

**Electricity supply competition:
An Ofgem occasional paper**

16 December 2002
83/02

Summary

Ofgem has published this paper to inform public debate on the level of wholesale and retail electricity prices. We recognise the important role Ofgem can play to inform such debate.

The paper therefore provides an overview of the relationship between prices, costs, and competitive forces. The paper is not intended to substitute for the detailed review of the competitiveness of domestic gas and electricity supply, which Ofgem will publish in Spring 2003 as part of an annual series.

This paper makes a number of observations:

- ◆ Prices to all electricity customers – domestic and business - reflect the impact of supply competition. Industrial and commercial (I&C) customers (who consume around two-thirds of electricity) were saving around 26 per cent in October 2002, compared to prices in October 1998. Meanwhile, domestic non-switchers have seen real prices fall 8 per cent since 1998; and the average of best discount available across Great Britain for domestic switchers is 17 per cent in real terms compared to prices in October 1998
- ◆ The 8 -17 per cent reduction in consumer prices over four years compares to a similar reduction in suppliers' overall cost-base over this period. It is misleading to focus only on changes in publicly traded wholesale electricity prices, ignoring other parts of suppliers' cost-base. For example, energy cost reductions have been mitigated by longer-term purchase contracts, which represent around a third of the average supplier's energy costs (as supply competition develops further, we would expect ex-PES suppliers to find it increasingly difficult to pass on above market purchase costs). Suppliers now have to work harder at marketing and customer service, which (among other factors) has raised their operating costs. Environmental costs have risen, although they remain a small proportion of the bill. Transmission and distribution costs have shrunk under the impact of regulation

- ◆ Market activity remains vigorous: around 88,000 domestic customers switch their electricity supplier each week.¹ There are many discounts available for domestic customers who switch supplier, on all payment methods, right across Great Britain, and
- ◆ It could be suggested that domestic suppliers smooth the impact on end users of fluctuations in wholesale costs, through accepting variations in their margins² over time. Margins are currently higher than historical levels, but in a market where fluctuations in input prices take time to feed through to final prices, snap-shot analysis is inappropriate. For example, deregulation of retail prices in Spring 2002 was not accompanied or immediately followed by a price-spike for any payment group.

The paper presents clear evidence that market pressure is eroding the market share of ex-monopolists. Experience of supply competition, during its first four years, suggests that sufficient savings are available to induce many customers to change supplier.

However, Ofgem will continue to monitor supply markets closely to ensure customers enjoy maximum benefit from the development of competition. Ofgem currently directs a large part of its monitoring resources to examining the supply offerings of incumbents (former Public Electricity Suppliers and British Gas) to switchers and potential switchers in “home” regions. Going forward, Ofgem will:

- ◆ pay particular attention to the consequences of industry consolidation
- ◆ pay particular attention to supply offerings that appear targeted by incumbents to switchers, including potential switchers. This is not to suggest that such offerings are necessarily anti-competitive; any investigation will need to consider whether a company has market power, and the potential or actual effect of the supply offering on competition

¹ Over the period June to September 2002.

² Supplier margins are defined in this paper as operating profit, expressed as a percentage on cost of sales.

- ◆ continue to follow the approach set out in the Energy Guidelines in applying the Competition Act 1998³, and
- ◆ make appropriate use of its investigation and enforcement powers under the Competition Act 1998 and sectoral powers (including financial penalties).

Meanwhile, Ofgem, in conjunction with energywatch, is also working to ensure that customers' perception of the market gives them confidence in switching and competition. Ofgem will deal with misselling, work to reduce the frequency of transfers that do not go smoothly, and ensure that errors that arise are corrected swiftly.

Against this background, Ofgem's advice to domestic customers is clear. Unless a customer believes non-price factors make the historic supplier more attractive, they should switch so as to capture the significant savings now available. These will be of particular benefit to those who struggle to pay fuel bills.

³ "The Competition Act 1998, Application in the Energy Sector" Ofgem and OFT, OFT 428, March 2001 (The Energy Guidelines).

Table of contents

1. Rationale	1
2. Review of retail prices	2
Introduction.....	2
Domestic gas.....	3
Domestic electricity.....	4
Industrial and commercial electricity prices	8
3. Costs driving domestic electricity prices	9
Data sources.....	9
Wholesale electricity costs	10
Supply costs	11
Environmental costs	13
Estimates of supplier margins	14
Dual-fuel	14
4. Developments in domestic supply competition	17
Price parallelism analysis.....	17
Switching	19
Impact of price differences	22
Incumbent market share.....	26
5. Areas for future compliance work	28
Introduction.....	28
Regulatory framework	28
The Competition Act 1998	28
Domestic gas and electricity supply offers.....	30
Implications for competition.....	33
Guidance.....	36
Appendix 1	38

1. Rationale

- 1.1. Retail supply of gas and electricity to domestic customers was opened to competition in stages between 1996 and 1999. Competition in supply has grown quickly, to the extent that the non-discrimination supply licence condition was removed as part of the Utilities Act 2000 in October 2001, and that Ofgem ended *ex ante* regulation through removal of retail price controls from April 2002.
- 1.2. Since Spring 2002 commentators have asked why reductions in domestic electricity prices have been smaller than those in wholesale markets, and whether the current pricing pattern – where switchers systematically pay less than non-switchers – reflects a competitive market.
- 1.3. Ofgem is committed to active monitoring of the domestic and I&C supply markets, and the rationale of this paper is simply to make public some recent results of our surveillance. This paper aims to give a rounded picture of the factors influencing the prices paid by customers in the context of significant wholesale price reductions since October 1998.

2. Review of retail prices

2.1. This report opens with a review of retail price trends and their drivers. Chapters 2 to 4 cover the following topics:

- ◆ retail prices – Chapter 2 sets out retail price changes since privatisation, and prices following the introduction of supply competition. It includes domestic gas prices for comparative purposes, as well as domestic and industrial and commercial (I&C) electricity prices
- ◆ suppliers' costs – Chapter 3 examines changes in the suppliers' cost-base over the years 1998-2002, focusing on the domestic sector, and the evolution of supplier margins, and
- ◆ supply competition – Chapter 4 discusses the extent to which competitive pressures exert a discipline upon prices.

Introduction

2.2. This chapter summarises domestic gas and electricity prices. It includes price trends since privatisation, and since full deregulation of the domestic sector. It also examines the prices charged by ex-PES (Public Electricity Supplier) suppliers in the former host supply regions (incumbent prices) in October 2002, and the savings available for a domestic customer. Finally, I&C electricity prices are examined.⁴

2.3. All prices are converted to bills assuming an average consumption of 3,300 kWh in electricity, and 19,050 kWh for standard credit and direct debit gas. All bills are converted into October 2002 money and include VAT.⁵ Competitors' prices are calculated as the average of best discounts available in each supply area for electricity, and the best

⁴ We examine electricity I&C prices in contrast to movements in domestic electricity prices.

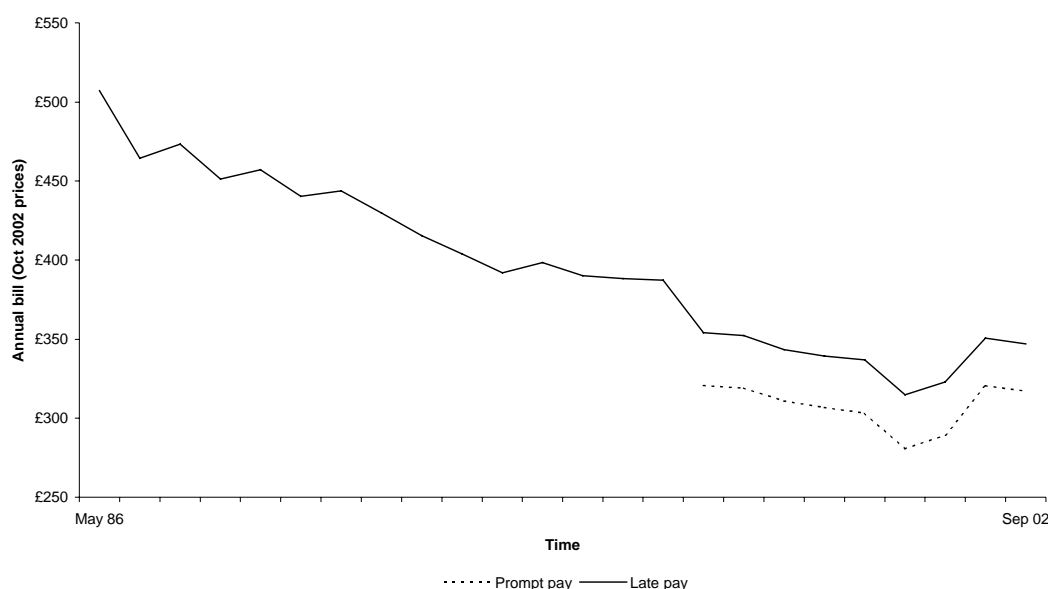
⁵ We use a general RPI index to convert nominal bills into October 2002 real money terms.

discount available nationally compared to British Gas Trading's (BGT's) prices for gas.⁶

Domestic gas

- 2.4. Figure 2.1 shows the long-term standard credit price trend for BGT's LatePay and PromptPay customers. Prices for LatePay customers have fallen by 32 per cent since privatisation in the gas sector, whereas PromptPay prices have fallen 37 per cent.⁷

Figure 2.1 – average standard credit gas bill from BGT



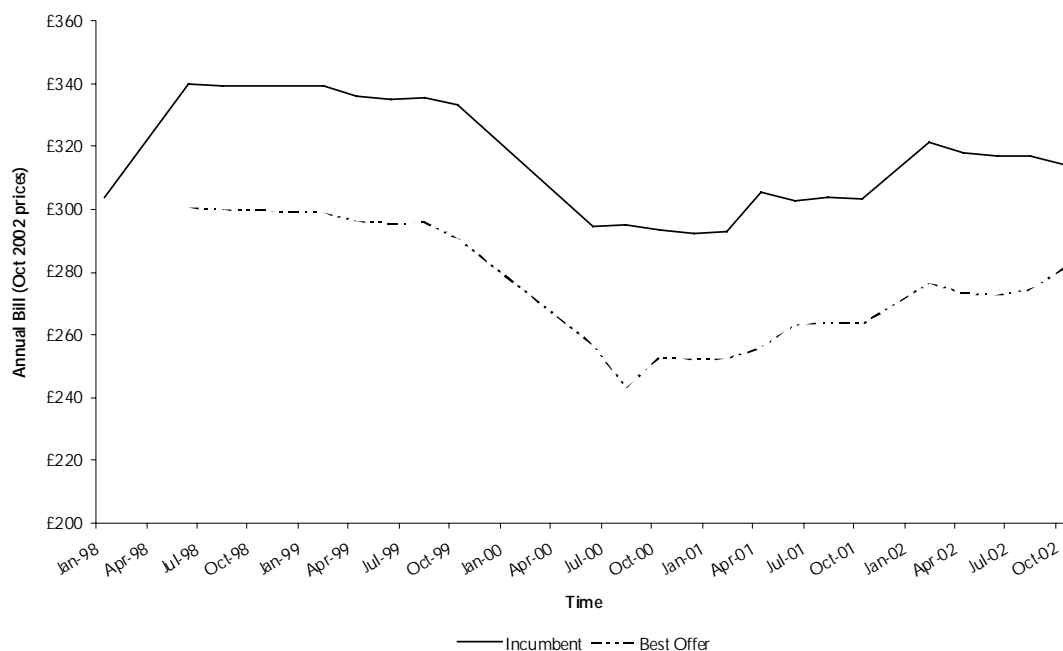
Source: Ofgem/energywatch

- 2.5. Figure 2.2 shows medium-term direct debit price trends for BGT and competitors' prices from January 1998, just prior to the full rollout of domestic gas competition in April 1998.

