ADDRESSING UNFAIR PRICE DIFFERENTIALS – RESPONSE OF E.ON

Summary

We are disappointed that Ofgem appears to be set on proposals which will weaken competition to the detriment of all customers and potentially stifle innovation in the key area for customers of managing energy risk. It is also unsatisfactory that Ofgem's current proposals only relate to pricing (where suppliers are already committed to changes in policy) and not to informational and other remedies which would allow for an informed judgement of the overall impact on competition.

Ofgem states that, 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".

This is a good test and, rightly, a high bar to be overcome and we would urge Ofgem to apply it rigorously. Ofgem should not be introducing regulation into areas where suppliers have already taken steps to act, and where the implications of the regulation will be to dampen competition in the market.

That said, we believe proposals for payment methods can be made to work without undue adverse effect on competition, although flexibility to manage credit risk fairly would be necessary to avoid disincentives to securing new quarterly credit customers.

In relation to a proposal for a no undue discrimination condition, many uncertainties still remain and therefore it is difficult for us to comment meaningfully at this stage. The Initial Findings Report issued in October identified differentials which it believed to be unjustified in four specified areas - payment methods; on and off-line; gas against electricity and in and out of area. Applying Ofgem's statement quoted above, therefore, any no undue discrimination condition should be restricted only to those areas (less gas against electricity, which we discuss separately below) since Ofgem has no justification for it to go any wider. However, the current proposed drafting goes much wider than that and cites those examples as illustrative. This appears to us wrong and disproportionate.

In addition, we require to see well-designed guidelines, which provide guidance around how such a condition might be interpreted and around what behaviour might carry a regulatory risk. Although we received some comfort from the meeting we had with Ofgem around this issue in early February, we would need

to have confirmation on this before we were able to assess whether this was something we could accept.

In relation to gas against electricity, Ofgem's analysis does not show that single electricity customers have been sustained high margin, only that gas margins have been low over the period 2005 - 2007. Moreover, low gas margins have been primarily due to a combination of suppliers' desire to compete with British Gas and the relative movement of energy costs, and success of hedging policies between, electricity and gas, and it is not clear that raising them would be to customers' benefit.

Furthermore, Ofgem has not established that electricity margins are excessive. All it has done is to note that electricity and gas margins are not equal, and that (in the case of companies competing against the market power of British Gas), electricity margins have tended to be higher than gas margins. To require artificially that electricity and gas margins are equal would introduce an unnecessary and disproportionate distortion into the competitive market.

Fundamentally we believe that this proposed measure is unnecessary and disproportionate. If Ofgem's intention is to protect the single electricity customer, who is has not switched, then a number of protections will already exist through steps taken already by suppliers, and other measures proposed by Ofgem.

We therefore recommend that in the next stage Ofgem:

- Proposes licence conditions for cost-reflectivity of payment methods, which suppliers can agree;
- Publishes draft guidelines to support a targeted no undue discrimination condition, for consultation; and
- Publishes its proposals for informational remedies.

Ofgem would subsequently propose licence conditions for informational remedies and, if appropriate, a targeted no undue discrimination condition. This process would be much more robust than a piecemeal approach, and would be complete by the summer.

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?

Ofgem states that its overall objective is be "effective in addressing unfair price differentials, particularly where vulnerable customers are adversely affected" but to do so "in a proportionate way" that does not undermine the development of competition. It then lists four aims which it will strive to achieve in carrying out its proposals:

- Maintain incentives and scope to compete, innovate, reduce costs and promote sustainability;
- Avoid undue regulatory risk and uncertainty
- Avoid disproportionate regulatory, compliance, enforcement burden;
- Remove conditions if they become superfluous.

There are a number of comments that might be made here:

- Unfair is a very emotive term to apply here and appears to be being used without any rigour. For example, Ofgem seems to be suggesting that non-vulnerable customers who are paying higher prices than they need to because they have not engaged with the market, should be protected at the potential expense of the substantial numbers[1] of elderly, rural, low income or disabled customers who have so engaged. At the least, distinction shoud be drawn between a price differential which a customer may not be able to avoid (for instance a charge for PPM or cash payment) and those arising from customer choice.
- It is unclear what Ofgem's criteria are for making judgements between the multiple objectives. Most of the proposed actions are intended to benefit some customers, but will have adverse effects for other customers, and, overall, will probably cause a customer detriment through the reduction in competitive pressures. The balance between objectives is much more difficult than Ofgem implies. By contrast, informational and other pro-market remedies are unlikely to have such significant downsides, and these should be considered on the same timescale as the conditions that Ofgem is now proposing (see Chapter 3 Q3);

[1] Energy Supply Probe: Initial Findings Report – 6 October 2008 ("Initial Findings Report") Figure 9.1. Almost 50% of DE social class and Age 65+ electricity customers have switched supplier.

