

## **Consumer Focus submission**

# **Addressing unfair price differentials – Ofgem consultation**

**February 2009**

## Ofgem consultation: Addressing unfair price differentials

### Recommendations

To help protect consumers from unfair pricing, Consumer Focus recommends that:

- Ofgem introduce a licence condition to prohibit undue discrimination in the supply of gas and electricity.
- Ofgem introduce guidance on the application of the undue discrimination licence condition.
- Ofgem commission an independent analysis of the **efficient** costs to serve different consumer groups as a matter of urgency.
- Ofgem ring fence products or services which must not be, for legitimate reasons, cost reflective (social tariffs for example).
- Ofgem protect the positive changes made by the energy suppliers whilst also mandating social tariffs which meet minimum standards.
- Ofgem set out a clear and set timeline for delivering each of the probe remedies and achieving agreed outcomes with measurement criteria.

### Background

1. The Ofgem energy supply probe initial findings report acknowledged there are features of the GB energy market that do not work effectively and create consumer detriment. The report confirmed there was evidence of unfair pricing by suppliers and attempted to quantify the associated level of consumer detriment. In response to the initial findings report, Consumer Focus raised concerns that the level of costs may be overstated and the level of consumer detriment understated. Ofgem's analysis was based on the cost data provided by suppliers rather than an independent assessment of the **efficient** level of costs. We are disappointed that Ofgem has not as yet commissioned this independent analysis and recommend that Ofgem do so as a matter of urgency.
2. Consumer Focus believes it is essential that prices are determined on the basis of effective competition. Suppliers' pricing must be made more competitive for all so the benefits of the liberalised market can spread beyond direct debit dual fuel consumers to include in area, electricity only, and standard credit and prepayment consumers. To make this situation a reality, Ofgem must not only address unfair pricing (Action 5), but must also implement the package of probe remedies including better consumer information (Actions 1 and 2) and ensure the wholesale markets function effectively (Action 3). Ofgem must set out a clear and set timeline for delivering each of the probe remedies and achieving agreed outcomes. They should also identify measurement criteria to identify whether the options implemented have succeeded or failed.
3. We recognise that in recent months suppliers have taken steps to help address **some** unfair pricing. It is important that the progress that has been made is not temporary and

consumers have long lasting protection. As Ofgem notes, even if the Big 6 were to unilaterally address the main issues identified in the probe, “unfair price differentials could re-emerge in subsequent price changes to the detriment of consumers”<sup>1</sup>.

4. When Ofgem removed the non-discrimination licence condition, it argued the best way to protect consumers would be through the promotion of competition and reliance on the provisions of the Competition Act 1998<sup>2</sup>. This approach has **not** been effective to date. There is no guarantee that the market as currently established will be able to provide fair outcomes for all consumers. Consumers have suffered from unfair pricing and have lost confidence in the prices they pay for their energy. We support the introduction of a new licence condition to enforce fairer pricing of electricity and gas to consumers and to help restore consumer confidence. Based on Ofgem’s current proposals, our preference would be to implement Option B: Prohibition of undue discrimination.
5. We note that one of the Big 6 argued in evidence to the Energy and Climate Change Select Committee that such a licence condition was required to keep the ‘industry honest’ and restore ‘public confidence’. It suggested that had an undue discrimination provision been in place, some suppliers pricing practices would not have been compliant (Ian Marchant, SSE Chief Executive, 11 February 2009, uncorrected oral evidence). It is vital that consumer confidence returns to the energy market and we hope that the implementation of an undue discrimination licence condition, in conjunction with the other probe remedies, will bring about a reinvigoration of confidence in the market.
6. While we believe the introduction of an undue discrimination licence condition will go a long way to preventing the unfair pricing practices we have witnessed from the energy suppliers, we nevertheless think that such a measure will not be sufficient to alleviate the plight of vulnerable consumers and those living in fuel poverty. With this in mind, we strongly support the widespread roll out of mandatory social tariffs with minimum standards, which should ensure that those on the lowest incomes and the most vulnerable have access to the cheapest deals regardless of payment method. It is essential therefore that any form of social tariff be exempt from an undue discrimination licence condition.

## Outline

7. This paper sets out Consumer Focus’s views on unfair pricing and Ofgem’s proposals to introduce a new licence condition to address this problem. Two annexes support our submission:
  - Annex A: Analysis of the potential impact of the Ofgem licence condition proposals.
  - Annex B: Responses to specific questions raised in the consultation document.

