

ENERGY MARKET INVESTIGATION

Summary of hearing with ScottishPower on 13 March 2015

Background

1. ScottishPower's opening statements reaffirmed its view that a thorough, rigorous and authoritative investigation into the energy market was necessary to restore consumer trust and investor confidence in the energy sector.
2. ScottishPower believed that large energy firms did not have unilateral market power over its standard variable tariff (SVT) customers, nor that those customers should be perceived in the investigation as a separate market. Instead it thought the retail energy market should be considered as one single market with a competitive dynamic between all standard and fixed products.
3. ScottishPower felt it was the lifetime behaviour of customers switching between fixed and variable products that provided competitive pressure in the market and ensured suppliers' profits were not excessive.
4. ScottishPower expressed the view that competition and consumer outcomes had been adversely affected by the Office of Gas and Electricity Markets' (Ofgem) interventions over the preceding six years, notably the Retail Market Review (RMR). In particular, it noted that the limited number of tariffs permitted under Ofgem's regulations did not act in the interest of consumers and agreed with the criticism put forward by other parties regarding Standard Licence Condition 25A. It welcomed the CMA's intended focus on RMR and recommended it look critically at the issue.
5. ScottishPower supported the CMA's position presented in the updated issues statement regarding theories of harm 2 and 3, notably on the subjects of liquidity and generation

Efficiency of wholesale markets

6. On the subject of how the wholesale market was arranged, ScottishPower thought the system of short-run dispatch was close to being technically efficient. It also felt that the short-term market was liquid and active, with sufficient volumes in terms of the N2EX exchange (run by Nord Pool and NASDAQ) and the APX exchange to be confident that markets reflected current prices.

7. ScottishPower considered the self-dispatch model in the New Electricity Trading Arrangements made energy generators sharpen their competitive focus and invest to be able to respond more flexibly, using its 60-minute dispatch from its Rye House plant as an example.
8. ScottishPower felt that the move to a single cash-out price was widely supported both by the industry and Ofgem. It supported an interim move to PAR 100 as pursuing PAR 1 was uncertain, with too narrow a set of generators setting the marginal price, and PAR 500 too wide.
9. ScottishPower's view was that Reserve Scarcity Pricing would not work as it was not certain how often it would apply and what its effect would be – this uncertainty made it difficult to incorporate into an investment plan when assessing new plant. It believed it would not encourage investment and could lead to higher costs when plants broke down, costs that would probably be passed onto consumers.
10. ScottishPower supported Contracts for Difference (CfDs) as a way of supporting low carbon investment, and had been an active participant in the Electricity Market Reform. It noted that the Electricity Market Reform gave it the confidence to invest in offshore wind, such as in the East Anglia offshore windfarm.
11. ScottishPower supported the principle of the CfDs auctions, believing them to be reasonably competitive, and that government deals prior to the auctions were necessary to maintain momentum.
12. During the auctions for CfDs, ScottishPower adopted a bidding strategy by formulating a bid based on achieving a cost level and a certain return. It believed the auction process worked well.
13. ScottishPower expressed the view that the retained power for non-competitive CfDs arrangements for the future was probably necessary for nuclear and new technology.
14. ScottishPower believed that pots 1 and 2 would not be merged because of the need for technological differentiation. It said that despite being cheaper than most pot 2 technologies, there were limits to pot 1 technologies: onshore wind generation because of its perceived impact on the landscape and solar power because it generated little power in the winter when it was most needed.
15. ScottishPower noted that the lead-up to the capacity auction managed by National Grid and the Department for Energy and Climate Change was run smoothly. It said that it was a strong supporter of the capacity auction in principle and that it would continue to participate in future auctions. It

questioned what would happen to some plants as there was money being lost in generation from 2015 to 2019 as a result of the first auction's delivery year.

