CMA ENERGY MARKET INVESTIGATION

SCOTTISHPOWER'S RESPONSE TO THE PROVISIONAL FINDINGS

1. INTRODUCTION AND EXECUTIVE SUMMARY

- 1.1 This document contains the response of ScottishPower to the Competition & Markets Authority's (CMA) Energy Market Investigation Provisional Findings Report published on 10 July 2015 (the **Provisional Findings Report**). ScottishPower welcomes a number of the provisional findings made by the CMA. We agree with the overall conclusions expressed by the CMA in relation to many issues, including those relating to the impact of the 'simpler choices' component of the retail market review (**RMR**), the conflict between Ofgem's competing statutory duties, competition in wholesale electricity markets, the current system of self-dispatch, the under-use of competitive allocation for contracts for difference (**CFD**s) and the positive competitive impact of vertical integration, as set out in greater detail below. In this submission however, we focus on those provisional findings that we believe require further consideration from the CMA.
- 1.2 Given the very large volume of material included in the Provisional Findings Report (plus Appendices) and the fact that the CMA has allowed only a relatively short period for responses, we do not attempt in this document to comment on every substantive point raised by the CMA. Instead, we focus on what we regard as the central themes in the investigation. However, no inferences should be drawn from the fact that we do not address particular topics covered by the CMA's Provisional Findings Report, and specifically this should not be taken to indicate that we agree with the CMA's analysis. This document should be read in conjunction with our response to the CMA's Notice of Possible Remedies published on 7 July 2015 (the **Remedies Notice**). We look forward to discussing points arising from our responses with the CMA at our hearing later this month.
- 1.3 We summarise our views here. The rest of the response provides our detailed views on:
 - (a) market definition and unilateral market power (**UMP**) (section 2);
 - (b) weak customer response and lack of engagement (section 3);
 - (c) efficiency (section 4);
 - (d) profitability (section 5); and
 - (e) the CMA's assessment of a competitive price benchmark (section 6).
- 1.4 The CMA has found an adverse effect on competition (**AEC**) in the domestic energy supply market on the basis of unilateral market power of the six large energy firms over inactive customers. The analysis presented in the Provisional Findings Report does not form a robust foundation for this conclusion. Without such a foundation, the grounds for implementing interventionist remedies such as Remedy 11, the safeguard price cap, are weak.
- 1.5 A coherent assessment of the underlying adverse effects is an essential starting point for judging the likely success and proportionality of any proposed remedy. We consider that the CMA's position on UMP is not consistent with its own market definition; its presentation of the evidence on customer disengagement is selective and, in places, misleading; and its assessment of 'competitive' benchmark revenues is flawed and therefore significantly overstates the reported gap between actual

and competitive revenues. These issues undermine, in particular, the grounds for the CMA's proposals on Remedy 11.

Market definition

- 1.6 The CMA provisionally concludes that there are separate markets for the retail supply of electricity and gas to domestic customers in GB (Summary of Provisional Findings (the **Summary**), para 27). We agree. It states that "market definition is a useful tool, but not an end in itself, and we note that the boundaries of the market do not determine the outcome of our competitive assessment in any mechanistic way" (Summary, para 28). Again, we agree. The CMA then argues in the main body of the report (para 3.31) that standard variable tariff (**SVT**) and non-standard tariff customers are not "sufficiently distinct to warrant defining separate markets for them". We agree with the basic proposition that SVT and non-standard tariff (**NST**) customers should be viewed as part of the same market, but we think the position could be stated more positively than the CMA has done. As we explained in our response to the Updated Issues Statement (**UIS Response**), the size of the differential between SVT and product prices is constrained by customer switching behaviour and reflects the level of saving that consumers typically require in order to encourage them to switch in the first place (UIS Response, para 5.28). It is this constraint which drives the conclusion that SVT and products are part of a single market.
- 1.7 However, it is illogical for the CMA to then go on to treat SVT and non-tariff customers as part of the same market (albeit separate segments of the market), while at the same time arguing that suppliers have UMP over their (undefined) 'inactive' customers. The CMA's finding that SVT and NST customers are part of the same market implies a competitive constraint between the prices that can be charged to them and, given the existence of such a constraint, it does not make sense to suggest that suppliers have UMP over a 'part' of the market. There are further reasons why we fundamentally disagree with the CMA's finding of UMP (notably because we do not accept the validity of the CMA's profitability analysis) and these are developed below, but looking at the issue solely through the lens of market definition, we believe the CMA's position on UMP to be untenable as a matter of logic.

Retail markets

1.8 The CMA identifies (Summary, para 110) three areas in which it considers domestic retail markets may not be working well for customers: (a) weak customer response and lack of engagement with domestic retail energy markets; (b) supplier behaviour; and (c) the regulatory framework governing domestic retail market competition. We touch briefly on each of these, but because the issue of supplier behaviour is closely linked to the CMA's views on profitability, we also discuss profitability when commenting on supplier behaviour.

Weak customer response and lack of engagement

- 1.9 We continue to believe that the CMA has over-stated the extent of the problem of weak customer response and lack of engagement. As we pointed out in our UIS Response (paras 5.2 et seq.) a significant number of customers are intermittently engaged, either switching between suppliers, or between tariffs with the same supplier, and it is this switching behaviour that constrains the prices that can be charged to inactive customers. Perhaps unsurprisingly, given that customers engage intermittently, the CMA has not been able to clearly define customers it considers to be inactive or disengaged. ScottishPower considers the group of customers where there may be genuine evidence of disengagement to be much smaller than that implied by the CMA's current assessment.
- 1.10 In particular, the CMA relies on a finding of unrealised gains from switching over the period Q1 2012 to Q2 2014 as evidence of weak customer engagement in domestic energy retail markets in GB (Summary, para 117). It acknowledges that "gains from switching are likely to be present in most

markets", but attaches "particular significance to the fact that they are available at such levels to customers for domestic gas and electricity (which are homogenous goods and constitute a significant proportion of household expenditure)". The CMA's provisional finding of weak customer response and a lack of engagement with domestic retail energy markets therefore appears to be based on the assumption that price dispersion where homogenous products are being sold by different retailers is problematic.

- 1.11 Firstly, there are differences in the features and scope of the customer service offerings of different energy suppliers, and we believe that the degree of homogeneity in energy supply is comparable to that of many other markets that display similar or greater levels of price differentiation.¹ Secondly, and more generally, we believe that price dispersion goes hand in hand with competition and should not, of itself, be considered to be of concern. Only with a certain degree of price dispersion will consumers be persuaded to engage with the market. Indeed the CMA itself has concluded that standard licence condition (**SLC**) 25A (designed to drive out price dispersion) was harmful for consumers, as it dampened the competitive dynamics between suppliers. In particular, we are concerned that CMA's proposed Remedy 11 risks running into the exact same problems as Ofgem had done previously and damaging competition even further.
- 1.12 As evidence of its findings of weak customer response, the CMA cites evidence that customers on NST (i.e., those that have actively engaged and switched within the last year) have potential gains from switching of around £137. Rather than concluding, as it does in paragraph 8.47 of the Provisional Findings Report, that this implies many of these customers are disengaged, this should highlight to the CMA that evidence of this level of gain from switching is a normal part of any market. Indeed it is broadly consistent with the evidence the CMA found in the GfK survey of the savings that customers say they require in order to incentivise them to switch (i.e., £120 median, £182 mean).²
- 1.13 ScottishPower supports those remedies (i.e., Remedies 3-10) which seek to improve market functioning and further reduce the cost of switching for consumers. Since we believe there to be a balance between consumers' perceived costs of switching and the gains from switching available to them, such measures should result in lower gains from switching being observed in the market. However, observed gains from switching should not in themselves be seen as an indicator of consumer harm.
- 1.14 The CMA also identifies two fundamental characteristics of energy consumption that it says are likely to impede customer understanding of, and engagement in, retail energy markets: the lack of quality differentiation in the product, and the fact that conventional meters are not very visible or immediately informative to the customer, meaning that customers are generally not aware of how much energy they are consuming, or their consumption patterns (Summary, para 123). We do not fundamentally disagree with the characterisation that consumers have limited visibility of their energy meters, albeit we would expect the position to improve with the roll-out of smart meters. We do, however, disagree with the notion of lack of quality differentiation in the product and note that there can be significant differences in the features and scope of the customer service offering of different companies³, which can have a significant effect on customer experiences.
- 1.15 We do not disagree with the suggestion that there are some consumers who find the process of searching and switching to be difficult. However, we do not believe that this is true for the majority of consumers and think that it is important to keep this in perspective. The CMA's customer survey shows that a significant majority (two-thirds) of respondents who shopped around in the last three

¹ See paragraphs 3.21 and 3.22 below for details.

² Values taken from Oxera's first disclosure room report, which found that estimates of the mean and median savings required for consumers to switch were understated in the GfK report due to 'don't know' responses being coded as zeroes.
³ An average of this is the shifts of the shi

³ An example of this is the ability of ScottishPower customers to adjust their direct payment within certain limits.

years did not have a problem and found the process to be 'very' or 'fairly' easy (para 8.100). Indeed, 89% of respondents to the CMA's consumer survey were aware that it is possible to switch supplier.⁴

Supplier behaviour

- 1.16 The CMA seeks to draw these threads together by arguing that this combination of 'features' of the markets for domestic retail supply of gas and electricity in GB give rise to an AEC through an 'overarching feature' of weak customer response. This is said (Summary, para 128) to give suppliers a position of UMP over their inactive customers. The CMA provisionally finds that suppliers are able to exploit this alleged UMP by pricing SVTs materially above a level that is justified by cost differences from NST, and/or by pricing above a level that is justified by the costs of operating an efficient retail supply business (Summary, paras 133, 135).
- 1.17 As set out above, ScottishPower considers these concerns to be ill-founded, both with respect to domestic and microbusiness customers.
- 1.18 We do not accept the basis for the CMA's finding of an AEC in relation to microbusinesses and specifically we do not accept that weak customer response gives suppliers a position of UMP over their inactive microbusiness customers which they are able to exploit through their pricing policies (Summary, para 175). To the extent that there is a problem in the supply of energy to microbusinesses, the issue is not a lack of engagement but a lack of price transparency (and the fact that tariffs are not generally published); this, together with narrow switching windows, unnecessarily complex notice arrangements prior to switching and the role of some third party intermediaries (**TPIs**) in charging significant commissions and giving poor advice, are the key factors which make it difficult for microbusinesses to compare prices and make informed switching decisions. This has important ramifications in terms of crafting appropriate remedies, as we set out in greater detail in our response to the Remedies Notice.
- 1.19 In domestic markets, we consider the CMA's reliance on price differentials between SVT and NST and its evidence on the alleged gap between actual and competitive revenue to be flawed. Particularly with respect to the latter evidence, the strong conclusion drawn by the CMA should be based on robust analysis, especially as it underpins the remedies relating to reintroduction of price controls. However, the assessment carried out by Oxera in the CMA disclosure room shows that the analysis undertaken by the CMA does not meet this benchmark in a number of areas.
- 1.20 The evidence on price dispersion in the domestic energy markets is in fact consistent with, and necessary for, the good functioning of competitive markets. Furthermore, the CMA's own finding that the two products (SVT and NST) are in the same market undermines its conclusion that this dispersion is material. Finally, evidence of price dispersion from other markets demonstrates that this is a normal feature of a well-functioning and competitive market.
- 1.21 The CMA relies on its analysis of supplier efficiency (using unconditional benchmarking of supplier performance) and profitability (derived from its return on capital employed (**ROCE**) analysis) to conclude that 'competitive' retail revenues would have been lower than those actually observed. However, as summarised below and set out in detail in sections 4 and 5 below, the CMA's analysis of efficient costs and efficient margins understates the competitive costs of a retail energy supplier. Correcting for the methodological errors and making minimal reasonable adjustments to some of the assumptions underpinning the analysis that the CMA has presented, the average estimated 'overcharge' in the domestic market is reduced to the point of being immaterial or negative. Correcting the wholesale and indirect cost efficient benchmark for small and medium enterprise (**SME**) customers based on materials in the disclosure room does show a gap between average actual and notionally efficient prices, but significantly lower than the 14% suggested by the CMA.

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Figure 35 of ENERGY MARKET INVESTIGATION: A report for the Competition and Markets Authority by GfK NOP (February 2015).

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- (a) On the basis of the analysis carried out by Oxera in the CMA disclosure room, we are concerned that the benchmarks used by the CMA to assess the efficiency of the large integrated supply firms are neither meaningful nor achievable as they are based on selective use of data and on a methodology that does not take proper account of: (i) year-on-year variability in cost drivers (particularly in relation to wholesale costs); (ii) the fact that many such cost drivers have different effects on different suppliers (due to differences in their customer mix such as the proportion of customers paying by direct debit); and (iii) that many such factors are driven by either unpredictable wholesale price variation or consumer choice and are therefore not directly controllable by suppliers.⁵ On this basis, we do not believe that the CMA has demonstrated that the large integrated suppliers have been inefficient.
- (b) With regard to the CMA's analysis of industry profitability, we do not accept that any reliable conclusions about excess profits can be drawn from the 28% ROCE figure cited by the CMA relative to the estimated weighted average cost of capital (WACC) of 10% (Summary, para 178). ScottishPower has previously explained why ROCE is an inappropriate measure of profitability for an asset-light business. In particular, because the energy supply industry is characterised by high levels of profit volatility and low levels of asset intensity, even small changes in capital employed can produce large swings in the ROCE.⁶ In addition, the CMA's estimates of the value of a customer base are relatively low in comparison to evidence from competitive market transactions. This indicates that the ROCE estimates obtained by the CMA are significantly overstated.
- (c) In our view, this reinforces the need for the CMA to place a much greater weighting on the evidence provided by industry sales margins. Critically, when profitability is considered on a margins basis, the average margins for the industry as a whole and for domestic supply in particular, are 3.4% and 3.3% respectively. These are only slightly higher than the top end of the CMA's own assessment of appropriate margins for energy supply of 1 to 3%.

