4.3 The retention of the advance notice requirement in the electricity condition may allow Ofgem to prevent some behaviour, which may have an anti-competitive effect, from being implemented. However, there is a possibility that, in addition to the costs of delaying pro-competitive offers coming to market and enforcing the condition, Ofgem might occasionally use the condition to stop the introduction of an offer that it believed would adversely affect competition, but that in practice would not have adversely affected competition. Such inadvertent errors are more likely when the monitoring burden is high, which it would be in a more dynamic market.
- 4.4 In contrast, an ex post approach to addressing anti-competitive behaviour together with powers to act quickly against behaviour that is causing serious harm to customers and for competition would reduce the monitoring burden

without reducing protection for customers. In most cases it is likely to be easier, because of the different conditions that have to be met, to issue Conditional Orders under sector specific legislation than to take interim measures under the Competition Act 1998. This suggests that there would be some additional protection for customers and competition from anti-competitive behaviour through the retention of licence conditions.

- 4.5 The retention of the current non-discrimination conditions, unamended, would allow Ofgem to use the powers under the Utilities Bill to levy monetary penalties for breaches of the conditions. However, as the powers to levy penalties under both sector specific and competition law powers are similar, the punishment and deterrent from the Utilities Bill powers would be no greater than under the Competition Act 1998.

**The most efficient use of Ofgem's resources to address anti-competitive behaviour in the gas and electricity supply markets**

- 4.6 If the non-discrimination conditions were retained, unamended, Ofgem would continue to be required to consider all new offers by dominant electricity suppliers to assess whether they breached the licence condition. Ofgem does not consider that this is the best use of its resources as all of the offers considered under the condition in the last year have been pro-competitive. If anything, the process, therefore, has delayed consumers benefiting from these offers.
- 4.7 Ofgem believes that an ex post approach to assessing anti-competitive behaviour in response to complaints or by Ofgem launching an investigation when it suspected there was anti-competitive behaviour would be a better use of resources. Such an ex post approach applies under the current gas licence condition and the Competition Act 1998. Ofgem also recognises that suppliers may want ex ante approval for new offers they believe have a serious risk of being considered anti-competitive and/or when a large initial investment is required. Under the provisions of the Act, suppliers can approach Ofgem for guidance or decisions as to whether agreements or conduct would breach either of the prohibitions of the Act. Suppliers would be charged £5,000 for guidance and £13,000 for decisions. Charges will provide an incentive on suppliers to seek guidance or decisions only for proposals that have a significant risk of

breaching either of the prohibitions of the Act. This incentive should reduce the burden on Ofgem's resources that is imposed by the current electricity condition, without reducing Ofgem's ability to protect the interests of consumers by promoting the development of effective competition.

### **Minimising the regulatory burden on gas and electricity suppliers**

- 4.8 The retention of the current non-discrimination conditions unamended will allow some anti-competitive behaviour in the gas and electricity supply markets to be investigated under either Ofgem's sector specific or competition law powers. This duplication of powers may increase suppliers' compliance costs, to the extent that they are unsure as to which power would be used in a particular case. However, given the broad similarities between the two regimes, Ofgem considers that the cost of duplication is likely to be small.
- 4.9 As explained in chapter 2, the current gas and electricity conditions are different in a number of material ways, which may not be justified by differences between the characteristics of the two industries. The differences between the conditions may increase suppliers' compliance costs and may distort competition if different considerations influence decisions in each market. The adverse effects of such distortions are likely to be magnified by the evolution of 'dual fuel' offers. The retention of the current conditions, unamended, would mean that the differences between the conditions remained.
- 4.10 The current electricity licence condition requires dominant suppliers to obtain pre-approval of new offers. Under the Competition Act 1998, undertakings can pay a fee to obtain guidance or a decision in advance as to whether an offer would breach the prohibitions. Ofgem believes that the requirement to pay a fee provides an incentive on suppliers only to seek guidance or a decision for proposals they believe have a serious risk of being considered anti-competitive and/or for which a large initial investment is required. Some suppliers believe that the process under the current electricity non-discrimination conditions provides a cheaper and faster process than is available under the Competition Act 1998.

**Ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development**

- 4.11 The advance notice requirement in the current electricity condition can delay pro-competitive offers coming to market to the detriment of consumers and the development of competition. The current electricity condition allows Ofgem to stop offers which may have an anti-competitive effect coming to market, and the ability to issue Conditional Orders under sector specific legislation allows Ofgem to act quickly when licences are breached. The power to take interim measures powers under the Competition Act 1998 would allow Ofgem to act quickly in some cases of anti-competitive behaviour causing a significant adverse effect to customers and competition. The current non-discrimination licence conditions are not designed to cope with some recent market developments, including the introduction of 'dual fuel' offers and the use of customer tie-ins.

