

Addressing undue discrimination

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Target audience: Energy suppliers and generators, consumers, consumer organisations and representatives, academics and other interested parties.

Overview:

Ofgem's Probe into GB energy supply markets proposed measures to address concerns over unfair price differentials. The Gas and Electricity Markets Authority has decided to introduce two new licence conditions: one requiring cost reflective payment methods; and the other prohibiting undue discrimination.

This impact assessment identifies a wide range of impacts, costs and benefits of the proposed licence conditions. It builds on our initial impact assessment and responses we received to the consultation on that initial impact assessment.

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Context

Ofgem's principal objective is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition. In keeping with this objective, we launched a study of the state of GB energy supply markets ('the Probe') in February 2008. In October 2008, we set out our initial findings on the operation of the GB retail energy markets and set out for consultation a package of measures to tackle the issues raised. In January 2009, we consulted on a range of proposals in relation to one of the key action areas identified - addressing unjustified price differentials. In April 2009 we consulted on final proposals for two new licence conditions designed to address undue discrimination and published an initial impact assessment. In the light of responses to that consultation, this document updates the initial impact assessment of our proposals.

Associated Documents

- Energy Supply Probe – Initial Findings Report (140/08), 6 October 2008
- Addressing Unfair Price Differentials (01/09), 8 January 2009
- Energy Supply Probe – proposed retail market remedies (41/09), 15 April 2009
- Addressing undue discrimination – final proposals (42/09), 15 April 2009
- Addressing undue discrimination – impact assessment (43/09), 15 April 2009
- Addressing undue discrimination – decision document (72/09), 26 June 2009

The above documents are available via the Ofgem website at the following location:

<http://www.ofgem.gov.uk/Markets/RetMkts/ensuppro/Pages/Energysupplyprobe.aspx>

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1. Summary

1.1. In January 2009, Ofgem consulted on a range of possible licence conditions to tackle the concerns about unfair price differentials identified by the Probe.¹

1.2. Following consideration of the responses to our consultation, the Authority has decided to introduce two new supply licence conditions for domestic gas and electricity suppliers as follows:

- Licence condition A: requiring any difference in the terms and conditions offered in respect of different payment methods to be cost reflective; and
- Licence condition B: prohibiting undue discrimination in any terms and conditions offered to consumers, with a sunset clause of three years.

1.3. The proposed licence conditions and draft guidelines for these conditions were published for consultation in April 2009.² The draft guidelines outlined the principles Ofgem intends to take into account when interpreting and applying the new licence conditions and, in particular, set out the factors that we intend to take into account in deciding whether there is any "objective justification" for practices that might otherwise be viewed as discriminatory.

1.4. This final impact assessment is published alongside our decision document which sets out our decision and updates the guidelines.³ The purpose of this final impact assessment is to identify and set out a wide range of impacts, costs and benefits of these licence conditions. This builds on comments received on our initial impact assessment, which accompanied our earlier consultation exercise. A summary of responses to our consultation document and the accompanying impact assessment is published in the decision document that this impact assessment accompanies.

1.5. Our assessment is that these measures will have significant benefits for many vulnerable consumers in the form of lower prices. While there are risks to the intensity of competitive activity between suppliers as a result of this measure, the precise impact on competition is ambiguous. We believe that the potential negative effects are likely to be constrained, in particular due to our approach to enforcement as explained in the guidelines and because licence condition B is intended to operate only for a limited period. Furthermore, these effects are likely to be offset to some extent by certain positive effects.

1.6. Given our statutory duty to protect consumers and to have regard to the interests of vulnerable consumers, we have attached particular weight to the benefits for vulnerable consumers. We therefore continue to believe that it is appropriate to introduce a licence condition prohibiting undue discrimination in the terms and conditions offered by suppliers to different groups of consumers.

¹ *Addressing unfair price differentials (01/09)*, 8 January 2009

² *Addressing undue discrimination – final proposals (42/09)*, 15 April 2009

³ *Addressing unfair price differentials – decision document (72/09)*, 26 June 2009

2. Key issues and objectives

The Energy Supply Probe

2.1. In October 2008, Ofgem set out the initial findings of its investigation into the operation of the GB retail energy markets (the “Energy Supply Probe”, or “Probe”). This found that the fundamental structures of a competitive market are in place, and the transition to effective competitive markets is well advanced and continuing. We did, however, identify a number of important areas where this transition needs to be accelerated. In particular, many consumers are not yet benefiting fully from the competitive market and vulnerable consumer groups are disproportionately affected.

2.2. Our Initial Findings Report also found a number of significant pricing differentials that could not be explained readily by differences in costs. Our key areas of concern centred on the differentials between payment methods, between regions and between fuels (gas and electricity).

2.3. We found that these pricing structures have had a significant detrimental impact on the consumers affected and a disproportionate impact on vulnerable groups. We identified that affected consumers were paying up to £1 billion extra per year compared to those consumers on the most competitive rates from the same supplier (after taking account of additional costs). Furthermore, vulnerable groups were more prevalent in the market segments where we identified detriment to consumers. In response to our Probe, suppliers have taken action to reduce these differentials.

Promoting competition in retail markets

2.4. Our principal objective, set out in legislation, is to protect the interests of present and future consumers, wherever appropriate by promoting effective competition.⁴ In responding to the concerns raised, we remain convinced that consumers benefit most from a vibrant competitive market. We are therefore proposing a package of measures designed to improve the functioning of the market for all consumers, particularly vulnerable households. Our proposals were set out in a consultation published in April.⁵

2.5. Over time, we would expect these remedies to undermine the ability of suppliers to sustain discriminatory pricing structures. Companies would be subject to more effective competitive constraints, which would incentivise innovation, improve service levels and reduce costs to the benefit of all consumers.

⁴ See Appendix 1 – The Authority’s Powers and Duties

⁵ *Energy Supply Probe – proposed retail market remedies (41/09)*, 15 April 2009

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2.6. Consistent with our principal objective, it is necessary to consider whether these retail market remedies alone are sufficient to protect the interests of consumers, present and future. As we have already noted, the scale of detriment at the time of the Probe was large and it is expected that our proposed package of remedies will take time to have the envisaged effect for consumers in the retail market.

2.7. In deciding whether to take specific action to address undue discrimination, we have also taken into account our other statutory duties. We believe the following general statutory duties are of particular relevance to this decision:

- Ofgem has a duty to carry out its functions in a manner which it considers best calculated to contribute to the aims of sustainable development. In this regard, we note that sustainable development principles used by the UK Government include “ensuring a strong, healthy and just society” (set out in the UK Government’s Strategy paper “Securing the Future” March 2005).
- In performing its duties, Ofgem is obliged to have regard to the interests of vulnerable consumers, as defined in section 4AA of the Gas Act 1986 and Section 3A of the Electricity Act 1989.
- In performing its duties, Ofgem is obliged under section 4AB of the Gas Act 1986 and section 3B of the Electricity Act 1989 to have regard to the Social and Environmental guidance issued by the Secretary of State. The current guidelines cover a range of social and environmental considerations that the Government expects Ofgem to take into account, including the achievement of the Government’s fuel poverty targets in respect of vulnerable consumers.

2.8. We also aim to better reflect Annex A(d) of EC Directives 54/2003 and 55/2003, which provide that “any difference in terms and conditions shall reflect the costs to the supplier of the different payment systems.” We believe it appropriate to reflect this requirement in supply licences.

3. Options

3.1. Our initial consultation paper, "Addressing unfair price differentials", outlined four broad proposals for licence requirements:

- A: Cost-reflective pricing between payment methods
- B: Prohibition of undue discrimination
- C: Relative price controls
- D: Prohibition of "cross subsidy" between gas and electricity supply.

3.2. Having considered responses to our consultation, the Authority decided to discard proposals C and D:

- Many respondents did not support the idea of relative price controls. Of those respondents who did express support, some preferred them as a means of addressing the main concerns identified. We agree with the view expressed by some that there could be difficulty in implementing such price controls, that they could be unnecessarily intrusive and would risk stifling innovation to a greater extent than under proposals A and B.
- There was limited support for a prohibition of cross subsidy between gas and electricity supply, although some small domestic suppliers and consumer groups did support the proposal. We agree with the views expressed that such a prohibition could disproportionately limit competition between gas and electricity suppliers. We also believe that a broader prohibition of undue discrimination in the terms and conditions offered by suppliers to groups of customers (proposal B), could limit some of the worst impacts of cross subsidy, such as the detriment to off-gas grid consumers.

3.3. Instead, the Authority has decided to introduce two new licence conditions, based on proposals A and proposal B as follows:

- Licence condition A: A new licence condition for domestic gas and electricity suppliers requiring any difference in the terms and conditions offered in respect of different payment methods to be cost reflective; and
- Licence condition B: A new licence condition for domestic gas and electricity suppliers prohibiting undue discrimination in any terms and conditions offered to consumers, with a sunset clause of three years.

3.4. Details of the licence conditions being introduced and the associated guidelines are set out for statutory consultation in our decision document.⁶

3.5. Our purpose in introducing licence condition A is to better reflect the contents of Annex A(d) of EC Directives 54/2003 and 55/2003 ('the EC Directives') and to address the detriment caused to consumers as a result of non-cost reflective differentials in payment methods applied by gas and electricity suppliers in the retail

⁶ *Addressing undue discrimination – final proposals (42/09)*, 15 April 2009

market. Licence condition A is not intended to introduce any additional obligations going beyond those imposed by the EC Directives.

3.6. We are introducing licence condition B to address other situations in which certain consumers may be losing out by reason of their inability to access (or difficulty in accessing) the same supply terms and conditions as other consumers.

3.7. Licence condition B is not intended to diminish in any way the ability of suppliers to innovate, roll-out or test new products, improve their efficiency or competitive advantage over other suppliers and/or to introduce initial or 'incentive' offers in a legitimate attempt to penetrate certain markets, market segments, or acquire new consumers. We have drafted the guidelines in a way which we believe will minimise the risks of negative impacts on competition and innovation.

