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In 2014 Scotland Welcomes the World



19<sup>th</sup> December 2014

Dear Roger,

## CMA ENERGY MARKET INVESTIGATION

The Scottish Government welcomes the Competition and Market Authority Investigation into energy markets. It comes at an important time as consumers are grappling with the impacts of rising energy bills. I have been shocked by the latest statistics<sup>1</sup> on fuel poverty in Scotland, revealing that 39 per cent of Scottish households were in fuel poverty in 2013. In the interests of consumers I would urge a swift conclusion to the review and the effective implementation of its conclusions.

I have attached analysis of the Scottish retail market, compiled by Scottish Government analysts. I hope you will find this useful.

In Scotland, the retail market is more concentrated than in Great Britain as a whole and the loyalty of certain groups of consumers in Scotland to incumbent 'home' suppliers (e.g. electricity consumers in the North of Scotland) may not provide enough stimulus to create the necessary level of competition to ensure that the market works equally well for all consumers. I believe consumers in the North of Scotland are being unfairly treated and would invite you to take steps to deal with this.

Scotland's retail energy market also exhibits a number of features which may mean suppliers are able to 'segment' the market and offer more competitive terms to certain groups, for both behavioural and structural reasons. For example, there is a significant proportion of Scottish

<sup>1</sup> Scottish House Condition Survey 2013: <http://www.scotland.gov.uk/Publications/2014/12/6903>

homes off the mains gas grid with electric heating supplied by Dynamic Teleswitched (DTS) Meters who appear to be particularly 'disengaged' with the energy market and face a range of barriers to switching to a different supplier or electricity tariff, as confirmed by Ofgem's recent research into consumer experience of DTS tariffs.<sup>2</sup>

I am concerned that regulatory interventions have not resulted in a well-functioning market which benefits all consumers: removal of social tariffs may have left vulnerable groups worse off, the introduction of standing charges seems to penalise low energy users, and although the reduction in the number of tariffs available may help when comparing tariffs, it will eliminate the most competitive tariffs for those who are actively engaged with the energy market and potentially increase the average price for all consumers.

I hope that your investigation is able to accurately identify these sections of the market where consumers exert weak pressure on suppliers, or where regulatory interventions have had adverse consequences, and propose adequate remedy without jeopardising healthy competition.

I have wider concerns that Ofgem is not protecting electricity consumers in the North of Scotland who face some of the highest electricity prices, driven by the methodology established by the regulator to recover the cost of building and maintaining the distribution network. I would welcome the panel's views on this issue as part of the investigation.

I am committed to working closely with the UK regulator and UK Government to address this and although I welcome steps taken by Ofgem, who recently committed to undertake a thorough assessment into the disparity in energy pricing across the British Isles, I remain concerned about the slow pace of progress.

Responsibility for these issues rests firmly with Ofgem under the current regulatory framework. Lord Smith has now published his recommendations for further devolution of powers to the Scottish Parliament – this is an important backdrop to the work of the CMA. While we welcome the transfer of those powers recommended by the report, the agreement falls well short of the Scottish Government's devolution proposals on energy<sup>3</sup>. Nevertheless, the Scottish Government intends to work constructively with the UK Government and Ofgem to improve outcomes for Scottish consumers.

The Smith proposals for increased powers over the design and implementation of energy efficiency and fuel poverty obligations on energy companies will help us, in conjunction with Scottish Stakeholders, to create energy efficiency schemes that are better suited to Scottish circumstances and needs including addressing fuel poverty and climate change.

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<sup>2</sup> Ofgem, November 2014, *Dynamic Teleswitched meters and tariffs – research into consumer experience*. <https://www.ofgem.gov.uk/publications-and-updates/dynamically-teswitched-meters-and-tariffs-%E2%80%93-research-consumer-experience>

<sup>3</sup>As published in *More Powers for the Scottish Parliament: Scottish Government Proposals* <http://www.scotland.gov.uk/Publications/2014/10/2806>

The Smith Commission also recommended new powers relating to competition policy and the ability for the Scottish Parliament to require the CMA to carry out a full second phase investigation. We will await the conclusions of the panel in due course but we may choose to exercise this new power to address any outstanding concerns relating to Scotland's energy market.

I look forward to engaging with the panel as the investigation progresses.