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<sup>1</sup> Addressing price differentials, Ofgem Consultation (8 January 2009) p.3

<sup>2</sup> For example, Utilities Act, Standard licence conditions Volume I, Final proposals (October 2000), Gas and Electricity Supply Licences, Proposals for Standard Non-discrimination Licence Conditions (July 2000), Competition in gas and electricity supply – Separating fact from fiction, Ofgem Website and ‘Ofgem sets out future of regulation in gas and electricity supply, Ofgem News (26 November 2001).

## Unfair pricing

8. We are concerned that Ofgem's current consultation document does not set out clearly the problem of unfair pricing or quantify the historic and current associated level of consumer detriment. While Ofgem tried to quantify this in the initial findings report it has not provided an updated analysis in the current consultation. Further, it has not published a sufficiently detailed impact assessment of the proposed options. We would urge Ofgem to provide this analysis in the future.
9. Ed Miliband (Secretary of State for Energy and Climate Change) described the problem of unfair pricing and set out his expectations for how suppliers can treat their customers fairly. He argued that *'If someone is forced to use a pre-payment meter, that is no excuse to overcharge them. If someone happens to live off the gas grid, that is no excuse to overcharge them. If someone lives in an area where a company used to have a monopoly that's no excuse for overcharging them'*<sup>3</sup>.
10. Consumer Focus is concerned that some consumers have been subject to unfair pricing practices by suppliers for a number of years. It is essential that consumers pay a fair price for their energy and that those consumers in fuel poverty do not end up paying more. The main areas where consumers end up paying unfair prices for their energy and where effective action needs to be taken include:
  - **Payment type:** Many prepayment meter (PPM) and standard credit (SC) consumers have been charged more for their energy than the costs to serve. This is especially a cause for concern as many consumers in fuel poverty pay by PPM or SC.
  - **Electricity only:** Consumers who live in locations off the gas grid are unable to take advantage of suppliers' cheaper dual fuel deals. Additionally, based on Ofgem's analysis, it appears that in some cases the suppliers' gross margins for gas have been negative, or at the very least lower than the gross margins for electricity. This is a particular problem in Scotland and Wales where a larger proportion of consumers are not connected to the gas network. Furthermore, these consumers are sometimes reliant on expensive heating fuels such as heating oil and LPG.
  - **In area:** Consumers who have stayed with their incumbent electricity or gas supplier almost certainly pay more for their energy. This is of greater concern to consumers in Scotland and Wales as a higher proportion have remained with their incumbent suppliers. Many consumers in Scotland with dynamic teleswitching are unaware that they may now have a viable alternative choice of supplier.
  - **Debt blocking:** Many consumers are unable to switch to a different supplier and access the best deals due to debt blocking. The Debt Assignment Protocol has not been effective with very few consumers having been able to switch. We have responded to Ofgem's consultation on debt blocking separately.
  - **Online deals:** Online direct debit deals are almost always a suppliers' cheapest deal. These deals are often not available to the least affluent consumers, as they are less likely to have access to the internet. Additionally, some suppliers have been selling online deals for short periods of time at prices which many market participants feared

<sup>3</sup> "The Rise and Fall and Rise Again of a Department of Energy" Ed Miliband speech at Imperial College, London (9 December 2008) p.8 <http://www.decc.gov.uk/pdfs/miliband-speech-imperial-091208.pdf>

were unsustainable and that consumers would never in fact realise the savings being quoted. It is, in some ways, akin to the ‘teaser’ deals offered to ‘sub prime’ mortgage customers in the US. Such practices have a negative impact on the competitive process.

- **Offline Direct Debit deals:** While online Direct Debit deals are almost always a supplier’s cheapest deal significant saving can still accrue to consumers by switching to an offline Direct Debit tariff. Such deals are out of reach of many less affluent consumers as they may find it difficult or may not be able to access financial services and, in particular a current account. Furthermore, the Direct Debit payment method is not suitable to many consumers who wish to make consistent payments to manage their budget.

11. We recognise that in recent months suppliers have taken steps to help address some unfair pricing. It is important that the progress that has been made is not temporary and consumers have long lasting protection. As Ofgem notes, even if the Big 6 were to unilaterally address the main issues identified in the probe “unfair price differentials could re-emerge in subsequent price changes to the detriment of consumers”<sup>4</sup>. When Ofgem removed the non-discrimination licence condition, it argued the best way to protect consumers would be through the promotion of competition and reliance on the provisions of the Competition Act 1998. This approach has not been effective to date. There is no guarantee that the market as currently established will be able to provide fair outcomes for all consumers. As a result consumers have suffered from unfair pricing and lost confidence in the prices they pay for their energy.

