

## Written evidence submitted by David Osmon

### Executive summary

- This submission points out that price caps are liable to have an adverse effect on competition. The proposed cap on default or 'standard variable' tariffs (SVTs) is liable to forestall effective competition and actually increase many people's bills.
- This submission proposes an alternative, limited measure that would benefit those consumers most in need of protection, stimulate competition and reduce carbon emissions.
- There is a flaw with the current pre-payment meter (PPM) price cap and Ofgem's proposed price cap for vulnerable consumers which means they provide minimal savings to customers. There is a risk that Ofgem, charged with devising a general price cap, may set it on the same basis.

## **Introduction and reason for submitting evidence**

1. I was a Senior Economist at Ofgem until June. While at Ofgem, among other things I led the market review referred to in Annex I below. I previously worked for a number of organisations in the private and public sectors, including the Competition Commission and the Office of Fair Trading, the predecessors of the Competition and Markets Authority (CMA).
2. I am submitting evidence because I believe a simpler, more effective measure to protect consumers (which would also boost competition and cut carbon emissions) and significant flaws in the design of the PPM cap and Ofgem's proposed cap have been overlooked.
3. The questions posed in the notice inviting written submissions that I have answered are shown in bold italics. Note that those relating to competition are addressed first. Recommendations are shown underlined.

## ***Impact of legislation***

- ***What is the likely impact of the legislation on energy suppliers, the energy market and investment in the energy sector?***
  - ***What is the likely impact of the cap on customer engagement and switching?***
  - ***What evidence is there of the impact of price caps on prices, competition and switching in other countries or in the UK?***
4. It is acknowledged that price caps are liable to have an adverse effect on competition by causing:-
    - Reduced customer engagement as they reduce the gain from switching supplier or tariff<sup>1,2</sup>. Given the persistence of switching habits, this effect might continue after a price cap was withdrawn.
    - Reduced competition between suppliers to attract customers who are protected by a cap, with a risk that the price cap forms a focal point to which suppliers raise their cheaper tariffs<sup>3</sup>.
  5. This means that many customers' bills are likely to increase following imposition of the proposed SVT cap.
  6. I recommend the Committee ask Ofgem to publish data on the effects observed following introduction of the PPM price cap in April.
  7. In addition, the proposed SVT cap is liable to damage the competitiveness of key challenger suppliers. The proposition of 'green' suppliers (e.g. Ecotricity, Good Energy) is based on pricing near to SVT levels to fund renewable energy development. Even if they were excluded from the cap (as proposed in the Draft Bill) they would be likely to lose market share if the cap was set lower than their tariffs.
  8. This cap could have a number of other adverse effects too:-
    - A perception of increased regulatory risk, leading investors to seek higher rates of return. This would increase costs to suppliers and ultimately the prices paid by consumers.<sup>4</sup>

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<sup>1</sup> *Energy market investigation Final report* (June 2016) Competition and Markets Authority (hereafter referred to as 'CMA Final report')

(<https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>) paragraphs 14.400-14.404.

<sup>2</sup> Research shows that the level of switching depends on the potential savings from doing so. Both the CMA and Ofgem have used survey evidence to estimate the amounts consumers need to save in order for switching to be deemed worthwhile. The CMA survey found the minimum savings needed to encourage respondents to switch supplier had a median of £120 and a mean of £204 as some customers responded with very large amounts (CMA Final report Appendix 9.1 Table 12 and paragraph 120 p.38). The Ofgem survey report found that consumers feel they need to save, on average, just under £300 per year to make it worth changing their supplier or tariff. *Consumer engagement in the energy market since the Retail Market Review - 2016 Survey Findings (Report prepared for Ofgem)* (August 2016) Ofgem (hereafter called 'Ofgem survey report'). (<https://www.ofgem.gov.uk/publications-and-updates/consumer-engagement-energy-market-retail-market-review-2016-survey-findings>). P.71

<sup>3</sup> CMA Final report paragraphs 14.405-14.413.