⁶ The 'best discount' is used as a proxy for new entrant prices, and it is useful for comparisons against the incumbent price. While some customers may choose a better offer but not the best offer, the proxy is useful because it shows the size of discounts available to customers.

⁷ In 1996/97, BGT's standard credit price was split into a Late Pay and Prompt Pay tariff (prior to 1996/97, the line labelled Late Pay reflects the 'standard credit' payment method). Prompt Pay price reductions can be calculated comparing standard credit prices at May 1986 to Prompt Pay prices at September 2002.

Figure 2.2 – domestic direct debit gas bills since competition



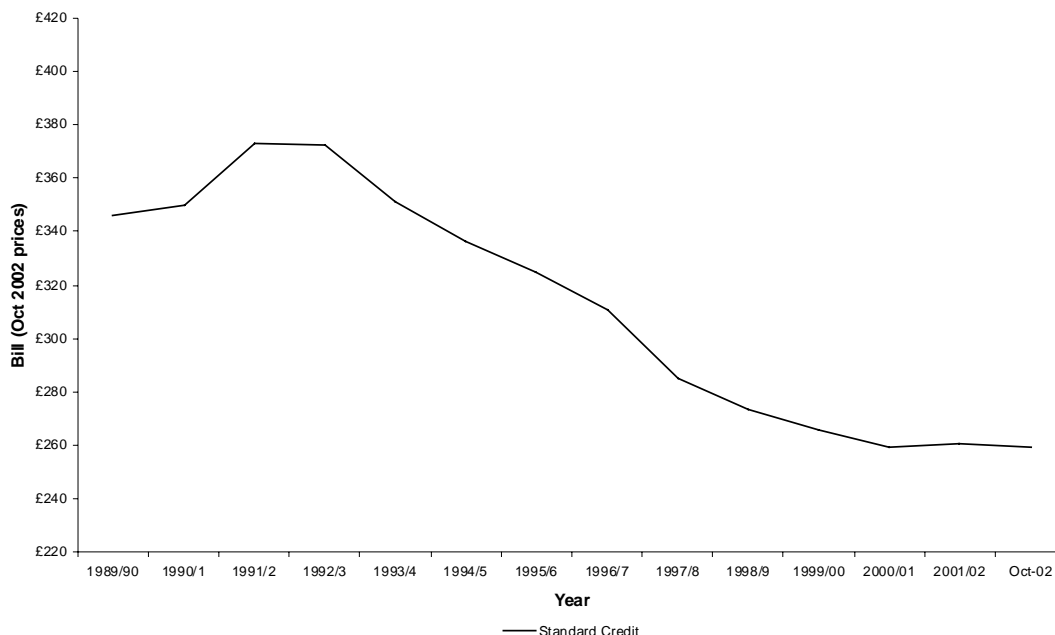
Source: Ofgem/energywatch

2.6. Domestic direct debit gas price increases since 2000 were driven by a sharp increase in wholesale gas prices, which doubled between 1999 and 2000. The increase in wholesale gas prices was in part driven by international factors including higher gas prices in continental Europe feeding through to Great Britain as a consequence of arbitrage over the Bacton-Zeebrugge interconnector. The lagged increase in retail gas prices of approximately 10 per cent since 2000 contrasts with a doubling of wholesale gas prices between 1999 and 2000. Figure 3.1 in chapter 3 show how wholesale gas prices have fallen since 2000.

Domestic electricity

2.7. Figure 2.3 shows average standard credit domestic bills since privatisation in 1989. The prices are average credit bills. The trend shows that average standard credit bills have fallen 25 per cent in real terms since privatisation.

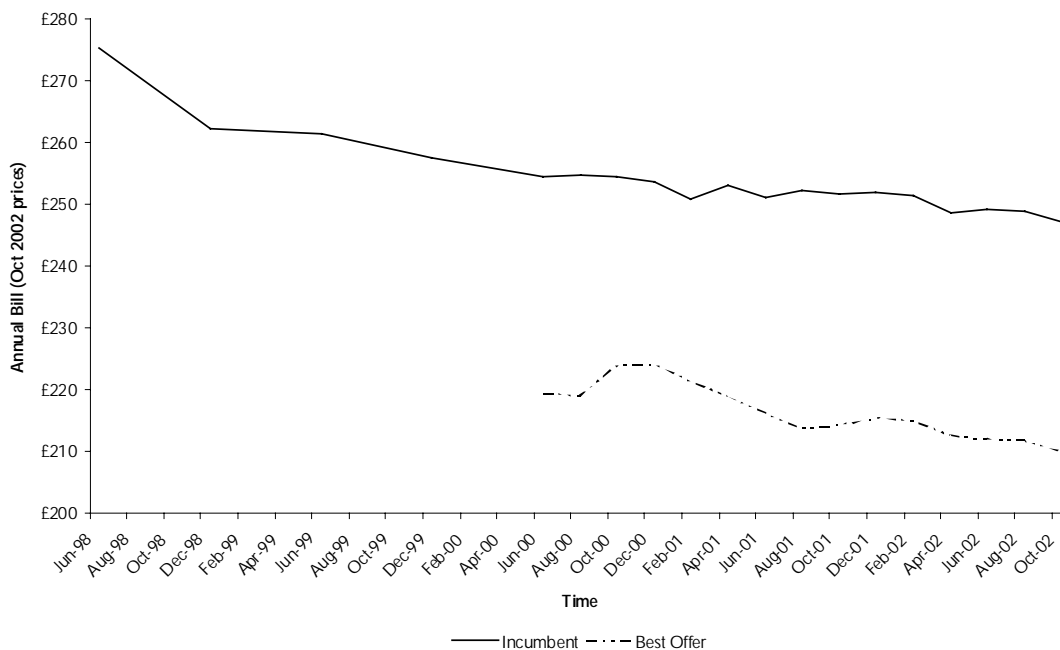
Figure 2.3 – average real standard credit domestic electricity bills



Source: Ofgem/energywatch

2.8. Figure 2.4 shows medium term direct debit price trends for ex-PES suppliers' in-area prices and competitors' prices, from 1998 – around the time competition began in domestic electricity supply. The incumbents' price is the average of all ex-PES suppliers' in-area direct debit prices.

Figure 2.4 – domestic direct debit electricity bills since competition

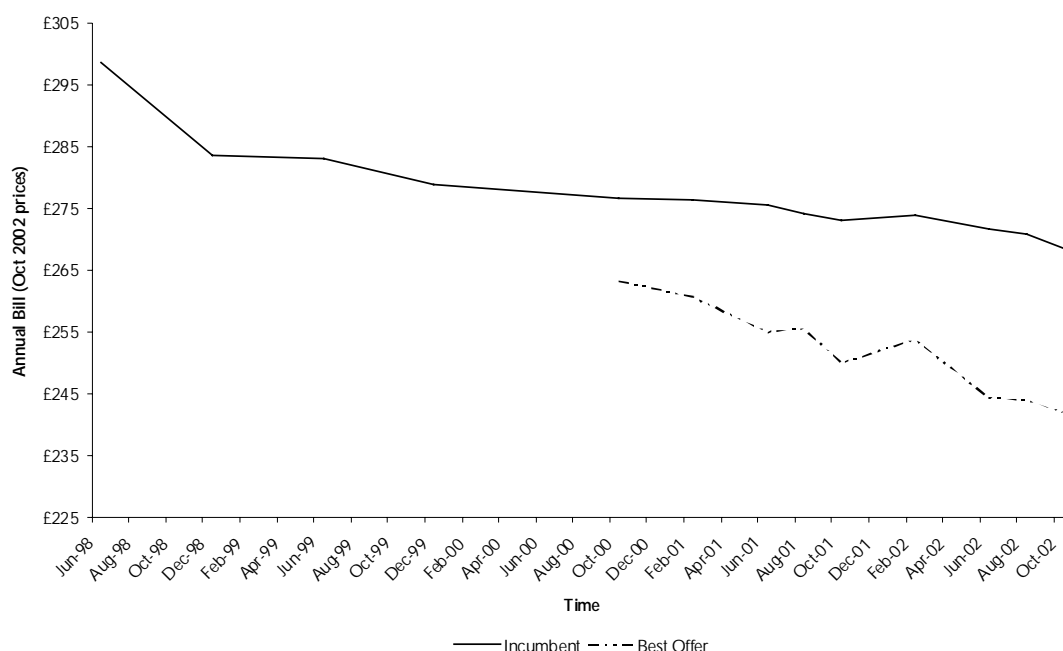


Source: Ofgem/energywatch

2.9. The trends show that real direct debit prices for non-switchers have fallen 8 per cent. Switchers were paying up to 17 per cent less in October 2002, in real terms, than they paid the incumbent in 1998.

2.10. Figure 2.5 shows a similar trend for prepayment prices. For non-switchers prices since 1998 have fallen 8 per cent in real terms. For switchers, prices have fallen by 13 per cent in real terms. Again, the price reduction for switchers is calculated by comparing incumbent prices at June 1998 with competitors' prices at October 2002.