Yours Sincerely

**Fergus Ewing**



## Annex A: CMA Energy Market Investigation – Scottish Government response

Retail consumers in Scotland face a broadly similar range of issues to those in the rest of the UK. There are, however, a number of distinct factors which mean that the extent to which these issues impact consumer bills differ for Scottish retail customers. The analysis below highlights some of these factors.

### Unit prices and payment methods

Average energy bills differ between tariff types in the domestic energy market, which can make comparison challenging. Using the average tariff available across the GB regions, as published by DECC, it is possible to highlight some interesting differences between Scotland and the UK.

#### Electricity

The costs that consumers face varies depending on the method used to make payment. On average across the UK, consumers of electricity using prepayment face 0.6 per cent higher bills than those using standard credit, and 8.7 per cent using direct debit payments.

**Table 1. Average unit cost for domestic standard electricity in Scotland and UK by payment type. (p/kWh)**

Average unit cost (p/kWh)	Standard Credit	Direct Debit	Prepayment
North Scotland	16.90	15.65	16.96
South Scotland	15.97	14.58	15.76
UK	15.83	14.65	15.93

Data source: DECC Quarterly Energy Prices, Table 2.4.2 and 2.2.3

This is of particular interest for Scotland, as both South Scotland (22 per cent) and North Scotland (18 per cent) have higher proportion of consumers using prepayment method for standard electricity than the overall UK level (17 per cent).

**Table 2. Proportion of consumers by payment method for standard electricity June 2014.**

Per cent	Standard Credit	Direct Debit	Prepayment
North Scotland	24	57	18
South Scotland	23	55	22
UK	27	56	17

Data source: DECC Quarterly Energy Prices, Table 2.4.2.

South Scotland (55 per cent) has slightly lower proportion of consumers using direct debit payment method than the UK average (56 per cent), whereas North Scotland is slightly higher (57 per cent). Both regions in Scotland have lower number of consumers choosing the standard credit payment method than the UK level.

The average unit costs for domestic standard electricity in North Scotland for all three payment methods are substantially higher than that of South Scotland and UK average (see Table 1). Consumers in North Scotland pay on average 16.96 pence per kilowatt hour by

using prepayment method, which is 6.5 per cent higher than the average price in UK. North Scotland consumers also pay 6.9 per cent and 6.7 per cent higher unit prices for standard credit and direct debit payment methods respectively.

## Gas

On average across the UK, consumers pay more by using standard credit payment. Consumers of gas using standard credit face 1.1 per cent higher bills than those using prepayment, and 9.4 per cent using direct debit payments.

**Table 3. Average unit cost for domestic gas in Scotland and UK by payment type. (p/kWh)**

Average unit cost (p/kWh)	Standard Credit	Direct Debit	Prepayment
North Scotland	5.02	4.58	4.75
South Scotland	5.07	4.61	5.01
UK	5.11	4.68	5.06

Data source: DECC Quarterly Energy Prices, Table 2.3.3.

The distribution of consumers payment methods for domestic gas consumption in Scotland differs from that of the electricity market. A higher proportion of consumers from North Scotland use direct debit to pay for gas bills (62 per cent) (see Table 4). However, the proportion of consumers who use prepayment in South Scotland (18 per cent) is higher than the GB level (15 per cent).

**Table 4. Proportion of consumers by payment method for domestic gas, June 2014.**

Per cent	Standard Credit	Direct Debit	Prepayment
North Scotland	23	62	15
South Scotland	26	56	18
GB	28	57	15

Data source: DECC Quarterly Energy Prices, Table 2.5.2.

The average unit costs for domestic gas consumption for all three payment methods in North Scotland are lower than South Scotland and UK average (see Table 3). Domestic gas prices in North Scotland for standard credit and direct debit payment method are around 2 per cent lower than the UK average, while prices for prepayment method are around 6 per cent lower than the UK average. Domestic gas unit prices in South Scotland are higher than those in North Scotland but lower than the prices of UK average.