- Suppliers might cut costs by reducing quality of service<sup>5</sup> and innovation<sup>6</sup>. For example, they might delay the introduction of time-of-use tariffs<sup>7</sup> for those with smart meters.
- The price cap might become permanent because removal of the protection afforded by the cap would be perceived negatively.<sup>8</sup>

### **Provisions of legislation**

- **Are the five matters listed in clause 1(6)(a) to (e) compatible?**

9. No. The lower is the price cap, the greater is the protection it seeks to provide (i.e. (a)) but the lower are the incentives for customers to switch (i.e. (d)), for suppliers to compete for those customers (i.e. (c)) and for investors to lend money to suppliers, affecting their ability to finance their activities (i.e. (e)).

### **Objective of legislation**

- **The Government's stated objective is "protecting customers until the conditions for effective competition in this market are in place". Is this a clear objective? Does the text of the draft legislation enable this objective to be achieved? Could it be better achieved by other legislative or non-legislative means?**

10. This objective is not coherent. As described above, customer protection is likely to forestall effective competition and a price cap to bring about higher prices for some who would otherwise have benefited from competition. It is important that protection is targeted at those who need it.
11. Consumers also need protection in terms of reducing greenhouse gas emissions and the security of supply to them. Indeed Ofgem's statutory principal duty to protect the interests of existing and future consumers specifically includes these<sup>9</sup>. To the extent that a price cap succeeds in lowering energy bills, and in particular the price per unit of energy, it is liable to increase overall energy consumption<sup>10</sup> and thereby increase carbon emissions and make energy supply less secure.

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<sup>4</sup> CMA Final report paragraphs 14.420-14.422.

<sup>5</sup> CMA Final report paragraph 14.419.

<sup>6</sup> CMA Final report paragraphs 14.423-14.430.

<sup>7</sup> Energy tariffs that charge different prices at different times of the day, week, month or year.

<sup>8</sup> CMA Final report paragraphs 14.431-14.435.

<sup>9</sup> See Ofgem's Corporate Strategy

([https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/corporate\\_strategy\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2014/12/corporate_strategy_0.pdf)) p.4

<sup>10</sup> It is important to dispel a frequent misconception that, as a necessity, consumption of energy is unaffected by its price. It is strictly necessary to consume only a certain amount and the utility conferred by each additional unit diminishes so the amount consumed will depend on the price. The CMA pointed out that the price elasticity of demand for energy (i.e. the responsiveness of demand for energy to its price) is relatively low in the short run but significantly greater in the long run as consumers are able to respond to increased prices by installing energy efficiency measures. (CMA Final report paragraphs 8.6, 8.9.)

12. Protection from high energy prices for those who need it would be better achieved by a cap on just the standing charge component of all gas and electricity tariffs<sup>11</sup>. Indeed this will also strengthen competition, reduce carbon emissions and improve security of supply. It would have to be supplemented by a ban on suppliers offering lower unit rates for higher levels of consumption in order to prevent them effectively retaining a standing charge by charging high rates for the first units consumed. I recommend the Government introduce this rather than its proposed SVT cap.
13. This limited measure effectively targets protection at low income households, who are the most in need of protection as they pay the most for energy and are the least able to look after their own interests in the energy market. They pay the highest prices per unit of energy because they consume the least energy<sup>12</sup> so the standing charge forms a large proportion of their total bill. They are also most likely to be on the worst value tariffs (including SVTs)<sup>13</sup>. This is because their lower consumption means the potential gains from switching are less<sup>14</sup>; they are the least engaged consumers<sup>15</sup> and they find it difficult to compare tariffs<sup>16</sup>. The combination of low income and high energy costs means they are the most likely to be in fuel poverty<sup>17</sup>.
14. The standing charges currently levied are substantially more than the costs energy firms incur in arranging to supply customers. Some dual fuel<sup>18</sup> standing charges cost customers more than £200 (including VAT) and the average amount is £156 p.a., whereas the appropriate, cost-reflective level is approximately £60 p.a. (see paragraph 19 below). Thus a standing charge cap would save the poorest consumers up to £100 p.a..
15. The following diagram illustrates the effects of a standing charge cap on the annual bills of SVT customers with different levels of consumption (and income, given the link

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<sup>11</sup> Energy bills consist of a standing charge per day and a price per unit of energy consumed: the unit rate.

<sup>12</sup> The strong link between household income and energy consumption is illustrated in Figure 1 (p.8) of *The case for a cap on the standing charge in energy bills* (hereafter referred to as 'Standing charge paper') <http://idealeconomics.com/the-case-for-a-cap-on-the-standing-charge-in-energy-bills/>.

