Addressing Unfair Price Differentials – ScottishPower Response

Consultation Questions

CHAPTER: Two

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

Ofgem's aim of addressing unfair price differentials while doing so in a way that does not undermine competition (having regard to innovation, cost reduction, sustainability, regulatory risk, avoiding disproportionate compliance burdens, and providing for a sunset clause) is appropriate. We have approached our response from the same point of view.

However, we are concerned that Ofgem may have underestimated the dangers of unintended consequences in seeking to place constraints around the operation of the competitive market. In particular, anti-discrimination measures risk making it harder to attack the market shares of other suppliers and could increase the attractiveness to suppliers of following a defensive strategy. If this risk comes about, it could lead to the most dynamic utility market in Europe – possibly the world – becoming more sluggish, to the detriment of consumers.

General restrictions on discrimination are not applied in the wider economy. Indeed, special offers and targeted promotions are a key part of the competitive process. Restricting them is more likely to disadvantage those who would have benefitted from them, than cut prices for others. It is not a zero sum process.

The challenge is therefore to find a way forward that addresses public concern without damaging the market or risking unintended consequences. In our view this is best achieved by a two stage condition based on non-discrimination. If that condition was limited to payment methods, we believe that we can be fairly sure that the impact on competition would be limited; a broader non-discrimination condition carries a commensurately greater risk

As Ofgem said in their Initial Findings Report, in the ten years since the domestic gas and electricity markets were opened to competition, both competitive activity and consumer switching now exceed the levels in almost every other energy market in the world. The report acknowledges that this activity exceeds other UK consumer services markets. A great deal has been achieved, with Ofgem's leadership, and many of the remaining wrinkles such as in area/out of area differentials – often inherited from the pre-competition days – are well on the way to being ironed out. It is important that the steps being taken at this stage build upon, and do not damage, what has been achieved and our suggestions are offered in that spirit.

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

Historical evidence shows that the best long term guide to cost allocation is the operation of the market; over time, it will seek out cost differentials that may not initially be understood by participants or by regulators. Accordingly, a degree of caution needs to be used in cost allocation principles to ensure that they do not diverge from market principles. Otherwise there is a risk that some customer groups will be over-charged and others will become unprofitable to serve.

The principles set out by Ofgem, of targeting costs relating to the characteristics of the product and smearing costs relating to the demographics of the customer base, could appear to run contrary to this principle in that – if the demographic element was significant – it could lead to some products being loss-making and therefore a tendency for companies to avoid serving market segments that sought them.

Whether this matters will depend on the extent to which the demographic and other smeared elements are material in the overall cost base. On our understanding of Ofgem's thinking, the smeared costs are small and therefore unlikely to lead to significant market distortions. If this turns out to be an incorrect assumption, the approach to cost allocation may need to be revised and we would suggest that Ofgem does not lock this down too tightly.

<u>Cost allocation by means of payment</u>

Costs which in our view should be differentiated between products include the following:

Expense Category	**Cost Allocation Principles**
Operating Costs	Costs incurred through servicing the customer base from a point when the customer is issued with their first bill until such time as they may decide to leave. This also includes such costs as change of occupier.
Debt	All costs arising from both live and final debt. This includes both the working capital cost associated with any debt position and the cost of debt written off. In our view, debt costs relate to the means of payment and not to the demographics of the customer base. In any event, it is such a large component of the cost to serve for some products that smearing it is not a realistic option. All payment methods currently have some debt costs – but standard credit is by far the largest.
Competitive Market Costs	Costs included in this expense category include customer acquisition; customer registration and account set up through to issuing the first bill; and if appropriate the process of de-registration. Differing products tend to acquire customers through differing channels, and the acquisition cost varies by channel. Some products, especially prepayment, have significantly more expensive registration and account setup processes because of the need to update the payment infrastructure. As well as variations in the base cost of these items, their incidence may vary between products because of loyalty features in the product, the way it is sold, or wider factors.

