

## Addressing unfair price differentials

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### Overview:

Ofgem's recent Probe into GB energy supply markets proposed changes to supply licences to address unfair price differentials for domestic consumers.

This document seeks views on proposed licence changes, building on responses to our Initial Findings Report.

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## Context

Ofgem's principal objective is to protect the interests of consumers, wherever appropriate by promoting effective competition. In keeping with this objective, we launched a study of the state of GB energy supply markets ('the Probe') in February 2008. In October 2008, we set out our initial findings on the operation of the GB retail energy markets and set out for consultation a package of measures to tackle the issues raised. This document consults on proposals for taking forward measures proposed in relation to one of the key action areas identified.

## Associated Documents

- Energy Supply Probe - Initial Findings Report, October 2008 (Ref: 140/08)

<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Documents1/Energy%20Supply%20Probe%20-%20Initial%20Findings%20Report.pdf>

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## 1. Introduction

1.1. One of the key findings of Ofgem's recent Probe into GB retail energy markets was that, despite the market working well in many important respects, a significant number of consumers remain disadvantaged by persistent unfair price differentials and that vulnerable consumers are disproportionately affected.

1.2. The Initial Findings Report identified a range of instances of differential pricing that are of concern to us, including: price differentials between payment methods and regions that do not appear to have a full cost justification, which disadvantages customers who have never switched or pay by certain payment methods; and significantly higher margins on electricity supply than on gas, which disadvantages stand-alone electricity customers.

1.3. We intend to address many of these issues by making competition in the retail energy markets work effectively for all consumers. Most of the remedies proposed in the Initial Findings Report are oriented primarily towards making competition work better through encouraging more consumers to participate actively in the market, improving the quality and accessibility of information available to consumers, and addressing inefficient barriers to new entry.

1.4. Over time, we would expect these remedies - through the operation of the market - to erode unfair price differentials. However, this process will take time and, in the meantime, we do not believe competitive pressures alone will protect all consumers from unfair price differentials.

1.5. Ofgem's duties extend beyond competition considerations and we are also concerned about impacts on consumers, and in particular on vulnerable consumers. In the absence of specific action to address unfair price differentials, it is in our view likely that many of these consumers would continue to be harmed as a result of paying higher prices for their electricity and gas. Our initial view is that the size of this consumer detriment is sufficient to warrant immediate interim measures.

1.6. In proposing action in this area, Ofgem is primarily concerned with vulnerable consumers. Nevertheless, we do not see this issue as a simple trade off between consumer protection on the one hand and competition on the other. As such, any potential adverse impact on innovation or incentives needs to be weighed against both the distortions to competition arising from the pricing features we observed in our Probe and the impact on vulnerable consumers.

1.7. Even if the Big 6 suppliers were to unilaterally address the main issues we have identified, we remain concerned that, until the implementation of other remedies has sufficiently improved the effectiveness of competition, unfair price differentials could re-emerge in subsequent price changes to the detriment of consumers.

1.8. The Initial Findings Report therefore stated that we would propose a new licence condition relating to cost reflective payment types and that we would consider requirements to address concerns over unfair price differentials.

### **Responses to consultation on the Initial Findings Report**

1.9. Responses to the consultation on the initial findings did not challenge our core observations on price differentials that cannot be justified by cost differences. Indeed, the responses of the Big 6 suppliers broadly confirmed our analysis. Furthermore, the large suppliers have already taken unilateral action to begin to address the impact of these pricing structures for the current winter:

- Centrica, RWE npower and Scottish & Southern Energy have all reduced the premiums paid by prepayment meter (PPM) customers; and
- Among the five former incumbent electricity suppliers, E.ON, EDF Energy and RWE npower have provided discounts to “off gas grid” customers in their former monopoly regions in order to offset the adverse impact of the implicit cross-subsidy between electricity and gas supply. ScottishPower substantially rebalanced its gas and electricity margins in September.

1.10. Moreover, several companies have indicated that they will take steps to address the remaining unfair differentials during future pricing adjustments. However, there is a lack of clarity on the timing and the exact nature of any such changes, or whether any of them would be sustained in the absence of specific action. Ofgem has nonetheless indicated that it would expect suppliers to implement changes as soon as possible in 2009.

1.11. The consultation identified a range of views on the proposal to introduce licence changes to address unfair pricing features. A summary of responses to consultation is given in Appendix 1. In broad terms, consumer representatives supported the proposals, citing in particular the potential benefits for vulnerable consumers. Most suppliers - large and small - had some concerns with the proposals, in particular that any policing of unfair price differentials could dampen innovation and hence hinder, rather than help the development of a more effective competitive market.

### **Ofgem's view**

1.12. In the light of the responses to the Initial Findings Report, we are consulting on a range of possible changes to the supply licences to ensure that price differentials, or certain types of price differentials, are fair and objectively justified. This includes consulting on whether, and if so how, to address the differences in profit margins between electricity and gas supply. In considering action in this area by way of licence change, we aim to guard against the most harmful effects of unduly discriminatory pricing on consumers whilst being concerned not to hinder innovation or the further development of competition.

1.13. In implementing reforms that address unfair price differentials, Ofgem is keen to ensure that it does not restrict suppliers' ability to innovate or incentives to

compete. As we said in the Initial Findings Report, in relation to any condition that goes beyond requiring cost reflectivity between payment types:

*"We would need to be sure that such a condition is a proportionate measure and serves to help, rather than hinder, progress towards an effective competitive market."*

1.14. We will consider whether the proposed licence condition should be time limited, given our hope and expectation that more effective competition should be sufficient to limit the scope for unfair price differentials in due course. We are also considering options for limiting the burden and risk of compliance, particularly through the use of a multi-stage enforcement process that would enable a quick and effective resolution of apparent undue pricing differentials.

### **Process**

1.15. This consultation document sets out, in high-level terms, a range of proposals for addressing concerns over unfair price differentials. An initial impact assessment is contained in Appendix 2, which we will refine in the light of responses to this consultation. Ofgem would like to hear the views of interested parties in relation to the issues set out in this document. Appendix 3 summarises the specific questions on which we would welcome responses. The closing date for responses is Friday 20 February 2009.

1.16. We are continuing with the development of the other potential remedies set out in the Initial Findings Report in the light of responses to consultation on that document. Our current expectation is to report back on this consultation later in the spring of 2009.

1.17. As we set out in the Initial Findings Report, we believe it is in the best interests of consumers to realise early implementation of potential remedies through agreement with the major suppliers. Any proposed licence changes would ideally be through a collective licence modification subject to statutory consultation. If, at any point, it becomes apparent that the prospect of reaching agreement with the companies on the broad range of matters is unlikely to be achieved, the Authority will consider alternative options, which include a reference to the Competition Commission for a Market Investigation or for a licence modification. The rest of this document is structured in the following way:

- **Chapter 2** sets out of our proposed approach to unfair price differentials
- **Chapter 3** sets out a range of proposals for licence requirements
- **Chapter 4** sets out the next steps in the process
- The **Appendices** include a summary of responses to our recent consultation and an initial impact assessment

## 2. Our proposed approach to unfair price differentials

### Chapter Summary

This chapter sets out our objectives in proposing action to address unfair price differentials. It then discusses the key issues of relevance, including how we propose to apply any licence conditions in terms of assessing cost allocation and materiality, and how we propose to approach enforcement. Finally, it seeks views on the scope and duration of the proposed licence requirements.

