CMA
Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with Centrica on 25 March 2015

Introduction

1. The effective and efficient supply of natural gas and electricity to customers in the UK was complex, but the markets were functioning well with the residential and business (business-to-business) markets benefiting from a large choice of suppliers, as well as third party intermediaries including brokers and switching sites.

2. Centrica noted that the effective operation of competitive markets was of vital importance to it given how extensively it interacted with them for both its upstream and downstream businesses. In its view, competitive markets, within stable consistent and appropriate regulations, delivered the most efficient outcomes for customers. However, the UK market had been subject to significant and frequent regulatory and political intervention in recent years which it considered had the potential to impact effective competition. Regulatory and political intervention had been particularly pronounced in the retail market, creating instability and inconsistency for suppliers and customers.

3. Centrica noted, however, that the market was not well understood by the general public and levels of trust in the energy system were low. There was confusion and distrust among customers who believed that rising bills were caused by our rising profits – when in fact the increases were largely caused by increased wholesale prices, transmission and distribution costs, and government environmental levies.

Market rules and regulatory framework

Dispatch

4. Centrica's view was that there was, in practice, little difference between a pool system and the current New Electricity Trading Arrangements (NETA). The advantage of NETA was that the responsibility for balancing fell to the market participants who had the best information about the behaviour of their assets and customers. The NETA system was highly transparent as well, and Centrica thought that prices and short-run marginal costs were in line with

what would be expected when factors like plant efficiency, merit order and input costs were taken into account.

5. Centrica's opinion was that the wholesale market worked well. Any case for changing to a pool/central dispatch system would need to show that there would be great benefits to be gained from doing so as the cost of changing would be very high.

Balancing and cash-out

6. Centrica supported the move to a single cash-out price. It also thought that the move to a sharper imbalance price was positive but that going straight from basing that price on the most expensive 500 megawatts to the most expensive 1 megawatt would be too volatile and could lead to pricing that did not accurately reflect the costs of the plants in the system. A phased approach, perhaps with a first move to a price based on 100 megawatts would be a better idea.

7. Centrica had some high-level concerns about reserve scarcity pricing as it was trying to correct for administrative actions (Short-Term Operative Reserve) that had been taken outside of the main functioning of the wholesale market. The same was true for the Supplemental Balancing Reserve. Its preference was for market solutions to issues like pricing and ensuring security of supply. Prior to having to address the issue of decarbonisation, the market had dealt with these sorts of issues well. The European Union's Emissions Trading Scheme (EU ETS) had been well-designed, but there was no political will to allow the price of carbon to rise to the level needed to encourage switching to lower-carbon generation methods.

8. Therefore, in order to meet the carbon reduction agenda, the UK government had set up the Renewables Obligation Certificate mechanism and had now replaced it with the Contracts for Difference (CfDs) system. This was a non-market solution that affected the operation of the energy market, specifically by subsidising renewable generation and, as a result, making gas-fired generation uneconomic. In order to address this problem, the government had then created the capacity market mechanism along with ancillary markets such as Short-Term Operative Reserve and Supplemental Balancing Reserve, if the EU ETS was allowed to work properly, the energy market would address these problems. While the wholesale market worked well and produced accurate prices today, in the longer term less and less of the electricity price would come from the wholesalers of electricity, and more would come from CfDs or capacity market contracts.

Contracts for Difference

9. Centrica was in favour of the introduction of competition in the allocation of CfDs. It accepted that during the transition to CfDs the government should have had a power to award some CfDs outside of the competitive mechanism, but it had been surprised by how much of the CfDs budget had been taken up by these interim CfDs. It also noted that a large wind farm project (Race Bank) led by Centrica had not received an interim CfD, [✂]. The competitive auction would help to reduce prices for renewable generation and was similar to practices in other countries. It was concerned that the government retained a residual power to award CfDs outside of the auction process.

10. Centrica had pulled out of its Race Bank project because of its failure to be awarded an interim CfD. [✂]

Capacity market

11. Centrica considered that demand-side response technology would enable more efficient balancing in future. However, it was difficult to predict how quickly it would become an integral part of the energy system and how much energy it would be able to save, while the output of a power plant could be determined. For this reason, while at present it was possible to award long-term contracts for power plants, it was much more difficult to do so for demand-side response providers.

12. Centrica had concerns about interconnectors being allowed to take part in the capacity auction. While it would be wrong to completely exclude them, it was difficult to assess how much capacity an interconnector could really provide as this would vary depending on energy consumption in other countries.