It is worth commenting more specifically on debt costs. Standard credit is extremely susceptible to debt build-up because the bill is allowed to accrue for three months before it is levied. Many people subject to financial stress operate on a weekly cash budget and find this process difficult to manage. There is then a lengthy process before effective action can be taken. Debt write-off and working capital costs in this category are a significant proportion of revenues – much too big a number to smear.

Paradoxically, there is some small element of debt cost attributable to prepayment meters. This arises principally from two sources:

(a) cases where there is an existing debt on the meter which “goes final” owing to a change of occupier or supplier and cannot then be recovered; and

(b) cases where debt arises from the operation of a token meter, for example mis-directed payments or where the customer does not provide access for recalibration. (A similar cost would arise, under a different label, if we wrote off rather than seeking to recover the cost of delayed tariff changes.)

At present, ScottishPower estimates these categories by attributing debt to the old product for the first year of prepayment operation and then to prepayment after that date.

Debt costs can also arise on direct debit products if the direct debit fails or the bill goes final at a time of year where the customer owes us money. However, we generally know about direct debit problems much faster than standard credit and we find that customers are less likely to put aside bills that are paid automatically. Accordingly, the debt costs for these products tend to be low.

<u>Cost allocation by other product types</u>

Moving to broader product types, it is significantly harder to identify a robust basis of cost allocation between, for example, fixed price, capped price and variable price offers as the attractiveness of these will depend on the customer’s appetite for risk and on views as to the likeliness of various future price outcomes.

It may be more sensible to recognise that these areas should not be regulated by the proposed condition rather than derive a methodology for this kind of comparison.

<u>Conclusion</u>

We acknowledge that our depth of understanding around the attributable costs at an individual customer level continues to increase and provide us with a greater ability to improve the cost reflectivity of what we offer. Our pursuit for a superior knowledge surrounding the allocation of our costs will help achieve this, but we will also need to understand and reflect in our cost allocation the impact that changing customer behaviours and market influences have on our business.

It would in our view be unwise for regulatory cost allocations to be used as a means to achieve social ends, as this would leave some customers unprofitable to serve and therefore less likely to gain from the benefits of competition.

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?

We agree that social or environmental issues can be appropriate objective justification for pricing that is not cost reflective. Such pricing is evident, for example in social tariffs or export tariffs for domestic micro-generation as well as the provision of free services to persons on the priority service register.

Our proposal for a two stage enforcement process would enable Ofgem to take a view on objective justification before deciding whether to make a preliminary determination that a pricing practice was discriminatory.

There are other elements of objective justification that we think Ofgem should consider within this framework. For example, if a company had innovated so that its cost to serve a particular class of customers was less than the competitive norm, they should be able to take the benefit in increased profits so as to reward it for the investment made.

Similarly, where a company is facing higher costs than its competitors in a particular segment, for example as a result of IT problems or a poorly performing subcontractor, it may be appropriate to accept reduced margins or even short term losses in the segment, in order to respond to competitive pressure, rather than passing the higher costs on to consumers and suffering attrition of market share.

It is also necessary to consider the role of special offers. It is generally thought that these, although not cost reflective, act in the interests of customers by eroding any tendency for companies in a market to defend existing market share rather than attacking competitors. Similar considerations apply to fixed price, capped and tracker offers, which may differ from standard products over their lifetime in manners which are not cost reflective.

It may be worthwhile to consider reversing the concept of objective justification and only taking action on non cost-reflective pricing where the pricing practice is considered to be contrary to the public interest.

Again, a two stage condition provides an appropriate framework for addressing these issues.

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?

We understand the dilemma faced by the specification of materiality thresholds in the licence condition or in guidance. On the one hand, in the absence of specified thresholds, suppliers will feel inhibited in innovating or in responding to competitive pressure. On the other, Ofgem have suggested that setting a lower limit to materiality might invite persistent low levels of undue price discrimination.

We think that the second limb of the dilemma, at least in theory, ought not to be a problem. If a particular market sector is genuinely being discriminated against with excessive prices, it should be in the interests of a supplier to improve its offering in that segment so as to gain market share while increasing profitability. In time, the forces of competition will eliminate any over-pricing against the true costs, though the comparison with any administratively determined cost estimates is less easy to predict.

