Appendix 8.4: Price discrimination (differences in costs to serve customers on different tariffs)

Contents

Introduction

1. We observe that the Six Large Energy Firms have since 2009 consistently offered fixed-term tariffs at discounts, at time of launch, to their standard variable tariff (SVT) (although some suppliers did so before this date and, excluding its white label offer, SSE has generally been less active in offering discounted tariffs).[1]

2. The purpose of this appendix is to set out the size of the discounts offered and to consider whether these price differentials are justified by higher costs in the supply of customers subscribing to an SVT as compared with fixed-term tariffs.

3. The scope of this analysis is limited to the Six Large Energy Firms and fixed-term tariffs offered at a discount, at launch, to the SVT from July 2013 to March 2015.

4. The structure of the appendix is as follows:

   (a) Background remarks and information (paragraphs 6 to 35).

   (b) Our approach (paragraphs 36 to 45).

   (c) Evidence on the size of the price differentials (paragraphs 46 to 50).

[1] See Appendix 7.3: The pricing strategies of the Six Large Energy Firms.

(d) An assessment of differences in direct costs between standard variable and non-standard tariffs (paragraphs 51 to 62).

(e) An assessment of differences in indirect costs between standard variable and non-standard tariffs (paragraphs 63 to 66).

(f) A summary of the materiality of differences in prices not justified by costs (paragraphs 67 to 71).

5. This appendix should be read in conjunction with others referred to below.

Background

Some remarks

6. We find that around 50% of customers on fixed-term tariffs are on tariffs with exit fees (see Appendix 7.4: Analysis of the potential gains from switching). In particular:

(a) most Centrica fixed-term tariffs, including Sainsbury's Energy, were subject to exit fees of typically £30 per fuel. Exit fees were removed from British Gas products (but not Sainsbury's Energy) sold from 30 November 2014;

(b) most E.ON fixed-term tariffs (excluding Age UK tariffs) have since 2012 been subject to exit fees of typically £5 per fuel for one-year tariffs and £10 per fuel for two-year tariffs;

(c) most Scottish Power fixed-term tariffs were until April 2014 subject to exit fees of £25 to £30 per fuel. Since then only two tariffs (a minority of those launched since then) have been subject to an exit fee of £30 per fuel; and

(d) many SSE fixed-term tariffs have been subject to exit fees, for example, until October 2014 exit fees typically of £25 to £50 per fuel applied. However, SSE said that in many circumstances these exit fees have been waived, most recently for people wishing to take advantage of SSE's price freeze.

7. EDF Energy's fixed-term tariffs (since April 2012) have not been subject to exit fees and, as regards RWE, only RWE's In Control tariffs, which provide a Nest Learning Thermostat™, have an exit fee.

8. Absent exit fees, in general we would expect fixed-rate fixed-term tariffs to be priced at a premium to the SVT reflecting their value to customers who want certainty. In particular, such tariffs offer customers reassurance that the price

will not increase and the option to switch at any stage, without penalty, to another tariff offered by their existing or another supplier (in effect, the tariff is a 'one-way' bet for customers).

9. With exit fees, we might expect fixed-rate fixed-term tariffs to be priced at a premium or discount to the SVT depending on the value customers attach to certainty, the size of exit fees, current forward prices for energy, and customer and supplier expectations in relation to future energy prices.

Evolution of suppliers' pricing strategies in response to regulation

10. Price discrimination appears to have been a consistent feature of retail domestic energy supply in Great Britain.[2]

11. Prior to 2009, incumbent electricity suppliers offered lower SVTs outside their 'home' area; and British Gas offered SVTs for electricity that were more competitively positioned than their gas tariffs.

    In 2009 Ofgem found that the incumbent electricity suppliers were earning significantly higher margins in electricity than in gas, and higher margins in-area than out-of-area.[3] In an attempt to address this, Ofgem implemented the Standard Licence Condition (SLC) 25A, which prohibited undue regional price discrimination. This originally applied to all tariffs, but Ofgem's guidance subsequently provided for the use of discounted fixed-term tariffs to allow suppliers to attract and retain domestic customers.

12. Following implementation of SLC 25A, the number of fixed-term tariffs launched by the Six Large Energy Firms increased (see Appendix 7.3: The pricing strategies of the Six Large Energy Firms). These tariffs included both variable-rate tariffs and fixed-rate tariffs. The former took various structural forms, including percentage discounts and minimum guaranteed percentage discounts to the SVTs and capped tariffs.

13. Ofgem became concerned that with many of the fixed-term variable-rate deals suppliers were able to increase prices within term. It also found that customers were being automatically rolled on to another fixed-term offer when their existing contract expired and that this tied customers into a tariff they could not get out of even if prices went up. In October 2013, Ofgem banned automatic rollovers, and required all fixed-term tariffs to be fixed-rate. These new rules applied to any contracts entered into on or after 15 July 2013.

---

[2] Price or margin discrimination is present in many industries and it is not, by itself, evidence that a market is not functioning well.
[3] See Ofgem (2008), *Energy Supply Probe – Initial Findings Report*, p52.

14. Our analysis indicates that gross margins were around double on SVTs than on non-standard tariffs (NSTs) at around 20% compared to 10% on NSTs (see Annex D of Appendix 10.2: Retail energy supply profit margin analysis), representing a differential of around £115 on direct debit, dual fuel typical consumption customers' annual bills. In Section 6 we noted that approximately 30% more SVT customers were on prepayment meters and standard credit arrangements than on other tariffs.[4] In Section 7 we note that premiums of around £75–£80 are applied for dual fuel customers who pay by standard credit and prepayment, which we take as an estimate of the additional costs of serving such customers. This indicates that on average an SVT customer may be around £24 (ie 30% x £80) more expensive to serve.

Pricing and energy purchasing strategies

15. We asked the Six Large Energy Firms to explain the approach taken to setting prices for their standard variable and non-standard tariffs. Our observations are set out in Appendix 7.3: The pricing strategies of the Six Large Energy Firms.

16. In summary, the Six Large Energy Firms all said that prices for fixed-term tariffs are primarily determined by: (a) strategic objectives on the competitive positioning of non-standard tariffs and therefore the prices of all rivals' tariffs; and (b) the performance of non-standard tariffs, which for discounted tariffs will be largely determined by their ranking on PCWs; subject to an expected positive contribution to fixed costs over the term of the tariff.

17. [✂]. EDF Energy also said that it could only continue to offer fixed-term tariffs at current levels while the portion of the markets addressed by fixed-price tariffs remained marginal. SSE said that it did not segment its customer base so that some customers subsidise short-term deals made available to others.

18. We also asked the Six Large Energy Firms (a) to set out their strategies for purchasing energy in the supply of standard variable and fixed-term tariffs, and (b) whether energy costs would differ between standard variable and fixed-term tariffs (see Annex A).

19. In summary, we find that the Six Large Energy Firms purchase the energy required by their standard variable customers up to two to three years ahead of delivery. Whilst the details of their strategies differ, in broad terms, they all purchase energy progressively in order to smooth the volatility of wholesale market prices. They said that the reduction in wholesale energy cost volatility

[4] Approximately 50% of SVT customers are on standard credit or prepayment, compared with around 20% of those customers on other tariffs.

reduced the required frequency and potential magnitude of corresponding retail price movements.

20. For their fixed-term tariffs the Six Large Energy Firms have different strategies: [✂]; and [✂] normally purchase [✂] energy requirements at launch of the relevant fixed-term tariffs or by the time the tariff is withdrawn from sale.

21. The Six Large Energy Firms said that these strategies are driven by customer preferences and behaviour, and competitive risk.

22. For all the Six Large Energy Firms, we have compared the average revenue per MWh for customers on SVTs paying by direct debit and on fixed-term tariffs (the majority of whom pay by direct debit). We found that the average revenue for SVTs is consistently higher than that for fixed-term tariffs for the period mid-2011 to end 2014 (see Appendix 7.5: Descriptive statistics (retail)).[5]

Parties comments

23. In summary, the Six Large Energy Firms made the following comments in relation to the pricing of their discounted fixed-term tariffs:

Centrica[6]

24. Centrica said that British Gas's approach to discounting had varied over time and that, currently, it was repositioning the British Gas brand on the basis of offering customers informed choice and control, rather than emphasising price. Currently, Centrica's British Gas branded fixed tariff is only 5% lower than its SVT, but its white-label Sainsbury's Energy tariff is significantly lower. Centrica said that customers chose providers for price and non-price reasons and that British Gas had gained new customers in the first quarter of 2015 and around [✂] of these had joined on SVT. British Gas assumed that a certain number of customers it acquired on fixed tariffs would move on to its SVT at some point. However, it aimed to make profits on all its products whether fixed or SVT.

25. Centrica said that the Sainsbury's Energy tariff was different from British Gas's in that it was direct debit only and whilst currently cheaper, would respond more rapidly to changes in the market, so its prices could be more

[5] The period for which each of the Six Large Energy Firms have been able to provide revenue data by tariff type.
[6] See main party hearing summary.

volatile than British Gas's. Sainsbury's customers accounted for around 3% of Centrica's customer base.