2.1. In proposing action, our overall objective is to be effective in addressing unfair price differentials, particularly where vulnerable consumers are adversely affected. However, we aim to do this in a proportionate way that doesn't undermine the development of competition. Specifically, we aim to:

- Maintain the incentives and scope to compete, innovate, reduce costs and promote sustainability
- Avoid undue regulatory risk and uncertainty
- Avoid a disproportionate regulatory, compliance and enforcement burden
- Provide for the removal of licence requirements if they become superfluous once the other initiatives identified in the Probe have had time to have an effect

2.2. We invite views on these aims and whether there are other issues we should focus on in taking a decision on the best way to proceed in this matter.

### Key issues

2.3. There are a number of ways in which licence conditions could address unfair differential pricing in electricity and gas supply, including a requirement for cost reflectivity between payment methods, a prohibition of undue discrimination or relative price controls and a prohibition of "cross subsidy" between electricity and gas supply. The specific features of each proposal are considered in the next chapter.

2.4. We set out possible draft licence conditions in this document for the purpose of eliciting more focussed responses - the precise drafting will certainly need further consideration before being put to statutory consultation. Further, and importantly, if licence modifications are made, we propose to provide guidance on how Ofgem would interpret any licence conditions, in order to facilitate compliance. The discussion in this chapter is intended to give a flavour of what those guidelines might capture, rather than the precise wording we would use. These guidelines would be applied, as appropriate, to each of the proposals.

### *Cost allocation*

2.5. Assessing cost reflectivity may be relevant in respect of certain of the proposals put forward in this consultation, and there are many drivers of costs. Some of these

are directly attributable to, for example, a certain payment type, region or service channel. Others are consequential, and might reflect, for example, the demographics of the customer base. In assessing cost reflectivity we would propose to apply the following principles:

- Costs that are directly attributable to the characteristics of a particular product should be reflected in the pricing of that product.
- All other costs should not be disproportionately recovered from particular groups.

2.6. Application of the proposed condition relating to cost reflective payment types would require us to set out clearly the approach that we would take to allocation of particular types of cost. We invite views on the appropriate approach to cost allocation including, in particular, allocation of costs of bad debt (which is relevant specifically in the context of a provision relating to cost reflective payment types).

#### *Objective justification*

2.7. As well as considering cost differences, there may be a range of other potential justifications for price discrimination, such as social or environmental considerations. We invite views on whether these are appropriate issues to consider in relation to objective justification. We also invite views as to how these exceptions might be captured in either licence conditions or guidelines.

#### *Materiality and proportionality*

2.8. We need to ensure any measures we take to address unfair price differentials are proportionate, which would require using discretion on whether any potential breach is material or not. In considering materiality, the price differential would need to be substantial, extensive and persistent. We would be more likely to consider an unfair price differential to be material if it disproportionately impacted on vulnerable consumers.

2.9. We invite views on whether it would be beneficial to give a clear indication of materiality thresholds either on the face of any licence conditions or in guidance. While we see benefits in providing greater certainty, there is a risk that setting a lower limit to materiality might invite persistent low levels of undue price discrimination. On the basis that we would not seek to penalise a supplier unless there was a clear breach, we are currently minded not to specify materiality thresholds.

#### *Enforcement*

2.10. As set out earlier, Ofgem would look to supplement any new licence conditions with appropriate guidance, both on interpretation and enforcement.

2.11. In deciding whether to take enforcement action in any particular case we would have regard to the principles set out in the guidance relating to the interpretation

and application of the licence conditions. We would also have regard to the prioritisation criteria set out in our enforcement guidelines.<sup>1</sup> These make clear that in considering the case for enforcement one of the factors we would take into account is the scale of any consumer detriment.

2.12. Consistent with the principles of better regulation, we would seek to be proportionate in any enforcement action we took.<sup>2</sup> Where a breach would not be apparent to a diligent licensee then our statutory 'Statement of policy with respect to financial penalties' makes clear that this would militate against the imposition of a financial penalty. For example, therefore, where a breach would be dependent on a particular approach to cost allocation that Ofgem had not previously set out in guidelines or raised with the supplier then it is unlikely we would move straight away to impose a penalty. In such cases we would either raise the matter informally with the supplier first or, in more significant cases, would issue a Provisional Order to secure compliance. A penalty would only be likely in such cases if the supplier chose to ignore any guidance or informal warnings given by Ofgem.

2.13. To further reduce the potential for regulatory uncertainty associated with our proposals (other than relative price controls), it has been suggested to us that we could introduce a specific mechanism for resolving apparent unfair price differentials. This could take the form of a multi-stage process, as set out below:

- If Ofgem perceives a differential that it believes to be potentially non-compliant with the licence conditions, it would issue to the supplier in question a "notice of potential objection" setting out the concern.
- The supplier would be required to respond to Ofgem within a reasonable period either justifying the differential or proposing adjustments to it.
- If Ofgem were not satisfied with the supplier's justification or proposed actions, it would issue a "notice of objection" giving reasons and requiring the differential to be adjusted within a certain time period to the extent specified in the notice. A notice could also require remuneration of harmed customers, if appropriate.
- Failure to comply with a notice of objection would lead to Ofgem taking action for a licence breach and the company would then, and only then, be liable to financial penalties.

2.14. Such an approach could reduce the regulatory risk for suppliers in making price changes and introducing new tariffs. In doing so, this could help limit the potential impacts on innovation and competition. On the downside, such an approach could undermine the incentive on suppliers to comply with the licence condition, thereby risking repeated infringements.

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<sup>1</sup> Enforcement guidelines on complaints and investigations, September 2007 (Ref: 232/07)

<sup>2</sup> The Gas and Electricity Acts also make clear that Ofgem cannot take enforcement action under its sectoral powers if it would be more appropriate to take action under the Competition Act.

2.15. We invite views on whether it would be beneficial to introduce a new enforcement process for any of the proposed licence conditions set out in the document and, if so, whether that should be of the form set out here. We also invite views on whether there are any other considerations in relation to the detail of how such arrangements might work.

### **Scope**

2.16. We invite views on whether the possible licence conditions set out in this document should apply to all suppliers active in the market for domestic consumers - or only to a subset of these suppliers, such as the Big 6.

### **Duration**

2.17. As outlined earlier, we are of the initial view that some of the possible licence conditions on which we are consulting here may only be needed as an interim measure. We would expect the package of measures proposed in the Initial Findings Report to accelerate the transition of energy supply markets to fully effective competition such that, over time, those measures would be sufficient to guard against unfair price differentials.

2.18. We therefore propose that most of the proposed licence conditions would become inactive after a predetermined period unless a positive case was made for retaining or restoring them in a review of the status of retail market competition.<sup>3</sup> We are of the initial view that a period of less than three years would not allow sufficient time for the reforms identified in the Probe to be fully effective. Any longer than five years would appear to be too long.

