Response to Ofgem consultation on
The Standardised Element of Standard Tariffs under the Retail Market Review

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Ofgem are consulting on how to set the per consumer element of tariffs, under their proposals to determine the standing charge for all standard tariffs for each supplier and payment method in each region as part of the Retail Market Review proposals. We have already responded to the overall thrust of that review, see http://competitionpolicy.ac.uk/c/document_library/get_file?uuid=85b50767-a8a4-473f-a9a2-a06d6c3126ea&groupId=107435 In this response we address the issues which fixing an element of the tariff may have on the behaviour of companies and the development of the market, as well as responding to the specific questions posed by Ofgem.

Ofgem identifies a number of issues for smaller suppliers, who have been the only source of entry into the industry in recent years, and who form a crucial competitive challenge to the 'Big6'. Small suppliers do not have to contribute to the ECO and Warm Home Discount schemes, which means that the marginal cost of recruiting the consumer who does make them liable for such contributions is extremely high. This is one reason why it may be difficult for an entrant to expand very rapidly, for example through response to the collective buying initiative of the Consumers' Association.

Moreover Ofgem's recognition of the fixed costs of entering the industry raises the question of the optimal structure of the industry. The need for companies to recover their fixed costs requires that prices remain above the marginal costs of supply, and is one reason that the market can never reproduce the text book conditions of perfect competition. In terms of industry structure, more providers will incur more of these fixed costs and so their presence argues for a more concentrated industry, though that, of course, raises concerns about market power. Ofgem implies that allowing small suppliers to recover their higher average costs removes discrimination against them (1.30 p. 26). But their higher costs are a feature of the market, not of discrimination, and subsidising them on anything other than a short term basis is likely to be at the expense of consumers and lead to higher prices. This has serious implications for a policy designed to encourage entry to challenge the 'big 6'.

We welcome Ofgem's commitment to explore the distributional effects of the changes on different groups of consumers. Given the wide range of tariff structures which persists in the market, many households on standard tariffs are likely to see substantial changes in their bills as a result of standardising the standing charge.

Question 1: Do stakeholders agree with our proposed approach to those costs that should be recovered through a standing charge and those costs that should be recovered through a unit rate?

Ofgem's broad approach to recovering these costs seems appropriate, in that it seeks to include in standing charges those costs which companies incur which are affected by consumer numbers rather than energy supplied. This should minimise both the distortion of the process itself and strategic responses by companies to recruit particular groups of consumers.

On a distributional basis, as Ofgem notes in paras 2.32 to 2.34, the reallocation of costs and charges to the unit rate is broadly progressive (see our response to question 2 below). However to the extent that Ofgem is concerned about measures of fuel poverty, this will adversely affect those low income households which have a high energy consumption (and are likely to be fuel poor), and is likely to push more people into fuel poverty, compared with recovering such costs through the standing charge.

Companies have used a variety of approaches to standing charges, using tariff structure actively to offer greater choice for consumers, but with some disadvantages in terms of segmenting the market and confusion for consumer choice. The development of such tariffs in the early years of electricity liberalisation is analysed in Nonlinear Pricing and Tariff Differentiation, by Stephen Davies, Catherine Waddams and Chris M. Wilson, http://competitionpolicy.ac.uk/c/document_library/get_file?uuid=64833097-85b1-4f8d-9072-08259d1cd2ac&groupId=107435.

Question 2: Do stakeholders have any comments on the proposed broad assessment of the possible elements of the standing charge (set out in Appendix 1)?

While we understand that this consultation is not about whether costs related to economic and social obligations should be recovered from consumers, and that Ofgem has little control over this, it is important to recognise the regressive distributional effect of any such scheme to recover such charges through energy tariffs. Since energy consumption increases less than proportionally with income, (almost any conceivable) scheme will inevitably impose a higher burden on low income consumers (relative to their income) than on richer households. Higher income households will (on average) pay more, but less as a proportion of their income.

This regressive effect is exacerbated if these costs are recovered through the standing charge, since this falls as an equal cost on each household, similar to a poll tax. As a proportion of income this will clearly place a much greater burden on low income families.

However the current arrangements of charging the companies and assessing market share by consumer numbers does mean that the companies incur higher costs if they recruit more consumers, so the costs are clearly consumer related for them. To maximise efficiency and minimise distortions, the tariff structure should follow company cost structures, and as Ofgem proposes, recover such costs through the standing charge. But any Impact Assessment would need to take account of the greater regressiveness of recovering costs through the standing charge than through the energy charge.

This particular problem would be somewhat ameliorated if market share were measured by energy supplied rather than by consumer numbers, so that the charges would be related to energy supplied rather than consumers served, and so recoverable through the unit rate. However this is not the tradition of the sector, and might be technically difficult to measure.

Question 3: Do stakeholders have any comments on the treatment of regional cost differences? Do they favour Option 1 or Option 2?

Option 2, allowing companies to vary their unit rate by region, would be preferable, since if there are local differences in costs, these can be reflected in the tariffs. If companies are constrained to set a single national price, there are likely to be more distortions in the tariffs, relative to costs, even allowing for Ofgem's regional adjustments. It also removes Ofgem from involvement in both parts of the tariff, which is likely to be more conducive to continuing rivalry between the suppliers, a process which will be hampered by Ofgem's determination of the standing charge. Given the continuation of the non discrimination clauses also proposed by Ofgem, there is little danger of wild diversions from cost based tariffs on a regional basis (though note we have expressed concerns about adverse effects of these clauses in other responses to Ofgem).

Moreover companies know more about their costs than does Ofgem, and so their choice of different unit rates in different regions will provide information both on costs and market conditions, and the non discrimination clauses will require justification by the companies of price differences. It is unclear that companies could advertise a national rate if it were then subject to local adjustments, which would seem to add to consumer confusion.

Question 4: Do stakeholders have any comments on the assessment of the individual elements of the possible regional adjuster (set out in Appendix 2)?

These seem appropriate. The treatment of regions also seems the best solution, though it will introduce a small incentive for suppliers to recruit consumers in the cheaper gas regions where these span more than one electricity region. However the incentive and distortion are unlikely to be large.