ENERGY MARKET INVESTIGATION

Summary of hearing with SSE plc on 6 March 2015

Background

1. SSE was a listed company (FTSE 100) in the United Kingdom (UK) that was active in the UK and Irish markets. It focused on providing energy to its customers in a reliable and sustainable way and conducting its business in a responsible manner.

2. SSE's view was that the retail energy market in Great Britain (GB) was competitive as there were approximately 25 suppliers attempting to reach different types of customers with a range of different products. It had sought to react to consumer concerns about price by freezing its prices in March 2014. It had reduced its standard variable gas tariff prices by 4.1% in December 2014 as a result of market pressure and had also extended its price freeze until July 2016.

Market rules and regulatory framework

Dispatch and balancing

3. SSE considered that liquidity in the wholesale market had improved in recent years. Self-dispatch was the most economically efficient way of running the market. The forthcoming changes to the balancing and settlement system would increase the penalties on suppliers and generators who were not in balance, and it considered that parties were best placed to reduce their exposure to imbalances rather than a centrally-run dispatch mechanism. The way the market operated had stabilised after a number of changes in the past decade, but there were a number of further changes on the way, including the introduction of the capacity mechanism. Any significant changes to the basic operation of the New Electricity Trading Arrangements/British Electricity Trading and Transmission Arrangements (NETA/BETTA) trading system could reverse the gains in liquidity that have been made and the number of participants in the market.

4. SSE did not think there was any need to introduce a mandatory pool in place of the NETA/BETTA system. Large amounts of energy were being traded every day, and these amounts compared favourably with those traded in other

European markets. Liquidity in the market was good, and although there were a few reforms at UK and EU level that might reduce levels of liquidity (the Regulation on Wholesale Energy Markets Integrity and Transparency, the Markets in Financial Instruments Directive II (MiFiD II) and issues around the carbon support mechanism), the general direction of travel was and continued to be in favour of increasing liquidity.

5. SSE was not certain whether the forthcoming changes to cash-out payments under the electricity balancing mechanism would increase or reduce energy prices. It was generally in favour of these reforms as it thought the current system was too favourable to those who were out of balance and did not reflect the costs of actions taken to resolve imbalances. The new cash-out rules would much more accurately reflect these costs.

Contracts for Difference

6. SSE was reasonably happy with the design of the new Contracts for Difference (CfDs) system of support for low-carbon generation. The recent auctions that had taken place appeared to be driving competition between generators and resulted in reasonable prices. [✂]

7. It was possible for the government to influence the award of CfDs. SSE considered that some influence on the process was necessary to ensure that a range of different types of renewable energy were used. It might be economically right to give most support to say, onshore wind generation, as this might be the cheapest way for the UK to meet its carbon reduction obligations, but from a long-term strategic perspective, it might be better to ensure that other forms of renewable energy were also funded. The most important thing was that the system should provide certainty for investors in renewable generation. It was necessary to strike a balance between certainty and competition, while ensuring that the real costs of technologies were taken into account.

8. The market was currently in a period of transition between the new CfDs system and the old Renewables Obligation Certificate system. SSE was still planning to use the Renewables Obligation Certificate system for some of its more progressed renewable generation projects. [✂]

9. SSE had not participated in the recent round of CfDs auctions, but it intended to participate in future ones. Its view was that the current ‘three-pot’ system for the auctions would be in place while technologies matured and this was likely to mean it would continue for the next three to five years.

Capacity market

10. SSE thought that the capacity market was a good long-term (from 2018 onwards) way of ensuring security of supply. Its concerns about the market related to the period between now and 2018. It was not clear how the market would respond to the signals given by a relatively low capacity mechanism outturn.

11. The capacity market was new, and it was likely that various improvements would be made to it in future, but SSE thought that the first round of auctions had been a fair process. [✂]

12. SSE had participated in the recent capacity auction. Around 60% of its plant had been successful. The result had been in line with its expectations. Preparing a bid involved conducting a complicated analysis of the interaction of a range of prices and spreads. It had based its bids on what it believed to be its own economic costs. Participants in the market had learned from this auction, and would learn from subsequent ones, and would become more sophisticated in how they prepared their bids.