3.8. We propose that licence condition B operates only for a period of three years, to allow time for our proposed package of retail market remedies to take effect.

4. Impacts on consumers

This chapter assesses the potential direct impacts on consumers of licence conditions A and B and estimates some of the potential impacts on consumers' bills. We consider each licence condition in turn. Both proposals are likely to benefit some consumers while making others worse off. We identify the groups of consumers likely to be made relatively better off and relatively worse off. We present evidence that vulnerable consumers are over-represented in those groups more likely to be made better off. Chapter 5 provides more detail on the impact on vulnerable consumers.

Overview of impacts on consumers

4.1. In assessing the impacts on consumers of licence conditions A and B, we have used Big 6 suppliers' prices from both before the Probe and current prices, implemented mainly since 1 April 2009. The Big 6 suppliers have argued that recent price changes have addressed unjustified price differentials. To the extent that unjustified differentials remain, our proposed licence conditions could have further impacts on consumers. Our proposals are intended to address any further undue discrimination that remains. Additionally, they will prevent unjustified differentials from re-emerging or new forms of discrimination arising. We therefore consider January 2008 price differentials, before the Probe was announced, to be an appropriate baseline for comparison and we compare these with April 2009 price differentials. Given that future pricing behaviour is uncertain, differentials may change relative to their current levels.

4.2. Our proposals may lead to suppliers' price changes reducing bills for some consumers and increasing bills for others. We consider each licence condition in turn, outlining the groups of consumers who may benefit and those who may lose out.

Licence condition A

4.3. This section discusses the impact of licence condition A on consumers.

Standard credit and direct debit differentials

4.4. The Probe identified particular concern over the differential between standard credit (SC) and direct debit (DD) tariffs. We found that price differentials on average did not reflect the average annual cost difference of around £25 per customer per fuel (based on 2005-07 costs).

4.5. Since the Probe was announced in February 2008, suppliers have taken steps to address the concerns identified. The following tables summarise the change in average differentials between SC and DD bills, between January 2008 and April 2009.

4.6. The total differentials are calculated separately, assuming firstly in table 1 that all SC customers do not receive prompt payment discounts and secondly in table 2 that all SC customers whose suppliers offer prompt payment discounts receive these discounts.

Table 1 – Weighted average differentials between SC and DD prices without prompt payment discounts (£/customer/year)⁷

	Jan-08	Apr-09	Change
Gas	52	41	-11
Electricity	20	29	9
Dual Fuel	68	82	14

Source: Ofgem

Table 2 – Weighted average differentials between SC and DD prices with prompt payment discounts (£/customer/year)

	Apr-08*	Apr-09	Change
Gas	56	21	-35
Electricity	13	16	3
Dual Fuel	76	50	-26

*Information not available for prompt payment discounts in January 2008.

Source: Ofgem

4.7. Since April 2008, SC-DD differentials without prompt payment discounts have on average decreased for gas customers, but increased for electricity and dual fuel customers. However, in this period, SC-DD differentials with prompt payment discounts have decreased for gas and dual fuel customers, and only increased slightly for electricity customers.

4.8. Prompt payment discounts are becoming increasingly common among the Big 6 suppliers (British Gas, E.ON UK, ScottishPower and Scottish and Southern Energy now all offer a prompt pay discount to their SC customers) and the average discount is increasing. We note that while an increasing number of consumers are able to access prompt payment discounts, the ability of consumers to pay promptly may not increase commensurately. Nevertheless, it is likely that more consumers are now receiving a prompt payment discount than in January 2008.

4.9. The cost reflectivity of payment method differentials is affected by the allocation of bad debt costs. Our intended approach to this is set out and explained further in the draft guidelines.

⁷ All calculations are based on standard consumption, 3,300kWh/year of electricity and 20,500kWh/year of gas.

Prepayment and direct debit differentials

4.10. The Probe concluded that while, on average, the premium charged to prepayment meter (PPM) customers over DD customers was broadly justified by the costs incurred, there was significant variation between suppliers, regions and different consumption levels.

4.11. Table 3 summarises the change in average differentials between PPM and DD bills between, January 2008 and April 2009. The average differential has fallen significantly for electricity, gas and dual fuel.

Table 3 – Weighted average differentials between PPM and DD prices (£/customer/year)

	Jan-08	Apr-09	Change
Gas	94	58	-36
Electricity	38	25	-13
Dual Fuel	133	100	-34

Source: Ofgem

Note: Change may not sum to difference due to rounding.

4.12. If suppliers were to make introduce price changes which further affected differentials as a result of licence condition A, this could have positive impacts for some consumers and negative impacts for others. Under these circumstances, SC and PPM customers are likely to gain relative to DD customers. This effect is illustrated by the most recent price changes, where a decrease in the differential between PPM and DD prices has been achieved through greater price decreases in PPM prices than DD prices.

4.13. We consider in particular the impact on vulnerable consumers. Vulnerable consumers are over-represented among those paying by SC and PPM, and hence under-represented among those paying by DD. Licence condition A is therefore likely to have a positive impact on vulnerable consumers, although we do note that some vulnerable consumers are likely to be made relatively worse off (e.g. those paying by DD). Chapter 5 discusses the impact on vulnerable customers in more detail.

Licence condition B

4.14. We set out in our guidelines the way in which our licence conditions will be applied as well as specific exceptions to the requirements. In this section we outline the potential impacts of licence condition B on the particular differentials we identified in our Probe: in-area versus out-of-area price differentials, off-gas grid differentials and gas versus electricity margin differentials.

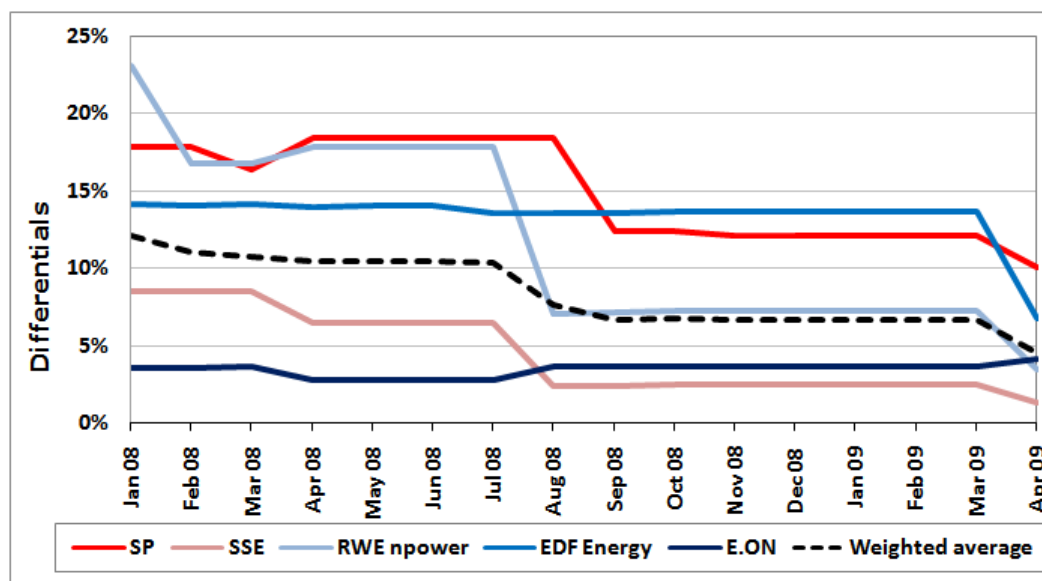
4.15. The following analysis largely considers the potential direct impacts on prices. Chapter 4 considers the potential indirect effects on price and non-price factors through the competitive process.

In-area versus out-of-area price differentials

4.16. Our Probe found that the five former incumbent electricity suppliers systematically charged their in-area customers higher electricity prices than their out-of-area customers, across all payment types. This differential consistently exceeded the small cost differential between serving these different groups of customers. We found that those customers on dual fuel tariffs tended to pay lower gas prices which off-set this difference in electricity prices. However, single fuel customers with their incumbent electricity suppliers were less likely to receive these lower gas prices, particularly those who have never switched who are also with the incumbent gas supplier (British Gas). This is discussed further below.

4.17. Since the Probe was announced, suppliers have taken steps to narrow their in/out-of-area price differentials for electricity customers, across all payment methods. Figure 1 illustrates the recent history of these price differentials for DD customers, having taken account of differences in network charges between regions. Average differentials for DD customers have fallen from 13 per cent in January 2008 to 5 per cent after the latest round of price decreases.

Figure 1 – Average premium of in-area DD over out-of-area DD electricity bills (network charges removed)



Source: Ofgem

Note: Indicative network charges used for April 2009.

4.18. The average differential between in-area and out-of-area electricity prices also decreased for customers paying by SC, from 12 to 5 per cent, and PPM customers, from 9 to 4 per cent. This is shown in table 4 below.

Table 4 – In-area bill premiums over out-of-area bills⁸

		Jan-08	Apr-09	Change
Weighted average % premium in-area	SC	12%	5%	-8%
	DD	11%	5%	-6%
	PPM	9%	4%	-5%
Weighted average (£/customer/yr)	SC	26	14	-12
	DD	25	12	-13
	PPM	21	11	-10

Source: Ofgem

4.19. If suppliers were to equalise their in-area and out-of-area prices by increasing out-of-area prices and decreasing in-area prices (for example, if they equalise in a revenue neutral way), then the actual change in customers' bills will be smaller than the value of the differential, as the new price will lie in between the former in-area and out-of-area prices. As the former electricity incumbents have more in-area customers than out-of-area customers, were suppliers to reduce differentials between in-area and out-of-area prices in a revenue neutral way, the reduction required for in-area customers would be smaller than the increase in out-of-area bills.

4.20. As suppliers have in recent months decreased in/out-of-area differentials across all payment methods, potential further savings for in-area customers, which could result from a reduction in this differential, have fallen. We note above that our proposals are intended to address any further undue discrimination that remains. Additionally, the licence conditions will prevent also to prevent suppliers reverting back to previous, larger, unjustified price differentials. We therefore include differentials for January 2008 to illustrate this baseline.