This analysis suggests that it could be beneficial to state clear materiality thresholds (probably in guidance rather than on the face of the condition, in order to allow for thinking to evolve with experience).

However, we would observe that a two stage condition side-steps the dilemma in that there would be no need to predefine acceptable materiality thresholds, but neither would their lack have the significant negative effect referred to above; instead, the pattern of interventions and questions raised by Ofgem would increasingly enable companies to understand Ofgem's thinking in areas which can be very complex.

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?

Our response to the Initial Findings Report set out the case for a two stage condition as we believe that such a process is likely to minimise the negative and unintended consequences of regulation in this area, without compromising Ofgem's ability to address unfair differentials.

We do not believe that the disadvantage cited in the paper – that a two stage condition could undermine the incentive to comply – is justified. We would envisage that the process of notices of *prima facie* discrimination, and their resolution, would be public (subject to protection of confidential data) and therefore that a body of informal regulatory jurisprudence would build up. Suppliers would wish to avoid the embarrassment of going through this process, not to mention the cost of changing tariffs and advising customers. But a two stage condition would help avoid the very real concern that suppliers would be highly risk-averse in setting price relativities, thus avoiding the offers and incentives that are the lifeblood of dynamic competition.

Turning to the detail of the condition, we think that the outline is broadly appropriate, though we believe that the concept of retrospective remuneration of harmed consumers is not appropriate as the prospect of it would introduce exactly the chilling effect that the two stage condition is intended to avoid. Once the process reached the stage of breach of the condition, then it would be reasonable to consider compensation if there were delays in remedying the matter.

On reflection, if a "notice of potential objection" is confirmed we suggest that it would be better simply to "unveil" the requirement to avoid undue discrimination rather than have Ofgem impose specific adjustments. This is because there may be several ways for a supplier to remedy a practice deemed contrary to the condition and it would not be in the interests of the market for Ofgem to specify which option should be chosen.

We will provide a supplementary response shortly containing specific drafting suggestions for a two stage condition.

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?

We understand that these proposals are not intended to remedy any effect such as dominance (where differential obligations for the dominant supplier are normal) but are proposed for the purpose of enhancing consumer protection. In those circumstances, the requirements should apply to all suppliers active in the domestic market, irrespective of their size. Consumers cannot be expected to differentiate between the regulatory obligations on competing suppliers when making choices in the competitive market.

In practice, the use of a two stage condition would allow Ofgem to give a wider degree of latitude to new or emerging suppliers, while maintaining the powers as a backstop.

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?

We have described in our answer to question 1 the reasons why regulation in this area could act against the interests of consumers and have suggested the mechanism of a two stage condition as the most appropriate way to mitigate these unintended consequences.

We agree that competition should in time deal with the issues that are of concern to Ofgem and therefore that a sunset clause would be appropriate to ensure that any regulatory intervention of the type proposed would be formally reviewed within in a reasonable period. A sunset clause would demonstrate Ofgem's commitment to resolving these issues through the operation and improvement of the competitive market, as opposed to through the long term use of regulation.

We believe that a period of three years would enable a good assessment to be made, both of the measures arising from the probe intended to improve the operation of the market, and of the effect of the proposed condition on differentials. We think a longer review period would be a mistake – it would signal that Ofgem believed that market development would be unlikely to deal with the issues at source.

However, because of the considerable uncertainty at present as a result of conditions in the wider economy, we think that it would be wise, in addition to the automatic review at 3 years, to have a process whereby suppliers could apply for disapplication of the condition.

CHAPTER: Three

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

We have commented above that we consider that a two-stage condition is the most promising approach to addressing the issues raised without having unintended or other damaging side effects. In addition, the drafts offered in Chapter 3 do not address such issues as guidance or the proposed sunset provision. Accordingly, they would need further development before they could be considered suitable for implementation.