12. For the reasons above, we support the introduction of a new licence condition to enforce fairer pricing of electricity and gas to consumers.

### Cost reflectivity

13. We do not support a move towards strict cost reflective pricing for all consumers. We believe broad cost reflectivity is preferable and will lead to better outcomes for some of the hardest pressed consumers in Great Britain. We are concerned that the delivery of absolute cost reflectivity will have significant perverse and unintended consequences.

14. Cost reflectivity is likely to lead in some instances to a rebalancing between prices rather than an aggregate decrease. We are concerned that this could lead to price increases for some vulnerable and low income consumers. With this in mind, we strongly support the widespread roll out of mandatory social tariffs with minimum standards, which should ensure that those on the lowest incomes and the most vulnerable have access to the cheapest deals regardless of payment method. It is essential therefore that any form of social tariff be exempt from an undue discrimination licence condition.

15. Ofgem should strive to protect the degree of progress suppliers have made to addressing unfair pricing practices. Indeed, as Ofgem states in their consultation “as well as considering cost differences, there may be a range of other potential justifications for

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<sup>4</sup> Addressing price differentials, Ofgem Consultation (8 January 2009) p.3

price discrimination”<sup>5</sup>.

16. We remain concerned that the level of costs may be overstated and the level of consumer detriment understated. Ofgem’s earlier analysis was based on the *historic* and *actual* cost data provided by suppliers. These costs are not the **efficient** costs to serve one would expect to see in a properly functioning market. Ofgem admit as much in the initial findings report where it states that the increases in the costs to serve do not seem to be consistent with a relentless drive towards increased efficiency. Furthermore, Ofgem states the evidence is not consistent with an effectively competitive market where it is expected that material cost differences would have been competed away<sup>6</sup>.
17. In our response to the initial findings report, we recommended that Ofgem commission independent analysis as a matter of urgency to determine the efficient level of costs. This should seek to identify what the level of costs would be where there are incentives on firms to become more efficient, reduce costs and invest in new technology. We are disappointed that Ofgem has not commissioned this independent analysis to date and believe Ofgem should commission this analysis as a matter of urgency. We would welcome the opportunity to comment on the terms of reference for the analysis.
18. We note the reference made in the consultation document to the cost reflectivity provisions set out in Annex A of the European Gas and Electricity Directives. The Directives state that “any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems”<sup>7</sup>. We would note that Annex A is intended to provide a minimum level of protection for consumers and does not prohibit Member States from putting in place additional protections where this will benefit consumers. We believe this allows for the introduction of policies to protect vulnerable and fuel poor consumers, for example social tariffs, which are legitimately **not** required to be cost reflective.

### Predatory pricing

19. Ofgem must take firm action where there is evidence of predatory pricing. Such practices damage the energy market and competition. They can also mislead and penalise even the most ‘active’ consumers. Ofgem should investigate concerns that have been raised about some online tariffs and report on the findings of its analysis.

### Licence condition proposals

20. In introducing new licence conditions, consideration should be given to any potential harmful effects including:

- **Consumer detriment:** It is possible that in seeking to protect one group of consumers there may be negative consequences for another group of consumers or that

<sup>5</sup> Addressing price differentials, Ofgem Consultation (8 January 2009) p.11

<sup>6</sup> Energy Supply Probe – Initial Findings Report, Ofgem (6 October 2008) p.95-6

<sup>7</sup> Directive 2003/54/EC, Common rules for the internal market in electricity and Directive 2003/53/EC Common rules for the internal market in gas, both Annex A.

voluntary arrangements that had been put in place to the benefit of consumers could be undermined. It essential that positive steps that suppliers have taken recently to help address unfair pricing differentials are protected and that the provision of social tariffs and other measures to protect vulnerable consumers are ring fenced (see paragraph 13).

