

February 2001

**Review of British Gas Trading's
price regulation**

Final proposals

Summary

This document sets out Ofgem's final proposals for the future regulation of BGT's domestic gas prices from 1 April 2001. The document takes account of responses to Ofgem's initial proposals for BGT's price control review and Ofgem's review of the development of competition in the domestic gas and electricity supply markets, which were published in December 2000, and explains Ofgem's reasons for the final proposals.

Ofgem's initial proposals

Ofgem's initial proposals for the future of BGT's price regulation set out Ofgem's preferred form of regulation for BGT from 1 April 2001. The proposal had three elements, which were:

- ◆ removing specific controls on BGT's remaining price controlled customers, PromptPay, LatePay and PrePayment from 1 April 2001;
- ◆ a public commitment from BGT that it would maintain the relative differentials between its tariffs, and in particular, would maintain a combined LatePay/ PrePayment tariff until at least April 2002, and
- ◆ BGT agreeing to 'substantial' progress in allowing customers in debt to switch supplier, by agreeing to a special condition in its gas suppliers' licence to reduce its right to object to the transfer of customers in debt.

In the initial proposals, Ofgem said that if BGT did not accept these proposals it would introduce a special licence condition that would cap the maximum differentials between BGT's Direct Debit and LatePay/ PrePayment tariffs, and between BGT's PromptPay and LatePay/ PrePayment tariffs to their current levels, referred to as relative price regulation.

Ofgem's final proposals

In the period since publication of the initial proposals, Ofgem has held discussions with BGT and other suppliers to attempt to make 'substantial' progress to allow customers in debt to switch supplier. Some progress has been made during this period, but Ofgem does not consider it to be 'substantial'.

Bearing in mind BGT's rejection of Ofgem's preferred option due to its failure to be prepared to make substantial progress to address the debt blocking issue, and after careful consideration of the views of the other respondents, Ofgem has decided to implement the alternative option. As part of implementing this option, Ofgem will continue to seek to make progress to improve the ability of customers in debt to benefit from the competitive market.

Relative price regulation

This document includes a statutory 28 day consultation on a proposed modification to Special Condition 3, which will bring into effect the conclusions of this review, and explains why Ofgem believes the modification is required. The modification caps the differentials between BGT's Direct Debit and LatePay/ PrePayment tariffs, and between BGT's PromptPay and LatePay/ PrePayment tariffs, at the current level of the differentials.

The condition will continue to apply until such time as the Authority decides that it should be disapplied. BGT can request from 1 January 2002 that the Authority disapply the condition from 1 April 2002 or at any date thereafter. As explained below, Ofgem will review BGT's price regulation later this year to decide what, if any, regulation is required from 1 April 2002. Ofgem expects, subject to sufficient progress in the development of competition, and co-operation from the industry on debt blocking, to remove relative price regulation from 1 April 2002. Ofgem seeks views on the proposed licence modification.

Debt blocking

Since the publication of the initial proposals, and particularly since receiving the responses to the proposals, Ofgem has been exploring a range of ways to address the debt blocking issue. Currently suppliers can block the transfer of customers in debt after fulfilling certain conditions. On 8 February 2001 Ofgem held a meeting for all gas and electricity suppliers to discuss how best to take the issue forward, and in particular to obtain comments from suppliers on proposals made on this issue by Powergen. The meeting showed that there was a mixed range of views on the issue amongst suppliers. However, there was a broad range of support amongst suppliers for participating in a trial.

On 15 February 2001 Ofgem wrote to all gas and electricity suppliers addressing the issues raised at the meeting and welcoming the Gas Forum's decision to reconvene a working group to consider the debt blocking issue. Ofgem requested views from the working group and from any individual suppliers by 15 March 2001 on how Powergen's proposal, and any alternative proposals, could be trialled effectively. Ofgem wants any trial to include as many suppliers as possible.

Depending on the outcome of the trial, Ofgem would expect to propose modifications to gas suppliers' licences to reduce suppliers' ability to block the transfer of customers in debt. Ofgem would also take account of the results of the trial when considering any proposed changes to the rights of electricity suppliers to block the transfer of customers in debt, under the Master Registration Agreement.

The 2002 review of the PESs and BGT's price regulation

Later this year, Ofgem will carry out a review to determine the future price regulation for PESs domestic electricity tariffs. When the current PES price controls were introduced, Ofgem explained that, subject to the sufficient development of competition, it intended to remove all price controls from April 2002.¹ This review will also consider the future form of regulation for BGT. Ofgem expects, subject to the development of competition for BGT's LatePay and PrePayment customers, to be able to remove relative price regulation from April 2002.

Process for submitting responses

If you wish to express a view on these final proposals, the proposed licence modification, or any related matter, we would like to receive your response by 26 March 2001. As Ofgem intends, subject to responses to the consultation, to bring into effect the modification to Special Condition 3 of BGT's gas suppliers' licence to implement the conclusions of this review on 1 April 2001, it is unlikely that it will be possible for Ofgem to take account of responses received after 26 March 2001. Chapter 1 contains details of where to send responses.

¹ "Reviews of Public Electricity Suppliers 1998 to 2000, Supply Price Control Review, Final Proposals", Ofgem, December 1999.

Table of contents

1. Introduction.....	1
Purpose of this document.....	1
Background.....	1
Rationale.....	3
Structure of the document	4
Responses to the consultation	4
2. Background.....	6
Introduction.....	6
Regulatory framework.....	7
Recent developments.....	7
3. Assessment of competition.....	14
Introduction.....	14
Summary of the conclusions of Ofgem’s assessment of competition.....	14
The development of competition for customers in debt, and particularly prepayment customers	16
BGT’s market position and behaviour	19
The development of competition in gas and electricity supply markets	20
The approach taken by Ofgem to the review and the factors taken into account	21
Conclusions	22
4. Options for future regulation.....	24
Introduction.....	24
Retaining revised price controls	24
Relative price regulation	26
Removal of price regulation on BGT	28
Conclusions	29
5. Ofgem’s final proposals	30

Introduction.....	30
Ofgem’s initial proposals.....	30
Respondents’ views.....	31
Ofgem’s final proposals.....	33
Appendix 1 List of non-confidential respondents' to the competitive market review and Ofgem's initial proposals for BGT's price regulation.....	37
Appendix 2 Summary of proposals to address the debt blocking issue and respondents' views.....	38
Ofgem’s original consultation document	38
Comments from suppliers and consumer groups on Ofgem’s document.....	38
Revised proposals from Ofgem.....	39
Views on Ofgem’s revised proposals.....	39
Appendix 3 Notice under Section 23 of the Gas Act 1986 (as amended) to modify BGT’s gas suppliers’ licence	41

1. Introduction

Purpose of this document

- 1.1 This document sets out Ofgem's final proposals for the future regulation of British Gas Trading's (BGT) domestic gas prices from 1 April 2001. The document takes account of responses to Ofgem's initial proposals for BGT's price control review² and Ofgem's review of the development of competition in domestic gas and electricity supply³, which were published in December 2000, and explains Ofgem's reasons for the final proposals.
- 1.2 This document forms part of the notice under paragraph 4(1) of Special Condition 3 of BGT's gas suppliers' licence, that in the opinion of the Gas and Electricity Markets Authority (the Authority), competition has not sufficiently developed in respect of domestic customers supplied under BGT's Regulated Terms to justify the disapplication of the condition on 1 April 2001. In accordance with paragraph 4(2) of Special Condition 3, the document includes a statutory 28 day consultation on a proposed modification to Special Condition 3, which will bring into effect the conclusions of this review, and explains why Ofgem believes the modification is required. Ofgem seeks views on the proposed licence modification.
- 1.3 After receiving and considering responses to this document and the proposed licence modification, Ofgem intends to put into effect the licence modification from 1 April 2001, subject to agreement from BGT to the proposed licence modification. If BGT does not agree to the proposed licence modification, Ofgem would expect to refer the matter to the Competition Commission.

Background

- 1.4 From 1 April 2000 Ofgem removed Direct Debit customers from the scope of BGT's price control and set revised controls for BGT's remaining customers, on the PromptPay, LatePay⁴ and PrePayment tariffs. Ofgem stated its firm intention

² "Review of British Gas Trading's price regulation, Initial proposals", Ofgem, December 2000.

³ "A review of the development of competition in domestic gas and electricity supply", Ofgem, December 2000.

⁴ LatePay is the name BGT uses for this tariff. It has previously commonly been known as standard credit.

to remove the remaining price controls from 1 April 2001, subject to satisfactory progress being made in the removal of the remaining barriers to entry.