The regulatory framework

1.22 On the other hand, we do agree with many of the CMA's observations on the impact of the 'simpler choices' component of the RMR rules. As we said in our UIS Response (paras 5.44 et seq.), the RMR tariff simplification rules have had a number of adverse consequences for competition and innovation, and we welcome the fact that the CMA is now proposing to abolish these rules. However, we would again suggest that the CMA gives more attention to the impact that the effective cessation of face to face marketing (whether on the doorstep or otherwise) has had on engagement, especially of consumers who do not use the internet or do not like to transact over it.⁷ In particular, there appears to be a correlation in time between the ending of face to face marketing and a significant reduction in switching rates. In this regard, we would further note the concerns raised by Stephen Littlechild, in his submission to the CMA of 11 January 2015, that the present marketing licence condition (SLC 25) and its interpretation have "restricted and distorted competition in several respects, to the disadvantage of customers, particularly vulnerable customers". While some doorstep switching in the earlier years was of poor quality (in that customers were sometimes given poor advice), the industry invested substantially in systems that greatly reduced this problem in later years. Given appropriate use of technology and sales validation processes, our view is that face to face marketing can now be conducted to a much better standard than before (albeit at relatively high cost). We therefore continue to think that the CMA should consider carefully SLC25 and the

⁵ In relation to customers' choice of payment method and tariff, please see paragraph 4.11 below for an explanation of why we believe that suppliers cannot exercise direct control over such factors.

⁶ See ScottishPower's response to the CMA's working paper of 17 April 2015 'Analysis of retail supply profitability - ROCE (Version for ScottishPower)'.

⁷ Oxera analysis of GfK survey data in the first CMA disclosure room found that customers whose contact with a potential supplier was face to face were twice as likely to switch as those contacted via other channels.

manner in which it has been implemented with a view to facilitating face to face selling in a manner that adequately protects consumers.

- 1.23 We also welcome the fact that the CMA has recognised the conflict between Ofgem's competing statutory duties (Summary, para 200) and we agree it is a matter of concern that Ofgem considers these duties to impose a constraint on its ability to pursue competition-based policies. We comment in more detail in our response to the Remedies Notice on the CMA's proposed mechanisms for allowing policy disagreements between Ofgem and the Department of Energy and Climate Change (**DECC**) to be aired publicly, but as a general note of caution, we believe it is important, both for legal and policy reasons, to ensure that the independence of Ofgem as an economic regulator is not compromised by the CMA's remedy proposals.
- 1.24 While some industry codes have weak governance that has reduced Ofgem's ability to drive timely change, we are not convinced that this is a problem in all cases. Much of the problem we have observed, for example around project Nexus, has been linked to weak governance in one particular code, the Uniform Network Code. One or two other codes may have similar problems. With these exceptions, most code modifications have in fact been progressed in a timely manner. In most of the cases where there have been delays, these have generally taken place while the issue has been in Ofgem's hands rather than those of the industry. Moreover, in formulating any response to an identified AEC here, it is important that the CMA takes account of the risk that Ofgem might push through a change with insufficient consideration and consultation, with the result that serious problems then arise.

Wholesale markets

- 1.25 We agree with the CMA's finding that generators do not have UMP, in light of the evidence showing generator profitability to be in line with or below the cost of capital (Summary, para 38). We also agree with the CMA's assessment that there is no need to move away from the current system of self-dispatch that underpins current wholesale market arrangements (Summary, para 42).
- 1.26 We agree that the introduction of locational pricing of transmission losses merits further consideration but we are not convinced that it would in fact have a significant impact on investment or dispatch decisions. We consider that the problem is not so much one between generators in the UK but more one of the level playing field between UK generators and imports. Transmission losses are one of a number of charges on the GB grid system that are paid by UK generators but not by overseas generators. There is an EU system of inter-transmission system operator compensation around interconnectors, but there is no clear basis for any payments made under this mechanism to be "seen" by the commercial parties flowing the electricity. The net effect is that the current system of transmission losses creates a competitive advantage for importers over UK generators.
- 1.27 Similar advantages are conferred by the exemption of interconnectors from transmission charges (TNUoS) and balancing charges (**BSUoS**), and the application of an £18/tonne CO2 carbon price support tax to UK generators on top of the EU Emissions Trading Scheme. Finally, the construction of interconnectors is being supported through a cap and floor mechanism. The net effect of these measures is to severely disadvantage UK generators compared to imports, to the extent that we question whether it will be possible in future to build thermal power stations in GB.
- 1.28 Accordingly, if the CMA wishes to address inefficient incentives about the location of power stations, it should look not only at zonal transmission losses but also at: (a) ensuring that the zonal losses average at zero to match the interconnector charge; (b) setting generator BSUoS to zero; (c) setting residual TNUoS to zero; (d) recommending a reduction in the carbon price support tax; and (e) ensuring that only well justified interconnectors receive cap and floor funding assistance.

1.29 As regards vertical integration (VI), we agree with the CMA's provisional conclusion that the vertically integrated structure of the Six Large Energy Firms does not give rise to an AEC (Summary, para 79). We are not surprised by the CMA's observation that it has not identified any areas where VI is likely to have a detrimental impact on competition for independent suppliers and generators, and we agree that there may be efficiencies resulting from VI, which have the potential to affect marginal costs and which are therefore likely to be passed through to consumers (para 6.116).

2. MARKET DEFINITION AND UNILATERAL MARKET POWER

- 2.1 The CMA has found an adverse effect on competition in the domestic energy supply markets on the basis of UMP of the Six Large Energy Firms over inactive customers. This conclusion is not borne out by the analysis presented in the Provisional Findings Report. This undermines the relevance of some of the proposed remedies, and Remedy 11 in particular. A coherent assessment of the underlying adverse effects is an essential starting point for judging the likely success and proportionality of any proposed remedy.
- 2.2 The finding of UMP over inactive customers is not sustainable as it is not consistent with the market definition defined by the CMA and the CMA has not been able to clearly define inactive customers.
- 2.3 The CMA has made a finding of broad markets for retail supply of gas and electricity (separately) to domestic customers in GB (Provisional Findings Report, para. 3.46 (c) and (d)). The CMA recognises that any less engaged/less active customers are not sufficiently different from the engaged customers to represent a separate economic market. In particular, a finding of UMP requires an underlying separate market as it is the essence of a finding of UMP to be able to treat a set of customers (a market) differently.
- 2.4 Second, there is no coherent definition of inactive customers. It would not be possible to uniquely identify an inactive from an active customer on the basis of the discussion in the Provisional Findings Report. Indeed, analysis of the CMA's own consumer survey (set out in more detail below) shows that the CMA's interpretation and presentation of evidence on this issue is misleading. Specifically, we show below, on the basis of the CMA's own data, that customers who are in one place labelled disengaged would be considered highly engaged on other measures. Without this clarity, any analysis of the proportionality of the proposed remedies is problematic, because there is no clear identification of the consumers suffering the AEC. Moreover, the very fact that the CMA has not been able clearly to define the customers it considers to be 'inactive', indicates that the energy companies themselves would not be able to effectively segment the market as the CMA alleges.
- 2.5 One interpretation of the CMA's analysis is that all SVT customers should be considered 'inactive'. This would be consistent with the proposal of Remedy 11, which effectively replaces this tariff with the safeguard tariff by specifying that customers who fail to actively choose another tariff at the end of their contract would automatically be defaulted onto the protected tariff, and that no other evergreen tariffs would be permitted. However, the CMA's own evidence recognises that not all SVT customers are inactive or disengaged. 33%⁸ of consumers are on an SVT currently, but have switched tariff or supplier in the past, and around 40% of non-PPM SVT customers have been on their current SVT tariff for two years or less.⁹ Furthermore, analysis conducted by Oxera in the CMA's disclosure room found there to be constraints between SVTs and non-standard tariffs that show that SVT customers respond to increasing (or narrowing) dispersion between the two tariff types by switching away from (or towards) SVT. This evidence confirms that SVT customers should not be judged inactive *per se* and is consistent with the CMA's own broad market definition.

^{48%} of SVT customers, which are 68% of the customers (Appendix 8.1 paragraph 244 and Table 4).

Table 7.1 and paragraph 7.72, Provisional Findings Report.

- 2.6 Even if the CMA's finding of UMP on the part of the Six Large Energy Firms could be sustained, the alleged exploitation of this UMP is not supported by robust evidence, in particular:
 - (a) the CMA purports to show a weak customer response and lack of engagement but its evidence supporting this provisional finding is not robust;
 - (b) the CMA provisionally finds that if the domestic retail energy market were competitive, prices would be lower; however its analysis of efficient costs significantly understates the competitive costs of a retail energy supplier; and
 - (c) the CMA provisionally finds that profitability for the industry as a whole is excessive; however, its chosen measure of profitability is inappropriate and poorly targeted.
- 2.7 We set out our main concerns with the CMA's analysis of these three elements in the following sections.

3. WEAK CUSTOMER RESPONSE AND LACK OF ENGAGEMENT

- 3.1 It is an important part of the CMA analysis to support its findings of an AEC that a large proportion of customers are found to be inactive and disengaged. Based on its consumer survey, the CMA draws together evidence on: the proportion of customers that have never considered switching (around a third); the observation that a third of customers have been on an SVT with the same supplier for over five years; and substantial gains from switching available to many customers, to conclude there is evidence of significant disengagement.¹⁰
- 3.2 Furthermore, the CMA puts strong weight on certain findings in the survey, as set out in paragraph 89 of the Summary:¹¹

"The survey provides material evidence of domestic customers' lack of understanding of, and engagement in, retail energy markets."

3.3 On the basis of this evidence the CMA concludes:¹²

"We regard this as evidence of a material degree of disengagement."

3.4 After its assessment of disengagement indicators, the CMA turns to its gains from switching evidence and relies on this as a key demonstration of weak consumer engagement:

"Our finding of material potential savings that are persistent over time, available to a significant number of domestic customers and that go unexploited provides evidence of weak customer engagement."¹³

- 3.5 We consider that the CMA should revisit its assessment of the evidence from its consumer survey. The CMA has not always presented the evidence correctly and has ignored some relevant evidence. Such survey evidence in any case needs to be considered in the round and given the appropriate weight, as responses are not always consistent, either within the survey or between surveys.
- 3.6 Four pieces of evidence from the CMA customer survey, set out in sub-sections (a) to (d) below, are cited a number of times in the Provisional Findings Report, indicating that these are seen as key measures of disengagement. The CMA presents the relevant findings from the survey as evidence of

¹⁰ Paragraph 8.3 of the Provisional Findings Report.

¹¹ See also paragraph 7.64 of the Provisional Findings Report. ¹² Description 7.65 of the Provisional Findings Papart

Paragraph 7.65 of the Provisional Findings Report.
 Paragraph 8.74 of the Provisional Findings Report.

¹³ Paragraph 8.74 of the Provisional Findings Report.

highly disengaged consumers; however, the statistics cited in (a), (c) and (d) can all be seen to give a misleading impression of (lack of) engagement. Each of these is examined in turn below.

(a) 36% of respondents either did not think it was possible or did not know if it was possible to change one (or more) of the following: tariff, payment method and supplier

3.7 This is incorrectly phrased. In fact, what the survey shows is that 36% of respondents did not know it was possible to change all three of these. Elsewhere in the Provisional Findings Report, the CMA does report the findings for each category separately:

"89% are aware it is possible to switch supplier, 81% are aware it is possible to change payment method, 76% are aware it is possible to change tariff and 64% are aware it is possible to do all three".¹⁴

3.8 Thus in fact only 11% of respondents are unaware of the opportunity to switch supplier. The CMA also cites more recent (2015) evidence on awareness from Ofgem's survey on engagement (designed to assess the success of the RMR findings).¹⁵ It shows that awareness has increased, particularly with respect to switching tariff. This awareness is a key determinant of search behaviour.

(b) 34% of respondents said they had never considered switching supplier

- 3.9 At first sight, measure (b) seems to capture a relevant aspect of disengagement. However, as set out above, only 11% of all respondents (or 32% of those who have never considered switching) were in fact unaware they could switch supplier. Thus 23% of respondents were aware of their options, but had never considered exercising this option. This could be consistent with these customers being engaged and satisfied with their provider. Data in the CMA disclosure room supports this theory. Gains from switching for customers who were aware that they could switch supplier, but did not consider it, are £153 (17% of bill), which are similar to the £157 (14% of bill) gains from switching for customers who have shopped around and switched.
- 3.10 In addition, the CMA does not cite the evidence from the survey on intention to switch in its summary. In Appendix 8.1, the CMA reports that, while 44% of respondents have never switched supplier and never switched tariff with their existing supplier, ¹⁶ only 22% have never switched supplier, never switched tariff with their existing supplier and are unlikely to consider switching in the next three years.¹⁷ Around one-third of those that have not yet switched are aware of the possibility of switching and are likely to consider switching in the next few years. In addition, we think it very likely that the 44% statistic excludes customers who chose to move onto a dual fuel tariff with their existing electricity or gas supplier, having been on single fuel tariffs previously.¹⁸ We believe that such customers cannot be considered to be necessarily disengaged given that they made a choice to change the supplier of either electricity or gas.

(c) 56% of respondents said they had never switched supplier, did not know it was possible or did not know if they had done so

18

¹⁴ See paragraph 4(a) of Appendix 8.1 of the Provisional Findings Report.

See Table 1 of Appendix 8.2 of the Provisional Findings Report. The Ofgem 2015 survey relating to the impact of the RMR remedies found: 90% of respondents are aware they can switch supplier; 85% are aware they can switch payment method; and 83% are aware they can switch tariff.

Paragraph 5(f) of Appendix 8.1 of the Provisional Findings Report.
 Paragraph 5(h) of Appendix 9.1 of the Provisional Findings Papart

Paragraph 5(h) of Appendix 8.1 of the Provisional Findings Report. We are led to this conclusion by the fact that, as of September 2014, only [CONFIDENTIAL]% and [CONFIDENTIAL]% of electricity customers in the Manweb and SP supply areas respectively were on ScottishPower's single fuel electricity SVT tariff ([CONFIDENTIAL]) and therefore [CONFIDENTIAL]% and [CONFIDENTIAL]% respectively of the customers in each relevant supply area will have switched their power tariff, switched electricity supplier, or switched their gas supplier (leaving aside house moves and no-gas households). There are a number of factors such as house moves, lack of gas supply or otherwise engaged customers having different suppliers for electricity and gas that are likely to be polluting the link between the proportion of single fuel customers and a measure of customer disengagement. However, we have no reasons to believe that such factors, when considered jointly, should bias that measure in any particular direction.

NON-CONFIDENTIAL VERSION

3.11 In (c), the CMA confuses actual switching behaviour with awareness of switching in arriving at the 56% of respondents in this category. There are many reasons why individuals may decide not to switch supplier even when well aware of the possibility to switch. The focus in this disengagement measure should be on awareness, separate from an analysis of why individuals are aware of the possibility and consider switching but then choose not to.