- **Unintended consequences:** An unintended consequence of implementing a strict cost reflective licence condition could be increased prices for PPM consumers, some of whom constitute the least affluent in society and who are often in need of additional protection. A situation could develop whereby smaller margins available to suppliers from certain consumer groups leads suppliers to withdraw from that market segment, which would deprive consumers of choice and lessen the competitive pressures. Additionally, in having to provide strict cost reflectivity some of the suppliers (for example E.ON), in their response to the Ofgem Probe, suggested they would introduce security deposits for those paying by quarterly cash/cheque. We are concerned about the detrimental impact this may have on the most vulnerable energy consumers. This point again illustrates the dangers in imposing a strict cost reflectivity requirement.
- **Market distortions:** It is important to ensure that new conditions promote the effective functioning of the market. Harmful effects that could damage the effective functioning of the market will impose a cost that will ultimately be borne by the consumers. *Possible* market distortions could include a *possible* lessening in price competition or potential withdrawal of certain tariff options that can be of benefit to consumers. Fixed rate and capped tariffs may need special consideration, as there is a chance when a customer signs up to such a deal they may 'lose' if wholesale energy prices fall, or may 'win' if wholesale energy prices rise. These tariffs can offer legitimate and valid choices to consumers where the consumer is made aware of the potential consequences of wholesale price changes and key terms and conditions such as duration and termination charges. However, we are aware that some consumers have raised concerns about the clarity of the terms and conditions they are received. Ofgem should explore if any action needs to be taken in this area.
- **Investment:** The UK energy market will come under increased pressure in the years ahead as current generation plants are decommissioned and we seek to meet the agreed environmental obligations. The need for new, diverse and secure energy supplies is all the more important in the context of geo-political and economic uncertainty. Any new conditions should consider whether there is likely to be any potential effects, direct or indirect, on investment.

#### Options C and D

21. We do not consider the introduction of Option C: Relative price controls or Option D: Prohibition of cross subsidy between gas and electricity to be in the best interests of consumers. We feel that Option D can be covered through Option B: Prohibition of undue price discrimination as such a cross subsidy could be said to inflict disproportionately higher prices on those consumers off the gas grid. Based on Ofgem's earlier analysis, if the issue of cross subsidy between gas and electricity is addressed, electricity prices could



fall by around 14% benefitting millions of households and potentially improving access to the market for new gas entrants<sup>8</sup>.

22. We do not think that Option C will ensure that consumers pay a fair price or that fuel poor consumers do not pay more. We disagree with Ofgem's assertion that relative price controls are a transparent and simple form of regulation because a relative price control is likely to be difficult to enforce and administer and provides no incentive on suppliers to reduce the cost of their 'benchmark' tariff. Additionally, we believe the risk of unintended and perverse consequences for consumers of this option will be high and significant.
23. Past experience shows that in administering price controls, the regulator often gets it 'wrong', almost always to the benefit of industry. This is because there is a natural asymmetry of information in favour of industry to the disadvantage of regulators and ultimately consumers. We have seen, for example, in the work Ofgem has undertaken for DPCR5 that the electricity distribution companies earned in excess (some by up to 3.5%) of the expected return on regulated equity<sup>9</sup>.
24. To give an example from a different sector, the water regulator Ofwat, has often been the victim of 'gaming' by the water companies. In 2005-06, the total under spend was almost £1bn or 22% lower than the level assumed by Ofwat when setting price limits<sup>10</sup>.

#### Options A and B

25. Ofgem's consultation suggests that Option B 'goes further than A in its 'coverage', implying that Option B is a more intrusive measure. For example, the consultation document states that *"This condition [proposal A] is targeted specifically at addressing unfair price differentials between payment methods. In this way, the condition [proposal A] reduces the risk of creating regulatory uncertainty and potentially adverse effects on competition or innovation compared to requirements targeting a wider range of unfair price differentials [proposal B]"*<sup>11</sup>. We believe that Ofgem's view is incorrect for the following reasons.
26. Some of the examples of unfair pricing experienced by consumers are not primarily related to cost reflectivity between payment methods. Further, it is not the 'coverage' of the licence condition that will have a material affect on the regulatory burden rather it is how it is administered and enforced by Ofgem.
27. Based on the options put forward by Ofgem, our preferred option is B. This option provides greater flexibility to address the range of unfair pricing practices including those experienced by consumers paying by PPM, SC and electricity only consumers. Annex A provides an analysis of the potential impacts of the four options proposed by Ofgem. We

<sup>8</sup> Although gas prices could rise by approximately 6% - Energy Supply Probe – Initial Findings Report, Ofgem (6 October 2008) p.112

<sup>9</sup> Electricity Distribution Price Control Review Policy Paper, Ofgem (5 December) p.11

<sup>10</sup> Poor Choices: The limits of competitive markets in the provision of essential services to low-income consumers, Richard Bates et al., Chapter 3: Water by Emanuele Lobina and David Hall (September 2008) p. 108-9

<sup>11</sup> Addressing price differentials, Ofgem Consultation (8 January 2009) p.12



also note some industry participants have declared their support for such a condition saying it will help restore consumer confidence in the energy market, a view which we also hold.

#### *Cost allocation*

28. We are in agreement with Ofgem's analysis that some costs allocated by suppliers to certain groups of consumers are inappropriate. We are particularly concerned that some of the bad debt costs allocated to PPM customers actually relate to other payment methods. We also agree that competition costs are not an appropriate element of cost allocation as competition costs are to be expected as a natural by-product of a healthy and competitive market.