1.5 Over the duration of the current price control review Ofgem has:

- ◆ in June 2000 held a public workshop to discuss how it intended to review the development of competition and the factors to take into account when deciding whether to remove the remaining price controls on BGT;
- ◆ in August 2000 published a quantitative and qualitative survey of the development of competition in the gas and electricity markets⁵;
- ◆ in December 2000 published its initial proposals for the future of BGT's price regulation and, at the same time, published the conclusions of its review of the development of competition in the domestic gas and electricity supply markets; and
- ◆ in December 2000 held a public workshop to discuss the initial proposals for BGT's future price regulation and the conclusions of the review of the development of competition.⁶

1.6 Ofgem's initial proposal for the future of BGT's price regulation set out Ofgem's preferred form of regulation for BGT from 1 April 2001. The proposal had three elements, which were:

- ◆ removing specific controls on BGT's remaining price controlled customers, PromptPay, LatePay and PrePayment from 1 April 2001;
- ◆ a public commitment from BGT that it would maintain the relative differentials between its tariffs, and in particular, would maintain a combined LatePay/ PrePayment tariff until at least April 2002, and
- ◆ BGT agreeing to 'substantial' progress in allowing customers in debt to switch supplier, by agreeing to a special condition in its gas suppliers' licence to reduce its right to object to the transfer of customers in debt.

⁵ "Domestic gas and electricity supply, Market survey 2000", Ofgem, August 2000.

⁶ A summary of main issues discussed at the workshop and a copy of the slides presented at the workshop are available on Ofgem's website at www.ofgem.gov.uk.

- 1.7 In the initial proposals Ofgem said that if BGT did not accept these proposals it would introduce a special licence condition that would cap the maximum differentials between BGT's Direct Debit and LatePay/ PrePayment tariffs, and between BGT's PromptPay and LatePay/ PrePayment tariffs to their current levels, referred to in the document as relative price regulation.
- 1.8 This document explains that BGT has not accepted Ofgem's preferred proposal, and consequently that Ofgem is seeking to introduce a licence modification to put into effect relative price regulation from 1 April 2001. The document also explains how Ofgem intends to take forward the debt blocking issue.

Rationale

- 1.9 Consistent with its duties under the Gas Act 1986 (as amended) and the Electricity Act 1989 (as amended), Ofgem believes that effective competition offers the best protection for all gas customers, in terms of price and service. A number of conditions characterise effective competition, including a market where:
- ◆ all customers can attract, and are aware of, a range of competitive offers;
 - ◆ the abuse of market power is prevented;
 - ◆ the operation of competition promotes innovation and improved economic efficiency.
- 1.10 Ofgem's regulation of the gas and electricity supply markets can influence the speed at which, and the way in which, effective competition develops and how the conditions set out above are achieved. Ofgem recognises the importance of protecting customers from abuses of market power during the transition from monopoly to effective competition. However it is important that measures introduced by Ofgem to protect the interests of customers, perhaps in the form of price controls, do not distort, restrict or prevent the development of effective competition. During this review of BGT's future price regulation Ofgem has sought to protect the interests of customers who are not yet fully benefiting from the competitive market, while ensuring that any regulation on BGT does not distort, restrict or prevent the development of effective competition.

Structure of the document

- 1.11 Chapter 2 explains the changes to the regulatory framework and recent developments since the publication of the initial proposals. Chapter 3 discusses responses to Ofgem's review of the development of competition. Chapter 4 discusses respondents' views on Ofgem's proposals for the future form of price regulation for BGT's domestic gas tariffs. Chapter 5 sets out Ofgem's final proposals for the future regulation of BGT's domestic gas tariffs from April 2001 and explains how Ofgem intends to take forward work to increase the opportunity for customers in debt to take advantage of the choice available in the competitive market.
- 1.12 Appendix 1 lists the non-confidential respondents to the competitive market review and Ofgem's initial proposals for the future price regulation of BGT. Appendix 2 summarises the previous proposals Ofgem has made to address the debt blocking issue and the responses received to those proposals. Appendix 3 is the Section 23 notice under the Gas Act 1986 (as amended) to modify BGT's gas suppliers' licence to implement Ofgem's final proposals.

Responses to the consultation

- 1.13 Ofgem wishes to continue conducting this review in as open a way as possible and to consider the views of all interested parties. If you wish to express a view on these final proposals, the proposed licence modification, or any related matter, we would like to receive your response by 26 March 2001. As Ofgem intends, subject to responses to the consultation, to bring into effect the modification to Special Condition 3 of BGT's gas suppliers' licence to implement the conclusions of this review on 1 April 2001, it is unlikely that it will be possible for Ofgem to take account of responses received after 26 March 2001. Responses should be addressed to:

Nick Fincham
Director, Supply
Office of Gas and Electricity Markets
9 Millbank
London, SW1P 3GE

- 1.14 Respondents can mark all, or part, of their response as confidential. However, we would prefer, as far as possible, that responses are provided in a form that can be placed in Ofgem's library.
- 1.15 If you have any queries concerning the issues raised in this document, please contact Colin Garland on 020 7901 7071 (colin.garland@ofgem.gov.uk) or Bethan Carver on 020 7901 7482 (bethan.carver@ofgem.gov.uk) who will be pleased to help.

2. Background

Introduction

2.1 Ofgem's document setting out the initial proposals for BGT's future price regulation and the document containing Ofgem's conclusions following the review of the development of competition in the domestic gas and electricity supply markets explained the regulatory framework and relevant recent developments. In particular the documents summarised the following parts of the regulatory framework:

- ◆ the Gas Act 1986 (as amended);
- ◆ the Electricity Act 1989 (as amended);
- ◆ the gas suppliers' licence;
- ◆ the first and second tier electricity licences; and
- ◆ competition law.

2.2 The documents summarised the following recent developments:

- ◆ Ofgem's 1999 review of the development of competition in the designated electricity market;
- ◆ Ofgem's 1999 domestic gas competitive market review;
- ◆ the electricity supply price controls;
- ◆ Ofgem's proposals to change the rights of suppliers to object to the transfer of customers in debt;
- ◆ Ofgem's proposals to remove the gas and electricity supply non-discrimination licence conditions;
- ◆ Ofgem's proposals for future standards of performance for supply businesses;
- ◆ Ofgem's proposals for future regulatory accounts;

- ◆ the Department of Trade and Industry's (DTI's) review of customer attitudes to switching⁷; and
- ◆ Ofgem's Social Action Plan.

2.3 This chapter updates the regulatory framework and recent developments discussed in those documents.

Regulatory framework

2.4 Since December 2000 some of the provisions of the Utilities Act 2000 have come into force, thereby modifying the Gas Act 1986 (as amended) and the Electricity Act 1989 (as amended). These changes are explained below.

2.5 On 20 December 2000 the 'Gas and Electricity Markets Authority' was established under the Gas Act 1986 (as amended) and the Electricity Act 1989 (as amended). The DTI appointed nine members to the Authority and introduced the relevant statutory instruments in Parliament to establish the Authority and enact the parts of the Utilities Act 2000 that set out the Authority's objectives and functions.

2.6 The remaining provisions of the Utilities Act 2000 are expected to be brought into effect by the DTI later this year.

Recent developments

2.7 This section explains the relevant developments since December 2000, which are:

- ◆ the National Audit Office's (NAO's) report on the introduction of competition into the designated electricity supply market;
- ◆ the research study conducted by Mori for Ofgem on domestic customers' experiences of the competitive electricity and gas markets;
- ◆ Ofgem's proposals for future standards of performance for supply businesses;

⁷ "Switching suppliers, A Research Study Commissioned by the Consumer Affairs Directorate", Department of Trade of Industry, November 2000.

- ◆ Ofgem's proposed approach to calculating financial penalties under the Utilities Act 2000;
- ◆ Ofgem's proposals for removing the supply non-discrimination licence conditions from the gas and electricity supply licences; and
- ◆ price increases for domestic gas customers.

NAO's report on the introduction of competition into the designated electricity market

2.8 On 5 January 2001 the NAO published its report on the introduction of competition into the designated electricity market.⁸ The NAO found that more than 6.5 million customers had saved money by changing supplier, and as a whole electricity customers' bills had fallen by £750 million since competition was introduced. The NAO also highlighted the continuing opportunities for customers to save money by switching supplier. The NAO highlighted a number of areas where Ofgem is acting to ensure customers benefit from the introduction of competition, and where further action may be required. In particular:

- ◆ making it easier for domestic customers to identify the best deal;
- ◆ acting to reduce the problems customers experience when changing supplier;
- ◆ working with the industry to reduce costs borne by prepayment meter customers; and
- ◆ minimising the barriers to entry into the electricity supply market, particularly in Scotland.

⁸ "Office of Gas and Electricity Markets: Giving Domestic Customers a Choice of Electricity Supplier", National Audit Office, January 2001.

