

COMMENTS ON OFGEM'S CONSULTATION ON "ADDRESSING UNFAIR PRICE DIFFERENTIALS"

(A) Introduction

The purpose of this note is to provide high level comments on Ofgem's consultation on "Addressing unfair price differentials".

The explicit purpose of the proposals is one of consumer protection, in other words to protect vulnerable consumers, which is a legitimate objective for Ofgem. We would note that the Initial Findings Report would not justify any action by Ofgem under the Competition Act.

We agree with all those remedies proposed in the Initial Findings Report, in particular Action items 1 and 2, which are designed primarily towards making competition work better through encouraging more consumers to participate actively in the market and improving the quality and accessibility of information available to consumers.

Given that Ofgem believes it necessary to introduce consumer protection measures to address vulnerable consumers we agree with the specific aims set out in para 2.1 of the consultation document. Our concerns arise from the considerable difficulties faced by Ofgem in designing consumer protection measures which are capable of both delivering the consumer protection objectives whilst at the same time not leading to a muting of competition and reduction in innovation.

In addition, there will be a significant increase in the regulatory burden upon suppliers and a significant burden on Ofgem in providing initial general guidance and specific guidance to individual suppliers and in monitoring and enforcing the proposed licence conditions. They would increase the regulatory risk for suppliers. However, there will be incentives for suppliers to increase efficiency and achieve cost reductions in serving their customer. Our principal concern may be summarised by saying that in going forwards suppliers will be competing with their hands loosely tied behind their back.

(B) Consequences of action

Given that Ofgem did not find that suppliers were charging excessive prices or benefited from excessive margins it appears that the likeliest responses by suppliers would not entail any overall price reductions but would be revenue neutral. In other words there will simply be a rebalancing of tariffs producing the same overall revenue.

In any event, it is unlikely that Ofgem would wish to see any diminution in suppliers margins or profitability given that it will be relying upon those suppliers to make the very significant investments in new generation capacity which will be required going forward.

If this assumption proves to be correct then the industry response to the proposals which are adopted will produce groups of consumers who are both winners and losers. It is intended that the winners will be in the most vulnerable consumer groups whilst the losers are likely to be the most proactive and price conscious consumers.

(C) **Competitive dynamic**

The reasons for the difference between electricity and gas margins and between electricity and gas prices in and out of area are both logical and understandable. Any electricity incumbent competing out of area will need to price at a reasonable discount to the incumbent to win business. As far as its in area electricity pricing is concerned it knew that it would face increasing competition from Centrica and other electricity suppliers and would need to manage and contain the loss of customers and where necessary to fight to win back lost customers. Thus, any attempt to limit the bands within which a supplier can price electricity in and out of area will limit its ability to compete out of area and win new customers but limit the ability of other suppliers to win new customers in its area. Although consumers say price is the main reason for switching it is apparent from the Initial Findings Report that many other factors influence switching decisions. A number of proposals would see on-line, dual fuel and direct debit tariffs increasing with standard credit tariffs decreasing. This reduction in the likely savings to be gained from switching is likely to mute the preparedness to switch.

If Proposal D were to be adopted this would remove any cross-subsidy between gas and electricity and would obviously lead to an increase in gas prices and a potential reduction in the margins for electricity. It is perfectly rational behaviour for electricity suppliers to price gas at a lower margin than their core electricity business. Gas supply is a tool to use in competing with Centrica in area and competing against the incumbent and Centrica with dual fuel offers out of area. Dual fuel offers are plainly very popular amongst consumers. Apart from Centrica none of the other suppliers is vertically integrated upwards in gas supply but buy gas on the wholesale market. A reasonable analogy may be supermarkets selling petrol. Large supermarkets would sell petrol at low or negligible margin (sometimes at a loss) both to retain and attract customers through their stores. Just as supermarkets buy petrol at wholesale market so do electricity companies buy gas in the wholesale market. It appears the case that electricity suppliers make a reasonable margin on their electricity supplies. In effect the result of the cross-subsidy rule would be to increase the price of gas which seems an inappropriate result of an exercise designed to protect vulnerable customers. There is nothing inherently wrong with cross-subsidy in these circumstances and certainly no grounds for action by Ofgem under the Competition Act. Indeed, in the past Ofgem's predecessors have refused to take action in relation to other cross-subsidy concerns which it has examined.