Figure 2.5 – domestic prepayment electricity bills since competition



Source: Ofgem/energywatch

2.11. The trend is similar for credit prices, which lie between direct debit and prepayment prices. Former PES in-area prices fell by 8 per cent in real terms. Comparing incumbents' April 1998 prices with the cheapest out-of-area prices in October 2002 shows that switchers have seen an average reduction of more than 17 per cent.

2.12. Two general trends emerge:

- ◆ for each payment type, the incumbent-price and competitor-price curves diverge over time. This could suggest that, during the first

few years of this young market, price competition has intensified, and

- ◆ the removal of *ex ante* price regulation of retail prices in Spring 2002 was not accompanied or immediately followed by a price-spike for any payment group.

2.13. Table 2.1 gives a snap-shot of the current extent of price competition in October 2002. The table shows current incumbent direct debit, standard credit, and prepayment electricity bills, compared with the best saving available from switching.

Table 2.1 – incumbents' current bills and cheapest offers (Oct 2002)

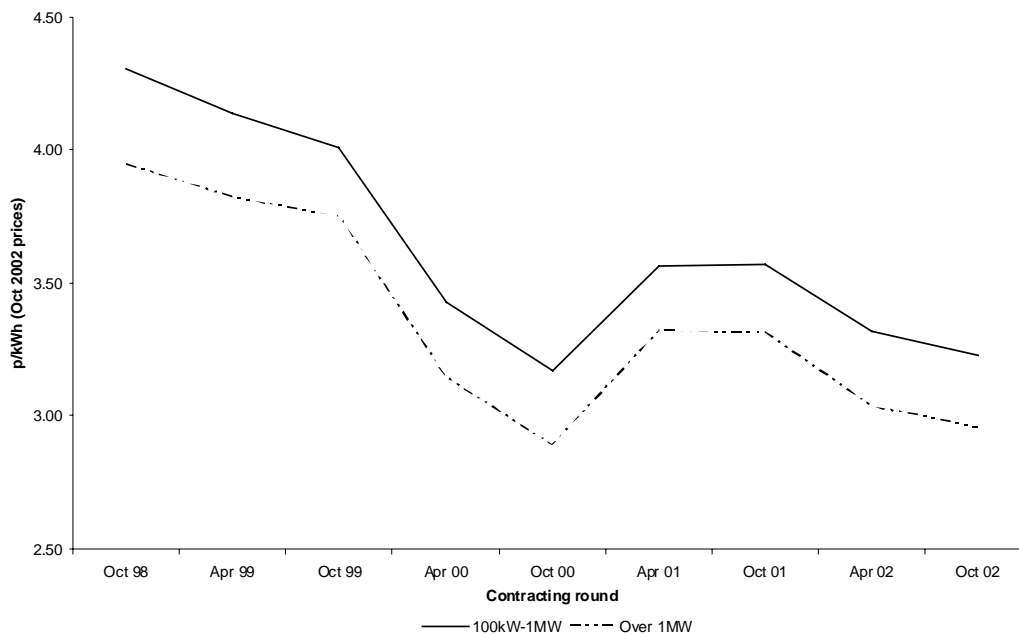
Incumbent	Standard credit		<i>Direct debit</i>		Prepayment	
	Incumbent bill £	Best offer %	<i>Incumbent bill</i> £	<i>Best offer</i> %	Incumbent bill £	Best offer %
Eastern	239	14	226	14	243	10
East Mids	236	11	226	13	244	10
London	247	12	238	18	255	10
Manweb	268	16	261	15	284	10
Midlands	236	11	243	14	259	10
Northern	264	20	251	22	276	11
Norweb	242	13	234	14	258	10
Seeboard	241	13	232	15	249	10
Southern	266	17	252	17	280	8
Swalec	290	14	276	14	306	12
Sweb	269	12	261	14	277	10
Yorkshire	251	17	238	18	266	10
S Power	280	12	271	15	294	10
S Hydro	283	16	269	17	283	11
BGT – gas	347	16	314	11	347	7

Source: energywatch

Industrial and commercial electricity prices

2.14. Figure 2.6 plots electricity prices paid by I&C customers in the April and October contract rounds from October 1998 to October 2002. Prices are real, and inclusive of the Climate Change Levy from its introduction in April 2001.

Figure 2.6 – average real industrial and commercial electricity prices



Source: Energy Information Centre

2.15. The curves show that headline prices for I&C customers fell 25 per cent from October 1998 to October 2002. Excluding the impact of the Climate Change Levy, prices came down 35 per cent over the same period.

2.16. Reductions in I&C prices have been greater than for domestic customers in part because wholesale prices account for 40 per cent of domestic bills, whereas they account for a larger proportion of industrial and commercial bills. In addition, this sector was opened up to competition earlier, and so competition can be expected to be more developed.

3. Costs driving domestic electricity prices

- 3.1. Why have prices fallen? The paper examines costs and margins in this chapter, and chapter 4 looks at competitive conditions.

Data sources

- 3.2. Table 3.1 provides an indicative view of the percentage point changes in the cost of serving an average electricity customer from 1998 to 2002.⁸ It observes that the 40 per cent wholesale market reduction – applied to the 39 to 49 per cent of the cost-base that is wholesale energy – suggests bills should have fallen 16 to 20 per cent.⁹ However, long term contracts dampen this impact.¹⁰ The table also sets out reductions in transmission and distribution charges,¹¹ and other cost increases. Environmental costs reflect the reported Fossil Fuel Levy, plus the estimated impacts from the Renewables Obligation and the Energy Efficiency Commitment. Ofgem’s view on supply costs is informed from various sources.¹²
- 3.3. Table 3.1 shows a fall of 8 to 17 per cent in the average supplier’s cost-base for serving domestic electricity customers over 1998-2002. In comparison, chapter two shows reductions in consumer prices of the same range of 8 to 17 per cent. This suggests that price trends identified in chapter two could be explained by movements in the cost to serve domestic customers, with non-switchers receiving on average a price reduction of 8 per cent in real terms and switchers benefiting from up to

⁸ That is, the change in costs from 1998 to 2002, expressed in percentage point terms.

⁹ Ofgem estimates that generation costs accounted for approximately 49 per cent of a domestic electricity bill, at average consumption, at 1998, compared to 39 per cent in 2002.

¹⁰ Generation costs are informed through data collected as part of an information request issued to suppliers in September 2002, and various forward and spot measures of wholesale prices, including month ahead IPE prices.

¹¹ Transmission and distribution charges (including meter asset provision charges) are from companies published charges.

¹² Ofgem’s view on supply costs is informed through various sources, including supplier’s responses to information requests issued by Ofgem (e.g., as part of previous price reviews and supplementary requests). However, audited data is now approaching 2-3 years old. Recent data – such as information provided by suppliers in September 2002, is unaudited and therefore caution should be exercised when interpreting the results.

17 per cent real reductions in prices. We would expect that the majority of customers would be realising benefits at the lower end of the range (e.g., 64 per cent of customers remain with their former PES supplier).

Table 3.1 – changes in supplier costs 1998-2002

Cost driver	Impact
Reduction in wholesale prices	↓ 40%
Wholesale energy cost as % of domestic bill	49% in 1998: reducing to 39%
Unadjusted view of reduced portfolio purchase costs for average supplier	↓ 16-20%
Impact of IPP and other long-term contracts	↑ 6%
Reduction in transmission and distribution charges	↓ 9%
Increase in supply infrastructure	↑ 5-10%
Increase in environmental costs	↑ 2%
Overall change in supplier cost-base	↓ 8-17%

Source: Ofgem

3.4. Table 3.1 also shows:

- ◆ suppliers' wholesale electricity purchase costs have not fallen 40 per cent, but 27 per cent on average (i.e., 40 per cent applied to two thirds of a typical supplier's energy portfolio)
- ◆ additional supply costs have been borne in the early stages of retail competition – cost savings continue to be realised, and
- ◆ environmental costs have risen, but only by 2 per cent of the average bill.¹³

Wholesale electricity costs

3.5. Suppliers buy electricity in different ways. Some methods expose the supplier to current prices, through:

- ◆ short-term contracts
- ◆ longer-term contracts indexed to current prices, and

¹³ This is the cost to the supplier, which is passed through to the customer. The net cost for many customers is less, as they are the ones to benefit from the energy efficiencies.

- ◆ purchases through exchanges.

- 3.6. However, other methods do not expose the buyer to wholesale price changes. All the ex-PES supplier groups have some long-term, legacy contracts. These have dampened the impact of recent wholesale price changes on the portfolio, such that average portfolio price reduction was closer to 27 per cent. This average masks a considerable spread, as some suppliers have seen their overall purchase cost reduce much more than others.
- 3.7. Most legacy contracts are with “Independent Power Producers” (IPPs). IPPs are generally generation plants project-financed partly by long-term contracts. Largely struck in the mid-1990s, these contracts expire towards 2010 and are usually indexed to gas and oil prices, wholesale electricity costs and retail price inflation. Indexing effectively guarantees revenue to cover the IPPs’ debt and equity cost.
- 3.8. As suppliers manage their way out of non-competitive portfolio costs, further benefits from wholesale price reductions will be realised by customers. As supply competition develops further, we would expect ex-PES suppliers to find it increasingly difficult to load legacy contract or other above market costs on to in-area customers. Those who continue to do so risk accelerating the loss of customer share.
- 3.9. It appears that IPPs rely heavily on the cash-flow from these contracts to finance interest payments. Reduced payments may represent a route to financial difficulty for these generators. This may explain why certain suppliers have met vigorous resistance when negotiating to reduce IPP prices. For some suppliers the best option has been to buy out the counter-parties. Some have done so, but continue setting prices to recover buy-out costs.

Supply costs

- 3.10. Between 1998 and 2002, the environment in which supply businesses have operated, and the scope of their activities, has changed significantly. In 1998, supply functions shared assets, personnel and premises within larger PES distribution businesses. This supply function provided electricity supply, billing

and meter reading services to a captive customer base within fourteen monopoly franchise regions.