In terms of the principle of the conditions, we think that proposals A and/or B would be capable of working, although care would be needed to avoid risking unintended consequences. These risks are likely to be more extensive under proposal B than under proposal A. Proposal A should be cast in terms of avoiding undue discrimination as respects methods of payment, rather than in terms of cost reflectivity.

We believe that proposal C is unlikely to be viable because of the difficulty of setting the control at an appropriate level. It would be more sensible to approach the subject matter of proposal C through proposals A and/or B.

We believe that proposal D is unlikely to be viable because of the difficulty of determining an acceptable basis for assessing wholesale input costs. Indeed it seems likely to us that such a proposal would do more harm than good. In the event that margins for electricity only customers are sustained at higher levels than other customers, there will be scope for others to compete the difference away, as has been demonstrated by the recent emergence of discounts for this sector.

Proposal A Cost-reflective pricing between payment methods

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

Our policy is to aim for broad cost-reflectivity by payment method, within a competitive context. This allows us, so far as the competition allows, to send signals to consumers about the costs of various ways of doing business with us, and so enabling them to make the most economic decisions around payment methods. We would therefore be prepared to accept a suitably framed licence condition which echoed that approach, so long as appropriate care is taken to avoid unintended consequences.

Nevertheless, we should add that we are not convinced that the subparagraph (d) of Annex A to Directives 2003/54/EC and 2003/55/EC does require cost reflectivity in tariffs by payment method. The Annexes distinguish between terms and conditions on the one hand and prices on the other, and there is no mention of prices in subparagraph (d). Ofgem's proposed "copy-out" condition in fact adds a mention of prices where one is not present in the Directives.

We believe that a condition addressed to payment methods should:

(a) be cast in terms of avoiding undue discrimination by reference to means of payment; and

(b) provide for exemptions for the public interest (ie social tariffs etc) and where reasonably necessary to meet competition; and

We have discussed in response to earlier questions our proposals for two stage enforcement and sunset clauses (including a disapplication mechanism), and we would also seek these in any condition.

Even with these precautions, there are risks that regulation in this area will have unintended consequences. In particular, if Ofgem were to take a view on cost allocation which was not accurate, or was influenced by political pressures, this could lead to some customers being unprofitable to serve.

In addition, if the benefit of any process improvements on a particular method of payment had to be handed over immediately to consumers, this might reduce the incentive to innovate. Conversely, if a company had additional costs for a particular payment method which its competitors did not face, it might choose to adsorb them at least in part in order to maintain market share. Again, a badly drafted condition might prevent this, to the detriment of consumers.

Some special offers may be dependent on a particular payment method. If the condition effectively rules these out, the outcome could blunt competition. Ruling out certain discounted products may not necessarily lead to an improvement in terms for the customers the condition is intended to help.

In summary, while an appropriately drafted condition in this area has the lowest risks to competition from all the options presented, some risks still remain. It would therefore be important to frame the condition carefully to minimise those risks; we have proposed what we believe to be the necessary elements to achieve this.

Proposal B: Prohibition of undue price discrimination

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

Because this proposal is wider than Proposal A, it would be more likely to have unintended consequences. Particular areas which could be difficult include:

- online offers – there is some evidence of suppliers offering special deals online in order to gain additional customers at lower margins (though some of the difference may be accounted for by lower acquisition costs). Restricting these offers may increase prices for online switchers without necessarily reducing them for other consumers;

- fixed price, tracker and capped offers – it is unclear how Ofgem would assess the pricing of these against standard products, since the valuation of these products may depend on attitudes to risk and views about the future direction of energy markets, and all these factors may change over time;

- special deals for new customers – in order to overcome inertia, it may be necessary to offer special deals to new customers. If these are forbidden, it may encourage suppliers to adopt a defensive rather than aggressive competitive stance, potentially leading to higher prices overall. This is particularly the case given that many suppliers have large inherited market shares in some localities; in order to attack these, competing suppliers may want to offer keener deals than they could afford to offer to their entire customer base;

- new products – these may need to be offered with reduced margins initially in order to build up consumer interest to a critical mass. Non-discrimination rules may mean that innovation is discouraged;

- social and environmental products – these are likely not to be cost reflective and may require exemptions;

- responding to competition. A supplier with a different cost structure to its competitors might wish to accept reduced margins in some business segments in order to stay competitive.

