

Addressing unfair price differentials: Response to Ofgem's consultation

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The consultation asks for comment on different means of eliminating 'unfair price differentiation'. This response addresses the desirability of enforcing such a constraint, rather than the most appropriate means of doing so. Ofgem identifies an unfair price differential as one which "does not have a full cost justification" (1.2), which seems to be similar to the economists' concept of price discrimination. There is a considerable body of economic analysis and literature which indicates that prevention of such price differences is likely to harm competition in the market; and there is little evidence that it will necessarily help vulnerable customers. This note addresses each of these aspects in turn and comments on the role of competition law.

Price differentials and competition

The consultation addresses three types of 'unfair price differential': between regions, between payment methods, and between electricity and gas. Preventing the first would deal a damaging, and probably fatal, blow to competition. The probe shows that suppliers make larger profit margins on consumers in areas where they are incumbent than they do where they are entrants. To equalise the margins across the regions which it supplies, a firm will therefore have to lower its prices in incumbent regions and/or raise them in regions where it is entrant. This pattern would be repeated in every region as each supplier adjusts its prices to conform to the 'non discrimination' requirement. The current price gap between the incumbent's and entrants' prices will be eroded, reducing the incentives for consumers to switch supplier. If all suppliers have the same costs and margins as each other (in each region), entrants would charge the same as incumbents and there would be no benefit to switching. Ofgem found a small cost advantage for entrants (an average of £3 per consumer per year), but this figure is likely to be very sensitive to assumptions about allocation of bad debts, and is in any case very small. Few consumers would switch to incumbents for such a gain if it were the only difference in prices. British Gas is in a different situation, since it is not incumbent in any single geographical area, but rather over all of Great Britain. If it could realise cost advantages in electricity over the incumbent electricity suppliers it might generate competition, but there would be only a duopoly (British Gas and the incumbent electricity company) in each region. Of course if other non incumbents could enter and supply more cheaply, competition could again be encouraged, but given the current predominance of the 'big 6' this seems unrealistic in the immediate future.

Competition will also be adversely affected (but probably with less dramatic results) by constraining the difference between prepayment tariffs and, say, direct debit tariffs. If a company reduces its differential as the result of such a constraint, it will do so both by lowering prepayment prices and by raising the 'reference' direct debit price (since there is a direct link between the direct debit price and the profitability of

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prepayment consumers). This runs the risk both of distorting the choice which consumers make between payment methods, and of harming many consumers who are regarded as vulnerable.

Price differentials and vulnerable consumers

Ofgem argues that those who do not switch may be vulnerable because they have fewer opportunities to switch well. The probe includes a number of excellent suggestions for making such opportunities more equitably available. To solve unfairness from failure to switch, within a market context, any barriers to exercising the choice need to be removed, for example through the education and information programmes which Ofgem has suggested.

In its 'probe' report Ofgem lists a large number of potentially vulnerable groups; without a clearer definition of the vulnerable groups it is impossible to identify the impact of changes in tariff differentials. However such constraints are an ineffective way of assisting such households. As Ofgem points out, "the majority of vulnerable groups are not prepayment meter users" (Probe para 8.52); this majority would pay higher prices as a result of restricting differentials between prepayment and other means, because the other tariffs would rise.

Price discrimination in competition and regulation policy

Price discrimination by a dominant undertaking is regarded as an abuse under both European and UK law if it is likely to lead to exclusion of potential competitors and from concern for exploitation of (particular groups of) consumers (Article 82EC) and UK Law (Chapter 2 of the Competition Act).

When the energy companies were nationalised, the meagre guidance on their operation included clauses that they should not show undue preference for, nor discriminate against, any consumers or group of consumers. Corresponding duties were transferred to their private successors, for example "a public electricity supplier shall not show undue preference to any person or class of persons, and shall not exercise any undue discrimination against any person or class of persons." (Electricity Act, 1989) though these were superceded by the Competition Act 1998. Regulators of monopolies have generally discouraged discrimination between consumers, though economists have been clear that in certain circumstances it can lead to greater welfare (both consumer and total). In its rulings under the Gas Act 1986, the Director General of Ofgas addressed the issues of price discrimination between payment methods and on the size of the standing charges in three reports in 1995 and 1996, finding that there was some degree of discrimination, but she did not judge it to be undue in the meaning of the Act.

Since 1998 energy suppliers have been governed by more general competition law, which constrains price discrimination only by dominant companies. While this section of competition law is notoriously difficult to enforce, many companies who believe they might be dominant express anxiety about any actions which could be interpreted as discriminatory for fear of invoking this clause. If Ofgem were to introduce a non discrimination clause for the 'big 6' suppliers, this might be seen as equivalent (in this

context) to labelling them as dominant, perhaps jointly so. This parallel may have both legal and practical implications.

Any form of price cap, whether direct or relative, would run counter to the current EC policy of removing such controls to allow the competitive market to work more effectively.

Conclusion

Reducing the differences in margins which each firm is permitted would stifle competition, given the presence of consumer switching costs. Market shares of the incumbent firms would climb considerably, and ex ante regulation might have to be reintroduced.

The probe provided much needed evidence and thoughtful analysis of the challenges in this market. Some of these findings and conclusions seem to have been ignored in the consultation paper on unfair price differentials. In particular the proposals seem inconsistent with the objective of “...making competition in the retail markets work effectively for all consumers.” (consultation para 1.3).