#### *Online tariffs*

29. With regards specifically to online tariffs, there is no doubt that these often constitute the lowest price for consumers. One of disadvantages of this is that certain vulnerable and fuel poor consumers have no or limited access to the internet which prevents them for accessing these cheaper deals. We need to think more innovatively about how we can extend access to online deals to vulnerable and fuel poor consumers. Ofgem should explore opportunities to work with other bodies such as consumer organisations, advice agencies, other regulators, in particular Ofcom, and the Financial Inclusion Taskforce.

#### *Offline Direct Debit deals*

30. While online direct deals are almost always a supplier's cheapest deal significant savings can still accrue to consumers by switching to an offline Direct Debit tariff. Ofgem should, in conjunction with the work on online tariffs, propose and test innovative solutions which may allow consumers without easy access to financial services and products to benefit from Direct Debit prices. DWP should lead work to modernise the Fuel Direct system to provide an alternative payment method for low income consumers and potentially provide the same price advantages as direct debit. Other alternatives for exploration includes affinity deals, where consumers come together to form a body to pay for their energy often through an organisation such as a housing association, and discounts for the regular payment of a fixed amount.

#### *Electricity only*

31. We recommend that Ofgem looks into a number of special provisions/policies to alleviate the consumer detriment faced by electricity only consumers. Possible options include:
- The introduction of a bespoke electricity only tariff for those off the gas grid. As these consumers are more likely to be in rural areas there may be scope to offer discounts to the consumer in exchange for providing regular meter readings. Where consumers are on time-of-use tariffs there may be scope for the supplier to provide guidance on how consumers can reduce and better manage consumption across the day.
  - Educate consumers with dynamic teleswitching about the choice of supplier and bespoke tariffs available to them. Many of these consumers in Scotland will not be

aware that they have a valid choice of supplier, some will not believe there are savings to be made and others may fear that something may go wrong with the switching process based on past experience. Ofgem should also work with suppliers to ensure that *all* suppliers offer bespoke tariffs for consumers with dynamic teleswitching.

- Consumer Focus is currently working on a project which aims to understand some of the problems that those consumers who rely on domestic heating fuels may face, and evaluate any potential consumer detriment which may follow from this study. We would expect to feed in the findings from this project into future deliberations on this issue. This may include the need for Ofgem, consumer bodies, DECC and the OFT to explore the need for new regulatory oversight, possibly administered by Ofgem, for consumers who use domestic heating fuels.
- Work with DECC and the industry to explore further options for extending the gas network. We are pleased to see that measures have already been put in place as part of the non gas fuel poor extension scheme, although we are aware that such schemes are fairly small scale and there have been problems targeting help where it is most needed. We would urge Ofgem to ensure that they properly monitor the scheme to ensure that the measures are benefitting vulnerable consumers and not just wait to retrospectively evaluate the impact of the scheme in 18 months time.

#### *Rural consumers*

32. Although rural consumers can often be identified as electricity only consumers, in some respects they experience problems unique when compared with other consumers. There are 1.1 million households in fuel poverty in rural areas in England<sup>12</sup>. Despite being twice as likely to be in fuel poverty, anecdotal evidence suggests households in villages, hamlets and more remote areas are still less likely to have benefitted from assistance available for energy efficiency improvements. Given Ofgem's duty to 'have regard to' consumers residing in rural area, the regulator should investigate the issue of electricity-only consumers as part of a broader strategy to help rural energy consumers. We would urge Ofgem to provide:

- More transparency about the allocation of CERT grants to not just rural towns but more remote rural areas and incentives to deliver improvements in the most rural areas.
- Inclusion of electricity-only rural customers under the new Community Energy Savings Programme.
- Promote greater awareness of proven low carbon technologies and energy efficiency measures to electricity-only consumers as an alternative to expensive home fuels such as LPG and oil.

#### *Debt Blocking*

33. Many consumers are unable to switch to a different supplier and access the best deals due to debt blocking. The Debt Assignment Protocol has not been effective with very few

<sup>12</sup> <http://www.nea.org.uk/policy-briefings/>

consumers having been able to switch. We have responded to Ofgem's consultation on debt blocking separately.

#### *Guidance*

34. We support the need for clear and transparent guidance to accompany licence requirements including approach to enforcement, cost allocation and materiality.