- If Ofgem is to apply a proportionate approach, without a disproportionate burden of compliance and enforcement, it should ensure that this is drawn narrowly and that it relates only to the areas where Ofgem believes it has uncovered a weakness in the competitive market as a result of its probe. It should not be drawn more widely. As a general principle, exceptions are construed strictly and narrowly, to restrict their effect. Ofgem generally believes in liberalised markets and that competition is the best way of ensuring benefits for consumers. These proposed conditions will constrain the natural operation of the market and dampen competition within it. Ofgem therefore has a duty to ensure that it distorts the market as little as possible through its present proposals. As it says itself, for every incremental step of regulation it proposes to add, it would "need to be **sure**" that it was a "proportionate measure and serves to help, rather than hinder" the development of a vibrant, dynamic competitive market.

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

It is not appropriate to allocate fixed costs to particular products. There is no economic rationale for doing so and little business benefit. Rather each product, or customer group, has to make a contribution – which covers fixed costs and profit (including margin for energy, credit and other risks).

We would therefore restate the principles of cost-reflectivity as:

- Costs that are directly attributable to the characteristics of a particular product should be allocated to the product; and
- The share of contribution from a particular group should be reasonable under all the circumstances applying to that group.

Obviously this leaves open the question of what circumstances are relevant, but that is the same question as to what is disproportionate, to which there is no clear answer.

The difficulty of directly attributing costs should not be underestimated. For example, Ofgem raises a number of cost allocation issues in paragraphs 7.57 – 7.60 of the Initial Findings Report. We agree that (most) bad debts on PPMs should not be attributed to PPM customers as they arise on a credit product. However, the bad debt costs do then need to be traced back to the original credit product. This allocation process is difficult, and also needs to recognise that costs may be higher for different products and customers – but we believe it will show that solo electricity standard credit prices are in fact lower relative to direct debit than cost reflectivity[2].

The complexity of cost allocation is also illustrated by the question Ofgem raises in paragraph 7.57 of the Initial Findings Report as to whether costs due to differences in customer characteristics (in this case frequency of house move and hence higher churn rate) should be recognised in cost allocation. Not to do so would be unfair, as the costs due to one group of customers would then be allocated to a different group, but where there are such variations it is all the more important that there are no obstacles to innovation – in this case the availability of more tariff slots for PPMs. These would allow the development of products for PPM customers who are not short term rentals or with a higher propensity to switch.

The complexities of allocating *energy* costs are greater still. We discuss some of the issues in our response to Chapter 3 Q6, and recommend that Ofgem allow time for review of the draft guidelines to ensure that they deal properly with this issue and are not naïve in their treatment of energy cost uncertainties.

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?

The question whether a differential between two prices is justified or not depends on whether the circumstances of the two customers are "relevantly different" or not. This is often described as the difference having an "objective justification". Whilst social or environmental issues may or may not make two customers "relevantly different" dependent on what those circumstances are, it is certainly open to Ofgem to specify that, for the purposes of this condition, they should be considered to be so. This could then achieve a commonsense outcome, for example, for suppliers' social products to be lower margin than other products.

This can be specified either in the licence condition itself, or in the proposed Guidelines. However, in either case it should be clear, for example specifying that the guideline criteria for a social product should be the same as for eligibility as a social programme; and that the minimum standard for a product to be classed as environmental is as appears in Ofgem's green supply guidelines.

[2] Ofgem's analysis is incomplete as it is for dual-fuel customers.

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?

It is essential to give clear indication of materiality thresholds. Not to do so will just add to the regulatory uncertainty that these proposed conditions are in any event likely to cause.

However, materiality may vary by circumstance. For example, materiality could be tighter for payment method differentials, where some customers may not have choice as to payment method, and wider for, say, in-area to out-of-area electricity, where all customers have the ability to choose suppliers. It might be wider still for off gas grid electricity to dual-fuel, where all customers again have the ability to choose their supplier (and product, and payment method) and also where near-equal margins would reduce the competitive pressure on the largest and generally highest priced supplier, British Gas.