- 3.11. Today, former PES suppliers operate as separate entities in a competitive market in which they must compete on service and price to retain in-area customers and to acquire new customers. They also operate nationally. Competition has forced suppliers to become proactive both in and out-of-area by building brands, diversifying and differentiating their services from other suppliers, and taking innovative approaches to marketing to customers. A key product innovation has been the introduction of dual fuel offerings, with four out of every five switchers now taking dual fuel. Former PESs now compete head to head with each other, BGT, and other new entrants both in and out-of area.
- 3.12. Between 1998 and 2002 the supply component of the average bill rose between 5 and 10 percentage points. This increase reflects the changing environment and scope of the supply businesses, compared with the supply arm function of former PES distribution business that existed in 1998. Costs that have arisen from these changes include:
- ◆ handling transfers – each costs £30 or more to complete
 - ◆ customer acquisition and brand-building costs that were negligible before competition
 - ◆ increased bad-debt, since customers gained the ability to switch – although debt prevention and management polices could be effective in managing debt in the future
 - ◆ higher depreciation charges – upgrading IT systems to deal with competition and improve customer care, and
 - ◆ higher customer-care costs – customers contact their supplier more frequently.
- 3.13. Market changes since 1998 have not all increased supply costs. Countervailing factors include:

- ◆ cost savings from consolidation. Given the time-lag before consolidation benefits emerge, there will still be considerable benefits to customers in the future
- ◆ extending the product-range allows the spreading of common and joint costs over more revenue-streams. Again, Ofgem finds that most suppliers' efforts in this area are still growing, largely because multi-product offerings require systems development, and
- ◆ innovation, like greater outsourcing, has reduced costs.

3.14. Available price savings have grown since market opening. Market developments, such as consolidation and multi-product offerings, suggest per-product-per-customer supply costs are unlikely to grow as they have done, and are more likely to reduce.

Environmental costs

3.15. Suppliers knew for some time about environmental costs commencing in April 2002, and would have been able to factor in these costs when setting current prices. Since April 2002, suppliers have been required to source at least three per cent of their sales volumes from renewable sources. The Renewables Obligation has therefore added between £1.50 and £3 per customer to domestic suppliers' costs (net of pre-existing NFFO contract costs). The objective behind the Obligation is to have 10 per cent of UK electricity requirements met by renewable sources by 2010.

3.16. The Energy Efficiency Commitment also increased in April 2002; to an indicative spend of £3.60 per household per fuel per year until 2005. Full pass-through, for the 20 million households using electricity and gas, would cost £7.20 each year, until 2005.

3.17. The Climate Change Levy was introduced in April 2001, and is paid by non-domestic electricity customers at the rate of 0.43p/kWh.

Estimates of supplier margins

- 3.18. Ofgem keeps abreast of estimates of supplier margins, as published in supplier companies' financial results and analysts' reports. Ofgem is aware that analysts' estimates of supplier margin reflect a range of legitimate interpretations, to which Ofgem has had regard when assessing the range of possible supply costs in the sector.

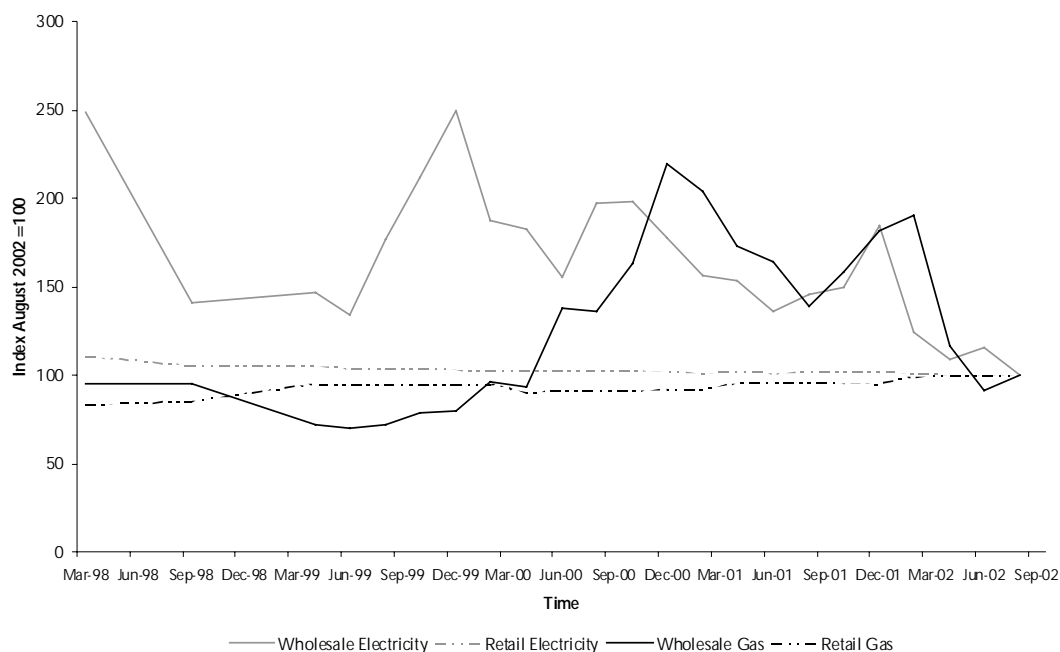
Dual-fuel

- 3.19. Margins in domestic gas supply have, over the last two years, been extremely low or negative. Suppliers seem keen to avoid price rises, and in some cases have seen strongly negative public reactions when raising prices.
- 3.20. The extent of linkage between gas and electricity markets is discussed in chapter 4, which concludes that these links are significant. Ex-PES suppliers appear to believe that recruiting a customer for gas supply is important in retaining their electricity account. This may be because of a perception that BGT's successful recruitment of electricity customers has been through existing gas supply relationships. Also, gas suppliers may believe that price increases may spur the customer into switching again and increase the general volatility of the market.
- 3.21. For whatever reasons, customers have not borne the brunt of large increases in wholesale gas costs since 2000. Stronger margins for electricity have helped suppliers make this a practical approach, with overall benefits for consumers.
- 3.22. Figure 3.1 illustrates the contra-cyclical movement between wholesale gas and electricity prices since 1998, and the smoothing of these price fluctuations into domestic gas and electricity prices.
- 3.23. Wholesale gas prices doubled between 1999 and 2000 resulting in higher retail gas prices both in 2001 and 2002. Conversely, 40 per cent reductions in NETA wholesale prices have resulted in lower retail electricity prices since 1998. Suppliers have an incentive to smooth retail prices for domestic customers because they prefer stable prices (or at least dislike nominal price increases).

Suppliers who pass on increases in wholesale prices could find that their customers are more likely to switch away to a competing supplier. Suppliers have chosen to smooth prices in part through offsetting lower gas margins with electricity margins that are higher by historical standards.

3.24. For example, the majority of suppliers have diversified to provide both gas and electricity supply, and in many cases offer both fuels to the same customers through a dual fuel offer. This dual fuel margin may provide a mechanism for allowing underlying profitability of the supply business as a whole, while providing customers with price stability.

Figure 3.1: Wholesale and retail gas and electricity prices



Forward look

- 3.25. Ofgem does not believe it possible or sensible to predict market trends in any detail. Against that background, we make some observations.
- 3.26. The differences between price changes and cost changes since 1998 mean electricity supply margins have grown. Whilst effective competition becomes more vigorous, the more efficient suppliers will differentiate price and service. In this environment, suppliers who maintain higher prices and margins will face loss of market share, while suppliers that lower prices will face reduced margins.
- 3.27. Margins could erode through reduced differentials between ex-PES suppliers' in-area tariffs and those offered by competitors. This will not mean a given supplier offers the same price to customers in- and out-of-area. Competitive conditions may differ between regions (this is discussed further in chapter 4), and the cost-base differs across regions because distribution and transmission charges vary.
- 3.28. It would appear that suppliers are managing their way out of above market costs related to past investments as the competitive supply develops further. Rapid adjustments will be risky for the ex-PES suppliers, who all have legacy contracts. In many cases, these legacy contracts do not expire before late in this decade. However, as discussed earlier, we would expect ex-PES suppliers to find it increasingly difficult to load legacy contract or other above market costs on to in-area customers as supply competition develops further.

4. Developments in domestic supply competition

- 4.1. This section comments on the state of competition in the domestic supply of electricity, picking up on emerging trends, and how these will act to constrain prices.
- 4.2. There are many ways to measure the development of competition. In this document, we focus on the following:¹⁴
- ◆ Price parallelism analysis
 - ◆ switching behaviour
 - ◆ price offerings, and
 - ◆ market shares.

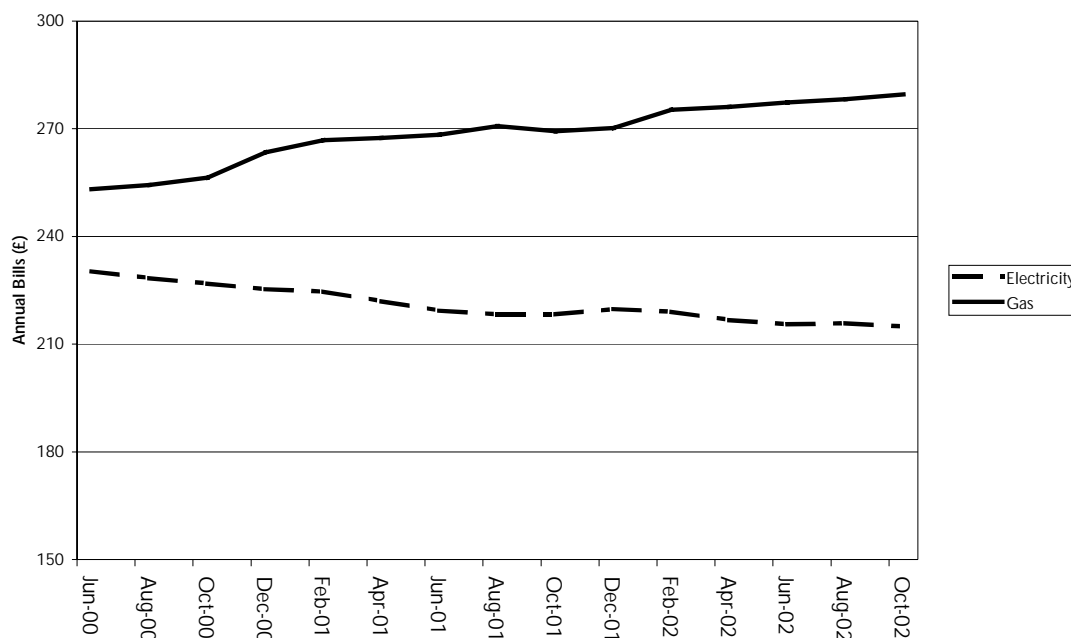
Price parallelism analysis

- 4.3. This section discusses the extent to which competitive conditions are uniform between domestic electricity and gas supply, and across different geographic areas.
- 4.4. In considering any future complaint or an Ofgem initiated investigation under the Competition Act 1998, Ofgem would examine questions of market definition, dominance and the implications for anti-competitive agreements, decisions or concerted practices, and the exercise of market power, based on the specific facts of the case and using most up to date market information available at the time of the investigation.