4.21. Consumers who have never switched are more likely to benefit from a reduction of in/out-area-price differentials, as they are more likely to be with their former electricity incumbent supplier.

4.22. Evidence presented in our Probe suggested that there are disproportionately more vulnerable consumers who are with their in-area supplier. In particular, we identified that those in social group D or E, those aged over 65, those without internet access and those who rent their accommodation (particularly if they do so from a private landlord) are less likely than others to switch supplier. While not all

⁸ Percentage changes are calculated as an in-area premium over out-of-area prices, after network charges have been removed. Percentage changes appear larger than absolute values due to January 2008 bills being significantly lower than April 2009 bills.

consumers within these groups would be regarded as vulnerable, we note that vulnerable consumers will be disproportionately represented within these groups. Therefore, vulnerable consumers will, in general, benefit from our action to address this price differential. Chapter 6 discusses the impact on vulnerable consumers in more detail.

Off-gas grid differential

4.23. We found in our Probe that consumers not connected to the gas grid ('off-gas consumers') are paying more for their electricity than consumers who are connected to the gas network.

4.24. The premium paid by off-gas consumers is a consequence of three pricing effects. Firstly, off-gas consumers are more likely to be in-area consumers and pay an associated premium as noted above. Secondly, off-gas consumers are not able to access dual fuel discounts. Thirdly, margins are higher in electricity than in gas supply, but off-gas consumers do not receive the "cheaper" gas.

4.25. The measures suppliers have taken since the Probe began to reduce in/out-of area price differentials have put downward pressure on the off-gas premium. However, increases in dual fuel discounts offered have offset some of this effect. Recently, three suppliers (E.ON UK, EDF Energy and RWE npower) have introduced special discounts for off-gas consumers, which have reduced the total off-gas premium.

4.26. We estimate the total value of discounts which off-gas electricity consumers are unable to access, by payment method.⁹ Discounts unavailable to off-gas customers have decreased significantly since the Probe was announced.

Table 5 – Discounts unavailable to off-gas consumers (£/customer/year)

		Jan-08	Apr-09	Change
	SC	41	20	-22
Weighted average	DD	56	35	-21
	PPM	24	13	-11

Source: Ofgem

4.27. We note that there is an overlap between discounts unavailable to off-gas customers and in-area and out-of-area differentials, because a portion of the off-gas

⁹ This analysis assumes off-gas customers have the same distribution across payment method, region and supplier as all electricity customers. More accurate data on the specific distribution of off-gas customers is not available. Dual fuel discounts are calculated as the difference between a supplier's combined electricity and gas single fuel tariffs and their dual fuel tariff. In/out of area discounts are calculated as before. Supplier specific off-gas discounts have also been included. We have not included the potential impact of any equalisation of gas and electricity margins in these calculations.

premium is due to in/out-of-area price differentials. This should be accounted for when estimating the total impact of proposed licence condition B.

4.28. The figures in table 5 may underestimate the potential savings to off-gas consumers, as for the purposes of these calculations we have assumed that off-gas consumers are equally as likely to have never switched as electricity consumers who are connected to the gas grid. However, our Probe research suggests that off-gas consumers are less likely to have ever switched.

4.29. Vulnerable consumers are also over-represented among off-gas consumers. This is because many off-gas consumers are fuel poor and live in rural areas. While the links between consumers being fuel poor, rural and vulnerable are discussed in further detail in Chapter 5, we note that addressing this differential is likely to disproportionately benefit vulnerable consumers.

Gas versus electricity margin differentials

4.30. Our Probe found that the former electricity incumbents consistently earned significantly higher margins from electricity than gas supply over the period 2005-7. Former electricity incumbents have been able to price up to their stand-alone electricity consumers while remaining competitive with British Gas in the dual fuel segment of the market. This pricing behaviour has been universal among the former electricity incumbents.

4.31. In applying licence condition B, we will consider conditions of supply of a product or service in conjunction with another product or service. This will apply, for example, to dual fuel offerings. With respect to dual fuel offerings, we will consider whether either product (gas or electricity) is being offered at below cost price.¹⁰ In particular, this provision may be applied in respect of those consumers not offered, or not able to access, both products, for example, off-gas consumers.

4.32. In our Probe, though we identified that in aggregate margins on domestic gas supply were negative in 2005-7, we did not find that suppliers were pricing below forward-looking avoidable costs. We therefore expect that the direct impact of licence condition B on the gas and electricity margin differential will be small relative to unacceptably high historical differences. However, licence condition B may have indirect effects on margin differentials as a result of its provisions in relation to other differentials, such as in and out-of-area price differentials. To the extent that pricing behaviour changes, suppliers' ability to earn significantly higher margins in one fuel (gas or electricity) than another may be reduced.

4.33. In the most recent round of price changes we have seen some evidence that suppliers are changing the relative balance of their gas and electricity margins, as

¹⁰ The relevant costs to be assessed are suppliers' forward-looking avoidable costs. See our guidance on materiality and cost allocation for further detail.

the most recent price cuts by the former electricity incumbents were greater in electricity than gas.¹¹

4.34. As discussed above (and in more detail in Chapter 5), vulnerable consumers are over-represented among consumers who are off the gas grid and among those with their former incumbent electricity supplier. Therefore, vulnerable consumers will disproportionately benefit from any narrowing of margins between electricity and gas.

¹¹ The balance between margin in gas and electricity is also dependent upon relative changes in costs between the two fuels.

5. Impacts on competition

This chapter assesses the potential impacts on competition of our proposed licence conditions. Firstly, we address the theoretical effects of price discrimination and whether it is good or bad for welfare. Secondly, we assess how the particular characteristics of the energy market affect the likely impact of price discrimination. Based on these assessments, we find that the potential impacts on competition are uncertain. Some characteristics of the domestic energy supply market may limit potential negative impacts on competition, while others imply that the range of possible outcomes is particularly wide and the impacts uncertain. There may also be some positive effects on competition that could offset these risks to some extent.

5.1. This chapter focuses on price discrimination, rather than any other form of discrimination, for example between other terms and conditions. We consider this to be the most likely form of discrimination given the findings of our Probe. Licence conditions A and B also apply to other forms of unjustified discrimination, in which case we consider the arguments that follow would still apply.

Theoretical effects of price discrimination

What is price discrimination?

5.2. Although there is no academic consensus on exact wording, price discrimination can generally be described as occurring where:

A supplier of a good or service is able to charge some consumers a higher price than others for a 'similar' good or service, where the price difference is not related to differences in costs of serving those consumers.¹²

5.3. We consider two types of price discrimination: second and third degree. Second-degree price discrimination occurs where a firm offers a range of tariffs and consumers self-select their tariff (for example, pricing differently for peak time and off-peak travel). Third degree price discrimination occurs where a firm is able to offer different prices to different consumers based on observable differences in their preferences, rather than relying on consumers to self-select. Firms can differentiate prices by changing tariff structure or absolute price levels.

¹² Price discrimination can also occur where differences in cost are not reflected in differences in price. Based on the Office of Fair Trading, 'Market Definition: Understanding Competition Law', December 2004, and others including Stole, 'Price Discrimination and Imperfect Competition', 2003 and Armstrong, "Recent Developments in the Economic of Price Discrimination", University College London, 2006.

When can firms price discriminate and why?

5.4. Price discrimination can only occur if the following three conditions are met:

1. *Firms must have an element of market power:* without an element of market power in at least one of the market segments, firms are unable to increase price above marginal cost so therefore are not able to price discriminate.
2. *Firms must be able to identify consumers or consumer groups with different price elasticities:* consumers must have different degrees of willingness to pay in order for a firm to charge different prices to them. The degree of price discrimination depends on the method by which firms are able to differentiate between consumers. Different price elasticities among consumers may reflect consumer preferences or variation in market characteristics.
3. *Consumers must not be able to trade with others who have paid a different price (arbitrage):* this prevents one market price prevailing and therefore allows a firm to sustain two or more different prices.

5.5. When all three conditions are met, firms can then charge higher prices to less price-elastic consumers or consumer groups (their 'strong' market) and price lower to more price-elastic consumers (their 'weak' market).¹³

5.6. Typically, second-degree price discrimination takes advantage of differences in consumer preferences, though these differences can be due to a lack of information. For example, consumers unaware of a differently priced alternative may not have a genuine preference for the product they choose.

5.7. Third-degree price discrimination, on the other hand, typically requires that consumers are unable to choose which price they pay for a product or which product they consume. This can happen, for example, where consumers have particularly high switching costs or are prevented from switching.

5.8. All forms of price discrimination allow suppliers to charge some price above marginal cost and therefore make profits in excess of perfectly competitive levels. Price discrimination can therefore maximise producer surplus (margin), giving firms an incentive to engage in it wherever possible.

Is price discrimination good or bad?

5.9. In this section we look at the implication of price discrimination for welfare. There is a wide-ranging literature addressing the welfare effects of price discrimination in competitive, oligopolistic and monopolistic markets. The theoretical welfare impact of price discrimination is ambiguous, and depends heavily on the particular characteristics of the market and the nature of the price discrimination in

¹³ Firms price differently to different consumer groups in the spirit of Ramsey pricing, whereby a monopolist sets price mark-ups to be inverse to the elasticity of demand for each market segment, though the rule only applies in a monopoly situation.

question. Price discrimination is, however, a particular concern if it leads to either exclusionary or excessive prices.

5.10. As noted earlier, price discrimination requires firms to have some market power. It is therefore useful to consider price discrimination within the context of a monopoly market, in order to illustrate its most fundamental effects. Price discrimination can reduce the efficiency with which goods and services are allocated between different consumer groups.¹⁴ Where there is no arbitrage some potentially beneficial trades between consumers remain unfulfilled¹⁵, indicating that the good or service is not allocated efficiently between consumers.