16. On the subject of demand-side response, ScottishPower felt that one-year contracts were too short for major projects, but that longer 15-year contracts would depend on whether companies could prove that they could provide demand-side response for 15 years and that the capital involved would need that long to recover.
17. ScottishPower did not take reserve scarcity pricing into account when forming its bids in the cash-out and balancing market. It felt it was too difficult to predict when high prices would occur, how often, and to what level they would reach, and thus how to incorporate such factors into bid prices.
18. ScottishPower expressed the view that there was not a compelling case for the cost of the capacity market to fall on a particular group of consumers. It was nonetheless content with the current system, where cost was borne slightly more by domestic customers than industrial.
19. ScottishPower noted that since the introduction of the British Electricity Trading and Transmission Arrangements in 2005 substantial charges had been levied on plant in Scotland due to locational pricing, which had a significant commercial impact on it. This came into conflict with the demand for on-shore wind turbines that could only be built in any serious quantity in Scotland in order to meet renewables targets.
20. ScottishPower mentioned that the need to 'constrain off' wind farms in Scotland was being alleviated by constructing the Western High-Voltage Direct Current Link, which was two gigawatts, and due to be operational in the summer of 2017.
21. ScottishPower was concerned with the competitiveness of energy generation in the UK as interconnection increased the availability of energy imports from Europe. Despite supporting interconnection and the efficient allocation of resources, it expressed the view that competitiveness was hindered by UK firms facing higher charges, namely: the carbon floor price, balancing costs, and transmission charges that applied to UK plants but not to overseas generators.
22. ScottishPower believed that the next two years of overlap between Renewables Obligation Certificates and CfDs were an appropriate transition to maintain investment and development.

Market power in electricity generation

23. ScottishPower measured profitability of its conventional generation business by earnings before interest and tax and return on capital over time, taking into account depreciated assets. It had faced declining returns in non-renewable generation. Returns for renewable energy generation had increased over the preceding years owing to significant investment.
24. ScottishPower did not perceive significant changes in the future returns on renewables unless there were large movements of wholesale prices. It predicted that return on capital employed for renewables would broadly stay at its historic level of [X]% but involve a lower cost as a result of competition.
25. ScottishPower felt that there was no mechanism to invest in energy storage in the UK. It had debated this subject with the Department for Energy and Climate Change officials and the Scottish government, and believed that electricity storage would require a support framework, due to the outlay of high amounts of capital and uncertainty of value in the future.
26. According to ScottishPower a large portion of profitability from its gas plants had come from ancillary services.
27. ScottishPower asserted that it did not make much money at its Cruachan plant due to peak versus off-peak prices, but rather on the flexibility of its ancillary services offering by being able to adjust the generation output or consumption (by pumping) very quickly.

Liquidity

28. ScottishPower considered that, for a generation business, operations would not improve with a fuller, longer-term market for shaping products. This was because each plant was considered individually by it, and was either on or off depending on whether it could make a positive contribution and sell into the market. If the generation portfolio were used to create a specific shape, then it would include a higher cost that would be passed onto suppliers and customers.
29. ScottishPower believed that for retail operations, a fuller longer-term market for shaping products might make it possible to provide more accurate and competitive long-term fixed products lasting from two to three years.
30. ScottishPower positioned its generation assets independently to the retail business, focusing on optimisation and maximising their contribution. It

believed that creating shape from its generation would entail an associated cost.

Incentives to compete

31. ScottishPower did not consider there to be two markets, one for SVTs and one for fixed tariffs, but one fluid market where customers moved between products. According to it, this was evidenced by the fact that, in an average week, [X] to [X] customers internally switched to fixed-products, with a total of [X] million of 5.3 million customers on SVTs.
32. ScottishPower felt the headline figure that [X]% of customers were on SVTs could lead to a misperception that downplayed the activity and engagement of its customers. It emphasised that of its [X] million customers on SVTs, [X] million were prepayment, and of the remainder close to half had been on a fixed term product in the preceding two years.
33. ScottishPower said [X] million of its non-prepayment customers had been on a standard variable tariff for over six years, but that there was no evidence that those customers were demographically unique or vulnerable when compared to the wider customer base.
34. ScottishPower felt that competitive pressure to acquire customers drove down prices for fixed-tariffs, which it was offering at discounted prices. This pressure also controlled the cost of standard products as customers moved between the two tariff types.
35. ScottishPower does not assess profitability by tariff type. When considering a new product, it assesses profitability over the lifetime that customers stay with ScottishPower. It also assesses profitability by payment method.
36. ScottishPower explained the process by which product pricing incorporated predicted lifetime behaviour of a customer, building into its pricing the fact that a certain percentage will default onto a standard tariff, actively choose a new fixed product, or choose a competitor and leave the energy supplier entirely.
37. ScottishPower noted that it looked at payment methods as the key differentiator of its indirect costs, whether by direct debit, prepayment or credit.
38. ScottishPower did not separate non-energy costs between standard variable and fixed tariffs, but rather by payment type.

