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Ofgem
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20 February 2009

Dear Neil

Addressing Unfair Price Differentials - Consultation

I am pleased to enclose EDF Energy's response to Ofgem's consultation: Addressing Unfair Price Differentials.

We agree with Ofgem's findings in the Energy Supply Probe Initial Findings Report that the "fundamental structures of a competitive market are in place". The report identified that there were elements of the ways in which markets work that could be improved to the benefit of some groups of customers.

We are already engaging with Ofgem to introduce improvements to the market for the customers identified, as evidenced by our commitment to reduce prices to our in-area, stand-alone electricity customers with effect from 27 February 2009 and to develop more effective communications for customers.


Ofgem states in its introduction to this consultation that in implementing reforms that address "unfair price differentials" it is keen to ensure it does not restrict suppliers' ability to innovate or incentives to compete. Like Ofgem we believe that the further development of competition is the best way to protect customers over time.

As outlined in previous correspondence, we recognise that at the present time there may be some discrepancies in margins between different products that could indicate that competitive pressures are not being fully brought to bear and progress is already being made to address this. Ofgem should be careful, however, to ensure that, in making any regulatory interventions in the supply market, it does not restrict competition and the benefits that a fully competitive market brings to the vast majority of customers.

It is essential, in our view, that any new supply licence obligation that seeks to address “unfair price differentials” should be consistent with Better Regulation Principles, and in particular should be proportionate and strictly targeted at the detriment Ofgem is seeking to address. Nevertheless, we would be prepared to agree a new licence condition provided it is suitably framed.

I attach our more detailed response to your consultation. If you have any queries on this response, please do not hesitate to contact me.

Yours sincerely

A handwritten signature in blue ink, appearing to read "D. Linford", with a long horizontal flourish extending to the right.

Denis Linford
Director of Regulation

Attachment

Addressing Unfair Price Differentials

EDF Energy's response

Key points:

- The introduction of new licence conditions to enforce cost-reflective pricing and/or prohibit undue price discrimination should be proportionate to the improvements the market needs.
- Any restriction on EDF Energy's ability to compete aggressively in particular areas where we have a less well established presence would result in a reduction in competition and reduce the opportunities for customers to switch supplier.
- The introduction of prescriptive relative price controls such as through Option C would represent a re-regulation of supply markets, which would create barriers to the continuing development of competition and innovation. Almost certainly such price regulation would not be able to keep pace with innovation in prices and services.
- EDF Energy continues to believe that the further development of competition will provide the best protection for most customers – for those customers who are vulnerable we believe targeted discounts through a mandatory social tariff is the best way to protect their interests.
- We are prepared to accept the minimum intervention proposed by Ofgem, i.e. Option A (cost reflective pricing between payment methods), since we believe that this could be introduced relatively easily, and, if suitable framed, can be consistent with the maintenance of the greatest level of competition.
- Conversely, price regulation aimed at significantly reducing price differentials across a wider market, by e.g. options B or C and D, presents greater difficulties, particularly as it could create disincentives to new market entrants and would almost certainly reduce customer churn.
- To unwind price differences that may not fully reflect costs in a competitive market context is complex, but the process has already begun. Some customers that have benefited from competitive market choices may lose out in the move to introduce more cost reflective pricing; e.g. EDF Energy was the first company to equalise PPM with standard credit tariffs for its electricity customers. Enforcement of cost-reflective pricing would require us to re-visit historic pricing decisions, which, for some customers, will mean that price differentials may be re-introduced.

- We believe that it will be very difficult to prohibit through licence conditions “cross-subsidy” between gas and electricity, since margin relativities can quickly change through the intrinsic volatility of wholesale markets. It would for example be damaging to both our commercial position and consumer interests if our prices had to closely reflect historic cost differentials rather than future cost expectations.

Summary of responses to questions raised in the consultation

Chapter 2

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’s primary remit is to protect consumers, wherever appropriate by promoting competition. Ofgem’s overall aims in carrying out this review are consistent with this, but care must be taken to ensure that these aims are not delivered to the detriment of a competitive supply market.

Any proposals which severely restrict how suppliers choose to set prices for particular groups or which seek to align suppliers’ pricing principles would clearly have a negative effect on competition. They may also not be in the interest of customers. At present customers can choose to transfer to the supplier that offers the best price and/ or service to their particular customer group. Customer research has shown that the majority of customers who switch supplier do so because they have concluded that they will be getting a better price. By strictly enforcing cost reflective pricing, customers will lose much of this differentiation between suppliers. Ofgem should seek to regulate only where the benefit to consumers outweighs the negative effect on competition.