(d) 72% said they had never switched tariff with an existing supplier, did not know it was possible, or did not know if they had done so

- 3.12 In (d), the CMA states that 72% of respondents have not switched tariff with an existing supplier, did not know it was possible, or did not know if they had done so. This is not a good measure of disengagement as it focuses on only one aspect of switching and one which is not clearly correlated with engagement. The fact that a respondent does not switch tariff (or is not aware of the possibility to do so) within their supplier is not a good basis for labelling them disengaged, as many such customers have recently switched supplier or have considered switching tariff but have decided not to:
 - (a) from Table 2 of Appendix 8.1 (at paragraph 69), only 49% of respondents have never considered switching tariff with an existing supplier or were unaware of the possibility. However, those who have not switched tariff but have considered doing so or were aware of the possibility (23% of respondents) are not necessarily disengaged because they could have made the active choice of not switching tariff;
 - (b) Figure 1 in Appendix 8.1 shows that 40% (20 percentage points) of the 49% of respondents that have not considered switching tariff, have in fact changed supplier in the last three years. This leaves only 29% of respondents that have not switched supplier or considered switching tariff in the last three years, a much smaller group than the 72% identified by the CMA;
 - (c) it also may be the case that the respondent only recently switched to their current tariff. Of the 72% mentioned above, 13 percentage points of respondents are currently on a fixed tariff; and
 - (d) Internal switching is not a complete measure of consumer engagement: 28% of respondents have switched supplier, but not tariff with the same supplier and 9% of respondents have shopped around but not switched.
- 3.13 The CMA also puts weight on the evidence on having shopped around to indicate engagement (paragraph 8.8 of the Provisional Findings Report and throughout Appendix 8.1 starting from paragraph 6, where shopping around is included among four measures of the level of engagement of customers). However, Figure 1 in Appendix 8.1 in fact shows that it is incorrect to define disengagement on the basis of whether customers have shopped around; Figure 1 shows that 12% of people that have **never** shopped around have in fact switched in the last three years. This is likely to be because of outbound marketing activity by energy providers.
- 3.14 The above gives an indication of the challenges associated with many of the statistics relied on by the CMA in forming its provisional findings. Of more fundamental concern, given the many indicators used by the CMA, is the fact that no clarity is provided on the CMA's actual definition of disengagement or inactivity. Table 9 in Annex 1 sets out the wide the range of potential definitions mentioned by the CMA and then identifies countervailing evidence that highlights why most of these will not be a good measure of disengagement. Finally, in the context of any intrusive remedy, we

consider that the CMA would need to find a much narrower definition of disengagement.¹⁹ In particular, this would need to be related to indicators of vulnerability of the customers concerned.

3.15 As we set out in our response to the Remedies Notice, we consider the best way to engage these customers is through prompts and direct contact and not through untargeted changes to tariffs that will have unintended negative consequences for engagement in the market as a whole. We believe that the evidence cited by the CMA in fact shows that customers over the age of 65, those with a disability or those on the priority services register (**PSR**) are as likely as any other type of customer to have switched tariff with their existing supplier and that customers on the PSR are less likely than average to be on the SVT (58% of PSR customers as compared with 68% overall).²⁰ This is linked to supplier activity to contact these vulnerable customers and ensure they are on the right tariff.²¹ This illustrates that such remedies can be successful.

Gains from switching

- 3.16 The CMA appears to take the view that any level of apparent gains from switching is problematic in energy markets. It is instructive to see how it deals with the evidence on gains from switching for customers on NST, SVT and pre-payment meters (**PPM**).
- 3.17 With respect to customers on NST (which implies the customer has made a recent active choice for that tariff), the CMA reports in Table 8.1 that for those customers on non-standard tariffs (i.e. those that are likely to have switched in the last year), there are still reasonable potential gains from switching (£137 on average under scenario 5). Its conclusion from this is:

"In relation to customers on non-standard tariffs, we note they have actively chosen their tariff... however, this does not explain the majority of the gains from switching for such customers. This may suggest that... some customers may not be fully engaged in the sense of having fully considered the option of switching supplier."²²

- 3.18 The CMA does state it is more concerned about the apparent gains from switching for SVT customers "*as most of these customers have not actively chosen this* tariff".²³ Furthermore, the CMA notes that pre-payment customers have lower gains from switching than other customers.²⁴
- 3.19 To be consistent with its argument on NST customers, the CMA should find PPM customers to be engaged on the basis of low potential gains from switching. However, in this case, the CMA considers that the low gains from switching for PPM customers should be seen as an indicator of the limited number of tariffs available to these customers.²⁵ This highlights the fact that the level of price dispersion cannot be used as a reliable measure of the level of competition in any given market. Rather, price dispersion is a useful market feature that rewards customers for engaging in active searching and switching. It is essential not to remove this key element from any competitive market and the CMA should revisit its assessment of the gains from switching in this light.
- 3.20 The issue is that the CMA does not have a clear benchmark for judging the gains from switching evidence. In fact it implies that any positive gain from switching is indicative of a lack of customer engagement on the basis of the 'uniquely homogenous' nature of energy services. This suggests that the CMA considers no price dispersion should exist for sales of similar goods. This is not realistic;

¹⁹ Please see our response to Remedy 11 of the CMA's Remedies Notice for our thoughts on indicators of customer engagement in this context.
²⁰ Decompression 212 and 214 of the Provisional Findings Perpert

Paragraphs 8.13 and 8.14 of the Provisional Findings Report.
 Paragraphs 8.15 and 8.16 of the Provisional Findings Report.

²¹ Paragraphs 8.15 and 8.16 of the Provisional Findings Report.

²² Paragraph 8.70 of the Provisional Findings Report.

²³ Paragraph 8.71 of the Provisional Findings Report.

Paragraph 8.58 of the Provisional Findings Report.
 ²⁵ Description of the Provisional Findings Report.

Paragraph 7.190 of the Provisional Findings Report. We have previously highlighted to the CMA the technical constraints that prevent suppliers from offering a greater choice of tariffs to PPM customers. Such constraints and the subsequent low gains from switching are a barrier to PPM customers engaging with the market to a fuller extent. However, we would also add that PPM customers are, in our experience, more price sensitive than other customers, and hence would be expected to react to lower available gains from switching.

most competitive markets exhibit price dispersion and that observed in the UK domestic electricity and gas markets is not out of line with other markets.

- 3.21 Retailers frequently compete through selling homogenous goods and one of the key differentiators will be price. The price advantages may come about through good procurement practice, through other cost efficiencies or through a quality differentiator such as good customer service. There are many examples of significant price dispersion in pure retailing activities (i.e. where suppliers compete to retail identical branded products) and in volume discounting. Just two examples of this are as follows.²⁶
 - (a) The difference between high and low prices charged by different online retailers for identical white goods frequently exceeds 30%.
 - (b) The price of identical milk per litre sold by the same supermarket can differ by up to a factor of two depending on the size of the container in which it is sold.
- 3.22 ScottishPower has also previously submitted evidence to the CMA which demonstrates that the level of price dispersion seen in energy supply is in fact somewhat below average compared to other homogenous services.²⁷
- 3.23 There are two potential benchmarks in the data which the CMA has that it could use. It has recognised that non-standard tariff customers have exercised choice and engaged with the market. For these customers average potential gains from switching of £137 (12% of their average bill) under scenario 5 are observed.²⁸ The survey also asked customers what gains would be required for them to switch. Again, looking at the subset of customers who have switched in the last year (and thus are engaged), gains in the region of £138 are required by customers to justify switching tariffs.
- 3.24 We present below the gains from switching (shown in absolute terms or as a percentage of their average bill) for different groups of customers according to the tariff, payment type and responses to selected engagement questions in the survey. Table 1 compares the gains from switching for customers who are and who are not engaged according to a range of measures of engagement cited by the CMA. Tables 2 and 3 focus on the gains by tariff type and payment method as presented in the two relevant appendices. The results are slightly different and both are presented, for completeness.²⁹ For example, from table 2, average gains from switching for all SVT customers who pay by credit under scenario 4b are £139 per year or 14% of their average bill. From table 1, this compares to a saving of 11% of the average bill for all customers on a non standard tariff under scenario 5.

²⁶ See Annex 2 for details and sources.

²⁷ See Annex 1 of ScottishPower's UIS Response.

²⁸ Scenario 5 is the most flexible switching scenario. A customer cannot change their payment method if they are a pre-payment customer, but they can change all other attributes including: supplier (including independents); payment method (DD and Credit); tariff structure (variable / fixed / capped); contract length; online. See Table 16, Appendix 7.4.

²⁹ Slightly different gains from switching numbers and percentages are reported by the CMA in sections 7 and 8 of the Provisional Findings Report and the related appendices (i.e., Appendix 7.4 and Appendix 8.1). This is because of differences in the methodology used to calculate the gains from switching and different data. For example, in Appendix 8.1 respondents' consumption data are used rather than those of representative consumers and in Appendix 7.4 only customers of the Six Large Energy Firms are included.

Characteristics	Yes	No	Source
Non Standard Tariff ⁱ	11%	18%	Appendix 8.1, Figure 11
Have ever considered switching ⁱⁱ	15%	17%	Appendix 8.1, Figure 13
Have ever switched supplier ⁱⁱ	14%	17%	Appendix 8.1, Figure 13
Switched last year ⁱⁱ	11%	16%	Appendix 8.1, Figure 13
Have shopped around in the last year ⁱⁱ	13%	17%	Appendix 8.1, Figure 13
Would consider switching in the next three years ⁱⁱⁱ	15%	17%	Appendix 8.1, Figure 13
Have ever switched tariff ⁱⁱ	15%	16%	Appendix 8.1, Figure 13

Table 1: Gains from	Switching hy	v engagement measu	re (scenario 5)
Table 1. Gams nom	ownering by	y engagement measu	i c (scenario 5)

Note: Results provided in Appendix 8.1 are calculated based on responses to the customer survey. Average gains available as a percentage of bills for dual fuel customers who could have gained from switching. ⁱ Sample: 4,366. ⁱⁱ Sample: 4,369. ⁱⁱⁱ Sample: 4,225.

Customer category (all	Average potential savings				Source	
are dual fuel)	Scenario 4b		Scenario 5			
	%	£	%	£		
SVT	13	143	15	171	Appendix 7.4, Table 11	
SVT, no Pre-payment	14	166	18	202	Appendix 7.4, Table 12	
SVT, Direct Debit	15	183	15	183	Appendix 7.4, Table 13	
SVT, Credit	14	139	22	232	Appendix 7.4, Table 14	
NST	11	124	12	137	Appendix 7.4, Table 16	

Table 2: Gains from switching by tariff and payment type (scenario 4b and 5)

Note: Results provided in Appendix 7.4 based on data on customer category for the six large energy firms.

	Direct D	ebit	Credit		Pre-paym	ent	Overall	
	%	£	%	£	%	£	%	£
NST	10	117	20	231	8	85	11	126
SVT	17	222	24	263	10	75	18	210
Overall	15	173	24	256	9	74	16	183
Overall							14	162
(scenario								
4b)								

Table 3: Gains from switching by tariff type and payment method (for scenario 5)

Note: Drawn from Tables 15 and 16 of Appendix 8.1 of the Provisional Findings. Average gains available as a percentage of bills for dual fuel customers who could have gained from switching under scenario 5 by payment and tariff type and scenario 4b (only overall gains). Appendix 8.1 uses data on tariff type and payment method based on the respondents to the GfK customer survey; gains from switching by tariff type are based on a sample of 4,195 and gains from switching by payment type are based on a sample of 4,219.

3.25 Our first conclusion from the data presented above is that any assessment of apparent gains from switching should not expect those gains to be lower than 11-12% in the context of the switching

process in its current form,³⁰ as these are the lowest gains the CMA has calculated, and these apply to the most active customers, for example those that have switched in the past year or are on NST. Tables 2 and 3 show that it is only those customers who are on SVT and are paying by credit that have a gain from switching (under scenario 5) that is markedly different from that of other customer groups. Table 2 shows that SVT customers paying by direct debit have gains from switching that are similar to NST customers (15% compared with 12%).

- 3.26 Standard credit, while being more expensive, does give customers more control over their payments. In addition, it is a form of credit for customers, which, given the observed price differentials with other payment methods, may be significantly cheaper than alternative forms of credit that are available to them. The CMA recognises that this may be a legitimate preference for certain customers.³¹³² In Table 3, we see that customers that are on NST but choose to pay by standard credit have an apparent potential gain from switching of 20%. Given these customers are on a NST, this indicates they made an active choice, including to pay by standard credit. It is not clear what proportion of dual fuel SVT customers have actively chosen to pay by standard credit. However, the fact they are dual fuel customers indicates they have made an active choice and would have been encouraged to pay by direct debit at that time. Customers that are on an SVT, pay by standard credit and do not source both fuels from the same supplier have gains from switching of £115 (18% of bill), in comparison to gains from switching of £158 for other customers (14% of bill).
- 3.27 Thus the CMA overstates the implications that can be drawn from any positive gain from switching. In our view, the evidence presented above should be interpreted as showing that there is a reasonable level of price dispersion in the market, consistent with any competitive retailing environment. In particular, there are limited differentials in the gains from switching for the groups of customers classified by the CMA as disengaged as compared with those that would be judged engaged on the basis of the CMA's definitions.

Evidence of switching between NST and SVT

- 3.28 The CMA's analysis of margin differentials between NSTs and SVTs cannot be equated to price discrimination. Indeed, the CMA has found the two tariffs to be part of the same market. ScottishPower agrees with this assessment; we see many of our customers moving between fixed and SVT tariffs and have observed the relationship between announced changes to the SVT tariff and SVT customer losses. Our ability to raise prices on the SVT tariff is limited by consumer switching, and any relative increase in the SVT tariff price leads to increasing SVT customer losses. Equally, a smaller difference in price between the SVT and other tariffs reduces the incentive for customers who have defaulted onto the SVT to find another fixed tariff deal quickly, either with ScottishPower or another supplier.
- 3.29 Oxera has undertaken an analysis of customer responses to changes in the price differential between the SVT and fixed tariffs. This analysis was based on the dataset for the CMA's domestic pricing analysis in Appendix 10.7, which was made available in the CMA disclosure room. The results indicate that, as this price differential increases, customers leave SVT tariffs. Testing a 10% increase in the SVT price, Oxera's estimates indicate that substantially more than 10% of SVT customers would switch within a year of the SVT price increase, confirming the CMA's conclusion of broad markets for all domestic electricity and gas customers, regardless of tariff type. This indicates that the acknowledged competitive pressure on NST does constrain pricing to SVT customers.