Hence, our concern that the different proposals will in different ways be likely to mute the extent of competition and therefore reduce the level of switching. It is for Ofgem to weigh-up whether the potential detriments from the loss of competition are out-weighed by the benefits in terms of protecting vulnerable consumers. In particular it should examine whether there are any more finely tuned measures which may deal with the most important differentials adversely impacting vulnerable customers.

One of the benefits of a competitive market, as Ofgem has recognised, has been the development of a range of new and innovative tariffs. Given that the different proposals will lead to considerable scrutiny of tariffs and their relationship to one another, these

proposals are likely to act as a disincentive to the introduction of new tariffs, and therefore in the level of competition as between the different suppliers.

Ofgem seemingly fear that one of the consequences of some of the proposals may be a reduction in the quality of service. However, it is equally likely that one of the consequences will be a focus on non-price competition. Also there may be scope for suppliers seeking to provide benefits in the form of discounts to customers from the supply of other services. Whilst Centrica may have abandoned its widely based service offering - telephone, the AA and credit cards, is conceivable that suppliers may look to provision of other related services which may give them the opportunity to provide implicit or explicit discounts targeted to particular customer groups.

(D) **Key issues**

We set out below our brief comments on the key issues identified by Ofgem in Chapter 2 of the consultation paper.

Cost allocation

It is desirable for Ofgem to give as much clarity as possible to the principles which it will apply in dealing with cost allocation. This is particularly important as cost allocation is both an art and a science and a number of suppliers may not have sought hitherto to allocate costs by payment method or by area and as between gas and electricity. Accordingly, Ofgem should give as much clarity as possible in public guidance. It goes without saying that Ofgem should first produce draft guidance on its proposed approach for proper consultation.

Two important issues are bad debt and the costs of acquiring and retaining customers. In principle if there are material differences between bad debts as between different payment methods then those costs should be attributable to that payment method. Similarly, if different sales methods/campaigns are used for different routes to market or customer groups, the relevant costs to acquire/retain customers should be allocated accordingly.

Materiality and proportionality

We believe that clear guidance needs to be given as to whether a breach is material. Ofgem state in para 2.8 that a "price differential would need to be substantial, extensive and persistent". In addition, Proposal B refers to "undue price discrimination". In other words it is not sufficient for there to be price discrimination but such discrimination has to be "undue". Proposal D uses "significant". Given the substantial penalties which may flow from a breach of any of these licence conditions we believe that it is imperative that guidance be given as to the meaning of these crucial terms. If guidance is not given that may mean that suppliers may be more conservative than they might otherwise be. Whilst we understand Ofgem's concern that suppliers might take advantage of the materiality threshold, we believe that this risk is outweighed by the need to provide clear guidance to all concerned. It is also important to bear in mind that such guidance is not only

important to the suppliers but also to their consumers and consumer groups in terms of monitoring observance of the conditions going forward.

There is also the danger that if guidance is given to individual suppliers in discussions with Ofgem on different aspects of their tariffs they may receive implicit approval for a particular tariff on a particular basis so that a secret system of guidance is developed. This would be unfortunate and undesirable.

Another approach which Ofgem may wish to consider would be to specify a *de minimis* level below which no action will be taken, therefore leaving suppliers to form their own judgment as to the risks which they run if they exceed that threshold.