Research study conducted by Mori for Ofgem on domestic customers' experiences of the competitive electricity and gas markets

2.9 In January 2001 Ofgem published the results of research carried out by Mori for Ofgem on domestic customers' experiences of the competitive electricity and gas markets.⁹ This research found that:

- ◆ those in social groups C1, C2, D, and E were taking greatest advantage of domestic gas competition and have switched the most (between 28% and 32% of these groups). By comparison those in social group AB had switched least (25%). All social groups were taking similar advantage of domestic electricity competition (between 18% and 20% switching);
- ◆ other groups of particular concern to Ofgem – the disabled, one parent families and those not working – were all switching at around or above average levels in both electricity and gas;
- ◆ those using prepayment meters and those without bank accounts tended to switch supplier at less than the average rate;
- ◆ levels of satisfaction with electricity and gas suppliers were overwhelmingly positive;
- ◆ awareness of the number of companies active in either of the electricity or gas markets is increasing, although nationally awareness of British Gas dominates in both the electricity and gas markets;
- ◆ about a third of customers say that they have received or seen information on comparative pricing for electricity or gas. Of these, about 40% found it very or fairly easy to compare prices, while a third said that it was very or fairly difficult to compare;
- ◆ price remained the main reason customers cited for changing supplier. Most switchers found the switching process easy; and

⁹ "Experience of the competitive domestic electricity and gas markets, Research study conducted for Ofgem by Mori", Ofgem, January 2001.

- ◆ the principal reason cited by customers for not switching either electricity or gas supplier was the lack of a reason to do so, or satisfaction with current supplier. 7% of electricity and 8% of gas customers who had not yet switched said that they were likely to switch during the next year.

Ofgem's proposals for future standards of performance for supply businesses

2.10 In October 2000, Ofgem consulted on its approach to setting standards of performance on suppliers in a competitive market¹⁰ and considered four possible options:

- ◆ setting regulatory standards for all electricity and gas suppliers;
- ◆ setting regulatory standards for dominant electricity and gas suppliers;
- ◆ removing existing standards in electricity and gas, where competition is sufficiently developed; or
- ◆ allowing suppliers to set their own standards, in codes of practice, under licence conditions.

2.11 Last month, after considering responses to the consultation, Ofgem published final proposals for the future standards of performance for supply businesses.¹¹ This consultation proposed that standards of performance should only apply to suppliers subject to formal price regulation. It proposed that standards of performance for metering activities should apply to all suppliers and dominant metering providers, until metering competition is sufficiently developed. Subject to responses to this consultation, the new proposals are expected to come into effect later this year.

Ofgem's proposed approach to calculating financial penalties under the Utilities Act 2000

2.12 The Utilities Act 2000 will allow Ofgem to impose financial penalties on licensees for past or present breaches of any relevant condition or requirement,

¹⁰ "Guaranteed and overall standards of performance, A consultation paper", Ofgem, October 2000.

¹¹ "Guaranteed and overall standards of performance, Final proposals", Ofgem, January 2001.

or failure to achieve any individual standard of performance. The penalty imposed must be reasonable in all the circumstances of the case, and may not exceed more than 10% of the licensee's turnover.

- 2.13 The Utilities Act 2000 requires the Authority to publish a policy statement explaining how it will calculate financial penalties levied under the Utilities Act 2000. Ofgem held an initial consultation on its approach in August 2000¹² and last month issued a formal consultation.¹³ It set out the factors Ofgem proposed considering when setting financial penalties. Ofgem will publish its final policy statement later this year. Ofgem's powers to levy penalties under the Utilities Act 2000 are expected to be brought into force by the DTI later this year.

Ofgem's proposals for removing the supply non-discrimination licence conditions from the gas and electricity supply licences

- 2.14 In July 2000 Ofgem proposed removing the supply non-discrimination conditions from the licences of all gas and electricity suppliers.¹⁴ Following careful consideration of the responses to that consultation, Ofgem confirmed its proposal to remove these conditions in October 2000, in the final consultation on the new licences to be introduced following the Utilities Act 2000.¹⁵ Only one respondent to this consultation commented on this issue and it supported Ofgem's proposal.
- 2.15 On 31 January 2001 Ofgem sent the Secretary of State for Trade and Industry the final licences it proposed should be introduced following the Utilities Act 2000. These licences took account of Ofgem's proposal to remove the supply non-discrimination licence conditions. It is expected that the new licences will be brought into force by the DTI later this year.

¹² "Utilities Act, Financial penalties", Ofgem, August 2000.

¹³ "Financial penalties, Consultation document", Ofgem, January 2001.

¹⁴ "Gas and electricity supply licences, Proposals for standard non-discrimination licence conditions", Ofgem, July 2000.

¹⁵ "The Utilities Act Standard Licence Conditions Volume 1: Final Proposals", Ofgem, October 2000.

Price increases for domestic gas customers

2.16 On 9 February 2001 BGT announced that it was increasing the prices it charges its domestic gas customers from 1 April 2001. Table 1 below shows the change in the unit charges for BGT's domestic gas tariffs.

Table 1 – Change in BGT's gas tariffs from 1 April 2001

Tariff	Current unit rates (p/kWh)		Unit rates from 1 April 2001 (p/kWh)	
	Tier 1	Tier 2	Tier 1	Tier 2
Direct debit	1.840	1.281	1.930	1.344
PromptPay	1.677	1.327	1.767	1.390
LatePay/ PrePayment	2.396	1.327	2.486	1.390
AdvancePay	1.802	1.254	1.892	1.317

2.17 In addition to the changes in the unit rates, BGT intends to restructure the PromptPay tariff so that customers will receive a discount of 28.9% off their bill per quarter, up to a maximum of £7.20, if they paid the previous bill within 10 days of it being sent. Currently, customers receive a discount of 30% off their bill per quarter, up to a maximum of £7.20. Table 2 below shows the comparison between BGT's current bills and the new bills from 1 April 2001, at tariff average consumption levels.

Table 2 – Comparison of BGT’s current annual bills and the new bills from 1 April 2001

Tariff (annual consumption)	Current bill (£)	New bill from 1 April 2001 (£)	Increase (%)
Direct debit (21,980 kWh)	307.13	322.21	4.9
PromptPay (16,529 kWh)	235.34	246.99	4.9
LatePay/ PrePayment (16,168 kWh)	263.43	274.85	4.3
AdvancePay (21,980 kWh)	300.69	315.77	5

2.18 Table 2 shows that BGT has increased its prices by between 4.3% and 5% at tariff average consumption, with the LatePay/ PrePayment tariff having the smallest increase.

2.19 Before BGT’s announcement of price changes from April 2001, four other gas suppliers (Northern Electric, Seeboard, Scottish and Southern Energy and Eastern Energy) had increased their prices by between 1% and 14%, depending on the customers’ tariff. These suppliers had not chosen to increase prices for prepayment customers.

2.20 Since BGT’s announcement, two suppliers have announced price changes. Powergen has announced that it will be increasing its domestic gas tariffs from 2 April 2001 by £14 per year at an annual consumption of 19,050 kWh. Scottish Power has announced that it will be increasing its domestic gas tariffs from 1 March 2001 by just over 5% per year at an annual consumption of 19,050 kWh. Neither of these suppliers has increased its prices for prepayment customers.

3. Assessment of competition

Introduction

3.1 Ofgem's initial proposals for the future price regulation of BGT's domestic gas prices summarised the conclusions of our review of the development of domestic gas and electricity supply competition, which was published at the same time as the initial proposals. The document explained how the assessment of competition informed Ofgem as to which (if any) domestic gas customers will continue to need protection through formal price regulation on BGT, from April 2001.

3.2 This chapter:

- ◆ summarises the conclusions of Ofgem's competition review;
- ◆ summarises respondents' comments on the issues raised in the review; and
- ◆ sets out Ofgem's response to those comments.

3.3 The chapter particularly focuses on the development of competition in gas supply as it is BGT's future price regulation that we are considering this year.

Summary of the conclusions of Ofgem's assessment of competition

3.4 Overall Ofgem believed that competition in the domestic gas and electricity supply markets had continued to develop well over the previous year. A range of factors were considered which supported this view, including:

- ◆ almost all customers were aware that competition in domestic gas and electricity supply existed, with 89% of switchers finding it easy to change supplier;
- ◆ the number of competing suppliers in both supply markets was sufficient to promote intensive rivalry;
- ◆ the level of customer switching in the gas supply market averaged 57,300 per week over the year to October 2000, up from an average of

52,500 per week over the previous year. Electricity switching levels were higher than gas, averaging 140,000 per week in the last year;

- ◆ BGT's market share fell over the previous year to 71% of domestic gas customers, while the PESs market share varied between 78% and 89%. The number of customers supplied on 'dual fuel' deals increased over the year from 5 million to 7.5 million;
- ◆ most customers were able to obtain a range of competitive offers, with available discounts of up to 20% compared to BGT's tariffs in gas supply, and up to 18% in electricity supply in comparison to the local PES tariffs; and
- ◆ barriers to entry in both gas and electricity supply were relatively low, with Ofgem taking action to address many of the remaining issues, including the introduction of New Electricity Trading Arrangements and the separation of PES supply and distribution businesses. However, Ofgem remained concerned that customers in debt were unable to benefit from the choice available in the competitive market because suppliers had the right to object to the transfer of customers in debt.