13. Centrica thought that the capacity auction had been well designed and well run, but it had concerns about how the government decided how much capacity it needed. If the capacity requirement was set too low, then the result of the auction would be plant closures rather than new generation capacity being supported. The policy behind how government set the requirement was crucial. If the policy was to ensure that supply met demand, then the forecasts used to set the capacity requirement should be right. If the policy was to keep prices low, then the forecasts would likely be too low and there would not be enough generation capacity.

14. Centrica had participated in the recent capacity auction. Two of its plants had been successful, but the failure of its other plants would lead to their closure. The price which the auction had generated had also been much lower than anyone had predicted. The fact that relatively little new build had been

attracted by the capacity auction was worrying. Also, the auction may need to evolve to have longer-term contracts to support significant capital assets to make it workable in the longer-term.

15. As far as any interaction between the capacity market and cash out prices from the balancing system were concerned, [✂].

Locational pricing

16. Centrica's view was that there were a number of factors, eg transmission, build, and losses and constraints, which introduced elements of locational pricing into the current system. It commented that if transmission charges changed for CfDs supported generation, then subsidy payments under CfDs would have to change to compensate, introducing an element of circularity. Wind farms were built in rural areas because there was sufficient wind and relatively little impact on people. The advantages of building them in these areas would need to be weighed against the costs this incurred. Cost-reflective pricing was generally a good thing, but introducing more locational pricing could lead to a more complex and geographically divided market with risk of diluting liquidity by creating zones rather than having a single market. It was a potential change which ought to be kept under review.

Generation

Market power

17. Centrica agreed with the CMA's initial assessment that the generation market was not characterised by the use of market power by one or more participants. The ownership of generation assets was fragmented and diverse, and this meant that any attempt to withhold generation capacity was unlikely to succeed. There was also a large amount of transparency, and it was possible to easily find out what generation plant was operating on a real-time basis. The Regulations on Wholesale Energy Markets Integrity and Transparency regulations meant that participants had to keep the regulator informed as to plants' status, and there were penalties for any attempt to manipulate the market.

Profitability

18. [✂]

19. Currently, there were few periods of time when the price of energy generated by Combined-Cycle Gas Turbine plants was significantly higher than the marginal cost of operating them, so there were few times when they could be

run profitably. This was in part due to shale gas and cheap coal entering the European market and the fact that carbon emission prices were too low.

20. [✄] It was a minority shareholder in a number of nuclear plants, and while it did not operate them, it was responsible for a share of the investment required to keep them operating. Centrica was currently conducting a major strategy review, [✄].

21. [✄]

22. [✄]

Liquidity and vertical integration

23. Centrica agreed with the CMA's initial assessment that there was sufficient liquidity in the markets to enable all energy suppliers to access the energy they needed and that competition was not being distorted. It noted that some smaller suppliers had argued that there was not enough liquidity to allow for the existence of long-term shape products, which would be helpful in reducing risk. It argued that the reason these products did not exist was because it was very difficult to predict shape six months to two years out for a variety of reasons (eg number of customers, weather). Short-term liquidity in the market was sufficient to allow suppliers to trade to create the shape they wanted nearer time of delivery.

24. Centrica noted the argument that it was easier for vertically integrated suppliers with substantial generation assets to achieve shape. It noted that, even from a theoretical viewpoint, it only had enough flexible generation that could provide shape for [✄]% of what British Gas needed, even if it used them in this way, so it was reliant on the wider market to manage its shape. A supplier with detailed knowledge of its customer base would still not be able to make long-term predictions about shape.

The retail market

Pricing and competition

25. Centrica highlighted the exposure to volatile global commodity prices and the resultant management of complex price and volume risk that was largely borne by suppliers that committed to providing secure and on-demand supply of an unknown future volume to be consumed by customers at a retail price set in advance and to manage the risk arising from that commitment (essentially therefore providing customers with a 'call option'). Standard variable tariffs (SVTs) smoothed out the volatility in the underlying wholesale

costs, in contrast to fixed-term tariffs, which exposed the customer more directly to the near-term wholesale price (with potentially significant changes in price at the end of the fixed period). These differences gave rise to very different outcomes under particular circumstances, such as when wholesale gas prices moved dramatically as it had seen over the last year.