EDF Energy[7]

26. EDF Energy said there was very strong competition between energy suppliers on their fixed-price products. It said that [✂]. Its strategy was to grow the proportion of customers it had on fixed tariffs, not to acquire customers via fixed tariffs and then hope they moved on to become SVT tariff customers. EDF Energy priced fixed-term tariffs [✂], which also covered by a contribution from its SVT customers.

27. Depending on the level and trends of wholesale market prices, the main cost difference between fixed and variable customers can be the energy cost, due to the tariffs being hedged differently. Payment methods were the main difference between the costs of serving fixed-tariff and SVT customers. SVT customers were more likely to pay by cash or cheque, and more debt recovery activities were associated with this payment method.

E.ON[8]

28. E.ON said that it had focused on having a competitive SVT and that, in 2012, it decided that 'deep-discounting' its fixed-term tariffs was unfair to its SVT customers [✂]. It considered that by having one of the lowest SVTs it could both retain its existing customers and promote its brand as being value for money and attract new customers. However, it also said that the fact that in the markets, it appeared that fixed tariffs were purchased on a one-year hedge, while SVTs were based on a two to three-year rolling hedge, had led to a significant divergence between the two products.

29. E.ON said that active switchers, who for the moment were content to be on an SVT, protected those who had never switched, in some cases because they lacked the confidence to do so. It noted that [✂]% of customers it had acquired in the last two years were now on SVTs. It had a campaign called 'Best Deal for You' through which it sought to engage with its existing customers and encourage them to switch internally if it was in their best interests.

[7] See main party hearing summary.
[8] See main party hearing summary.

30. E.ON said that there was a very small difference between the cost of serving customers on SVTs and those on non-standard tariffs. Differences in the cost of serving customers arose from other factors, such as payment methods.

RWE[9]

31. RWE said that to attract customers it had to offer discounts on its SVT. [✂].

32. [✂]. There are customers that move between standard and non-standard and they are inter-related [✂] – the competitive pressure being on both ends of the chain.

Scottish Power[10]

33. Scottish Power said that competitive pressure to acquire customers drove down prices for fixed-term tariffs, which it was offering at discounted prices, but that the movement of customers between standard variable and fixed-term tariffs was a competitive pressure which acted as a constraint on the price of SVTs. It said that in pricing fixed-term tariffs it assessed the profitability over the lifetime that customers stay with Scottish Power and it expected a certain percentage would default onto an SVT, actively choose a new fixed-term tariff, or choose a competitor and leave the energy supplier entirely.

34. Scottish Power noted that it looked at payment methods as the key differentiator of its indirect costs, whether by direct debit, prepayment or credit.

SSE[11]

35. [✂].

Approach

36. In this section we set out: (a) the scope of the analysis; (b) how we calculated the differential between standard variable and fixed-term tariffs; and (c) the relevant costs in considering the extent to which the differential might be justified by differences in costs.

[9] See main party hearing summary.
[10] See main party hearing summary.
[11] See main party hearing summary.

Scope of the analysis

37. The analysis is limited to the following:

    (a) The Six Large Energy Firms (for British Gas and SSE we include Sainsbury's Energy and M&S white label tariffs).

    (b) Customers on standard meters.

    (c) Fixed-term tariffs offered at a discount, at launch, to the SVT from July 2013 to March 2015 (over this period all fixed-term tariffs were also fixed-rate).

38. The analysis is based on information provided by the suppliers on annual bills for a monthly direct debit, dual fuel, typical consumption (using Ofgem's current definition) customer. We consider this to be a reasonable approach as:

    (a) this approach is widely used in the industry in the comparison of tariffs;

    (b) it provides a like-for-like comparison of tariffs offered by the suppliers; and

    (c) the majority of customers who are on fixed-term tariffs are dual fuel, direct debit customers (see Section 6).

39. By focusing on the tariffs available to direct debit, dual fuel customers we can exclude as reasons for the observed price differentials differences in costs of supply related to payment method and whether a customer takes one or both fuels from a supplier.

Estimating differentials

40. Each of the Six Large Energy Firms have provided the following:

    (a) A list of all fixed-term tariffs launched from July 2013 to March 2015.

    (b) For each of these tariffs, applying the rates at time of launch, the annual bill for a monthly direct debit, dual fuel, typical consumption customer.

    (c) Applying standard variable rates at time of launch, the annual bill for a monthly direct debit, dual fuel, typical consumption customer.

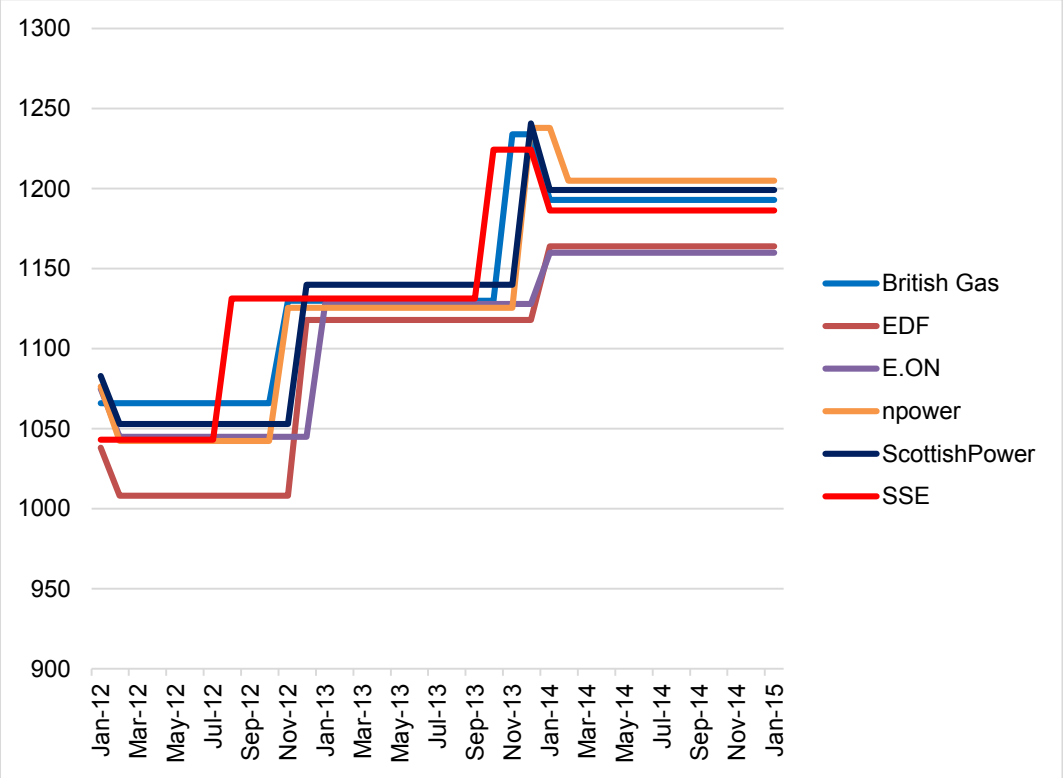
41. We used this information: (a) to identify fixed-term tariffs that at time of launch were priced at a discount to the SVT; and (b) for these tariffs, to estimate the size of the discount as both a percentage of the annual bill for the SVT and the absolute difference in the bill.

42. We note that the estimated discount (at time of launch) will differ (potentially upwards or downwards) from the actual discount over the term of the tariff if the SVT changed during term. Figure 1 shows changes in the SVTs over the period January 2012 to March 2015 based on the annual bill for a dual fuel, direct debit, typical consumption customer. This suggests that:

(a) for fixed-term tariffs launched by the Six Large Energy Firms before they each increased their SVTs between September and December 2013, the discount at time of launch will have been lower than the actual discount over the term of the tariff; and

(b) for fixed-term tariffs launched by British Gas, RWE, Scottish Power and SSE between increasing their SVTs towards the end of 2013 and then reducing them (following announcements on changes in ECO costs), the discount at time of launch will have been higher than over the life of the tariff. However, British Gas also reduced the prices of its fixed term tariffs by the same price at the announcement of the SVT price cut in January 2014.[12]

Figure 1: SVT based on an annual bill (£) for a dual fuel, direct debit, typical consumption customer



Source: CMA analysis.

[12] See British Gas's website.

Relevant costs

43. The main costs items in retail domestic supply are: (a) direct costs comprising wholesale energy costs, transmission and distribution costs, and environmental and social obligation costs; and (b) indirect costs comprising costs to serve (billing, customer service, metering, bad debt), acquisitions, sales and marketing, and an allocation of central costs. Direct costs account for around [85%] of total costs and indirect costs the remaining [15%].

