



energy perspective

The return of retail price control (but in a different guise)?

Despite intense pressure from the politicians for sliding wholesale energy prices to translate into widespread household bill reductions, no suppliers have yet announced cuts across their standard prices. Recently we discussed why the industry would resist the pressure and such reductions might not occur until well into the first half of the New Year (*Energy spectrum* 160, p2). In this *Energy perspective* we consider recent developments and the political and regulatory response that seems to be emerging. We conclude a definite pattern is emerging.

An emerging picture

In the last two weeks three suppliers have made modest price reductions in targeted offerings. British Gas has cut its prepayment prices; E.ON UK has cut its in-area electricity-only prices and launched a new social tariff; and RWE Npower has decided to equalise gas prepayment and standard credit prices and make a £20 credit to off-gas grid power consumers in its home areas. It is no coincidence that these changes have been made around the 1 December deadline for responses to Ofgem's initial probe findings, and they all address particular concerns raised in that document.

If it has four legs...

But there continue to be very strong official comments on how suppliers pitch their prices. These comments and the timing and nature of supplier responses underline how the

current policy framework with its emphasis on "voluntary" measures and high-level scrutiny is effectively creating a new dynamic but one which we think has many features of the old supply price control regime which lapsed in 2002.

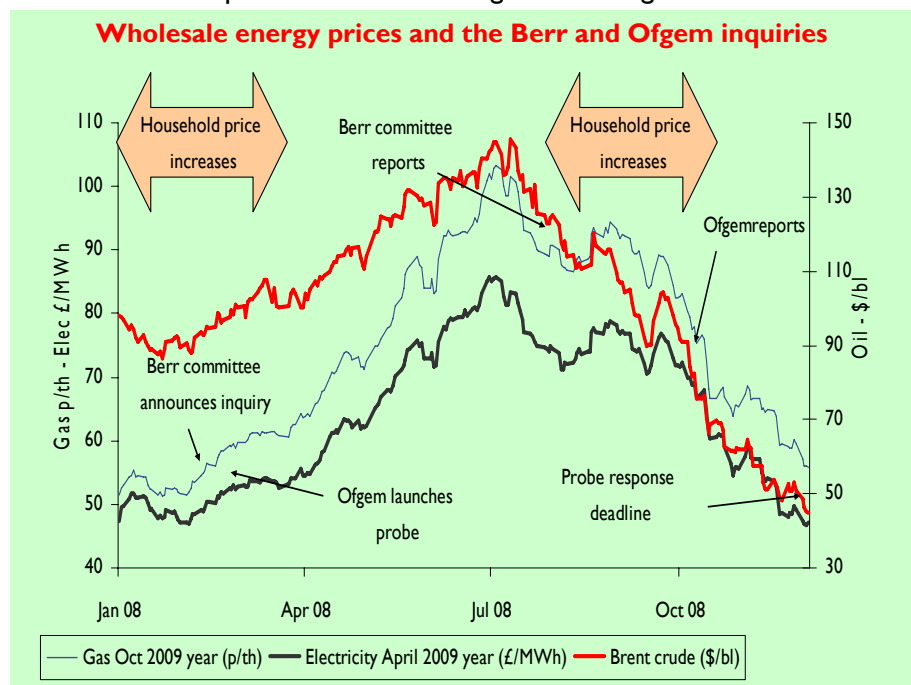
An opportunity to catch-up with the way official thinking has developed to reach this situation was afforded by the Business and Enterprise select committee the week before last before it hands over responsibility for energy to a new select committee formed to shadow Decc. On two consecutive days it heard from energy minister Mike O'Brien and Ofgem's chief executive Alistair Buchanan as part of a follow-up to its spring inquiry into the energy market.

A quick glance at the chart above shows how the macro-environment has changed since the inquiry was launched. Oil prices—Brent crude plunged below \$40/b| last Friday—are now comfortably less than half the level they were at their peak mid-year. But at home the concerns over domestic retail prices are being sustained, and the political focus on the level of energy bills and their consequences for consumers is undiminished. Admittedly the debate is now framed round the relief of price reductions rather than mitigating the pain, but the way suppliers price upstream quantities remains at the heart of the debate.