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

In a fully competitive market, the allocation of costs is a matter for suppliers. Those suppliers whose products and services best meet their customers’ needs will flourish. Any action taken to regulate cost allocation will reduce the opportunity for suppliers to differentiate the prices and products they offer compared with those offered by their competitors and will therefore have a negative effect on their ability to compete. Ofgem has a wider remit in ensuring the safety and security of supply, in the protection of vulnerable customers, and in the promotion of environmental initiatives. It should, in our view, seek to regulate cost allocation by suppliers only where this regulation delivers a benefit in accordance with its wider remit.

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?

In accordance with its wider remit, it is appropriate that Ofgem considers both social and environmental issues as part of this review. The delivery of social and environmental services and commitments will have a higher cost to suppliers than their standard cost to serve and these costs need to be recognised in any cost-reflective pricing regime that Ofgem introduces.

Customers with average or higher than average consumption are generally more attractive to suppliers and the promotion of the competitive market will provide the best protection for these customers who are able to switch supplier easily.

In the long term EDF Energy believes that a mandatory social tariff is the only sustainable way of helping vulnerable customers, and would be much more effective than re-introducing prescriptive price regulation for all customer groups.

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?

When enforcing against non-compliance, Ofgem must always ensure that any penalty imposed is proportional to the level and duration of the non-compliance and the adverse effect this has had on the competitive market and on customers. Historically this has been delivered through the initiation of a full investigation followed by a review of all the evidence presented, including the effects on competition and those customers affected by the breach.

We tend to agree with Ofgem that the disadvantages of materiality thresholds outweigh the advantages in terms of regulatory certainty.

Ofgem would need to consult further, as to the details of any such proposals, prior to the implementation of such a regime. We would, in particular, wish to understand the difference in approach Ofgem would take to enforcement, if any, should materiality thresholds be included in guidance notes rather than on the face of the licence.

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?

We are generally supportive of the new enforcement process identified by Ofgem in this consultation. In their present format, however, a number of the proposals are not clearly defined. If the proposed changes are adopted, suppliers will require further clarification from Ofgem in order to ensure that they are correctly following Ofgem's intention.

We note Ofgem's comment at paragraph 2.14 that such an approach could reduce regulatory risk for suppliers in making price changes and introducing new products, which could undermine the incentive on suppliers to comply with the licence condition. We suggest that Ofgem could address this issue by imposing additional penalties on any supplier that systematically breaches these conditions.

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?

Ofgem states that the purpose of these proposals is to address unfair pricing differentials for domestic customers. We believe that restricting such new price regulation to the "Big 6" suppliers would conflict with Ofgem's primary remit (the protection of customers) and that Ofgem should, therefore, apply these licence requirements equally across all domestic suppliers.

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?

Ofgem states in its consultation "Energy Supply Probe – Initial Findings Report" that energy markets in Great Britain have moved from pure monopolies to markets where there are now greater levels of competitive switching than almost any other energy market in the world and most other UK consumer service markets. Despite this, Ofgem notes that there are important areas where the transition to competitive markets now needs to be accelerated. Once the energy markets have achieved the level of competition that Ofgem aspires to, regulation in the area of pricing would seem to be superfluous or detrimental to the competitive operation of these markets. We strongly believe that any new licence conditions introduced to regulate pricing policy should include a sunset clause.

Ofgem proposes an initial period for these licence conditions of not less than three years and no more than five years. The period that will be required to ensure that suppliers are fully compliant across their full range of products will vary, depending on

which regulatory option(s) is introduced and the time period required for suppliers to become fully compliant. Less prescriptive and complex price regulation, e.g. Options A or B, is likely to be effective more quickly than more intrusive and prescriptive options such as C and D. Nevertheless, timescales will vary by supplier and Ofgem will need to draw its own conclusions as to the length of that initial period, which could be as little as a few months or, as Ofgem comments, as much as three years.

Once all suppliers are compliant with the new licence obligation, it would seem appropriate (based on evidence and experience from the regulation of competitive supply markets through to 2002) that a further period of no more than two years would be needed to allow Ofgem to assess the impact of these clauses on the market. We believe that the sunset clause should be set no later than April 2012 if less intrusive options such as A or B (with tolerances) are followed and April 2013 at the latest. At this point Ofgem should consult further on the effects of their introduction.

CHAPTER: Three

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

Overall, we believe that the imposition of regulatory restrictions on suppliers' pricing will have an unnecessary and potentially damaging impact on competition. All of Ofgem's proposals will tend to have the effect of reducing suppliers' ability to differentiate their product offerings to different customer segments. This will also reduce suppliers' ability to market to niche groups.

Ofgem should be completely satisfied before proceeding that a significant improvement in the protection of domestic customers will be gained, by whatever option it decides to implement. Inappropriate regulation could lead to distortions of competition that will act against the interests of customers, both now and in the future.