³⁰

We note that switching costs and gains from switching are likely to be in an equilibrium where customers whose gains from switching exceed their switching costs are the ones who choose to switch. The advent of smart meters and near instant switching would be expected to lower costs of switching, bringing down the equilibrium gains from switching that are seen in the market.

³¹ Paragraphs 7.82, 8.54 and 8.56 of the Provisional Findings Report.

³² From the perspective of suppliers, standard credit is associated with higher bad debt, working capital and other costs.

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- 3.30 These results suggest that sufficient SVT customers can and do move to fixed tariffs in direct response to increasing price differentials to have a constraining effect on suppliers' ability to profitably increase SVT tariff rates. This undermines the argument that suppliers have UMP over inactive consumer groups. It is through the process of active customers moving between fixed tariffs and SVTs in response to relative price changes, and the fact that the SVT customer group contains both active and less active customers, that less active customers are protected.
- 3.31 If these two products are part of the same market, the feasible price discrimination is inherently limited by customer-switching. While some discrimination is sustainable, it does not follow that this should be considered to represent an AEC, in particular given that it is implicit in the CMA's conclusions that there is sufficient cross-price elasticity to place the two products in the same market.
- 3.32 In any case, the CMA has not taken into account the fact that a large proportion of customers move between the two tariffs. Its Table 7.1 shows that 40% of customers have been on their current SVT for two years or less, meaning they have recently defaulted onto SVT from an NST or have switched to the SVT of their current supplier.³³ Any assessment of alleged price discrimination must take into account the fact that many customers have recently moved between the tariffs, paying a weighted average of the two prices. Thus, there is no clarity over the segment of customers that have allegedly suffered discrimination.
- 3.33 SP does acknowledge that there is evidence of some domestic customers that are significantly disengaged with the energy market; however, it does not agree that the evidence indicates these customers are being exploited. Despite this, it is supportive of remedies that will lead to an even more effectively competitive market. These are the remedies targeted at increasing engagement and that remove the unhelpful regulatory interventions that are suppressing competitive activity.

4. EFFICIENCY

- 4.1 The CMA has determined an annual competitive price for the supply of domestic electricity and gas. This price has been determined by a partial benchmarking method applied to suppliers' costs and the implicit assumption that a 10% rate of return on efficient capital balances represents a reasonable 'competitive' profit benchmark. ScottishPower considers this assessment to be incorrect and to understate the reasonable efficient costs of an energy supplier. In this section, we set out our concerns with the CMA's efficiency benchmarking methodology, in the next section we explain the issues with the profitability benchmark chosen by the CMA and in section 6 we present a revised view of competitive revenues, given these criticisms and show that the apparent 'over-charging' in domestic revenues disappears and reduces significantly in SME revenues.
- 4.2 Oxera has undertaken a review of the benchmarking analysis carried out by the CMA in the CMA disclosure room. The benchmarking the CMA has done is unconditional in the sense that no adjustment is made for differences in supply- and demand-side factors that may affect the firms' cost performance and over which they may have little or no control. In assessing the reliability of a benchmarking regime, the key issue is whether the comparator is meaningful, in that it represents an achievable outcome in the same way for all the industry participants. On the basis of the analysis carried out by Oxera, we are concerned that the benchmarks used by the CMA to assess the efficiency of the large integrated supply firms are neither meaningful nor achievable as they are based on selective use of data and use a methodology that does not take proper account of: (i) year-on-year variability in cost drivers (particularly in relation to wholesale costs); (ii) the fact that many such cost drivers have different effects on different suppliers (due to differences in their customer mix such as the proportion of customers paying by direct debit); and (iii) that many such factors are

³³

Paragraph 7.72, Provisional Findings Report.

driven by either unpredictable wholesale price variation or consumer choice and are therefore not directly controllable by suppliers.³⁴

- 4.3 In particular, we have the following concerns with regard to the approach used by the CMA.
 - 1. *Use of lower quartile benchmark* under this benchmark, efficiency is defined relative to the unconditional upper quartile (ie, lower quartile in terms of cost) performance of the companies.
 - 2. *Unconditional benchmarking* measures of efficient cost are not conditioned on (observable) factors that may be beyond companies' control.
 - 3. *Selective inclusion of mid-tier suppliers in benchmarking analysis* cost numbers for one of the mid-tier suppliers, which Oxera deem to be a valid comparator, appear to have been excluded from the list of mid-tier suppliers that are used as a benchmark for the six large suppliers. This makes a material difference to the results of the CMA's benchmarking analysis.
 - 4. *Efficiency in wholesale costs* the CMA analysis assumes that wholesale costs incurred by a supplier higher than the CMA's chosen benchmark necessarily represent performance inefficiency.
 - 5. *Annual benchmarking* the efficient benchmark is determined on an annual basis rather than for the whole period examined by the CMA.

Our concerns relating to each of these are set out in more detail below.

Use of lower quartile benchmark

- 4.4 Using the lower quartile benchmark to assess industry-wide efficiency is equivalent to assuming that the industry is inefficient before any analysis is carried out. No matter how cost-efficient firms are in absolute terms, if there are relative differences between firms, the benchmark cost defined in this way will always be lower than the industry average. As there are six large energy suppliers, with a significant competitive fringe of independent suppliers that now accounts for around 10% of the market, it would be wrong to assume that there are persistent inefficiencies in their cost base. Suppliers have every incentive to reduce them: every pound saving in costs represents a pound increase in a supplier's pre-tax profits.
- 4.5 The CMA justifies its use of the lower quartile benchmark by relying on the historic cost performance of mid-tier suppliers, effectively assuming that these do represent efficient performance, unlike the six large energy suppliers.³⁵ First, we note that the cost performance cited by the CMA applies to a particular historic period which the CMA analysed. Since this period may not be representative and the costs examined by the CMA have generally been volatile during the period in question, we would urge the CMA to be cautious in drawing strong conclusions from data pertaining to a limited historic period.
- 4.6 In addition, the use of mid-tier suppliers as the benchmark for assessing the performance of the large integrated suppliers can only be valid if they are subject to similar operating conditions and characteristics of their customer base. In the presence of differences in such factors, any benchmarking analysis would need to be conditioned on these factors to be valid. Analysis undertaken by Oxera in the CMA disclosure room (*Unconditional benchmarking*) shows that the use of unconditional benchmarks is incorrect in the context of wholesale costs due to scale effects and different suppliers having different proportions of SVT customers. In principle, it is also

³⁴ In relation to customers' choice of payment method and tariff, please see paragraph 4.11 below for an explanation of why we believe that suppliers cannot exercise direct control over such factors.

³⁵ See paragraphs 33 and 48 of Appendix 10.5 of the Provisional Findings Report.

incorrect to use unconditional benchmarks in the context of indirect costs since different firms will have a different customer mix, particularly by payment method and the need for priority services, where each of these factors could have a significant impact on cost measures such as bad debt and billing.

4.7 More problematic for the justification of the lowest quartile measure for the indirect cost benchmark is the selective use of the cost information of the mid-tier suppliers. Oxera's disclosure room analysis showed that there is only one mid-tier firm that represents a valid comparison to the large integrated suppliers and which had indirect costs below the lower quartile measure for those suppliers. This approach is inherently biased and sensitive to outliers since, in the presence of differences in customers and operating conditions across firms, the single best performing firm is unlikely to be a good representative of the industry as a whole. More evidence of this is set out below (*Selective inclusion of mid-tier suppliers in benchmarking analysis*). The indirect cost performance of the best performing comparable mid-tier supplier is out of line with the average performance of the three appropriate mid-tier comparators (\pounds 73) by a wide margin.

Unconditional benchmarking

4.8 In benchmarking the performance of regulated companies, it is standard practice to condition that performance on factors that are outside of those companies' direct control. The benchmarking analysis for the six large supply companies carried out by the CMA does not control for any such factors. While conditions in the CMA disclosure room did not allow Oxera to include a full set of controls in their analysis, the following factors were included, which are likely to have the greatest influence on supplier costs. These factors were derived separately for electricity and gas.

Wholesale cost

- Volume of electricity/gas delivered to SVT customers
- Volume of electricity/gas delivered to customers on other tariffs

Indirect costs

- Total number of customers served
- Number of direct debit customers
- Number of customers on the PSR
- 4.9 The proportion of gas/electricity delivered to SVT customers would be expected to have an effect on wholesale costs because hedging of demand for SVT customers takes place on a different basis from hedging of demand for fixed tariff customers. For SVT customers, hedging generally takes place on a rolling basis where suppliers start acquiring energy in anticipation of SVT customer demand 2-3 years ahead of delivery and gradually complete the hedge between this time and the day ahead of delivery. For fixed tariff customers, suppliers buy wholesale hedging products that match the tenor of the customers' tariffs as more customers are signed up. This process takes place over the small number of weeks in which a given fixed tariff product is available.
- 4.10 For indirect costs, the following controls were investigated:
 - the number of customers, since billing and customer relationship costs are more closely related to the number of customers than their total demand;

- the number of direct debit customers, since this is assumed to affect indirect costs as these customers are generally much less affected by bad debt. The cost of billing and processing payments for these customers is also expected to be lower as it can be more automated than for credit customers; and
- the number of customers on the PSR, since the cost of serving such customers can be expected to be higher. Such customers may require their meter to be read for them, and disconnecting them if they fail to pay their bills is much more difficult than for other customers.
- 4.11 Critically, for the purposes of the CMA's assessment, the factors set out above are largely beyond the direct control of suppliers. In particular, while a lot of work has been done by ScottishPower to try to persuade our customers to move to direct debit contracts, which is in our interest from a working capital and bad debt management perspective, customers must have the final say over their payment method and we do not believe that they should be forced into a choice that they do not feel is right for them. Equally, while suppliers can and do undertake marketing to encourage their and other suppliers' customers to consider alternatives to the SVT tariff, they are unable to force customers to do so and the regulation introduced by Ofgem forces suppliers to default customers with an expired fixed tariff onto the SVT. Finally, suppliers have little control over the number of their customers registered for priority services.
- 4.12 The results of Oxera's conditional efficiency analysis, which are set out in full in Oxera's confidential disclosure room submission to the CMA, are stable across different model specifications but show a very different ranking in each case compared to that which is derived from unconditional analysis as undertaken by the CMA. This demonstrates the importance of conditioning any analysis of efficiency on factors that can influence cost and are beyond the reasonable control of suppliers. The CMA's derivation of 'competitive revenues' from unconditional cost benchmarks is therefore highly problematic. Such revenue or price predictions should be based on cost benchmarks derived from efficiency analysis that encompasses all relevant suppliers and controls for differences in relevant cost drivers.

Selective inclusion of mid-tier suppliers in benchmarking analysis

- 4.13 As set out above (*Use of lower quartile benchmark*), in its Provisional Findings Report, the CMA justifies the use of the lower quartile benchmark by referring to performance by some mid-tier suppliers, which it says is in line with that benchmark. In addition, the cost numbers for one of the mid-tier suppliers, which Oxera deem to be a valid comparator, appear to have been excluded from the list of mid-tier suppliers that are used as a benchmark for the six large suppliers. This makes a material difference to the results of the CMA's benchmarking analysis. We consider that the fullest set of available mid-tier comparators to the large integrated energy firms are First Utility, Co-op and OVO. We believe that Utility Warehouse is not an appropriate comparator because, given the nature of its arrangement with RWE, it does not appear to report its costs in the same way as other mid-tier independent suppliers.³⁶
- 4.14 Oxera carried out further analysis of indirect costs using the appropriate comparators set out above. The analysis covered the period from 2011 to 2013 inclusive. This excludes an earlier period for which cost data for mid-tier comparators is incomplete. It also mitigates any concern around figures for mid-tier suppliers being distorted by them being in an early phase of their growth cycle.
- 4.15 Average indirect costs across all three years and all suppliers within the mid-tier and large integrated categories are £73 and £75 per customer account respectively, indicating that, on average across the relevant companies and the period from 2011 to 2013, the performance of the large integrated

³⁶ Evidence of this was obtained by Oxera from the CMA disclosure room and included in Oxera's confidential submission to the CMA.

companies in controlling their indirect costs has not been significantly different from that of the midtier independents. These numbers compare to a lower quartile benchmark for the large integrated suppliers of £64 per customer account for the same period, which is substantially below the average performance of the comparable mid-tier suppliers.

4.16 This assessment of the indirect unit costs of the six large energy suppliers and the broader group of mid-tier suppliers calls into question the CMA's choice of the lowest quartile indirect costs of the six largest suppliers as the relevant competitive benchmark for indirect costs.

Efficiency in wholesale costs

- 4.17 Aside from the argument of introducing appropriate controls for the costs of suppliers, the exercise of benchmarking the wholesale hedging costs undertaken by the CMA is conceptually flawed. These costs are determined by the price of wholesale hedging products, are inherently very volatile, and are influenced by two factors wholesale price fluctuations and approach to risk which indicate nothing about the efficiency of the supplier.
 - 1. Wholesale price fluctuations Volatility of wholesale prices of electricity and gas means that fortuitous timing of purchases can determine the ranking of a given supplier in terms of wholesale cost for a given year or longer. The purchase of a year-ahead product is made at a price in one given moment in time and this price is then fixed for the entire year in which this product is delivered. This factor is amplified in the case of longer contracts which exist in the gas market.
 - 2. Risk management strategy SVT tariff prices tend to change gradually, matched by the gradual changes in the total cost of a rolling hedge. However, a supplier can choose to adopt a higher risk strategy by deviating from the rolling hedge and relying on products with shorter tenor. In a market where wholesale prices are falling, which has generally been the case from around 2013 to date, spot prices will be lower than forward prices for the corresponding delivery period, and hence suppliers that choose a more risky hedging strategy will look more efficient. Indeed, comparing ScottishPower's outturn energy costs to theoretical energy costs under the assumption that all energy is bought at spot market prices shows that, for 2005-2008, the reported cost was 18% lower than the theoretical spot market cost. This indicates that comparison of outturn wholesale costs incurred under different hedging strategies is meaningless and that due consideration should be given to the risk associated with a given hedging strategy. It is not obvious that there is any merit in judging suppliers that take more risk in their hedging decisions to be more efficient.
- 4.18 On the basis of data in the CMA disclosure room, Oxera produced rankings of the six large integrated suppliers in terms of their annual wholesale gas and electricity costs for the period from 2007 to 2013. These are reproduced in the graphs below.