¹⁴ Clearly, there are other indicators of competitiveness, such as an examination of barriers to entry and exit, which Ofgem regularly consider as part of its competitive market review of domestic gas and electricity supply. We do not propose to provide a detailed assessment of these indicators here, but rather discuss competition in the context of recent price trends.

- 4.5. Ofgem tends to view market conditions as reasonably comparable between sectors if these conditions impact similarly on prices.¹⁵ This section reviews analysis of how much prices have moved in parallel.
- 4.6. Figure 4.1 shows national average gas and electricity direct debit prices¹⁶ since June 2000. This payment method was the first to have price controls lifted, and could be viewed as a leading indicator of emerging supply trends and characteristics. Most companies use direct debit as their spearhead for gaining customers. Also, it is the fastest growing payment method. The direct debit price is a general indicator of competitive pressures.

Figure 4.1 – national average gas and electricity direct debit prices



Source: Ofgem/energywatch

- 4.7. Gas and electricity prices have moved in opposite directions since 2000. Real electricity prices are falling slowly whilst real gas prices are rising more steeply.
- 4.8. The trend could suggest a lack of substitutability between fuels. For instance, the largest amount of domestic gas and electricity is used for heating. Most consumers are unable to switch their central heating quickly from gas to electricity or vice versa. Arguably, gas and electricity provide weak constraints on each others prices, at least in the short term. Further, most white goods and

¹⁵ "The Competition Act 1998, Market Definition", OFT, OFT 403, March 1999, p.6.

¹⁶ Prices are based on a medium consumption bill – see paragraph 2.3 for detail.

other household appliances can only run on electricity. Generally, electricity can substitute for gas in the long-term, but gas cannot completely substitute for electricity.

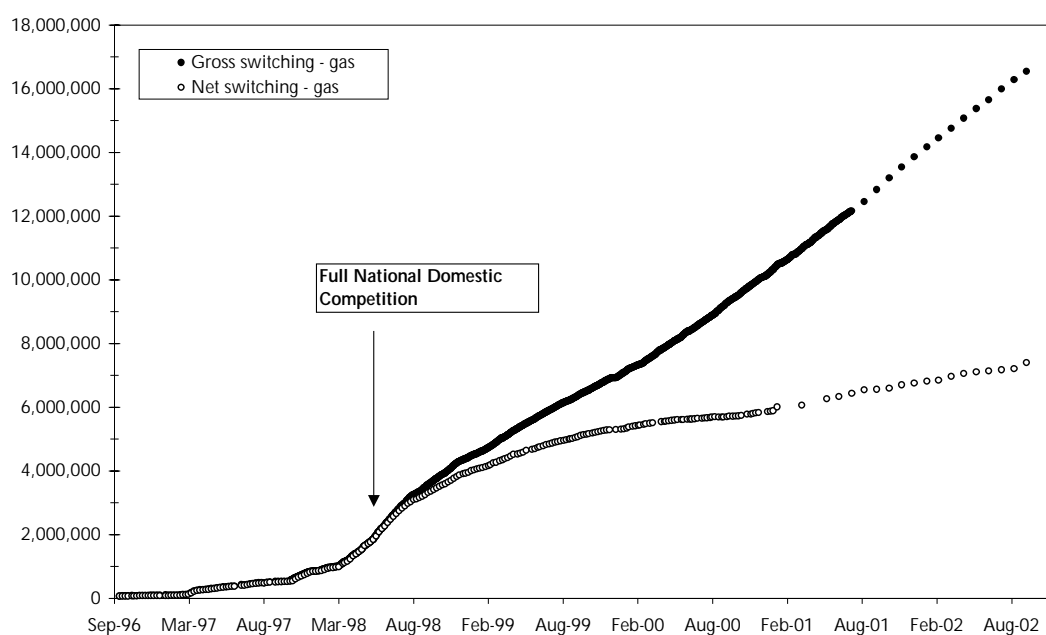
- 4.9. This does not mean that the gas and electricity sectors are unrelated. Suppliers' purchase costs for gas and electricity are related. Because gas is important in generation some co-movement between wholesale prices may be expected, all else being equal. Down-stream, the majority of customers who switch supplier move for a "dual fuel" offer. This suggests customers are more willing to buy both fuels from the same company. This may reflect positive brand equity with the old supplier, or a perception of risk in switching to a new, untried company. Some suppliers provide positive financial incentives to gain both accounts. As noted in chapter 3, suppliers seem to regard dual fuel sales as essential in building and protecting their customer book.
- 4.10. Given the lack of co-movement between gas and electricity prices, Ofgem will continue, for the present, to monitor gas and electricity retail prices separately.
- 4.11. Figure A1 in Appendix 1 shows average gas prices by ex-PES region. Transportation cost variations are excluded. There is clear co-movement of prices across areas, indicating that competitive conditions do not vary materially. This supports the hypothesis of national characteristics in gas supply.
- 4.12. Figure A2 in Appendix 1 shows the average electricity prices by ex-PES region. Transmission and distribution cost variations, DUoS and TUoS, are excluded. Price co-movement is not evident, indicating continued regional characteristics for domestic electricity supply. Meanwhile, suppliers have national marketing strategies and purchase generation for a single national portfolio. Given the unclear picture, Ofgem will continue monitoring regional electricity supply.

Switching

- 4.13. Gross switching continues apace: nationally, during July to September 2002, 88,000 electricity customers, and 68,000 gas customers, switched each week – almost 160,000 customers per week in domestic gas and electricity combined.

4.14. Figure 4.4a shows gross switching and net switching for gas, which was liberalised fully from 1998, a year earlier than in electricity. Erosion of incumbent share slowed earlier in that market, and now continues at a moderate pace. Figure 4.4b shows continued high gross switching in electricity. Net switching – erosion of incumbents’ market share – continues, although the pace has slowed in recent months (see discussion below).

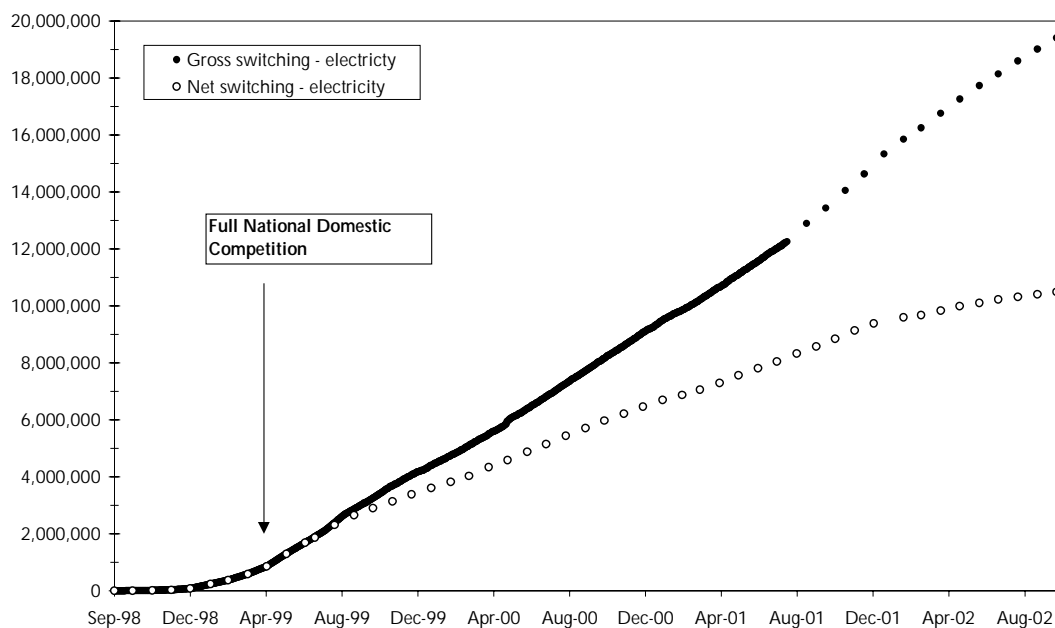
Figure 4.4a – net versus gross switching in gas (Sept 96 – Aug 02)¹⁷



Source: Ofgem

¹⁷ In both figure 4.4a and 4.4b, the line changes from filled to dotted, reflecting the change from daily to monthly source data.

Figure 4.4b – net versus gross switching in electricity (Sept 98 – Aug 02)



Source: Ofgem

4.15. The difference between gross and net switching reflects customers switching more than once, including those returning to the incumbent. Such behaviour is characterised as “churn”. Ofgem views gross switching and net switching as valid indicators of competition, neither being inherently more important. Healthy gross switching reflects continued marketing, and customers’ willingness to switch. However, Ofgem would have some concerns if a large proportion of churn represented customers switching very frequently. At present, this does not seem the case: around two-thirds of electricity switchers have only switched once, a quarter have switched twice, with the remaining switchers having switched more than twice.¹⁸

4.16. Ex-PES suppliers have retained an average 64 per cent of their in-area domestic electricity customers. This may suggest competition in electricity intensified quicker than gas, where BGT retains 64 per cent of the domestic gas sector despite exposure to competition one year earlier (May 1998).¹⁹

¹⁸ November 2001, “Experience of the competitive domestic electricity and gas markets,” Research study conducted for Ofgem by MORI.