All these reasons may help explain why the general law does not require non-discrimination except insofar as necessary to prevent the abuse of a dominant position. Buy one, get one free offers in supermarkets are not cost reflective, but are allowed because the principal effect of banning them would be that consumers would lose out from bargains. The same applies to other sales promotions.

In addition, there is a risk that an ex-post condition could leave companies unwilling to innovate. It could put Ofgem in a dilemma whereby detailed guidance could leave it determining almost every aspect of the products on offer, while broad guidance would increase regulatory risk and encourage a defensive rather than innovative approach.

We do not believe that supplementary guidance in this situation would be sufficient to recognise the volume and complexity of possible permutations of offer that the market has in place even now. It is also unlikely that such guidance could exist in isolation of the ability to take forward product or pricing discussions directly with Ofgem particularly as products evolve and suppliers wish to trial potentially innovative tariffs in areas such as smart metering. Overall, we believe that the likelihood of a detrimental impact on competition is more likely under Proposal B than Proposal A.

If proposal B is to be pursued, the most effective way to mitigate these risks would be:

(a) to cast the restriction in terms of avoidance of undue discrimination, relying on the normally accepted meaning of that term, rather than seeking to expand it with examples which may rule out the concept of objective justification;

(b) for the condition to use a two-stage enforcement approach, so that a pricing practice would not be subject to the non-discrimination rule until Ofgem had made a preliminary determination that it appeared discriminatory and the supplier had had a reasonable opportunity to respond or amend the practice; and

(c) to provide for exemptions for the public interest (ie social tariffs etc) and where reasonably necessary to meet competition;

The reference to "offering terms" in the example text provided should not be retained in any final version as this could be interpreted as seeking to regulate marketing activities as well as the terms of supply. This would not be practicable.

We would also strongly recommend the use of a sunset clause, together with a disapplication mechanism.

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

We believe that the concept of undue discrimination is sufficiently broad to take account of all relevant factors.

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?

As a matter of drafting, Proposal B could be adapted to address instances of cross subsidy between gas and electricity supply without the requirement for an additional condition.

However, we would caution strongly against attempting to do this for the reasons given in our response to Proposal D.

Proposal C: Relative price controls

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

A relative price control brings with it the same dilemma that we have described above in relation to detailed guidance, but in a more acute form. Namely, how can the acceptable band of pricing be set broad enough to enable a dynamic market to flourish, but narrow enough to meet the concerns that the condition is trying to address?

This dilemma is hugely complicated in an *ex ante* control by the fact that some cost differentials are related to commodity costs and others are not. The main difference in cost between credit and direct debit customers, for example, relates to the cost of working capital and written off debt. These costs are broadly proportional to the price of the energy being sold, but are also influenced by matters such as the state of the economy. A fixed band intended to encompass this differential would be unlikely to be valid beyond the next tariff change.

Conversely, some other cost differentials, such as the differential between direct debit and prepayment customers, are driven by operational costs of each supplier.

It is difficult to capture the concept of objective justification in an *ex ante* price control. For example, it is unclear how this approach could deal with fixed, tracker and capped price products in addition to standard ones.

In principle, it would be possible to minimise the risks from a relative price control by a combination of restricting the coverage to a small number of specific differentials, and setting the allowable band broad enough to ensure that innovation was not constrained. However, it is questionable in our minds whether the resulting condition would be seen as sufficient.

Price control usually seeks to reproduce a competitive market outcome in circumstances where competition is not appropriate. This is reflected in Ofgem's principal duty to protect consumers through competition wherever appropriate. Broad ranging price controls applied to a competitive market could, we fear, lead inexorably to Ofgem micro-managing every aspect of the market and every deal on offer. In a market where suppliers have been striving to differentiate themselves through the use of innovative payment mechanisms, more efficient third party providers, creative staff incentive schemes and commercial arrangements and signals for behavioural change in consumers, Ofgem would risk the introduction of inaccurate and artificial cost barriers that create unintended consequences, leading to the distortion of business decisions and directing the businesses to maximise revenues against the controls rather than by beating the competition.