5.11. In a monopoly setting, price discrimination can lead to higher prices for some consumers or consumer segments, relative to perfect competition, reducing consumer surplus and increasing producer surplus. As noted, the motivation for firms to engage in price discrimination in this setting is higher margins. However, price discrimination can also benefit consumers, if it allows firms to lower prices for some consumers, relative to the equivalent uniform price¹⁶ and can therefore increase consumer welfare. This is especially likely to increase welfare overall if these lower prices expand demand. This can increase consumer surplus, particularly where this consequently expands demand or allows a new market to be served where it was not previously.

5.12. This is a key factor in determining whether the overall impact of price discrimination on consumers and firms is good or bad. The more price discrimination expands demand, the more likely it is to be beneficial. Whether the overall effect is positive or negative, in monopoly it is always the case that compared to uniform pricing (where suppliers cannot price discriminate) some consumers are better off and others are worse off.¹⁷

5.13. Broadly, the factors which allow suppliers to price discriminate: lack of information, barriers to switching, locked in consumers, or simply consumer preference, can be split between market failures and consumer preferences. The more price discrimination reflects market failures, the more likely it is to be symptomatic of consumer detriment. Price discrimination that purely reflects consumer preferences is less likely to inflict consumer detriment and is weaker motivation for intervention to protect consumers.

5.14. Where firms can use profits from less price-elastic consumers to price below avoidable costs to other, more price-elastic consumers, they can reduce

¹⁴ Compared to perfectly competitive markets (because price is not equal to marginal cost). The inverse elasticity rule, which maximises profit for a price-discriminating monopolist where different consumer segments have different price elasticities, dictates that a profit-maximising monopolist should charge these groups different prices.

¹⁵ Marginal rates of substitution differ between consumers in different market segments.

¹⁶ For the purposes of this document we consider 'uniform pricing' as the alternative to price discrimination. A 'uniform price' may include differences in price between market segments, where these are cost reflective.

¹⁷ Theoretically in a situation of monopoly or intense competition a profit-maximising uniform price must necessarily lie within the range of prices charged under price discrimination.

competitiveness in the latter segment by reducing margins and therefore reducing the attractiveness of entry. Under these circumstances price discrimination is more likely to have a negative effect on consumers by reducing competitive pressure as a consequence of either reducing the number of suppliers in a market, or reducing the threat of entry.

5.15. One respondent believed that the attractiveness of entry in segments of the market which on which higher margins are earned (currently PPM and SC) would become less attractive. However, small suppliers that responded to our consultation did not highlight this as a concern. Furthermore, margin is only one of many factors affecting a new entrant's decision to target customer segments.

Price discrimination in an oligopoly

5.16. Above we describe the general effects of price discrimination in a monopoly context, but its effects are highly dependent upon the structure of a market. We consider price discrimination in an oligopoly, that is, in a market with a small number of firms where suppliers' pricing decisions are interdependent. This is the most relevant theoretical context in relation to the energy supply market (see section below 'Price discrimination in domestic energy supply markets').

5.17. The effects outlined above apply to varying degrees in an oligopoly, making it even harder to generalise about effects on welfare. A particular complicating factor is the potential impact of price discrimination on the dynamics of competition.

5.18. Competitive dynamics depend critically on whether suppliers are 'strong' and 'weak' in the same markets (or market segments) as each other. Where suppliers have the same strong and weak markets, the effect on welfare of prohibiting price discrimination is that the uniform price always lies between the two prices charged under price discrimination.¹⁸

5.19. However, in many markets firms are strong and weak in different segments of the market¹⁹, for example, where these are determined by geographical location.²⁰ This has a dramatic impact on the general theoretical welfare impacts of price discrimination.

5.20. In an oligopoly²¹, where suppliers have different strong and weak markets to each other, price discrimination can lower prices universally by increasing competition in every market segment. In these circumstances, prohibiting price

¹⁸ Stole, 'Price Discrimination and Imperfect Competition', 2003.

¹⁹ This is known as 'best response asymmetry'.

²⁰ Consequently suppliers' high prices are charged in different regions to their low prices. In the Hotelling model used to derive these conclusions, strong and weak markets are differentiated through travel cost. Though in the energy market location of consumption is fixed, this 'travel cost' can be interpreted as the combination of factors causing differences in price elasticity between consumer segments: poor information, locked-in consumers, barriers to switching and consumer preferences.

²¹ These results are derived in an oligopoly setting with two firms.

discrimination could increase prices for all consumers.²² Intuitively, this can happen because suppliers base their pricing decisions in part on what other suppliers will do. Each supplier knows there is a risk that others may price discriminate, in which case they are better off if they also price discriminate. Individual suppliers also know that their competitors face the same decision. Given this, under certain circumstances all suppliers may end up price discriminating, even if this makes them collectively worse off (compared to uniform pricing by all suppliers). In this way, a 'prisoner's dilemma' situation can occur. This result is derived under restrictive assumptions and it is also theoretically plausible that prohibiting price discrimination could decrease prices for all consumers. The distribution of consumers between strong and weak segments is crucial. Equally important is the cross-price elasticity of consumers relative to aggregate demand elasticity.²³

5.21. The key point here is that in an oligopoly all suppliers can be better off, or all worse off under uniform pricing compared to price discrimination. Consequently, the particular characteristics of oligopoly make a comparison of the welfare impacts of price discrimination more difficult. The impacts on competition of requiring uniform pricing are, therefore, all the more uncertain.

Price discrimination in domestic energy supply markets

5.22. The domestic energy supply market²⁴ is a market with a relatively small number of suppliers, where suppliers' tariff-setting decisions are influenced by other suppliers. We identified in the Probe that while there is competition in the market, there are some segments of the market where competition is not intense. For these reasons, domestic energy supply markets can be characterised as an oligopoly in theoretical economic terms.

5.23. Some fundamental characteristics of the energy market allow suppliers to price discriminate. The Big 6 suppliers, which now collectively have over 99 per cent of GB market share, were all formerly regulated monopolists. At the beginning of competition, the former monopoly suppliers had 100 per cent market share in their incumbent regions. As competition developed, the most price-elastic consumers switched away from the former incumbent to other suppliers. Though some consumers subsequently switched back, those consumers with the former incumbent supplier tend to be relatively price inelastic.

5.24. The historical context in which competition has developed in the energy market therefore allows suppliers to very easily segment the market into in-area (incumbent) and out-of-area (non-incumbent). Given this segmentation they are

²² Based on the Hotelling model, assuming linear demand curves, concave profit functions, uniform distribution of consumers and that industry demand elasticity is zero while cross-price elasticity depends inversely on the level of product differentiation and the intensity of competition.

²³ This ratio determines the weight any individual supplier places on its assessment of its competitors' actions, when deciding its own prices.

²⁴ Because of the nature of gas and electricity products, we refer to the supply of these products as the terms and conditions under which gas and electricity are supplied, rather than the individual units of gas and electricity which are supplied.

able to price discriminate by charging in-area consumers more and out-of-area consumers less. In doing so, they make a higher margin on their incumbent consumers while being able to compete more intensely for consumers outside these incumbent regions.

5.25. Competition has therefore developed in part as a result of suppliers' ability to price discriminate, charging a lower price in their non-incumbent areas than they would otherwise have been able to. A number of respondents to our initial impact assessment highlighted the risk that reducing suppliers' ability to price discriminate could limit the development of competition.

5.26. In each region in electricity, and in gas nationally, there was formerly only one supplier. In electricity, this has led to suppliers' strong and weak markets being based on geographical location. One supplier's strong market is therefore another supplier's weak market. As noted in the theoretical section above, this broadens the range of possible competitive outcomes that could result from our proposed licence conditions. The small number of suppliers and nature of competition in the market make the overall impact on competition all the more uncertain.

5.27. Any supplier response which reduces differentials could therefore potentially result in prices rising or falling for all consumers through either all out competition or, in theory, a tacitly collusive outcome where suppliers do not compete on price. It is, of course, still possible that the uniform price level will lie somewhere within the range of previous prices, leading to some consumers paying lower prices and others paying higher prices.

5.28. The optimal price for a supplier to set is based on the trade-off between potential gains in market share from pricing low and any resultant loss in revenue in the short term. A supplier's preference for price discrimination or uniform pricing is therefore dependent on how different this trade-off is between groups of consumers. Several different characteristics of a supplier's position affect the balance of incentives to charge uniform or differentiated prices. These incentives are likely to change over time as competition develops.

- *Market shares in/out area:* The more even are market shares between different consumer groups, the more attractive is price discrimination, as the trade-off relating to a uniform price is greater. There is least incentive for price discrimination where imbalance is greatest (for example, a supplier which has 1 per cent of consumers' out-of-area gains very little from price discrimination in the short run). Therefore, as competition develops, the influence of this factor increases up to a point then diminishes once a supplier has more consumers out of area (assuming this trend continues).
- *Differences between consumer groups:* The greater the differences in price elasticities between consumer groups, the greater difference between a uniform price and the optimal prices for each individual group, so the more a supplier loses out by charging one price. Differences in price elasticities depend on how equally well informed consumers are and how equally well they are able to access all segments of the market. Again, differences may increase initially as some consumers become engaged in competition, but may decrease as more

consumers become engaged. Differences that are a consequence of consumer preferences, though, would remain intact even with perfectly informed consumers.

5.29. Price discrimination is not always a cause of consumer detriment in a market. As noted, in a market where consumers make well-informed decisions and barriers to switching are low for all consumers, price differentials which reflect differences in consumer preferences may remain. Furthermore, price discrimination is widely practiced across many different industries and can be an efficient way of recovering costs.

5.30. We have noted that price discrimination is most likely to be beneficial if demand expands as a result. In domestic energy supply markets the number of consumers is fixed (with the exception of new house builds). Price elasticity of demand is not well established for domestic energy consumers in Great Britain, but changes in price differentials are unlikely to affect demand, given the scale identified. Furthermore, there is little potential here for new markets to be served through the ability of suppliers to price lower.