¹⁹ The figure of 64 per cent is derived from figures provided in Centrica’s Annual review and summary financial statement 2001 and transcripts from Centrica’s presentation of Interim Results 2002 held on 5 September 2002 (page 5). A 4 per cent year on year reduction in customers is applied to BGT’s

Impact of price differences

- 4.17. A further element of effective competition is whether customers have access to good, competitive offers. Theoretically, all offers could be the same price, with competition expressed in non-price terms. It seems likely that service standards are an important means of brand definition. However, in today's market Ofgem would be concerned by an absence of price competition.
- 4.18. Chapter 2 showed that competitors in each region offer significantly better electricity prices than the ex-PES supplier. Indeed, the gap between the average incumbent price and the average competitor price continues to widen.
- 4.19. Ofgem recognises customers are not as price sensitive for domestic electricity as they are for some other products. It is necessary to consider whether existing price differentials are sufficient to persuade customers to switch.
- 4.20. The evidence since market opening suggests they are, for a significant proportion of customers. Since competition was fully implemented in April 1999, ex-PESs have lost, on average, 11 per cent of their in-area customer base, year on year. This loss is associated with continued discounting by competitors - the national average of best discounts to an incumbents in-area offer has ranged between 8 and 14 per cent since competition was introduced.
- 4.21. MORI (2001)²⁰ finds 69 per cent of electricity customers who switch do so in pursuit principally of savings, which supports the assessment that customers are not indifferent to the savings currently available.
- 4.22. Ofgem has reviewed some of the academic research available on this point. A number of economists have examined how customer-side characteristics affect the rate of switching. The research views switchers as individuals, and assesses their benefits and costs from switching, given the pattern of search and switching costs, risks and possible savings prevalent at a particular time. Since perceptions

13.4 million gas accounts held at the end of calendar year 2001, which represented 67 percent of the domestic gas supply sector at that time.

²⁰ November 2001, "Experience of the competitive domestic electricity and gas markets," Research study conducted for Ofgem by MORI.

and weightings of risk and reward vary, the propensity to switch varies across the population.

4.23. Waterson (2001)²¹ provides price elasticity information for domestic electricity demand. The paper, using the results of a 1999 survey derived from work with Giulietti and Waddams, asked customers the savings necessary to make switching worthwhile. The results, in Table 4.1, suggested that 38 per cent of customers would switch for savings of up to 28 per cent. Waterson finds that, to see a significantly greater erosion of incumbent share, the savings would have to increase dramatically to nearly half of the bill.

Table 4.1 – propensity to switch

Possible annual savings	Proportion of average bill	Additional switchers	Cumulative switchers
£24	9%	7%	7%
£48	19%	14%	20%
£72	28%	17%	38%
£96	37%	6%	44%
£120	47%	24%	67%
£144	56%	2%	69%
£168	65%	2%	71%
£192	75%	3%	75%
£240	93%	4%	79%

Source: derived from Waterson 2001

4.24. Waterson also compares a theoretical incumbent's revenue reductions from losing customers to the gains from charging more for remaining customers. When savings exceed £96-per-year enough customers express a willingness to switch to make the price differential uneconomic for the incumbent. In this scenario, the incumbent could rationally maintain prices around £8-a-month above competitors' levels, so long as customers' price-elasticity stayed at the low-level suggested by the survey.

4.25. Green (2001)²² constructs a scenario in which perceived high switching costs by consumers could allow a rational incumbent to maintain high prices even if it lost 55 per cent of its customer base. The relevant costs for Green's analysis are not the actual search and switch costs, but those inferred by customers' perceptions, given observed switching rates.

²¹ Waterson, M., "The Role of Consumers in Competition and Competition Policy", Warwick Economic Research Paper no. 607, University of Warwick, July 2001.

²² Green, R., "Can Competition replace Regulation for Small Utility Customers", University of Hull and CEPR, July 2001.

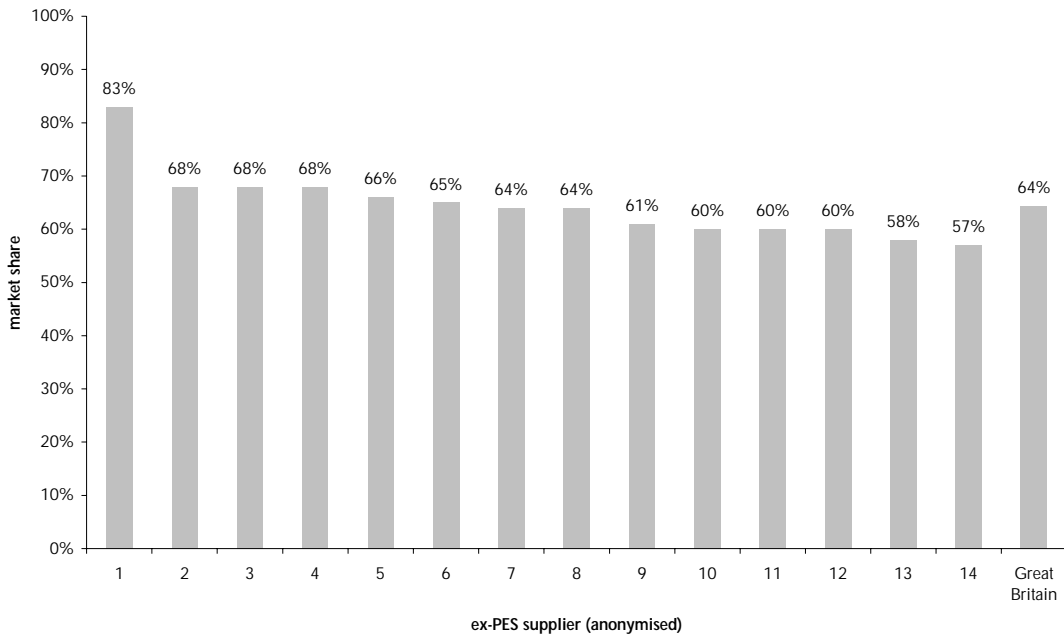
- 4.26. This work is largely based on research in the very early days of domestic energy supply competition. For example, while the survey quoted by Waterson suggested savings of 26 per cent were required for 35 per cent of customers to switch, in reality this proportion of customers have switched for average savings up to 17 per cent (see Chapter 2). Moreover, if the population willing to switch for savings were almost exhausted, gross switching would drop sharply, or, at least, the numbers of once-only switchers would fall to low levels. As discussed earlier, this is not the case empirically.
- 4.27. MORI (2001) supports the thesis that a substantial number of potential switchers exist for whom the current benefits do not outweigh their perceived costs. MORI found 13 per cent of electricity non-switchers would switch for less than £50 per year (a 20 per cent saving), while one-third would switch for between £50 and £100 (a 20 to 40 per cent saving). A further 6 per cent wanted over £100, while 24 per cent would not switch for any level of saving – the remaining 23 per cent did not know.
- 4.28. Competitors may need to offer greater savings to challenge the remainder of the incumbent market share. Moreover, if savings do not motivate switching, then competitors may need to consider product and service variations. Ofgem will continue to monitor the development of customers' willingness to switch in relation to available savings and other aspects of offers.
- 4.29. It is worth mentioning that price is not the only decision variable when customers decide to switch supplier. Customers who are less sensitive to price may be sensitive to non-price factors, such as the convenience of energy bundled with other products. Suppliers are increasingly diversifying and differentiating their product offerings through bundling, which provide incentives for more customers to switch supplier.
- 4.30. Another important finding is that customers' perception of risk and reward affects their switching behaviour rather more than the reality. Perceptions in 1999 were not always accurate. In the 1999 survey, cited by Waterson, 43 per cent of customers did not know how long switching would take, whilst a third believed making a switch would take more than a day. Therefore, perceived switching costs were seen as high.

- 4.31. As competition has developed, with more people enjoying savings and smooth transfers, this has allayed some fears about the risks and costs, resulting in greater switching. Experience since market opening seems to have significantly changed customer attitudes. In MORI (2001), almost two-thirds of electricity non-switchers said they thought changing electricity supplier would be easy, as against 14 per cent who thought it difficult.
- 4.32. Ofgem recognises an important consequence: customers' confidence in the market is of prime importance to the continued health of competition. This is driving Ofgem to focus on improving customers' experience of the competitive market – including areas where the occurrence of problems is relatively small, but the impact on customers' perceptions of risk might be large. These include:
- ◆ tackling misselling
 - ◆ making it easier for customers to make price comparisons in the market
 - ◆ making the transfer process more robust
 - ◆ considering debt prevention management through the debt blocking protocol, and
 - ◆ ensuring suppliers deal efficiently with problems when they arise, and pay compensation if they fail.

Incumbent market share

4.33. Market share is the final indicator of competition considered. Figure 4.6 shows incumbents' market shares from September 2002.

Figure 4.6 – ex-PES suppliers' incumbent market shares



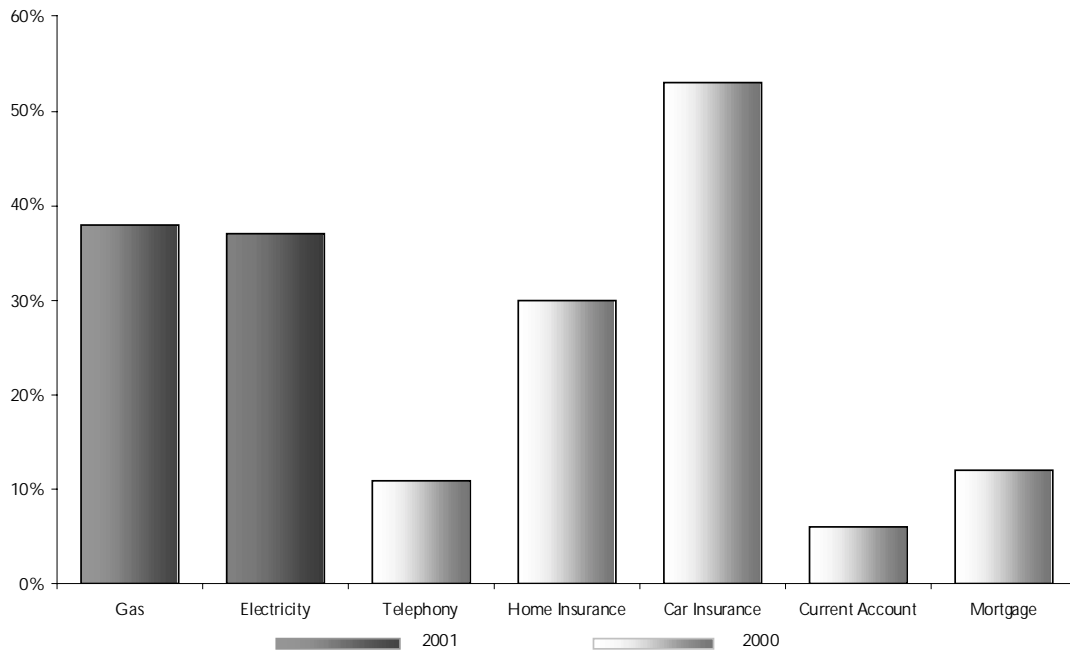
Source: Ofgem

4.34. By the standards of most comparable retail markets, the transfer of market share from incumbents to new entrants has been both significant and rapid (see figure 4.7).