26. Centrica's view was that there had been four distinct phases in the development of the retail market. From 1997 until the first half of 2008, the market had been characterised by liberalisation, acquisitions of GB energy firms by continental companies, the removal of price controls, and competition and switching focused on SVTs. Suppliers were loss-making through much of this period. In the latter half of the period, due to rising commodity prices, fixed tariffs began to be offered at a premium to SVTs. The second phase, between the second half of 2008 and the first half of 2011, saw a major commodity price spike in 2008 that led to most suppliers moving to longer-term hedging strategies. The economic downturn led to a focus on the affordability of energy bills and an increase in regulation of the market through measures like Standard Licence Condition 25A (SLC 25A). At the same time, an explosion in the number of tariffs ultimately led to the introduction of the Retail Market Review (RMR). Customer service improved during this period, and switching levels began to fall. The third phase, from the second half of 2011 to the first half of 2013, saw increases in commodity prices and fixed-price tariffs generally being priced above SVTs. Switching declined further with the phasing out of door-to-door sales, and suppliers began to narrow their product ranges in response to consumers being confused by large numbers of tariffs. The fourth phase, from the second half of 2013 to now, had seen the introduction of RMR and the four-tariff rule, increased political interest in the market, declines in commodity prices, and deep discounting of fixed tariffs and the growth of price comparison websites (PCWs) and collective switching leading to higher switching rates.

27. Centrica had a very broad customer base, and its customers' needs varied widely. Over the different phases described above, customers' preferences for SVTs and fixed tariffs had changed. It had needed to respond to the changes in order to grow its market share. Around [✂]% of its current group of SVT customers had previously been on a fixed tariff. The SVT was a product that some customers had always preferred. Its research had found that, typically around [✂]% of customers preferred SVTs to fixed tariffs all other factors being equal. Customers who preferred SVTs gave a number of reasons for doing so, including flexibility and ease of budgeting. Customers actively chose SVTs or fixed products depending on their personal circumstances and the majority of customers, according to the CMA's survey, believed they were on the right tariff for their needs.

28. The relative pricing of fixed and SVT products had varied over time. [✂] For the past few years, as commodity prices had fallen, fixed-price products had been cheaper than SVTs. At various times in the past, customers moving from one fixed tariff to another would have experienced very large increases, while SVT customers would have experienced more gradual changes in prices.

29. Centrica considered that its SVT was the first reference point in the market for judging competitiveness, and it sought to ensure its SVT was competitive, though how competitive it had been had varied over time depending on the success of Centrica's hedging strategy, its cost structures and the behaviour of the commodity market. Currently, its British Gas branded fixed tariff was only 5% lower than its SVT, but its white-label Sainsbury's fixed tariff was significantly lower. Centrica and Sainsbury's would jointly decide on the level of this tariff, although Centrica had the final say.

30. Sainsbury's product was different to British Gas's in that it was direct debit only [✂]. Also, some customer service measures that were part of the British Gas brand (eg no smart meters) were not part of the Sainsbury's offer.

31. Centrica had a multi-year contract with Sainsbury's [✂].

32. Centrica's approach to discounting had varied over time. [✂] Customers' decision making reflected both price and non-price reasons. It had gained new customers in the first quarter of 2015 and around [✂]% of these had joined on SVTs. There were some cost advantages to serving dual fuel customers, and the discount it offered to its customers of around £15 reflected this. It was working on sending its dual fuel customers single bills.

33. [✂]

34. Whether smaller suppliers that had entered the market in recent years would prove to have sustainable business models in the long-term depended on a number of factors, including their financial backing and their relationships with commodity suppliers. Centrica's view was that the majority of new entrants were better placed to survive a commodity price shock than their predecessors had been a few years ago. The current gap between discounted fixed products and SVTs was large, but it would likely narrow over the next 12 months if commodity prices stayed low, [✂]. Smaller suppliers were also able to offer cheaper tariffs because they were exempt (to varying degrees) from certain environmental and social obligations. Smaller suppliers could also decide to target particular groups of consumers, eg those that could pay by direct debit, and this allowed them to reduce their risks. It was likely that, so far as they could, smaller suppliers would continue to compete by offering lower prices.

35. Centrica had removed exit fees from its British Gas fixed-tariff products in September 2014. Its Sainsbury's fixed-tariff products kept exit fees [✂]. It had noted consumer reluctance to enter into fixed contracts with exit fees, so it had decided to address this on its British Gas products by removing the fees and reducing the discount from the SVT.