<sup>13</sup> The CMA domestic customer survey revealed that the proportion of consumers on SVTs is highest (75%) among those whose income is below £18k pa (CMA Final report paragraph 9.14 and Appendix 9.1 paragraph 251). Ofgem's consumer survey similarly found that low income, disadvantaged and financially struggling consumers are most likely to be on SVTs. (Ofgem survey report p.77 and Table 12 of data tables.)

<sup>14</sup> See footnote 2 above.

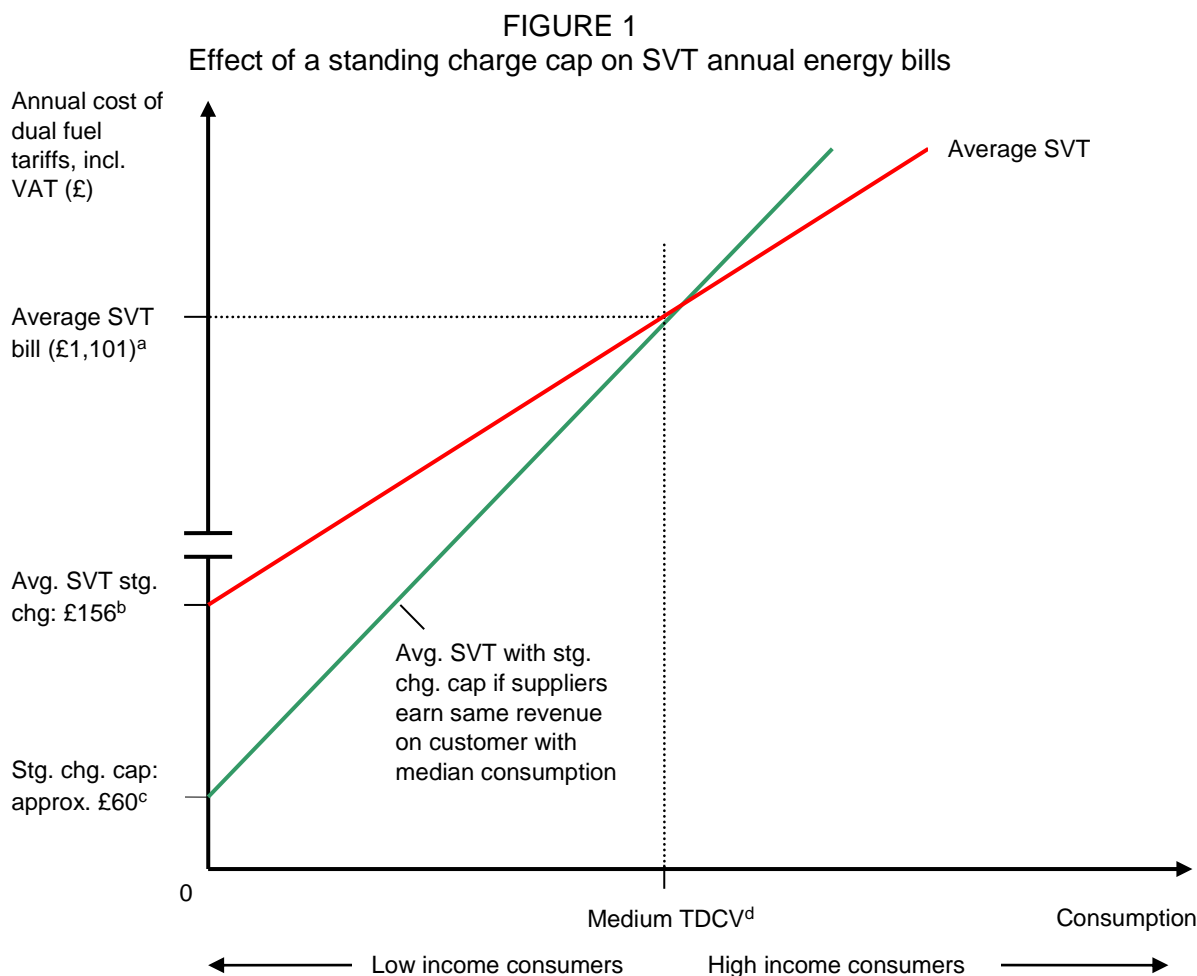
<sup>15</sup> The CMA domestic customer survey showed that those with household incomes below £18,000 a year are significantly less engaged. They are less likely to have ever considered switching supplier in the past; to have shopped around in the last three years; to have switched supplier in the last three years or to consider switching in the next three years. (CMA final report paragraphs 9.9-9.11 and paragraph 7 p.3 and paragraph 64 p.17 of Appendix 9.1.) Ofgem's survey of consumer engagement also detailed the link with income. Those with incomes below £16,000 a year are significantly less likely to have switched supplier; changed tariff with their existing supplier; compared tariffs and to say they have time for switching energy supplier. (These survey results are shown in Annex 1 of the Standing charge paper.)