4.35. Market share is one of many competition indicators and, in itself, does not summarise the level of competition in the market. It is possible for incumbent suppliers to retain customers, not as a consequence of falling competition, but because customers are satisfied with their existing provider. This could stem from the incumbent providing a premium service, although it is not obvious that this is the current case. Alternatively, such customer preference could come from brand strength. Certain suppliers may lack local affiliation, which some customers value. As noted, customers may value staying with the incumbent because they fear switching is difficult, that any savings will evaporate over time,

or that switching is risky. Ofgem is working to reduce these demand-side barriers to switching.

Figure 4.7: Switching rates across comparable industries



Source: DTI, "Switching Supplier: a research study", November 2000, page 8/Ofgem

5. Areas for future compliance work

Introduction

- 5.1. Ofgem is keen to ensure that the competitive process continues to benefit all customers in all segments of the market. Accordingly, this chapter discusses those areas where Ofgem views continued retail market surveillance to be a priority, and the role of competition law.

Regulatory framework

- 5.2. Ofgem monitors compliance with the full range of obligations placed on suppliers, for example by the standard supply licence conditions and by non-sectoral consumer protection regulations. Ofgem enforces compliance with such obligations; the most recent case involved a £2m penalty on London Electricity.²³ In the context of market monitoring, however, the obligations contained in the Competition Act 1998 (“the Act”) are of particular relevance and will be the focus of this chapter. The Office of Fair Trading (OFT) and Ofgem have published joint guidelines on the application of the Act in the Energy Sector.²⁴

The Competition Act 1998

- 5.3. Under the Act there are two prohibitions: one against anti-competitive agreements, decisions or concerted practices and the other against anti-competitive behaviour, in Chapter I and Chapter II of the Act, respectively. These are outlined below.

23 Decision of the Gas and Electricity Markets Authority following an investigation into compliance by London Electricity plc with its obligations under standard licence condition 48 of its gas and electricity supply licences, 14 November 2002

24 “The Competition Act 1998, Application in the Energy Sector” Ofgem and OFT, OFT 428, March 2001 (The Energy Guidelines), p.15.

“Chapter I”

- 5.4. Chapter I prohibits certain agreements between undertakings, decisions by associations of undertakings or concerted practices which may affect trade within the United Kingdom (or a part thereof) and have as their object or effect the prevention, restriction or distortion of competition within the United Kingdom (or a part thereof) and which may affect trade within the United Kingdom (or a part thereof).
- 5.5. Some examples of behaviour that might breach this prohibition include agreements with the effect of price fixing, limiting output, sharing markets, discrimination and including unrelated supplementary provisions in contracts. As noted above, these activities are only illegal to the extent that they have as their object or effect the prevention, restriction or distortion of competition.

“Chapter II”

- 5.6. Chapter II prohibits any conduct on the part of one or more undertakings which amounts to the abuse of a dominant position in a market in the United Kingdom (or a part thereof) which may affect trade within the United Kingdom (or a part thereof). Some examples of behaviour that might breach this prohibition include predatory pricing or behaviour, excessive pricing, limiting output, discrimination and requiring unrelated supplementary obligations in contracts. Being dominant is not itself prohibited, so the focus is on how an undertaking conducts itself, and whether the effect is such that trade may be affected.

Penalties

- 5.7. The penalties that may be imposed upon an undertaking that has infringed the Act may be up to 10 per cent of UK group turnover for up to three years, or the period of the infringement, whichever is the shorter.
- 5.8. Ofgem refers all undertakings to the Energy Guidelines²⁵ and the OFT guidelines on the Act.²⁶

²⁵ Ibid.

Domestic gas and electricity supply offers

- 5.9. Ofgem gives considerable priority to monitoring developments in this area given Ofgem's principal objective and statutory duties in the Gas Act 1986 and the Electricity Act 1989, as well as its powers under the Competition Act 1998.
- 5.10. In its application of the Act, Ofgem will be particularly vigilant in seeking to ensure that agreements, decisions or concerted practices and conduct of dominant incumbent undertakings does not have an anti-competitive effect by restricting the opportunities for others to address markets in innovative ways. This restriction could occur, for example, by preventing the introduction of new products or services or by artificially restricting the profits that could be made by new entrants from the introduction of new products and services.
- 5.11. The following discussion focuses on suppliers' approach to domestic energy supply and considers three forms of supply offers that characterise the development of competition:
- ◆ bundling of certain goods and services with the energy supply contract (affinity deals, complementary offers and dual fuel offers)
 - ◆ contractual terms and conditions that 'lock-in' customers, and
 - ◆ contractual terms and conditions aimed at switchers (win-back strategies).²⁷

Bundling

- 5.12. Many suppliers now provide a range of services in addition to their single fuel supply contract. This 'bundling' of additional services adds value for customers by providing a convenient means for purchasing services or being referred to services (local tradespersons, services, etc). Bundled services may also attract discounts, which may reflect a supplier's economies of scope from offering multiple product lines.

²⁶ These documents are available from the OFT. Their website address is www.ofg.gov.uk.

²⁷ This list is to aid discussion, and is not an exhaustive overview of all supply offers.

- 5.13. The most prevalent bundled offer is of gas and electricity ("dual fuel"). Dual fuel offers can benefit customers who find it more convenient to deal with one supplier than two for their energy supplies. Customers may benefit from cost savings arising from synergies in the provision of dual fuel.
- 5.14. One supplier offers a dual fuel offer with a £15 discount off the standard bill. Other suppliers offer discounts of £5-10. Most recent estimates²⁸ available to Ofgem indicate that around 80 per cent of switchers move to a dual fuel offer, and most customers cited the dual fuel price, including discount, as the reason they choose to switch supplier. This suggests the dual fuel discount significantly affects customer switching.
- 5.15. Some suppliers have diversified into a wider range of 'home services': examples include central heating maintenance, telephone and internet services, electrical and plumbing services, and insurance contracts for central heating, plumbing and drains. Energy suppliers also offer financial products, like credit cards and personal loans as well as roadside services.
- 5.16. One supplier offers gas, electricity and telephone with a common bill. A number of suppliers are making substantial IT investments to enable common billing and service of multiple products, and so we expect this trend to extend to other suppliers.
- 5.17. Some suppliers have entered partnerships to capture benefit from another company's brand equity, customer franchise or capabilities. Examples include retailers' loyalty card schemes, enabling customers to earn, amongst other things, loyalty points and Air Miles on purchases of energy. We understand that one such partnership attracted customers who churned at about a third of the normal rate.²⁹ Again, this result suggests that affinity deals, through affecting a customer's overall evaluation of a supplier's tariff, can significantly affect customer switching.
- 5.18. Ofgem pays attention to bundled offers and their impact on switching. For instance, dual fuel prices appear to comprise a highly competitive price (giving

²⁸ November 2001, "Experience of the competitive domestic electricity and gas markets," Research study conducted for Ofgem by MORI.

the supplier a much reduced margin) for the 'diversified' fuel, compared with a higher, less competitive price for the 'core' fuel. Coupled with a discount, dual-fuel pricing appears to be a key driver of switching for domestic customers.

- 5.19. In relation to discounts, OFT Guidelines³⁰ state that "the offering of discounts to certain customers is a form of price competition and is generally to be encouraged. As with price discrimination, discounts will only infringe the Chapter II prohibition only if they are anti-competitive: if prices are set to predatory levels or if they are used to foreclose a market, for example." Ofgem would expect dual fuel discounts offered by dominant undertakings to be cost reflective. If the discount were excessive, it could be seen as a way of discriminating in favour of potential switchers in order to foreclose the market.

Lock-ins

- 5.20. In competitive markets, firms and consumers can find mutual benefit from fixed-term contracts, where the size of the benefit increases with the length of the contract. For example, customers who enter longer-term insurance or banking contracts may benefit from lower premia or interest rates.
- 5.21. A similar trend is emerging in gas and electricity supply. For example, one supplier introduced a capped electricity offer, where the supplier committed not to raise prices over a period. The supplier also indicated that, if circumstances permitted, it could reduce prices further below the cap. The supplier charges a termination fee to customers that switch.
- 5.22. Another supplier has used a loyalty scheme to offer extra points for every three-months a customer takes gas and electricity from them.
- 5.23. These offers create a benefit for customers: a reduction of risk, in the first instance, and (should prevailing prices rise), savings. They also reduce risk for the supplier, allow suppliers to avoid (or at least recover) switching costs and giving fractional additional certainty to the supplier's projection of its energy requirements.

²⁹ "Marketing Alliances in the UK Energy Retail Sector", Adrian Dineen Consulting, September 2002.

³⁰ OFT Guidelines on the Chapter II Prohibition, paragraph 4.17, page 11, March 1999.

- 5.24. Ofgem will continue to examine lock-in offers, including the impact on competition of offering different terms and conditions to customers in lock-in arrangements compared with customers in non-lock-in arrangements.

Win-back strategies

- 5.25. Some suppliers are altering their marketing strategies, giving customer retention a higher priority relative to acquiring new customers. As part of this strategy, some suppliers are targeting former customers, with inducements to return to their original supplier.
- 5.26. One supplier offers a discount on the annual bill if an in-area customer switches back. The offer is in the form of two vouchers, one voucher – a third of the discount – is redeemable after three months with the customer's original supplier, and the remaining two-thirds is redeemable after one year.
- 5.27. Win-backs can be a legitimate response to meet vigorous competition in gas and electricity supply. Customers may benefit in the short run from significant discounts. At the same time, these offers may make existing in-area customers less sticky – for example, in-area customers become more willing to switch to a non-incumbent knowing that they can return to their incumbent at a considerable discount. However, Ofgem is again interested in the potential impact on competition of such strategies.