36. Price was not the only factor when customers chose a tariff. Some customers would not feel comfortable having a fixed tariff if they rented or thought they were likely to move home in the near future. A number of Centrica's SVT customers had gone onto fixed tariffs for a time, then moved back to SVT. It informed its customers when their fixed tariff was likely to end, so customers were aware that they would move onto an SVT if they did nothing. [✂] It thought that this was due to increased competition, heightened media coverage and the government's switching campaign. It was not clear whether this indicated a long-term change in customer behaviour or was just a short-term event.

37. Looking ahead, while there were aspects of previous stages of the market which might reappear in future, it thought it unlikely that the market would revert back entirely to one of these stages due to changes in customer behaviour and the stronger position of smaller suppliers.

38. The SVT was based on a series of hedges bought gradually over time ahead of delivery. Unlike the petrol market, where customers bought a small amount of their annual total each time they visited a pump and consumers had a choice as whether to buy or not, energy customers needed to buy energy and they bought it in larger chunks, so a pricing method like SVTs, which spread costs and helped them to budget, was what they preferred. The risk of volatility in the wholesale energy markets was very high, so many consumers wanted a product that managed this volatility for them.

39. When looking at how SVTs were priced it was necessary to look at pricing over years rather than a few months, as this could give a false impression of the link between the wholesale and retail markets. It was necessary for Centrica to buy some of its energy significantly in advance of its being sold to consumers in order for it to ensure security of supply. [✂]

40. Centrica's pricing strategy was primarily concerned with competing in the market. Its costs were a factor in how competitive it could be at any one time. These costs included not just energy costs but also operating and non-commodity costs, which were now a larger part of the bill than in the past. It had reduced its costs to improve its competitiveness. Over the past eight or so years, it had removed around [✂] of costs.

41. When Centrica cut its SVT in January 2015, it had decided to do so for competitive reasons, ie to retain and gain customers, in doing so it took a risk that commodity prices might rise in the near to medium term. There was also a political risk arising from the forthcoming general election and the threatened Labour party's price freeze. Prior to it announcing its price cut, E.ON announced one of its own, and it appeared to it that E.ON had likely been considering similar issues. Its decision to cut its SVT in this instance had been driven by price and competitive position, rather than cost. It had also made a price cut for similar competitive reasons in 2012.

42. Centrica's customer losses were mainly through switching sites. It gained customers, including SVT customers, from a number of different sources, including collective switches. [✂]

43. Centrica had generally not pursued a strategy of offering short-term highly discounted products at the same time as changes in SVTs.

44. Centrica did not consider that the 'rockets and feathers' criticism of how suppliers set their prices applied to it. It passed on reductions in price to its customers as soon as it was able and avoided passing on increases as long as it could. It noted that the clear conclusion of work done by its economic advisers (CRA), which had been submitted to the CMA (comprising an empirical assessment of how prices and costs have evolved), was that there was no evidence of rocket feather pricing for Centrica. It had reduced its prices five times since 2009 and had always been the first or second supplier to do so. It tried to ensure that it was competitive overall across all its tariffs, not just on its fixed offers. [✂]

45. If in future, a large majority of Centrica's customers moved to fixed tariffs, this would change its risk profile and its collateral requirements. In such a scenario, it would change its wholesale purchasing strategy to ensure it could cover its fixed-tariff customers, but this would not protect it from the risk of increased gas usage should the weather be colder than expected.

Margins

46. Of the six large energy firms, Centrica had had the highest average revenue per kilowatt hour on gas [✂]. It believed that margins on gas were usually higher than those on electricity for several reasons (including price risk and volume risk (gas demand was highly sensitive to weather and more so than electricity) and it was much more exposed to gas than its competitors). It had also pursued a strategy of low electricity pricing in order to win customers from its competitors and get them to take up its dual fuel tariffs. Its six large

energy firm rivals had generally pursued a similar strategy for their gas prices, in the hope of obtaining customers from it.

47. Centrica had noted the chart in the CMA's updated issues statement, which suggested that the gap between energy suppliers' costs and margins had widened between 2009 and 2014. It argued that when its actual costs were added, instead of those estimated by the Office of Gas and Electricity Markets (Ofgem), there was little if any widening during this period. Going back to 2007, many energy suppliers' margins had been very low, so some widening between costs and margins for the industry was not unexpected.

48. If direct and indirect costs and Centrica's hedging strategy were taken into account; then there had been little, if any, widening of the gap between costs and revenues. Its overall post-tax profit per customer over the past eight years had been approximately £50.