<sup>16</sup> The CMA listed the groups of customers that lack the capability to search and consider tariff options fully as those with low levels of education or income; the elderly and/or those without access to the internet. (CMA Final report paragraph 9.563(b)(i).)

<sup>17</sup> A household is considered to be fuel poor if they have required fuel costs that are above average (the national median level) and, were they to spend that amount, they would be left with a residual income below the official poverty line. The drivers of fuel poverty are income, energy costs and the energy efficiency of dwellings.

<sup>18</sup> I.e. gas and electricity.

between these<sup>19</sup>). The amount saved is the vertical distance between the red and green lines.



<sup>a</sup> Weighted average annual SVT (direct debit) bill of the 10 suppliers with more than 250,000 non-PPM customers. Source: Ofgem website (SVT bills as of June 2017, no. of SVT customers as of Aug. 2017).

<sup>b</sup> Weighted average standing charge of the 10 suppliers with more than 250,000 non-PPM customers (Sept. 2017)<sup>20</sup>.

<sup>c</sup> See paragraph 19 below.

<sup>d</sup> Medium Typical Domestic Consumption Values (TDCV) is the median level of household consumption in Great Britain<sup>21</sup>.

16. The total benefit of a standing charge cap is estimated at £336 million p.a. for those on (non-PPM) SVTs with below average consumption (and income)<sup>22</sup>. It would be higher still if the cap on PPM tariffs was replaced by a standing charge cap as this would reduce the amount most PPM customers pay (see paragraphs 26-28 below).

17. The total benefit is likely to be much greater than this as, unlike caps on the total bill, a cap on the standing charge will dramatically improve competition. It will be much easier

<sup>19</sup> See footnote 12 above.

<sup>20</sup> See Annex 2 of Standing charge paper.

<sup>21</sup> As of Sept. 2017 this was 3,100 kWh p.a. for electricity and 12,500 kWh for gas.

<sup>22</sup> See paragraph 52 of Standing charge paper.

for consumers to compare tariffs as they will only need to consider the unit rate<sup>23</sup>. In addition, while suppliers will respond by trying to raise their unit rates, their ability to do this will be constrained. Those most affected by higher unit rates are those who consume most energy and they are more able to drive competition as they gain more from switching to better tariffs.

18. Lower standing charges will mean those in fuel poverty can afford more energy but overall the higher unit rates will lead consumers to reduce their energy consumption. This will lower carbon emissions, improve security of supply and reduce the investment needed in additional generation capacity and network enhancements, which feeds through to bills.
19. The appropriate level of a cap on dual fuel standing charges for non-PPM customers is approximately £60 p.a. (including VAT). Analysis shows that most costs incurred by suppliers depend on the amount of energy supplied rather than the number of customers served so should be recouped through the unit rate rather than the standing charge.<sup>24</sup>
20. This includes the costs of government policies aimed at tackling fuel poverty and reducing carbon emissions. Capping the standing charge will stop suppliers recouping them through the standing charge rather than the unit rate, which makes energy less affordable for low income households and incentivises higher energy consumption and emissions.<sup>25</sup>
21. The standing charge could be lower still, in which case the benefits of a cap on it would be further enhanced, if:-
  - (a) Ofgem took action to resolve competition problems in metering markets. This would reduce the costs suppliers incur for providing their customers with meters. See Annex I. I recommend Ofgem or the Business Secretary make a market investigation reference of all metering markets to the CMA.
  - (b) The Government withdrew VAT (currently levied on energy bills at 5%) from the standing charge. The standing charge confers the ability to access a supply of energy, which is a necessity<sup>26</sup>. The belief that EU rules prevent this appears to be a misconception, as explained in Annex II. I recommend the Government does this.
22. Similar competition problems apply in the supply of energy to SMEs.<sup>27</sup> The CMA conservatively estimated the detriment to them from high energy bills at £220 million p.a., of which £180 million p.a. related to micro-businesses. As with domestic bills, capping the standing charge would strengthen the competitive constraint on suppliers by