Ofgem also need to bear in mind that suppliers will have to formulate tariffs based upon whichever licence proposals are adopted on a forward looking basis using their current business plans. It is perfectly conceivable that the outturn in terms of costs and differentials may differ from those which were envisaged and potentially lead a licensee into a licence breach. In such a circumstance it would be unlikely and inappropriate for Ofgem to take enforcement action. However, suppliers would have to make the appropriate changes to deal with that unintended consequence.

It is also likely to be desirable to indicate whether any threshold is based on a percentage or on a value. Given the size of energy bills it is a matter of judgment as to the appropriate measure by which to assess materiality.

Enforcement

We agree with the sentiments expressed in para 2.12. However, if suppliers support the process outlined in para 2.13 we believe that this would be an appropriate process to adopt. Ofgem fears that such a process might undermine the incentive for suppliers to comply with licence conditions. Although that is a possibility it is also possible that if Ofgem were to adopt a strict approach to the interpretation of a relevant licence condition then in practice it may be able to achieve a more restrictive enforcement through this process. This is again a matter for suppliers to form their own judgment as to whether Ofgem's interpretation is something which they are prepared to accept or alternatively prepared to challenge through the formal statutory process. For this reason we do not believe that Ofgem needs to fear that suppliers would run the risk of repeated infringement.

This process brings out another important point in that where issues are clarified in during the course of the operation of these licence conditions this will in turn require Ofgem to update its published guidance at appropriate intervals.

Scope

Given that other suppliers only represent 0.3% of supply and that Ofgem wishes to encourage new entry, it would seem inappropriate to extend any such licence conditions to those suppliers. Such additional regulatory burdens would operate as a further disincentive to existing small suppliers and potential entrants.

Duration

Given that as a matter of principle the introduction of new regulation in a liberalised supply market should be limited in scope and duration to that what is necessary to deal with the particular issue, a three year sunset clause would appear to be appropriate. It will be very important for Ofgem to monitor the operation of the licence conditions and produce an annual report on both their operation and impact to ensure that the licence conditions are achieving their objectives without unintended and undesirable consequences.

(E) Proposal A

Given that this possible licence condition reflects the requirements set out in the EC's second gas and electricity liberalisation directives it is relatively uncontroversial.

As Ofgem recognise a great deal more will need to be set out in the accompanying guidance.

As Ofgem's proposals emphasise transparency it may be feasible to set out the additional cost of each payment method. However, given that it assumed that the application of its principle will be judged over a year, any judgment by a supplier as to the likely costs attached to any particular payment method will be a forecast based upon its business plans for the forthcoming year.

As regards payment by direct debt which is made in advance the supplier is receiving a benefit by receiving payment early and if there is any substance in the press reports that suppliers have been increasing the amounts of the periodic direct debts and building up a substantial credit then that benefit will be increased. It is therefore logical that the cost to serve those customers is correspondently reduced.

If tariffs are changed during a year any judgment will need to be made based upon the outturn for the year although suppliers will have the opportunity to adjust the tariffs to reflect performance in the year to date.

It is assumed that this proposal would be applied to each tariff for gas and electricity separately and would likewise be applied separately to in area and out of area supplies. It is assumed that this will mean a common margin with the only difference between a tariff for a particular form of supply will be the different cost of each payment method.

(F) Proposal B

This is a very far-reaching proposal capable of having potentially wide ranging consequences. Although suppliers may be able to produce objective justification for differences it is clear from the consultation paper that the licence condition is designed amongst other things to reduce differences between in area and out of area prices. This would mean significant reductions in area prices and increases in out of area prices. This proposals must therefore by definition significantly mute the competition in each area by significantly reducing the price differentials and thus the tools suppliers use to compete and encourage customers to switch.

Given that competitive conditions vary as between in area and out of area in that the incumbent is the largest supplier in area and a small supplier in out of area it might be argued that such differences in the competitive conditions could be an objective justification. But this is plainly not Ofgem's view.