5.31. We outlined in our Probe report that in the domestic energy supply market, price discrimination reflects not only consumer preferences, but also switching barriers and a lack of information for some consumers. Where consumers pay higher prices for reasons not related to their preferences, this may lead to detriment to consumers. For example, suppliers are able to target discounts specifically at dual fuel consumers, which prevents off-gas consumers from accessing these discounts.

5.32. The consumer detriment identified is a consequence of different forms of price discrimination. Where consumers face switching barriers, suppliers are able to engage in third-degree price discrimination. To the extent that consumers are unable to make well-informed choices about their tariffs, some second-degree price discrimination may be causing detriment to consumers if they are on a more expensive tariff than they could be (and would want to be if they knew about it). For example, this is the case for off-gas consumers, who are unable to take advantage of dual fuel discounts, PPM customers who are debt-blocked, or consumers without bank accounts who cannot have a DD tariff or pay by cheque.

5.33. In the Probe we did not identify any detriment to consumers or consumer groups which resulted from predatory price discrimination. No tariffs were offered at a price consistently below cost.²⁵

5.34. Table 6 provides a summary of the impacts on welfare of price discrimination in the GB energy markets. It illustrates that the net impact on welfare is ambiguous.

²⁵ Online tariffs which were below cost initially were introductory offers only. To the extent that this was not clear to consumers, we believe this is a matter of insufficient information and will be addressed by our broader package of proposed remedies.

Table 6 - Impacts of price discrimination on overall welfare (in an oligopoly)

Price discrimination feature	Impact on welfare (overall)	Application in GB energy markets?
Expands demand	+	Unlikely/limited
Due to market failure (not consumer preferences)	-	Likely at present in some market aspects (though some due to consumer preferences)
Firms able to price below cost	-	No evidence found
Different strong & weak markets	+ OR -	Likely

The scope of our proposed licence conditions

5.35. The Probe identified a number of areas where the functioning of the retail supply markets could be improved. In time, we expect our wider package of proposed remedies to promote the effectiveness of competition by, amongst other things, improving information for all consumers. For this reason, licence condition B contains a sunset clause, which limits the operation of the condition to a period of three years. Any remaining premiums being paid by consumers should increasingly reflect genuine consumer preference, rather than barriers to switching or lack of information. To this end, we will continue to monitor the market to ensure that consumer detriment does not persist.

5.36. In our guidelines, we outline which gas and electricity products are likely to be covered by the proposed licence conditions and particular objective justifications in respect of licence condition B. Only those suppliers licensed to supply gas and electricity in GB are subject to our licence conditions. The GB energy retail markets are self-contained within the UK and we therefore do not expect these proposed licence conditions to affect suppliers outside the GB.

5.37. The particular consumer groups who will be affected by licence condition B would depend upon the overall impact on competition of the licence condition. An increase in the general intensity of competition would have less effect on consumers in the more competitive market segments, such as dual fuel and direct debit, customers less than those in the less competitive segments, such as electricity only and standard credit customers. Conversely, a decrease in the general level of competition would have more impact on the most competitive market segments.

5.38. These licence conditions have limited scope to indirectly affect markets for other products and/or services. Licence condition A may affect the relative attractiveness to consumers of different payment methods, which could affect markets related to metering provision and services. However, we believe any effect would not be significant, particularly in comparison to other current issues in the metering market (for example smart metering).

5.39. We also believe any impact on the attractiveness of gas and electricity as domestic fuels compared to alternatives such as LPG and oil would not be significant.

Substitutability between fuels is comparatively low due to the associated costs (except for new builds, which constitute a very small proportion of households). Furthermore, any effect on price will be small in comparison to both long and short-term volatility in oil and LPG prices.

Identifying competitive effects

5.40. The degree to which the following effects occur is dependent upon the strictness of any prohibition of undue discrimination. As shown by our guidelines, we intend to apply the licence conditions flexibly in order to minimise any negative impact on competitive intensity.

5.41. The Office of Fair Trading (OFT) outlines four ways in which regulatory intervention can affect rivalry between firms and therefore competitive intensity within a market.²⁶ We consider each in turn.

Would the licence conditions directly limit the number or range of suppliers?

5.42. We do not expect our proposed licence conditions to directly limit the number or range of suppliers in the domestic gas and electricity supply markets. They do not include any direct restrictions on the number of suppliers of domestic gas and electricity, nor do they affect the ease or cost of obtaining a licence to supply domestic gas or electricity. Similarly, the licence conditions do not place any direct restriction on the number or range of gas and electricity tariffs which can be offered by licensed suppliers and we do not propose to grant any exclusive rights to supply.

Would the licence conditions indirectly limit the number or range of suppliers?

5.43. We note that indirect effects are primarily linked to impacts of regulations on suppliers' costs. OFT guidance states that "where the impact on costs is small and likely to affect all suppliers equally, there is likely to be little impact on competition". Licence conditions A and B will be implemented as standard licence conditions. We note that these licence conditions may increase administrative costs for suppliers. One respondent raised concerns over the potential for licence conditions A and B to place a disproportionate burden on small suppliers. Both licence conditions will only apply to suppliers with more than 50,000 customers. However, smaller suppliers will still need to expend some effort on compliance. Any increase in regulatory burden could increase economies of scale in the industry, to the detriment of small suppliers and new entrants. In addition to the administrative burden, this could reduce the threat of new entry and have a detrimental impact on competition.

5.44. We will not consider infringement of our licence conditions A or B unless a materiality threshold is met. This materiality threshold will in part depend on the scale and degree of impact on consumers, making it less likely to increase their

²⁶ In 'Completing competition assessments in Impact Assessments' – Office of Fair Trading http://www.offt.gov.uk/shared_offt/reports/comp_policy/oft876.pdf

administrative costs and less likely to deter new entry. Any effect which may limit the number or range of suppliers is therefore minimised.

5.45. Our proposed licence conditions do not introduce any requirements for new products or services, so we do not believe the feasibility of supplying domestic consumers with gas and electricity will be affected.

5.46. In summary, we believe our proposed licence conditions would not have a significant impact on the number or range of suppliers, either directly or indirectly. Indeed, we note that recently three companies have newly been granted domestic gas or electricity supply licences.

Would the licence conditions limit the ability of suppliers to compete?

5.47. Both licence conditions A and B place a degree of control over the price(s) a supplier may charge relative to their costs. There is a possibility that doing so may place a restriction on suppliers' ability to engage in some forms of competitive activity. We have therefore drafted our guidelines to minimise this risk.

5.48. Neither licence conditions A nor B limit the scope for suppliers to offer tariffs, either in terms of services they are able to offer or the consumers they can offer them to. As we outline in our guidelines, neither licence conditions A nor B is intended to diminish in any way the ability of suppliers to innovate, roll out new products, improve their efficiency or to introduce initial offers in a legitimate attempt to penetrate certain markets or segments to acquire new customers.

5.49. The proposed licence conditions do not limit the sales channels suppliers can use, or geographic area which suppliers can operate in. They also do not limit suppliers' freedom to organise production processes or choice of organisational form. These geographical considerations are expressly recognised in our guidelines as potential objective justifications for certain price differentials.

5.50. Several respondents to our initial impact assessment noted the potential for our proposed licence conditions to reduce competitive pressure. They argue that our proposals could limit the ability of suppliers to price differently between regions, therefore reducing their ability to compete through non cost-reflective price differentials. This will limit suppliers' ability to offer lower prices in areas where they are non incumbents, which could decrease differentials between incumbent and non-incumbent suppliers in all regions. This may have the effect of reducing potential savings available for consumers from switching, therefore reducing their incentives to switch supplier. Respondents to our initial impact assessment believe that this reduction in competitive pressure would maintain prices at a higher level than they would otherwise have reached. In their view this would have detrimental effects on all consumers and one respondent believes this would have a detrimental effect on vulnerable consumers. It is too early to judge whether recent narrowing of differentials has had an impact on competition.

5.51. One respondent also noted that this could lead to disincentives for new entry and would reduce customer churn. Another respondent was concerned that this would dampen innovation. Currently all suppliers price differently in-area and out-of-area, though differentials have decreased recently, as outlined in Chapter 3. Consequently, the highest price is generally offered by the former incumbent supplier and the lowest by non-incumbent suppliers (though this is not always the case).

5.52. There are several different aspects of supplier behaviour that affect these differentials. Clearly one of these is price discrimination, but strategic differences between suppliers and average cost differences between suppliers can also have an effect. Our proposed licence conditions would not prevent suppliers from pricing differently based on cost or some strategic considerations. See below for a discussion of these impacts on suppliers' *incentives* to compete.

5.53. Our proposed licence conditions do not impose direct limits on the characteristics of the products which can be supplied, but they may have some impact on suppliers' ability to innovate and compete. In light of this, we have drafted our guidelines with every effort to minimise any potential impact on innovation and competition. These are outlined in particular in the Objective Justification section of our guidelines.

Would the licence conditions limit suppliers' incentives to compete vigorously?

5.54. Having established possible impacts on suppliers' ability to compete, we now turn to assessing their incentives to compete.

Effects of reduced price differentials on competition

5.55. Our research for the Probe suggested that cost differentials between suppliers' incumbent and non-incumbent regions are very low (around £3 per consumer per year on average). This cost differential is insignificant in comparison to observed differentials. Price discrimination is therefore the major contributor to differentials between the most expensive and least expensive tariffs in each region.

5.56. Licence condition B would alter the trade-off between targeting margin or market share discussed above. Suppliers would face conflicting incentives, given that they would be less able to differentiate on price between more and less price-elastic consumers. Suppliers would face a greater trade-off from cutting prices, as these cuts would reduce revenue across a larger number of customers. By the same token, this lower price would be on offer to more consumers and may therefore have a greater impact on a supplier's market share.

5.57. The relationship between discounts available to consumers and the level of switching may not be linear, particularly when strong and weak segments are combined. The shape of this curve and relative position along the curve would therefore influence the trade-off discussed above, making it more difficult to predict the effect on incentives to compete on price.