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<sup>23</sup> Large and variable standing charges make it difficult for consumers to compare tariffs so reduce the competitive constraint on energy bills. The CMA described how this leads to the weak customer response to which it attributed the market power of suppliers, which they exploit in the pricing of their SVTs. (CMA Final report paragraphs 9.165, 9.562, 9.563(b)(i)).

<sup>24</sup> See section 9 of Standing charge paper

<sup>25</sup> See Annex 3 of Standing charge paper.

<sup>26</sup> That energy is an 'essential of life' was an argument propounded by, for example, the Mirrlees Review of the tax system (a collaborative research venture led by the Institute for Fiscal Studies) in favour of goods such as domestic fuel facing lower rates of tax. Mirrlees, J., Adam, S., Besley, T., Blundell, R., Bond, S., Chote, R., Gammie, M., Johnson, P., Myles, G. and Poterba, J. (2011), *Tax By Design*, Oxford University Press pp. 156, 159. (<https://www.ifs.org.uk/docs/taxbydesign.pdf>)

<sup>27</sup> In his letter to Ofgem of 21 June 2017 Greg Clark, the Business Secretary, asked Ofgem to advise him what action it intended to take to ensure that micro businesses were fairly treated, as well as to safeguard domestic customers on the poorest value tariffs and in relation to SVTs.

improving price transparency and consumer engagement. In particular it would substantially reduce the energy bills of micro-businesses.

23. A cap on the standing charge is likely to be simple and quick to implement. Indeed Ofgem has previously set out how it could fix the standing charge (which is more restrictive than capping it)<sup>28</sup> and a standing charge cap could be implemented in the same way. Ofgem also said recently that it “could be implemented relatively quickly”<sup>29</sup>. It would also be easier and less costly than any cap on overall bills to calculate accurately<sup>30</sup> and monitor compliance (for both Ofgem and suppliers).

### **Provisions of legislation**

- **Are the draft legislation’s provisions necessary, workable, and clear? If not, what changes need to be made?**

24. As explained above, a cap on total bills is unlikely to be effective. A further obstacle is that the draft provisions require Ofgem to devise the price cap.
25. Ofgem has recently consulted on setting a temporary price cap for vulnerable consumers equal to the PPM cap, which it imposed in April on the recommendation of the CMA. It is possible that Ofgem will set the SVT cap on this basis too.
26. This is problematic because the PPM cap has a fundamental flaw: it offers the greatest savings to those households that consume most energy and they are typically the least in need of protection. Those who consume relatively small quantities (including most PPM customers, as well as most of those on low incomes, on SVTs and in fuel poverty) save much smaller amounts.<sup>31</sup>
27. The PPM cap is calculated<sup>32</sup> for each level of consumption of both gas and electricity according to a straight line drawn through prices for supplying zero energy and the median level of energy consumption<sup>33</sup>. The latter price reflects the CMA’s estimate of a competitive benchmark tariff for PPM customers. However, the former is the average of the Big Six suppliers’ PPM standing charges. This is not a competitive price: the CMA identified that the Big Six exploited their market power through their prices and that PPM

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<sup>28</sup> In 2012 Ofgem proposed imposing a fixed standing charge by incorporating a schedule of standing charges into licences, with an automatic adjuster for subsequent years. It considered that it would be possible to estimate the level of future costs with a reasonable degree of accuracy but would monitor actual costs incurred by suppliers and might propose a change to the licence if observed costs differed significantly from those anticipated. (*The Standardised Element of Standard Tariffs under the Retail Market Review* February 2012 Ofgem <https://www.ofgem.gov.uk/publications-and-updates/standardised-element-standard-tariffs-under-retail-market-review> paragraphs 2.26-2.29.)