2.19. We invite views on our proposal to review any licence conditions and on what a suitable time period would be before such a review.

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<sup>3</sup> Cost reflectivity of payment methods would remain in force.

### 3. Proposals for licence requirements

#### Chapter Summary

This chapter sets out a number of broad proposals for licence requirements to address unfair price differentials. It describes the specific features of each proposal and puts forward possible licence condition drafting. It then discusses the relative merits of each licence condition and invites views on a number of specific issues.

3.1. In seeking to address concerns over unfair price differentials, we have considered four broad proposals for licence requirements:

- A: Cost-reflective pricing between payment methods
- B: Prohibition of undue discrimination
- C: Relative price controls
- D: Prohibition of "cross subsidy" between gas and electricity supply

3.2. These proposals are not all mutually exclusive. Rather:

- Proposal A could be put in place without any of the further options. The Initial Findings Report proposed that, at a minimum, this condition will be implemented - as it better reflects the EC Directive requirements.
- Proposals B and C are alternatives and are mutually exclusive. Proposal B is broader than proposal A and may or may not encompass proposal A depending on the drafting of the condition (in this document, the drafting of proposal B does encompass proposal A). Proposal C is also broader than proposal A and may or may not encompass proposal A depending on the drafting of the condition (in this document, the drafting of proposal C does encompass proposal A).
- Significant differences in margins between gas and electricity supply are likely to be difficult to address through proposals A to C and therefore we may need to have an additional condition - proposal D - to deal with this issue. As such, proposal D may be brought into force alongside any of the other proposals.

3.3. These broad proposals are examined below. For each proposal, we give a description of the licence requirement, set out a possible draft licence condition and discuss how we would look to apply such a condition. We then discuss the relative merits of the each licence condition and set out specific issues.

3.4. We invite views on the relative merits of each of the proposals.

#### **Proposal A: Cost-reflective pricing between payment methods**

3.5. The Probe report proposed a new licence condition on suppliers requiring that differences in charges for different payment methods must be cost reflective. Ofgem is of the initial view that a clearer obligation would be helpful in order to ensure that suppliers do not maintain non-cost reflective price differentials, and this is consistent

with the requirements on cost reflectivity set out in the EC's Gas and Electricity Directives.<sup>4</sup> Including this obligation as an explicit licence condition and providing guidelines on interpretation and enforcement would, we believe, have the clear benefit of reducing uncertainty for both consumers and suppliers.

3.6. While consumers have choice between suppliers, they may not have a choice in terms of their payment method. For example, those without a bank account cannot pay by direct debit; customers that have poor credit profiles or those who are or have been in debt with their supplier may be restricted to PPMs. Others may use them for budgeting reasons (including, but not confined to, customers on low incomes) or use PPMs because of the type of housing they live in. As such, non-cost reflective premiums for standard credit (and, to a lesser extent, PPMs) affects vulnerable consumers disproportionately as they are more likely to pay by these methods – and less likely to have access to direct debit or online deals.<sup>5</sup>

3.7. A possible draft licence condition is set out in Box 1:

*Box 1: Possible Licence Condition - cost reflectivity of payment methods*

*1. Any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems.*

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

3.8. Chapter 2 describes some of the issues relating to how we propose to apply this licence condition in terms of assessing cost allocation and materiality, and how we propose to approach enforcement. However, a great deal more would need to be set out in guidance or in the licence condition (the above drafting adopts a simple "copy out" approach). Specifically, we envisage that suppliers would be required to ensure transparency on the amount per annum that relates to the payment type chosen by the customer. For example, it would need to be made clear precisely how much more the customer was paying because the payment method was standard credit, or PPM.

3.9. Secondly, we would need to set out clearly how we would assess whether the amount the customer is paying accurately reflected the costs of that payment method. This would require clear rules on cost allocation.

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<sup>4</sup> Directives 2003/54/EC and 2003/55/EC of June 2003 concerning common rules for the internal markets in electricity and gas.

<sup>5</sup> Energy Supply Probe - Initial Findings Report. See in particular Chapter 8.

3.10. This condition is targeted specifically at addressing unfair price differentials between payment methods. In this way, the condition reduces the risk of creating regulatory uncertainty and potentially adverse effects on competition or innovation compares to requirements targeting a wider range of unfair price differentials.

3.11. We acknowledge that there would be a regulatory burden for suppliers in ensuring compliance across the range of their tariffs.

3.12. We invite views on this proposed licence condition and, in particular, on the following issue:

- How would we best apply such a condition in order to minimise concerns over regulatory uncertainty and risks to competition and innovation?

### **Proposal B: Prohibition of undue price discrimination**

3.13. The Probe report stated that we would consider imposing a prohibition on undue discrimination. Such a condition would be designed to address situations where consumers are losing out through their inability to access particular tariff deals as a result of their personal circumstances, such as access to certain payment methods or where they live. As such, this proposal would go further than proposal A in its coverage, encompassing not just price differentials by payment type, but by any other customer characteristic too.

3.14. A possible draft licence condition is set out in Box 2. Condition 2(a) is an alternative to proposal A above.

*Box 2: Possible Licence Condition - prohibition of undue discrimination in supply*

- 1. The Licensee (taken together with its affiliates and related undertakings) shall not, in supplying or offering terms for the supply of [gas / electricity] to Customers, exercise undue discrimination between any persons (or classes of person).*
- 2. For the purpose of this Condition, undue discrimination includes but is not limited to:*
  - (a) offering terms to Customers paying by different payment methods where the differences in terms do not reflect differences in costs; and*
  - (b) offering terms to Customers in different geographical areas where the differences in terms do not reflect differences in costs.*
- 3. In this Condition "terms" means all terms on which a supply of [gas / electricity] is offered or provided, including terms as to price, which significantly affect the evaluation of that supply.*

3.15. We are aware that one risk with such an obligation is that it could lead to regulatory uncertainty, including lack of clarity over interpretation of the condition (which is potentially very wide-ranging) and uncertainty over how new types of tariff would be treated. For this reason, we would seek to minimise uncertainty by publishing guidance on how Ofgem would interpret the obligation. We set out below an indication of how we would be likely to interpret the meaning of undue discrimination.

3.16. In the context of this proposed condition, undue discrimination means offering different terms and conditions to different customers (or groups of customers) in equivalent circumstances without objective justification. Equally, undue discrimination could occur where there are differences in customers' circumstances but the terms and conditions do not reflect these relevant differences.

3.17. In assessing whether differences in tariffs are objectively justified, differences in costs may be a key factor. If there are features of a product that mean it is not accessible by certain customer groups, then the absence of cost reflectivity (in the differential compared to other tariffs that are available to all customers) would be likely to be viewed as discriminatory in the absence of any other justification.

3.18. Where differences in tariffs can be shown to reflect differences in the underlying costs of serving different groups of customers then such differentials would not breach the condition. Chapter 2 describes some of the issues relating to how we propose to apply this licence condition in terms of assessing cost allocation and materiality, and how we propose to approach enforcement.