***Conclusions***

- 4.12 The current non-discrimination licence conditions do not address all types of behaviour that would cause appreciable harm to customers. The current conditions do not take account of some recent market developments. In addition, the licence conditions do not evolve like the Competition Act 1998 to take account of market developments and developments in UK and EC competition law.
- 4.13 Ofgem believes that the retention of the current non-discrimination conditions would require Ofgem to use a large amount of resource to evaluate pro-competitive offers. The delays caused by the advance notice requirement distort the development of competition by delaying pro-competitive offers coming to market.
- 4.14 The Competition Act 1998 and the gas non-discrimination licence condition do not have an advance notice requirement, so Ofgem is able to use its resources to respond to complaints from customers and competitors who suffer harm from anti-competitive behaviour or initiate its own investigation if Ofgem suspects anti-competitive behaviour. The Competition Act 1998 provides a process for suppliers to obtain guidance or a decision as to whether behaviour would be

considered anti-competitive in advance of the introduction of an offer. As suppliers have to pay a fee for this guidance or a decision, there is an incentive to apply only if suppliers have a concern that behaviour has a serious risk of being considered anti-competitive and/or a large initial investment is required.

4.15 Ofgem does not believe that retaining the current non-discrimination licence conditions, unamended, is the best way either to protect the interests of consumers where possible by promoting effective competition or to meet the government's objective to better co-ordinate gas and electricity regulation.

**4.16 Ofgem would welcome views as to whether it is appropriate to retain the current non-discrimination conditions in their existing form and, if so, why.**

## 5. Option 2 – Amendment of the current non-discrimination conditions

### *Introduction*

- 5.1 The second option Ofgem has considered is the amendment of the current non-discrimination conditions. The recent market developments that are not addressed by the current non-discrimination licence conditions and the main differences between the current gas and electricity conditions are explained in Chapter 2. Possible amendments that could be made to the current conditions to take account of market developments and to align better the gas and electricity conditions are discussed below.

### *Possible amendments to the current conditions*

- 5.2 The recent market developments explained in Chapter 2, such as the effect of ‘dual fuel’ offers and anti-competitive customer tie-ins, could be addressed by adding new clauses to the current conditions. These clauses could allow the effects of behaviour in one industry to be considered when making a decision about behaviour in the other industry, and could prohibit customer tie-ins by dominant suppliers that have an adverse effect on competition.
- 5.3 If the conditions were retained and amended, the differences between the current gas and electricity conditions could be aligned, where the different characteristics of the two industries do not justify the differences between the two licence conditions. Of the six main differences identified in Chapter 2, Ofgem would expect amendments to the current licence conditions to align the first four.
- 5.4 First, to be consistent with the Competition Act 1998, Ofgem believes that the possibility of addressing anti-competitive behaviour in markets related to that in which the supplier is dominant should be included in the electricity condition as well as the gas condition.
- 5.5 Second, not least because it has not been used in practice, Ofgem would be minded to remove the public interest exclusion from the gas condition rather than adding it to the electricity condition. The changes to Ofgem’s duties in the



Utilities Bill, and particularly the requirement to have regard to statutory guidance on social and environmental matters, provide a common basis for taking account of these issues in the gas and electricity markets. Ofgem considers that using these statutory provisions provides, through initiatives such as the Social Action Plan,<sup>20</sup> a more appropriate basis for taking these issues into account than a “public interest” exemption in the non-discrimination conditions.

- 5.6 Third, Ofgem considers that the prohibition on a cross-subsidy does not recognise that it is the effect on competition rather than the form of the behaviour that is important. Since anti-competitive cross-subsidies would generally be covered by the prohibition on showing undue preference or exercising undue discrimination, Ofgem would be minded to remove this constraint from the electricity condition.
- 5.7 Fourth, Ofgem considers that the disapplication procedure in the electricity condition does not add anything over the process in the gas condition. The effect of the gas condition is that a supplier can, at any time and in each particular case, when it has been judged to be dominant by the DGGS, contest the decision, including through judicial review. This requires the DGGS to consider the circumstances of each case as is the case under the Competition Act 1998. Dominant electricity suppliers have to follow the procedure set out in Condition 4B to contest a DGES’s finding of dominance. The DGES is not necessarily required to consider whether a supplier is dominant in each individual case.
- 5.8 The existence of 14 incumbent PESs in electricity as compared to only 1 incumbent supplier in gas, and the consequent smaller geographic areas of dominance, provide some rationale for the advance notice requirement in the electricity condition and the lower minimum number of customers to constitute a class. However, in the case of the advance notice requirement, Ofgem is of the view that the benefit is not proportionate to the costs involved, including Ofgem and supplier resource costs, possible delays to innovation, and costs of inadvertent errors in decisions. Ofgem would therefore be minded to remove the advance notice provisions in the electricity condition.

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<sup>20</sup> “Enhancing social obligations, A decision document”, Ofgem, May 2000.

### ***Assessment against Ofgem's approach***

- 5.9 Several of the arguments against retaining the licence conditions in their current form in Chapter 4 are also relevant to considering amended conditions. Therefore, in assessing this option against the factors set out in Chapter 3, Ofgem will not repeat the arguments made in Chapter 4. Ofgem will consider whether the possible amendments to the conditions discussed above would overcome the other concerns expressed in Chapter 4 about the retention of the current conditions.