44. We consider that the relevant costs for the purposes of this assessment are:

    (a) costs that are variable with the number and/or type of customers subscribing to the standard variable and/or fixed-term tariffs;

    (b) costs that are variable with the volumes of energy (KWh) delivered to customers subscribing to these tariffs; and

    (c) these costs might be different in the supply of customers subscribing to the SVT as compared with fixed-term tariffs.

45. Relevant costs are not limited to those that – for a given domestic customer – would differ with their choice of tariff. The costs of supply might also differ because the characteristics of people subscribing to the SVT differ from those subscribing to fixed-term tariffs (for example, suppliers have said that subscribers to the SVT are more likely to use call centres).

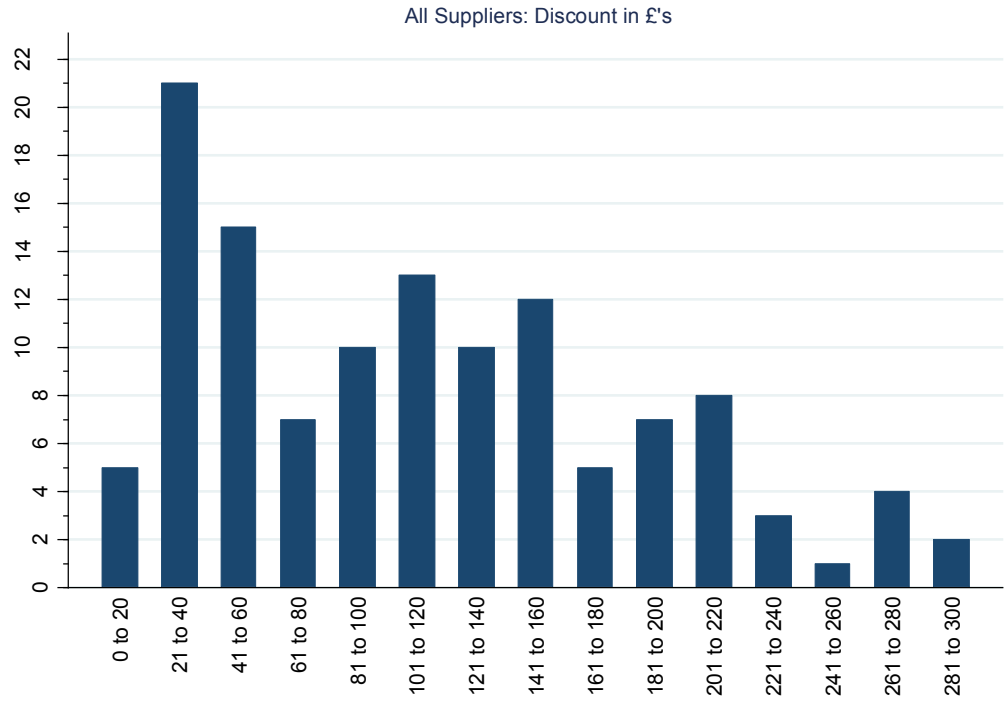
Evidence on price differentials

46. We have found that around 27% of customers on fixed-term tariffs were on tariffs with a term of one to two years. These tariffs will typically have been launched at a discount to the SVT.

47. Figures 2 and 3 provide results on the size of discounts, at time of launch, for discounted fixed-term tariffs launched since mid-2013. Results for each firm are attached in Annex B. These fixed-term tariffs will typically have a term of up to one or two years at time of purchase.

48. Figure 2 shows that discounts ranged in value from £20 or less to as much as £281 to £300 on an annual bill. We estimate that over 50% of discounted fixed-rate tariffs (including white label tariffs) were priced at a discount of more than £100 on an annual bill.

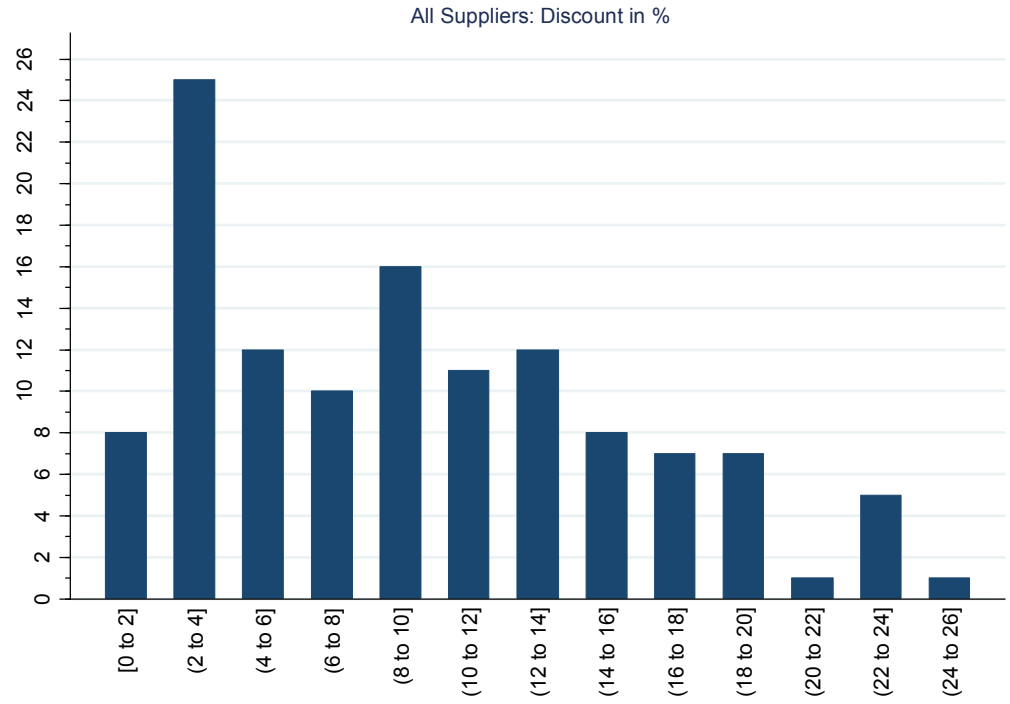
Figure 2: Distribution of fixed-term tariffs offered by the Six Large Energy Firms at a discount, at launch, to the SVT, mid-2013 to March 2015, £ discount (based on annual bill for dual fuel, direct debit typical consumption customer using Ofgem's currect definition)



Source: CMA analysis.

49. Figure 3 provides the same information in percentage terms. We calculate that just over 40% of fixed-tariffs were priced at a discount of 10% or more on the SVTs.

Figure 3: Distribution of fixed-term tariffs offered by Six Large Energy Firms at a discount, at launch, to the SVT, mid-2013 to March 2015, percentage discount (based on annual bill for dual fuel, direct debit typical consumption customer using Ofgem's current definition)



Source: CMA analysis of data provided by the Six Large Energy Firms.
Note: the range of, for example, (2 to 4] means greater than 2 and up to and including 4.

50. Results for each of the Six Large Energy Firms are at Annex A. These show that:

(a) British Gas launched the most discounted fixed-term tariffs in the period (33 compared with EDF Energy 14[13], E.ON 19[14], RWE 24, Scottish Power 21 and SSE 11);

(b) 19 of the British Gas and 6 of the SSE discounted tariffs in this period are white-label tariffs (Sainsbury's Energy and M&S Energy respectively) (see Appendix 7.3: The pricing strategies of the Six Large Energy Firms); and

(c) that there are differences between suppliers in the distribution of the discounts. In particular:

[13] EDF Energy noted that it launched 10 fixed-term tariffs with duration of around 2 years or less in the period January 2014 to March 2015. In the same period, it also launched 3 fixed-tariffs with duration of over 3 years.
[14] E.ON said that for the period July 2013 to end 2013, using the current Ofgem consumption values rather than the prevailing Ofgem consumption values at that time, has a small impact in the level of discount in these tariffs. The most notable example being its Fixed 1 Year v6 tariff which is at a small premium to SVT using prevailing Ofgem consumption values, but at a small discount to SVT using current Ofgem consumption values.

(i) 9 out of 11 of the SSE fixed-term tariffs offered a discount at launch of 10% or less;

(ii) 11 out of 19 of the E.ON fixed-term tariffs offered discounts of 4% of less;

(iii) [✂] of EDF Energy fixed-term tariffs offered discounts of more than 10%;

(iv) [✂]; and

(v) around 50% of the British Gas and the Scottish Power fixed-term tariffs offered discounts of more than 10%.