3.19. By covering all forms of price discrimination, this condition would address most of the instances of unfair price differentials identified in the Probe report, including both payment method and in area/out-of-area differentials. It would be more wide-ranging than proposal A, as it would enable consideration of cases of discrimination on non-price grounds and would cover online deals.

3.20. In applying this condition, it should be possible to minimise any potential negative impacts on innovation and should maintain incentives on suppliers to reduce costs. However, such an approach has the potential to create regulatory uncertainty, particularly around interpretation and enforcement issues, which could have a detrimental effect on competition and innovation. As noted earlier, we would look to minimise this risk through providing appropriate guidance.

3.21. We acknowledge that there would be a regulatory burden on suppliers in implementing this licence condition. This would likely be greater than for proposal A, given the wider scope of this proposal.

3.22. We invite views on this proposed licence condition and, in particular, on the following issues:

- How would we best apply such a condition in order to minimise concerns over regulatory uncertainty, and risks to competition and innovation?

- Are there other non-price issues we should specifically seek to take account of?
- Could this sort of prohibition be used to address instances of cross subsidy between gas and electricity supply – or would an additional condition, such as an explicit prohibition on cross subsidy, be needed to address this issue?

### **Proposal C: Relative price controls**

3.23. The Probe report stated that we would consider a relative price control as one means of addressing unfair price differentials. Under this approach, Ofgem would set *ex ante* limits on the amount extra that suppliers could charge over a “benchmark” tariff to customers paying by different payment methods. A relative price control could also be used to put limits on the differences between ‘in area’ and ‘out of area’ prices.

3.24. A possible draft licence condition is set out in Box 3. If the model set out in the drafting were employed, it would be necessary to specify a price control for each separate form of price differential.

#### *Box 3: Possible Licence Condition - relative tariff differentials*

*1. The charge for [e.g. specify payment method] shall at any time be no greater than [X (% or £) per year] more than [a specified benchmark tariff, which may be the lowest tariff of a particular description offered by the supplier] in effect at that time.*

*2. For the purposes of paragraph 1, the degree of price differentials shall be assessed by calculating the amount payable under one tariff as against any other tariff over a period of one year and on the assumption of such consumption level or range of consumption levels as shall be published by Ofgem from time to time.*

3.25. A relative price control relating to payment methods only is, again, an alternative to proposal A above. Under such a condition, Ofgem would set *ex ante* limits on the amount extra that suppliers could charge over a certain “benchmark” tariff (for example, monthly direct debit) to customers paying by different payment methods. We would express this in terms of a limit on the fixed annual premium (or discount) on the total annual bill. The premium (or discount) would be set to reflect Ofgem’s assessment of the costs associated with providing the payment method in question. For example, we would expect the premium for PPMs over direct debit to be greater than that for standard credit over direct debit.

3.26. Under a relative price control relating to geographical areas, Ofgem would set *ex ante* limits on the differences in prices for equivalent tariffs offered to ‘in area’ and ‘out-of-area’ customers. We would most likely express this limit as a percentage, such that suppliers could only charge ‘in area’ customers a certain percentage more than their average ‘out-of-area’ prices for the same payment method and same consumption level. In setting this limit, we would need to balance fairness with the need to maintain sufficient flexibility for suppliers to compete.

3.27. We propose that each relative price control would last for a certain period of time, say 3 years, consistent with any sunset clause as discussed earlier. If the relative price controls were to be retained beyond this period, Ofgem would review and reset the limits that apply.

3.28. We propose that the relative price controls, if based on specified sums rather than percentages, would include an annual inflation adjustment - to avoid any systematic under-recovery of costs over the price control period as a whole. We also propose to allow for the price controls to be re-opened in certain circumstances, so we could revisit the differential limits in the light of developments (for example, if there was some sort of exogenous cost shift between reviews).

3.29. Relative price controls are arguably a transparent and simple form of regulation. By their nature, relative price controls would provide regulatory certainty for suppliers regarding compliance with the licence condition and would provide customers with greater clarity as to what to expect. Such a condition would also be easier for Ofgem to monitor and enforce than *ex post* measures such as proposals A and B.

3.30. Relative price controls would provide suppliers with an incentive to become more efficient, and would provide them with the flexibility to price below the limit set out in the control. The relative price control could also be set in a way that allowed some headroom, which could help to encourage competitive entry into the market.

3.31. On the downside, such controls could take longer to implement. We would need to carry out more work on the detail of the controls and would probably need another round of consultation before final proposals could be brought forward.

3.32. As with the other possible licence conditions outlined in this document, relative price controls have the potential to impact negatively on competition and innovation. For example, if the price limits were set too tight, then this might stifle innovation and the scope for competitive entry. However, this risk could be mitigated by providing headroom in the price limits. In addition, price controls could lead to an incentive on suppliers to reduce customer service to, for example, PPM and standard credit customers if the premium they are allowed to charge these customers is limited.

3.33. Any controls would require upfront regulatory intervention. This could include some costs for suppliers in providing the information needed to set the limits. Furthermore, any such controls would only target in advance of particular types of unfair price differential, so may not be as flexible to innovation in tariff types as proposals A or B.

3.34. We invite views on this proposed licence condition and, in particular, on the following issues:

- How would we best apply such a condition in order to minimise concerns over risks to competition and innovation?

- Which price differentials should be covered by relative price controls?
- How would we define the relevant benchmark tariffs by payment method and by geographical area?
- Would 3 years be a reasonable length for each price control period to last, after which time we would look to reset the differential limits (or should there be a firm sunset clause)?
- Under what circumstances should we allow the price controls to be re-opened?
- How would we take into account different consumption levels? Should the limit in relation to payment methods be expressed in a way that avoided the amount charged varying with consumption?
- Would a revenue cap be preferable to a relative price cap? This could involve a cap on the differential in terms of the extra revenue generated across customers as a whole for the tariff in question, rather than in terms of the extra charge made to an individual customer on that tariff. While this could allow suppliers more charging flexibility within tariff, we have concerns that it could be less effective than a price cap in protecting specific consumers, and could have further unintended consequences.

#### **Proposal D: Prohibition of "cross subsidy" between gas & electricity supply**

3.35. The Probe report identified that the five former incumbent electricity suppliers have consistently earned significantly higher margins on electricity supply than on gas. There are a number of reasons why margins may differ between electricity and gas, relating to the different nature of the commodities. For example, we note that gas margins are inherently volatile as they are affected by exogenous factors such as temperature, which can have a significant impact on overall demand. How margins are defined is also an issue. However, as a result, higher prices have tended to be charged to customers taking only electricity under a single fuel arrangement. This particularly disadvantages consumers that are not connected to the gas network, who are unable to move to a more competitively priced dual fuel deal.<sup>6</sup>

3.36. This issue could be characterised as one of implicit "cross subsidy". If so, the licence condition could take the form of a prohibition of cross subsidy of gas supply. This would be designed to tackle the significantly higher margins earned on electricity supply than on gas and hence address the situations where consumers are losing out, in particular those that are off the gas grid.