49. The extent of economies of scale had changed over time due to the introduction of new technologies. Previously, billing was one area where economies of scale were significant, but the introduction of off-the-shelf supplier administration systems had reduced their size. Economies of scale being greater in the past had arguably partly led to small suppliers being exempt from various environmental obligations, such as the Energy Company Obligation. Centrica suggested that for large suppliers like itself, any economies of scale in areas such as billing were likely cancelled out by the costs of complying with environmental and social legislation. It highlighted the diseconomies of scale associated with meeting the environmental obligations (ie finding the incremental property).

Standard variable tariff customers

50. Around [✂]% of the customers Centrica gained were on their SVT. These customers were not obtained via PCWs, but via a number of other channels, such as inward and outward bound phone calls, house builders with new supply points, people moving house, relationships with housing associations and a small amount of face-to-face sales.

51. Some of Centrica's customers preferred its SVTs to its fixed products for a number of reasons including reassurance against sudden large changes in price on renewal, wanting to be able to budget easily, wanting to retain flexibility should their circumstances change and not being tied to a contract. Even when customers were offered cheaper fixed tariffs, some would choose the SVT because they wanted to stay flexible and experience price changes in a gradual way.

52. Centrica might have higher numbers of new customers on its SVT because of its relationships with house builders and housing associations. When a new house was built and supplied by Centrica, the initial tariff would be the SVT, and housing associations tended to prefer prepayment meters and SVTs. It had worked hard to engage house builders with the right proposition, for example by installing smart meters in the homes they built.

53. Around [✂]% of Centrica's gas customers had been with it for ten or more years. Customers decided to join and stay with it for a number of reasons: price, tariffs that suited their needs, service quality and advice about consumption. It was giving increasing amounts of advice to its customers about how they could better manage their consumption. It had also introduced ways that customers could measure and compare their energy use, such as a tool on its website, the 'My Energy' report, and via the initial rollout of smart meters as well as Hive. It also regularly contacted customers about whether there might be a better tariff for them. Customers valued the familiarity of the British Gas brand and the stability associated with it. All of these measures were offered to customers regardless of the length of time they had been with Centrica.

54. Centrica did not break down revenues from its gas customers by how long they had been with it. It did analyse its customers by socioeconomic criteria, and its analysis had reached different conclusions from the survey carried out by the CMA. Its analysis suggested that its SVT customers were less likely to be retired, and it had not found the difference in income and educational profile between SVT and fixed tariff customers that the CMA's research appeared to have done. It did note that many customers aged over 75 preferred to pay by cash or cheque so were not obtaining any direct debit discounts.

55. Centrica noted that the proportion of renters on its SVT was higher than on the rest of the base. As far as the overall number of customers on its SVT was concerned, [✂]% of the current base had been on another tariff previously. Internal switching also needed to be taken into account. Around [✂]% of customers that it contacted about their tariffs switched to another Centrica tariff, which were often cheaper fixed tariffs. Customers were increasingly responding to being prompted about cheaper tariffs.

56. Of Centrica's original customer base of 19 million customers in 1997, only [✂]% had not changed their status in some way. Of the [✂]% which had changed, [✂]% of these had moved to its competitors, while the remainder had been active in some other way, eg had changed their tariff or switched to dual fuel. Of the [✂] gas only customers who still lived at the same address they did in 1997, [✂] had changed their tariff or payment method, so there

were only around [✂] customers who still had the same arrangements they had in 1997. Approximately half of these [✂] customers had opted out of British Gas contacting them about offers. It tried to contact this group in other ways, eg via Nectar cards and online advertising.

Consumer engagement and smart meters

57. Consumers increasingly wanted to have more control of their energy consumption and their bills, so they needed to understand how much energy they were using and how they could control their use. Smart meters and tools like Hive Active Heating gave consumers more information about their use and were also a means of competing for customers. Centrica felt competitive pressure from within and outside the energy sector, and it was now necessary to compete on service and technological innovations, as well as on price.

58. Centrica considered that smart meters would increase customer engagement and had been pleased that the Department for Energy and Climate Change had confirmed that the rollout of smart meters should be completed by 2020. Around 60% of consumers should have a smart meter by 2018. Centrica's evidence suggested that if the benefits of smart meters were communicated to consumers and the technology was straightforward for them to use; then their energy usage would drop by an average of around 2.5%. Smart meters would also improve the accuracy of billing, so reducing complaints and improving overall customer satisfaction. It also planned to launch a smart 'pay-as-you-go' product later this year, which it believed would be attractive to customers.

