To Nigel Nash at Ofgem

PRICING OF DEEMED CONTRACTS

From Roger Barnard at EDF Energy

At the meeting of the Duty to Supply Workgroup last week, we discussed deemed contracts and, in particular, the provisions of paragraph 3 of SLC 28 in both the gas and electricity supply licence. Paragraph 3 sets out criteria for determining whether the prices to be charged under a deemed contract are unduly onerous.

There appeared to be agreement in the workshop that Ofgem should retain a broad regulatory control over the terms of deemed contracts through the licence, given that these are not contracts into which customers enter of their own free choice. Some concern was expressed, however, about the specific drafting of paragraph 3 and you indicated that Ofgem would be happy to consider alternative proposals.

Having considered the matter further, it is not clear to EDF Energy that the substance of the drafting as it stands is inappropriate. As I pointed out at the meeting, the test applied by paragraph 3 is essentially a double margin test. It says that prices for any class of domestic or business customers under a deemed contract are unduly onerous if the revenue from that class (i) significantly exceeds the licensee's costs of supply, and also (ii) exceeds those costs by significantly more than revenue exceeds costs in the case of the generality of the licensee's domestic or business customers (as the case may be). Both tests have to be satisfied for the licensee to be in breach.

EDF Energy considers that, in assessing questions of excessive pricing, an economic regulator would normally look for evidence that prices are substantially higher than would be expected in a competitive market and that there is no effective competitive pressure to bring them down to market levels. However, we recognise that this type of assessment is not easily applicable to deemed contracts, where the key regulatory task is to distinguish unduly onerous pricing from seemingly high prices that may be an integral part of a process that is divorced from competitive pressures.

On that basis, EDF Energy has concluded that the framing of the dual-test approach of paragraph 3, with its focus in each case on the relativities of the margins as between a particular deemed contract market and the comparable general supply market, is about as good as legal drafting can provide in this difficult area. On the evidence of either of parts (a) or (b) of paragraph 3, a licensee could not be found to be charging unduly onerous prices – but he could on the evidence of both of them, and it is hard to think of an alternative approach to assessment that would be more robust.

I should like to confirm, therefore, that EDF Energy no longer has an issue with the drafting of paragraph 3 (though others may have a different view). We do object, however, to paragraph 4 of SLC 28, which excludes promotional, marketing, and advertising costs from the cost base to which paragraph 3 applies. There is no rational basis for paragraph 4, and we would expect Ofgem to remove it.

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