The risk that this form of regulation would create inappropriate incentives for companies is significant. For example, suppliers may choose to rely more heavily on non-price incentives to customers such as the case in established retail loyalty schemes, as a means to attract or retain customers. Under relative price regulation there may be a greater incentive to offer such affinity deals to customers in the benchmark tariff group and the difficulty in valuing the affinity offer would significantly complicate the question of enforcing the link between the benchmark and target tariffs. This situation is further complicated by the emergence of energy services products, micro-generation and smart metering where price and product incentives become increasingly difficult to separate and accurately value.

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

The only differentials which in our view are suitable for this kind of regulation are those which are well understood, stable and not liable to lead to wider distortions.

The differential between direct debit and prepayment pricing might potentially be the most promising candidate for this approach. But the fact that it is well understood suggests that a non-discrimination approach will work as well – if not better as the latter would automatically update for any technological changes. And even in this case, a relative price control might lead inadvertently to the banning of internet special offers.

Another example that might be considered would be geographical differences, though consideration would need to be given as to how to handle transmission and distribution differences, which have historically been passed through to differing extents. But this approach would risk reinforcing a defensive approach around existing historical supply areas by making it uneconomic to attack competitors.

This leads us to the conclusion that few, if any, differentials are suitable to be addressed by the introduction of a relative price control.

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

Identification of an appropriate benchmark tariff in any relative price control should based upon a market offering where competition is strong and customers are seeing immediate and continuing benefits. At present, this would probably be the standard offline direct debit product for each distribution area. There would however be complexities, for example where gas and electricity areas do not coincide.

In a highly competitive market the choice of benchmark tariff would be likely to vary over time as the market develops and prices change as a result of customer demand, innovative products and structural changes within the industry that may impact on underlying charges. For example, the prevalence of non-standard products such as capped, fixed or tracker offers where a previously "standard" product may no longer represent a particularly competitive offering and the particular payment policies of varying suppliers around more "standard" products such as advance payment, security deposits and interest charges all require to be considered.

In an evolving market choosing a benchmark tariff will involve some foresight and ongoing monitoring of market conditions to ensure that the target market does not actually suffer a greater detriment under price control conditions than could be achieved, or may have actually been the case under the competitive market. This is particularly the case for pre-payment meter customers where several suppliers, including ScottishPower, have equalised their prepayment and standard credit prices, a position that is unlikely to be maintained in a regulated market environment.

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)?

Under any of the proposals being discussed, Ofgem would need to consider the appropriate balance between regulatory certainty and distortions caused by controls or guidance that become out of date. We suspect that three years may in fact prove too long a time to be confident that any differential bands are appropriately set, even in the case of the more predictable and well understood differentials.

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

Whatever the period of the price control, it would be essential for both Ofgem and regulated companies to be able to trigger a review to adjust inappropriate decisions or remove ineffective controls without delay. This is of course somewhat contrary to the normally intended course of price controls, where they are set for a reasonably long duration with only exceptional re-opening.

It is difficult to predict situations where the re-opening of a control would be appropriate but we would assume that this would need to occur in cases such as unintended customer detriment; unforeseen changes in costs; clear evidence of barriers to innovation; and conflicts with evolving Government policy and economic conditions.

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?

This question illustrates a further area of complexity in relative price controls. Much of the difference in costs between a credit customer and a direct debit customer is around working capital and debt, and therefore proportional to the value of commodity consumed (both unit price and quantity). Other differentials by payment method are less dependent on commodity value.

Other differentials which would vary by commodity value would be differences between standard products and fixed, tracker or capped offerings.

The need to design any relative price control to take account of varying consumption levels, at least for some differentials, raises further questions as to the viability of this approach and the likely complexity – and unintended consequences – of going down this route.

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

While a differential revenue cap, or a differential revenue cap per customer, might reduce the extent of micro-management needed to create a viable control, it has its own complexities.