It therefore feels like materiality is too complex to include in a licence condition, but that it absolutely must be comprehensively covered in the Guidelines. This is important whether or not Ofgem specifies in the drafting of the condition that the undue discrimination must be material. This is because:

- if Ofgem does specify that the undue discrimination must be material, it needs to explain what it means by this to assist regulatory certainty; and
- if it does not specify this on the face of the licence condition, the assumption will be that it should be interpreted in accordance with the existing jurisprudence on undue discrimination, which, whilst it is clearly broader than merely looking at cost reflectivity (and this is discussed further below) may not give rise to a sufficiently "deep" materiality-based threshold as Ofgem wishes to see applied. This is on the basis of our understanding from the meeting we had with Ofgem in early February.

In terms of what "undue discrimination" does mean, the English cases which look at statutory provisions in these terms, taken together, establish the following propositions:-

- The inquiry in each case as to whether a difference in treatment amounts to "undue discrimination" as between two classes requires analysing the facts of the particular case, and the reasons for the different treatment;
- **All** relevant circumstances should be taken into account in deciding whether different treatment amounts to undue discrimination (or undue preference). The cases show that the range of potentially relevant factors is wide. It may include issues related to the costs of supplying the service; but it is not restricted to these. It may also include factors related to the customers' own situation. In past cases, for example, this

has included as a relevant difference the fact that one customer has a competing offer available to it, whilst another has not[3];

- The cases apply a statutory prohibition "broadly". The courts have intervened to hold that differences are prohibited "undue discrimination" when 'the making of a difference between customers goes beyond measure and reason'[4] or "is so extravagant that it must be wrong"[5] .

Therefore the guidance should cover:

- An illustrative mix of the circumstances that Ofgem believes can relevantly be taken into account in considering whether differences are due or undue discrimination;
- Materiality for payment method differences, including the treatment of differences in risk;
- Materiality for each other differential Ofgem is seeking to regulate; and
- How materiality might vary with different types of objective justification – competitive conditions might be regarded differently for instance from innovation, smaller scale test & learn differently from established products, the relevance of brand strength and partnerships.

We do not envisage that Ofgem would define a "maximum" materiality, as this would contradict the objective justification principle (which cannot be so precisely defined). However, it would greatly reduce the regulatory burden if Ofgem set out a minimum level, or "safe harbour" below which no objective justification would be required. For instance £25/y margin difference would be consistent with ensuring some level of viable competitive sales activity (with a lower differential where choice was severely restricted, for instance for some payment methods and for dynamic teleswitch).

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?

Since this is a new requirement, and one which sits uncomfortably in a dynamic competitive market, there is value in introducing a new enforcement process of the type that Ofgem sets out. However, there is a balance between the value that this sort of staged process can bring, and the potential for abuse of it, with

[3] Pickering Phipps v LNWR [1892] 2 QB 229

[4] Viscount Kilmuir L.C. in South of Scotland Electricity Board v British Oxygen Co. Ltd [1959] 1WLR 587

[5] Karminski LJ in London Electricity Board v Springate [1969] 1WLR 524

some suppliers basically seeing what they can get away with and for how long, with impunity.

Therefore, given that the theory behind the proposed process is that the supplier will have considered in advance (before introduction) whether his price difference is justified, the supplier should have no difficulty with producing this justification on request and within a reasonably tight period of time[6]. This is more likely to reveal "try ons". In complex cases, Ofgem are very likely to want further information, but comparsion of the final assessment to the immediate response will facilitate any test of whether the supplier genuinely thought the price discrimination was within the guidelines and hence mitigate any breach.

Obviously, Ofgem's guidelines should be sufficiently precise for suppliers to be confident that normal market behaviour will be compliant and we propose in response to Chapter 3 Q3 a review process which will help achieve this. Suppliers should of course be able to seek clarification where the guidelines do not cover a particular situation.

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?

This depends. Ofgem has identified certain areas where the requirement, if it is to be applied at all, should apply to all suppliers operating in the market as any supplier could supply the customers Ofgem is seeking to protect[7]. Examples of these are differentials between payment methods; on and off-line and gas against electricity. However, some areas apply more appropriately to suppliers with an ex-incumbent population of customers, for example, in and out of area.

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?