13. SSE did not know whether the new cash-out arrangements and the capacity mechanism could lead to some energy firms being double-paid. It had considered how the new cash-out arrangements would affect its plant when it was preparing its bid for the capacity auction, but this was only one of a number of significant factors in how it prepared its bid.

Possible changes to the energy market

14. It was likely that there would be further policy or regulatory changes to the energy market between now and 2018/19 that would affect the price of energy and the return energy firms received on their generation assets. For example, every time the carbon support mechanism was changed, the viability of different types of plant altered. SSE wanted the carbon support mechanism to be changed to provide more certainty. Also, the market was very concerned that if firms were found to be making supernormal profits, then there would be significant government intervention, and this also made it difficult for generators to be certain about what returns their assets would make.

15. SSE was concerned that any move to introduce locational pricing would be another change to the market, and as noted above, too much change discouraged investment. Locational pricing would increase complexity into the market, which could reduce liquidity and transparency and create zonal market or pricing. In any case, some of the issues that locational pricing might

be intended to address, such as balancing costs, were now beginning to be resolved by other means.

16. Locational pricing, particularly its effects on losses and constraints, would create more uncertainty around how energy firms could best meet the UK carbon and renewable energy goals. It would also be difficult to explain to retail customers. Adding complexity would create confusion for consumers and increase levels of mistrust in the market.

Market power in generation

17. SSE agreed with the CMA's initial view that generators, either individually or collectively, did not use market power to influence the generation market.

SSE's generation business

18. SSE's generation business's earnings before interest and tax (EBIT) for the period 2010 to 2013 had shown a significant decline from that for the period 2007 to 2009. Its shareholders expected to see its gas generation profitability improve, but it was not clear when this would be. [✂] It did expect that wholesale energy prices would rise at some point, but it was very difficult to predict when this would happen. The profitability of coal was dependent upon the government's carbon support scheme, and therefore could only be predicted up to two years ahead. It was also linked closely to gas prices, so there were a number of variables that had to be taken into account, which made predicting the profitability of coal very difficult.

19. SSE expected to invest around £1 billion in its generation capacity over the next four years. Much of its investment in new generation would be in wind. The costs of maintaining the coal plants, if running, would be significant. [✂] It was also involved in developing a carbon capture gas plant at Peterhead, but, if successful in the competitive process, this project would be funded with a CfD.

SSE's trading business

20. Liquidity in the market had steadily improved over the years. The greater role of exchanges, such as N2EX, had helped to increase levels. SSE was also supportive of Ofgem's Secure and Promote licence condition, which it considered had worked well. It was keen to see high levels of liquidity as this assisted it when selling the power it produced and buying the power it needed. The situation could be improved further. It would like to see increased use of exchanges by other firms. If high levels of liquidity could be achieved in the day-ahead market; then this would attract new participants to

the trading market, which could compensate for the lower level of trading resulting from the exit of financial players following the financial crisis. As noted above, regulatory stability would also help increase levels of liquidity.

21. SSE did not think that its strategy for trading wholesale gas and electricity would change greatly if its generation and retail businesses were to be vertically separated. It had been moving towards greater separation for some time. It had published consolidated segmental statements since 2009/10 and, with the introduction of a new IT system, expected to achieve full accounting separation in 2015/16. Both its generation and retail businesses would welcome greater liquidity and greater ability to hedge.

22. SSE agreed with the inquiry group's initial view that there were no opportunities for generators to foreclose smaller suppliers. It had contacted smaller suppliers about entering trading relationships with them, and it adhered to the Secure and Promote credit and pricing guidelines in its dealings with them.