In the first place, it would be necessary to decide how to handle the elements of differential that are proportional to commodity value and either integrate them with the elements that are proportional to customer numbers or else run two concurrent caps covering different classes of differential.

Secondly, depending on coverage it might be necessary to develop an algorithm for how to score the differences between prices charged on standard products and those on fixed, tracker or capped products within the regulated differential.

And thirdly, mechanisms would be needed to address changes in customer mix and development of new products.

To these difficulties, one would need to add considerable complexity in compliance and the possibility that this might require additional price changes during each year, as well as Ofgem's concern that individual customer groups would not be protected.

Our overall view is therefore that a revenue cap approach would increase the complexity of an already unviable option further, with much increased risk of unintended consequences.

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

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

We think that the difficulty of pursuing regulation of cross subsidy between electricity and gas has been under-estimated by Ofgem. The principal area of difficulty is how to handle the commodity purchase costs of each supplier.

Each supplier will have a mix of power generation facilities and long term gas purchase contracts (and in some cases equity gas production) in its group. In addition, it will have a trading programme in the wholesale market and its own individual hedging strategy.

It is unclear whether the proposed cross subsidy condition would be based on the actual position of the supplier, the wholesale price using the supplier's actual hedging strategy, or the wholesale price using a notional hedging strategy. Each option would cause distortions that in our view make this proposal unviable.

Actual position

In the first place, Ofgem would need to define a methodology for pricing equity gas production and own generation. This would not be straightforward.

Secondly, once this work was done, suppliers would have widely differing wholesale input costs and in particular differing relativities in their input costs between gas and electricity.

A requirement to avoid cross subsidy would then require these variations to be passed into sales prices, with the result that most suppliers would be required to price uncompetitively on one of gas or electricity, or price below their competitors on the other.

We doubt that a competitive market can operate sensibly on that basis.

Wholesale prices; actual hedging strategy

This leads to similar problems. A supplier whose hedging strategy in gas purchases led to a significantly higher cost than others in the industry during a particular period might choose to adsorb some of the difference rather than price his product out of the market. A prohibition on cross subsidy would require him to maintain his price above the going rate (and so lose customers) or else cut his electricity price to a level which failed to give a reasonable return.

Conversely, a supplier with good availability of low cost gas may choose to share some of the benefits of this with consumers to increase market share. This approach to cross subsidy would prevent him doing that.

Wholesale prices; notional hedging strategy

If suppliers are required to set their price relativities between gas and electricity according to a notional hedging strategy laid down by Ofgem, they will have a strong incentive to use Ofgem's notional model as their actual hedging strategy as any other approach risks them having to price one product or the other out of the market. The result would therefore be that Ofgem rather than the market would be determining hedging strategies for the industry. We doubt that Ofgem would be comfortable with that.

This option again would prevent a supplier with plentiful cheap gas from sharing the benefits with customers.

Conclusion

We find it difficult to see how Ofgem can implement regulation in this area without causing major market distortions and in effect taking control over suppliers' strategies in the wholesale market.

In our view, the market is capable of addressing this issue. In September, both British Gas and ScottishPower set electricity prices significantly below the average of other suppliers. These prices were attractive to customers with only electricity; soon afterwards, a number of other suppliers came forward with offers for electricity-only customers.

We are also concerned that rules which prevented former electricity companies offering discounts on gas without also cutting their power prices could make it much harder to attack British Gas's remaining large market share in gas. We are not convinced that making defence of existing market shares easier is in the interests of consumers.

It might be possible, if a problem does persist for off-gas grid customers, to look at some provision directed at ensuring that their terms are not unduly onerous compared with dual fuel customers, but defining and enforcing regulation in this area looks to us fraught with difficulty.

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?

It is difficult to judge how this aspect could be addressed without understanding how variations in the wholesale market will be dealt with as described above.

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?

We support the principle of commonality across both the electricity and gas supply licences where it is possible that issues may arise in either market. Should any regulation be introduced in this area, it should therefore apply to both markets to ensure that companies with a strong position in the gas market do not gain an unfair position in electricity.