#### **The best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets**

- 5.10 The non-discrimination licence conditions could be amended to take account of recent market developments such as 'dual fuel' offers and anti-competitive customer tie-ins. However, even with such amendments, the conditions would be unlikely to address any behaviour that harms customers and competition that would not be covered by the Competition Act 1998. In addition, the Competition Act 1998 should evolve to take account of future developments in the gas and electricity supply markets and in UK and EC competition law.

#### **The most efficient use of Ofgem's resources to address anti-competitive behaviour in the gas and electricity supply markets**

- 5.11 A change to the electricity non-discrimination condition to remove the advance notice requirement would mean that Ofgem was only required to investigate offers after receiving a complaint or on its own initiative. Such an amendment would allow Ofgem to focus on the behaviour that it, and customers and competitors, believed was having an appreciable anti-competitive effect, as is currently possible under the gas condition.
- 5.12 Gas and electricity suppliers could still approach Ofgem under the Competition Act 1998 to seek guidance or a decision as to whether proposed new offers would be anti-competitive. However, the requirement to pay a fee for guidance or a decision may ensure that suppliers only bring to Ofgem those offers they

believe have a serious risk of being considered anti-competitive and/or for which a large initial investment is required.

### **Minimising the regulatory burden on gas and electricity suppliers**

- 5.13 Even with amendments to the non-discrimination licence conditions it is unlikely that the conditions would address all types of behaviour in the retail supply markets causing harm to customers that could not be addressed by the Competition Act 1998. Nonetheless, amended conditions could remove any unjustifiable differences between the gas and electricity conditions, which would reduce any distortions of competition through different considerations applying to the gas and electricity industries.
- 5.14 A change to the electricity non-discrimination condition to remove the advance notice requirement would allow suppliers to bring offers to market more quickly and allow customers to obtain the benefits of those offers earlier. This would reduce any distortion to the development of competition by the regulatory process. The removal of this requirement would allow suppliers to decide whether to seek pre-approval of new offers.

### **Ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development**

- 5.15 Amendments to the current non-discrimination conditions could allow the conditions to take account of recent market developments, including the introduction of 'dual fuel' offers and anti-competitive customer tie-ins. The conditions could also be amended to allow Ofgem to consider the effects of dominant electricity suppliers leveraging their market power into other markets, as can currently be considered under the gas condition. However, unlike the Competition Act 1998 which will evolve as new EC and UK cases are considered, the licence conditions may require modification to take account of future market developments and developments in UK and EC competition law.
- 5.16 The removal of the advance notice requirement in the electricity condition would ensure that new offers could be brought to market without any regulatory delay, unless the supplier chose to seek guidance or a decision under the

Competition Act 1998. While the removal of this requirement may mean that some anti-competitive offers are brought to market, Ofgem believes that the Conditional Order powers under sector specific legislation and the interim measures powers under the Competition Act 1998 would allow it to act fairly quickly against such behaviour if it was having a significant anti-competitive effect.

### ***Conclusions***

- 5.17 There are a number of changes that could be made to the current non-discrimination conditions to reflect better recent market developments and to remove unjustifiable differences between the gas and electricity conditions.
- 5.18 The removal of the advance notice requirement in the electricity condition would allow Ofgem to focus its resources on anti-competitive behaviour causing harm to customers and competition while also removing any regulatory delay to new offers coming to market. However, it is not clear to Ofgem that even with such amendments the conditions would provide any appreciable, additional protection to customers against anti-competitive behaviour, over and above that already provided by the Competition Act 1998.
- 5.19 While amendment of the current conditions would meet the government's objective of better co-ordinating gas and electricity regulation, the conditions would not give any additional protection to customers as compared to the Competition Act 1998.
- 5.20 Ofgem would welcome views on whether it is necessary to retain non-discrimination conditions for gas and electricity supply, and if so, how the current conditions should be amended to remove any unjustifiable differences between the current conditions. Ofgem would also welcome suggestions as to what changes could be made to the licence conditions to reflect recent markets developments.**

## 6. Option 3 – Removal of the non-discrimination conditions

### *Introduction*

- 6.1 The third option considered is the removal of the non-discrimination conditions from both the gas and electricity supply licences. Ofgem would rely on the Competition Act 1998 to control anti-competitive behaviour in the gas and electricity supply markets. This option is assessed below against the factors set out in Chapter 3.

### *Assessment against Ofgem's approach*

#### **The best use of Ofgem's powers under sector specific legislation and competition legislation to address anti-competitive behaviour in the gas and electricity supply markets**

- 6.2 Ofgem believes that the Competition Act 1998 can address all types of anti-competitive behaviour that will cause harm to customers in the retail gas and electricity supply markets, which is currently covered by the non-discrimination licence conditions or that would be covered if the amendments discussed in Chapter 5 were made. Unlike sector specific licence conditions, the Competition Act 1998 will evolve, without amendment, to take account of future market developments and developments in EC and UK competition law.
- 6.3 The power to issue interim measures under the Competition Act 1998 should allow Ofgem quickly to address any anti-competitive behaviour that is causing serious and irreparable damage, or is detrimental to the public interest. Ofgem has similar powers under the Competition Act 1998 and the Utilities Bill to levy monetary penalties. Therefore, the removal of the licence conditions will not reduce Ofgem's power to levy penalties that deter anti-competitive behaviour.