Direct costs

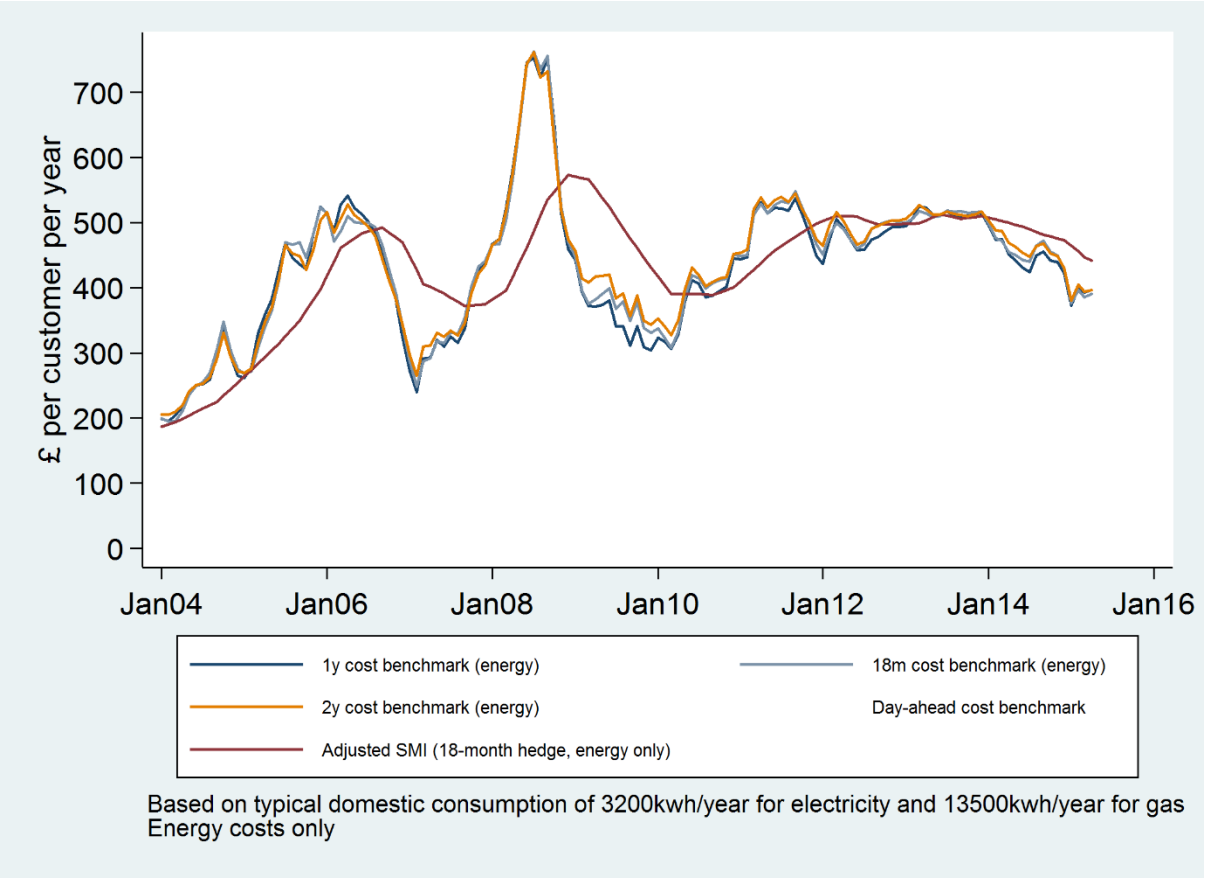
51. We asked the Six Large Energy Firms to set out the drivers for the main direct cost items. Some said that: network transportation and distribution charges and balancing and settlement charges are variable with volumes delivered, customer numbers and customer location; and that the costs of meeting social obligations and environmental obligations are variable with customer numbers. However, these responses do not suggest that these costs are variable with the characteristics of the customers.

52. Based on these responses, we have observed that transmission and distribution charges and costs of meeting social and environmental obligations are unlikely to differ between customers subscribing to standard variable and fixed-term tariffs. In the remainder of this section we therefore focus on how wholesale energy costs might differ between standard variable and fixed-rate, fixed-term tariffs.

Energy costs

53. Each of the Six Large Energy Firms, with the exception of British Gas, have different strategies for purchasing energy for their SVTs and fixed-term tariffs (see above). This means that their expectations in relation to future energy costs are likely to differ between SVTs and fixed-term tariffs. However, our comparison of various industry cost benchmarks and the stylised 18 months hedging strategy in Appendix 7.2: Cost pass-through shows that no cost indicator results in systematically higher or lower expectation of wholesale costs.

Figure 4: The range of forward-looking cost benchmarks



Source: CMA analysis (see Appendix 7.2: Cost pass-through).

54. Furthermore we consider that any differences in energy costs arising from how a supplier has chosen to purchase energy for these tariffs does not provide an objective basis for assessing the relative energy costs of SVTs and fixed-term tariffs.

55. The purpose of suppliers' energy purchasing strategies is to manage the risk created by volatility in wholesale energy prices and the uncertainly in relation to future wholesale energy prices. We therefore consider that the only objective basis for concluding on the relative energy costs in the supply of customers on SVTs and fixed-term tariffs must be fundamental differences in the characteristics of these tariffs and the associated risks to suppliers which is impacted by price sensitivity of customers subscribing to these tariffs.

56. It appears to us that the fundamental differences between standard variable and fixed-term tariffs are as follows:

(a) All else equal, the prices at which suppliers offer their SVTs will be less responsive than fixed-term tariffs to changes in wholesale energy costs (particularly increases in wholesale energy costs) as: (i) suppliers are required to give customers 30 days' notice of a proposed increase in the

SVT price and (ii) the costs associated with the notification and implementation of price changes, whereas fixed-term tariffs can be withdrawn from sale at no cost at any time and replaced with new tariffs.

(b) A supplier can withdraw a fixed-term tariff from sale at any time but it cannot increase the price for customers signed-up to the tariff in term, whereas a supplier can change the price for existing standard variable customers at any time (subject to giving required notice).

(c) A supplier can mitigate the risks of a customer leaving a fixed-term tariff in term with exit fees.

57. Suppliers have said that the frequency with which they can change SVT prices is also limited by:

(a) customer preferences for smoothed profile of charges; and

(b) a reluctance on the part of suppliers to be the first to increase prices given the risk that this would result in customer losses and be detrimental to their reputation.

58. Given these characteristics it appears to us that there are potentially downside risks for suppliers associated with lower than expected wholesale energy prices with both standard variable and fixed-term tariffs. In particular, we would expect low energy prices to result in new fixed-term tariffs being launched at lower prices which could result in customers already on fixed-term tariffs switching in term to a cheaper fixed-term tariff (offered by their exiting or a rival supplier), and with larger differentials between standard variable and fixed-term tariffs, more customers switching from standard variable to cheaper fixed-term tariffs (offered by their exiting or a rival supplier).

59. With both tariffs, for lost customers, a supplier may have to resell energy purchased in advance on the wholesale market at a loss and for customers who transfer to cheaper tariffs, it may sell at a retail price consistent with lower wholesale energy prices.

60. We expect that this risk will be more pronounced for fixed-term tariffs as customers are generally more price sensitive than those on SVTs (see Sections 6 and 7). That said, with fixed tariffs this risk can be mitigated to an extent by exit fees.

61. With higher than expected wholesale energy prices there appears to be limited downside risks for a supplier with fixed-term tariffs. With the SVT there are risks arising from the speed with which a supplier can increase prices and

the costs associated with doing so. We found in Appendix 7.2: Cost pass-through that increases in SVT prices were typically around [£40] on the annual bill of a typical consumption customer suggesting that only when cost pressures justified an increase of this size did suppliers raise prices.

62. On balance, we have observed that there are no reasons to expect that downside risks associated with purchasing energy costs are inherently systematically and materially higher in the provision of standard variable as compared with fixed-term, fixed-rate tariffs.

Indirect costs

63. Table 1 provides a breakdown of indirect costs for each of the Six Large Energy Firms. This shows that the following items account for over 95% of indirect costs: bad debt; metering; sales and marketing; customer service; and central services.

Table 1: A breakdown of indirect costs (as a proportion of total indirect costs), average for the period 2007 to 2013, total retail supply, business (%)

	Bad debts and related costs	Metering and related costs	Sales, marketing and related costs	Customer service costs	Central service costs	Other costs
SSE	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
RWE	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Centrica*	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
E.ON	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
EDF Energy	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Scottish Power	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CMA analysis of data provided by the Six Large Energy Firms.
* [✂]

64. All of the Six Large Energy Firms confirmed that they would expect: (i) cost to serve (which includes costs associated with all telephone calls, enquiries and direct communications; billing and account management; home moves, account transfers and change of supply; costs related to unpaid bills; customer mailing and complaints; and meter reading); and (ii) indirect costs for direct debit, dual fuel customers subscribing to a SVT to be much the same as those for direct debit, dual fuel customers subscribing to a non-standard tariff. In addition:

(a) EDF Energy said that the main driver of cost to serve was payment method and that there were some differences in the levels of self-service which are currently [✂] for standard variable and [✂] for fixed tariffs.

(b) E.ON said that the key drivers of any differences in cost to serve were payment methods and customer behaviour. For example, non-SVT customers might be more likely to pay by direct debit compared to SVT customers.

(c) RWE confirmed that whilst the [✂].

(d) Scottish Power said that payment type was the main factor impacting on costs.