Retail market

SSE's approach to fixed and standard variable tariffs

23. SSE did not currently offer greatly discounted tariffs in order to win customers as such discounts were not sustainable. In the 2000s, when it had offered large discounts to gain customers, this strategy had been backed by generation assets and contracts, but this was no longer the case. Since 2009/10 it had tried a range of other strategies to attract customers. Even though it did not currently offer large discounts to attract customers, doing so was an option it kept under review.

24. In 2014, SSE had offered a product for a short time with a 12% discount, which had attracted some customers, but competitors' discounts rapidly exceeded this as prices fell across the market. [✂] It had tried to broaden its appeal in a number of ways, including a partnership with Marks & Spencer (M&S), through which customers could get M&S vouchers. It also sold a broadband package that was available to both new and existing customers. Finding ways of delivering price benefits to customers without using large discounts was challenging. The rationale for large discounts could be difficult to explain to existing customers (notwithstanding that they were able to sign up to such tariffs).

25. Customers obtained by discounting tariffs were often less expensive to serve as these customers usually paid by direct debit. Existing customers would pay their bills in a number of ways including prepayment meters and would have

higher levels of bad debt. On a like-for-like basis, however, there was little difference between the indirect costs SSE incurred in serving these customers. SSE explained that, in current market conditions, direct energy costs were often lower for customers obtained by discounting tariffs than those customers on standard variable tariffs (SVTs). The forward looking position in respect of discounted offerings meant there was a cost advantage in respect of these tariffs that SVT did not benefit from.

26. The 12% discounted tariff that SSE had offered last year was for acquisition purposes. It was not an offer that was sustainable over the long term. Like other suppliers, when it offered a discounted tariff it knew that some of the customers it acquired would stay with it and move on to a different tariff that would be profitable for SSE. It was disadvantaged when competing with smaller suppliers as they did not have to cover the social and environmental levies that it and other large energy firms did.

27. SSE made a £48 margin on an average dual fuel domestic customer, where 90% of customers were on SVTs. Its fixed tariffs currently focused on price stability over a longer period rather than large discounts. It did not think that deep discounting was a sustainable model for its business. Smaller suppliers had the advantage of the exemption from the social and environmental levies that assisted them to quickly build their customer bases and obtain economies of scale. This was a strategy that it would find challenging.

28. SSE's policy was to be fair to all its customers, so when it had cut its gas prices by 4.1% this reduction had been available to all customers on all tariffs. It wanted to retain the customers it acquired, not just attract new ones, and treating all its customers in a fair way on price reductions was one way of doing this. It was also able to offer its customers other services, such as broadband, and various offers via its sponsorship of music venues such as the SSE Hydro in Glasgow and Wembley Arena, which helped to engage customers.

SSE's position in the market

29. As a privatised utility providing an essential service, SSE considered that it should act and be seen to behave as a responsible company. It was a Living Wage employer and also took pains to make sure that its corporate tax affairs were responsibly handled (it had been awarded the Fair Tax Mark).

30. SSE had discovered that it was not a well-known brand, so it had looked to raise its profile with consumers through television advertising and increased use of social media. It considered that its high customer service rating was an

important asset in attracting customers, but it had been difficult to get this across to consumers.

Pricing

31. In order to ensure compliance with Ofgem's Retail Market Review (RMR), SSE did not bundle its broadband offer as part of its energy tariff but presented it as an additional offer that customers could take up if they wished. Retention rates for customers when they moved from fixed to SVTs were very variable. When it supplied energy through its partnership with M&S, [✂]. The bonus for customers of the M&S product consisted of M&S vouchers [✂].

32. When deciding prices for its SVTs, SSE would look at a number of factors including a forward view of the wholesale price and what its hedging costs were and what they were expected to be in future. It also took into account other relevant costs and risks, and then set as competitive a price as it considered it could.

33. When deciding prices for its fixed-rate tariffs, SSE looked at where the market currently was and its costs. It would want to recover at least its short-term marginal costs on these offers but would be willing to consider some reduction to this as these offers were intended to acquire customers who might purchase other products from it and/or become long-term energy customers.