## Domestic consumption in Scotland by Local Authority

### Electricity

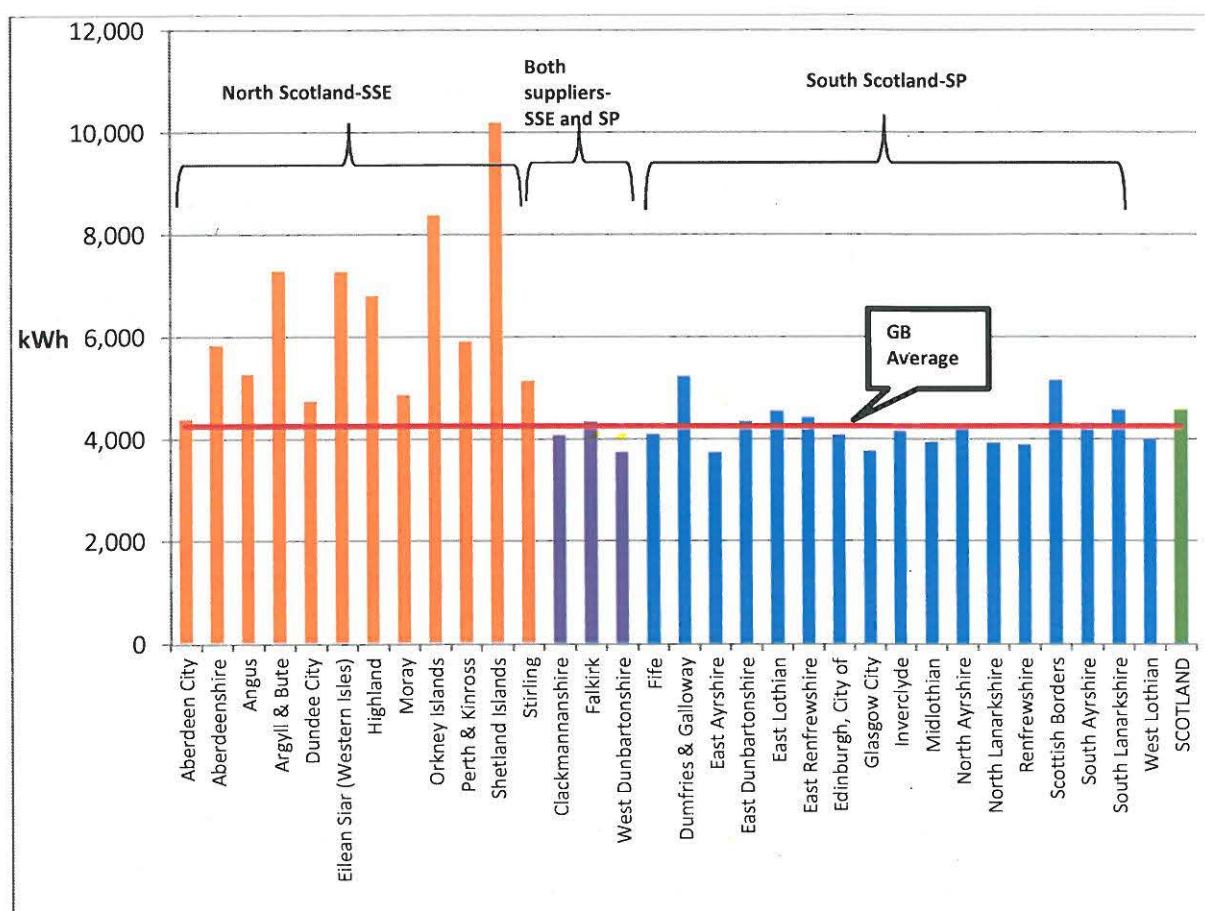
The higher average unit prices faced by some Scottish consumers is exacerbated by the fact that average consumption is also higher in Scotland. Domestic electricity consumption per



household in Scotland in 2012 was estimated to be the highest in Great Britain, at 4.6 MWh (around 9.5 per cent higher than the GB average)<sup>1</sup>.

Households from the majority of regions in North Scotland consume more electricity than both the Scotland and GB average amount (see figure 1). For example, households consumption of electricity in Shetland was over twice that of the GB average, due in part to the weather conditions and the concentration of electrical heating. The chart below sets out the estimated electricity consumption across all of Scotland's Local Authorities, in comparison to the GB average.

**Figure 1. Average annual household consumption of electricity in Scotland (2012). (kWh)**



Data source: DECC Sub-national electricity sales and numbers of customers (year 2012).

It is clear that there is a variation in average annual household consumption across Scotland's Local Authorities. Both regional price differences for electricity and variation in the domestic electricity consumption have impacts on the energy bills within Scotland. Taking North Scotland as an example, variations in the domestic electricity consumption are larger than the variation in South Scotland. In addition, customers in North Scotland pay higher unit electricity prices for all three payment methods. Therefore, the average household electricity bill would be higher than the GB average. The aggregated average annual household

<sup>1</sup> The Scottish Government "Energy in Scotland 2014".

consumption of electricity in North Scotland in 2012 was around 4,577 kWh<sup>2</sup>, which is 8.2 per cent higher than the GB average<sup>3</sup>.