...a tail and...

First to appear was the minister. His comments clearly set out the Government's expectations:

- there are "problems" in the relationship between wholesale and retail prices because "we need ... the ability to see how those companies are hedging their purchases [...] so we can better gauge what's happening to the market." The



solution proposed (or at least a key part of it) was previewed then and reiterated in the pre-budget report, and this was a new task for Ofgem to report every quarter on retail and wholesale prices and the relationship between the two;

- there is a “level of non-cost reflective-ness” in consumer prices “particularly around some of the prepayment meters, some of the standard credit and direct debit figures ... It is not just disparity between some of the individual figures within companies, but between the different companies”. This is as clear a steer to the Big Six on the detail of their pricing and the relationship between the different offerings; and
- it is “fair to say that certainly among our many members of our House there have been some concerns expressed about Ofgem and some issues around confidence in Ofgem.” Though the probe’s report of its initial findings was “a very strong report ... I would not for a moment say that, at least among MPs, [Ofgem] can hold its hand on its heart and say it is where it ought to be.” It is not just the industry that is under the squeeze at the moment—the regulator may have seen the clearing, but it is not out of the woods yet.

...it barks...

With his audience warmed up, Alistair Buchanan appeared in front of the committee the following day. He welcomed Ofgem’s new wholesale and retail reporting requirement and spoke of “an unfortunate situation for retail customers where there is a lag [between retail and wholesale prices].” Suppliers had

Supply chain costs	Franchise market (1990-98)	Liberalised market (2008)	Liberalised market (soon)
Wholesale costs	No—but economic purchasing obligation in electricity supply licences	Unregulated	Quarterly retail and wholesale price reports
Networks charges	Network price controls	Network price controls	Network price controls
Suppliers’ own costs	Yes—price control	Unregulated	Licence conditions on cost differentials
Final prices	Yes—price control	Voluntary tariffs and rebates	Formal commitment to voluntary social tariffs and rebates

bought ahead for the winter, a situation Ofgem was “monitoring very carefully”, and “would expect those prices to come off early in the New Year. Clearly, for the 4.3mn [off gas grid electricity] consumers who have been short-changed, and the prepayment meter customers who have been short-changed, we expect that this side of Christmas”. He continued: “If they do not do that this side of Christmas, candidly, I think these companies are going to get themselves into a lot of difficulty.”

Some of his other words had an even rougher edge. Responding to questioning about whether Ofgem was a “toothless tiger” or “a dragon without fire,” Buchanan said “we are an organisation that knows how to use both the claw and the paw.” Ofgem had also “put on ... the regulatory hobnails ... we will tighten those laces unless they [the Big Six] act and the board is quite determined to do that.” And they “have simply behaved so badly to this group [SME customers].”

Buchanan also suggested Ofgem’s next moves should be finalised very soon: “I would be disappointed if we have not taken everything to the board, which is in the middle of February, for final sign-off. It may be January; it may be February, but certainly in the first two months of next year.”

...it must be a price control

But even before we learn of the regulator’s specific proposals, the comments from both sessions show both the minister and the regulator using information derived from the probe to make firm judgments about their concerns on the market and what needs to be done to address them.

The base elements of the merging approach include:

- the quarterly report on retail and wholesale prices—which we suspect will also look at generators’ fuel costs as well as the forward curve—is targeted at the pricing of upstream energy to downstream businesses;
- licence conditions will be used to enforce acceptable differentials between charges under different payment terms, effectively targeting the suppliers’ own service costs; and
- agreements with the Government have separately established the principle of social tariffs and rebates offering favourable terms to targeted groups, with the costs effectively being passed through to other customers.

So while we have not seen the return of formal price control, a framework seems to be emerging within which the Big Six will be expected to pitch household prices. The speed with which it has emerged since the summer is striking, as is the response of the three companies by making important changes to their pricing structures in advance of wider price reductions that have been clearly flagged for the first part of next year. But maybe we are barking up the wrong tree?