3.37. While the issue we are currently looking to address is in relation to the margins observed in electricity and how they impact on electricity-only customers, it is possible that a similar situation could also arise in gas, so we are seeking views on a licence condition that could cover both fuels.

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<sup>6</sup> Energy Supply Probe - Initial Findings Report. See in particular Chapter 8.

3.38. A possible draft licence condition (for the Electricity Supply Licence) is set out in Box 4.

3.39. This licence condition would effectively seek to ensure that margins earned by electricity suppliers on electricity and gas supply are broadly the same over a sustained period of time, so as to avoid any implicit cross subsidy. We would also look to introduce a reciprocal condition to deal with potential cross subsidy of electricity supply from gas supply.

*Box 4: Possible Licence Condition - prohibition of cross subsidy of gas supply*

- 1. The Licensee shall use its best endeavours to avoid a situation of significant implicit cross subsidy between the supply of electricity and the supply of gas.*
- 2. In this Condition "a situation of implicit cross subsidy" means a situation where, over a sustained period of time, the supplier earns a significantly greater gross profit margin in electricity supply than in gas.*

3.40. This licence condition would eliminate undue cross subsidy between electricity and gas supply. The resultant rebalancing of gas and electricity prices would reduce a potential barrier to entry into the supply markets, particularly in the areas of gas and dual fuel customers.

3.41. On the downside, such an approach has the potential to create regulatory uncertainty, which could have a detrimental effect on competition and innovation. As noted earlier, we would look to minimise this risk through providing appropriate guidance and through a proportionate approach to enforcement.

3.42. We acknowledge that there would be a regulatory burden for suppliers in implementing this licence condition, including the need to produce separate accounts for gas and electricity supply.

3.43. We invite views on this proposed licence condition and, in particular, on the following issues:

- Are there alternative ways to address the sustained high margins earned on single fuel electricity customers?
- Should we specify what represents a significant implicit cross subsidy or, as we have proposed, rely on the principle of materiality in order to decide?
- Would it be appropriate, as we have proposed, to introduce a reciprocal condition to deal with potential cross subsidy of electricity supply from gas supply?

## 4. Next steps

4.1. We invite views on our proposed licence conditions – and our initial impact assessment (see Appendix 2). We seek responses by Friday 20 February 2009.

4.2. Following this consultation we will seek agreement with suppliers on one or more of the proposed licence conditions – modified as appropriate in the light of comments received from stakeholders – which we will aim to propose formally by March 2009, so that they can benefit consumers as soon as possible. At a minimum, we will seek to introduce a condition to ensure cost reflectivity between payment methods. Subject to the result of this consultation, any proposed licence changes would ideally be through a collective licence modification subject to statutory consultation, failing which a reference to the Competition Commission may need to be considered.

4.3. We are continuing with the development of the other potential remedies set out in the Initial Findings Report in the light of responses to consultation on that document. Our current expectation is to report back on this consultation in the spring of 2009.

4.4. As we set out in the Initial Findings Report, we believe it is in the best interests of consumers to realise early implementation of potential remedies through agreement with the major suppliers. If, at any point, it becomes apparent that the prospect of reaching agreement with the companies on the broad range of matters is unlikely to be achieved, the Authority will consider alternative options, which include a reference to the Competition Commission for a Market Investigation or licence modifications.

## Appendices

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## Appendix 1 - Responses to Ofgem's Initial Findings Report

1.1. Ofgem received a wide range of responses to our Initial Findings Report. Respondents to the findings and proposals on unfair price differentials were mainly either suppliers or consumer organisations and representatives. The views expressed are summarised below.<sup>7</sup>

### *Views on Probe findings*

1.2. Respondents did not challenge our core observation on price differentials that cannot be justified by cost differences - or on the differences in margins between electricity and gas supply. Indeed, the responses of the Big 6 suppliers broadly confirmed our analysis and accepted that there were issues in relation to price differentials. Many suppliers noted that they were looking to improve the cost reflectivity of their tariff differentials.

### *Views on proposed remedies*

1.3. The consultation identified a range of views on the proposal to introduce licence changes to address unfair pricing features.

1.4. While many suppliers accepted the principle of broad cost reflectivity in the setting of tariffs, most suppliers - large and small - had some concerns with the proposals. These concerns primarily related to the way in which any licence conditions would be applied in practice and the potential risks to competition and innovation in the market.

1.5. Suppliers generally argued that rigid application of any licence requirements - particularly in relation to cost reflectivity - could reduce incentives to innovate and distort competition. As such, they stressed that care would be needed in applying any conditions to avoid undermining competition and innovation. For example, it was suggested that there would need to be some flexibility in the application of any regulatory rules and, in particular, that cost reflectivity would need to be interpreted broadly - to reflect the fact that cost differences are dynamic and that price differentials are based on forward-looking costs and risks.

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<sup>7</sup> Copies of non-confidential responses to the Initial Findings Report can be found on the Ofgem website at:  
<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx>.

1.6. More broadly, there were concerns that measures designed to reduce price differentials could stifle the development of the competitive market. Some suppliers noted that smaller differentials could lower the incentives for consumers to switch supplier, leading to lower churn rates and a reduction in competitive pressure on suppliers.

1.7. One supplier requested that any licence requirements be accompanied by guidance on how they would be implemented by Ofgem, in particular relating to our approach to enforcement, cost allocation and materiality. In addition, it was argued that Ofgem should take a light touch approach to enforcement of any conditions and focus on big, persistent instances of unfair price differentials.

1.8. Some suppliers noted potential unintended consequences of regulatory action, including potential price rises for some vulnerable customers.

1.9. Consumer organisations and representatives supported the proposals, citing in particular the potential benefits for vulnerable consumers and the potential to improve the prospects for new entrants and smaller suppliers. Some recommended that Ofgem prioritise measures to address concerns affecting PPM and standard credit customers and the treatment of single fuel electricity customers.

1.10. Consumer groups stressed the importance of considering the efficient level of costs in assessing any differentials.

## Appendix 2 - Initial Impact Assessment

1.1. Ofgem has a duty under the Utilities Act 2000 to publish an impact assessment when conducting a statutory consultation on certain proposed licence modifications.<sup>8</sup> This document does not represent a statutory consultation. Nevertheless, the analysis set out in this appendix constitutes our initial assessment of the impact of the proposals outlined in the document - in line with best regulatory practice.

1.2. We invite views on the issues discussed below. Respondents are encouraged to give an indication of the magnitude where they identify costs and benefits. We acknowledge, however, that there is a significant qualitative element to this assessment and that it may not be possible to quantify many of the secondary impacts and costs of these proposals. We are hopeful that this consultation will help to firm up the detail of this impact assessment.

### Summary

1.3. Ofgem's recent Probe into GB energy supply markets proposed changes to supply licences to address unfair price differentials for domestic consumers. Building on responses to our Initial Findings Report, this document invites views on a number of broad proposals for licence requirements.