If Ofgem's position is that a licence condition on payment methods supports compliance with the EC's Gas and Electricity Directives[8], a sunset clause would not be appropriate. However, it is possible that substantial change will be appropriate when smart meters are established. Ofgem should keep this licence condition under continual review.

[6] FSA apply this as 'within 48 hours'

[7] Notably, Ofgem have identified private rentals as a particular issue. A relatively less active new tenant will likely continue with the supplier of the previous tenant.

[8] Directives 2003/54/EC and 2003/55/EC

The benefit of a sunset clause for any other licence condition is that it forces a substantive review of the domestic market, whilst not allowing an easy 'roll-over' option. However, it is unlikely that the impact on the competitive market can be robustly assessed in much less than five years and time also needs to be allowed for thorough review and agreement on any changes (say 18 months). We suggesta sunset date of October 2015. Ofgem could of course initiate an earlier review if the impact on competition was more adverse than expected.

Any licence condition should also be reviewed if there is a significant change in the support arrangements for vulnerable customers. Currently over 500,000[9] customers benefit from social programmes and if this number increases significantly, the overall benefit of any licence condition will reduce as fewer vulnerable customers remain on standard tariffs whilst the regulatory burden and detriment to all customers of reduced innovation and competition will be unchanged.

CHAPTER: Three

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

It is not possible to give a definitive answer to this question without clarity over the guidelines which Ofgem would apply.

As we stated in our response to Ofgem's Initial Findings Report, we believe that the proposals are disproportionate in light of the existing high levels of competition in the market and are likely to lead to a serious risk of dampening competition, to the detriment of all customers.

We believe this to be true of all the proposals, but perceive the risks to be less with Proposal A if it is well designed, allows credit risk to be priced into products and is flexible enough to support innovation.

On the information given we would expect Proposal B to be incompatible with Ofgem's aims, being likely to stifle innovation and competition, whilst creating regulatory risk and a disproportionate regulatory and compliance burden. Proposal B as currently drafted is very general in its area of application – indeed it specifies in paragraph 2 of the draft that the areas of potential discrimination given are illustrative and not definitive. This seems at odds with Ofgem's approach and entirely disproportionate. Ofgem has identified differentials which it believes to be unjustified in four specified areas - payment methods; on and

[9] Ofgem – Monitoring suppliers' social programmes 2007-08. Para 1.6 quotes over 800,000 accounts on social or discounted tariffs; Table 1 suggests a ratio of at least 0.63 customers/account [291,198 customers BG Gas + EdF/E.ON/npower/SSE electricity; 458,494 accounts]

off-line; gas against electricity and in and out of area. Any no undue discrimination condition should be restricted only to those areas (less gas against electricity, which we discuss separately below) as Ofgem has no justification for it to go any wider. In addition, well-designed guidelines are required which make clear that normal competitive behaviour does not carry a regulatory risk.

We discuss Proposal C below, but do not believe it to be workable.

We do not agree with the objective of Proposal D to equalise electricity and gas margins as this would lead to the perverse consequences of reducing any incentive to switch from the supplier that entered the competitive arena with the biggest single inherited incumbent customer advantage, British Gas. Every other supplier in the market has to use any legitimate means it can to seek to persuade customers to switch from British Gas and this proposal will restrict their ability to do so.

However, we support the precision of Proposal D – in targeting regulation on a specific issue, as reducing regulatory risk and allowing for more innovation, than is potentially the case under a broader condition as currently outlined in Proposal B.

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?

Any licence condition should recognise that prepayment and regular cash payment are different from standard credit:

Issue	**Prepayment and regular cash payment**	**Quarterly credit**
Existing licence obligation	Yes – SLC 27.1	No
Are there alternatives? (customer choice is protection)	Not if customer wishes to pay regularly and does not have a bank account or, for PPM, a good credit history	Yes – can switch to DD or RCP
Is suppliers' risk higher than DD? (see Q2 - allow for in cost analysis)	Not substantially, as account normally in credit	Yes, two quarters potentially at risk, plus costs of credit management
Is suppliers' risk higher for new customers? (low margin would stifle competition)	Slightly - additional set-up costs	Significantly – unknown credit history and consumption uncertainty

Our price differentials are better than cost-reflective and therefore we do not believe that a licence condition, with its inevitable regulatory overhead and risk to competitive activity is justified. However, if Ofgem are minded to introduce one we believe the principle should be to ensure that, for customers who have a reduced choice, their payment method is no higher margin, allowing for risk, than if they paid by monthly direct debit.