39. ScottishPower's research, backed up by GfK research, led them to believe that price was the primary concern for customers – in addition to non-price features such as the quality of the website and customer service.
40. ScottishPower explained that the price differential for customers to switch tariff based on the GfK survey was approximately £100 higher than it had assumed in the past. It felt the price differential between SVT and products was also widening due to the fall in wholesale price being reflected immediately in fixed products.
41. ScottishPower acknowledged that price announcements have, in the past, stimulated the marketplace and influenced large numbers of customers to switch supplier. It offered acquisition tariffs that depended on the cost of energy it purchased up-front, permitting a fixed amount of customers to be acquired as all tariffs covered their variable costs
42. ScottishPower felt that new energy suppliers had hedged and priced at the bottom of the market, below the larger suppliers. These recent entrants had aggressively acquired new customers due to the declining wholesale prices and buying short term, but their future growth might be hampered by a less favourable wholesale market and the cost of abiding by the Energy Company Obligation.
43. ScottishPower felt that the model adopted by smaller suppliers, might not be sustainable in terms of building customer management systems, weathering volatile movements in wholesale prices, and meeting the requirements of Energy Company Obligation.
44. ScottishPower did not think that price drops prompted the same trigger for customers to switch as price rises, with the latter leading to more significant numbers of customers switching.
45. ScottishPower determined its future energy prices based on a forward-look at energy costs, environmental obligation costs, transportation costs and predicting how the market was likely to behave.
46. ScottishPower noted that there was a physical restriction on tariffs in the prepayment market due to the infrastructure supporting a limited number of tariff codes. The RMR prevented suppliers offering cash-backs, and thereby the ability to provide incentives for customers to switch by bypassing the restrictions of the prepayment system. Of its [X] prepayment customers, [X] were on a fixed product – despite the restriction of a limited number of tariff codes available for suppliers to deliver gas and electricity products.

47. According to ScottishPower, approximately [X]% of gains were on to SVTs rather than fixed-term products.

Price comparison websites

48. Most of ScottishPower's domestic customers had been acquired via five channels: price comparison websites, inbound telesales, outbound telesales, its website and a small number of energy advisers.
49. According to ScottishPower between [X] and [X]% of sales were via third party intermediaries. It believed that offering products through price comparison websites was necessary, despite the commission it charged, in order to retain existing customers and acquire new ones.
50. ScottishPower noted that it typically only advertised on Ofgem accredited price comparison websites.
51. ScottishPower emphasised that it could appreciate both the argument for improving clarity in the way price comparison websites showed tariff results, and to the need to maintain a viable business model.

Smart meters

52. ScottishPower expressed the view that new technology, such as smart meters, would affect the industry by improving customer service by providing accurate energy usage and prices, promoting tariff innovation and facilitating customer switching.
53. ScottishPower felt that smart meters were unlikely to feature prominently in the market until 2017, and would require timely investment to build the infrastructure to accommodate the large volume of data that smart meters produce.

Regulatory interventions

54. ScottishPower agreed that the framework of market regulation broadly determined how suppliers behaved and their interaction with the rules.
55. ScottishPower did not find any evidence to support the 'rockets and feathers' analysis made by Ofgem regarding costs and prices.
56. ScottishPower attributed its change in pricing behaviour from 2009 to new regulatory interventions and its effect on competition. Prior to 2009 it said that the average price of the SVT was brought down by competition between

incumbents and other suppliers on a regional level. After 2009 Ofgem prevented suppliers offering regional price differences, with competition shifting to offering discounted fixed-tariffs.

57. ScottishPower considered the four tariff rule introduced as a result of Ofgem's RMR not to be in the interest of the consumer as it limits choice, opportunity to innovate and the ability of suppliers to launch new products.
58. ScottishPower believed that customer engagement was driven by low prices and choice, not by tariff restrictions as imposed by RMR (which prevented suppliers offering the varied tariffs customers demanded). It said that Ofgem further hindered innovation with any derogations being 'by exception', from the rules laid out in RMR. This had the likely effect of preventing suppliers from benefiting from products that give them competitive advantage.
59. ScottishPower noted that the requirement by Ofgem to print on customer bills the possible savings by switching internally had had a significant impact.