#### **The most effective use of Ofgem's resources to protect customers from anti-competitive behaviour in supply markets**

- 6.4 The removal of the non-discrimination conditions and the reliance on the Competition Act 1998 will allow dominant electricity suppliers to bring pro-

competitive offers to the market without any regulatory delay. This will allow customers to benefit from these offers earlier. The combination of Ofgem's response to complaints received, own-initiative investigations and the process for suppliers to pay a fee to receive guidance or a decision under the Competition Act 1998, should allow Ofgem to better focus its resources on anti-competitive behaviour that is causing appreciable harm to customers and competition and focus less on considering pro-competitive offers.

### **Minimising the regulatory burden on gas and electricity suppliers**

- 6.5 The removal of the non-discrimination conditions and the reliance on the Competition Act 1998 will remove the duplication of powers to address anti-competitive behaviour in the gas and electricity supply markets that currently exists and would exist even with amendments to the licence conditions. This may reduce compliance costs on suppliers.
- 6.6 The provisions under the Competition Act 1998 for suppliers to seek guidance or decisions on proposed behaviour before it is introduced will allow suppliers, if they believe it is necessary, to obtain an ex ante view as to whether a proposal is anti-competitive.
- 6.7 As with the possible use of amendments to the current conditions discussed in Chapter 5, the Competition Act 1998 should ensure that the same factors are considered when assessing anti-competitive behaviour in gas and electricity supply markets, thereby removing any distortion of competition.

### **Ensuring that Ofgem's approach to address anti-competitive behaviour in the gas and electricity supply markets reflects the development of competition so far and the prospects for its future development**

- 6.8 Ofgem believes that removing the non-discrimination conditions and using the Competition Act 1998 to regulate the gas and electricity supply markets will help to ensure that competition in these markets continues to develop. The removal of the conditions should ensure that there is no delay caused by regulation, in bringing pro-competitive offers to market.
- 6.9 However, should anti-competitive offers be brought to market, Ofgem should be able to act fairly quickly under the interim measures powers of the Competition

Act 1998 against behaviour that was having a significant adverse effect on competition.

- 6.10 In addition, the application of the Competition Act 1998 should evolve to take account of future developments in the gas and electricity supply markets and in UK and EC competition law.

### *Conclusions*

- 6.11 Ofgem believes that the removal of the current non-discrimination conditions and the use of competition law to address anti-competitive behaviour in supply markets is the most effective way to protect consumers and promote effective competition. In particular, it will:

- ◆ achieve the government's objective of better co-ordinating gas and electricity regulation;
- ◆ avoid duplication of powers, thereby reducing compliance costs for suppliers;
- ◆ allow regulation of anti-competitive behaviour to evolve as the markets develop;
- ◆ allow Ofgem to better focus its resources on addressing anti-competitive behaviour; and
- ◆ minimise any distortions of competition caused by regulation.

- 6.12 Therefore, Ofgem is proposing to remove the current non-discrimination conditions from the gas and electricity supply licences. This proposal is an example, along with the reduction in the scope of the supply price controls from April 2000, of Ofgem's commitment to reduce regulation once competition is sufficiently developed.

- 6.13 Ofgem would welcome views on whether removal of the non-discrimination conditions from the gas and electricity suppliers' licences would be appropriate. Ofgem would particularly welcome views on whether the provisions of the Competition Act 1998 are sufficient to protect the interests of**

consumers and to secure the development of competition in the domestic gas and electricity supply markets.



## 7. Ofgem's proposal and the timetable for the review

### *Ofgem's proposal*

- 7.1 As explained in Chapter 6, Ofgem considers that the removal of the current non-discrimination licence conditions and the use of the Competition Act 1998 to address anti-competitive behaviour in gas and electricity supply markets will provide the best protection to consumers against anti-competitive behaviour, while not distorting the development of competition in supply markets. Removal of the current non-discrimination conditions will also help in meeting the government's objective of better co-ordinating gas and electricity legislation.
- 7.2 Ofgem believes that it is appropriate, bearing in mind the development of competition in retail gas and electricity supply so far, and the prospects for the future development of competition, to move to an ex post approach to regulation, removing, where possible, ex ante obligations. This proposal is also an example of Ofgem reducing regulation when competition is sufficiently developed.
- 7.3 **Ofgem welcomes views on its proposal, and in particular, whether it is appropriate to remove the current non-discrimination conditions and rely on the Competition Act 1998 to address anti-competitive behaviour in the gas and electricity supply markets.**

### *Timetable*

- 7.4 Responses to this document are requested by 4 September. The process for submitting responses is explained in Chapter 1. Ofgem will summarise the responses to this consultation and publish its final proposals for changing the non-discrimination licence conditions in the document that sets out the final proposals for the gas and electricity standard licence conditions in the autumn.
- 7.5 If Ofgem's final proposals are to remove or amend the current non-discrimination conditions then these changes would take effect, if accepted by the Secretary of State, on the date on which the new licences are deemed to have effect by the Secretary of State.