<sup>29</sup> Ofgem said this in relation to mandating a particular tariff design (e.g. mandating tariffs without a standing charge) in its consultation for a vulnerable customer safeguard tariff. *Financial protections for vulnerable consumers Technical document* Ofgem October 2017 (hereafter referred to as ‘Ofgem’s technical document’) ([https://www.ofgem.gov.uk/system/files/docs/2017/10/financial\\_protections\\_for\\_vulnerable\\_consumer\\_s\\_-\\_technical\\_document.pdf](https://www.ofgem.gov.uk/system/files/docs/2017/10/financial_protections_for_vulnerable_consumer_s_-_technical_document.pdf)) Paragraphs 3.21-3.22.

<sup>30</sup> It is simpler to estimate the appropriate level of just the few categories of costs that belong in a standing charge.

<sup>31</sup> The CMA acknowledged this: “We note... that, when comparing the [PPM] cap to existing tariffs, it is in fact less stringent at lower levels of consumption and more stringent at higher levels of consumption” (CMA Final report footnote 44, p.955).

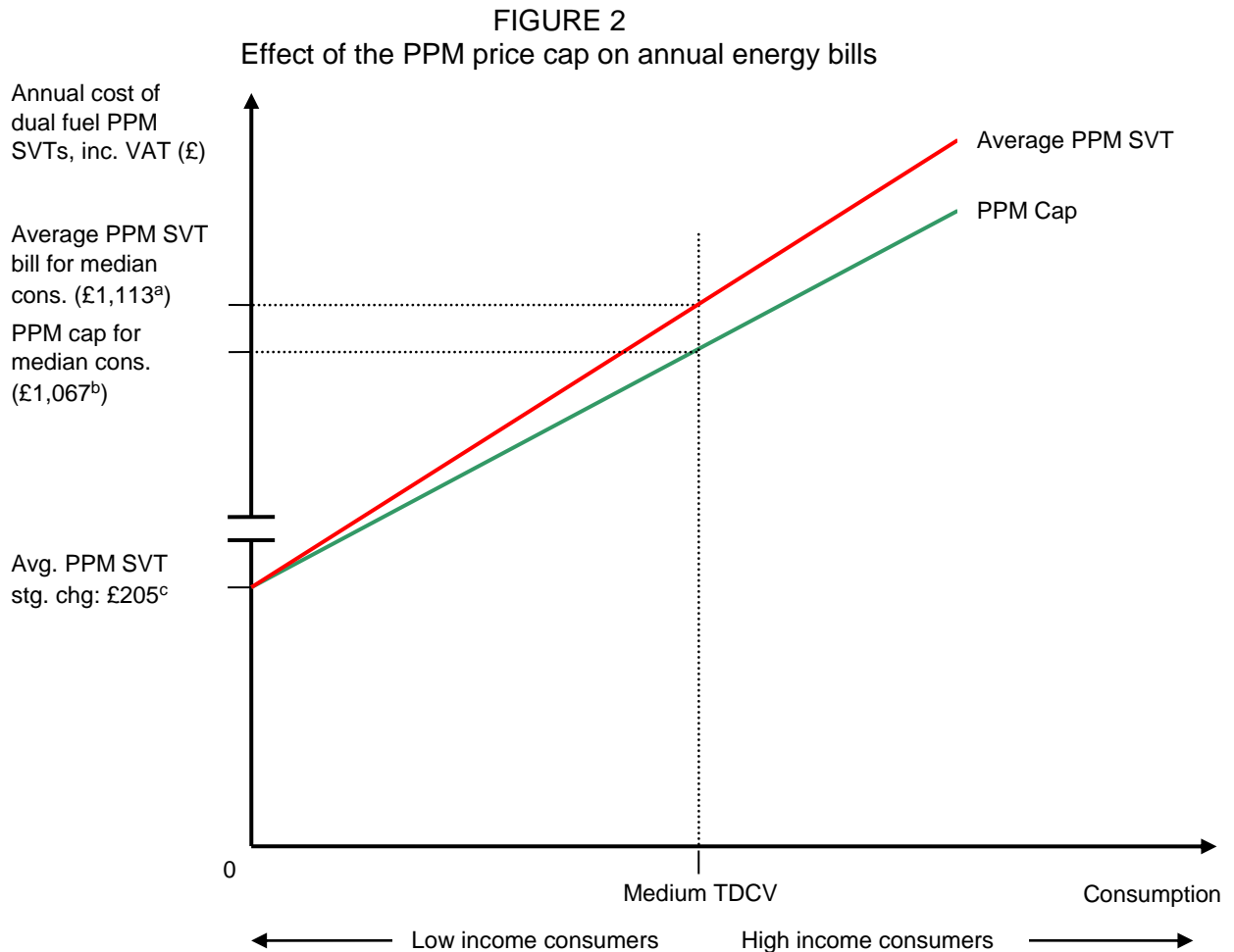
<sup>32</sup> CMA Final report paragraphs 14.70-14.77 and 14.103-14.254.