### Objectives

1.4. In proposing action, our overall objective is to be effective in addressing unfair price differentials, particularly where vulnerable consumers are adversely affected. However, we aim to do this in a proportionate way that doesn't undermine the development of competition. Specifically, we aim to:

- Maintain the incentives and scope to compete, innovate, reduce costs and promote sustainability
- Avoid undue regulatory risk and uncertainty
- Avoid a disproportionate regulatory, compliance and enforcement burden
- Provide for the removal of licence requirements if they become superfluous once the other initiatives identified in the Probe have had time to have an effect

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<sup>8</sup> Guidance on Impact Assessments, Ofgem, March 2008

**Options**

1.5. In seeking to address concerns over unfair price differentials, we have considered four broad proposals for licence requirements:

- A: Cost-reflective pricing between payment methods
- B: Prohibition of undue discrimination
- C: Relative price controls
- D: Prohibition of cross subsidy between gas and electricity supply

**Impacts on consumers**

1.6. Our Initial Findings Report showed that unfair price differentials were a significant and persistent feature of gas and electricity pricing.<sup>9</sup> We would, therefore, expect the proposals outlined in this document to have a significant impact on consumer bills to the extent that these measures prohibit such undue discrimination.

1.7. It could be argued that the current level of pricing to dual fuel, out-of-area customers paying by direct debit reflects the competitive level of pricing in the retail energy market. If this were the case, we would expect consumers to benefit in aggregate to the extent of the undue discrimination addressed by these measures. However, the current level of pricing could reflect an implicit cross subsidy from other, less price-sensitive consumers, such that it is actually below the level we would expect from a fully competitive market. As a result, the erosion of price differentials may be through a rebalancing between prices rather than by a straightforward decrease in price for the most impacted customers.

1.8. Some suppliers have recently made changes to some of their price differentials, so the impact of these proposals could be reduced to the extent that those price changes improve cost reflectivity. If Ofgem were not to take action, there is no guarantee that any recent progress will not be reversed. The potential impact on consumers of each proposal is discussed below.

*Proposal A*

1.9. The Initial Findings Report highlighted that a number of price differentials between payment types do not appear to have a cost justification - particularly for those customers who pay by standard credit. The Report also noted that price differentials for PPM customers did, on average, reflect cost differences. However, there is variation between suppliers and some PPM customers still pay a larger premium than is justified by the costs incurred.

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<sup>9</sup> Energy Supply Probe - Initial Findings Report, paragraph 1.17

1.10. We would expect proposal A to lead most suppliers to make adjustments to their relative prices between payment methods. We would expect to see some price reductions, particularly for many standard credit customers. Standard credit is a particularly important payment method for vulnerable consumers. For example, we note that 50 per cent of the fuel poor using this route to settle their bills. In addition, standard credit tends to be used by over-65s and households in social group DE. We would also expect to see price reductions for some of the highest consuming PPM customers, a group which includes many fuel poor. Vulnerable consumers are disproportionately represented among PPM customers.

1.11. We would also expect to see prices increase for certain payment methods, in particular for some direct debit customers. We note it is possible that prices could increase for some PPM customers, particularly for those at low consumption levels. The aggregate impact on prices would likely be broadly neutral - reflecting largely a rebalancing of tariffs.

### *Proposal B*

1.12. We would expect proposal B to lead to a broadly similar impact on consumers as proposal A as regards relative prices between payment methods.

1.13. The Initial Findings Report highlighted that the five former incumbent electricity suppliers charge electricity customers in their former monopoly areas ('in area' customers) an average of over 6 per cent higher prices than comparable 'out-of-area' customers. We found no cost basis for this premium. As such, we would expect proposal B to also lead to a rebalancing of 'in area' and 'out-of-area' prices.

1.14. Based on September 2008 data, if 'in area' and 'out-of-area' electricity prices (net of network charges) were equalised in a revenue neutral manner<sup>10</sup>, we would expect prices for around 8 million 'in area' customers to fall on average by around 1.5 per cent (or £6 off the average annual bill). Many of these consumers will be off the gas grid, live in rural areas and are more likely to be fuel poor. For around 2.5 million 'out-of-area' customers, prices would be expected to rise on average by around 5 per cent (or £18 on the average annual bill).<sup>11</sup> We note that it is possible that some 'in area' customers could see small price increases. Again, the aggregate impact on prices is likely to be broadly neutral.

1.15. We note it is possible that there could be impacts on other tariff types, for example online tariffs.

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<sup>10</sup> Such that suppliers' total revenues from their electricity customers remained unchanged.

<sup>11</sup> There is significant variation between suppliers' 'in area' and 'out-of-area' differentials. The range of reductions in 'in area' prices would be expected to be between zero and 4 per cent, and the range of increases in 'out-of-area' prices would be between 2 and 8 per cent. These numbers are all based on prices as of September 2008.

*Proposal C*

1.16. The impact of proposal C on consumers would depend on which price differentials were subject to price controls. For price controls relating to price differentials between payment methods, we would expect to see a broadly similar impact on prices as set out under proposal A. However, the actual impact would depend on the tightness of the relative price cap (and, as such, the degree of flexibility for suppliers to price under the prescribed limits on price differentials). In addition, the imposition of a single limit for each differential across suppliers could lead to less efficient suppliers facing lower margins on their differentials compared to more efficient suppliers.

1.17. For price controls relating to price differentials between geographic areas, we would expect to see a broadly similar impact to that under proposal B (though, again, this would depend on the tightness of any relative price caps).

*Proposal D*

1.18. In the Initial Findings Report we estimated that, based on 2007 data, if in area margins earned in gas and electricity were equalised, electricity prices would need to fall by around 14 per cent and gas prices rise by around 6 per cent.<sup>12</sup> Several suppliers have recently announced price changes designed to narrow this differential, so the impact of this proposal would likely be somewhat less than indicated here.

1.19. We would expect this measure to disproportionately benefit vulnerable consumers, as many of those seeing price reductions will be electricity-only customers, who - as noted above - are far more likely than others to be fuel poor.

1.20. We invite views on the potential impacts on consumers of these proposals.

**Impacts on competition**

1.21. These proposals have the potential for both positive and negative impacts on competition in supply markets.

1.22. As noted in this document, and highlighted by responses to our Initial Findings Report, intervention runs the risk of undermining competition and innovation to various degrees by reducing suppliers' scope to compete with each other. Reducing price differentials could also lower the incentives for consumers to switch, and therefore reduce the competitive pressure brought about by customer churn.

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<sup>12</sup> Energy Supply Probe - Initial Findings Report, paragraphs 8.67 to 8.69

1.23. It is possible that intervention could improve competitive pressure in some ways. It is possible that discriminatory pricing - by allowing suppliers to recover costs disproportionately from less price-sensitive customers - can reduce competitive pressures on suppliers (as they can focus their competitive tariffs only on certain segments of the market) and make it more difficult for new entrants to grow their businesses profitably. Regulatory intervention could improve competition between suppliers, in particular by improving the prospects for new entrants and small suppliers because margins for the most price sensitive and active segments would improve to levels that may make market entry profitable.