(e) SSE said that as non-standard tariff customers typically had larger than average consumption, indirect costs would be lower compared with SVT customers when measured on a £ per MWh basis, and that customers on fixed tariffs were mostly online and direct debit customers. The cost to serve these customers per MWh was lower (due to increased certainty regarding customer numbers and energy required) than for SVT customers (a mix of direct debit, on demand and prepayment payment methods with an undefined lifetime).

65. We are also of the view that:

(a) we can exclude differences in indirect costs related to payment method, prompt payment or whether a customer is dual fuel as the reasons for the observed price differentials (see paragraph 39);

(b) we have no reasons to expect costs related to bad debt to differ materially for direct debt customers between standard variable and fixed-term tariffs; and

(c) central allocations are unlikely to be variable (in an economic sense) in any material way with the customer number or volumes.

66. Furthermore, information provided by suppliers on discounts, rewards and incentives provided to domestic customers (see Appendix 7.3: The pricing strategies of the Six Large Energy Firms), suggests that differences between standard variable and fixed-term tariffs in (a) the propensity of customers to manage accounts online and to use call centres, and in (b) the availability and take-up of rewards and incentives is unlikely to explain the observed price differentials. In particular:

(a) Discounts provided to incentivise online management of the accounts have been around £5 to £10 per fuel.[15] Whilst suppliers were not required to ensure that such discounts were cost reflective, we consider the size of the discount gives an indication of cost savings to a supplier of customers managing their accounts in this way.

[15] See Appendix 7.3: The pricing strategies of the Six Large Energy Firms.

(b) EDF Energy has not offered, over the period, any discounts other than payment related, dual fuel discounts or discounts to vulnerable customers.

(c) E.ON, from December 2013, offered single electricity and dual fuel customers who opted into the scheme reward points (if they were on an eligible tariff) worth up to £15 of high street vouchers or 1,500 Tesco Clubcard points per year with higher take-up among fixed-term customers.

(d) Scottish Power has not offered in the relevant period any discounts other than prompt payment discounts, dual fuel discounts, paperless billing discounts and WHD.

Summary

67. We estimate that around 60% of NSTs were priced at a discount of more than £100 on an annual bill and around 50% of NSTs were priced at a discount of more than 10% on the SVT.

68. All of the Six Large Energy Firms said that fixed-term tariffs were not determined by reference to the price of SVTs and expectations in relation to the relative cost of supplying customers subscribing to standard and non-standard tariffs. Rather, all suppliers said that their fixed-term tariffs were determined strategic objectives on competitive positioning and therefore by the prices of rivals' tariffs, subject to an expected positive contribution to fixed costs.

69. With regard to direct costs, we observed that transmission and distribution charges and costs of meeting social and environmental obligations do not differ between customers subscribing to standard variable and non-standard tariffs. In relation to energy costs, we observed that there is no evidence that energy costs are systematically and materially higher for standard variable as compared with fixed-term, fixed-rate tariffs.

70. With regard to indirect costs, suppliers have said that they would expect indirect costs to be much the same for customers subscribing to standard variable and non-standard tariffs. Our analysis suggests that any differences are unlikely to explain the observed differentials in the annual dual fuel bill.

71. Finally, that there are material differentials in prices for standard variable and fixed-term, fixed-rate tariffs that are not explained by differences in costs is consistent with statements made in relation to the strategic positioning of fixed-term tariffs as acquisition and retention products.

Annex A: Description of energy purchasing strategies

1. We asked the Six Large Energy Firms to (a) set out their strategies for purchasing energy in the supply of standard variable and fixed-term tariffs, and (b) whether energy costs would differ between customers subscribing to standard variable and fixed-term tariffs. The responses are set out below. Fixed-term tariffs will now be fixed-rate tariffs.

British Gas

2. British Gas told us that its standard variable customers valued the inherent flexibility of SVTs over the certainty of a fixed rate in terms of more gradual changes in price. Customers were also said to cite not wanting to be 'tied-in' as the key reason for preferring SVTs.

3. British Gas said that its rateable strategy for purchasing energy helped to smooth retail prices for its standard variable customers by either averting the need to buy energy during short-term price spikes (as volumes would have been purchased in advance and over time) or by extending the period over which any long-term market trends/corrections were passed onto consumers. For example if purchasing on a two-year rateable basis, British Gas will have purchased most of the energy by time of delivery over the previous 24 months (buying 1/24 per month).

4. British Gas also said that its fixed-term tariffs provided absolute price certainty over the duration of the contract which was particularly valued by customers when wholesale commodity prices were rising, or at times of significant wholesale price volatility. It said that its fixed-term fixed-price tariffs had been predominantly chosen by existing customers. [✂].

EDF Energy

5. EDF Energy said that its objective in purchasing energy was to minimise the financial risk as a result of future movements in wholesale prices, whilst ensuring that its domestic retail business remained competitive in both the standard variable and fixed-term tariff markets. [✂].

6. EDF Energy said that with the SVT its strategy was to purchase energy progressively so as to smooth the volatility of wholesale market prices for customers. The reduction in supplier wholesale energy cost volatility reduced the required frequency and potential magnitude of corresponding retail price movements. There was a judgement to be made on how far in advance to purchase energy. [✂].

7. [✂].

8. [✂].

9. [✂].

E.ON[16]

10. E.ON said that with its SVT it purchased volumes [✂]. The actions of customers in response to price movements indicated that a [✂]. In particular: customers were believed to value the reduced volatility that resulted from a hedge of [✂]; and customers responded asymmetrically to price movements with customer losses following a price increase being larger than the customer gains following a price decrease. Whilst a shorter hedge might well pass on price decreases as a result of falling wholesale prices, it was also more likely to result in price increases when wholesale prices were increasing.

11. E.ON said that in order to be competitive in the market for one-year fixed-rate tariffs, it moved in December 2014 to [✂].

RWE

12. [✂].

13. RWE said that for its [✂].

Scottish Power

14. Scottish Power said that the energy purchasing strategy for its SVT varied from time to time and involved judgments about how the markets were likely to evolve and an assessment of the competitive aspects of different possible approaches. [✂].

15. Scottish Power said that with its fixed-term tariffs it normally purchased [✂] requirement for the duration of the tariff subject to making appropriate allowances for variations in demand and customers leaving the tariff. Prices paid for volumes already purchased did not therefore normally impact on pricing decisions for fixed-term tariffs. However, if sales fell short of expectations and Scottish Power did not expect to use all the energy purchased, the [✂].

[16] See E.ON response to the updated issues statement, paragraphs 138–149 [✂].

SSE

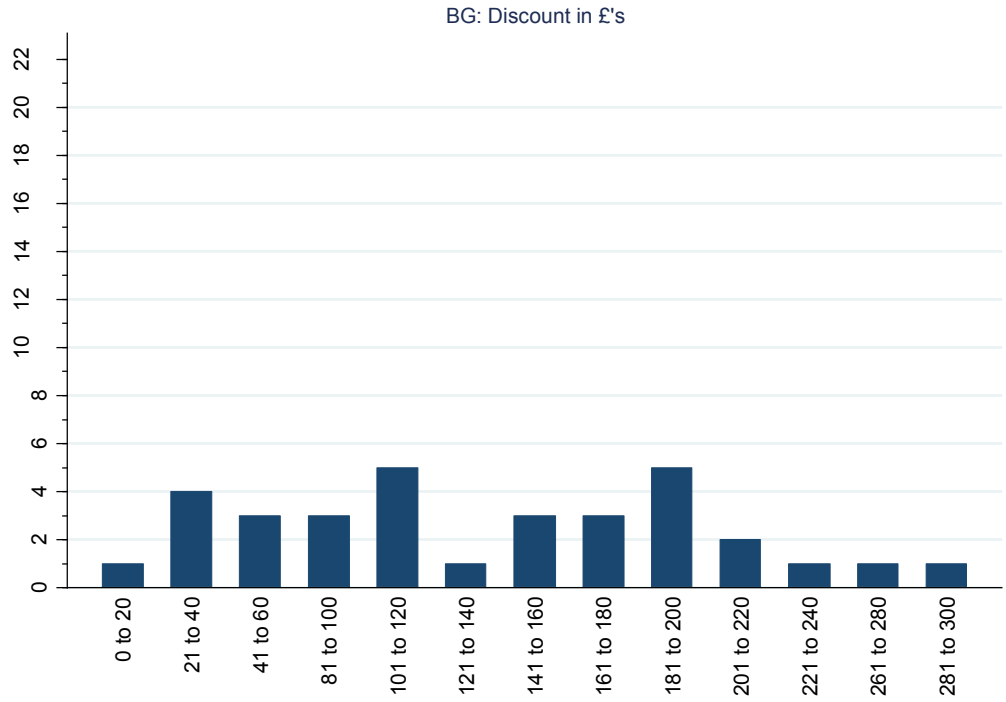
16. [✂].

17. [✂].