## Gas

Although domestic gas unit prices are lower in Scotland than the UK average, the average domestic gas bills faced by Scottish consumers is still estimated to be higher than the UK average. This is mainly because domestic gas consumption per consumer in Scotland remains the highest of any GB region<sup>4</sup>. As expected, the northern parts of the UK tend to have higher domestic consumption per customer, due to the impact of weather differences on demand for heating fuel.

Figure 2 shows that the annual consumption of gas per consumers in Scotland vary across Scottish authorities. Islands in Scotland and parts of remote and rural Scotland are off the gas grid. East Ayrshire and East Renfrewshire in South Scotland are the two region have highest average gas consumption. All regions in North Scotland (except Dundee City) have higher gas consumption than the GB average.

The aggregated average annual domestic gas consumption per consumer were around 15,861 kWh in North Scotland and 14,589 kWh in South Scotland<sup>5</sup>. Using the average overall unit costs from DECC, the average annual gas bill per consumer were around £ 753 in North Scotland and £700 in South Scotland, which were 10.2 per cent and 2.4 per cent higher than the average gas bill in the UK (£684), respectively.

<sup>2</sup> Household number projection data from "NOS: Household Projections for Scotland, 2012-based". Average household consumption of electricity data from "DECC Sub-national electricity sales and numbers of customers (year 2012)".

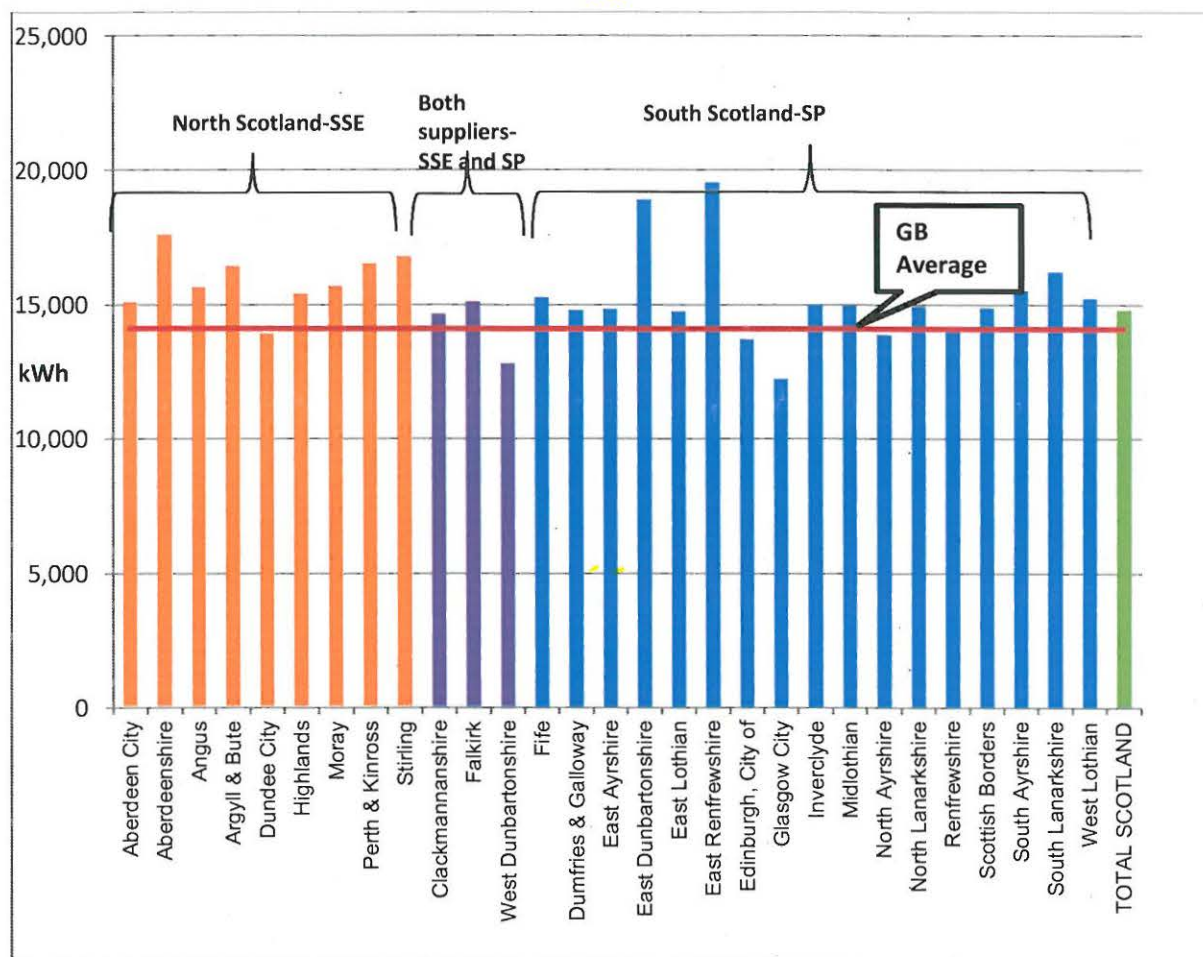
<sup>3</sup> Based on the average overall unit costs from DECC, the average annual electricity bill for household in North Scotland was around £742, which is 15.4 per cent higher than the average household electricity bill in Great Britain (£643). This reflects the fact that households in North Scotland have higher proportion to use electric heating.