For prepayment or regular cash payment the licence condition could therefore apply to any product, whilst for quarterly credit it would only apply to the standard product (which customers have not switched from). The licence condition should reflect the intent to protect customers with restricted choice, i.e. be phrased as a cap [‘charges must not materially exceed any additional cost’], rather than be expressed as an objective of cost-reflectivity (which could suggest an increase in PPM or quarterly credit charges).

Finally, it is important to note that, as we made clear in our response to the Initial Findings Report[10], “cost-reflective” should be a broad test, which is interpreted flexibly and does not mean reflect as in a mirror; it means that you should have taken account of the costs in formulating your prices.

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?

As already mentioned, Ofgem has only found differentials which it believes to be unjustified in four specified areas and the condition should be limited to those specific areas. The examples should not be illustrative but definitive. The risks to competition and innovation from a more broadly applying condition would be disproportionate to the prospective issue it sought to address.

In terms of Ofgem’s guidelines, the critical requirement to minimise regulatory uncertainty is for them to be comprehensive, specific and clear, and to allow normal competitive activity. Competitive pricing and innovation would then be permitted so long as there was objective justification for any differentiation. If a new product is being developed, for example, suppliers would have to carefully consider the rationale for any restrictions to its application and whether this was objectively justified. The effect would be a bias towards making offers more widely available, reinforcing the benefit of the other steps Ofgem are taking.

Badly drawn guidelines, or a non-specific licence condition, would undermine even these benefits and will confirm our belief that regulation is disproportionate and a risk to the benefits of competition. If Ofgem are minded to propose an

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[10] E.ON Para 2.50

undue discrimination licence condition we believe that a process on these lines might lead to a practicable solution:

End March	Ofgem publish draft guidelines (and any payment method licence condition)
April	Stakeholder engagement process, with suppliers and other parties (includes review of the legal drafting)
May	Ofgem publish final guidelines and propose a licence condition
June	Suppliers accept licence condition if confident in guidelines
	Immediate implementation

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

The guidelines should not seek to suggest an undue discrimination test which is tighter than established legal precedent – that would cause uncertainty. They can, however, offer more flexibility than existing precedent through the express inclusion of an additional threshold such as "material" (although, as indicated above, case law would suggest that a need for some materiality is already implied). In particular, greater flexibility should be given where a products are innovative or are to meet specific competitive conditions (for instance the need to offer a greater saving to overcome customer inertia, including switching from established brands).

The guidelines should include criteria for determining fairness in sales and marketing activity – some differences between customer groups is inevitable, but practices which make it hard for customers to be aware of or switch to better products could be unduly discriminatory.

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?

This seems to us predominantly to be a legal drafting issue. We would suggest although there would be a problem in trying to control terms for the supply of one fuel to customers in a licence that authorises supply only of the other fuel it is only necessary to control the terms of the fuel in the relevant licence, but this can be done with reference to any other named offer. Moreover, we do not believe that a cross-subsidy condition is necessary or proportionate. It should be recognised that the adverse impact on customers of reducing competitive pressure on British Gas is likely to be greater than other restrictions.

There is a question, however, how well the no cross subsidy condition meets Ofgem's objectives since it is fuel based, whilst the non-discrimination condition is customer based (discrimination between, say, dual-fuel customer and an off gas grid electricity customer). The cross-subsidy definition in Box 4 would also weaken incentives to purchase boldly as it would seem to require some feedback mechanism whereby if an electricity hedging policy turns out to be successful prices have to be reduced.

Proposal C

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

Relative price controls are only practical if they are quite specific, for instance applying to standard products only. Other products would not be covered and the regulation would not therefore undermine innovation. Excluding non-standard products would also avoid the complexity of allowing for acquisition costs and acquisition strategies based on lower initial prices and high retention rates (achieving a profitable lifetime value).