1.24. It is important to reiterate that we are proposing action significantly for consumer protection reasons and, even then, only as a temporary measure while other pro-competitive remedies have time to take effect. We are also consulting on ways to ensure that regulation is as light touch as possible, so as to minimise the risks to competition.

#### *Proposal A*

1.25. It is possible that proposal A could help promote competition, for example by improving margins in the market for direct debit customers and thereby providing headroom for new entrants.

1.26. On the downside, this proposal could have adverse effects on competition by creating regulatory uncertainty and potentially reducing incentives to innovate. This potential impact is likely to be lower than under proposals B and C, given the broader scope of those requirements in terms of the range of differentials covered. As noted earlier, however, we consider that if we were to produce clear guidelines to accompany such a licence condition, this would help minimise these risks.

#### *Proposal B*

1.27. It is possible that proposal B could help promote competition, for example by improving margins in the market for 'out-of-area' customers and thereby providing headroom for new entrants.

1.28. On the downside, this proposal has the potential to create regulatory uncertainty, particularly around interpretation and enforcement issues, which could have a detrimental effect on competition and innovation. Again, we would look to minimise this risk through providing appropriate guidance.

#### *Proposal C*

1.29. Proposal C could have similar potential competition benefits as proposals A and B, including in terms of providing headroom for new entrants (depending on the level at which relative price caps were set).

1.30. On the downside, as for any form of price controls, this proposal has the potential to impact negatively on competition. Depending on the level at which relative price caps were set, there could be an adverse impact on new entrants.

#### *Proposal D*

1.31. Proposal D could help promote competition, particularly in the gas supply market. Increased margins on gas supply could create more scope for competitors and new entrants to enter the market profitably (though not the dual fuel market).

1.32. On the downside, this proposal has the potential to create regulatory uncertainty and could have a detrimental effect on competition and innovation, albeit likely less than any such effect from the other proposals. As noted earlier, we would look to reduce this risk through providing appropriate guidance and through a proportionate approach to enforcement.

1.33. We invite views on the potential impacts on competition - and on small suppliers - of these proposals.

### **Impacts on sustainable development**

1.34. The unfair price differentials identified in the Initial Findings Report have a disproportionate impact on vulnerable groups. In seeking to address these issues, we would expect these proposals to have a significant positive impact on sustainable development, by supporting the theme of eradicating fuel poverty and protecting vulnerable consumers. As highlighted in the earlier discussion on impacts on consumers, many vulnerable consumers stand to benefit from lower prices. Furthermore, by leading to price reductions for many of the fuel poor, these proposals would be expected to lead to lower levels of debt and disconnection.

1.35. We are aware of the potential impact on energy efficiency and environmental initiatives, such as green tariffs and integrated energy services offerings. We invite views on whether there is anything in the proposals outlined that would preclude the development of such tariffs and similar innovations.

1.36. We invite views on whether these proposals would have a significant impact on other sustainable development themes (managing the transition to a low carbon economy, promoting energy savings, ensuring a secure and reliable gas and electricity supply and supporting improved environmental performance).

### **Impacts on health and safety**

1.37. We believe that these proposals would not have a significant impact on health and safety. Nevertheless, we invite views on the potential impacts on vulnerable consumers as part of the sustainable development criteria noted above.

**Risks and unintended consequences**

1.38. As outlined in the discussion of impacts on competition, in addition to having the potential to promote competition, all of the proposals could - to differing degrees - have unintended consequences. These could, despite our best efforts to mitigate any impacts, include an adverse impact on competition (in the form of less competitive rivalry or reduced prospects for new entry), less product innovation and less incentives on suppliers to be cost efficient. Another potential unintended consequence of proposals A to C is that they could lead to an excessive focus on price, which could in turn lead to suppliers reducing their quality of service in certain areas.

1.39. In terms of the potential impacts on prices, several assumptions are made. A key assumption used for illustrative purposes is that action to address regional price differentials and differences in margins between gas and electricity supply would lead suppliers to rebalance their prices across customers in a revenue neutral way. Whether this assumption would hold in practice would depend on the effectiveness of competition in the markets and the impact on competition of the measures themselves. There is a risk that if our assessment of the effectiveness of competition in the more active segments of the market is overly optimistic, then prices could be rebalanced in such a way as to lead to an overall increase in margins. However, as outlined earlier, it is also possible that the more competitive segments of the market will provide an effective discipline on the less price-sensitive segments of the market, leading to a net reduction in the average level of prices.

1.40. These proposals could also lead to price increases for some vulnerable customers, for example those paying by direct debit, gas customers of the five former incumbent electricity suppliers and those who take electricity from one of the five former incumbent electricity suppliers that is not the former incumbent for their region (i.e. they represent an 'out-of-area' customer).

1.41. We invite views on the risks and potential unintended consequences of these proposals.

**Other impacts**

1.42. We would expect there to be some costs to suppliers of implementing any of the proposals. These could include: one-off costs of adjusting prices to ensure compliance with any new licence requirements; and ongoing costs of ensuring compliance in the context of future pricing rounds. We would expect these costs to be higher under proposal B than proposal A given the wider range of differentials covered. Proposal C would require upfront input from suppliers in order to enable Ofgem to set the price controls in the first place.

1.43. We would expect all the proposals to have some resource implications for Ofgem. Proposal C would involve further work to establish a framework for the relative price controls and to set the initial limits.

1.44. We invite views on the existence and magnitude of the cost of implementing these proposals.

### **Post-implementation review**

1.45. We would expect to evaluate the impacts of any of these proposals in a number of ways, including through our regular market monitoring activities and through investigations into specific complaints.

1.46. As outlined earlier, we would envisage that some of the possible licence conditions on which we are consulting here may only be needed as an interim measure. Therefore, we would propose that the licence conditions would become inactive after a predetermined period unless a positive case was made for retaining or restoring them in a review of the status of retail market competition.

1.47. We invite views on whether such a sunset clause would be appropriate and on what a suitable time period would be before any review of the market.

### **Conclusion**

1.48. Proposal A would better implement EC Directive requirements on cost reflectivity between payment methods, would likely benefit a significant number of vulnerable consumers and would involve the least potential negative impacts on competition and innovation of any of the proposals.

1.49. Proposal B would be likely to have a greater consumer impact by tackling a broader range of unfair price differentials and, in doing so, could remove more potential impediments to competition. However, this proposal would have potentially greater negative impacts on competition and innovation given its broader scope.

1.50. Proposal C would likely have a broadly similar impact on prices as proposals A and B (depending on how any relative price caps were set) and, compared to the other proposals, would provide greater regulatory certainty for suppliers. However, this proposal would have potential negative impacts on competition and innovation, as well as greater up-front regulatory costs.

1.51. Proposal D would benefit single fuel electricity customers, including a significant number of vulnerable consumers, and has the potential to improve the scope for competition in the gas supply markets. However, it could also have small negative impact on competition and innovation - though less than the other options.

1.52. Ofgem is not minded to propose a preferred proposal at this stage. Instead, the aim of this document is to consult on views in order to facilitate a fuller impact assessment, which would be published alongside any statutory consultation. Final decisions will be taken in the light of Ofgem's statutory duties.