## Appendix 1 Statutory duties of the DGGs and the DGEs

### *Gas Act 1986 (as amended 1995)*

1.1 The Gas Act 1986 (as amended 1995) sets out the statutory duties of the DGGs. The DGGs has a statutory duty to exercise his functions in a manner which is best calculated to:

- ◆ secure effective competition in the supplying and shipping of gas;
- ◆ secure that all reasonable demands for gas are met; and
- ◆ that licence holders are able to finance their licensed activities.

1.2 Subject to these duties, the DGGs also has a duty to exercise his functions in a manner best calculated to:

- ◆ protect the interests of consumers of gas through pipes in terms of prices and quality of service supplied;
- ◆ promote efficiency and economy on the part of the licensees; and
- ◆ promote effective competition in activities that are ancillary to the shipping and supply of gas.

### *The Utilities Bill*

#### **Gas**

1.3 The Utilities Bill will transfer these statutory duties, as amended, to the Gas and Electricity Markets Authority (the "Authority"). The principle objective of the Authority will be:

- ◆ to protect the interests of consumers, where possible by promoting effective competition.

1.4 The Authority shall carry out its functions in the manner that is best calculated to:

- ◆ secure that, so far as is economical to meet them, all reasonable demands for gas are met; and
- ◆ that licence holders are able to finance their licensed activities.

1.5 In doing so the Authority shall have regard to the interests of:

- ◆ individuals who are disabled or chronically sick;
- ◆ individuals of pensionable age;
- ◆ individuals with low incomes; and
- ◆ individuals residing in rural areas,

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

1.6 Subject to this, the authority shall carry out its functions in the manner which it considers is best calculated:

- ◆ to promote efficiency and economy on the part of persons authorised by licences or exemptions to carry on any activity, and the efficient use of gas through pipes;
- ◆ to protect the public from dangers arising from the conveyance of gas through pipes or from the use of gas conveyed through pipes;
- ◆ to secure a diverse and viable long-term energy supply,

and shall have regard, in carrying out those functions, to the effect on the environment of activities connected with the conveyance of gas through pipes.

### ***The Electricity Act 1989***

1.7 Section 3 of the Electricity Act 1989 sets out the statutory duties of the DGES. The DGES has a statutory duty to exercise his functions in a manner which is best calculated to;

- ◆ promote competition in electricity generation and supply;

- ◆ secure that all reasonable demands for electricity are satisfied; and
- ◆ secure that licence holders are able to finance their licensed activities.

1.8 Subject to these duties, the DGES also has a duty to exercise his functions in a manner best calculated to:

- ◆ protect the interests of customers in terms of prices and quality of services supplied;
- ◆ promote efficiency and economy;
- ◆ promote new techniques;
- ◆ protect the public from dangers arising from the generation, transmission and supply of electricity; and
- ◆ take into account, in exercising those functions, the effect on the physical environment of the relevant activities.

### ***The Utilities Bill***

#### **Electricity**

1.9 The Utilities Bill will transfer these statutory duties, as amended, to the Authority. The principle objective of the Authority will be:

- ◆ to protect the interests of consumers, where possible by promoting effective competition.

1.10 The Authority shall carry out its functions in the manner that is best calculated to:

- ◆ secure that, all reasonable demands for electricity are met; and
- ◆ secure that licence holders are able to finance the activities which are the subject of obligations imposed by or under this Part or the Utilities Act 2000.

1.11 In doing so the Authority shall have regard to the interests of:

- ◆ individuals who are disabled or chronically sick;
- ◆ individuals of pensionable age;
- ◆ individuals with low incomes; and
- ◆ individuals residing in rural areas,

but that is not to be taken as implying that regard may not be had to the interests of other descriptions of consumer.

1.12 Subject to this, the authority shall carry out its functions in the manner best calculated to:

- ◆ promote efficiency and economy on the part of persons authorised by licences or exemptions to transmit, distribute or supply electricity and the efficient use of electricity conveyed by distribution systems;
- ◆ protect the public from dangers arising from the generation, transmission, distribution or supply of electricity; and
- ◆ secure a diverse and viable long-term energy supply,

and shall have regard to the effect on the environment of activities connected with the generation, distribution or supply of electricity.