#### *Materiality thresholds*

35. Materiality thresholds must be at the very least a part of Ofgem's guidance to suppliers. As we have previously argued, Ofgem should not just be concerned with the number of consumers affected. Thresholds should in fact strike a balance between the quantity of consumers affected and the **severity of consumer detriment experienced**. The regulator will have to make a judgement, with the assistance of general principles, when deciding when to act, as to try to quantify the thresholds for example 10% of consumers affected and a price differential in excess of 10% would be an arbitrary decision which could not be based on reason and/or evidence. We agree that an unfair price differential is more likely to be material if it disproportionately impacted on fuel poor and vulnerable consumers. Ofgem needs to ensure it can also take action against persistent and small misdemeanours which suppliers may be guilty of.
36. In more general terms, Ofgem should be focusing first and foremost on the unfair pricing practices that create consumer detriment and then determine the best way to address these practices in a coordinated, effective and efficient manner. While it is entirely appropriate to consider the potential regulatory burdens placed on the energy suppliers because of the introduction of new regulatory requirements and the effects this may have on competition, innovation etc., these should nevertheless be considered secondary to the regulators primary duty of protecting consumers.

#### *Multistage process*

37. We believe it is essential for Ofgem to provide a clear enforcement policy and process as part of its guidance to suppliers on the new licence condition. We agree that the multi-stage process *could* provide an appropriate way forward. The multi stage process could have a beneficial impact of addressing unfair pricing practices more swiftly to the benefit of consumers. It should enable early flagging up of breaches of the licence and should enable Ofgem to take swift action within a given timeframe. In particular provision must be made to prevent repeat infringements. It could also increase transparency and help minimise concerns around the impact of new regulation on innovation and competition. While we are supportive with the general thrust of ScottishPower's five point process<sup>13</sup>, we believe there are a number of ways in which it could be enhanced.

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<sup>13</sup> As detailed in their response to the Ofgem Probe – Initial Finding Report.

#### *Annual cost data and independent cost analysis*

38. The first stage ScottishPower recommend is that there is a requirement for suppliers to provide certain annual cost information to Ofgem. Whilst Consumer Focus agree with this proposal we believe this procedure must be supplemented with independent analysis of the **efficient** costs to serve for the reasons articulated above.

#### *Breaches, market monitoring and stakeholder input*

39. We agree with the second step that if Ofgem identifies or is notified of a differential that it believes not to be compliant with the new licence condition and acts against the best interests of consumers, it should issue a 'notice of potential objection' setting out the concern. The process should be further enhanced by allowing external bodies, such as Consumer Focus and other consumer organisations, to submit evidence where they believe a breach has occurred. We are therefore encouraged by Ofgem's statement that they 'would expect to evaluate the impacts of any of these proposals in a number of ways, including through their regular market monitoring activities and through investigations into specific complaints'.
40. We believe it is vital that Ofgem is more proactive in its market monitoring and reporting of the behaviour of energy suppliers. Monitoring should be, making exceptions for commercially confidential information, made available in the public sphere as such an action would go a long way to improving consumer confidence in the energy market by demonstrating in a methodical way whether or not energy suppliers are indulging in unfair practices. Ofgem must ensure they make adequate provision in their budget for market monitoring and enforcement.

#### *Supplier response*

41. We completely support the third stage which would place a requirement on the supplier to respond to Ofgem within a set period either justifying the differential or proposing amendments to it. We would suggest that an evidence based justification made on the basis of benefiting vulnerable customers must certainly be allowed.

#### *Redress*

42. We agree with the fourth step that if Ofgem is not satisfied with the supplier's justification or proposed actions, it should 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. We believe this time period should be no more than three months. We note that Ofgem has further added the point that a notice could also require remuneration of harmed customers, if appropriate. We believe that in principle this would be a fair and just penalty which should be borne by the offending supplier(s). We do however realise that the costs in remunerating customers may, in some cases, outweigh the benefits. In such cases, we believe that an unfairly treated consumer should still have a right to claim compensation from his/her supplier.

