

Jemma Baker
Regulatory and Energy Economist
Ofgem
9 Millbank
London
SW1P 3GE

11 April 2012

Dear Jemma,

CONSULTATION ON THE UNDUE DISCRIMINATION PROHIBITION STANDARD LICENCE CONDITION

Thank you for the opportunity to comment on Ofgem's current 'minded to' proposal to extend the life of Standard Licence Condition 25A (SLC 25A) to July 2014.

In our response of 20 February 2009 to Ofgem's proposals to introduce SLC 25A, we assessed the objectives of the proposed condition. We considered that competition would drive cost reflectivity more surely and more accurately than a regulatory approach, since administrative views on cost reflectivity – like any approach to controlling prices – are prone to error or becoming out of date. We pointed out that competition incorporates natural mechanisms that iron out and compete away any cost reflectivity imbalances. Nevertheless, we accepted that it could be useful in terms of promoting confidence in the market, to reinforce and perhaps accelerate those natural mechanisms with a suitably framed licence condition.

In doing so, we pointed out that there were risks of adverse effects in going down that path, commenting that:

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

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

Accordingly, to mitigate these adverse impacts we strongly recommended that any such condition should:

- (a) have exceptions to allow competition to continue as far as possible;
- (b) be based on two-stage enforcement; and
- (c) be subject to a three year sunset clause.

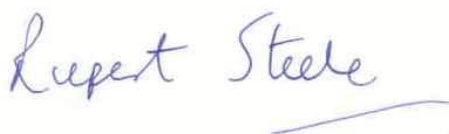
We continue to stand by all these judgements. SLC 25A has probably accelerated the ironing out of some regional imbalances, but at the cost of some blunting of competition which may have increased prices to consumers generally. This has been commented on by independent commentators such as Professor Littlechild¹,

There is no evidence that the historic differentials which SLC 25A was intended to help reduce would widen out again if the Condition was allowed to lapse as originally intended. However, it is clear from general economic theory that there is a risk of a reduction in competition if the condition is retained.

We therefore recommend that Ofgem allows the condition to lapse as originally planned. If it is extended, it is essential that the existing exceptions and two stage enforcement process, which help mitigate some of the detrimental impacts on competition, are retained.

I attach an Annex containing answers to the consultation questions. If you would like to discuss this further, please contact me.

Yours sincerely,



Rupert Steele
Director of Regulation

¹ Ofgem's Procrustean Bed: a response to Ofgem's Consultation on its Retail Market Domestic Proposals', Stephen Littlechild, 23 January 2012, page 6
<http://www.eprg.group.cam.ac.uk/wp-content/uploads/2012/01/Ofgems-Procrustean-Bed-23-Jan-2012.pdf>

CONSULTATION ON THE UNDUE DISCRIMINATION PROHIBITION STANDARD LICENCE CONDITION

RESPONSE BY SCOTTISHPOWER

Ofgem's 'minded to' proposal and general views on SLC 25A

The Undue Discrimination Prohibition Licence Condition was developed as part of the original Supply Market Probe, in response to Ofgem's concerns that customers may be experiencing differing product terms that may impact their ability to access the benefits of competition, particularly in different regions.

ScottishPower's policy in setting tariffs at that time was as it is now - to aim for broad cost-reflectivity within a competitive setting. As described in the covering letter, we accepted the Licence Condition on the basis that it was designed to be a short term regulatory feature which would reinforce and perhaps accelerate the natural competitive processes that iron out cost reflectivity imbalances. However, we remained concerned about the longer term risks to competition and the potential restrictions on innovation, and cautioned Ofgem about the risks of such undesirable side-effects developing.

We note that (whether or not they would have been competed away without the Condition) the cost reflectivity imbalances, especially between "in-area" and "out-of-area" supplies are now much less pronounced. As Ofgem notes in its letter of 24 February 2012:

"From January 2008 to January 2011, the average differential between suppliers' in-area and out-of-area tariffs, net of network charges, decreased from over £30 to around £13 per customer, per year with the maximum differential falling from £55 to £17 per customer²"

It would appear then that the particular market features that Ofgem sought to address through the introduction of SLC 25A no longer exist and that, accordingly, the risks to competition from the requirements arising from SLC 25A are no longer justified.

Ofgem has suggested that the historic differentials between in-area and out-of-area pricing might re-appear if the condition were allowed to lapse. We are not aware of any evidence to support this view. The differentials were falling naturally in any event under the influence of competition and to retain this requirement (and the attendant risks) in the longer term 'just in case' such large differentials return, seems unjustified, particularly within the context of the competitive market.

SLC 25A was intended to restrict the charging of high prices in suppliers' traditional home areas while selling energy more cheaply elsewhere. But as Littlechild has observed, the result of restricting such differentials by licence rather than through competition may be higher prices out-of-area rather than lower prices in-area. Furthermore, the artificially reduced level of price dispersion may make it harder for firms to tempt consumers into engaging with the market.

We have expressed strong concerns about the Retail Market Review (RMR) core tariff proposals and the chilling effects that we think that these proposals could have

² Ofgem, The Retail Market Review – Findings and Initial Proposals, March 2011, p24, para 2.25

on the competitive market if implemented. Our response to the recent RMR consultation included survey evidence indicating that consumers require a level of financial incentive to be encouraged to switch supplier, and that the propensity to switch is strongly influenced by the potential savings available. In the light of Ofgem's conclusion that SLC 25A has been successful in reducing the differentials between 'in-area' and 'out of area' tariffs, this suggests that prices for all suppliers are at broadly the same level across each area. Therefore the potential savings available from switching from the 'host' supplier in that area are likely to have been significantly reduced across the board, meaning the financial incentive on customers to switch away from their original supplier has reduced.

In order to work best for the benefit of customers and to allow suppliers like ourselves to grow, the market needs competition to set its own prices. With restrictions on the ability of competition to drive prices freely, such as those under SLC 25A, the ability of a medium sized supplier such as ScottishPower to grow its business and genuinely challenge larger rival suppliers for customers is significantly constrained. This outcome would also not be in consumers' interests.

We therefore recommend that Ofgem allows the condition to lapse as originally planned. If it is extended, it is essential that the existing exceptions and two stage enforcement process, which help mitigate some of the detrimental impacts on competition, are retained. Otherwise we are concerned that this approach, particularly when considered in light of the Retail Market Review Core tariff proposals, will have a further dampening effect on competition and will harm consumers, rather than bring them benefits.

Review of the Licence Condition Threshold

Ofgem notes that the Licence Condition does not apply to suppliers with less than 50,000 customers per fuel.

We think that this is a reasonable threshold. Managing compliance with SLC 25A involves a degree of cost, which could fall disproportionately on a very small supplier. It is reasonable that suppliers who are gaining a foothold in the competitive market are not weighed down with heavy administrative costs.

We think that the cost of managing compliance with SLC 25A for a small supplier is likely to be of the order of £100,000 per year per fuel, which at the level of 50,000 customers is around £2 per customer account per year. This is unlikely to be material in the overall scheme of things.

Once a company reaches a scale where the compliance cost is proportionate, it is appropriate in terms of a level playing field for restrictions such as SLC 25A to apply to all companies or not at all. Otherwise, competition would be distorted with larger small companies able to make non-cost reflective discriminatory offers which the target company would be unable to match.

We therefore see no need at this stage to review the 50,000 customer per fuel threshold, should Ofgem decide to retain the condition.

ScottishPower
11 April 2012