<sup>33</sup> Medium TDCV.



customers were especially badly affected. Indeed this was the reason for the PPM price cap.<sup>34</sup>

28. The following diagram illustrates the effect of the PPM cap on the annual energy bills of PPM customers with different levels of consumption (and income).



<sup>a</sup> Data for 28 Jan. and 28 Feb. 2017 (i.e. prior to imposition of PPM cap). (Source: Ofgem.)

<sup>b</sup> For April – Sept. 2017. (Source: Ofgem.)

<sup>c</sup> PPM cap at zero consumption for April – Sept. 2017 (i.e. gas £95.60 and electricity £99.99, excl. VAT). (Source: Ofgem.)

29. Ofgem used the median consumption level in estimating the savings at £110 per dual fuel customer<sup>35</sup>. However, Ofgem is applying its price cap to consumers in receipt of the Warm Home Discount rebates. This means they are either in or at risk of fuel poverty so do not consume anything like the average consumption level. As a result their savings will be a fraction of this amount.

30. In addition, a price cap for customers with conventional meters set on the same basis as the PPM cap should be lower than the PPM cap by the difference in the costs to serve these meter types (£63 p.a. for dual fuel customers)<sup>36</sup>.

<sup>34</sup> CMA Final report paragraphs 154, 156-160, 162-167 and 245 of Summary.

<sup>35</sup> Ofgem's technical document paragraphs 5.8, 5.11.

<sup>36</sup> CMA Final report paragraph 14.122.

31. That savings for low income consumers will be minimal under Ofgem's cap can be gauged from the fact that the PPM cap at zero consumption (£205) (see Figure 2) is actually much *higher* than the average non-PPM SVT standing charge (£156) (see Figure 1).
32. Note also that Ofgem did not take into account the effect on carbon emissions<sup>37</sup> and security of supply<sup>38</sup> even though its principal statutory duty obliged it to (see paragraph 11).
33. The CMA developed its PPM cap during the course of its exhaustive two year investigation of the energy market and still produced something that is flawed. Even if Ofgem doesn't adopt the PPM methodology for the SVT cap, the fact that it blindly copied this for its temporary cap calls into question whether it has the wherewithal to develop an effective cap (unless it is straightforward – like a standing charge cap).

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<sup>37</sup> To the extent that such a price cap will be successful in lowering prices, it will lead to higher energy consumption and carbon emissions. However, Ofgem's only statement is that "Carbon emissions associated with electricity generation are captured within the EU Emissions Trading Scheme (ETS) and capped. Therefore any changes in consumption should not affect emissions or the UK's legally binding energy targets." (Ofgem's technical document paragraph 5.58.) This ignores the fact that Ofgem's proposed price cap covers gas as well as electricity (for the majority who purchase gas from the same supplier as they purchase electricity) and the widely held view that the cap on emissions in the ETS is insufficiently stringent. As Ofgem will be well aware, this is why it is to be tightened from 2021 and is one of the reasons the UK government has developed alternative policies to invest in low carbon generation and improve energy efficiency. (See CMA Final report paragraphs 2.79-2.80 and 5.238.)

<sup>38</sup> Ofgem's only statement with regard to the effect on security of supply was "Due to only marginal increases in the short term levels of consumption, we do not foresee any significant impact on security of supply." (Ofgem's technical document paragraph 5.58.) However, this ignored the much greater long term impact on consumption (see footnote 10 above and paragraph 5.55 of Ofgem's technical document).