34. When SSE had introduced its frozen SVT offer, it was aware that this involved a considerable degree of risk that needed to be hedged. This involved locking in a large amount of costs until the end of 2015, and this had made it painful for it to recently drop its prices by 4.1%, which was why it had dropped prices later than some of the other energy suppliers. The large discounts that some suppliers were currently offering were due to a position where wholesale costs had dropped significantly below hedged costs.

Relationship between costs and prices

35. In order to acquire customers, in addition to offering good customer service and other attractive non-price features, it was necessary to offer a discount as an incentive to switch energy suppliers. SSE considered that the figures of between £158 and £234 quoted as potential gains through switching were not reflective of the savings most customers would achieve. The figure was measured at the mean, so the savings available to the majority of customers would be much lower. The figures also included savings that could be made by customers with their existing supplier (eg through a change in payment method) and so captured things that were not valid about customer switching. It considered that the suggestion that there were long-run discounts of over

£200 was highly misleading and looked forward to its advisers having the opportunity to interrogate the data underpinning the CMA's emerging analysis. Customer churn in the market, which was around 13%, was actually driven by smaller levels of discounts with many customers seeing potential savings of between £40 and £60.

36. In a competitive market, SSE would expect to see a reasonably close relationship between movement in costs, variable costs and tariffs. It argued that the CMA's analysis of this issue so far had not correctly taken into account the importance of indirect costs, which would affect the trend that the CMA had identified for margins and costs in its updated issues statement. It argued that if these indirect costs were taken into account then the gap between margins and costs would narrow. It also considered that Ofgem's estimates of suppliers' margins were inaccurate.

37. As far as economies of scale were concerned, these were generally marginal in SSE's experience. Suppliers' costs varied as they grew. For example, a new supplier with a growing customer base would have to expand its customer service facilities or change its billing system to meet increased demand.

Trust in the market

38. SSE thought that the current lack of trust in the market in part was down to the fact that retail prices had to include costs other than the wholesale price of energy, such as government schemes, use of system costs and investment in the network. It said the cost of government schemes had doubled while use of system costs had risen by 50% in the last five years. Also, the industry did have some practices, such as doorstep selling and cold calling, which tarnished its image. Since 2007, increasing energy prices had become a political issue, and even though politicians did not like rising energy prices, they had continued to add burdens to the industry. It should not be up to the energy suppliers to defend government policies that add to consumers' bills.

39. SSE noted the CMA's customer survey, which said that across the whole market around 70% of energy customers trusted their current supplier. This appeared to be at odds with the perception of the market as untrustworthy. Its own customer satisfaction scores were generally pretty high.

Attracting new customers

40. Most customers who switched to SSE had been on their previous supplier's SVT. However, many customers did not switch to its fixed offers but on to its

SVTs. It considered that the SVTs were also competitive. It was not correct that all competition was centred on fixed tariffs.

41. SSE sought to attract new customers through a number of channels, including price comparison websites (PCWs), direct sales, advertising and offers. It did not attempt to attract other suppliers' customers who had not switched recently as it could not differentiate these from any other customers these suppliers had. It considered that its SVT was fair. Politicians and the public were constantly telling energy suppliers that they should behave in a fair way, consistent with the requirements of an essential service. This sat uneasily with a position where some customers could achieve large discounts while others could not.

Smart meters

42. SSE did not consider that smart meters would be a silver bullet that would address the perceived problem of customer engagement but did feel they could contribute positively. In trials, smart meters had increased customers' awareness of their energy usage and made them more interested in switching their tariffs. It saw them as supporting a growing trend towards customer engagement with the market.

43. However, installing smart meters in every household in the country was going to be challenging and potentially very costly. It was possible that consumers' bills might increase significantly as a result so ensuring that consumers saw a substantial benefit from having and using smart meters was crucial. Based on previous experience of customer engagement work that the Department of Energy & Climate Change had undertaken, there would likely be a substantial number of customers who would positively engage with smart meters. There were other ways that suppliers could engage with customers, such as smartphone applications, which would advise them about their energy usage and costs, and which customers might find more relevant to their daily lives than in-home displays. Smart meters would provide customers with real-time information about their energy usage and costs, which would be worthwhile.