## Appendix 3 - Consultation Responses and Questions

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. We would especially welcome responses to the specific questions which we have set out in each chapter and which are replicated below.

1.2. Responses should be received by 20 February 2009 and should be sent to:

**Neil Barnes**

Ofgem  
9 Millbank  
London  
SW1P 3GE  
[energysupplymarketsp@ofgem.gov.uk](mailto:energysupplymarketsp@ofgem.gov.uk)

1.3. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website [www.ofgem.gov.uk](http://www.ofgem.gov.uk). Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. Respondents who wish to have their responses remain confidential should clearly mark the document(s) to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

### *Consultation questions*

#### **CHAPTER: Two**

Question 1: In proposing action, are the overall aims we set out appropriate? Are there other issues we should focus on in taking a decision on the best way to proceed in this matter?

Question 2: What is the appropriate approach to cost allocation?

Question 3: Are social or environmental issues appropriate to consider in relation to objective justification? How might these exceptions be captured in either licence conditions or guidelines?

Question 4: Would it be beneficial to give a clear indication of materiality thresholds either on the face of any licence conditions or in guidance?

Question 5: Would it be beneficial to introduce a new enforcement process? If so, should this process be of the form set out in this document? Are there any other considerations in relation to the detail of how such arrangements might work?

Question 6: Should the proposals for licence requirements set out in this document apply to all suppliers active in the market for domestic consumers - or only to a subset of these suppliers, such as the Big 6?

Question 7: Would a sunset clause be appropriate for any licence conditions? What would be a suitable time period before any review of the market?

### **CHAPTER: Three**

Question 1: What are the relative merits of each of the proposals for licence requirements?

#### *Proposal A*

Question 2: How would we best apply such a condition in order to minimise concerns over regulatory uncertainty and risks to competition and innovation?

#### *Proposal B*

Question 3: How would we best apply such a condition in order to minimise concerns over regulatory uncertainty, and risks to competition and innovation?

Question 4: Are there other non-price issues we should specifically seek to take account of?

Question 5: Could this sort of prohibition be used to address instances of cross subsidy between gas and electricity supply – or would an additional condition, such as an explicit prohibition on cross subsidy, be needed to address this issue?

#### *Proposal C*

Question 6: How would we best apply such a condition in order to minimise concerns over risks to competition and innovation?

Question 7: Which price differentials should be covered by relative price controls?

Question 8: How would we define the relevant benchmark tariffs by payment method and by geographical area?

Question 9: Would 3 years be a reasonable length for each price control period to last, after which time we would look to reset the differential limits (or should there be a firm sunset clause)?

Question 10: Under what circumstances should we allow the price controls to be re-opened?

Question 11: How would we take into account different consumption levels? Should the limit in relation to payment methods be expressed in a way that avoided the amount charged varying with consumption?

Question 12: Would a revenue cap be preferable to a relative price cap?

*Proposal D*

Question 13: Are there alternative ways to address the sustained high margins earned on single fuel electricity customers?

Question 14: Should we specify what represents a "significant implicit cross subsidy" or, as we have proposed, rely on the principle of materiality in order to decide?

Question 15: Would it be appropriate, as we have proposed, to introduce a reciprocal condition to deal with potential cross subsidy of electricity supply from gas supply?

**APPENDIX: Two**

Question 1: What are the potential impacts of the proposals set out in this document? Where possible, please indicate the magnitude of any impacts.

Question 2: What are the potential impacts on consumers of these proposals?

Question 3: What are the potential impacts on competition of these proposals? What are the potential impacts on small suppliers?

Question 4: Would these proposals have a significant impact on sustainable development? In particular, is there anything in the proposals that would preclude the development of green tariffs, energy services offerings and similar innovations?

Question 5: What are the potential impacts on health and safety of these proposals?

Question 6: What are the risks and potential unintended consequences of these proposals?

## Appendix 4 - The Authority's Powers and Duties

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

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.<sup>13</sup>

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly.<sup>14</sup>

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

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

- The need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- The need to secure that all reasonable demands for electricity are met;
- The need to secure that licence holders are able to finance the activities which are the subject of obligations on them<sup>15</sup>; and
- The interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>16</sup>

<sup>13</sup> Entitled "Gas Supply" and "Electricity Supply" respectively.

<sup>14</sup> However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

<sup>15</sup> Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

<sup>16</sup> The Authority may have regard to other descriptions of consumers.

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

- Promote efficiency and economy on the part of those licensed<sup>17</sup> under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- Protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- Contribute to the achievement of sustainable development; and
- Secure a diverse and viable long-term energy supply.

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

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

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation<sup>18</sup> and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

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<sup>17</sup> Or persons authorised by exemptions to carry on any activity.

<sup>18</sup> Council Regulation (EC) 1/2003

## Appendix 5 - Glossary

### **B**

#### *Barrier to entry*

A factor that may limit a firm's ability to enter the market.

#### *Barrier to expansion*

A factor that may limit a firm's ability to increase in size or scope.

#### *Big 6*

The name collectively given to the six companies that supply most of the energy to domestic households in the GB market. They are: Centrica plc (three retail brands, British Gas, Scottish Gas and Nwy Prydain in England, Scotland and Wales respectively), E.ON UK, Scottish and Southern Energy (SSE), RWE npower, EDF Energy and ScottishPower.

### **C**

#### *Churn*

In this report churn represents the number of customers moving away from a supplier to a new supplier (suppliers' customer losses) as a per cent of the total number of that class of customer.

#### *Cross subsidy*

The part financing of one product or activity by another.

### **D**

#### *Direct debit*

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

#### *Dual Fuel*

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

**F***Former incumbent electricity supplier*

The previous Public Electricity Supplier (PES) for one of the 14 electricity regions in England, Wales and Scotland.

*Fuel poor*

Those households who need to spend more than 10% of their annual income on fuel to maintain an adequately heated home.

**G***Green tariffs*

An energy tariff which is marketed as having environmental credentials.

**I***In-area customers*

Customers of an electricity supplier who are located within the supplier's original ex-PES region.

*Incumbent*

An incumbent is the company of the former monopoly supplier in a particular region. The incumbent in each region for electricity is known as the ex-PES. British Gas (Centrica) is the incumbent in the gas market.

**N***New entrant*

An entrant that does not have an incumbent customer base.

**O***Out-of-area customers*

Customers of an electricity supplier who are located outside of the supplier's original ex-PES region.

**P***Prepayment meter (PPM)*

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

*Price differential*

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

*Price discrimination*

Occurs when different prices are set for different consumers or groups of consumers for the same good or service for reasons not associated with the costs of production.

**S***Small suppliers*

Suppliers that operate in the gas and electricity market but only have a small market share.

*Social groups DE*

DE is a reference to the ABC1C2DE system of socio-economic classification. DE groups two categories that include partly skilled or unskilled people as well as the unemployed and can be viewed as the most vulnerable groups in this classification system.

*Standard Credit*

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

## Appendix 6 - Feedback Questionnaire

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

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

1.2. Please send your comments to:

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London

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