Annex B: Distribution of discounts by supplier (for the Six Large Energy Firms)

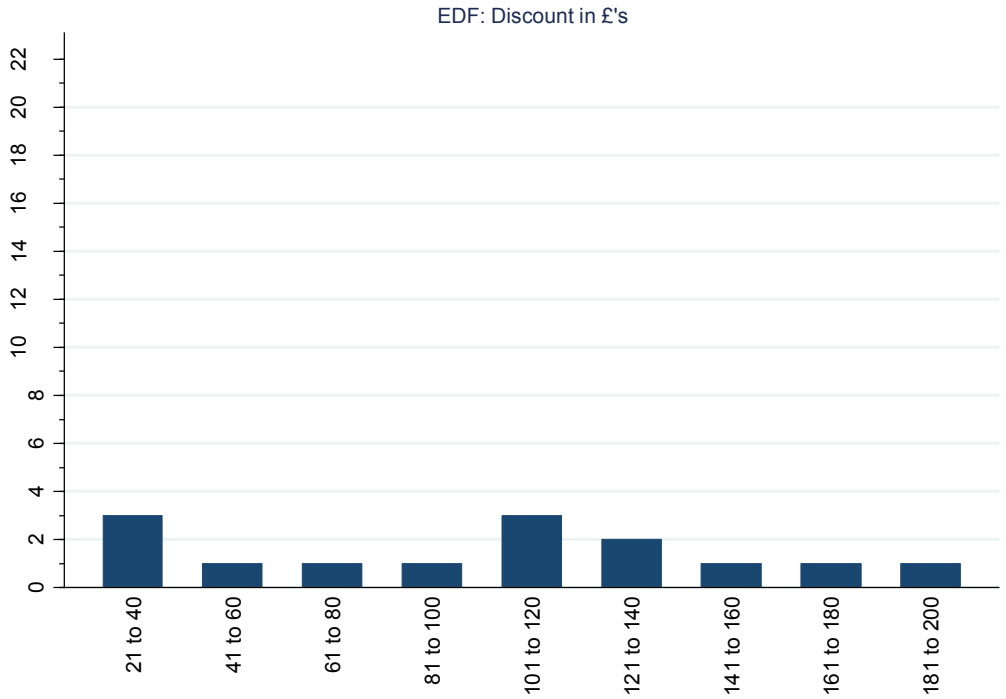
1. Distribution of fixed-term tariffs offered by Six Large Energy Firms at a discount, at launch, to the SVT, mid-2013 to March 2015, £ discount (based on annual bill for dual fuel, direct debit typical consumption customer using Ofgem's current definition).

Figure 1: British Gas and Sainsbury's Energy (discount in £)



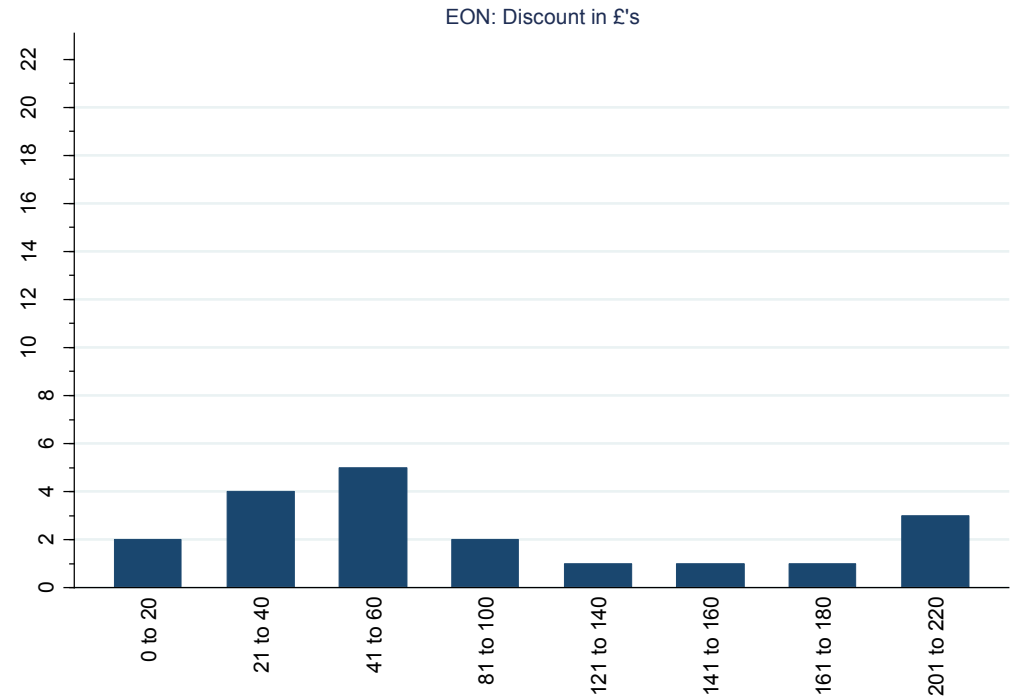
Source: CMA analysis of data provided by Centrica
Note: Includes Sainsbury's Energy tariffs.

Figure 2: EDF Energy (discount in £)



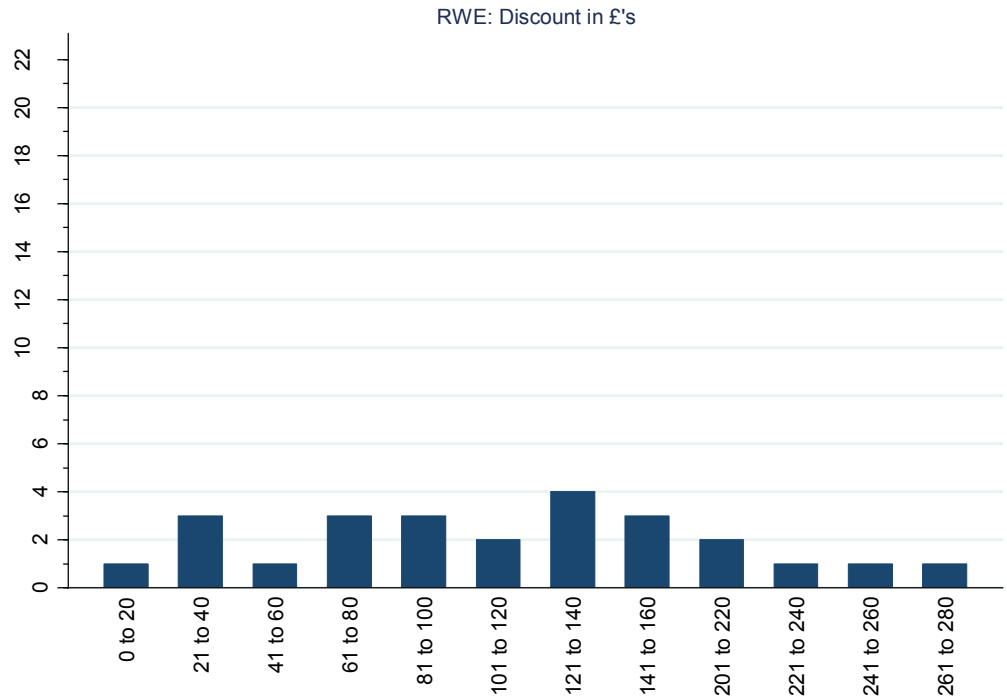
Source: CMA analysis of data provided by EDF Energy.

Figure 3: E.ON (discount in £)



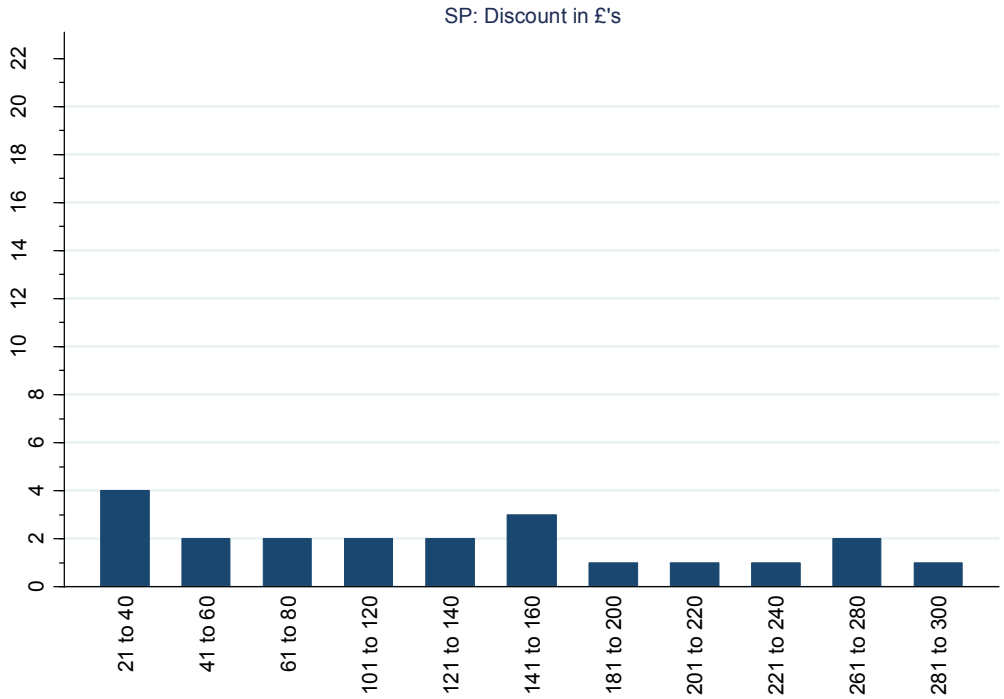
Source: CMA analysis of data provided by E.ON.