## Appendix 2 Standard Condition 13 of the gas suppliers' licence

### Condition 13: Undue discrimination and undue preference

- (1) Subject to paragraphs (2), (3), (7) and (9) to (14), if the licensee, taken with its related persons operating in the same market, is in a dominant position in a market for the supply of gas to customers at premises, then the licensee, in the terms on which it supplies or offers to supply gas to customers in that market –
  - (a) shall not show undue preference to any person or class of persons, and
  - (b) shall not exercise any undue discrimination against any person or class of persons,  
and shall not set charges for the supply of gas to customers at premises
  - (c) in any market or markets in which it has a dominant position, which are unduly onerous, or
  - (d) in any market or markets, which are predatory.
- (2) Paragraph (1) shall not prevent the licensee from supplying or offering to supply gas to all of, or any class of, the customers in an area on terms which are reasonably necessary to meet established competition in relation to such customers, provided that the licensee -
  - (a) does not set terms in respect of the customers in question which:
    - (i) are predatory, or
    - (ii) show undue preference or unduly discriminate as between any such customers, and
  - (b) does not set terms in respect of the supply of gas at premises to consumers of any other class, or in any other area, in relation to whom the licensee has a dominant position, which are unduly onerous.
- (3) For the purposes of paragraphs (1) and (2) -
  - (a) terms shall be taken to be predatory if, but only if -
    - (i) charges in accordance with those terms would not cover such avoidable costs as they ought reasonably to cover, and
    - (ii) the terms are made available for the purposes of, or are likely to have the effect of, unfairly excluding or limiting competition between the licensee and one or more other gas suppliers;
  - (b) terms in respect of consumers shall be taken to be unduly onerous if the revenue from the supply of those consumers on those terms -
    - (i) significantly exceeds costs in respect of that supply, and
    - (ii) exceeds such costs by significantly more than in the case of the supply of the generality of customers supplied with gas at premises by the licensee save for those in any market which is by virtue of paragraph (8) considered to be a separate market,

but, unless the converse is manifestly the case, terms shall not be taken to be unduly onerous if other gas suppliers licensed to supply gas to customers at the premises in question are only willing to do so on more onerous terms, having regard to the costs of market entry they have incurred or would thereby incur.

(4) In determining which customers constitute a class for the purposes of paragraph (2), due regard shall be had to all the circumstances of supply (including, in particular, volumes, load factors, conditions of interruptibility, location of premises being supplied, date, duration and terms of agreement).

(5) Any question arising -

(a) under paragraph (1), as to whether the licensee, taken with its related persons operating in the same market, is in a dominant position in a market;

(b) under paragraph (2)(b) as to whether the licensee is in a dominant position in relation to consumers of any class other than that first mentioned in paragraph (2) or in any area other than that so mentioned, or

(c) under paragraph (3)(a)(i), as to which avoidable costs ought reasonably to be covered by charges,

shall be determined by the Director, after considering any representations made to him.

(6) In the preceding paragraphs

“area” means the whole of Great Britain or, in relation to the application of this condition to the supply of gas to domestic customers, either the whole of Great Britain or an area forming a part of Great Britain and containing no less than 100,000 premises at which gas is supplied to such customers;

“avoidable costs” means those costs which would not be incurred by the licensee if it did not supply the customers in question, including such costs arising in the future calculated having due regard to the timing thereof;

“terms” means all the terms on which a supply of gas is provided or offered, whether as respects charges, methods of payment or otherwise.

(7) Nothing in this condition shall apply to the supply of gas under a deemed contract.

(8) For the purpose of this condition, any market for the supply of gas to domestic customers shall be considered to be a separate market from any market for the supply of gas to non-domestic customers.

(9) This condition shall not apply to a pricing policy of the licensee if such policy is treated by paragraph (10) as being in the public interest.

(10) A pricing policy shall be treated as being in the public interest if -

(a) the licensee delivers to the Director a written request (“public interest request”) made in accordance with paragraph (11) in relation thereto and the Director agrees in writing to that request; or

(b) the application of this condition to the pricing policy has been terminated by paragraph (12) or (13) by virtue of a notice given for the purposes thereof by the licensee.

- (11) Any public interest request shall be in writing and be addressed to the Director and it shall contain a statement of the licensee's pricing policy and state the date ("disapplication date") from which the licensee wishes the Director to agree that this condition shall cease to have effect in relation to the pricing policy, but the disapplication date therein stated shall not be before whichever is the later of 1st April 1999 and any date which is less than 9 months after the date upon which the public interest request is delivered to the Director.
- (12) If the Director has not made a reference to the Monopolies Commission<sup>21</sup> under section 24(1) of the Act relating to the pricing policy specified in the public interest request before the beginning of the period of 6 months which will end with the disapplication date, the licensee may by written notice given to the Director claim that the application of this condition to the pricing policy should terminate with effect from the disapplication date or such later date as is specified in the notice, not being more than 3 months after the date thereof; and where such a notice is given this condition shall cease to apply as claimed in the notice.
- (13) If the Monopolies Commission<sup>22</sup> makes a report, on a reference made by the Director relating to the pricing policy specified in the public interest request, after the request and such report does not include a conclusion that the licensee's pricing policy operates, or may be expected to operate, against the public interest the licensee may within 30 days after the receipt of the report by the Director give him written notice claiming that the application of this condition to the pricing policy should terminate with effect from the disapplication date or such later date as is specified in the notice, not being more than 3 months after the date thereof; and where such a notice is given this condition shall cease to apply as claimed in the notice.
- (14) In this condition, "pricing policy" means the principles governing the licensee's terms of supply to all domestic customers in such an area, within the meaning of paragraph (6), as may be specified by the licensee in its public interest request.

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<sup>21</sup> By section 45(4) of the Competition Act 1998 any reference to the MMC shall be read as a reference to the Competition Commission.