<sup>4</sup> The Scottish Government, Energy in Scotland 2014.

<sup>5</sup> Household number projection data from "NOS: Household Projections for Scotland, 2012-based". Average household consumption of gas data from "DECC Sub-national gas sales and numbers of customers (year 2012)".



**Figure 2. Average annual consumption of gas per consumer in Scotland (2012) (kWh).**



Data source: DECC Sub-national gas sales and numbers of customers (year 2012).

### Stickiness to home suppliers

Ofgem's "Customer Engagement with the Energy Market: Tracking Survey 2014" report found that in 2013 levels of switching by Scottish consumers are slightly higher than in England and Wales: the proportion of gas customers and of electricity customers who have switched supplier in 2013 is 13 per cent in the UK (17 per cent for gas customers and 16 per cent for electricity customers in Scotland respectively). However, there is a lack of disaggregated figures for different regions in Scotland.

However, DECC data show that electricity consumers in Scotland are still more likely to choose their home supplier than the UK average (home suppliers are the original supplier in any given area). In particular, consumers in the North of Scotland are more likely to be with their home supplier irrespective of payment type. There are 70 per cent of prepayment customers in North Scotland with home suppliers, compared to only 38 per cent for the UK average (in Table 5).



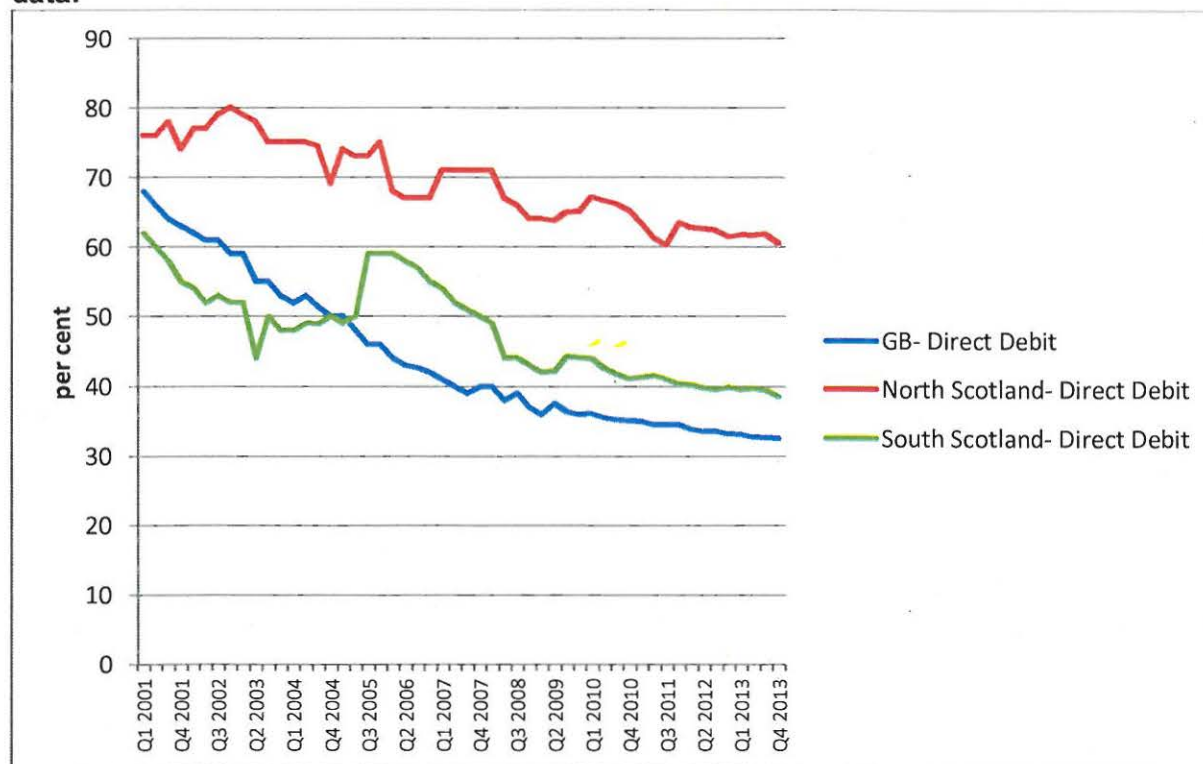
**Table 5. Proportion of home suppliers for standard electricity by payment type (2013).**