3.5 Since the removal of BGT's direct debit price control last April, competition had continued developing for direct debit customers. Competition had also continued to develop for BGT's PromptPay and LatePay customers, with BGT's market share falling for this group of customers as most were able to obtain alternative competitive offers. There remained significant numbers of LatePay customers who could not switch supplier because of BGT's right to block their transfer as they were in debt.

3.6 Over the previous year, competition had not developed significantly for prepayment customers, and BGT had retained almost all of these customers. These customers were not able to obtain a range of competitive offers, although two suppliers offered discounts compared to BGT's tariff, with Equigas offering a 13% discount. Ofgem believed that suppliers blocking transfers of customers in debt had a particularly adverse effect on the development of competition for these customers.

- 3.7 The competition assessment showed that in electricity competition had developed more quickly for direct debit customers than other customers. As with gas, a significant number of customers on other credit payment methods and prepayment could not take advantage of the choice offered by the competitive market because their current supplier could block their transfer to another supplier because they were in debt.
- 3.8 Ofgem received sixteen responses to the consultation on the conclusions of the competition assessment, with thirteen from suppliers and three from consumer representatives, including a response from energywatch. Appendix 1 lists the non-confidential respondents to the competitive market review and Ofgem's initial proposals for the future price regulation of BGT. Respondents raised four main issues:
- ◆ the development of competition for customers in debt, and particularly prepayment customers;
 - ◆ BGT's market position and behaviour;
 - ◆ the development of competition in gas and electricity supply markets; and
 - ◆ the approach taken by Ofgem to the review and the factors taken into account.
- 3.9 Respondents' comments on each of these issues, and Ofgem's response to those comments, are set out in turn below.

The development of competition for customers in debt, and particularly prepayment customers

Respondents' views

- 3.10 Consumer representatives were particularly concerned that many disadvantaged customers had not benefited from competition to the same extent as other customer groups. Two suppliers and two consumer representatives believed that prepayment customers were not switching supplier due to factors other than suppliers' right to object to the transfer of customers in debt, including the lack

of competitive offers available to these customers. One PES supplier believed that pressure from Ofgem to reduce prepayment prices had made it difficult for suppliers to compete for these customers.

- 3.11 Another supplier believed that customers found the budgeting facilities of a prepayment meter convenient and saw no reason to switch supplier. One supplier believed that the current ownership of prepayment infrastructure services by the PESs was not a barrier to the development of competition for these services, as the independent ownership of the system in gas had not led to more competition. One supplier believed that the market share figures for BGT and the PESs showed that competition was stronger in gas than electricity for prepayment customers.
- 3.12 All suppliers, including BGT, objected to Ofgem's proposal to make changes to BGT's right to object to the transfer of customers in debt. Suppliers believed that the issue needed to be tackled through industry wide agreement, and that it should not be linked to the removal of price controls. Customer representatives generally welcomed Ofgem's proposal to reduce the rights of suppliers to object to the transfer of customers in debt, although they were concerned to ensure that suppliers had better debt prevention processes in place.
- 3.13 Powergen set out a proposal to reduce the rights of suppliers to object to the transfer of customers in debt. Powergen proposed that suppliers would no longer have the right to object to the transfer of prepayment and regular payment credit customers in debt. A code of practice would be established that would set out the processes by which suppliers would assign debt when customers switched supplier. Suppliers could reach bilateral agreements to use different processes than those set out in the code. A governance arrangement for the code would be developed to allow changes to reflect best practice.

Ofgem's response

- 3.14 As explained in Chapter 2, Ofgem commissioned research from Mori on the experiences of domestic electricity and gas customers. This showed that those in social groups C1, C2, D and E were taking greatest advantage of domestic gas competition and had switched the most. By comparison those in social group AB had switched least. All social groups were taking similar advantage of

domestic electricity competition. Some groups of customers of particular concern to Ofgem – people with disabilities, single parent families, and those out of work – were all switching supplier at around or above average levels in both electricity and gas. The research also showed that those on very low incomes, those with prepayment meters, and in gas those of pensionable age, were switching at rates below the average. These latter customer groups are consequently not benefiting to the same degree as other customer groups from offers available in the competitive market.

- 3.15 Ofgem has identified a number of priorities for the coming year aimed at addressing the issues brought up by the findings for these customer groups that have switched at less than the average rate. A number of initiatives fall under Ofgem's Social Action Plan and include, for example, ensuring that new company codes of practice provide relevant advice and information for disadvantaged and vulnerable customers. Ofgem is also working with Help the Aged to promote the awareness and benefits of the competitive market among older people.
- 3.16 Ofgem continues to believe that it is important that significant progress is made to increase the opportunity for customers in debt to participate in the competitive gas and electricity supply markets.¹⁶ Ofgem recognises that other factors may also be affecting the ability of prepayment customers to benefit from competition, and we are currently taking forward work under the Social Action Plan to address these issues.
- 3.17 Ofgem is disappointed that BGT did not accept changes to its licence to substantially address the concerns about customers in debt. Nevertheless Ofgem welcomes BGT's commitment to participate in a trial to assess possible ways to address the issue. Ofgem particularly welcomes the proposal from Powergen to address this issue, and believes that this proposal should be given serious consideration by all gas and electricity suppliers, as a possible way forward. Ofgem's proposals to take this issue forward are set out in Chapter 5.

¹⁶ Appendix 2 summarises the previous proposals Ofgem has made to address the debt blocking issue and the responses received to those proposals.

BGT's market position and behaviour

Respondents' views

3.18 Nine suppliers and two consumer groups had concerns about the impact of BGT's market position and behaviour on the development of competition.

Respondents raised specific concerns that:

- ◆ BGT was leveraging its dominant position in the gas supply market to gain an unfair advantage in the electricity supply and 'dual fuel' markets;
- ◆ BGT had an unfair advantage because competitors were not able to match BGT's marketing and advertising expenditure. This included a concern about the advantage Centrica obtained from marketing a wide range of products under the British Gas brand, giving customers a perception that all the products and services are provided by one company; and
- ◆ BGT had an unfair advantage in the domestic gas supply market because of the Centrica group ownership of the Morecambe Bay gas field, with its high swing capability.

3.19 Two suppliers suggested that Ofgem should consider breaking up BGT to allow competition in the domestic energy markets to better develop.

Ofgem's response

3.20 Ofgem continues to monitor BGT's behaviour in the domestic supply markets to ensure that it is not behaving in an anti-competitive manner. If Ofgem finds any evidence of BGT or any other supplier behaving in an anti-competitive manner, Ofgem will seek to take action under either the gas or electricity licences or competition law, in particular the Competition Act 1998.

3.21 Ofgem recognises that BGT has been competing vigorously in the electricity supply market, and has been the largest acquirer of new customers. Ofgem believes that it is for BGT to decide how to spend any profits made from its gas supply business, providing it does not engage in anti-competitive behaviour. So

far Ofgem has not found any evidence that BGT has been acting anti-competitively in the electricity supply market.

- 3.22 Ofgem explained in its July 1999 follow-up document to the 1998 domestic gas competitive market review¹⁷ that it would seek to take action under the Competition Act 1998 if there was evidence that BGT's advertising, as the dominant supplier, was anti-competitive. Since then Ofgem has not found any evidence that BGT's advertising has been anti-competitive.
- 3.23 Ofgem continues to monitor closely the wholesale gas market, and investigates specific events where we are concerned that there may have been anti-competitive behaviour.
- 3.24 Ofgem has not been provided with any evidence to justify seeking to split up BGT.

The development of competition in gas and electricity supply markets

Respondents' views

- 3.25 Seven respondents broadly agreed with Ofgem's conclusion that competition is continuing to develop well. Three respondents disagreed with Ofgem's conclusion, and believed that BGT's substantial market share and the increasing number of customers switching back to BGT showed that competition was not developing as well as Ofgem believed.
- 3.26 One supplier was concerned that the recent increases by some suppliers of domestic gas prices suggested that competition was not developing well. Another supplier believed that any decreases in the number of competing suppliers was a sign that competition is not developing well. One consumer representative was concerned that customers found it difficult to compare competing suppliers' offers.

Ofgem's response

- 3.27 Ofgem believes that competition is developing well in the gas and electricity supply markets. Ofgem understands the concern of some respondents about

¹⁷ "Review of British Gas Trading's Behaviour in the Domestic Gas Market", Ofgem, July 1999.

BGT's market position, but as discussed above Ofgem does not currently have any evidence that BGT has acted anti-competitively. Ofgem believes that customer switching, both to and from BGT, is evidence of a well functioning competitive market, and the recent DTI report on customer switching in a number of sectors showed that switching in gas and electricity was amongst the highest of any sectors.