59. Centrica's initial rollout of smart meters had given it valuable experience in learning how to teach customers about the meters' benefits and about what support, including after care, it was necessary to provide, particularly for older customers. The in-home displays on its smart meters could express energy use in pounds and pence, which the vast majority of customers found more useful than units like kilowatt hours, which was how bills were expressed.

60. Although customers' use of smart meters tended to reduce the amount of energy they bought from Centrica, it saw smart meters as a way of winning and retaining more customers in the long term. That customers would have and would expect to have more information about the amount of the energy they used and their bills was inevitable, so its strategy was to use this information and the technology that supported it to build relationships with its customers.

61. Feedback from Centrica's smart meter and Hive customers said that they regularly engaged with their meters, often on a daily basis. Around a fifth of

these customers also had a better perception and an increased affinity for British Gas. It considered that it would have to keep its service quality at a high level to retain these customers.

SLC 25A and RMR

62. When SLC 25A was introduced, Centrica observed that the differential between in-area and out-of-area tariffs narrowed by around £10, and that this had some effect on the intensity of competition. How much of an effect was difficult to determine because it enabled short-term introductory offers at the same time and there was a sharp increase in the number of tariffs.

63. Following the introduction of SLC 25A, discounted online tariffs became a significant driver of switching activity. This led to tariff proliferation. By 2011 Centrica was offering around 12 tariffs, but feedback from customers that they found the number of available tariffs confusing led the market to start to self-correct and it reduced its number of tariffs to six tariffs well before the introduction of RMR. Its view was that the market was already addressing the proliferation issue before RMR was introduced. It noted that during the period of tariff proliferation, there was still significant competition on SVTs. Its tariffs had been particularly competitive during this period due to other suppliers raising their prices because of SLC 25A and its own strong hedging position.

64. RMR had helped to increase transparency and simplicity in some respects, but in others, such as the amount of information required on bills and the prescription of telephone scripts, it had not. Centrica would have preferred a larger number of tariffs being allowed, say six or seven, allowing a green tariff, possibly a tracker and an alternative SVT with a different standing charge to appeal to low-usage customers. The withdrawal of cash incentives had reduced incentives to switch and reduced the effectiveness of telephone and door-to-door sales. It had managed to introduce fixed-term, fixed-price products for prepayment customers. New entrants had probably not been as keen to compete for prepayment customers because of the cost structure, the complexities of management and the perceived difficulties of introducing fixed tariffs.

Price comparison websites

65. Centrica was supportive of the role played by PCWs in the market, but it had concerns about transparency in two respects. One, customers should be able to see all available products when they looked at a PCW, not just the ones for which the PCW received a commission. Two, there needed to be greater transparency about the commissions that PCWs received from suppliers. It was supportive of moves to increase transparency in these areas and of

Ofgem's Confidence Code. It also noted that PCWs could offer cash incentives even though suppliers could not under RMR.

Settlement systems

66. Project Nexus would help to fix various problems associated with the current gas settlement Annual Quantity review process and improve its accuracy. The implementation of Project Nexus would also help to highlight many of the complexities embedded in industry systems which could then be addressed by the rollout of smart meters. It was on track for Project Nexus's implementation, but it was not sure about the rest of the industry.

67. As far as half-hourly settlement for domestic electricity customers was concerned, Centrica was working towards this, but it would only be cost-effective to introduce it once a sizeable majority of households had smart meters, so it would not stack up in the short term. How quickly time-of-use tariffs were taken up by customers would also affect when half-hourly settlement would become viable. The introduction of half-hourly settlement would be the single biggest systems change that it was having to take account of.

The non-domestic market (microbusinesses, small and medium-sized enterprises, larger businesses)

68. Centrica considered the business retail market to be very different to the domestic one for a number of reasons. First, the characteristics of businesses (eg size) varied and consequently their needs varied greatly. Second, there was much less emphasis on dual fuel supply. [✂]

69. The fact that most business customers were on fixed-term and/or fixed-price contracts meant that the business market was riskier than the domestic market because the commitments involved in longer-term fixed contracts could not be easily predicted (eg transmission costs, government levies). The business market also had much higher levels of bad debt, eg Centrica's small and medium-sized enterprises (SMEs) business had a bad debt level of [✂]% while its domestic business had [✂]%. Levels of bad debt in the SMEs business differed depending on the type of contract customers were on. Bad debt charges (ie the amount Centrica did not expect to recover) for fixed contract customers were around [✂]%, while for customers who were out-of-contract or on deemed contracts, levels were higher. Bad debt charges on deemed contracts were around [✂]%.