5.58. Evidence from our Probe identified a correlation between consumers paying the highest prices and factors limiting effective participation in the market. Currently suppliers have less incentive to compete for these consumers because of their lower price elasticity.

5.59. The most price-elastic consumers already face lower gains to switching than consumers switching away from their former incumbent. These differentials are likely to be affected much less than incumbent to non-incumbent differentials. Incentives for consumers who have already switched would be affected much less than for those who have never switched. Given the stickiness of consumers who have never switched, as identified in the Probe, the material impact on effective switching would be lower than if differentials were reduced for all consumers. This particular characteristic of the energy supply market therefore has the potential to limit the extent to which any reduction in switching will affect suppliers' incentives to compete for consumers on price.

5.60. Although suppliers' incentives to target low-elasticity consumers on price may be reduced, their incentives to do so on non-price terms will not be affected, and could become relatively more important as a result. In any case, these consumers have historically experienced less price competition. Suppliers may therefore turn to alternative methods to retain and attract customers, such as marketing, advertising, brand building, quality of service or costs.

5.61. Furthermore, our proposed informational remedies will also seek to increase the price-elasticity of these particular consumer groups, which may help reduce any negative effect on the incentive to compete for these consumers on price terms.

5.62. One respondent to our initial impact assessment expressed concern that allowing price differentials on these offers would reintroduce the differences we are seeking to remove (but only for customers who switch after the licence condition is implemented). On the other hand, they believe that preventing these differentials would have anticompetitive effects (identified above) and also hinder consumers' decisions, therefore reducing competitive pressure. However, introductory offers are already a feature of the domestic energy supply market. The licence conditions would therefore only limit consumers' choices to the extent that it encouraged greater focus on introductory offers than would otherwise be the case.

Effects of changing margins in market segments

5.63. The attractiveness of entry could be increased by these proposed licence conditions, if margins increase in some segments of the market. Price-elastic consumers, who are easier for a supplier to attract, currently only deliver low margins. New entrants therefore find that consumers who are easiest to gain are also the least profitable. If the effect of licence condition B were to increase the margins on these consumers, this may promote new entry into the market by making competition on price easier and entry more profitable. In addition, where margins on particular market segments increase, existing suppliers may have a

greater incentive to compete on price and non-price factors. Our proposed licence conditions may result in this being manifested in greater non-price competition.

5.64. Suppliers' margins on off-gas consumers may decrease as a result of licence condition B. This could reduce incentives for investment in distributed generation. We believe that this effect is not likely to be significant, given the sunset clause in licence condition B and the small change in margin relative to other factors affecting decisions on investment in distributed generation.

Impacts on risk of collusion

5.65. Our Probe found no evidence that domestic energy suppliers were colluding when setting their prices. We now consider the likely impacts of our proposed licence conditions on the incentives for suppliers to collude. In some markets where a small number of firms interact repeatedly, tacit collusion (referred to as 'collusion' onwards) may occur. This can allow firms to earn higher profits than if they competed more intensely.

5.66. One necessary condition for collusion is the ability to monitor other firms' behaviour, in order to detect whether they have deviated from a collusive outcome. The ability to monitor other firms' behaviour to detect deviation is therefore an important prerequisite for collusion.²⁷

5.67. Our proposed licence conditions may have implications for suppliers' ability to monitor competitors' behaviour. In particular, if licence condition B reduces the level of differential pricing between regions, it could simplify pricing strategies and may make it easier for suppliers to monitor their competitors' behaviour. The easier it is to detect deviation from a collusive strategy, the less attractive deviation becomes. It is possible that the risk of collusion becoming a viable strategy may increase following the implementation of our proposed licence conditions. We will continue to monitor the market and were we to find evidence of such collusion we would be able to take action in accordance with our powers under the Competition Act 1998.

Risks and unintended consequences

5.68. We have highlighted the potential for our proposed licence conditions to affect the intensity of competition. In particular, the small number of suppliers in the domestic energy supply market, where suppliers' pricing decisions are interdependent, increases the risks associated with the secondary effects identified above. Potential competitive outcomes resulting from our proposed licence conditions range from benefitting all consumers to causing detriment to all consumers, but several respondents believe this impact assessment underestimates the risk of negative effects on competition.

²⁷ First discussed in Stigler, "A Theory of Oligopoly." *The Journal of Political Economy*. Vol.72, No.1, 1964: 33-61.

5.69. The nature of the market also allows for the possibility of 'rule of thumb' pricing, for example the development of pricing focal points, which could either be an absolute price or a price differential. This kind of behaviour could reduce the intensity of competition. Our guidelines aim to minimise the risk of encouraging this kind of pricing behaviour by avoiding reference to quantified differentials or materiality thresholds. Instead, we define qualitative principles in our guidelines and avoid specific reference to materiality thresholds.

Conclusion

5.70. We recognise that there are risks to the intensity of competitive activity between suppliers as a result of this measure. The impact on competition is ambiguous and made particularly uncertain by the specific characteristics of the energy supply market. As outlined in our Probe report, suppliers take account of competitor positioning, likely future behaviour and reaction. We recognise that some forms of price discrimination have in the past helped competition to develop in the domestic energy supply market.

5.71. The flexibility with which we intend to apply our proposed licence conditions, as outlined in our draft guidelines, should mitigate the potential negative effects on competition. In addition, we have included a three year sunset clause for Licence Condition B, intended to limit the duration of any potential negative impact on competition.

5.72. Furthermore, we believe there are specific characteristics of the energy market which will help to reduce any potential negative impact on competitive intensity. For example, differentials for consumers who have already switched are likely to fall much less than for those who have never switched. The incentives of those consumers currently exerting the most competitive pressure on suppliers should therefore be reduced the least. Certain positive effects, such as potential increases in margin for new entrants, may also offset any negative effects.

5.73. Should compelling evidence be presented to the Authority that any competitive dis-benefits are damaging consumers, the Authority can review the licence conditions at any time.

6. Impacts on sustainable development

This chapter assesses the potential impacts on our sustainable development duties. These duties include eradicating fuel poverty and protecting vulnerable customers, managing the transition to a low carbon economy, promoting energy savings, ensuring a secure and reliable gas and electricity supply and supporting improved environmental performance.

Eradicating fuel poverty and protecting vulnerable consumers

6.1. Our Probe found that vulnerable consumers are disproportionately affected by unjustified price differentials. Our Probe identified groups of customers we believe to be vulnerable and found that lack of information, lack of internet access, reliance on cash and tight budgets all create barriers to switching for these consumers.²⁸

6.2. As discussed in Chapter 1, in meeting our principal objective to protect the interests of present and future consumers, Ofgem has a duty to have specific regard to the interests of vulnerable consumers. We therefore place particular weight on the impact of our proposals on vulnerable consumers.

6.3. It is, however, difficult to identify which consumers, or consumer groups, are vulnerable. Similarly, there is overlap between vulnerable consumers and the fuel poor.²⁹ The two are not synonymous. Some vulnerable consumers are not fuel poor but face barriers to participating in the competitive market that others do not. Many fuel poor consumers are fuel poor for reasons unrelated to the functioning of the energy market, such as low incomes or poor housing. Vulnerable consumers are distributed across all payment methods and all regions, but the Probe report identified certain categories in which consumers are more likely to be vulnerable.

6.4. Some vulnerable consumers are on social tariffs. Our guidelines explain that we intend to exclude social tariffs from the scope of the proposed new licence condition which should limit the positive and negative effects on vulnerable consumers to those not on social tariffs. However, consumers on social tariffs, which make up a significant but relatively small proportion of vulnerable consumers (around 800,000 customer accounts on social tariffs compared to 3.5million people in fuel poverty and as many as a quarter to a third of all consumers classified as vulnerable).³⁰

²⁸ Energy Supply Probe - Initial Findings Report (140/08), 6 October 2008 – Chapter 9 'Vulnerable Consumers'.

²⁹ The Fuel Poor are those who spend more than 10 per cent of their annual income to have an adequately heated home.

³⁰ The UK Fuel Poverty Action Plan, 6th Annual Progress Report (BERR and Defra) and Energy Supply Probe - Initial Findings Report (140/08), 6 October 2008.

Licence condition A

Payment method differentials

6.5. Evidence from research carried out as part of the Probe suggests that vulnerable consumers are over-represented in some groups that are more likely to pay by SC or PPM than by DD. Hence, consumers in these groups are more likely to benefit from decreases in these differentials through decreases in the price charged for their payment method.

6.6. One potential indicator of vulnerability is whether consumers struggle with money. This may, for example, prevent consumers receiving prompt payment discounts. Our research indicates that 31 per cent of consumers in social group D or E strongly agree with the statement “financially, things are a bit of struggle for me”, compared to 13 per cent for social group C1C2 and 6 per cent for social group AB. We do also note that consumers aged over 65 and those in rented accommodation did not indicate that they struggle any more than others.

6.7. With regards to SC-DD price differentials, we are therefore particularly concerned with the impact on consumers in social groups D or E. Table 7 shows that 38 per cent of consumers in social groups D or E pay by SC, whereas only 19 per cent of others do. A higher proportion of consumers in rented accommodation are also paying by SC than those that do not rent (35 per cent versus 18 per cent).

6.8. With regards to PPM-DD price differentials, again we are concerned with the impact on consumers in social groups D or E: 20 per cent of these consumers pay by PPM, whereas only 7 per cent of others do so. Those who are renting are more likely to pay by PPM compared to those who don't rent (25 per cent versus 4 per cent). Although many of these consumers are not vulnerable, this is a particular concern as many consumers who rent are unable to switch due to restrictions placed on them by their landlord.

Table 7 – Split of payment method by consumer group

	D or E	All excluding D or E	65+	All excluding 65+	Rented	All excluding rented
DD	41%	74%	71%	64%	40%	77%
SC	38%	19%	26%	23%	35%	18%
PPM	20%	7%	3%	12%	25%	4%

Source: Ipsos MORI

Note: SC includes consumers paying by payment card/book, weekly/fortnightly scheme or by Fuel Direct.