Implications for competition

- 5.28. The Office of Fair Trading's Competition Act 1998 Guidelines makes clear that "[I]t is for the parties to an agreement or conduct themselves to take on the responsibility of ensuring that their agreements and conduct are lawful...in any particular case".³¹ The responsibility to self-assess agreements and commercial practices and behaviour for competition law compliance therefore rests clearly upon undertakings themselves, not upon Ofgem. Furthermore, the OFT's and Ofgem's guidelines as to the application of the Act in the energy sector states

³¹ "The Competition Act 1998, The Major Provisions", OFT, OFT 400, March 1999, p.10.

that "Ofgem expects companies within the gas and electricity sectors to implement corporate compliance programmes if they do not already have them" in order to ensure compliance with the requirements of the Competition Act 1998.³² Suppliers may in this regard find it useful to consult the OFT's leaflet entitled "How your business can achieve compliance" with the Act.³³

- 5.29. The Director General of Fair Trading (DGFT), supported by the OFT, has primary responsibility for enforcing the Act. For the gas and electricity industries, enforcement is carried out by Ofgem concurrently with the DGFT.
- 5.30. The Secretary of State has, as allowed for under the Act, made regulations setting out aspects of the co-ordination of concurrent powers between the DGFT and the sectoral regulators. These allow for the exchange of information between the DGFT and Ofgem for the purposes of determining who has jurisdiction, prevention of simultaneous exercise of powers by more than one authority, and provision for the transfer of cases. At a working level, the DGFT, Ofgem and certain other regulators are parties to the Concurrency Working Party, chaired by a representative from the OFT. The Concurrency Working Party aims to ensure full co-ordination and consistency of action under the Act.
- 5.31. Each sectoral regulator with concurrent competition law powers has in addition published a guideline on how it intends to apply the Act to its own sector. Ofgem's guideline is the Energy Guidelines.³⁴ Sectoral regulators, including Ofgem, may among other things:
- ◆ consider complaints about breach of the Prohibitions
 - ◆ impose interim measures to prevent serious and irreparable damage
 - ◆ carry out investigations both on the regulator's own initiative and in response to complaints, and

³² "The Competition Act 1998, Application in the Energy Sector" Ofgem and OFT, OFT 428, March 2001 (The Energy Guidelines), p.15.

³³ "How your business can achieve compliance", OFT, OFT 424, August 1999.

³⁴ "The Competition Act 1998, Application in the Energy Sector" Ofgem and OFT, OFT 428, March 2001 (The Energy Guidelines).

- ◆ require the production of documents and information and search premises with or without a warrant where they have reasonable grounds for suspecting a breach.
- 5.32. Ofgem's role (concurrently with the OFT) is therefore not, unless specifically requested, to give detailed guidance to undertakings in how to comply with the Act, but to investigate and where necessary, impose sanctions for breaches of the Act.
- 5.33. All undertakings should therefore ensure they are complying with the Competition Act 1998. The Energy Guidelines³⁵ state that Ofgem expects that corporate compliance programs "will minimise the risk of the infringements by systematically ensuring that all relevant employees are sufficiently knowledgeable about the provisions of the law, and that they will put that knowledge to good effect."
- 5.34. In assessing the compliance of particular market initiatives with the Act, it is important that suppliers consider the effect on competition. This consideration will be particularly important when it comes to offers being made available in-area. Whilst aiming to retain customers is clearly not in itself anti-competitive, Ofgem will pay particular attention to focused initiatives aimed at prospective or past switchers which aim to reduce switching in the incumbent's favour and hence may foreclose the market. Assessment of such initiatives will consider a range of issues, which might include:
- ◆ whether the likely benefit to the supplier of the offer (e.g., retaining or winning back a customer) is commensurate with the cost of the offer
 - ◆ whether the offer forecloses further entry or expansion of new or existing competing suppliers, and
 - ◆ whether the offer applies different terms and conditions to equivalent transactions in a way which makes it particularly attractive for prospective or past switchers to take supply from the incumbent.

³⁵ *ibid*, paragraph 4.14, page 15.

Guidance

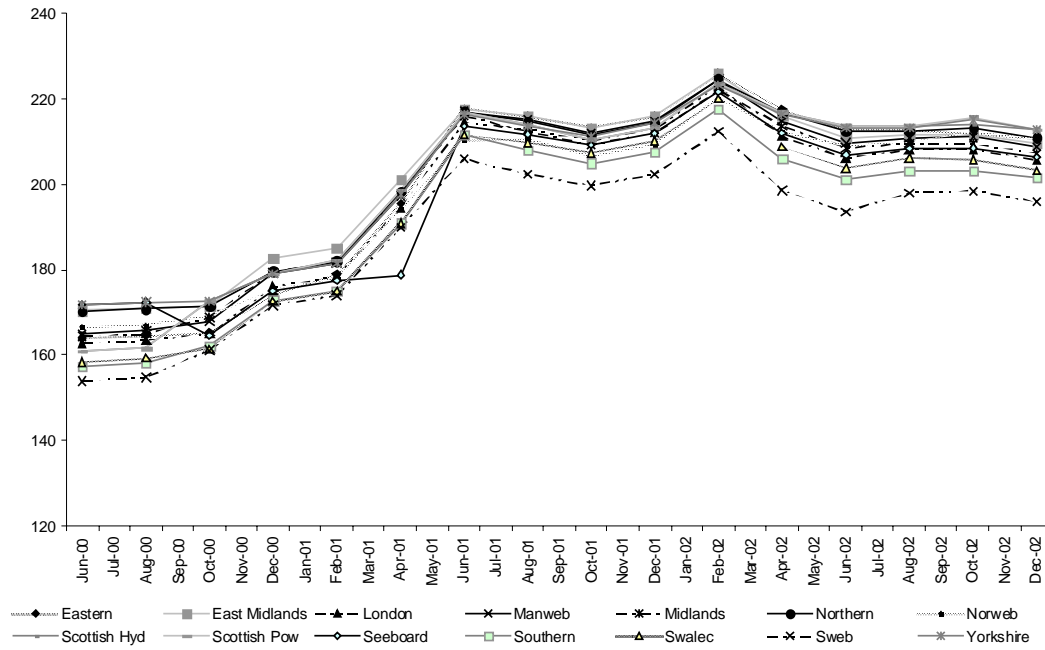
- 5.35. Although, as noted above, the responsibility to ensure compliance with competition law rests upon undertakings, the Act does allow Ofgem to provide undertakings with formal guidance or a decision on whether conduct or an agreement is compliant with the Act.³⁶ These forms of assistance involve a formal process and a statutory fee is payable: £5,000 for formal guidance, and £13,000 for a decision. Ofgem would strongly recommend that suppliers wishing to take advantage of this possibility should always seek their own legal advice in the first instance. However, Ofgem will be able to help with explanations of the process.
- 5.36. Ofgem wishes to discourage the making of failsafe applications, that is, applications made by undertakings in relation to agreements or conduct that do not raise any real concerns about a possible infringement of the Prohibitions. If Ofgem receives applications of this nature, we may determine the application by exercising our discretion not to give guidance or make a decision. Formal notification cannot be made in respect of prospective agreements (that is, where the parties have not yet entered into the agreement) or prospective conduct.
- 5.37. Subject to the operation of concurrency, Ofgem may also be prepared to offer informal guidance on conduct and agreements, although there is no statutory requirement for it to do so. This is the only form of guidance that can be given in respect of certain prospective conduct or agreements, since formal guidance or a decision cannot be given in relation to conduct which has not yet happened or agreements which are not yet in existence.
- 5.38. The provision of informal guidance will only be considered if sufficient information on the conduct or agreement in question is provided in advance. This is likely to extend to a detailed description of the agreement or conduct in question, the supplier's own initial assessment of what market is affected, and of the impact on that market. Ofgem has an internal process for determining whether to give informal guidance, and so guidance will not be available "on

³⁶ SI 2000 No. 293, The Competition Act 1998 (Directions rules) Order 2000, (rule 6 and Annex 2 to this Statutory Instrument states the fees).

the spot". If Ofgem decides to agree to provide informal guidance, it will arrange a meeting. The informal guidance will only be given orally and on the basis that it is non-binding and confidential. No written confirmation of the informal guidance will be provided to the undertaking(s).

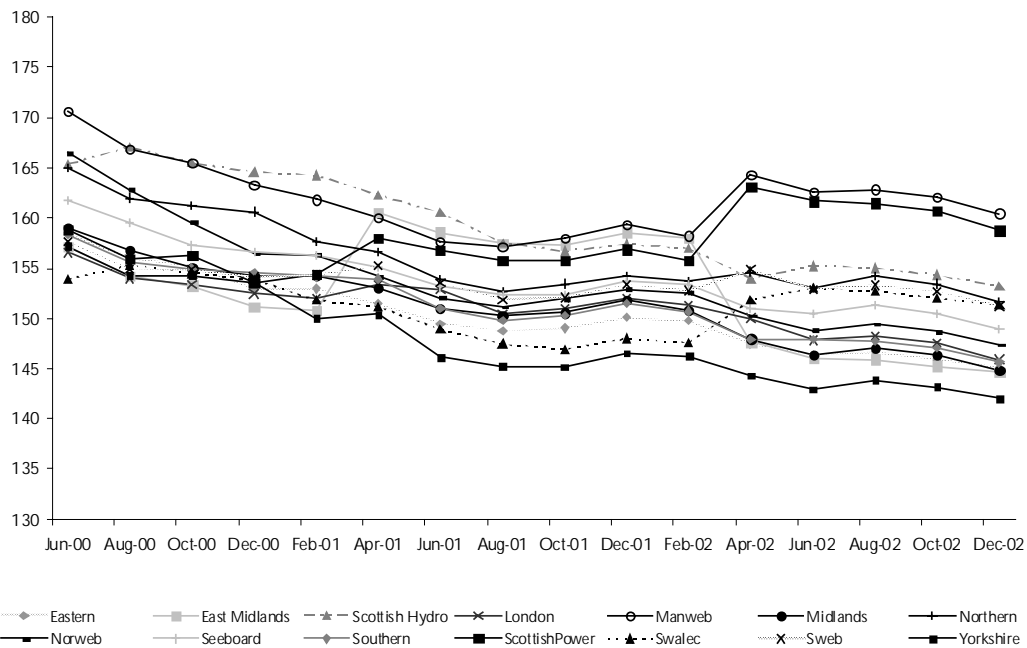
Appendix 1

Figure A1 – regional gas prices weighted by standard credit and direct debit



Source: Ofgem/energywatch

Figure A2 – average electricity prices by ex-PES region



Source: Ofgem/energywatch