- 3.28 Ofgem believes that the recent increases in domestic gas prices are due to the level of wholesale gas costs, rather than suggesting that competition is not working well for domestic customers. Ofgem recognises the difficulties some suppliers have faced as a result of the level of wholesale gas costs. However Ofgem believes that there remain a sufficient number of gas and electricity suppliers to promote intensive rivalry. Ofgem currently publishes pricing factsheets to help customers compare prices and we also monitor internet price comparison service providers to ensure they meet certain minimum standards.

The approach taken by Ofgem to the review and the factors taken into account

Respondents' views

- 3.29 Respondents broadly agreed with Ofgem's approach to the assessment of the development of competition. Two suppliers believed that the MORI research should be expanded to include customer awareness of the PESs' brands, and customer attitudes to, and experience of, switching when they are already taking more than one product or service from a supplier. One supplier believed that we should have included more detail in the review about other suppliers' offers, and not just about BGT's.
- 3.30 Respondents' expressed concern that insufficient time was given to provide the information requested in the survey, and that it should not be issued during the summer when many staff are on annual leave. A supplier suggested that Ofgem should consult more widely with suppliers prior to issuing the survey to ensure that suppliers were able to provide the information requested.

Ofgem's response

- 3.31 Ofgem welcomes comments on the factors that should be considered in the assessment of competition, and the comments received will be considered when carrying out this year's review and developing this year's survey of customer attitudes.
- 3.32 Ofgem recognises that the information requested in the survey is detailed and extensive. Ofgem seeks to balance the need to collect sufficient information to make a rigorous assessment of the development of competition, with the burden placed on shippers and suppliers to provide the information. For this year's review, Ofgem will endeavour to consult shippers and suppliers in advance of publishing the survey. Ofgem issues the survey in the summer so that as up to date information as possible can be collected, and sufficient time is available for Ofgem to analyse the information to inform decisions about future price regulation.

Conclusions

- 3.33 Overall, Ofgem believes competition is continuing to develop well in gas and electricity supply, albeit at different rates. Customer switching in both supply markets is up from last year. The number of competitors exceeds that required for competition. Most customers are able to receive significant discounts on incumbent prices. There is evidence of continuing growth in the size of the 'dual fuel' market, with Ofgem estimating that over the last year an additional 2.5 million customers were supplied on 'dual fuel' contracts. It is a concern that, in both gas and electricity, there remain barriers to entry that need to be addressed, particularly in the electricity supply market. However Ofgem has developed plans to address most of these issues in the coming twelve months.
- 3.34 Ofgem will continue to monitor the behaviour of dominant companies in the gas and electricity supply markets to ensure that they are not behaving in an anti-competitive manner. Ofgem will seek to take appropriate action under the Competition Act 1998 if it believes any supplier has been acting in an anti-competitive manner.

- 3.35 In the domestic gas supply market Ofgem considers that, since BGT's price control was removed last April, competition has continued to develop well for direct debit customers. Competition has also continued to develop for BGT's PromptPay customers. Ofgem remains concerned that competition is not protecting the interests of customers in debt on the LatePay/ PrePayment tariffs. Ofgem believes that the significant numbers of these customers who cannot switch supplier is due to BGT's right to block their transfer as they are in debt.
- 3.36 As set out in Ofgem's initial proposals for the future price regulation of BGT's domestic gas tariffs, Ofgem wants to make substantial progress to increase the ability for customers in debt to switch supplier. We have explained in Chapter 5 how we intend to take this issue forward.

4. Options for future regulation

Introduction

- 4.1 The previous chapter considered respondents' views about Ofgem's view of how well competition had developed in gas and electricity supply. Bearing in mind the conclusions of the competitive market review, it is necessary to consider which form of regulation is appropriate for the level of competition.
- 4.2 BGT's present price control is a cap on the tier 1 and tier 2 p/kWh charges for its PromptPay and LatePay/ PrePayment tariffs. Ofgem's initial proposals document considered three options for the future regulation of BGT's domestic gas prices:
- ◆ retaining revised price controls;
 - ◆ relative price regulation; and
 - ◆ using competition legislation, in particular, the Competition Act 1998.
- 4.3 This chapter:
- ◆ summarises the three options set out in the initial proposals;
 - ◆ summarises respondents' comments on the three options; and
 - ◆ sets out Ofgem's final view.

Retaining revised price controls

Ofgem's initial proposals

- 4.4 Setting revised price controls requires Ofgem resetting tariff caps on tariffs where it considers that competition is not sufficiently protecting the interests of customers. This could be similar to the present tariff caps. Tariff caps can act to protect the interests of customers by setting a guaranteed maximum price. These tariff caps can be accompanied by guaranteed minimum standards of service.
- 4.5 Chapter II of the Competition Act 1998 prohibits the abuse of a dominant position. This suggests that regulation over and above the Competition Act 1998 would only be required if BGT's market power is at a level in excess of

dominance. Such a market position is most commonly associated with network owners and operators like Transco or the National Grid, who have a near monopoly position, which is unlikely to be significantly eroded.

- 4.6 When underlying costs are volatile and a dominant supplier is subject to tariff caps, significant distortions can be introduced to a competitive market. These distortions could act against the interests of competitors and customers, both present and future. The recent volatility in wholesale gas costs illustrates the difficulty in accurately forecasting some costs that are determined in a competitive market.
- 4.7 A price control can protect customers' interests, in terms of price and service, where a company has a near monopoly market position. However in markets where competition is developing and costs are volatile, price controls may distort the development of competition.

Respondents' views

- 4.8 All suppliers, except for one, supported the removal of price caps from BGT from 1 April 2001. These suppliers cited the distortionary effect of the present price caps on the development of competition as their principal reason for supporting the removal of the caps. The one supplier that did not support removal of price caps from BGT's tariffs viewed competition as not being sufficiently developed to protect the interests of customers.
- 4.9 energywatch agreed that the market is more efficient at determining prices than the existing price control and that the success of price controls is dependent on accurate forecasts of costs. Two other consumer groups that commented on this issue were of the view that Ofgem should retain price caps for BGT's prepayment customers.

BGT's view

- 4.10 BGT said that the present price caps are distorting the development of competition and that price regulation of this form is inappropriate in a market where competition has developed.

Ofgem's view

- 4.11 Ofgem continues to consider that in a market where competition is developing and costs are volatile, price caps are inappropriate and can introduce significant distortions that act against the interests of competitors and customers, both present and future. Ofgem shares the concern of some consumer groups and one supplier as to whether competition is sufficiently developed, or the prospects for its future development are sufficient, to remove formal price regulation for all customer groups, and particularly customers in debt. However Ofgem does not believe that price caps would be an effective form of regulation, bearing in mind the difficulty of setting caps that did not distort the development of competition, and the volatility of costs, particularly wholesale gas costs.

Relative price regulation

Ofgem's initial proposals

- 4.12 Relative price regulation requires Ofgem to set maximum differentials between prices offered to customers whose interests are not sufficiently protected by competition (the 'target' group) and the prices offered to customers whose interests are sufficiently protected by competition (the 'marker' group). Relative price regulation would allow customers in the target group to obtain some of the benefits of competition obtained by customers in the marker group.
- 4.13 Ofgem considered relative price regulation to be preferential to tariff caps for regulating BGT's prices and protecting the interests of customers in markets where competition has been introduced. Relative price regulation could be used to spread the benefits of competition to those customers that are not fully benefiting from competition.

Respondents' views

- 4.14 Suppliers had mixed views about adopting relative price regulation to regulate BGT's prices. The four suppliers that were in favour of relative price regulation said that Ofgem should ensure that the capped differential is reflective of the difference in costs of supplying different customer groups. These suppliers also said that Ofgem should seek to remove this form of price regulation as soon as possible and use the Competition Act 1998. The four suppliers not in favour of

relative price regulation said that this form of regulation could distort the market, have a detrimental effect on competition and that the provisions of the Competition Act 1998 were adequate to ensure that BGT maintained appropriate differentials between its tariffs.

- 4.15 Two consumer groups said that formal relative price controls must be maintained for as long as some sectors are not competitive. Two consumer groups did not think that relative price regulation was sufficient protection for prepayment customers and that capping differentials would not reduce the cost of supplying prepayment meter customers.

BGT's view

- 4.16 BGT said that relative price regulation was an acceptable proposal, subject to it reaching agreement with Ofgem over the wording of the modification to its price control licence condition.

Ofgem's view

- 4.17 Ofgem continues to consider relative price regulation to be preferential to tariff caps for protecting the interests of customers where competition has been introduced, but is not yet sufficient to protect customers' interests. Ofgem agrees that this form of regulation should only be required until competition is sufficient to protect customers' interests and the Competition Act 1998 can be used to address anti-competitive behaviour.
- 4.18 Ofgem recognises it is important that the cap on the differential accurately reflects costs, and that a divergence of the tariff differential away from the cost differential could distort the development of competition. The analysis that Ofgem undertook during this price control review showed that the differential between BGT's costs of supplying different customer groups is reflected in BGT's current tariff differentials.
- 4.19 Ofgem believes that relative price regulation provides BGT with an incentive to reduce the costs of serving all its customer groups, including prepayment customers, as competition should ensure that BGT continues to seek to find efficiencies for customers on its Direct Debit and PromptPay tariffs, and relative

price regulation should ensure that these efficiencies are passed on to customers on the LatePay/ PrePayment tariff.