Whether relative price controls undermined competition would depend on the allowed price differential and whether there was any distorting effect from applying a relative price control in a way which does not reflect movements in costs. The first of these issues is similar to materiality, as discussed in response to Q4. The risk from the second issue depends on the potential for differential movement in product costs. Our assessement is that the risk is severe, though varies by the type of product being compared:

Comparison	**Potential cost movements**	**Risk to competition**
Single fuel to dual-fuel	Electricity v gas – energy commodity, energy balancing, settlements, networks charges, brand spend	Very high – no relative price control can meaningfully recognise these factors
In area to out area	Settlements, networks charges, brand spend	High – relative price control control would be too simple
On-line to off-line	n/a – on-line is not a standard product (and potentially requires a quite different hedging strategy)	n/a – but would be high – acquisition and hedging issues

Payment method	Customer service costs, metering charges, credit management risk, customer call frequency	Moderate – if relative price control recognises the high costs of PPM and quarterly credit (most likely change is for them to reduce)

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

None. Relative price controls are practical as a means of regulating payment method differentials, but it would be simpler and quicker to implement a licence condition as we suggest in response to Q2. We do not agree that relative price controls give greater certainty to suppliers or customers. In contrast, Proposal A gives suppliers certainty that they could cover their costs (assuming competitive conditions allow this) and also that there would be no regulatory barrier (only an overhead) to introducing cost-reflective innovations, whilst for customers the principal uncertainty is over the movement in energy costs, for which there is no benefit in relative price controls.

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

If relative price controls were used to regulate payment method differentials the benchmark tariff should be monthly direct debit at a reference consumption (which could vary by product, although it is not critical that it is exactly average consumption). Suppliers would have freedom over how the differential was applied at other consumption levels; there being no means of reflecting the different drivers (e.g. bill size, customer or account, purchase frequency) in a relative price control which is robust for all consumption levels. Suppliers would also have freedom to vary the differential by geographic area, to accomodate any regional variation in costs and credit management risk.

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)?

We would agree that three years is a reasonable period.

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

A three yearly review should allow stakeholders to seek timely change to the relative price controls, although as with any licence condition it would be open to stakeholders to make representations to Ofgem for earlier change.

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?

As discussed in response to Q8, a relative price control should apply to a reference consumption.

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

We do not see how this would work. A revenue cap would allow suppliers to vary price differentials within the cap, which would seem to be the very behaviour that Ofgem would be trying to constrain. It would also add to the regulatory overhead, by requiring consumption data by product, a level of detail which may not be available.

Proposal D

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

This question starts from a mistaken premise. Ofgem's analysis does not show that single electricity customers have been sustained high margin, only that gas margins have been low over the period 2005 - 2007. Moreover, low gas margins have been primarily due to a combination of suppliers' desire to compete with British Gas and the relative movement of, and success of hedging policies between, electricity and gas. It is not clear that raising gas margins would be to customers' benefit.

Furthermore, Ofgem has not established that electricity margins are excessive. All it has done is to note that electricity and gas margins are not equal, and that (in the case of companies competing against the market power of British Gas), electricity margins have tended to be higher than gas margins. To require that electricity and gas margins are equal would clearly be to introduce an unnecessary and disproportionate distortion into the competitive market.

Moreover, the implication of this proposed condition is to dictate to companies what they must do in the event of successful hedging, namely adjust their margins to the level of their least successfully hedged fuel. This should be a choice in a competitive market, which different suppliers will adopt or not depending on their strategy, and should not be dictated by a regulator.

It appears from Ofgem's drafting (and we hope that this is the correct interpretation) that this is not Ofgem's intention. Instead, Ofgem's objective is to remove the potential for substantial persistent intentional differentials between electricity and gas margins. Ofgem appears to have identified a symptom, but it is going about treating the underlying cause in the wrong way.

For example, one of the reasons for low gas prices is the need to offer a larger saving given British Gas's brand strength. Therefore, a key step Ofgem could take to deal with this issue would be to implement proposals to allay customer concerns over switching – this comes back to the point already made above about British Gas having had the largest single inherited incumbent customer advantage at liberalisation of the market.

In our December response to the Initial Findings Report, we also presented a number of measures to tackle this issue (paragraph 2.73):

- Consumer Focus, through the recognition they give to switching sites, can encourage the development of comparison features which increase customers' ability to choose unduly low priced gas offers *(and hence make such offers unattractive for suppliers).* The two necessary steps are (i) display of separate electricity and gas options with dual-fuel quotes; and (ii) easy to access display of off-line offers, for increased transparency to occasional internet users;

- Media interest in price differentials, increasing customer awareness of the need to consider separate offers and potentially leading to adverse comment on any supplier with untoward differentials;

- Increased awareness of the potential benefits of proactive engagement with the market amongst single electricity customers (whether on-line or by phone).

These initiatives will make it easier for current non-switchers to benefit from competition, but although increased competitive pressure will benefit all customers, the greatest benefit will still go to those who now exercise their choice.