<sup>22</sup> By section 45(4) of the Competition Act 1998 any reference to the MMC shall be read as a reference to the Competition Commission.



## Appendix 3 Conditions 4A and 4B (Conditions 3A and 3B in Scotland) of the electricity supply licence

### Condition 4A. Prohibition of discrimination in supply

1. This Condition applies where the Licensee is in a dominant position in a market for the supply of electricity to customers at premises.
2. Where this Condition applies the Licensee shall not supply or offer to supply electricity to customers in any market in which it is dominant on terms which are predatory.
3. Where this Condition applies, but subject to paragraph 4, the Licensee (taken together with its affiliates and related undertakings) shall not, in supplying or offering terms for the supply of electricity to customers in any market in which it is dominant:
  - (a) show undue preference to any person (or class of persons) within such market;
  - (b) exercise undue discrimination between any persons (or classes of person) within such market; or
  - (c) set terms which are unduly onerous.
4. Nothing in paragraph 3 shall prohibit the Licensee, within any area or class of customers (the "relevant area or class") in respect of which there is established competition in the supply of electricity, from supplying or offering to supply electricity on terms which are reasonably necessary to meet that competition, save that the Licensee (taken together with its affiliates and related undertakings) shall not, in supplying or offering terms for the supply of electricity:
  - (a) show undue preference to any person (or class of persons) or exercise undue discrimination between any persons (or classes of person) within the relevant area or class of customers; or
  - (b) set terms in respect of any person (or class of persons) in a market in which the Licensee is dominant, save such persons who are within the relevant area or class of customers, which are unduly onerous.
5. For the purposes of this Condition, terms are unduly onerous if the revenue from the supply of electricity to customers on those terms:

- (a) significantly exceeds the costs of that supply; and
  - (b) exceeds such costs to a significantly greater degree than the revenue from supply to all other customers of the Licensee (and of its affiliates and related undertakings) within the same market exceeds the costs of supply to those customers.
- 6. For the purposes of this Condition, a market may be defined by reference to a geographical area, or to a class of customer or both, save that no market defined by reference to Designated Customers shall comprise fewer than 50,000 such customers.
- 7. In determining, for the purposes of this Condition, whether any persons constitute a class of person, due regard shall be had to the circumstances of supply to such persons including (without limitation) volumes, load factors, conditions of interruptibility, location of premises being supplied and date and duration of the supply contract.
- 8. For the purposes of this Condition, the Director shall determine any question as to:
  - (a) whether any area or class of customers constitutes a market for the supply of electricity;
  - (b) whether the Licensee is dominant in any market for the supply of electricity;
  - (c) whether there is established competition in respect of the supply of electricity in any area or to any class of customers; and
  - (d) whether any terms are predatory, having due regard to whether such terms:
    - (i) incorporate charges which do not reasonably cover the avoidable costs incurred in consequence of supplying the customers in question; and
    - (ii) are intended or are likely to restrict, distort or prevent competition in the supply of electricity.
- 9. The Director may determine that the Licensee is dominant in a specified market:
  - (a) at any time prior to this Condition coming into force; or

- (b) having first consulted with the Licensee and such other persons as he considers appropriate (and having taken into account any representations made to him), at any time after this Condition has come into force,

and where the Director does make such a determination he shall immediately notify the Licensee.

10. Where the Director has notified the Licensee of his determination in accordance with paragraph 9 that it is dominant in a specified market, the provisions of paragraphs 11 to 16 shall apply in respect of that market.
11. Where this paragraph applies the Licensee shall, prior to supplying or offering to supply electricity under a tariff or Designated Supply Contract on any new terms, give to the Director at least 28 days' notice in writing of its intention to supply on such terms.
12. For the purposes of this Condition, a tariff or Designated Supply Contract is on "new terms" if:
  - (a) it is a form of tariff or Designated Supply Contract under which the Licensee has not previously supplied or offered to supply electricity;
  - (b) it is a tariff or Designated Supply Contract in respect of which the Licensee is varying the terms as to price; or
  - (c) it is a tariff or Designated Supply Contract in respect of which the Licensee is varying any other terms in such a manner as to significantly affect the evaluation of that tariff or contract.
13. Where the Licensee has given notice to the Director of its intention to supply on new terms it shall not supply or offer to supply electricity on such terms until either the period of notice given to the Director has expired and:
  - (a) the Director has not given or sent to the Licensee a counter-notice (the "counter-notice") in accordance with paragraph 14; or
  - (b) prior to the expiry of such period, the Director has informed the Licensee that he will not issue a counter-notice in respect of such terms.
14. The Director may issue a counter-notice where, having considered the new terms and having had regard to the likely effects of issuing such counter-notice (including, but not limited to, the likely effect upon the business of the Licensee), he determines that further consideration is required to assess whether such terms are in breach of the provisions of this Condition.

15. Where the Director issues a counter-notice in respect of any new terms the Licensee shall not supply or offer to supply electricity on such terms until either:
- (a) a period of 3 months from the date of the counter-notice has expired; or
  - (b) prior to the expiry of such period, the Director indicates to the Licensee that he has no present intention of taking enforcement action under Section 25 of the Act in respect of such terms.