Figure 4: RWE (discount in £)



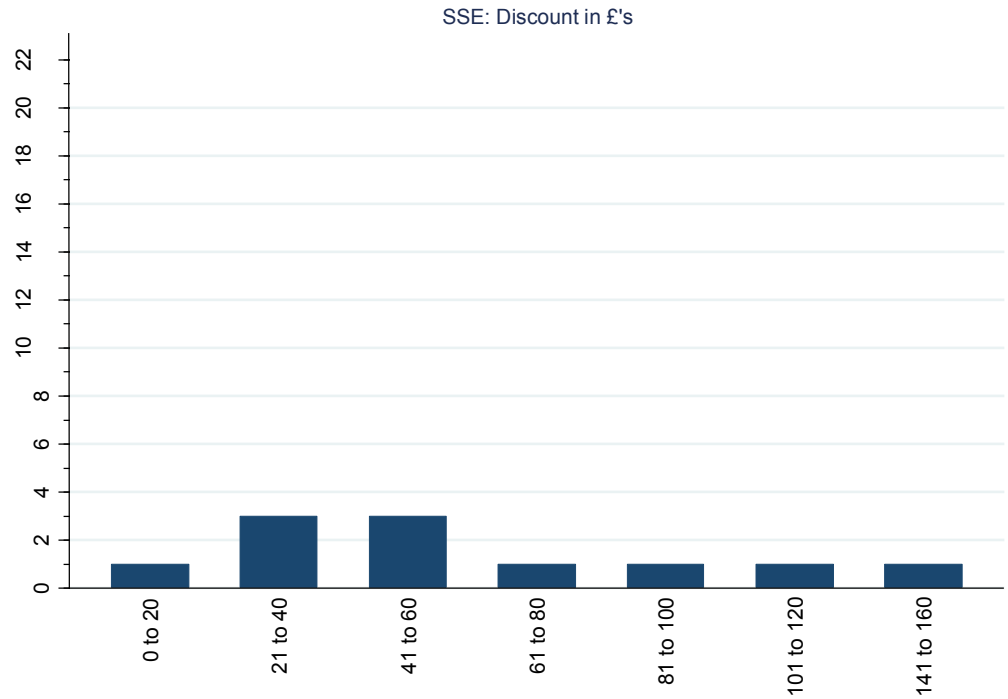
Source: CMA analysis of data provided by RWE.

Figure 5: Scottish Power (discount in £)



Source: CMA analysis of data provided by Scottish Power.

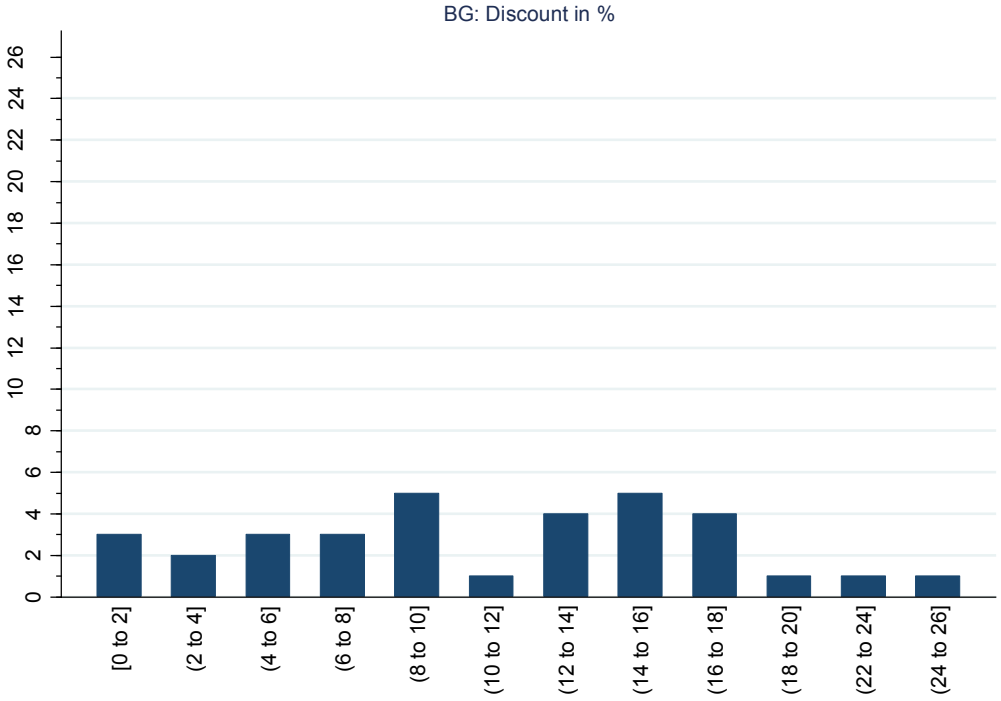
Figure 6: SSE and M&S (discount in £)



Source: CMA analysis of data provided by SSE.

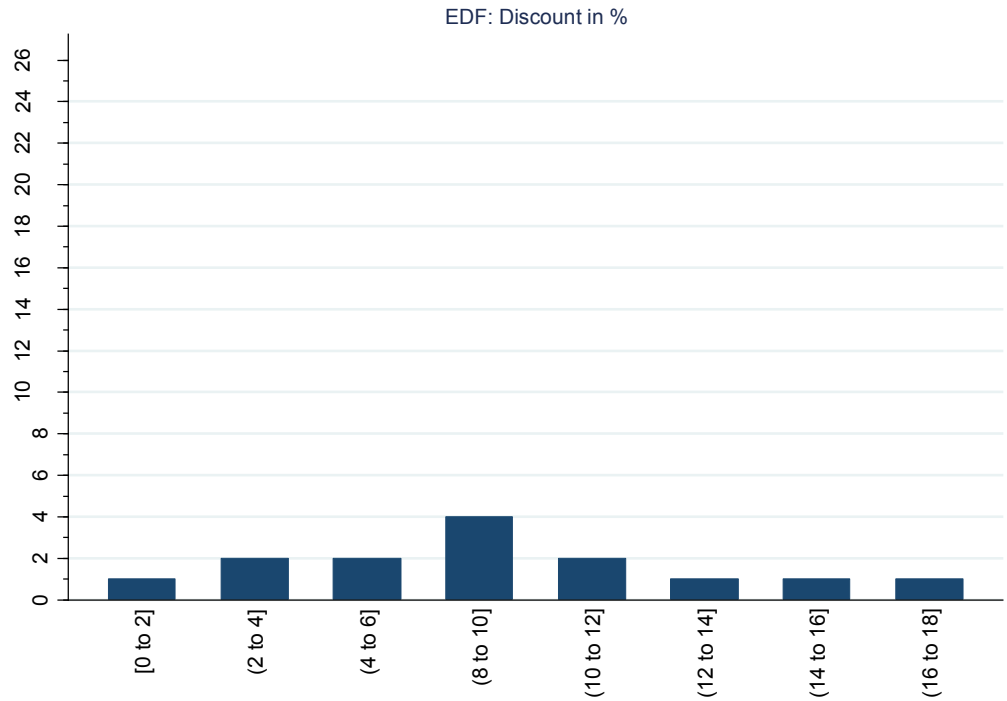
2. Distribution of fixed-term tariffs offered by Six Large Energy Firms at a discount, at launch, to the SVT, mid-2013 to March 2015, percentage discount (based on annual bill for dual fuel, direct debit typical consumption customer).