44. It might have been more efficient if the installation of smart meters had been the responsibility of the distribution networks rather than the energy suppliers. SSE considered whether the 100% coverage that the UK government had prescribed would be achievable in terms of the cost benefit analysis and referred to the European Union's 80% target coverage as more realistic. Given that many of its customers were in rural areas, there would be a disproportionate effect on it in meeting the UK target. It also noted that suppliers with customers in densely populated urban areas might have problems with the mobile network coverage required to make the smart

meters work. The UK was the only country where suppliers had the responsibility to install smart meters, which could lead to different suppliers visiting the same street many times to install them, while the distribution network might only have to do so once.

45. If the programme was conducted sensibly and costs were controlled; then smart meters would provide real benefits, eg reduced customer complaints about billing.

Regulation of the retail market

46. SSE considered that it was important that the energy market had a strong, credible regulator that could take action in a sensible, fair and proportionate way. It had tried to be as supportive of Ofgem as it could.

47. As far as Ofgem's RMR was concerned, SSE understood why Ofgem wanted to introduce these reforms, but it felt that parts of the RMR package had led to unintended consequences, in that they had been too prescriptive and prevented innovation that might have been beneficial to consumers.

48. SSE had particular concerns about the degree of prescription regarding the information that had to be provided on bills and annual statements and which set out in detail precisely how it and other suppliers should communicate with their customers. It felt that it and other providers were in a better position than Ofgem to listen to their customers and find out how they wanted to be communicated with. Its customers told it that they found the current layout of bills confusing, and it was working on designing a simpler version. It agreed with Ofgem that customers should be provided with clear and simple information that would allow them to make informed decisions, but the current regulations resulted in cluttered bills that consumers found difficult to understand. It would be reasonable for the regulations to say what the minimum amount of information that should be included on a bill was, but it should be up to suppliers to present that information in a way that their customers found most helpful.

49. SSE understood Ofgem's reasoning for introducing the four-tariff rule. It was a response to feedback from consumers that there were too many tariffs for consumers to compare and choose from. The way the rule had been implemented had restricted its ability to construct and bundle tariffs, which had limited its ability to differentiate its products and give consumers some products they wanted. The introduction of smart meters, which would enable the introduction of time-of-use tariffs, would require a relaxation of the current four-tariff rule.

50. Tariffs had proliferated in the wake of the restriction on discounts to out of (former Public Electricity Supplier) area customers (Standard Licence Condition 25A (SLC 25A)) as energy suppliers tried to attract new customers. SSE's customers had told it that it had too many tariffs, so it began a programme of tariff simplification. It noted that the large number of tariffs had become difficult for it to manage as well. Other suppliers had also simplified their tariffs around this time, so it was arguable that the industry had already been moving in the right direction when Ofgem introduced the four-tariff rule which eliminated a number of attractive offers, such as tracker tariffs and early and/or prompt payment discounts.

51. Under RMR it was no longer possible to have tracker tariffs, which were a popular type of SVT, so discounted products were restricted to fixed-priced products. It was no longer possible to offer a discounted SVT for acquisition purposes, as it was no longer possible to preserve an existing SVT product (ie close it to new customers whilst maintaining the price for existing customers on that tariff). Under the RMR, when an SVT was withdrawn from sale, all customers on that tariff had to be migrated to the cheapest live SVT.

52. SSE did not think that the introduction of SLC 25A had led to an increase in suppliers' margins. There had been a couple of price shocks in the 2000s, which had affected margins (resulting in negative margins in some years), so it would have expected margins to recover at some stage, whether or not SLC 25A had been introduced.