Gas and electricity settlement

60. ScottishPower felt that without a package of reforms to the performance assurance framework, then changes ushered in by Project Nexus would fail to have the same impact as similar reforms had in the electricity market over the last 15 years.
61. ScottishPower believed that the governance arrangements around gas settlement had not operated in the best interest of consumers.
62. ScottishPower explained that gas and electricity settlement arrangements had diverged due to the prominence of gas network operators in governance panels. It felt that this did not provide an incentive to promote the viewpoint of domestic customers.

Microbusinesses and small and medium-sized enterprises

63. ScottishPower noted that the difference between domestic and microbusiness customers was that the latter signed one-year or two-year contracts during which suppliers could object to customers leaving and block them. It felt this was justified with large businesses owing to the purchase of significant amounts of energy over a long period. It noted that this was not the right approach for microbusinesses with domestic-level consumption.

64. ScottishPower said that the acquisition cost of a small business was five times that of a domestic customer, in part due to the cost of the third party intermediary broker system.
65. Of its business customers, ScottishPower stated that less than [X]% were on deemed tariffs, approximately [X]% on variable tariffs, and approximately [X]% on fixed tariffs.
66. ScottishPower had a pricing structure with individual contract rates for lengths of one, two, and three years. These were not visible online but were negotiated between itself and the customer – acquired through either inbound telesales, outbound telesales, or through a broker.
67. ScottishPower identified the lack of standard pricing being published as a barrier for price comparison websites operating in the microbusiness market similar to those in the domestic market.
68. ScottishPower made higher earnings before interest and taxes margin per microbusiness customer when compared to a domestic customer. A reason for this, as identified by it, was that the broker system of acquiring customers, and the greater ability to block switches, dampened competition between suppliers.

Industry codes

69. ScottishPower felt that the principles of the system of governance for industry codes were appropriate, though there were areas in need of improvement.
70. It recognised that the system could be difficult for new suppliers and supported more help so that such suppliers could engage better with the system.
71. ScottishPower believed, given both the technical nature and the potential distributional impacts of code modifications, that the principle of having checks and balances for market participants was important.
72. ScottishPower considered that Ofgem having plenipotentiary powers to overrule governance panels might lead to poor decision making, observing that the CMA had itself questioned Reserve Scarcity Pricing and PAR1. It was the threat of a judicial review more than the governance itself that inhibits and lengthens the decision-making process.
73. ScottishPower acknowledged that the complexity of code governance and the resources required for participation in the panel posed a difficulty for small suppliers, but it also drew attention to the varied and diverse make-up of

those who attend: trading parties, suppliers, transmission companies, and independent members. Large, critical computer systems were involved and it was essential that the proper expertise was brought to bear on proposed changes.

74. ScottishPower felt that despite the appropriateness of the principles that underpin code governance, there were still ways to improve the governance, including through changes to the membership of code panels, possibly merging codes, standardising working processes across panels, and making Ofgem's involvement more timely.

Retail profitability

75. ScottishPower had taken a hit on its retail profitability in 2011, which led to a change in its hedging strategy. Prior to 2011 its retail demand would be hedged by three years – which proved detrimental in the market of low prices.
76. ScottishPower felt that it was not a good idea to increase transparency of suppliers' hedging strategies as it would end their ability to try to gain a competitive advantage through superior hedging.
77. ScottishPower believed that a benefit of long-term hedging, beyond the requisite period necessary to change tariff pricing, was to smooth market volatility and absorb shocks in prices.
78. ScottishPower reported that it had retrospectively reviewed the benefits of hedging compared to purchasing at spot prices and concluded that hedging on average had proven beneficial.
79. ScottishPower said it had changed its hedging strategy since 2011; resulting in a shorter, more dynamic approach that was reviewed more often than before.
80. ScottishPower felt that low indirect costs had been achieved via an efficiency drive, by building a more dynamic workforce, offering voluntary severance and early retirement, whilst outsourcing call centres. It said that its improvements included better procurement procedures, investing in a new billing system, reducing customer debt, and offering self-service through its website.
81. ScottishPower believed that smaller suppliers faced lower costs because their customer base did not include as high a level of costly customers such as prepayment, that they served more direct debit customers, and had few legacy issues such as mismatched meters.