Figure 7: British Gas and Sainsbury's Energy (discount in %)



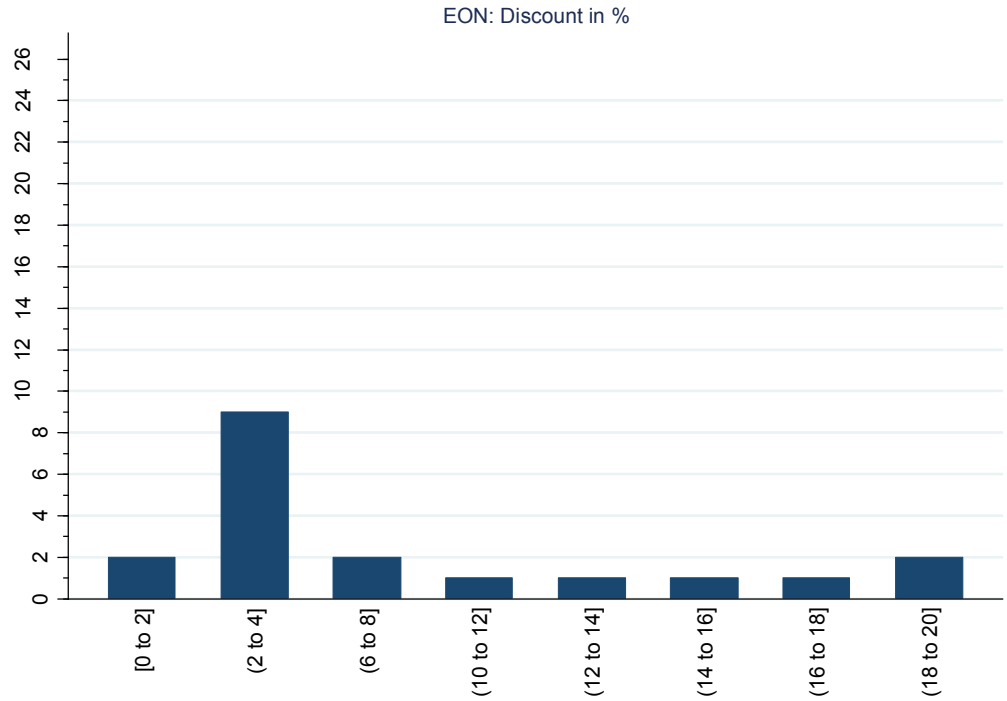
Source: CMA analysis of data provided by Centrica.

Figure 8: EDF Energy (discount in %)



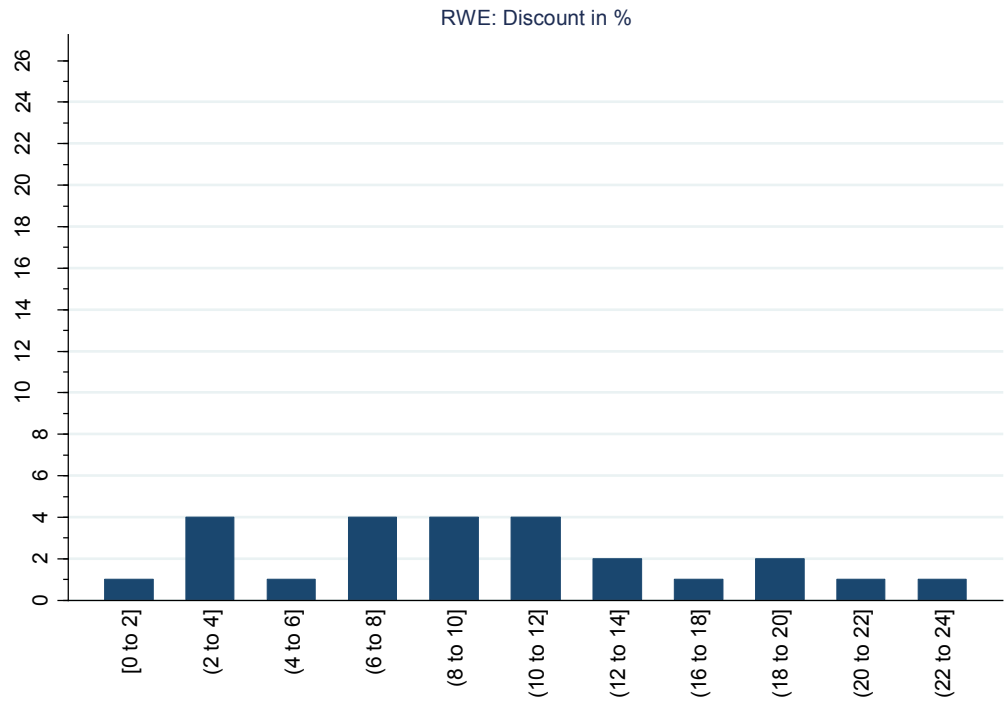
Source: CMA analysis of data provided by EDF Energy.

Figure 9: E.ON (discount in %)



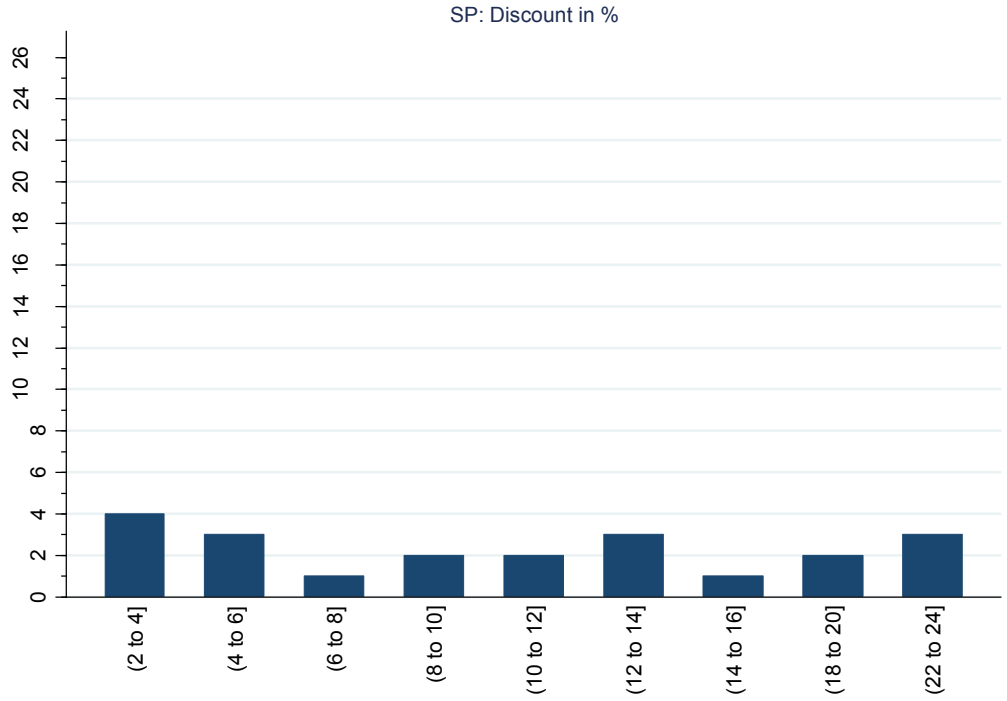
Source: CMA analysis of data provided by E.ON.

Figure 10: RWE (discount in %)



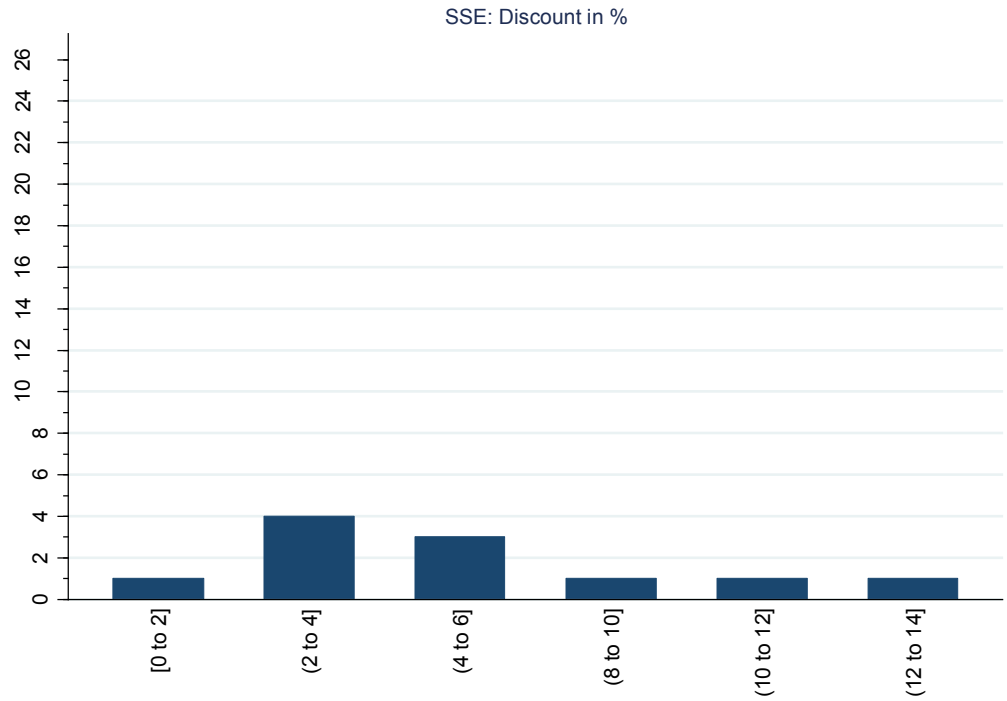
Source: CMA analysis of data provided by RWE.

Figure 11: Scottish Power (discount in %)



Source: CMA analysis of data provided by Scottish Power.

Figure 12: SSE and M&S (discount in %)



Source: CMA analysis of data provided by SSE.