## Annex I: Metering costs (see paragraph 21)

34. A report published by Ofgem last year<sup>39</sup> expressed concern that competition in the provision of gas metering products and services at non-domestic premises was not as effective as it should be<sup>40</sup>.
35. In particular, gas suppliers incur significant costs when they switch meter provider. Incoming providers appointed by suppliers are not generally able to adopt meter assets in situ so must replace them<sup>41</sup>. These switching costs weaken competitive constraints on metering providers and form a barrier to entry<sup>42</sup>. The limited competition, costs incurred in replacing meters and raised financing costs for meter provision (as shorter asset life means riskier investment) result in higher meter rental charges to suppliers. These are likely to feed through to end customers in their energy bills.<sup>43</sup>
36. The rental charges on gas meters provided at domestic premises are regulated, although the report included evidence which indicates that meter providers' margins on these meters may actually be higher than for other meters.<sup>44</sup>
37. The same issues affecting suppliers' metering costs may apply in relation to electricity meters and to smart meters once they are installed.
38. Dermot Nolan (Ofgem's Chief Executive) gave a commitment to the Public Accounts Committee in June 2014 (in relation to smart meters) that there should be a requirement (as opposed to just a commercial incentive) for suppliers to use the same physical metering equipment when a customer changes supplier<sup>45</sup>. Note that this would require ownership of metering equipment to be transferrable between providers rather than merely for meters to be interoperable, which just means that different companies would be *able* to operate the meters (if given permission by the meter owners).
39. Ofgem said in the report that it intended to take a number of actions to address its concerns<sup>46</sup> such as exploring the scope for encouraging meter providers to sell or rent meters in situ to incoming providers<sup>47</sup>. It said that in due course it would review progress and the effect of its actions on the state of competition in the market. If progress was not

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<sup>39</sup> *Review of the non-domestic gas metering market* (March 2016) Ofgem (hereafter referred to as 'Market review report').

([https://www.ofgem.gov.uk/system/files/docs/2016/03/market\\_review\\_report\\_final.pdf](https://www.ofgem.gov.uk/system/files/docs/2016/03/market_review_report_final.pdf)).

<sup>40</sup> Market review report p.4.

<sup>41</sup> Market review report p.4.

<sup>42</sup> Market review report chapter summary p.18.

<sup>43</sup> Market review report p.30.

<sup>44</sup> It said analysis of one meter provider's costs and prices (which appeared to be representative of the industry) suggested that additional mark-ups that were unrelated to costs were being added to what were already comfortable rates of return net of inflation. (Market review report p.30.) These mark-ups were 20% for domestic-size meters and 15% for other meters (Market review report footnote 43 p.30).

<sup>45</sup> Stephen Lovegrove, Permanent Secretary at the Department for Energy and Climate Change (now BEIS, the Department for Business, Energy and Industrial Strategy), gave a similar commitment. (<http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/public-accounts-committee/smart-meters-followup/oral/10401.html> Qs.68-73, 76).

<sup>46</sup> Market review report p.32.

<sup>47</sup> Market review report p.33.

evident it would consider whether it might be appropriate to take other actions, including consulting on a market investigation reference to the CMA<sup>48</sup>.

40. However, it is not known what Ofgem has done with regard to these various commitments.

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<sup>48</sup> Market review report p.37.

## **Annex II: EU rules on exempting the standing charge from VAT (see paragraph 21)**

41. EU directives constrain the application of reduced rates of VAT. They permit no more than two different reduced rates (each of no less than 5 per cent) that can apply to a restricted set of goods and services<sup>49</sup>. However, there are exceptions whereby EU members are allowed to charge 'special rates' of VAT – reduced rates for additional goods and services and reduced rates under 5 per cent (including zero rates). They are allowed to apply a reduced rate to the supply of natural gas, electricity and district heating.<sup>50</sup>
42. Moreover items not subject to VAT prior to the introduction of the EU Single Market in 1992 may continue to be zero-rated where the exemptions have “been adopted for clearly defined social reasons and for the benefit of the final consumer”.<sup>51</sup> It is thought that this means the standing charge could be zero-rated as energy bills (including the standing charge) were zero-rated prior to 1992.

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<sup>49</sup> Article 98 of the EU VAT Directive (*Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax*) (<http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:32006L0112>). The categories of goods or services to which the reduced rates may apply are listed in Annex III of the Directive.

<sup>50</sup> Article 102 of the EU VAT Directive.

<sup>51</sup> Article 110 of the EU VAT Directive.