70. Centrica's margins (earnings before interest and tax (EBIT) percentage) for its non-domestic business were higher than for its domestic one. This was due to

number of fixed contracts (requiring higher capital) and the levels of bad debt that were present in the business market. The business market was more volatile than the domestic one and accordingly required it to allocate more capital to this part of its business in order address the greater risks involved.

71. As far as tariffs were concerned, the business retail market had changed significantly over the past five years. It had become more competitive and had seen a significant decline in the use of automatically renewed fixed contracts. The high profit levels that suppliers were able to make back in 2009 and 2010 attracted many new entrants to the market and had also led to an increase in the number of brokers, which had in turn led to increased competition. [✂] and its profits in this market had halved.

72. Centrica had responded to its loss of customers by ending the automatic renewal of contracts, which customers increasingly saw as unfair. [✂] It had replaced automatic renewal with to a new offer called Variable Pricing Product, which although it had higher rates than the fixed contracts offered to customers at that time, it allowed customers to exit with 30 days' notice. It had noticed that many more of its business customers were better engaged and were more active in renewing their contracts with it or switching suppliers. [✂]

73. Brokers had become much more active in the microbusiness sector, and there was evidence that microbusinesses were highly aware of pricing and how contracts worked (as evidenced by the Ofgem survey). PCWs were not a major factor in the microbusinesses sector as of yet, but this was likely to change with the end of automatic renewal.

74. Tariffs in the business retail market were negotiated between suppliers and customers. This was because of the wide variety of types of customers and their needs, changes to the wholesale price, and the high level of competition in the market. In order to offer attractive terms to customers, it was necessary to negotiate with them individually. Customers often shopped around and would obtain quotes from a number of suppliers. Centrica had looked into moving away from negotiation with SMEs business customers, and it had found that slightly larger ones wanted to stick with individual negotiations, while some of the smaller ones were keen to have a simpler process. [✂]

75. [✂]

76. In order to help stem the loss of business customers, Centrica had focused on reducing costs and improving its service. [✂]

77. Brokers were important to Centrica as a means of attracting SME and microbusiness customers. It was supportive of good brokers who acted in the best interest of their customers, and it considered that they had a useful role

in the market. It recognised that there were concerns around transparency, particularly in relation to the commissions brokers received, and there was recent evidence that suggested that most customers who used brokers did not understand what fees they received.

78. Most of Centrica's business customers were single, rather than dual fuel, customers.

Industry codes and governance

79. The codes that governed the energy market were complex and reflected incremental changes that had taken place over a number of years, partly in response to changes in government and regulatory policy. The codes' complexity reflected the complexity of the processes they governed, so simplifying the codes would likely require simplifying these processes, eg balancing and settlement. The introduction of smart technology and the real-time data it would provide should assist with this process.

80. The code modification processes could likely be improved by the imposition of deadlines, which would help to drive proposed changes forward. Having adequate resources for engaging with modification processes was a challenge for all participants in the market. Centrica noted that some smaller participants were working together or engaging consultants to ensure their views were represented on the various panels. Ofgem and the Department of Energy & Climate Change were also providing assistance to smaller participants.

81. Centrica was in favour of a body that could oversee the code modification processes and coordinate them in order to ensure that the considerable amount of change the industry was currently experiencing was properly managed.

82. Centrica's view was that each code modification differed in its complexity and its potential consequences, so it would not be appropriate to have standardised time limits for approving or rejecting modifications, as the implications of more complex changes would need to be thought through. It was in favour of an evolutionary approach to changes in industry regulation, as too much change too quickly could lead to uncertainty. It did not think that the current governance system was perfect, but it believed that it could be fixed by incremental changes and did not require a wholesale overhaul.

83. The energy industry functioned on a very long-term basis (ie decades) while government and regulators worked to a much shorter-term horizon. There were challenges in translating European Union and international obligations

into UK government policy, and there were uncertainties about how UK policies, such as the capacity market, would affect the GB market in the long term as well as the sheer frequency of changes the market had to deal with.