Removal of price regulation on BGT

Ofgem's initial proposals

- 4.20 Ofgem believes that effective competition best serves the interests of customers, and we seek to remove sector specific regulatory requirements where competition is sufficiently developed. After removal of sector specific regulations, Ofgem still has available to it competition law, and in particular the Competition Act 1998, to regulate the behaviour of market participants.
- 4.21 Ofgem believes that where competition is sufficiently protecting the interests of customers, their interests are best served by the removal of sector specific regulation and use of the Competition Act 1998.

Respondents' views

- 4.22 Of the suppliers that commented, four indicated that they believed that competition had developed sufficiently to remove all specific price regulation from BGT and rely on the Competition Act 1998 to regulate its behaviour. Five suppliers did not agree that competition was sufficiently developed to rely on the Competition Act 1998. One of these suppliers supported retaining price caps, while the other four advocated that Ofgem should impose a form of relative price regulation to offer protection to BGT's LatePay/ PrePayment customers.
- 4.23 None of the consumer groups supported Ofgem removing price controls from BGT. Two consumer groups said that Ofgem should retain price caps for BGT's prepayment customers, while two said that Ofgem should introduce some form of relative price regulation.

BGT's view

- 4.24 BGT did not specifically comment on removing the remaining price controls on its prices to its domestic customers, although it expressed support for removing regulation.

Ofgem's view

- 4.25 Ofgem continues to consider that effective competition best serves the interests of customers, and that at the earliest possible opportunity sector specific regulation should be removed and competition law used to regulate behaviour in competitive markets. Ofgem, along with the Office of Fair Trading ('OFT') and the other sector regulators, has published guidance on how the Competition Act 1998 will be applied. These guidelines are available on the OFT website at www.offt.gov.uk. The final version of the guideline for the energy sectors will be published shortly.

Conclusions

- 4.26 Ofgem considers that as competition develops it is important that regulation is removed and competition law is used to address anti-competitive behaviour. However, where competition is not sufficiently developed, Ofgem is concerned to ensure that all customers are able to obtain the benefits available from competition.
- 4.27 To meet these objectives, Ofgem considers that relative price regulation is an appropriate mechanism to protect the interests of BGT's LatePay/ PrePayment customers. Relative price regulation should ensure that the benefits of competition are passed from those customer groups in which competitive pressures are strongest to those groups where competitive pressures are less strong. There is less risk that relative price regulation will distort the development of competition than the setting of price caps.
- 4.28 Ofgem expects, subject to sufficient progress in the development of competition, and co-operation from the industry on debt blocking, to remove relative price regulation from 1 April 2002.

5. Ofgem's final proposals

Introduction

5.1 This chapter draws together Ofgem's conclusions on the development of competition and the alternative approaches to regulation discussed above. These final proposals have been reached after careful consideration of the comments received in response to Ofgem's initial proposals. This chapter sets out:

- ◆ a summary of Ofgem's initial proposals;
- ◆ a summary of respondents' comments on the initial proposals; and
- ◆ Ofgem's final proposals.

Ofgem's initial proposals

- 5.2 Ofgem believed that competition was sufficiently developed for PromptPay customers to allow the removal of price controls for these customers, and to use competition law to regulate BGT's offers to these customers. Ofgem also believed that the prospects for the continued development of competition for LatePay and PrePayment customers would be sufficient to allow the removal of price controls and the use of competition law, if substantial progress was made in addressing the concerns that some customers are unable to switch supplier because of their existing debt.
- 5.3 Ofgem believed that substantial progress to address the debt blocking issue could be made if BGT accepted a special condition in its gas suppliers' licence, reducing the scope of its right to object to the transfer of customers in debt. To ensure that BGT was not placed in a different position from other suppliers for a lengthy period, Ofgem would limit the length of the condition and seek to introduce a similar provision into all gas suppliers' licences as soon as possible.
- 5.4 As an additional protection for LatePay/ PrePayment customers and particularly those in debt, Ofgem would seek a public commitment from BGT to maintain the relative differentials between its domestic tariffs and in particular, a merged LatePay/ PrePayment tariff, at least until April 2002.

5.5 Ofgem believed that this represented a balanced proposal to allow the removal of the remaining price controls, while making significant progress in allowing customers in debt, who are currently unable to take advantage of the choice offered by the competitive market, to obtain the benefits of competition. Ofgem explained that, should BGT reject the proposal, it would offer BGT an alternative package before referring the issue to the Competition Commission. This package aimed to ensure that there was sufficient formal protection of customers in debt if sufficient progress was not made to remove the barriers to these customers benefiting from the competitive market.

5.6 Ofgem's alternative proposal was as follows:

- ◆ price controls would be removed from BGT's PromptPay customers from 1 April 2001;
- ◆ price regulation would be extended for a further year for BGT's LatePay and PrePayment customers. This would involve relative price regulation. It would require BGT to continue to offer a combined LatePay and PrePayment tariff. The differentials between this tariff and BGT's Direct Debit and PromptPay tariffs would be capped. Ofgem expected these caps to reflect the current differentials between the tariffs;
- ◆ during the next year Ofgem would propose a modification to the standard conditions of the gas suppliers' licence to reduce the right of suppliers to object to the transfer of customers in debt; and
- ◆ Ofgem would carry out a further review of BGT's price regulation, in parallel with its review of the PES supply price controls. This would review whether to continue regulating BGT's relative prices beyond 1 April 2002.

Respondents' views

Non-BGT suppliers and customer representatives

5.7 All non-BGT suppliers, except one, supported the removal of price caps for BGT's domestic tariffs. Two consumer representatives did not believe that

competition was sufficiently developed to allow the removal of price controls, particularly from prepayment customers.

- 5.8 All suppliers objected to Ofgem's proposal to make changes to BGT's right to object to the transfer of customers in debt. Suppliers believed that the issue should be tackled through industry wide agreement, and that it should not be linked to removal of price controls. Powergen set out a proposal for reducing suppliers' right to object to the transfer of prepayment and regular payment customers in debt, subject to the new supplier following an agreed code of practice. Customer representatives generally welcomed Ofgem's proposal to reduce the rights of suppliers to object to the transfer of customers in debt, although they were concerned to ensure that suppliers had better debt prevention processes in place.

BGT's view

- 5.9 BGT stated that it could not accept Ofgem's preferred option because it believed the proposed changes to its right to block the transfer of customers in debt would expose it to too much financial risk from customers transferring to another supplier without paying their outstanding debt, and without the new supplier taking responsibility for the debt. BGT was particularly concerned that it should not be placed in a different position to other suppliers, and suggested that the issues associated with customers in debt should be addressed across the whole of the gas and electricity sectors. BGT indicated that although there was scope for some limited trials by BGT alone, the issues affected all gas and electricity suppliers and it indicated a commitment to the development of, and participation in, any trial of new arrangements to address the issue. It suggested in developing a cross industry trial that the following objectives could be included:

- ◆ ceasing to object to the transfer of prepayment customers with debts below an agreed threshold;

- ◆ make clear to these customers that if they choose to transfer to another supplier any outstanding debts would continue to be payable in full¹⁸;
- ◆ the developing and trialling of a debt assignment process; and
- ◆ investigating the scope for using a measure of past payment behaviour as a blocking criterion.

5.10 BGT said that it was prepared to accept Ofgem's alternative proposal, subject to agreeing the drafting of the licence modification.

Ofgem's final proposals

5.11 Bearing in mind BGT's rejection of Ofgem's preferred option due to its failure to be prepared to make substantial progress to address the debt blocking issue, and after careful consideration of the view of the other respondents, Ofgem has decided to implement the alternative option. As part of implementing this option Ofgem will continue to seek to make progress to improve the ability of customers in debt to benefit from the competitive market. We have explained in turn below how the different parts of the alternative option will be implemented:

- ◆ relative price regulation;
- ◆ customers in debt; and
- ◆ the 2002 review of the PESs and BGT's price regulation.

Relative price regulation

5.12 Appendix 3 sets out the modification Ofgem proposes to make to BGT's gas suppliers' licence to introduce relative price regulation. The modification caps the differentials between BGT's Direct Debit and LatePay/ PrePayment tariffs, and between BGT's PromptPay and LatePay/ PrePayment tariffs, at the current level of the differentials.

5.13 The condition will continue to apply until such time as the Authority decides that it should be disapplied. BGT can request from 1 January 2002 that the

¹⁸ This outstanding debt could be paid by the new supplier on behalf of the customer, and the new supplier would have the right to recover the debt.