In our view, there have been welcome signs of innovation in the energy supply market in recent years, and there is every indication that this trend has very much further to go, as suppliers find new ways of differentiating their services, as a result of changes such as in metering, energy saving measures and in low carbon supplies. There is a very real danger that reintroduction of price regulation will stifle these developments, which will be of benefit to consumers and to meeting environmental objectives.

On the basis that Ofgem believes that some form of price regulation is necessary to protect domestic customers, EDF Energy's views on the four proposals identified by Ofgem are as follows:

Proposal A - Cost reflective pricing between payment methods

We believe we will be able to accept Proposal A, subject to the precise drafting of the condition and any associated guidance. We would be interested in proposing how the condition might be drafted once Ofgem has decided the way forward. Of the options proposed by Ofgem we believe this will have the least damaging impact on competition.

The enforcement of cost reflective pricing dependent on payment method is less likely to stifle the development of new products and services of benefit to consumers and the environment, such as renewable energy, smart metering, energy reduction products such as our own Read, Reduce, Reward (RRR) etc. An additional benefit is that cost reflective pricing by payment method will not affect suppliers' customer acquisition strategies in different geographical regions or across fuel types, leading to less disturbance in the market during difficult economic times.

Proposal B – Prohibition of undue discrimination

We believe that a "light touch" variant of this option may have some merit in helping to move the market for energy products from its current position, which is largely historic, to one which is effective for all groups of customer. Ofgem must, at the same time, ensure that the real benefits that competition has brought to customers in the form of product innovation and differentiation along with lower prices are not eroded. This could be achieved by allowing some tolerance for price differences across geographical regions and fuels.

We would not support the imposition of price controls which overly restrict suppliers' ability to target different geographical regions and customer groups with very competitive products and prices where the form of that regulation is broad in scope and has little or no flexibility, e.g. by covering all instances of "unfair price differentials" and non-price deals (as described in paragraph 3.19 of Ofgem's paper).

At the opening of the competitive market in supply it was necessary for suppliers to be able to compete in a geographical region (or fuel type) where they had no previous market presence. The competitive market that currently exists for energy products has been achieved precisely because the market regime established at the time provided opportunities for new entrants to gain customers from incumbent suppliers by offering new and discounted products.

Currently, British Gas remains the dominant supplier for gas, nationally, and the other five suppliers still have significant market shares in their ex-host public electricity supply areas. Attempting to restrict suppliers' ability to offer competitive, low priced products outside of their traditional areas will remove their ability to compete on an equal footing in their non-traditional areas against suppliers who have strong brand recognition and reputations in those areas.

Proposal C – Relative price controls

We are strongly opposed to this proposal as we believe that the introduction of prescriptive price regulation as set out in this proposal will lead to the complete re-regulation of the domestic supply market, which is completely inconsistent with the further development of competition. Furthermore the regulatory burden of the option, both for Ofgem and suppliers, cannot, in our view, be justified.

Proposal D – Prohibition of cross-subsidy between gas and electricity supply

Considerable progress has already been made in addressing this issue, which is related to the historical way in which energy supply competition was able to develop so rapidly. This is evidenced by EDF Energy's commitment to reduce prices to its in-area, stand-alone electricity customers with effect from 27 February 2009 and to develop more effective communications for customers. We do not, therefore, believe that further regulatory constraints in this area are necessary or desirable. Should Ofgem consider that additional regulation is required to protect customers from discriminatory behaviour across different products, prices and geographical regions, this would, we believe, be better achieved by adopting the "light touch" version of Option B we have suggested above.

All ex-host public electricity suppliers have traditionally developed flexible product and pricing tactics between fuels to allow them to compete more effectively outside their traditional business areas through the promotion of dual fuel offers. As a result, the UK Energy market has been able to demonstrate a rate of customer switching and level of competition that far outstrips most other country's energy markets and most other customer markets in the UK.

Ofgem justifies this proposal by a wish to protect customers who are unable to receive dual fuel incentives as they only have a single fuel. This is an issue that suppliers, including EDF Energy, have sought to address with the introduction of new discounts for electricity customers since Ofgem announced its probe findings last year. We are pleased that Ofgem has been supportive of these initiatives. If, as Ofgem states, it wishes to continue to protect customers who have no access to a gas supply, then guidelines or a no undue price discrimination licence condition should be produced to reflect this.

We also believe that the introduction of specific regulation to ensure that single fuel customers receive prices equal to prices for those who sign up for dual fuel offerings will have a disproportionate effect on traditional electricity suppliers who have a large number of customers whose properties are not supplied with gas. There are no properties in the UK which are supplied purely by gas and, as they have acquired primarily dual fuel customers, British Gas has very few electricity only customers without a mains gas supply. Attempting to introduce regulation specific to this area, therefore, risks further distorting rather than improving competition in the market.

EDF Energy
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