53. While the end of doorstep selling had changed the way SSE was able to reach some types of customers, it had found other ways of reaching them, for example by partnerships with trusted brands such as M&S. It was trying to attract every potential customer it could. [✂]

Future development of the market

54. SSE's view was that many of the smaller suppliers would remain in the market. It could foresee their having a collective market share of between 10 and 20%. Smaller suppliers were often more trusted by consumers, and they had cost advantages as they did not have to comply with all the regulation that larger suppliers did. Even though they would lose some of these cost advantages as they grew, it was likely that many of them would be able to adjust. To survive they would need sustainable business models and to be profitable.

55. [✂] SSE continually needs to develop ways to challenge other suppliers.

56. SSE bilaterally traded energy with smaller suppliers, and it had observed that a number of them seem to be becoming more sophisticated in terms of risk management and appear to be using longer-term hedging strategies, rather than thinking short-term. This implied that they were becoming more resilient against sudden wholesale market changes with an expectation that they would achieve longevity in the market.

57. SSE did not think that small suppliers' business models were necessarily in danger once they grew above a certain size and were no longer eligible for the exemptions from the social and environmental obligations. The very fact of their growth meant that they had significant numbers of customers, which should help them to survive. Also, some of the smaller suppliers were backed by larger companies, so it was unlikely they would all disappear. [✂] However, the market was changing, eg the introduction of smart meters, and it was likely that some smaller suppliers would be able to exploit these changes to grow their customer numbers.

58. Smaller suppliers also had the advantage of being able to recruit the type of customers they wanted: ie those who could use the internet, could pay by direct debit and were unlikely to have bad debt. They also had more flexible IT systems.

Price comparison websites

59. All the PCWs that SSE's tariffs were listed on were accredited by Ofgem's Confidence Code. The energy industry was held to a higher standard than others whose products were available on PCWs, so that customers could trust the information they provided. If energy consumers did not trust PCWs, this would damage their trust in the overall energy market. When it acquired a customer via a PCW, its reputation as well as the PCW's was as stake. If the PCW had not treated the customer properly; then it would fall to SSE to deal with any complaints the customer might have. The Confidence Code needed to allow PCWs to innovate while ensuring that customers were sufficiently protected.

60. SSE suggested that customers were best placed to judge the fairness of the methodology used to calculate how much a customer could save when switching, which was prescribed by Ofgem. Customers needed to understand the results and feel confident using them to decide whether or not to switch. Whether consumers understood and trusted the advice they received was at least as important as how the calculation was done.

61. If the Confidence Code or other types of regulation became too complex and prescriptive; then this might be unhelpful as it was incredibly difficult to be

overly prescriptive whilst retaining the spirit and intended purpose of the rules. For this reason, SSE favoured a move towards more principle-based rather than rules-based regulation of how energy firms dealt with their customers. There would be areas where prescriptive rules would be necessary, but in some cases, like RMR, the level of prescription had become too heavy-handed. It appeared that Ofgem's current management was minded to unwind RMR to some degree. There were a number of energy firms, including SSE, which were willing to do the right thing by their customers and hopefully this would become more apparent in future as a result of the actions suppliers were taking.

Settlement systems

62. SSE considered that the current gas settlement system, known as Reconciliation by Difference, did not work well for energy firms or their customers. Over the years, it had had to pay for large quantities of gas that it could not bill to customers as it was not reconciled at the meter point. Whilst this appeared to provide no incentive to suppliers to reduce consumption the industry had been successful in achieving around 20% reduction in consumption across the UK over the last five or six years. The situation had improved in recent years following the reallocation of losses between the domestic and business sectors. Moves were underway (Project Nexus) to bring the gas settlement system more in line with the meter point reconciliation system used for electricity. These reforms should lead to a fairer allocation between the industrial and domestic markets. The introduction of smart meters, which would enable half-hourly settlement, would improve the situation further.