- 4.19 The rankings are extremely volatile despite the companies' respective hedging strategies remaining more or less the same over time. It is not uncommon for the ranking of a company to change from first to last within just two years. This provides strong evidence that the long-term direction and short- and medium-term fluctuations in suppliers' wholesale costs are largely outside of their control and assessing the performance of individual suppliers or the industry as a whole in terms of wholesale cost levels is therefore inappropriate.
- 4.20 The problems highlighted above are amplified significantly by benchmarking wholesale costs on an annual level in the case of the lower quartile benchmark. This is discussed in more detail below (*Annual benchmarking*). The effect of this is that the benchmark becomes a weighted average of the wholesale costs of the most fortuitous suppliers in every given year.

Annual benchmarking

- 4.21 The lower quartile benchmark is assessed on an annual basis in the CMA analysis for both wholesale and indirect costs, meaning that the firms that form a part of the benchmark can be and often are different from one year to the next. This is contrary to the practice of benchmarking costs in regulated utilities, where cost performance is assessed for the whole duration of a price control period.
- 4.22 Tables produced by Oxera in the CMA disclosure room demonstrate that the gap between average company cost performance and the lower quartile benchmark is much larger when it is assessed on a year-by-year basis than when it is assessed for average costs across the period from 2007 to 2013.³⁷

³⁷ Full details are contained in Oxera's confidential submission to the CMA.

In particular, the following tables show the difference in the average estimated efficiency ratings (ratio of the lower quartile measure of cost against either average or median cost) for the large integrated suppliers depending on whether these are calculated year-by-year or on the basis of average costs across different years. These are shown for wholesale gas and electricity costs, noting that such costs are particularly volatile and therefore the difference in approach to calculating efficiency ratios is expected to have the greatest impact in these cost categories.

	Average ratio calculated on year-by-year basis	Ratio calculated on the basis of average costs across different years
LQ/average ratio	0.95	0.99
LQ/median ratio	0.96	0.98

Table 4: Relative efficiency measures (wholesale costs – gas)

Table 5: Relative efficiency measures (wholesale costs – electricity)

	Average ratio calculated on year-by-year basis	Ratio calculated on the basis of average costs across different years
LQ/average ratio	0.96	0.98
LQ/median ratio	0.97	1.00

- 4.23 For both gas and electricity, the choice of efficiency benchmark is shown to have a significant impact on estimated efficiency of the large integrated suppliers. For example, when assessing average supplier performance against the lower quartile benchmark (lower quartile (LQ)/average ratio), calculating the lower quartile benchmark and assessing supplier performance on a year-by-year basis results in estimated inefficiency of around 5%. However, if the lower quartile benchmark is assessed on the basis of performance across the period from 2007 to 2013, estimated inefficiency is only around 1%.
- 4.24 Another way to look at this issue is to see whether the average performance of any company beats the average LQ benchmark used by the CMA, which was calculated year-by-year by Oxera. For wholesale gas costs, the average LQ benchmark is £20.0/MWh and [CONFIDENTIAL] outperforms this on an average basis. For wholesale electricity costs, the average LQ benchmark is £56.7/MWh and [CONFIDENTIAL] outperforms this on an average basis. This simple analysis shows the distortive effect of annual benchmarking on the efficiency estimates.
- 4.25 To the extent that one supplier's costs differ from another's due to wholesale price fluctuations or long-term trend, this should not be attributed to efficiency. To the extent it is driven by different approaches to managing risk, each company is best-placed to take that judgement itself and will bear any costs that arise from its choice of a particular strategy. Thus, again, it is not obvious that cost variations arising from different risk approaches should be attributed to efficiency.
- 4.26 We therefore consider that observed wholesale costs should be passed through in the analysis to determine benchmark competitive revenues. As an alternative, any wholesale benchmark should be calculated over the whole relevant period to avoid a benchmark based predominantly on random fluctuations in wholesale prices and fortuitous timing of wholesale market transactions.
- 4.27 In relation to indirect costs, while the rankings of different firms are more stable than for wholesale costs, we note that the absolute indirect cost levels for each company are volatile. In addition, we

note that these costs are not adjusted for quality of service, customer numbers or customer characteristics which we have shown above (*Unconditional Benchmarking*) could have a large impact on relative rankings. These factors put into doubt the validity of using the unconditioned lower quartile benchmark to assess indirect costs of suppliers.

Conclusion

4.28 The evidence set out above leads us to believe that the benchmarks used by the CMA to assess the efficiency of the large integrated supply firms are neither meaningful nor achievable. Since the benchmarking analysis undertaken by the CMA is used as evidence for the alleged gap between actual and competitive revenue of the large integrated suppliers, and ultimately underpins the proposed price control remedy (Remedy 11), the strong conclusion drawn by the CMA in the Remedies Notice with respect to Remedy 11 should be based on robust analysis. On the basis of the evidence obtained by Oxera from the CMA disclosure room, we do not believe that the appropriate standard of robustness in the benchmarking analysis undertaken by the CMA has been met.

5. **PROFITABILITY**

- 5.1 The CMA relies on its finding that profitability for the industry as a whole is excessive to support its conclusion that the average domestic customer paid around £60, or 5%, more on a typical dual fuel bill than would have been expected if the markets had been functioning more effectively.³⁸ The CMA has analysed the profitability of the Six Large Energy Firms using ROCE. The average ROCE for the industry is calculated to be 28% and this is then compared to the estimated WACC for supply of 10%. The CMA concludes this is a sign that market power is being exploited in the domestic energy supply market.
- 5.2 Energy supply is characterised by very low and changeable levels of capital employed. Based on the CMA's analysis of capital employed, industry revenues are about 10 times greater than the capital employed. As previously argued by ScottishPower, this suggests that ROCE statistics are unlikely to provide meaningful or consistent indicators of excess returns at either company or industry level. In particular, companies with good working capital management techniques may be flagged as earning excess returns because their observed capital employed is likely to be small or even negative. For example, ScottishPower has the highest proportion of direct debit customers of the Six Large Energy Firms³⁹ which explains why in some years the working capital component of the capital employed might be negative. This has a disproportionate effect on the calculated ROCE statistic. However, it is not evident that this is a good indicator of excess profitability.
- 5.3 To demonstrate this effect, the table below shows a high level indicative estimate of the EBIT and capital employed for ScottishPower in 2012,⁴⁰ disaggregated between its domestic direct debit business and the rest of ScottishPower.⁴¹ Although in practice no energy supplier is likely to sell exclusively to direct debit customers, we consider the 'ScottishPower direct debit business' could represent a reasonable proxy for an independent supplier which has grown to a similar scale to ScottishPower.

³⁸ Paragraph 10.134 of the Provisional Findings Report.

³⁹ According to Ofgem's Quarterly Social Obligations Monitoring Q4 2013, 65.5% of ScottishPower's electricity customers were paying by direct debit and 73.7% of its gas customers, in each case the highest percentage of any of the Six Large Energy Firms (see https://www.ofgem.gov.uk/ofgem-publications/92059/monitoringsocialobligations-q42013datareport.pdf). The average for GB as a whole

is around 57% for both electricity and gas (see https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/388121/qep_dec_14.pdf).

⁴⁰ The first year for which suitable data was available for us readily to perform the analysis. Similar calculations for 2013 could be provided

 ⁴¹ if required, given more time.
 ⁴¹ We have based this on the ROCE analysis provided by the CMA, i.e. before making any of the adjustments suggested in this paper.

	SP DD business	Rest of SP business	SP total
Adjusted EBIT (£m)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
Adjusted Capital Employed (£m)	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]
ROCE	[CONFIDENTIAL]	[CONFIDENTIAL]	[CONFIDENTIAL]

Table 6:	Theoretical ROC	E calculation	for SP DD and	l remaining retai	il husiness
I able 0.	Incorcaca noc			i i cinanning i ciai	n business

Source: ScottishPower analysis

- 5.4 The ROCE for the ScottishPower direct debit business is **[CONFIDENTIAL]**% as a result of positive EBIT and negative capital employed. This suggests to us that the ROCE is meaningless as a measure of profit for an energy retail business.
- 5.5 In addition, the choice to treat a particular cost item as an in-year expense, rather than investment that is capitalised onto the balance sheet and then depreciated, is likely to increase ROCE estimates substantially. This effect may be disproportionately large for a business such as an energy supplier, which has few tangible assets.
- 5.6 Having reviewed the assumptions underpinning the CMA's ROCE calculations, it is evident that the statistics are highly volatile between years and between companies and are very sensitive to the underlying assumptions. As can be seen from the figure below, even at the industry level capital employed and, in particular, working capital balances exhibit high volatility.



Figure 1: Capital employed, EBIT and working capital per customer for the industry (GBP) – using CMA's estimates

- 5.7 Further, we have reservations about the CMA's valuation of the customer base and its treatment of the trading fee. On the valuation of the customer base, we are concerned that the customer value obtained by the CMA is very low relative to the values implied by transactions involving large numbers of relatively engaged customers. On the treatment of the trading fee, we are concerned that treating it as an expense item, rather than using it to derive the implied value of risk capital held by the large integrated energy suppliers, understates the value of the assets employed by these suppliers. Our specific concerns are discussed in more detail below.
- 5.8 We therefore believe that the CMA has placed undue weight on the ROCE evidence in forming its assessment of the adverse effects on competition and suitable remedies and that, given the concerns highlighted in this note, the ROCE estimates obtained by the CMA are significantly overstated. In our view, this reinforces the need for the CMA to place a much greater weighting on the evidence provided by industry sales margins.
- 5.9 When profitability is considered on a margin basis, the average margins for the industry as a whole and for domestic supply in particular, are 3.4% and 3.3% respectively. These are only slightly higher than the top end of the CMA's own assessment of appropriate margins for energy supply of 1 to 3%.⁴²

Customer valuation

5.10 A key asset of an energy supply business is likely to be the underlying customer base. The CMA's methodology for capitalising the costs recorded by companies as customer acquisition costs in the P&L implies the following valuations for individual companies' customer bases and total capital employed per customer respectively.

⁴²

Paragraph 10.102 of the Provisional Findings Report.

	2007	2008	2009	2010	2011	2012	2013	Average (2007-13)	Average (2009-13)
Using the CMA's estimate of the customer base	41	41	41	42	41	40	38	41	41
Using the CMA's estimate of the entire balance sheet	83	85	97	75	107	98	107	93	97

Table 7: Implied value per customer (£) using CMA's estimates

- 5.11 However, evidence from transactions involving the transfer of large numbers of customers between suppliers suggests that energy supply customers in fact have a much higher value. In particular, we would draw attention to the transaction between RWE npower and Utility Warehouse owner, Telecom Plus, in which the business containing approximately 800,000 customers of RWE's white label business Electricity Plus and Gas Plus customers who are likely to be at the more 'active' end of the switching spectrum was valued at approximately £280 per customer.⁴³
- 5.12 Substituting the £280 value per customer account into the CMA's ROCE analysis for the industry as a whole reduces the average industry ROCE to levels close to the benchmark WACC of 10%, as illustrated in the figure below. To recognise that the transactions may have involved the transfer of the associated working capital balances and other assets associated with serving these customers, we have used the £280 figure as an estimate of the total capital employed per customer in our calculations.



Figure 2: Industry ROCE, sensitivity to customer valuation

⁴³

These customers had previously been supplied on a 'white label' basis by Telecom Plus's Utility Warehouse brand. (See https://npower.presscentre.com/Press-releases/RWEnpower-announces-sale-of-subsidiariesto-Utility-Warehouse-owner-Telecom-Plus-Plc-for-218m-12dd.aspx). Similar figures for customer valuation are also obtained using the recent discussions between Mayfair Equity Partners and Ovo relating to Mayfair offering to acquire a large minority stake in Ovo, which reportedly values Ovo at over £200m (http://www.lbc.co.uk/energy-challenger-ovo-close-to-200m-deal-108196). Assuming Ovo currently has 770k services (based on Cornwall data), this is equivalent to £260 per service.

- 5.13 This results in a higher capital base for the industry than implied by the CMA's analysis. This may reflect the fact that, at the industry level, the CMA's analysis, which only capitalises very specific customer acquisition costs and assumes an 8-year customer asset life, may be unduly conservative. For example, there may be other costs that merit similar treatment due to their enduring value.
- 5.14 Recognising that there are a number of uncertainties with such a calculation, and that the £280 figure relates to a transaction from 2013, we have also tested a scenario where the customer account value is adjusted with inflation (assumed to be 2.5% p.a. for illustration) and the subsequent holding gain due to inflation is recognised on the P&L. This scenario represents the upper bound for the ROCE in the figure above.
- 5.15 Under the scenarios considered, the average industry ROCE reduces to about 10%-15%, as shown in the figure above (rounded to the nearest 5% to reflect the high-level nature of the calculations). This is much closer to the benchmark WACC and illustrates the importance of the customer valuation assumption in the CMA's conclusions.

Trading fee

- 5.16 A notional trading fee is added to wholesale energy costs of the six large suppliers to account for services provided to the supply arm by the trading arm of the same integrated business. The CMA had previously argued that such fees are equivalent to a holding of risk capital by an integrated energy firm.
- 5.17 On the basis of the information on equivalent trading arrangements entered into by some mid-tier suppliers that has been released by the CMA to date, we are not confident that such arrangements cover all of the risks to which an integrated energy firm is exposed.
- 5.18 Whether the fee is treated as an operating cost incurred by the suppliers or treated as a component of the capital employed can make a material difference to the results, given the low observed capital intensity of the business.
- 5.19 For example, using the same figures as used by the CMA for the trading fee but instead translating it into the required amounts of notional risk capital, the industry ROCE reduces from 28% to c.20%. This is simply a re-presentation of the CMA's own analysis and using the CMA's own WACC, but translating the trading fee into a financially equivalent balance sheet item.
- 5.20 This again highlights the sensitivity of ROCE results to changes in the underlying assumptions or businesses with low levels of capital employed and suggests that these headline statistics are critically dependent on assumptions related to underlying asset values, and are therefore not a reliable indicator of excess returns.
- 5.21 The above analysis illustrates how the ROCE statistic can vary significantly even while core underlying financial features of the performance of the industry remain unchanged. In our view, this reinforces the need for the CMA to place much greater weight on the evidence provided by industry sales margins.