### *Financial penalties and compensation*

43. We also agree with the final step that if a supplier fails to comply with a notice of objection, Ofgem should then take action for a licence breach. We would note some concerns we have from reading the consultation response that suggests the multistage process will only act as a preliminary stage before the formal licence breach investigation is enacted. Current licence breach investigations take approximately 9 months to complete and if this time were to be added to the maximum 4 months we would expect the multistage process to last, the procedure would take over a year. This would constitute far too long a time scale to remedy any potential consumer detriment. We do not believe that the multistage process should act as a preliminary stage to the formal licence breach investigation process as many of the issues and data analysis will already have been progressed as part of the multi-staged process. The multi stage process timeframe should be included in the maximum 9 months for completion of a formal licence breach investigations.
44. On the issue of financial penalties, we suggest that fines obtained from offending suppliers should be placed in a designated 'pot' rather than returned to the consolidated fund. This fund would need to be administered by an organisation independent of the energy supplies. The designated pot could then be used to directly benefit energy consumers and help supplement initiatives to assist vulnerable consumers. Alternatively parts of the pot could be used to fund a compensation fund for consumers that have been subject to unfair pricing practices. We believe this approach is a far more just solution than allowing the fines to be swallowed up in the consolidated fund with no guarantees that initiatives will be directed to the benefit of energy consumers. These options should not be seen as mutually exclusive.

### *Mandatory product approval*

45. We would not support the introduction of a mandatory product approval process. Whilst it is reasonable for companies to have informal discussions with the regulator to see whether any new products it wishes to launch meet existing licence requirements, it is inappropriate to introduce a formal process. Such a process would likely place a restraint upon product innovation. We have witnessed a similar scenario with the procedures that Royal Mail must go through to get any of their new products to market, which can prove to be lengthy. This can result in them missing the immediate market opportunities, which can lead to inefficient outcomes for consumers.
46. Finally, we note that Ofgem state the possible downside of a multi-stage approach is that it could undermine the incentive on suppliers to comply with the licence condition, thereby risking repeated infringements. We agree that this is a real risk. The regulator needs to ensure that in drafting the licence condition and guidance, it ensures that it can take enforcement action against repeated infringements and possibly apply a 'premium' to any corresponding fine.

*Licence condition – should it be applied universally or discretionary?*

47. In principle, we believe that, to ensure consumers are adequately protected and have confidence that they are protected irrespective of the supplier they choose, any licence condition should apply to *all* energy suppliers. This would assure consumers that the regulator will not allow unfair practices adopted by any supplier to go unchecked. However, we are mindful of the need to help support the development of a competitive fringe through new entry and expansion of independent suppliers. We understand that some concerns have been raised about the disproportionate burden this condition would place on independent suppliers which in turn could have a negative impact on competition and ultimately consumers in the longer term. We therefore recommend that Ofgem undertake a detailed impact assessment on the effects on small suppliers, competition and consumers. If the assessment demonstrated that the licence condition would have a disproportionate impact on small suppliers and the effects of not placing a condition would not lead to an increase in consumer detriment, we would support an appropriate exemption. For example this could be through an extension of the existing exemption for some licence conditions for those suppliers with energy suppliers with less than 50,000 customers.

*Sunset clause*

48. We believe that a sunset clause would be inappropriate for the new licence condition. We think that Ofgem is being slightly overoptimistic in its opinion that the other four probe actions will provide the impetus required to correct the functioning of the market in the short to medium term. Ofgem seems to underestimating the length of time it will take to push through many of the remedies such as the roll out of smart meters and securing a step change in consumer behaviour. However, this does not mean that any licence condition should not be periodically reviewed every few (perhaps every three to five years). In any case, any review to abolish the new licence condition must place the burden of proof, that it is no longer required, on the suppliers. The suppliers (and of course any independent parties) must demonstrate that competition is sufficiently strong to allow the mechanism of competitive markets to prevent unfair pricing to consumers.



## Annex A: Analysis of the potential impact of the Ofgem licence condition proposals

Ofgem Proposals	Effects on							
	Competition		Consumers		Innovation		The Regulator	
	Positive	Negative	Positive	Negative	Positive	Negative	Positive	Negative
<b>A. Cost-reflective pricing between payment methods</b>		Pricing is not simply a case of x% above costs. Pricing is also strategic. Such a licence condition may be incompatible with a free market structure	More likely that customers will be charged only on how much it costs to serve the customer rather than because the customer is 'captive'.  If Ofgem's analysis on cost to serve is correct SC customers can expect to see a price reduction in their energy bills.	A strict interpretation of the condition may have unforeseen consequences, for example more expensive energy for PPM customers.  We may also see some of the positive measures that suppliers have put in place to address concerns about unfair price differentials being unwound.	Such a licence condition may act as a driver, albeit a weaker one than competition, which is not as strong as it should, to reduce costs to serve.	A strict interpretation of the condition may have unforeseen consequences, for example dampening suppliers' incentives to drive efficiency gains.		If the condition is interpreted too strictly then the condition may be impossible to enforce.