63. SSE had also found that its customers who had trialled smart meters had reduced their energy usage. The introduction of half-hourly settlement was not essential for the realisation of all the potential benefits of smart meters, but it was important for many of them. Business customers were the next group of customers who would move on to half-hourly metering. Before migrating groups of customers on to half-hourly metering, it was necessary to consider whether the benefits and costs of doing so at a particular time made sense. At present, the costs of moving all domestic customers on to half-hourly settlement in a rapid fashion would outweigh the benefits.

64. The fact that the costs of various social and environmental regulations fell more heavily on electricity customers than gas customers probably did not create major distortions for competition between suppliers, but it did penalise consumers who had storage or electric heating as they paid more of these costs. This could affect customers' choices about the kinds of heating

systems they bought. It also had a disproportionate impact on potentially vulnerable and poorer customers. A relatively high proportion of customers living in small, electrically heated properties were in this category

Microbusinesses and small and medium-sized enterprises

65. SSE tended to treat all its small business customers the same regardless of their precise size, it was therefore difficult for it to comment specifically about microbusinesses, but it could do so about its small business customers in general. Small and microbusiness customers could have widely varying energy needs and were therefore a more diverse group than domestic customers. Its view was that its business customers, whether large or small, benefited from having fixed-price/fixed-term contracts.

66. SSE had between [✂] small business customers. When negotiating with a customer or a potential customer it would offer them what it considered would be a competitive quote. It would quote a price based on the costs of supplying energy to a particular customer. It no longer automatically rolled over business customers whose fixed-term contracts had ended onto new contracts. Instead it encouraged them to compare its quote for a new fixed-term contract with those available from other suppliers. Where a customer did not take up a new fixed-term contract with SSE or another supplier, it would stay with it on a different 'deemed' rate. It published its deemed rate on its website and would inform customers that they would be moved on to it if they did not take up a new fixed-term contract. The deemed rate would be higher than a fixed-term one in order to take into account of the risk that the customer might leave it and/or the increased possibility of bad debt. Around 5% of its business customers were on deemed rates.

67. Many of SSE's business customers used third party intermediaries such as brokers when comparing its prices with other suppliers'. It considered that for most businesses the process of obtaining quotes from a few suppliers, either by themselves or via a broker, should take a few minutes and not be onerous. Businesses seeking quotes from it could access these via third party intermediaries but would need to contact it directly to receive the most up to date quotes, as it continually revised its business tariffs in order to ensure they reflected wholesale prices and were competitive.

68. For small businesses and microbusinesses, SSE would base its quotes on the business's energy use profile and the region where they were located. It might also run credit checks for small and larger businesses, especially for those in sectors that tended to have higher bad debt risks. Every non-domestic customer, regardless of whether they were a large industrial and commercial or a microbusiness customer, had the same opportunity to negotiate the

renewal price. A lot of customers would simply accept the quote or switch to another supplier, however, in many cases, customers would enter into negotiation with it. Its marketing strategy for its business customer division was to run it in as low cost a fashion as possible

69. SSE thought that it would be possible for the PCWs to enter the small business market. If any did, it would be happy to provide them with rates on a daily/weekly basis. Precisely what the PCWs' business model for the small business sector would be, and how it might differ from that for domestic customers was not clear. PCWs would only enter this market if it would be profitable for them to do so.

70. Currently, the costs of supplying a business customer on a fixed price were lower than those for supplying a domestic customer.

Industry codes

71. Industry codes were necessary as they underpinned the operation of all parts of the energy market. Their complexity reflected the complexity of the overall market and the need to ensure it operated smoothly. There was merit in considering how they could be simplified in the medium term, and the introduction of smart metering was an opportunity for this, particularly as the implementation of smart metering would reduce the importance of some codes.

72. The codes' governance process was designed to take into account the interests of all participants in the market, and it was natural that not all participants in the market would agree about a particular change. Ofgem oversaw the process. The process involved in modifying a code was time consuming, and there might be ways in which it could be streamlined, but it would still be necessary for there to be such a process so that the evolution of the industry could be managed.