Fundamentally we believe that this proposed measure is unnecessary and disproportionate. If Ofgem's intention is to protect the single electricity customer who has not switched, then the following protections already exist:

- E.ON, and some other suppliers, have committed to lower electricity prices for customers off the gas grid, removing the particular disadvantage cited in paragraph 3.35 of the present consultation;
- If Ofgem implements its proposals for non-discrimination between in and out of area customers, this group of in-area customers (assumed for this purpose to be non-switchers, though they could be winbacks) will be protected by, and receive the benefit of, the prices offered to customers in what Ofgem would view as the more competitive part of the market;
- Further, if these customers are, for example, on standard credit, they would receive the benefit of the provisions that Ofgem puts in place for cost reflectivity or non-discrimination between payment methods, provided these are implemented; and
- Finally, E.ON and other suppliers offer very attractive single electricity deals both on and off-line, to which such customers could change. They would be encouraged to do so through the additional measures Ofgem intends to put in place around informational transparency and openness.

Therefore, we do not think that this proposed condition is either proportionate or appropriate and would urge Ofgem to reconsider its inclusion.

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?

Should Ofgem go ahead with this, we would expect Ofgem to give a clear explanation of the principles underlying a possible breach of it in guidelines. Moreover, we would expect the bar to be set high – as indicated above, Ofgem has not established that electricity margins are excessive. To require that electricity and gas margins are equal would clearly introduce an unnecessary and disproportionate distortion into the competitive market. Ofgem needs to make clear, as it suggests in the draft, that this condition would only bite if differences are really significantly greater and over a sustained period of time.

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?

Neither condition is appropriate, but if Ofgem's objective is to equalise margins between electricity and gas (as a means of reducing differences between customers who switch and those who do not) then there is at least as much need to deal with higher gas margins BG may be able to secure as apparently higher electricity margins from ex-PESs.

As we noted above, the potential disadvantage to customers off the gas grid noted in paragraph 3.35 has already been tackled by suppliers. As we noted in our December response to the Initial Findings Report[14], the evidence from Ofgem's probe findings is that switching rates are high for customers on standard electricity products and the off gas grid issue is principally one of lack of competition for dynamic teleswitch customers (in part due to the relatively low margins on these customers for their level of energy demand risk).

[14] E.ON Para 2.75

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?

The impact of these proposals depends on how they are implemented and will vary over time.

The immediate impact of these proposals will only be seen when all suppliers have responded to falling wholesale prices, but we would expect there to be a marked reduction in the savings available for switching to standard off-line products. Only time will tell whether this reduction in competitive pressure leads to higher retail margins. It will not be possible to quantify any adverse effect on the wholesale market, although as described in section 3 of our December response to the Initial Findings Report this could be significant.

The adverse effects of the proposals will also be felt in different areas, for example the greatest impact might be as follows:

Area of intervention	**Worst case adverse consequences**
Payment method differentials	Security deposit required for standard credit sales
Electricity v gas	British Gas market power increased (reduced competition and strengthened price leadership) Gas price margins increase; reduced dual-fuel competition
In v out area	Reduced competitive pressure on historic ex-PES brands
On-line v off-line	Stifle most innovative and competitive sector of the market

The impact of the proposals on small suppliers will depend on their business model. One which seeks to engage non-switchers (for example, entry by a well-known brand) would be harmed, as customers are more likely to doubt the evidence of savings messages believing they are protected by Ofgem; one based on innovative products (for example, using smart meters to manage energy risk) would be helped by the regulatory burden on major suppliers.

We attach a confidential annex on E.ON’s price position.

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?

This depends on how Ofgem implement any proposals, but environmental benefits (within the standard set by the green supply guidelines) should be regarded as an objective justification for discrimination, with a low regulatory risk.

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

Any effect is likely to be small, but positive. The weakening of price competition could increase the importance of non-price features, such as CO alarms.

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

We do not agree with Ofgem's assertion in paragraph 1.39 of the present consultation that a reduction in competition and an increase in margins is a "risk"; this must be the expected outcome. The scale will depend on how the proposals are implemented. The risk is that the overall detriment to customers outweighs the potential benefit to non-switchers of Ofgem's proposals by more than expected. Indeed, it is quite possible that there will be an overall adverse effect even for non-switchers, due to reduced competitive pressures leading to higher margins or wholesale costs.

A reduction in price competition is also likely to have an unintended consequence of increasing British Gas market power.