Ofgem Proposals	Effects on							
	Competition		Consumers		Innovation		The Regulator	
	Positive	Negative	Positive	Negative	Positive	Negative	Positive	Negative
<b>B. Prohibition of undue discrimination</b>	<p>Such a condition should allow the regulator to penalise firms that indulge in predatory pricing.</p> <p>There has previously been a non-discrimination licence condition so may be less contentious</p>	<p>If flawed or no guidance is issued by Ofgem of how this power will be enforced this may lead to regulatory uncertainty and resulting market distortions.</p>	<p>As well as ensuring that customers are not paying prices for a service above the cost to provide it, this condition should prevent suppliers from charging customers unfairly because of their circumstances.</p> <p>Such a condition should allow the regulator to penalise firms that indulge in predatory pricing.</p> <p>More flexible and greater scope to address problems beyond payment type differentials</p>	<p>The regulatory burden imposed on the suppliers may produce additional costs over and above the present market price.</p>	<p>Such a licence condition may act as a driver, albeit a weaker one than competition which is not as strong as it should, to reduce costs to serve.</p>	<p>If flawed or no guidance is issued by Ofgem of how this power will be enforced this may lead to regulatory uncertainty and resulting reductions in innovation.</p>	<p>There has previously been a non-discrimination licence condition so may be less contentious</p>	<p>If flawed or no guidance is issued by Ofgem of how this power will be enforced this may lead to regulatory uncertainty and resulting market distortions.</p>

Ofgem Proposals	Effects on							
	Competition		Consumers		Innovation		The Regulator	
	Positive	Negative	Positive	Negative	Positive	Negative	Positive	Negative
<b>C. Relative price controls</b>		<p>Market distortions and unintended consequences are likely to follow.</p> <p>Additional costs will be placed upon suppliers as they will have to provide the regulator with detailed cost to serve information.</p>	<p>Should prevent customers paying above the level it costs to serve (for payment type).</p> <p>It should also equalise 'in' and 'out' of area prices.</p>	<p>Such a measure could take a long time to implement.</p> <p>A rebalancing of prices may lead to some PPM customers paying more or even suppliers no longer seeking to supply them</p>	<p>Such a measure may provide suppliers with an incentive to become more efficient in its cost to serve for those products that are subject to the relative control.</p>	<p>Market distortions and unintended consequences are likely to follow, including a reduction in product/service innovation.</p> <p>Such a measure may lead to a process of formal product consultations.</p> <p>No incentive for firms to become more efficient in its cost to serve the 'benchmark' product.</p>	<p>Such a measure may be easier to enforce than an ex post measure.</p>	<p>Such a measure could take a long time to implement.</p> <p>The control may be set at the right level due to the asymmetry of information between the regulator and the suppliers. This may favour the suppliers rather than consumers.</p>

Ofgem Proposals	Effects on							
	Competition		Consumers		Innovation		The Regulator	
	Positive	Negative	Positive	Negative	Positive	Negative	Positive	Negative
<b>D. Prohibition of “cross subsidy” between gas and electricity</b>		<p>There could be resulting market distortions and unintended consequences</p> <p>A lessening of competitive pressure on British Gas</p> <p>It may be costly for suppliers to produce separate gas and electricity accounts.</p>	<p>Such a measure may benefit those ‘captured’ customers who are off the gas grid</p>			<p>Market distortions and unintended consequences are likely to follow, including a reduction in product/service innovation.</p>	<p>It is possible that this problem might not be solved by resorting to proposals A, B and C.</p>	<p>Such a measure may be superfluous if any of the other options can tackle the “cross subsidy”.</p> <p>Gas margins are inherently volatile as they are determined by exogenous factors making it difficult to enforce such a licence condition.</p> <p>There would be a regulatory burden placed on suppliers to provide separate gas and electricity accounts.</p>

## **Annex B: Responses to specific questions raised in the consultation document**

### **Chapter Two**

This annex provides a cross check of our response against the questions posed in the Ofgem consultation document for ease of reference.

**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?**

Please refer to paragraphs 8 to 12 of the main body of our response.

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

Please refer to paragraphs 13 to 18 and 28 of the main body of our response.

**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?**

Please refer to paragraph 6,14 and 20 of the main body of our response.

**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?**

Please refer to paragraphs 35 and 36 of the main body of our response.

**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?**

Please refer to paragraphs 34 to 44 and 46 of the main body of our response.

**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?**

Please refer to paragraph 47 of the main body of our response.

**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?**

Please refer to paragraph 48 of the main body of our response.

**Chapter Three Questions 1 to 15**

Please refer to paragraphs 21 to 27 of the main body of our response and Annex A.

**Appendix 2**

Please refer to paragraphs 20 to 27 and 47 of the main body of our response and Annex A.