73. While engaging with the code governance process did require participants to commit resources, the process did not necessarily favour larger participants over smaller ones. There were numerous opportunities for smaller participants to make their views known during a modification process. Ofgem hosted small supplier forums at which these firms' views would be heard even if they were unable to attend meetings of the various code panels and working groups. As part of its oversight of the codes, Ofgem would act to ensure that any changes to them would be in the interests of consumers and competition.

74. Although Ofgem reviewed and approved the decisions of the various code panels, it also attended many of their meetings and participated in the

decision-making process as well. A number of reforms, such as changes to the gas and electricity cash-out rules, had been the result of Ofgem initiating a Significant Code Review process.

75. Simplification of the codes would be welcome, but only if it was able to significantly reduce their size and complexity. It should be noted that the industry also had to take account of EU regulations, and the objectives of some of these appeared to be contrary to those of Ofgem and the UK government (eg MiFiD II and Secure and Promote respectively). SSE was concerned about the effect of MiFiD II, which was currently under review and due to come into effect in 2017, might have on liquidity in the electricity market as it would require energy companies to ensure their trading operations were backed by large amounts of capital.

Profitability

76. SSE's profit margins had been lower prior to 2010 as it had been trying to gain customers during this period. From 2010 to 2014 profits for its domestic customer division ranged from 2.8 to 6.4% and averaged around 5%. Overall retail margins (including business customers) ranged from 2.3 to 4.9% and averaged 3.6%. Whether margins in electricity were higher than those in gas or vice versa depended on the differing levels of liquidity and costs in each market. Costs in the electricity market had increased significantly more than in gas.

77. SSE's objective was to ensure that it was competitive on its dual-fuel offering in the medium term. Margins varied for a number of reasons including weather and costs. It wanted to have a fairly balanced position between its margins on electricity and gas, but in doing so it needed to ensure that it did not put itself in a disadvantageous position on one of them, particularly in relation to costs (eg electricity).

78. SSE's tariffs were cost-reflective. While it took other factors into account, such as what its competitors were doing, it was ultimately the cost of energy that drove its prices and its profitability. When setting its dual fuel tariffs it tried to ensure that they were competitive but still allowed it to make a reasonable margin.

79. The market was very difficult to predict and had been affected by a range of external factors in the past few years, such as changes in the cost of oil, the recession, and events in Japan, the Middle East and Russia. Of course, weather also had a major effect on the market. SSE also noted that in 2010 it had negative margins on gas (–5%) and electricity (+8%), while by 2014 these

margins were (4.5%) and (3.4%) respectively. It was important to look at margins over a number of years rather than looking at one year in isolation.

80. SSE's margins for its large business customers were generally lower than those for the rest of its business. This was because of the volumes of energy it could sell were larger, and there were generators that were prepared to sell directly to these customers and did not charge fully for capacity. There were also a number of factors that made this market more volatile, and some other energy providers were willing to take on price risk on behalf of their customers and charge them for this, but SSE did not do this.

81. Other factors that added volatility to the large business market were changes to balancing charges (Balancing Services Use of System) and various UK and EU carbon reduction policies.

82. SSE had worked hard to become efficient and reduce its costs. It had done this by increasing its customer numbers, locating its offices in places where it was cheaper to do so, maintaining low levels of debt, working on running its business efficiently, especially its customer service provision, having relatively few layers of management, keeping staff costs down, being a UK and Ireland-based business rather than part of a larger European or global one, spending relatively little on marketing, and up until now, limiting its spending on IT. [✂]

83. SSE indicated that there were areas where it sought to make further improvements. It needed to ensure its IT projects were properly delivered and to increase its roll-out of smart meters, and re-focus on the practices, noted above, that had made it efficient in the first place. It had benefited from having few changes in its senior management during the past decade, so it had been able to pursue a consistent business strategy.

84. Each of the six large energy firms' costs and spending, eg IT investments, varied, so it was difficult to make comparisons between them. In a competitive market, it would be surprising if all competitors were pursuing the same strategies and had the same costs at the same time.