Such a proposal goes beyond the purpose of addressing different customer groups through their inability to access particular tariff deals as a result of their personal circumstances and would substantially undermine competition in the different areas. We would suggest that likely cost of this proposal is significantly greater than the benefits which it confers.

We also note here that the licence condition is not aimed at price discrimination per se but at "undue" price discrimination. It therefore behoves Ofgem to give guidance as to what is or is not "undue".

The actual licence condition would need to incorporate the objective justification defence and the guidance needs to clearly articulate what such justification may include.

If this Proposal is limited to different payment methods it would be preferred over Proposal A.

Given the breadth of this proposal Ofgem should give very careful consideration to responses by suppliers and others as to the implications of this proposal. The limitations of this proposal are recognised by Ofgem in its discussion of Proposal C.

(G) Proposal C

In principle it is undesirable that the actual licence condition itself should fix precise price differentials as between payment methods or tariffs.

One of the difficulties with this proposal is identifying an appropriate benchmark tariff. Ofgem's Initial Findings Report indicated the difficulties surrounding the benchmark choice. Even if the dual fuel direct debit tariff was taken as the benchmark Ofgem itself recognises that those prices may currently be below competitive levels. Indeed it appears that the average product only just breaks even at the net profit levels. Thus it is an inappropriate benchmark. Thus, Ofgem would have to create a competitive benchmark tariff for both electricity and gas and construct a robust assessment of the standard cost differentials as between different payment methods. We would suggest that this is undesirable for two reasons. First, it is excessively cumbersome and detailed. Secondly, it is building one construct upon another and therefore introduces increased scope for error.

As far as a relative price control between areas is concerned this effectively entails Ofgem setting the bounds within which competition may take place. This is in principle undesirable and it is suggested that its disbenefits would materially outweigh its benefits. It is far wider in scope than is required to address the limited vulnerable consumer groups with which Ofgem is concerned.

This is a significantly intrusive Proposal, one which would require very detailed work by both Ofgem and suppliers, would introduce significant rigidities into business operations and substantially constrain the scope for competition.

(H) **Proposal D**

As you can see from the discussion above we would be opposed to a cross-subsidy condition for the reasons outlined above. As far as the five former incumbent electricity suppliers are concerned the supply of gas is a competitive weapon to compete with Centrica and as between themselves.

Instead, we suggest that Ofgem focus on licence changes which directly address their concerns regarding single fuel electricity customers.

As regards extending the licence condition to cover cross-subsidy from gas to electricity, it is not apparent from the Initial Findings Report that this is a pressing concern. Accordingly there is no particular need to address the possible issue. Ofgem should consider going no further than including such a provision in the licence condition but it would be turned off from the outset and would only be switched on if a clear need is established at a future date.

(I) **Conclusion**

Of the four proposals, Proposal A implements the EU energy directives and it is relatively uncontroversial in itself. Proposal B is very wide sweeping and would substantially diminish competition if it extended to discrimination between in area and out of area. Proposal C is excessively rigid and intrusive insofar as price benchmarking is concerned and if it extended to relative price control as between areas would effectively give Ofgem the power to determine the bounds within which competition may take place. Proposal D is unnecessary given the supply of gas is a competitive tool used by the five former incumbent electricity suppliers to compete with Centrica and as between themselves, and its introduction would only lead to an increase in gas prices and a reduction in electricity prices. It is also likely to reduce the competitive pressures upon Centrica.

In short the most appropriate method to deal with differentials as between payment methods would be Proposal B. The relative price controls as between areas in Proposal B and C would significantly limit the scope for competition. It is suggested that Ofgem seek an alternative solution for the vulnerable groups in particular the electricity only customers.

There is a clear need for detailed guidance to be given by Ofgem following appropriate consultation with the intent of making sure that guidance is open, detailed and transparent. Insofar as guidance is given to individual companies Ofgem needs to publish updated guidance to make sure that other suppliers are not disadvantaged.