6.9. Consumers that are currently in debt to their supplier are less likely to be in a position to switch. For example, the Probe found that around 9 per cent of all transfer requests were blocked on grounds of debt, and many more indebted

consumers would not have tried to switch because of debt. Consumers who are vulnerable may be more likely to be in debt, in which case addressing unjustified pricing differentials will have a beneficial impact on vulnerable consumers. However, there is little evidence that consumers in social groups D or E, aged 65 plus or in rented accommodation are more likely to be debt blocked than the population at large.

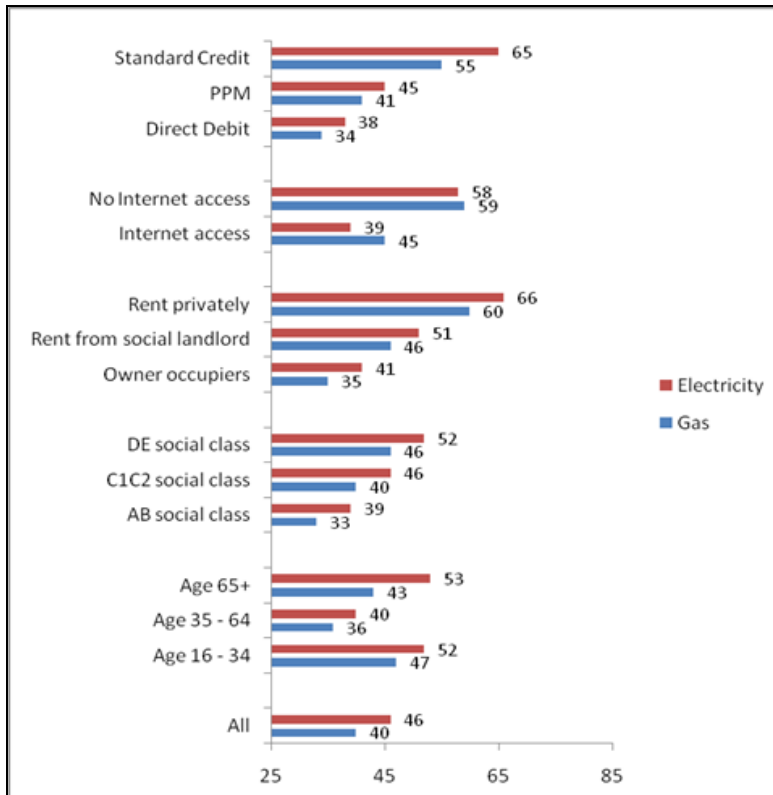
6.10. One respondent to our initial impact assessment was concerned about the potential for licence condition A to increase bills for fuel poor consumers paying by direct debit. The latest available data published by DECC from 2006 indicates that 39% and 41% of fuel poor households pay for their gas and electricity respectively by DD. While these customers may face relative increases in prices as a result of licence condition A, the majority of fuel poor households, 61% and 59% respectively for gas and electricity (those paying by SC or PPM) are likely to pay less as a result of licence condition A.³¹

Licence condition B

In/out-of-area price differentials

6.11. Consumers who have never switched are more likely to benefit from a reduction of in/out-of-area price differentials, as they are more likely to be with their former incumbent supplier. Consumers who have never switched can be with a non-incumbent supplier, for example if they have moved house and taken over supply from a non-incumbent, but this group is likely to be small relative to the total number of consumers who have never switched. Therefore, to the extent that vulnerable consumers are more likely to be in-area consumers for their suppliers, these consumers will benefit more from reductions in regional price differentials.

³¹ DECC 'Fuel Poverty Statistics – Detailed tables 2006, annex to fuel poverty strategy report'. Gas figures based on only those households with gas. It is widely accepted that the number of fuel poor has increased since 2006. This may have altered which could have altered the distribution of fuel poor by payment method.

Figure 2 – Per cent of consumers who have never switched supplier

Source: Ipsos MORI Ofgem Consumer Engagement Survey, July 2008.

6.12. Evidence research carried out as part of the Probe suggests that there are disproportionately more vulnerable consumers who are with their in-area supplier, as shown in figure 2. In the Probe we identified that those in social group D or E, those aged over 65, those without internet access and those who rent their accommodation (particularly if they do so from a private landlord) are less likely than others to switch supplier.

6.13. The following tables compare in-area/out-of-area consumers for several consumer groups. As previously discussed, we are more concerned with consumers that have never switched electricity or gas (i.e. are with their incumbent gas and electricity supplier), as these are more likely to be vulnerable consumers.

6.14. The figures in these tables are therefore likely to under-estimate the imbalance of vulnerable consumers in-area versus out-of-area, as they are based on a cross section of all consumers, rather than vulnerable consumers alone.

6.15. Table 8 suggests that consumers aged over 65 and those in social groups D or E are likely to benefit more than others from a narrowing of differentials between in and out-of-area prices. However, these figures indicate that consumers in social groups D or E are not significantly more likely to be in-area than others.

Table 8 – Proportion of consumers in/out-of-area by consumer group

	D or E	All excluding D or E	65+	All excluding 65+
In-Area	53%	50%	58%	51%
Out-Area	47%	50%	42%	49%

Source: Ipsos MORI Ofgem Consumer Engagement Survey, July 2008 – based on all consumers with a former incumbent electricity supplier

6.16. Table 9 shows that consumers living in accommodation rented from a Council or Housing Association are also more likely to be with their in-area electricity supplier than those in other types of accommodation.

Table 9 – Proportion of consumers in/out-of-area by property ownership

	In-area	Out-of- area
Owned outright	51%	49%
Buying on mortgage	46%	54%
Rented from private landlord	42%	58%
Rented from Council	57%	43%
Rented from Housing Association	61%	39%
All	51%	49%

Source: Ipsos MORI Ofgem Consumer Engagement Survey, July 2008 – based on all consumers with a former incumbent electricity supplier

6.17. Table 10 illustrates that customers paying by SC and PPM are significantly more likely to be in-area customers compared to DD customers. As we identified above, these consumers are more likely to be vulnerable than DD consumers.

Table 10 – Proportion of consumers in/out-of-area by payment method

	In-area	Out-of- area
SC	65%	35%
DD	44%	56%
PPM	59%	41%
All	51%	49%

Source: Ipsos MORI Ofgem Consumer Engagement Survey, July 2008 – based on all consumers with a former incumbent electricity supplier

Off-gas consumers

6.18. We identify rural consumers as vulnerable and therefore have a statutory duty to have specific regard to these consumers. Although from a social perspective off-gas consumers do not differ from the population at large, consumers off the gas

network are more likely to be fuel poor, partly because of the higher electricity prices they pay and partly because they rely on more expensive alternatives to gas.³²

6.19. This is driven, in part, by the fact that the majority of off-gas consumers are also rural consumers (research as part of our Probe suggests that 64 per cent of rural consumers have access to mains gas compared to 83 per cent of other consumers). If differential pricing is constrained, unjustified differentials between fuels and between in-area and out-of-area prices will reduce the premium being paid by off-gas consumers. Therefore, to the extent that off-gas consumers are more likely to live in rural areas, vulnerable consumers will benefit disproportionately from licence condition B.

6.20. Off-gas consumers are also less likely to have ever switched supplier than those connected to mains gas: only 44 per cent have ever switched, compared to 57 per cent of consumers that have both fuels. Furthermore, our research found that only 15 per cent of off-gas consumers had switched in the previous 12 months compared to 25 per cent of consumers that have both fuels. In addition, we estimate that there are in excess of one million fuel poor customers off the gas grid.³³

Conclusions

6.21. The impact of licence condition A is likely to be positive for vulnerable consumers as they are over-represented among those groups paying by SC in particular and to a lesser extent by PPM. Consequently, vulnerable consumers are also under-represented in those groups likely to experience a rise in price, those who are paying by DD.

6.22. Licence condition B is more likely to benefit vulnerable consumers, as they are over-represented in those groups likely to experience a decrease in price rather than an increase: consumers who have never switched supplier for either gas or electricity. Vulnerable consumers are also likely to benefit disproportionately as they are over-represented among those who are off the gas grid, who may experience a reduction because of narrowing of differentials between both in-area and out-of-area prices and between gas and electricity margins. We do note that some vulnerable consumers would pay more as a result of these licence conditions. Social tariffs may mitigate some of this effect, as our guidelines explain, we intend to except them from the scope of the proposed licence conditions.

6.23. Some of the benefits to vulnerable consumers have already been delivered through suppliers reducing their unjustified differentials between payment methods and off-gas discounts. Our proposed licence conditions seek not only to reduce any remaining unjustified pricing differentials but to safeguard these benefits to

³² Energy Supply Probe - Initial Findings Report (140/08), 6 October 2008

³³ As above, calculation based on 2006 figures in BERR/defra, 'Fuel Poverty Statistics, Annex to Fuel Poverty Strategy Report', 2006. There are likely to be more fuel poor customers off the gas grid now than in 2006.

vulnerable consumers by preventing suppliers from returning to these unjustified differentials.

Managing the transition to a low carbon economy

6.24. We believe that our proposed licence conditions would not have a significant impact on the transition to a low carbon economy. The impact of our proposed licence conditions on new suppliers, and new suppliers offering green tariffs, is neutral with potential upsides for new entrants if margins are increased in some segments of the market. The materiality thresholds included in the guidelines also limit the impact on small suppliers and new entrants.

6.25. As noted in Chapter 4, we believe that any impacts on incentives to invest in distributed generation will not be significant, given the small size of potential changes in bills, relative to the large sums involved in an investment decision, and the limited period over which the licence condition is intended to remain in force.

Promoting energy savings

6.26. Our guidelines provide for an exception to licence condition B for any green tariffs offered by a supplier that are made available to all consumers on a non-discriminatory basis at the time of offering. In doing so, we aim to minimise any potential negative effect on innovation in green tariffs.