Per cent	Standard Credit	Direct Debit	Prepayment	All Payment Types
North Scotland	73	61	70	66
South Scotland	42	37	54	42
GB	44	33	38	37

Date source: DECC Quarterly energy prices Sep 2014 Table 2.4.1.

This suggests that electricity customers in Scotland have lower responsiveness to the price changes of energy than the UK level. For example, Figure 3 shows that as domestic electricity prices have increased in real terms, the proportion of home suppliers for standard electricity paid by direct debit has a clear downward trend. Customers in GB as a whole appear to be more responsive to these price changes than consumers across, albeit there are a number of factors which will affect changing supplier. There is a clear downward trend in the proportion of home suppliers for standard electricity by all payment methods across the GB have been falling over time. By contrast, the pace of switching away from home suppliers in North Scotland is notably slower in the past decade.

**Figure 3. Proportion of home suppliers for standard electricity by direct debit payment in North Scotland, south Scotland and Great Britain, 2001-2013, quarterly data.**



Data source: DECC Quarterly Energy Prices, Table 2.4.1, year 2001-2013.

Domestic gas consumers in North Scotland appear least sticky to home suppliers compare to South Scotland and GB level (see Table 6). The proportion of home suppliers for domestic gas by all three payment methods in North Scotland are lower than the GB level. However,

there are slightly more consumers in South Scotland, paying by standard credit and direct debit, who stay with their home suppliers than the GB average.

**Table 6. Proportion of home suppliers for domestic gas by payment type (2013).**

Per cent	Standard Credit	Direct Debit	Prepayment	All Payment types
North Scotland	42	22	28	28
South Scotland	59	36	38	42
GB	56	32	44	40

Data source: DECC Quarterly energy prices Sep 2014, Table 2.5.1.

### Off-gas grid households

Scottish House Conditions Survey (SHCS) 2013, found that approximated 15 per cent of dwellings in Scotland are not on the gas grid. This is largely due to the lower gas grid coverage in rural areas where more than half of all households are not on the gas grid (see Table 7).

**Table 7. Gas Grid Coverage Overall and by Urban/Rural Split.**

Gas Grid Coverage			Location			
			Urban		Rural	
	000s	%	000s	%	000s	%
On Gas Grid	2,033	85%	1,880	94%	153	37%
Off Gas Grid	369	15%	110	6%	259	63%
Total	2,402	100%	1,990	100%	412	100%
Sample size		2,725		2,106		619

Data source: Scottish House Conditions Survey 2013, Table 4.

According to the "Off-gas consumers" report from Consumer Focus<sup>6</sup>, 76 per cent of homes in Scotland are heated by mains gas. Rural consumers are particularly likely to use non-main gas heating fuels. 32 per cent of rural homes in Scotland use heating oil. 22 per cent of rural homes in Scotland are heated by electricity. Also, 22 per cent of urban homes in Scotland are heated by electricity. In Scotland, 82 per cent of high rise flats are heated by electricity.

Homes reliant on non-gas heating fuels have much lower energy efficiency standards than gas-heated homes. This reflects the higher heating costs associated with these fuels and the greater likelihood of such homes being older, detached and built with solid walls.

Proximity to the grid allows households to use gas for heating and hot water. Gas is currently the cheapest of the major commercial fuels, so gas grid access can have a strong effect on the costs that consumers face<sup>7</sup>.