Margin benchmarking

5.22 We would also note that the CMA's ROCE analysis implies that a reasonable level of profit (earnings before interest and tax (EBIT)) margin is 1.3% for the industry. This is low and is not fully consistent with the CMA's own analysis of potentially suitable profit margin benchmarks for the sector. Specifically, the CMA also states that: (Chapter 10, para 10.131)

"We note that EBIT margins are very sensitive to the level of capital employed and would caution against a precise estimate, however margins in the range of 1 to 3% would appear to provide a reasonable guide for what is required to cover efficient levels of capital employed and operating costs. We would emphasise that whilst average out-turn domestic margins of 3.3% are only slightly above this range, the average disguises wide variations in profit margins between suppliers."

- 5.23 The observed average margin over the period is 3.4% for the Total Supply business and 3.3% for domestic supply. Based on the CMA's own conclusion that margins in the range of 1 to 3% might be reasonable, the CMA's own analysis does not support the finding of excessive profitability, when considered on a margins basis. If operators are efficient (as discussed previously, the evidence on inefficiency is weak), then a margin of 3.3% might suggest that the average bills are only 0.3% above their hypothetical competitive level.
- 5.24 The CMA's range of 1 to 3% is partially informed by average out-turn margins in the industrial and commercial (I&C) segment of 2% and evidence from independent suppliers who suggested that a margin of 3% might be a reasonable target for an efficient supplier. There is, however, no direct evidence presented by the CMA to support the lower bound of 1% of its proposed benchmark range. In particular, we would note that regulatory precedent from GB energy sector suggests that even for a regulated supplier with ability to fully pass-through changes in wholesale costs, the allowed profit margins were around 1.5 to 2%. The CMA notes that GB energy suppliers today also have some ability to pass through wholesale costs. Unless the CMA has conclusive evidence that suppliers can pass on all changes in wholesale costs, which we do not believe to be the case, the appropriate level of margin should be higher than 1.5 to 2%.
- 5.25 In relation to I&C customers, as acknowledged by the CMA, I&C customer contracts tend to allow for greater pass-through of costs than domestic customer contracts. The CMA suggests that I&C customers might be more risky than domestic customers because of greater exposure to the economic cycle, which may offset some of the lower risk features of the contracts themselves. While we do not fully agree with the CMA's assessment and overall consider I&C to be lower risk than domestic supply, even if one were to follow the CMA's logic, at the very least, one would conclude that domestic customers are broadly similar risk to I&C customers, and, therefore, a benchmark margin of 2%, not 1.3%, is appropriate.
- 5.26 All of this suggests to us that the benchmark margin of 1.3% implied by the CMA's ROCE analysis is unrealistically low. As explained above, this is likely to be explained by the CMA understating the capital employed for the energy suppliers. A figure in the upper half of the 1 to 3% range identified by the CMA is more plausible.
- 5.27 Finally, we would note that the CMA generally places less weight on margin benchmarking, partially because it is an incomplete picture of profitability but also because it is difficult to find suitable comparators to estimate the appropriate benchmark margin. The issue of difficulty of identifying comparators also arises in estimating the asset beta for energy supply.
- 5.28 The CMA itself has been unable to find suitable comparators. The estimated betas for the few energy suppliers that have a stock market listing produce unreliable results, as noted by the CMA. The CMA therefore has suggested that the asset beta for energy supply should be the same as for the market on average (which it derives to be around 0.7-0.8 using an equity market beta of 1 and average gearing for the market).
- 5.29 Energy supply is an asset light business. Based on the CMA's analysis of capital employed, industry revenues are about 10 times greater than the capital employed. This suggests that even small movements in profits will generate large changes in the underlying enterprise value of the companies (and it is the change in enterprise value relative to the stock market that is effectively captured by the beta statistic).

- 5.30 For example, a 1% volume shock (which leads to a 1% decline in revenues), assuming that around 70% of an energy supplier's costs are variable, and using the CMA's assumption of a 10% benchmark WACC, would imply a reduction in the enterprise value of the firm by 3%. This sensitivity of market value to the profit fluctuations would appear to be large and suggest a relatively high exposure to systematic risk (potentially higher than the market).
- 5.31 To conclude that energy supply betas will behave similarly to the average market beta (which will be representative of average capital intensity in the market) is a very strong assumption to make. The enterprise value is likely to be materially greater relative to revenues and profits for average firms in the market. Therefore, it is quite likely that using the CMA's definition of capital employed the average correlation of returns of energy supply businesses with the market will be greater than for the market on average. This could have the effect of increasing the WACC by several percentage points. This calls into question the reliability of the CMA's profitability analysis that relies heavily on the assumption that the benchmark WACC for energy supply is 10%.

Conclusion

5.32 In summary, we do not accept that any reliable conclusions about excess profits can be drawn from the 28% ROCE figure cited by the CMA relative to the estimated WACC of 10%. First, these statistics are highly volatile and sensitive to the CMA's underlying assumptions, given the low capital intensity of the business. Secondly, the CMA's estimates of the value of a customer base are relatively low in comparison to evidence from market transactions. This indicates that the ROCE estimates obtained by the CMA are significantly overstated. In addition, the profit margin implied by the ROCE analysis is implausibly low and is not consistent with the CMA's own evidence base on plausible levels of benchmark margins. Since the profitability analysis undertaken by the CMA contributes to estimates of the gap between actual and competitive revenue of the large integrated suppliers, and ultimately underpins the proposed price control remedy (Remedy 11), we believe that the CMA should seek a reliable methodology for assessing energy supply profitability.

6. COMPETITIVE PRICE BENCHMARK

6.1 The CMA's views on efficient costs and margins, which are critiqued above, are an important part of its basis for finding an adverse effect on competition in the market. It uses this analysis to:

"inform our view of the level of prices that suppliers would have required in order to cover reasonably efficient levels of costs and earn a fair rate of return on capital employed. We term this the 'competitive benchmark' on the basis that, had competition functioned more effectively over the period, we would expect prices to have been driven down to this level. As such we consider this provides an illustration of price levels in a better functioning, but not necessarily perfectly competitive, market."⁴⁴

- 6.2 On the basis of its views as to efficient levels of costs and profits, the CMA reports that domestic gas and electricity revenues have been 5% higher and SME gas and electricity revenues have been 14% higher than these benchmarks.
- 6.3 Using the data contained in the CMA disclosure room and reflecting some of the criticisms of the CMA's analysis set out above, Oxera produced alternative estimates of these figures. Using a number of more reasonable alternative approaches, Oxera found that the alleged 5% gap between the estimated competitive benchmark and actual prices charged by the large integrated suppliers for domestic customers reduces to 1% or is even negative. For SMEs the 14% gap reduces to 7% on the basis of changes to the cost benchmarks alone.

⁴⁴ Paragraph 10.43 of the Provisional Findings Report.

- 6.4 In particular, Oxera examined four alternative scenarios:
 - 1. Pass-through of average wholesale costs as set out above, this is chosen on the basis that variations in these costs are largely determined by wholesale price fluctuations and the level of risk inherent in a given strategy;
 - Indirect cost benchmark calculated on the basis of average mid-tier indirect costs (not LQ SLEF)

 this is chosen on the basis that the CMA appears to justify its use of the lower quartile benchmark for indirect costs on the cost performance of a single mid-tier independent supplier that has the lowest costs of all such comparable suppliers⁴⁵, an approach that is highly selective and vulnerable to outliers. Average mid-tier cost performance is a more reliable benchmark;
 - 3. Lower quartile wholesale cost benchmark on the basis of average company costs across several years this scenario is modelled as a second alternative to the CMA's approach. It will remove much of the apparent 'efficiency' that in fact is driven by the benchmark changing very frequently due to annual volatility of wholesale costs;
 - 4. Adjusting the capital base to reflect a market-tested customer value —this scenario is modelled to reflect a more realistic valuation of the customer base that is verified against corporate transactions involving acquisitions of portfolios of customers that were acquired competitively. We would note that this scenario captures two different effects. First, it shows the impact of more representative customer values on the benchmark revenues. Secondly, it also offsets the implied overcharge resulting from the supposedly inefficient levels of capital employed identified by the CMA in the benchmarking exercise. Specifically, the CMA adjusts the fixed assets and the working capital components of the capital base to reflect its view of 'efficient' levels of these balances. Both of these effects are significant. Finally, we note that this scenario is not appropriate in the case of SME customers since the valuation of such customers would be expected to be very different to domestic customers due to, among other factors, their significantly greater average demand;
 - 5. Scenarios (1) and (2) together this scenario jointly addresses our critiques of the approach to benchmarking of wholesale and indirect costs taken by the CMA;
 - 6. Scenarios (1), (2) and (4) together this scenario jointly addresses our main critiques of the approach taken by the CMA. We note that this scenario is not appropriate in the case of SME customers since the valuation of such customers would be expected to be very different to domestic customers due to, among other factors, their significantly greater average demand.
- 6.5 The table below shows the impact of the different scenarios set out above on the percentage gap between the estimated competitive benchmark and actual prices charged by the large integrated suppliers for domestic and SME customers respectively.

	Estimated efficiency gap (domestic)	Estimated efficiency gap (SME)
CMA base case	4.6%	14.2%
Scenario 1 – wholesale cost pass-through	2.5%	12.7%

Table 8: Impact of different scenarios

⁴⁵

See paragraph 48 of Appendix 10.5.

Scenario 2 – average mid-tier indirect costs	2.8%	10.1%
Scenario 3 – average wholesale costs	3.3%	13.9%
Scenario 4 – market-based customer valuation	0.9%	n/a
Scenario 5 – scenarios 1 and 2 combined	0.9%	7.4%
Scenario 6 – scenarios 1 and 2 and 4 combined	-2.8%	n/a

- 6.6 In particular, for domestic customers, combining the more reasonable approaches to benchmarking of wholesale and indirect costs (Scenario 5) brings the estimated efficiency gap to less than 1%. Also, in the absence of any other changes to assumptions or methodology, employing the alternative proposed approach to reflecting customer value in supply business financials (Scenario 4) brings the estimated efficiency gap down to less than 1%.
- 6.7 As noted in our overview of the CMA's profitability analysis, we consider that for the energy supply industry, analysis of profitability using return on sales, or margin, statistics is more appropriate than ROCE analysis.
- 6.8 The CMA's analysis of profitability based on ROCE implies a competitive benchmark level of EBIT margin of 1.3%. Given that the average domestic profit margin over the five-year period is 3.3%,⁴⁶ the implied 'overcharge' at the industry level is (by simple arithmetic) alleged to be around 2.1%. If instead of using the ROCE basis and the implicit 1.3% margin, the CMA were to assume that a 2%⁴⁷ margin was a more reasonable level of profit margin for the industry in their competitive benchmark analysis, the 'gap' in scenario 5 above of 0.9% would reduce to close to zero. If the upper bound of the range they consider reasonable (3%) were used, the gap would be negative.
- 6.9 This further highlights the sensitivity of the CMA's results to the underlying assumptions and reinforces our view that the CMA has placed undue weight on its profitability and benchmarking analysis in its findings of AECs in the energy supply market. Overall, the criticisms of the analysis underpinning the Provisional Findings Report that are set out above put into doubt the robustness of the evidence relied upon by the CMA in support of its conclusion that the relevant markets exhibit material inefficiency and excess returns, a finding that we submit must be based on a high evidential threshold and one that has not been met in the present case.

46 47

Appendix 10.2, Table 1 of the Provisional Findings Report.

The observed average margin of 2% for I&C customers might also serve as a potential benchmark, according to the CMA (Paragraph 10.96 of the Provisional Findings Report).

ANNEX 1

SUMMARY OF CMA CONSUMER SURVEY ANALYSIS

Table 9: Potential definitions of disengagement mentioned by the CMA

Indicator	Percentage of respondents	Reference paragraph	Alternative interpretation
Have never considered switching supplier	34%	Appendix 8.1.5.a	Only 11% do not know it is possible to switch supplier. 22% would not consider in the future
Never shopped around or did not know it is possible to switch supplier	60%	Appendix 8.1.5.b	90% know it is possible to switch.
Did not know it was possible to switch supplier	11% (10% in RMR)	Appendix 8.1.4.a	
Never shopped around	49%	Appendix 8.1.5.a- c	12% of respondents have never shopped around, but have switched supplier
Never switched supplier or did not know or did not know it was possible	56%	Appendix 8.1.5.c	89% know it is possible to switch supplier
Never switched tariff with the same supplier or never considered it or know they could	49%	Appendix 8.1.5.e	Focuses on tariff switching within supplier. Some suppliers do not have attractive tariff offerings. 44% of respondents have switched supplier. 10% of respondents don't know if they've considered internal switching/are unaware of internal switching.
Never switched supplier and never switched tariff	44%	Appendix 8.1.5.f, Table 3	56% have switched. 44% have switched supplier, 12% have switched tariff, but not supplier.
Unlikely to consider switching supplier in the next three years	42%	Appendix 8.1.5.g, Figure 1 in Appendix 8.1	Figure 1 shows that 12% of respondents that say that they are unlikely to switch have switched in the last 3 years. Only 22% of respondents have not already switched and are unlikely to consider switching.
Never switched supplier and tariff and are unlikely to consider doing so in the next three years	22%	Appendix 8.1.5.h	
Attitudes towards energy: take active interest in their energy usage and expenditure	70%	Annex A	15% of the people who disagree have switched in the past 3 years (Figure 4 of Appendix 8.1)
Attitudes towards energy: agree that there are no real price differences between suppliers	48%	Annex A	18% of the people who agree have switched in the past 3 years (Figure 4 of Appendix 8.1)
Attitudes towards energy: agree that switching is a hassle they do not have time for	57%	Annex A	17% of the people who agree have switched in the past 3 years (Figure 4 of Appendix 8.1)
Tariff type: SVT	69% gas, 71% electricity, of which	7.66-73, Table 7.1	37-39% of SVT customers have

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	respectively 35% and 31% for over 61 months.		duration less than 2 years. Only 30-35% for 5 years or more.
Payment method: standard credit	26% electricity, 24% gas with Big Six suppliers. 32% electricity, 38% gas with incumbent suppliers. 25% electricity, 21% gas with non-incumbent suppliers.	Figure 7.7, Table 7.2, Table 7.3	Electricity standard credit and SVT (19%), and standard credit and NST (5%). Gas standard credit and SVT (21%), and standard credit and NST (5%). There are benefits from paying with standard credit, e.g. greater flexibility, so it can be an active choice.
With respect to payment type, tariff and choice of supplier, the most likely to be inactive are customers on single fuel, SVT and paying with SC	6% gas, 10% electricity	Table 7.2	

ANNEX 2

EVIDENCE ON PRICE DISPERSION

White goods

Product	Highest price (£)	Lowest price (£)	High to low savings	Median price (£)	Median to low savings
Washing machines	369	240	35%	281.99	23%
Microwave oven	94.36	58	39%	69.99	17%
Refrigerator	829	524	37%	554.99	6%
Dishwasher	375	260	31%	279.99	7%