6.27. We outline that prices for some consumers may increase while others may fall. Any change in the general price level can affect consumers' incentives to save energy, however, given the small changes relative to total bills we consider that the overall effect is likely to be small.

6.28. For these reasons, we believe that our proposed licence conditions will not have significant impact on incentives to save energy. No respondents to our initial impact assessment raised concerns about significant impacts on incentives to save energy.

Ensuring a secure and reliable gas and electricity supply

6.29. We believe our proposals would not have a significant impact on any factors that ensure a secure and reliable gas and electricity supply and we did not receive any consultation responses which suggested otherwise.

Supporting improved environmental performance

6.30. As outlined above, we believe any impacts on incentives to invest in distributed generation are not significant. Furthermore, we do not believe there to be any further impacts on incentives to invest in generation to improve environmental

performance. We did not receive any responses to our initial impact assessment relating to environmental performance.

7. Impacts on health and safety

7.1. We believe that neither proposed licence condition A nor B would lead to any significant impact on health and safety. Furthermore, we did not receive any responses to our initial impact assessment indicating that health and safety would be adversely affected by these proposals.

8. Risks and unintended consequences

8.1. As outlined in the discussion of impacts on competition in Chapter 4, licence conditions A and B could have unintended consequences. These could, despite our best efforts, lead to an adverse impact on the intensity of competition, less product innovation or fewer incentives for suppliers to be cost efficient. Another potential unintended consequence is that our proposed licence conditions could lead to an excessive focus on price or quality, which could lead suppliers to neglect competition in other areas. This is mitigated to some extent by our intended approach to enforcing licence condition B, which we propose to apply to terms and/or conditions of supply, not only price.

8.2. In our analysis we make several assumptions when considering the potential impact on prices. For example, we consider the circumstance in which action to address regional price differentials and differences in margins between gas and electricity supply would lead suppliers to rebalance their prices across consumers in a revenue neutral way. Whether this assumption would hold in practice would depend on the effectiveness of competition in the markets and the impact on competition of the measures themselves. There is a risk that if our assessment of the effectiveness of competition in the more active segments of the market is overly optimistic, then prices could be rebalanced in such a way as to lead to an overall increase in margins. However, unless this effect is significant, it is unlikely to outweigh the benefits to vulnerable consumers. Furthermore, as outlined earlier, it is also possible that the more competitive segments of the market will provide some discipline on the less price-sensitive segments of the market, leading to a net reduction in the average level of prices.

8.3. Any reduction in differentials between in-area and out-of-area pricing would reduce potential savings from switching for consumers currently supplied by the former electricity incumbent in their area. These consumers may therefore have a reduced incentive to switch. Our other proposed retail market remedies seek to reduce any switching barriers which these consumers face, mitigating any negative effect on their incentives to switch.

8.4. These proposals could also lead to price increases for some vulnerable consumers, for example those paying by DD, gas consumers of the five former incumbent electricity suppliers and those who take electricity from one of the five former incumbent electricity suppliers that is not the former incumbent for their region (i.e. they represent an out-of-area customers). However, we believe this group of vulnerable consumers represents a minority, and it should be kept in mind that vulnerable consumers on social tariffs will not be affected by the proposed licence conditions.

9. Other impacts, costs and benefits

9.1. We would expect there to be some costs to suppliers of implementing any of the proposed licence conditions. These could include: any one-off costs of adjusting prices to ensure compliance with any new licence requirements; and ongoing costs of ensuring compliance in the context of future pricing rounds. We would expect these costs to be higher under licence condition B than licence condition A given the wider range of differentials covered.

9.2. We do not expect our proposals to have significant impact on the cost of obtaining a licence for a new supplier. Our guidelines explain that the proposed licence conditions will be subject to a materiality threshold. This aims to limit the impact on costs by providing for a materiality threshold based in part on the scale and degree of detriment caused to consumers. Among other factors, one factor considered will be the number of consumers affected.³⁴ Smaller suppliers in particular are therefore less likely to be affected by our proposed licence conditions.

³⁴ Significant harm to a small number of consumers could still lead to enforcement action.

10. Post-implementation review

10.1. We would expect to evaluate the impacts of the proposed licence conditions in a number of ways, including through our ongoing market monitoring activities and through investigations into specific complaints. We intend to be vigilant for impacts on vulnerable consumers and overall competition in particular.

10.2. As noted in the guidelines, licence condition B includes a sunset clause whereby the licence condition will fall away after three years. Before the termination of licence condition B we would expect to undertake a full review of the impact of the new licence conditions and, once it is implemented, our proposed package of retail market remedies. In doing so, we would consider the functioning of the retail energy supply market.

11. Conclusion

11.1. This impact assessment has attempted to identify the full range of potential impacts, costs and benefits of our proposed licence conditions designed to address undue discrimination in the domestic energy supply market.

11.2. Our assessment is that these measures will have significant benefits for many vulnerable consumers in the form of lower prices. Reductions in unjustified differentials between payment methods, in-area and out-of-area prices, and between fuels, will benefit consumers paying by PPM or SC, as well as those supplied by their former incumbent supplier and those off the gas grid. These groups of consumers contain a significantly greater proportion of vulnerable consumers than the population at large.

11.3. The impact on competition of these licence conditions is ambiguous, with potential upsides and downsides. We believe that the potential negative effects are likely to be constrained by some characteristics of the market, such as the limited reduction in differentials for those consumers who have already switched. However, we do recognise that other characteristics of the market also make the competitive effects more uncertain. These effects are likely to be offset to some extent by some positive effects, such as increased incentives to compete for increased margins in certain market segments.

11.4. Our approach to enforcement and the fact that licence condition B is intended to operate only for a limited period further mitigates some of the potential risks to competition.

11.5. Given our statutory duty to protect the interests of consumers, and to have regard to the interests of vulnerable consumers in particular, we have attached more weight to the benefits to vulnerable consumers. We therefore believe that it is appropriate to introduce a licence condition prohibiting undue discrimination.

Appendices

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Appendix 1 – The Authority’s Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority (“the Authority”), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.³⁵

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly.³⁶

1.4. The Authority’s principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of existing and future consumers, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them³⁷;
- the need to contribute to the achievement of sustainable development; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.³⁸

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

³⁵ Entitled “Gas Supply” and “Electricity Supply” respectively.

³⁶ However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

³⁷ Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

³⁸ The Authority may have regard to other descriptions of consumers.

-
- promote efficiency and economy on the part of those licensed³⁹ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
 - protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
 - secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation⁴⁰ and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

³⁹ Or persons authorised by exemptions to carry on any activity.

⁴⁰ Council Regulation (EC) 1/2003

Appendix 2 – Glossary

B

Barrier to entry

A factor that may limit a firm's ability to enter the market.

Big 6

The name collectively given to the six companies that supply most of the energy to domestic households in the GB market. They are: Centrica plc (three retail brands, British Gas, Scottish Gas and Nwy Prydain in England, Scotland and Wales respectively), E.ON UK, Scottish and Southern Energy (SSE), RWE npower, EDF Energy and ScottishPower.

C

Churn

In this report churn represents the number of consumers moving away from a supplier to a new supplier (suppliers' customer losses) as a per cent of the total number of that class of customer.

Cross subsidy

The part financing of one product or activity by another.

D

Direct debit (DD)

A method of payment where a fixed or variable amount is taken from a bank account each month, quarter or year.

Dual Fuel

A type of energy contract where a customer takes gas and electricity from the same supplier.

E

Elasticity

A measure that looks at the responsiveness of demand to changes in price, with all the other prices remaining unchanged. Own-price elasticity measures the

responsiveness of the demand for a product to a change in its own price; cross-price elasticity measures the responsiveness of demand for a product to a change in the price of a different product.

F

[Former incumbent electricity supplier](#)

The previous Public Electricity Supplier (PES) for one of the 14 electricity regions in England, Wales and Scotland.

[Fuel poor](#)

Those households who need to spend more than 10 per cent of their annual income on fuel to maintain an adequately heated home.

G

[Green tariffs](#)

An energy tariff which is marketed as having environmental credentials.

I

[In-area consumers](#)

Consumers of an electricity supplier who are located within the supplier's original ex-PES region.

[Incumbent](#)

An incumbent is the company of the former monopoly supplier in a particular region. The incumbent in each region for electricity is known as the ex-PES. British Gas (Centrica) is the incumbent in the gas market.

M

[Monopoly](#)

A market with a single firm and the price of the good or service is determined by the firm.

N

[New entrant](#)

An entrant that does not have an incumbent customer base.

O

Oligopoly

A market with a small number of firms where suppliers' pricing decisions are interdependent.

Out-of-area consumers

Consumers of an electricity supplier who are located outside of the supplier's original ex-PES region.

P

Prepayment meter (PPM)

These are meters that require payment for energy to be made in advance of use or they will prevent the supply of gas or electricity. A PPM customer pays for energy by inserting electronic tokens, keys or cards into the meter.

Price differential

The difference between two sets of prices. For example, the difference in the price charged by one electricity supplier to consumers using different payment methods.

Price discrimination

Occurs when different prices are set for different consumers or groups of consumers for the same good or service for reasons not associated with the costs of production. Price discrimination is also said to occur where differences in costs are not reflected in differences in price.

S

Small suppliers

Suppliers that operate in the gas and electricity market but only have a small market share.

Social groups DE

DE is a reference to the ABC1C2DE system of social classification. DE groups two categories that include partly skilled or unskilled people as well as the unemployed and can be viewed as the most vulnerable groups in this classification system.

Social tariff

A tariff aimed specifically at low income and vulnerable customer groups.

Standard credit (SC)

A payment method where consumers pay on receipt of the bill. This typically covers a wide range of payment mechanisms, including cash, cheque, credit card and standing order.

Appendix 3 – Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Do you have any comments about the overall process, which was adopted for this consultation?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?
- To what extent did the report's conclusions provide a balanced view?
- To what extent did the report make reasoned recommendations for improvement?
- Do you have any further comments?

1.2. Please send your comments to:

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