<sup>6</sup> <http://www.consumerfocus.org.uk/files/2011/10/Off-gas-consumers.pdf>

<sup>7</sup> Scottish house conditions survey 2013.



## Heating costs for off-gas consumers

Consumer Focus "Off-gas consumers" reported the heating costs for fuel types. It is clear that heating costs for off-gas consumers are higher than the gas heating consumers. In some cases the heating costs can be twice or more (for example, Bottled LPG, electricity heating) than the cost of mains gas heating (See Table 8).

**Table 8. Heating costs for different fuels for a typical three bed semi-detached home.**

Fuel type	SAP 2009 fuel prices Pence/kWh <sup>i</sup>	Additional standing charges £	Cost of 18,000 kWh fuel only £ <sup>ii</sup>	Allowing for appliance efficiency <sup>iii</sup>	Total cost of heating with S.C. £
Mains gas	3.10	106	558	558	664
Bulk LPG	5.73	70	1,031	1,031	1,101
Bottled LPG	8.34		1,501	1,501	1,501
Heating oil	4.06		731	731	731
Smokeless coal	3.73		671	755	755
Wood logs	3.42		616	693	693
Standard tariff electricity	11.46	27	2,063	1,857	1,884
7 hour tariff – on peak	12.82	27	423	381	1,040
– off peak	4.78		703	632	
Gas communal heating	3.78	106	680	680	786
Bottled LPG	8.34		1,501	1,501	1,501

Data source: Consumer Focus "Off-gas consumers", Table 1.

Electricity is the second most common heating fuel in Scotland (see Table 9). While a higher proportion of off-gas consumers in Wales and Scotland use heating oil than England.

**Table 9. Proportion of housing in Scotland by heating fuel.**

Primary Heating Fuel	All Stock (000s)	Per Cent
Mains gas	1,870	78%
Electricity	316	13%
Oil	140	6%
Communal Heating	25	1%
LPG bulk or bottled	21	1%
Solid mineral fuel	19	1%
Biomass	7	0%
Other	1	0%
Sample		2725

Data source: Scottish House Conditions Survey 2013.

### Dynamic teleswitched meters (DTS)

According to Ofgem “The state of the market for customers with dynamically teleswitched meters”(2013), DTS meters are geographically concentrated. There were around 550,000 DTS meters in GB by 2012, located almost entirely in three regions: East Midlands (70.8 per cent), Northern Scotland (14.4 per cent) and Southern Scotland (14.8 per cent).

In Scotland, incumbent suppliers continue to have high market shares in DTS segment, above 93 per cent in December 2012<sup>8</sup>, while this figure in East Midlands is much lower (39.7 per cent). Data shows a higher degree of concentration among suppliers for domestic DTS meters customers in Scotland.

In Northern Scotland, where the incumbent, SSE, already has a 70 per cent share in the domestic market segment, this share increases to 93 per cent and 95 per cent for teleswitched and DTS meters, respectively. This is due to the presence of remote load managed areas and the lack of connections to mains gas.

In Southern Scotland, where the incumbent, Scottish Power, has a 47 per cent share in the domestic market segment, this share increases more significantly, to 87 per cent and 93 per cent for teleswitched meters or DTS meters. Scottish Power acts as the group code sponsor for all radio teleswitched meters located in the Southern Scotland area, being responsible for the switching instructions to these meters.

Incumbents’ market shares have barely changed in the teleswitched and DTS customer segment in the Scottish regions. This may raise concerns about barriers to entry into this market segment and the relatively limited switching options. Recent research commissioned by Ofgem reinforces this view; finding that the level of market engagement amongst DTS customers is generally low.<sup>9</sup> While competition appears to be less vigorous for DTS customers, they do not appear in general to be paying higher prices, although there are some exceptions, for example, high price of a specific DTS product in the Northern Scotland region<sup>10</sup>.

<sup>8</sup> Ofgem “The state of the market for customers with dynamically teleswitched meters”(2013), Table 2.

<sup>9</sup> Big Sofa, *Understanding the consumer experience of Dynamically Teleswitched meters and tariffs*. <https://www.ofgem.gov.uk/ofgem-publications/91291/understandingthecustomerexperienceofdtsmetersandtariffsfinalversion.pdf>

<sup>10</sup> Ofgem “The state of the market for customers with dynamically teleswitched meters”(2013)