Authority disapply the condition from 1 April 2002 or at any date thereafter. As explained below, Ofgem will review BGT's price regulation later this year to decide what, if any, regulation is required from 1 April 2002. Ofgem expects, subject to sufficient progress in the development of competition, and co-operation from the industry on debt blocking, to remove relative price regulation from 1 April 2002.

- 5.14 Subject to any comments received in response to the consultation on the licence modification in Appendix 3, and BGT's final view, Ofgem expects the modification to come into effect on 1 April 2001.

Customers in debt

- 5.15 Ofgem continues to believe it is important that significant progress is made to increase the opportunity for customers in debt to participate in the competitive gas and electricity supply markets. Ofgem is disappointed that BGT did not accept changes to its licence to substantially address the concerns about customers in debt. Nevertheless Ofgem welcomes BGT's commitment to participate in a trial to assess possible ways to address the issue. Ofgem particularly welcomes the proposal from Powergen to address this issue, and believes that this proposal should be given serious consideration by all gas and electricity suppliers, as a possible way forward.
- 5.16 Since the publication of the initial proposals, and particularly since receiving the responses to the proposals, Ofgem has been exploring a range of ways to address the debt blocking issue. On 8 February 2001 Ofgem held a meeting for all gas and electricity suppliers to discuss how best to take the issue forward, and in particular to obtain comments from suppliers on Powergen's proposal. The meeting showed that there was a mixed range of views on the issue amongst suppliers. However there was a broad range of support amongst suppliers for participating in a trial.
- 5.17 On 15 February 2001 Ofgem wrote to all gas and electricity suppliers addressing the issues raised at the meeting and welcoming the Gas Forum's decision to reconvene a working group to consider the debt blocking issue. Ofgem requested views from the working group and from any individual suppliers by 15 March 2001 on how Powergen's proposal, and any alternative proposals,

could be trialled effectively. Ofgem wants any trial to include as many suppliers as possible.

- 5.18 Depending on the outcome of the trial, Ofgem would expect to propose modifications to gas suppliers' licences to reduce suppliers ability to block the transfer of customers in debt. Ofgem would also take account of the results of the trial when considering any proposed changes to the rights of electricity suppliers to block the transfer of customers in debt, under the Master Registration Agreement.

The 2002 review of the PESs and BGT's price regulation

- 5.19 Later this year Ofgem will carry out a review to determine the future price regulation for PESs domestic electricity tariffs. When the current PES price controls were introduced, Ofgem explained that, subject to the sufficient development of competition, it intended to remove all price controls from April 2002.¹⁹ This review will also consider the future form of regulation for BGT. Ofgem expects, subject to sufficient progress in the development of competition, and co-operation from the industry on debt blocking, to remove relative price regulation from 1 April 2002.
- 5.20 Ofgem's review will include the following formal opportunities for interested parties to participate in the review:
- ◆ Spring 2001 – workshop to discuss the main factors to be taken into account when reviewing the PESs and BGT's future price regulation;
 - ◆ Spring/ Summer 2001 – quantitative and qualitative survey of gas and electricity suppliers, gas shippers, and other interested parties for information to assess the development of gas and electricity supply competition;
 - ◆ November 2001 – the conclusions of the assessment of competition and Ofgem's initial proposals for the future price regulation of the PESs and BGT will be published for consultation;

¹⁹ "Reviews of Public Electricity Suppliers 1998 to 2000, Supply Price Control Review, Final Proposals", Ofgem, December 1999.

- ◆ December 2001 – workshop to discuss the conclusions of the assessment of competition and Ofgem’s initial proposals;
- ◆ February 2002 – Ofgem’s final proposals for the future price regulation of the PESs and BGT, including any licence modifications that are needed, will be published for consultation; and
- ◆ April 2002 – changes to PESs and BGT’s licences to implement Ofgem’s final proposals come into effect.

Appendix 1 List of non-confidential respondents' to the competitive market review and Ofgem's initial proposals for BGT's price regulation

1.1 We have listed below the non-confidential respondents to the competitive market review and Ofgem's initial proposals for BGT's future price regulation. Copies of the responses can be obtained from Ofgem's library. The non-confidential respondents were:

- ◆ Amerada Hess;
- ◆ Aquila Energy;
- ◆ energywatch;
- ◆ Equigas;
- ◆ London Electricity;
- ◆ National Association of Citizens Advice Bureau;
- ◆ National Energy Action;
- ◆ Northern Electric;
- ◆ npower;
- ◆ Powergen;
- ◆ Public Utilities Access Forum;
- ◆ Seeboard;
- ◆ TXU Europe;
- ◆ Virgin Energy; and
- ◆ Yorkshire Electricity.

Appendix 2 Summary of proposals to address the debt blocking issue and respondents' views

Ofgem's original consultation document

- 2.1 In December 1999 Ofgem issued a consultation document, "Customers in debt and their access to the competitive market" setting out proposals for the reform of arrangements on debt blocking. The document explained that Ofgem's overall objective in seeking reform was the removal of barriers to competition, thus enabling customers to exercise choice of supplier more easily. The need for reform was identified in proposals for Ofgem's Social Action Plan. Ofgem concluded that the right to block a customer's transfer on the grounds of debt should be abolished. Ofgem said that it had also considered the future of procedures in the electricity and gas licences for assigning final bill debts, and concluded that these had not worked well and should be removed.

Comments from suppliers and consumer groups on Ofgem's document

- 2.2 The majority of suppliers said they were opposed to Ofgem's proposals as these would seriously affect existing debt management processes, resulting in cost escalation, with a damaging effect on all customers, and in particular the disadvantaged. Suppliers also said that some customers may use the opportunity to switch suppliers to evade their debts, since customers could not be disconnected for a debt owed to their previous supplier. Most suppliers considered that debt assignment had not been given the opportunity to work properly and should be reviewed. There was some support among suppliers for placing an agreed minimum threshold on the amount that could be objected to for debt, subject to a review of the impact that this would have on industry costs. Suppliers generally commented that prepayment meter customers were unlikely to benefit from reforms given the absence of worthwhile competitive offerings to this group.
- 2.3 Consumer bodies, while in principle in favour of reform, expressed some concerns about the potential impact of Ofgem's proposals. They wanted to see safeguards introduced to ensure that disadvantaged customers were not penalised through being forced to accept credit checks, security deposits or

prepayment meters, or harassed by debt collection agents pursuing unrecovered debts. Options suggested included a trial period to judge the impact of removing debt blocking, improved procedures for assigning debt, and a minimum threshold on debt blocking of £100.

Revised proposals from Ofgem

2.4 Having considered these views, Ofgem wrote to suppliers and consumer organisations on 12 April 2000 seeking views on some revised proposals. Ofgem said that it remained determined to secure reforms. However it wished to take account of the views that had been received, and to establish a procedure that safeguarded the interests of all stakeholders as far as possible. Ofgem's revised proposals comprised the following main elements:

- ◆ the right of suppliers to block a transfer to another supplier on the grounds of debt should be subject to certain thresholds. All customers with existing debts up to £50 should be allowed to transfer automatically. In addition a new procedure should allow customers complying with agreed repayment plans – with debts up to a ceiling of £300 – to transfer;
- ◆ the right to assign the final bill within 90 days should remain and should be extended to include past debts up to a minimum of £50; and
- ◆ suppliers should conclude a code of conduct on the transfer of customers in debt and arrangements for assignment.

Views on Ofgem's revised proposals

2.5 Many of the organisations that commented on Ofgem's original proposals commented again on the revised proposals. Workshops were held to discuss the proposals with suppliers and consumer groups. A number of suppliers participated in a working group, convened and chaired by BGT, to establish some common views among suppliers. The concerns of this group reflected the views of many suppliers.

2.6 Concerns remained about increased risk for suppliers, in an area where suppliers believed there was little objective data. Suppliers said that what evidence there

was suggested that customers were less likely to pay their debts once they had transferred to a new supplier. The operation of a two-tier objection process was considered inconsistent with the current automated transfer procedures. Suppliers saw the introduction of selectivity criteria as increasing complexity. They continued to have reservations over the extent to which Ofgem's proposals would help the fuel poor. As a first step the working group proposed undertaking a trial, using a single debt threshold of £50, with the focus on analysing customer behaviour.

- 2.7 Consumer groups generally welcomed Ofgem's revised proposals, but continued to express concerns about the potential effects of their implementation on customers. They generally favoured the idea of a trial, using a single debt threshold of £50 - £100, with provisions to support assignment arrangements for unpaid debts.
- 2.8 Copies of the responses from suppliers and consumer organisations are held in Ofgem's library.