16. Where the Director issues a counter-notice he may:

- (a) give or send a copy of that counter-notice to any Interested Person;
- (b) invite representations from Interested Persons as to the matters to which the counter-notice relates; and
- (c) require the Licensee, within a reasonable period determined by the Director, to provide him with such further information relating to the new terms as he may specify (save that he may not by virtue of this paragraph require the Licensee to furnish him with information for the purpose of exercising his functions under Section 48 of the Act),

and the Director shall take into account any representations made to him by the Licensee in respect of such terms.

17. The Director may, at any time after notifying the Licensee of his determination in accordance with paragraph 9 that it is dominant in a specified market, determine that the Licensee is no longer dominant in that market, and where he does make such a determination:

- (a) the Director shall immediately notify the Licensee; and
- (b) the provisions of paragraphs 11 to 16 shall cease to apply in respect of the specified market.

18. For the purposes of this Condition, any reference to the Licensee being dominant in a market for the supply of electricity shall be treated as a reference to the Licensee, taken together with its affiliates and related undertakings, being so dominant.

19. In this Condition:

“Interested Persons”	Means all Electricity Suppliers which supply electricity within the market or area or to the class of customers in question, the Relevant Consumers’ Committee and such other persons or bodies as in the opinion of the Director have a legitimate interest in the terms on which the Licensee supplies electricity.
“terms”	Means all the terms on which a supply of electricity is offered or provided which significantly affect the evaluation of that supply, and shall include all terms as to price.

**Condition 4B. Duration of discrimination conditions**

1. Condition 4A shall cease to have effect (in whole or in part, as the case may be) if the Licensee makes a disapplication request in accordance with this Condition and:
  - (a) the Director agrees in writing to that request; or
  - (b) the application of Condition 4A (in whole or in part) is terminated by notice given by the Licensee in accordance with paragraph 4 or 5 of this Condition.
  
2. A disapplication request pursuant to this Condition may be made by the Licensee only where the Director has notified it, in accordance with paragraph 9 of Condition 4A, of his determination that the Licensee is dominant in a specified market, and any such request shall:
  - (a) be made in writing to the Director;
  - (b) specify whether the request relates to the whole of Condition 4A or any part or parts thereof; and
  - (c) state the date (the “disapplication date”) from which the Licensee wishes the specified provisions of Condition 4A to cease to have effect, which date shall be in accordance with paragraph 3 and not earlier than 12 months after the date on which the request is made.
  
3. Where the Licensee was notified by the Director prior to this Condition coming into force of his determination that the Licensee is dominant in a specified market, no disapplication request made by the Licensee shall be effective to disapply any of the provisions of Condition 4A prior to 31 March 2000.

4. If the Director has not by the date which is 6 months prior to the disapplication date made a reference to the Monopolies Commission (under Section 12 of the Act) relating to the modification of Condition 4A, the Licensee may give to the Director a notice in writing terminating the application of such of the provisions of Condition 4A as are specified in the disapplication request with effect from the disapplication date or from any later date specified in the notice.
  
5. If the Monopolies Commission reports on a reference made by the Director relating to the modification of Condition 4A and does not conclude that the disapplication of any of the provisions of that Condition (being provisions specified in the disapplication request) would or may be expected to operate against the public interest, the Licensee may within 30 days of the publication of the report under Section 13 of the Act give to the Director notice in writing terminating the application of such provisions with effect from the disapplication date or any later date specified in the notice.

## **Appendix 4 Responses to earlier consultations on the development of new non-discrimination licence conditions**

### **Introduction**

4.1 Ofgem has published two documents that have considered the development of the gas and electricity supply non-discrimination licence conditions. In November 1999, the first consultation was published. A second consultation paper was published in February. Fourteen of the responses to these documents commented on the development of the non-discrimination licence conditions. These included one electricity trade association, 10 responses from domestic gas and/or electricity suppliers and 3 from customer representatives.

### **Summary of responses**

- 4.2 Of the 10 responses from suppliers, 7 supported the removal of the non-discrimination conditions and the use of the provisions of the Competition Act 1998 to address anti-competitive behaviour in the gas and electricity supply markets. One supplier argued that retaining the non-discrimination conditions in the licences would not allow for the regulation of new developments in the market, e.g. 'dual fuel' supplies.
- 4.3 All suppliers that commented supported the alignment of the current gas and electricity conditions if they are retained. Respondents had differing views on which was the most appropriate licence condition on which to base alignment. Four suppliers supported taking the most pro-competitive clauses from the gas and electricity conditions. One supplier said that the conditions should be aligned with the principles of the Competition Act 1998, i.e. moving away from cost based analysis to the prohibition of the abuse of a dominant position.
- 4.4 The 3 customer representatives welcomed Ofgem's intention to separately consult on the gas and electricity supply licence non-discrimination conditions. One representative encouraged Ofgem to think carefully about the issues involved. Another representative encouraged Ofgem to consider carefully the various types of anti-competitive behaviour that gas and electricity suppliers could adopt.