84. There had also been inconsistency in the approach to the regulation of the GB market which had swung between promoting competition and 'fairness' and this had translated into standardised outcomes and had the potential to dampen innovation and the forces of competition. Centrica was in favour of a move towards a principles-based, rather than a prescriptive, form of regulation for the energy industry. However, the transition from a prescriptive style to a principles-based one would not be straightforward. Its experience of principles-based regulation in its dealings with the Financial Conduct Authority (FCA) had been positive, in part because the FCA's policy and enforcement divisions worked closely together and took a consistent approach to issues. [✄]

85. Centrica would like to see suppliers given more leeway in how they communicate with their customers, particularly in relation to the design of bills and requirements for telephone calls. It would also welcome a reduction in restrictions on tariffs. It was, however, important to ensure that vulnerable customers were protected, and this might be the one area where more prescriptive regulation would be beneficial, for example in relation to standardising which customers were eligible for the Warm Home Discount Scheme.

Profitability

86. Centrica used Economic Profit as a consistent measure of financial performance across the group, however for managing the performance of individual businesses; it used a varied set of performance measures dependent on its nature. For asset-intensive and capital-employed intensive businesses, like the upstream gas business or the power generation business, return on capital employed, margin and EBIT profit measures and for upstream gas, net operating profit after tax were used. For the downstream businesses, it was primarily an EBIT measure used to assess financial profit performance.

87. At a group level, Centrica needed to ensure that all its businesses had enough capital backing, and at a group level it routinely reviewed its hedging strategy for its retail businesses to ensure they were sufficiently covered, but in the short term at least it used EBIT to measure the performance of its retail businesses because return on capital employed was not a suitable short-term accounting measure for retail businesses and was therefore not a good way to incentivise performance.

88. As far as margin trends were concerned, supplier margins, particularly on gas were fairly volatile. Margins for Centrica's domestic retail business had varied considerably since 2008 depending on wholesale prices, the success of its hedging strategy and weather. Profits had varied from approximately £370 million in 2008 to £740 million in 2010 and to £430 million in 2014. Its gas and electricity margins had started to converge over the past couple of years, but generally its electricity margins had been significantly lower than its gas margins, in part because of its pricing strategy. It had not always had the highest margins for gas of the six large energy suppliers, but its margins had generally been among the highest.

89. Centrica considered gas to be more risky, in respect of volume and price, than electricity so having a higher margin on gas was not unexpected. [✂] Its gas margins were on average higher than its competitors because it was more reliant on, and thus more exposed to, gas. As noted above, it had pursued a pricing strategy that discounted electricity in order to encourage customers to take up its dual fuel tariffs, while its competitors had done the opposite. It noted that there were still a number of single fuel customers in the market.

90. Approximately [✂]% of the customers that Centrica was losing were gas-only customers. While its dual fuel pricing strategy had been successful, the margins it was making on gas had meant that it had not always been as competitive on gas as a stand-alone product, resulting in the loss of many gas-only customers. It continued to review and refine its overall pricing strategy to try to get the balance of margin and competitiveness right. It considered that although its overall dual fuel margin was higher than the market average it was not out of line with it. The last two times it had changed its SVTs, it had either reduced its gas price or increased it by less than it increased electricity, so its gas margin had started to reduce.

91. In terms of efficiency and costs, Centrica's view was that following its investment in new billing systems in the mid-2000s, it was one of the most efficient of the large firms in 2009 and 2010. Other large firms had since made similar investments and following a bed-in period for their new systems their efficiency had improved as well, so its advantage in this area had reduced. In order to remain competitive on customer service by improving quality and reducing costs, it had recently made further investments in the 'front end' of its systems. It wanted to be a leader in efficiency and cost reduction and keeping its operating costs was important to it, but it did not want to achieve this at the cost of reducing the quality of its customer service.

92. Centrica considered that its operating costs for direct debit customers might be similar to those of smaller suppliers. As a large supplier, it had a much more diverse customer base than smaller suppliers, so its overall cost per

customer would be quite different. Smaller suppliers had few cash cheque customers (which was where bad debt tended to arise) and virtually no prepayment customers (which required access to separate infrastructure and associated costs). For a customer service perspective there was no reason why smaller suppliers could not continue to expand so long as they managed their growth well. Some smaller suppliers had used outsourcing to help them manage any major step changes they had faced. As they grew, smaller suppliers would reach a stage where they would need to keep more capital and collateral to ensure their supplies and would be less able to use middlemen to do this for them.