Sources for the data are as follows:

Product	Brand and model	Source high price	Source low price	Source median price	Number of retailers compared	
Washing machine	Hotpoint BHWM 129 2 - Washing machine - built-in - width: 59.5 cm - depth: 55 cm - height: 82 cm - front loading - 52 litres - 7 kg - 1200 rpm - white	Littlewoods	Ashcott Appliances Online	Whitebox	23	
Microwave oven	Panasonic NN-E271WMBPQ - Microwave oven - freestanding - 20 litres - 800 W	iNest.co.uk	Electronic empire	Multiple retailers	27	
Refrigerator	Hotpoint Quadrio French- Door Fridge Freezer - Stainless steel - FFU4D X - Class A+	Home base	BHS direct	Appliance World	25	
Dishwasher	Bosch ActiveWater Classixx SMS40C02GB - Dishwasher - freestanding - height: 81.5 cm - white	Peter Tyson Appliances	Boots Kitchen Appliances	RDO Kitchen Appliances	19	

Note:

- 1. Data on prices is from August 1st, 2015, from Google Shopping, excluding used or refurbished goods and taking the base price.
- 2. High to low savings = (Highest price Lowest price) / Highest price
- 3. Median to low savings = (Median price Lowest price) / Median price

Milk

Product	Retailer	Price size 1 (£)	Price per litre size 1 (£)	Price size 2 (£)	Price per litre size 2(£)	Price size 3 (£)	Price per litre size 3 (£)	Max potential savings per litre (£)
Sainsbury's/ TESCO British Semi Skimmed Milk	Sainsbur y's, TESCO	0.75 (2 pints)	0.66 (2 pints)	1 (4 pints)	0.44 (4 pints)	1.48 (6 pints)	0.43 (6 pints)	0.23
Semi Skimmed milk essential Waitrose	Ocado	0.49 (1 pint)	0.86 (1 pint)	0.89 (2 pint)	0.78 (2 pint)	1.48 (6 pints)	0.43 (6 pints)	0.43
Tesco Semi- skimmed long life milk	TESCO	0.54 (500ml)	1.08 (500ml)	0.90 (11)	0.90 (11)			0.18
UHT Semi Skimmed Milk essential Waitrose (long life)	Ocado	0.55 (500ml)	1.10 (500ml)	0.90 (11)	0.90 (11)			0.20

Note: Max potential savings per litre are calculated as the difference in the price per litre of the largest size and the smallest size.

Source:

- 1. Sainsbury's website <u>http://www.sainsburys.co.uk/shop/gb/groceries/dairy-eggs-chilled/fresh-milk#langId=44&storeId=10151&catalogId=10122&categoryId=12173&parent_category_rn=12157&top_category=12157&pageSize=30&orderBy=FAVOURITES_FIRST&searchTerm=&beginIndex=0_</u>
- TESCO website http://www.tesco.com/groceries/product/search/default.aspx?searchBox=milk&icid=tescohp_sws-1_milk&N=4294698001

3. Ocado website

https://www.ocado.com/webshop/getSearchProducts.do?clearTabs=yes&isFreshSearch=true&chosenSuggestionPosition=0&entry=milk



CMA ENERGY MARKET INVESTIGATION

SCOTTISHPOWER'S RESPONSE TO THE REMEDIES NOTICE

INTRODUCTION AND EXECUTIVE SUMMARY

- (a) ScottishPower welcomes the opportunity to respond to the Competition and Markets Authority (CMA)'s Notice of Possible Remedies (the Remedies Notice) published on 7 July 2015 in the CMA's investigation into the supply and acquisition of energy in Great Britain (GB) (Market Investigation). We have responded separately to the Provisional Findings. This document sets out our interim thinking on the issues raised by the CMA in the Remedies Notice. However, given the complexity of the issues and the limited time allowed for written responses to the Remedies Notice, it is likely that our views will evolve between now and the response hearing later this month. We look forward to sharing our views with the CMA at the hearing as our thinking develops.
- (b) Although we consider that consumer engagement levels are, in fact, significantly higher than portrayed by the CMA in its Provisional Findings, we welcome the broad thrust of Remedies 3 to 10, which are generally pro-competitive and seek to improve engagement and make competition work more effectively. We particularly welcome the proposed removal of the Retail Market Review (RMR) tariff rules (Remedy 3) which have imposed an unnecessary constraint on competition and innovation.
- (c) Even without the CMA's proposed remedies, there is reason to believe that engagement will improve substantially over the coming years. Next day switching will dramatically improve the switching experience and lower the perceived cost of switching. Smart meter rollout will make consumers more aware of their energy consumption and provide a platform for innovation and new business models. Printing of QR codes on bills and the development of associated switching apps will lower the barrier to search and switching for those with smartphones. The 'competitive fringe' which has grown from 2% to 10% in the last two years is increasingly seen as a viable alternative to the incumbents. All these developments can be expected to bring disengaged customers on standard variable tariffs (SVTs) into the market.
- (d) However, the Provisional Findings suggest that the CMA considers price dispersion in GB energy markets to be a problem which must be eliminated or reduced to protect consumers. We think that this view is mistaken. As with many markets, consumers will only engage where there is an incentive to do so. This should form an equilibrium where the level of price dispersion matches the incentive needed for customers to engage. Remedies, such as 3 to 10, which are designed to make engagement easier, have the potential to reduce dispersion while promoting competition. But remedies such as the proposed transitional safeguard regulated tariff (**SRT**) (Remedy 11), which seek to over-ride the competitive process, would inevitably damage competition.
- (e) It is widely recognised by the European Commission, by the Australian regulator and in the US that price regulation impedes the development of competition, reducing the incentives for consumers to search and switch, and creating a false sense of security. Consumers are likely to suffer from 'endorsement bias', mistakenly thinking that if they are on a 'government-approved' safeguard tariff, it is unlikely that there is a better deal for them. There is accordingly a very real risk that policies of this kind may discourage search and accordingly hurt the very people they are intended to help.

NON-CONFIDENTIAL VERSION

- (f) A regulated tariff, even if 'transitional' and intended to act as a 'safeguard', will also increase the perceived regulatory risk and cost of capital for suppliers, and is likely to lead to distortions of competition by discouraging innovation and new entry. It would be complex and expensive to operate, with uncertain impacts on the market and high risks of unintended consequences. For these reasons, as explained further below, we consider that this proposed remedy would be disproportionate. The CMA should therefore heed the lessons of standard licence condition (SLC) 25A and the RMR tariff rules and be extremely cautious of creating a further setback to competition caused by regulation.
- (g) Finally, we are very concerned about the signal that re-regulating tariffs, even if only transitionally, sends to other markets in Europe and around the world that are wondering whether they dare to relinquish price controls. The UK has been at the forefront of liberalising energy markets. GB energy prices have not been controlled since 2002, setting a precedent that has driven competition and all its dynamic benefits in many other jurisdictions. Given its historical leadership position, if the UK were to indicate that competition cannot after all be relied upon to protect the interests of consumers, this may have an impact beyond the UK, putting those gains at risk.
- (h) We welcome the proposed remedies around improved administration of CfD allocation (Remedy 2), more effective policy decision making and communication (Remedy 15) and revision of Ofgem's statutory duties (Remedy 16). We have concerns, however, about proposals to give the Department of Energy and Climate Change (**DECC**) the power to give directions to Ofgem (Remedy 17) which we believe could undermine Ofgem's independence.
- (i) We support the intention behind the proposed remedies to achieve timely implementation of Project Nexus and improve the accuracy of Annual Quantity (AQ) updates (Remedy 12), but have suggested ways in which the design of the remedies could be improved. Similarly, we are supportive of the intention to improve the efficiency of industry-led code governance (Remedy 18), but are not convinced that the specific remedies proposed by the CMA will be effective.
- (j) We agree that the introduction of locational pricing of transmission losses (Remedy 1) merits further consideration but are not convinced that it would in fact have a significant impact on investment or dispatch decisions.
- (k) We support in principle proposals for proportionate improvements in regulatory financial reporting (Remedy 14). However, it is important that the reporting is on the basis of the hedging decisions actually made by the firm in question and not on the basis of some other purchasing strategy. It will therefore be important for the CMA to provide more clarity as to the detailed financial reporting requirements that it is contemplating in relation to this possible remedy.

1. REMEDY 1 – LOCATIONAL PRICING OF TRANSMISSION LOSSES

"Introduction of a new standard condition to electricity generators', suppliers', interconnectors', transmission, and distribution licences to require that variable transmission losses are priced on the basis of location in order to achieve technical efficiency"

- 1.1 We agree that the introduction of locational pricing of transmission losses merits further consideration but we are not convinced that it would in fact have a significant impact on investment or dispatch decisions. We consider that the problem is not so much one of a lack of technical efficiencies as between generators in the UK but more one resulting from the lack of a level playing field between UK generators and imports.
- 1.2 Transmission losses are one of a number of charges on the GB grid system that are paid by UK generators but not by overseas generators. There is an EU system of inter-transmission system operator (**TSO**) compensation around interconnectors, but there is no clear basis for any payments made under this mechanism to be 'seen' by the commercial parties flowing the electricity. The net
effect is that the current system of transmission losses creates a competitive advantage for importers over UK generators.

- 1.3 Similar advantages are conferred by the exemption of interconnectors from transmission charges (**TNUoS**) and balancing charges (**BSUoS**), and the application of an £18/tonne CO2 carbon price support tax to UK generators on top of the EU emission trading scheme. Finally, the construction of interconnectors is being supported through a cap and floor mechanism. The net effect of these measures is to severely (and inefficiently) disadvantage UK generators compared to imports, to the extent that we question whether it will be possible in future to build thermal power stations in GB.
- 1.4 Accordingly, if the CMA wishes to address inefficient incentives about the location of power stations, it should look not only at zonal transmission losses but also at: (a) ensuring that the zonal losses average at zero to match the interconnector charge; (b) setting generator BSUoS to zero; (c) setting residual TNUoS to zero; (d) recommending a reduction in the carbon price support tax; and (e) ensuring that only well justified interconnectors receive cap and floor funding assistance. In short, although Remedy 1 has been designed by the CMA to address a potential Adverse Effect on Competition (AEC) in the GB market, it does not address the whole picture and we consider that the CMA should also look at the issue in the context of international competitiveness of UK generation.

(a) What would be an appropriate method for ensuring that variable transmission losses are priced on the basis of location?

- 1.5 To ensure that costs are appropriately allocated, real and valid technical data should be used and applied using electrical flow characteristics. Whilst this can be complex to calculate, we do not consider other solutions to be technically appropriate. A degree of complexity in the methodology is unavoidable if the intention is to create efficient price signals.
 - (b) How should the variable transmission losses be allocated between generators and suppliers?
 - (i) Is the 45-55 split appropriate or could efficiency be improved further by changing this allocation?
- 1.6 We are unable to comment on whether the 45-55 split remains appropriate without seeing the results of an up to date technical and economic analysis. This would need to take into account:
 - (a) detailed electrical flow analysis and transmission loss modelling;
 - (b) views (scenarios) of future generation and demand; and
 - (c) the relative ability of different types of generation and demand to respond to locational price signals.
- 1.7 In any case, we believe that the residual losses cost should be borne entirely by suppliers so that the zonal generator charges average out to zero. This would help create a more level playing field between generators in GB and those elsewhere in Europe, who are exempt from UK losses charges.

(c) What will be the distributional impacts of this remedy? Should the CMA take these into account in coming to a view on the proportionality of this remedy?

1.8 Locational zonal charging for transmission losses would penalise generators in Scotland and the north of England and favour those in the south. Conversely customers in Scotland and the north of England would benefit at the expense of those further south. Over time, with the expectation of thermal plant closures in the north (that we would not expect to be replaced under the existing market structure), we would expect the differentials between the north and south to be eroded.

- 1.9 Distributional impacts should be taken into account in coming to a view on proportionality, as should the expected efficiency impact from parties responding to the price signals. However, if we are correct in expecting the price differentials between the north and south to reduce over time, we think it is unlikely that the distributional impacts would call into question the proportionality of this remedy.
 - (d) Should the CMA implement this remedy directly, ie via an order, or should it make a recommendation to Ofgem to initiate a BSC modification instead? Are there any particular aspects of Ofgem's objectives and duties to which the CMA should have regard if implementing this remedy by a licence change?
- 1.10 Should the CMA decide to proceed with this remedy, we believe a recommendation should be made to Ofgem to make a licence modification aimed at facilitating the necessary BSC changes, rather than the CMA imposing a licence modification to that effect. In terms of what any licence condition might say, we assume the CMA has in mind something similar to SLC11.6 (i.e. a requirement to take all reasonable steps to secure, and not to take unreasonable steps to prevent or delay, the implementation of the necessary changes to the BSC).
- 1.11 If the CMA wishes to impose such a licence modification itself, it would need to satisfy itself that it has the necessary powers to do so. In particular, if the CMA wished to make an order under section 161 of the Enterprise Act 2002 (**EA 2002**), it would need to ensure that the scope of any such order fell within one of the categories set out in Schedule 8 EA 2002, and that the licence modification was *"requisite or expedient for the purpose of giving effect to, or taking account of, any provisions made by the order"*.¹

2. REMEDY 2 – ADMINISTRATION OF CFD MECHANISM

Remedy 2A "DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism"

- 2.1 We support the proposed remedy and agree that greater transparency in decision making, along with the requirement to prepare and disclose an impact assessment, could result in improved decision making by Government. This would ensure the optimal allocation of available Levy Control Framework (LCF) support and minimise the impact on customer bills over the longer term.
- 2.2 Bilaterally allocated CfDs should only be allocated by exception. We would expect this to only include technologies where a competitive approach is not feasible this should be done on the full understanding that bilateral awards will be less effective in minimising costs than awards made by way of a competitive auction. However, the long term aim should be to progress to technology-neutral auctions. Extension of the LCF and the CfD Delivery Period to 2025, providing investment foresight and context, could facilitate progress towards these technology-neutral auctions.

(a) Would this remedy ensure that CfDs that are allocated outside the auction mechanism are awarded only when the benefits of doing so outweigh the costs?

2.3 To ensure an optimal approach is taken to address the 'energy trilemma', it is essential that there is clear and rational decision-making when electing to divert the finite investment support under the LCF from the established competitive allocation process. We recognise that there may be a need for Government to enter into discussions outside the competitive allocation process, however, the justification for doing so should be more clearly defined and documented.