Appendix 3 Notice under Section 23 of the Gas Act 1986 (as amended) to modify BGT's gas suppliers' licence

NOTICE

pursuant to section 23(3)
of the Gas Act 1986

Notice of proposal to modify the special conditions of the licence treated as granted under section 7A(1)(a) and (b) of the Gas Act 1986 (*the Act*) to British Gas Trading Limited

The Gas and Electricity Markets Authority (*the Authority*) hereby gives notice as follows:

1. The Authority proposes to make modifications to the special conditions of the licence treated as granted under section 7A(1)(a) and (b) of the Act to British Gas Trading Limited to the effect set out in the Schedule hereto.
2. The reasons why the Authority proposes to make the modifications are stated in the consultation paper to which this Notice is attached.
3. Any representations or objections with respect to the proposed modifications may be made to the Gas and Electricity Markets Authority, marked for the attention of Nick Fincham, at 9 Millbank, London, SW1P 3GE by 26 March 2001.

The application of the official seal of the Gas
and Electricity Markets Authority is authenticated by -

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authorised in that behalf by the Authority

26 February 2001

SCHEDULE

MODIFICATION

For Special Condition 3 of the Special Conditions of the licence treated as granted under section 7A(1) (a) and (b) of the Gas Act 1986 to British Gas Trading Limited there shall be substituted the following Special Condition-

Condition 3: Restriction of certain prices for domestic customers

Interpretation

1 In this condition, unless the context otherwise requires-

“Additional Charge” means a charge for the provision of goods or services to a particular domestic customer, or a class of domestic customers, making payment for gas supplied under either the Marker Tariff (Category A), Marker Tariff (Category B) or the Target Tariff in addition to the charge for gas supplied;

“Advance Payment Tariff” means the category of Gas Payment Provisions described as Advance Payment;

“Gas Payment Provisions”, in relation to the terms or terms and conditions referred to in paragraph 2 below, means the provisions relating to payment of charges for gas supplied (other than the amounts to be charged) therein described;

“last resort supply customers” means customers supplied with gas pursuant to a direction given to the licensee by the Authority in accordance with Standard Condition 5 of the Standard Conditions;

“Marker Tariff (Category A)” means the category of Gas Payment Provisions described as monthly direct debit payment or ValuePlus;

“Marker Tariff (Category B)” means the category of Gas Payment Provisions described as Prompt payment by cash or cheque, quarterly direct debit payment

or standing order payment;

“permitted tariff” means any Gas Payment Provisions which comply with the provisions of paragraph 2;

“Standby Tariff” means the category of Gas Payment Provisions described as the Schedule of Standby Charges for gas supplies not exceeding 73,200 kWh per annum (determined by the licensee under paragraph 8 of Schedule 2B to the Act);

“Target Tariff” means the category of Gas Payment Provisions in force immediately before 1 April 2001 described as late payment by cash or cheque (later than 10 days), payment with magnetic card, payment by Benefit Agency, monthly repayment or using a prepayment meter; and

“urgent request” means a request notice given to the Authority under paragraph 5 in relation to which the licensee demonstrates that its commercial interest would be seriously prejudiced if the proposed request contained within the request notice was not introduced quickly.

Permitted tariffs

2. Subject to paragraphs 4 and 5, the licensee shall ensure that -
 - (a) the terms on which it is prepared to enter into a contract for the supply of gas to domestic customers determined under Standard Condition 3(1)(a) of the Standard Conditions;
 - (b) the terms and conditions on which it supplies gas to domestic customers, other than last resort supply customers, determined in accordance with the scheme made under paragraph 8(8) of Schedule 2B to the Act; and
 - (c) the terms and conditions on which it supplies gas to domestic customers, determined by, or in accordance with, the scheme made under paragraph 19(4) of Schedule 5 to the 1995 Act,

provide for payment of charges for gas supplied (other than the amounts to be charged) in accordance with –

- (i) the Marker Tariff (Category A),
 - (ii) the Marker Tariff (Category B),
 - (iii) the Target Tariff;
 - (iv) the Advance Payment Tariff, or
 - (v) the Standby Tariff.
3. Subject to paragraphs 4 and 5, the licensee shall ensure that such of the terms or terms and conditions referred to in paragraph 2 which applied immediately before 1st April 2001 apply after that day.

Introduction of new permitted tariffs, variation or abolition of the permitted tariffs

4. The licensee may vary the Gas Payment Provisions of Prompt payment (as set out in the Marker Tariff (Category B)), to provide for the percentage discount on the Target Tariff to be reduced to 28.9%.
5. The licensee may introduce a new permitted tariff, vary a permitted tariff (including a change to Table 1, or as the case may be, Table 2 in paragraph 7) or abolish a permitted tariff -
- (a) to give effect to any change in the law affecting relations between the licensee and its domestic customers;
 - (b) for the sole purpose of withdrawing a new permitted tariff or disapplying a variation or abolition to which paragraph 6 below applies; or
 - (c) by sending a request notice to the Authority accompanied by -
 - (aa) a statement of the reasons (including, where the new permitted tariff,

variation or abolition relates to the imposition, variation or abolition of an Additional Charge, a forecast of costs that would not be incurred by the licensee if the new permitted tariff, variation or abolition were made after deducting any additional costs that would be so incurred); and

(bb) in the case of an urgent request, sufficient information as will enable the Authority to consider the urgency of the matter,

and the request shall have effect if the Authority –

- (i) has consented to the request;
- (ii) in the case of an urgent request, has not objected to the request within 14 days of the receipt of the request notice by the Authority;
or
- (iii) in the case of any other request, has not objected to the request within 2 months of the receipt of the request notice by the Authority.

6. Where a new permitted tariff, variation or abolition under paragraph 5 entitles the licensee to impose, vary or abolish an Additional Charge, the Authority may, after consulting the licensee and taking into account any representations made by it, not later than 3 months after the giving of the consent by the Authority to the licensee in respect of that new permitted tariff, variation or abolition under sub-paragraph (c)(i) of paragraph 5, direct that, so long as the new permitted tariff, variation or abolition has effect, paragraph 2 and the entry in Table 1 or, as the case may be, Table 2 in paragraph 7 relating to any maximum charges differential for gas supplied shall be treated as varied in such a manner as the Authority may specify in the direction.

Maximum charges differentials

7. The licensee shall ensure that from 1 April 2001 -

- (a) the maximum difference between the charges for gas supplied to any

domestic customer on the Target Tariff and the charges for gas supplied to any domestic customer on any Marker Tariff (Category A) are as shown in Table 1.

TABLE 1
(p/kWh)
FROM 1 APRIL 2001

	Marker Tariff (Category A)
for the first 1143 kWh per quarter in respect of a customer's consumption	0.556
for any consumption greater than 1143 kWh per quarter in respect of a customer	0.046

- (b) the maximum difference between the charges for gas supplied to any domestic customer on the Target Tariff and the charges for gas supplied to any domestic customer on any Marker Tariff (Category B) are as shown in Table 2.

TABLE 2
(p/kWh)
FROM 1 APRIL 2001

	Marker Tariff (Category B)
for the first 1143 kWh per quarter in respect of a customer's consumption	0.719
for any consumption greater than 1143 kWh per quarter in respect of a customer	0.000

Disapplication of this condition

8. The licensee may, at any time after 1 January 2002 (and in any case no more often than once in any 4 month period), request by notice served on the Authority complying with paragraph 9 (in this condition, the “disapplication request”) that the Authority provide for this condition to cease to have effect in this licence.
9. Any disapplication request pursuant to paragraph 8 shall –
 - (a) specify the date (in this condition, the “disapplication date”) from which the licensee requests the Authority to agree this condition should cease to have effect (subject to paragraph 12, the date specified shall be no earlier than 1 April 2002 or 2 months after the date of service of the disapplication request); and
 - (b) provide a statement of the reasons for disapplying the condition and present evidence to support the disapplication.
10. A disapplication request shall cease to have effect if, within 2 months of the date of service of the notice, the Authority serves a notice on the licensee stating that the Authority is of the opinion that the disapplication request should not take effect together with the reasons for the rejection.
11. Within one month of the date on which a disapplication request is served, the Authority may serve a counter-notice (in this condition, the “information counter-notice”) on the licensee specifying such further information as the Authority may reasonably require for the purposes of considering any aspect of the disapplication request.
12. The information counter-notice shall operate to increase the 2 month period referred to in paragraphs 9 and 10 by the number of days between the service of the

information counter-notice and such time as the licensee provides all such information as requested to the Authority and either the Authority has confirmed in writing that such information is complete or a period of one month from the date on which the last such information was provided by the licensee to the Authority will have elapsed.

13. If the Authority –

- (a) agrees to the disapplication request; or
- (b) does not send a notice to the licensee pursuant to paragraph 10 within 2 months (or such extended period as provided for by paragraph 12),

this condition shall cease to have effect from the disapplication date or, in the case of (a), such later date as the Authority may direct.

14. The Authority may, at any time, direct the licensee that this condition shall cease to have effect in this licence from a date specified in that direction.