¹

Electricity Act 1989, section 15(1). (There are corresponding provisions in Gas Act 1986, section 27(1), albeit not relevant to the BSC.)

- 2.4 Through the completion of an impact assessment and consultation with the industry and stakeholders, Government would have a comprehensive understanding of the implications of its proposals and could then progress, or not, any bilateral negotiation of CfDs.
- 2.5 This would allow for greater transparency and confidence in the decision making process undertaken by DECC, delivering the optimal outcome with regard to policy objectives.
 - (b) How much discretion should DECC retain in terms of the weight it places on each factor that it takes into account in coming to a decision on which projects to award CfDs outside the CfD auction mechanism? Should DECC be required to consult on and determine these factors and their relative importance in advance to enhance transparency? Should the weighting of each factor be constant across projects?
- 2.6 Government clearly needs to consider its objectives when deciding whether to award bilateral CfDs to projects outside of the CfD competitive allocation mechanism. Given the varying performance characteristics, technology development status, deliverability and costs of the generation options open to Government when assessing the future technology mix, there is a need to consider how an optimal outcome could be achieved given the current market and grid infrastructure of the UK. Given this uncertainty, Government needs to retain flexibility as to how the factors may be weighted. How Government has determined and analysed these factors should be disclosed as part of the consultation process.

(c) In which, exceptional circumstances should DECC be able to allocate CfDs outside the auction process? For example, for reasons of industrial policy, where there are wider market failures, or where there may be insufficient competitors to hold an auction?

- 2.7 We appreciate that Government may seek to effect outcomes that would not necessarily occur under a competitive allocation process. Indeed, the lengthy development timescale and significant development expenditure associated with certain types of electricity generation may require early stage investment support and certainty in longer term financial viability, if these projects are to be realised.
- 2.8 That said, it may be beneficial for Government to retain some flexibility to review those decisions should projects fail to progress in line with the timescales or achieve certain pre-defined milestones. Projects that are successfully allocated a CfD through the competitive allocation process are subject to a number of obligations and defined milestones, and risk termination should they fail to maintain their programme to meet the specified requirements.
- 2.9 It would seem appropriate for projects allocated CfDs outside the auction process to be subject to an analogous scrutiny and monitoring process with the maximum appropriate transparency of the contracts recognising the specific nature of some of the technologies involved.

Remedy 2B "DECC to undertake and consult on a clear and thorough assessment before allocating technologies between pots and the CfD budget to the different pots"

(a) Would the remedy ensure that future decisions by DECC on the allocation of technologies and the CfD budget to the different pots are taken in a robust and transparent manner?

2.10 As mentioned above, we consider that the ultimate aim should be to move to technology-neutral auctions, perhaps around 2025. However, in the short term we consider that the current allocation of technologies to pots in the CfD auctions is appropriate, reflecting the underlying economics of the various technologies. Consultation, as proposed in this remedy, would be appropriate when periodically reviewing this allocation and making any changes, but there are no immediate problems here.

2.11 However, we strongly agree with the proposal to see a clearer explanation and justification of the proposed allocation of budget to each pot, with consultation on the proposals. This is linked to the wider problem of the LCF and the lack of transparency on how projections of the available budget are calculated.

(b) Is the remedy likely to result in a positive change in how DECC makes decisions regarding the allocation of the CfD budget to the different pots?

- 2.12 We understand that DECC assesses the future need for low carbon generation prior to setting budgets for each allocation round. At the moment, however, this process is relatively opaque. Adopting a more consultative approach by publishing an impact assessment would allow developers/investors to provide DECC with additional information so that more informed decisions can be taken.
 - (c) How regularly should DECC review the allocation of technologies between pots? What information should DECC publish when deciding to amend the allocation of technologies between pots? Should it also on a regular basis consult and/or publish reasons for not amending the allocation of technologies between pots?
- 2.13 We do not see any immediate need for a review of the allocation of technologies to pots, though we believe that there would be merit in such a review occurring once every few years. However, we do not believe that the imposition by the CMA of a remedy to mandate such a periodic review is necessary or proportionate, as the timing would be better left to DECC to determine as part of normal Government business. We would, however, highlight again the need to consult fully on any changes, thereby providing the industry with the opportunity to feed into the process.

(d) Should DECC be limited in the maximum proportion of the CfD budget that it can allocate to each of the different pots?

2.14 We do not believe that DECC should be limited in the maximum proportion of the CfD budget that it may elect to allocate to each pot. The CfD budget allocation process will need to consider deployment potential, technology status and associated costs of the various technologies within the pot. This will vary from pot to pot and potentially from allocation round to allocation round depending on uptake and outturn from previous rounds and other delivery mechanisms (e.g. Small Scale Feed in Tariff and Renewables Obligation). Setting a maximum could lead to curtailment of cheaper technologies which would not be in the best interests of consumers.

3. **REMEDY 3 – REMOVE RMR 'SIMPLER CHOICES' RULES**

"Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules"

- 3.1 We welcome the proposal to remove the RMR 'simpler choices' rules from domestic supply licences, which we believe will have a positive impact on competition in the retail energy market.
- 3.2 We believe that at least the following amendments to SLCs would be required by the introduction of this remedy:

SLC	Necessary changes				
1. Definition of standard conditions	This condition would require some consequential amendments.				
22A. Unit rate and standing charge requirements	Two tier 'no standing charge' tariffs were a popular option (chosen by around [CONFIDENTIAL]% of our customers ²) before they were banned under RMR. They protected very low usage consumers from the full standing charge. We believe this condition would need to be completely repealed.				
22B. Restrictions on tariff numbers and tariff simplification	This includes:				
	• Four tariff cap , which constrains suppliers' ability to compete and innovate;				
	• Ban on cashbacks (only online and dual-fuel discounts are allowed): cashbacks were an important way to incentivise some customers to switch, and in particular for customers with prepayment meters, where it was not possible to offer products in the same way as with other payment methods (around [CONFIDENTIAL] % of our sales in 2013 included cashback incentives); and				
	• Ban on prompt payment discounts : these were a popular option before they were banned under RMR, and incentivised customers to pay on time, reducing costs for all.				
	In our view, this condition would be fully repealed.				
22C. Fixed term supply	Some elements of this condition could be eliminated, in particular:				
	• 22C.7 : Requires that at the end of a fixed-term product, if the customer does not actively choose otherwise, he or she is automatically rolled over onto the cheapest evergreen tariff, which encourages suppliers to only have one evergreen tariff. We believe suppliers should be allowed to roll over onto <i>any</i> tariff, so long as there are no exit fees during the whole duration of the new tariff.				
	• 22C.9 : Bans 'tracker' or capped tariffs (i.e. tariffs which comprised a discount off our standard prices for a period of say a year before reverting to standard, or which limited any increase for a period before reverting to standard). These were very popular options, and we believe it would be beneficial for competition if they were allowed again.				
22CA. Transitional provisions	This condition can be deleted, as it is no longer applicable.				

Table 1: Necessary changes to SLCs

At the time immediately before RMR came into force.

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SLC	Necessary changes
for SLC 22C (end of fixed term)	
22CB. Transitional provisions for certain existing Fixed Term Supply Contracts	If 22A and 22B were to be repealed, 22CB would become redundant.
22D. Dead tariffs	Repealing this condition would allow suppliers to make new SVTs available for sale, while maintaining existing customers (whose consumption has already been hedged for) on the old tariff(s).
22E. Unmetered supply arrangements	If 22A and 22B were to be repealed, 22E would become redundant.
22F. Bespoke heating system arrangements	This condition would require some consequential amendments. In particular, if 22A and 22B were repealed, paragraphs 22F.3(a), 22F.4, 22F.5, and 22F.6 would become redundant.
31A. Bills, statements of account and annual statements	This condition would require some consequential amendments.
31C. Tariff Comparison Rate	This condition would require some consequential amendments. In particular, if the nature of the tariffs is de-regulated, the methodology to calculate the TCR might need to be revised.
31D. Temporary provisions for white label tariffs	The paragraphs relating to the provision of information would still be relevant, but paragraphs relating to tariff restrictions should be deleted.

- 3.3 We also note that in footnote 12 to the Remedy 3 description, the CMA say they "have not received any submissions raising concerns regarding the impact of Ofgem's rules on doorstep selling. (...) Therefore, [the CMA] are not minded to consider remedies that would relax Ofgem's required standards of conduct in relation to doorstep sales." The impact of Ofgem's SLC25 rules on doorstep selling has previously been raised in submissions by ScottishPower³ and Professor Littlechild.⁴ Given the unique capability of doorstep and other face to face selling to engage with customers who would otherwise be disengaged, but recognising the importance of consumer protection, we continue to think that the CMA should consider carefully SLC25 and the manner in which it has been implemented with a view to facilitating face to face selling going forward in a manner that adequately protects consumers. We address this further in paragraphs 10.7 to 10.11.
 - (a) Would this remedy be effective in increasing competition between domestic retail energy suppliers and/or between PCWs? What additional tariffs would energy suppliers be likely to offer that they currently do not due to the RMR restrictions?
- 3.4 ScottishPower supports this remedy and considers that it would be effective in increasing innovation in the market and as a result increase competition between energy suppliers.
- 3.5 However, it is unclear from the Remedies Notice which element(s) of the 'simpler choices' component of the RMR rules would be removed. In our view, all elements of 'simpler choices'

 ³ ScottishPower response to Updated Issues Statement, paragraphs 3.35(iii), 5.46, and 5.54 to 5.58.
 ⁴ Stephen Littlechild submission of 11 January 2015: <u>https://assets.digital.cabinet-</u>

office.gov.uk/media/54b8e0d8ed915d1597000007/Stephen_Littlechild - regulation_of_energy_marketing.pdf.

should be removed as per the above table, allowing for tariff innovation to develop as suppliers respond to the different preferences of different groups of customers.

3.6 One of the main characteristics of competition is that it is a discovery process, and through rivalry the market finds the best solutions to meet the needs of consumers. In this respect, it is difficult in practice – and possibly wrong in principle – to seek to identify precisely what additional tariffs could come into play if RMR restrictions were relaxed. Based on previous experience, energy suppliers might consider returning to offering discounted tariffs (where the tariff is priced for a fixed term at a fixed discount to the SVT), tariffs with no standing charge, cashbacks, and capped and 'tracker' products, as well as experimenting with time-of-use tariffs when a critical mass of smart meters has been rolled out.

(b) Removing the four-tariff rule is likely to increase the range of tariffs on offer and result in different tariffs being offered on different PCWs. Are there, therefore, any remedies that the CMA should consider alongside this remedy, to encourage domestic customers to use more than one PCW in order to facilitate effective competition between PCWs and domestic energy suppliers?

- 3.7 Although energy suppliers are likely to increase the range of tariffs on offer, there are operational and practical limits to the number of tariffs that can actually be offered at any given time. Hence, it is unlikely that new tariffs will proliferate to such an extent as to require the introduction of additional remedies. Examples of these operational limits are:
 - each new tariff has to be built on the billing system, and there are significant costs in doing so; and
 - the 'cheapest tariff' calculation (for compliance with the 'cheapest tariff messaging' obligation) has a significant impact on the processing time for a billing run, and the time taken will increase with the number of tariffs that need to be compared.
- 3.8 We are not convinced that there is a need to provide additional encouragement for consumers to use more than one PCW. PCWs already compete with each other through advertising and this is likely to raise consumers' awareness of the different price comparison services and prompt them to consider alternatives. It is therefore not clear to us that an additional remedy would be necessary.
- 3.9 Moreover, choosing one PCW among all the possible options is already a sign of engagement, and of the customer shopping around. It is not clear to us why consumers should be encouraged to use more than one PCW after they have considered the options and have chosen which one to use. There is a risk that by encouraging consumers to use multiple PCWs, the time costs of the searching process are increased, and therefore consumers end up being discouraged to search altogether.
 - (c) We note that if this remedy were to be imposed, Ofgem's Confidence Code requirement for PCWs to provide coverage of the whole market appears likely to become impractical as the number of tariffs offered increases and PCWs agree different tariff levels and commissions with energy suppliers. Should this element of the Confidence Code be removed, therefore, as part of this remedy? If so, are alternative measures to increase confidence in PCWs required? For example, in order to maintain transparency and trust, should PCWs be required to provide information to customers on the suppliers with which they have agreements and those with which they do not?
- 3.10 As suggested above, we would not expect the number of tariffs available in the market to increase to a level that makes compliance with the 'whole-of-market' requirement impractical. In any event, we think that the problem can easily be resolved by amending the Confidence Code to allow PCWs to 'group' similarly priced multiple tariffs from the same supplier so that they appear on the results page as a single entry, with further detail below. However, PCWs will have their own views as to

what extent they would be able to comply with a provision such as this, should the number of tariffs increase beyond a given threshold.

- 3.11 Should it become impractical to maintain the whole-of-market obligation, we would expect that one of the key marketing differentiators among PCWs would be the breadth of tariffs that they can compare, and PCWs would have an incentive to disclose the list of compared tariffs. If the whole-of-market obligation was removed from PCWs, this might increase the need for the CMA's Remedy 6 proposal for an independent place for consumers to compare all available offerings.
- 3.12 It is important that the filtering of displayed tariffs is fully transparent, and that tariffs are ranked on the basis of price, unless the consumer actively chooses otherwise.

(d) Rather than removing all limits on tariff numbers and structures, would it be more effective and/or proportionate to increase the number of permitted tariffs/structures? If so, how many should be permitted and which tariff structures should be allowed?

- 3.13 We do not think increasing the <u>maximum</u> number of permitted tariffs/structures would be an effective remedy. The CMA has identified limits on tariff numbers and structures to be an AEC and those limitations should be removed. As we have explained above, we do not expect the number of tariffs to cause problems and certainly not problems which would make a specific limit necessary. Furthermore, in order to set a limit, the experience of RMR shows that it is necessary to specify in great detail what constitutes a separate tariff. This has added many pages and unnecessary complexity to the current supply licence conditions and it would be desirable to avoid this complexity if possible.
 - (i) For example, would requiring domestic energy suppliers to structure all tariffs as a single unit rate in pence per kWh, rather than as a combination of a standing charge and a unit rate, reduce complexity for customers, while avoiding restricting competition between PCWs? Alternatively, would such a restriction on tariff structures have a detrimental impact on innovation in the domestic retail energy markets?
- 3.14 We do not support a requirement that all tariffs should be composed of just a single unit rate with no ability to set a standing charge. The structure of tariffs should be a matter for companies; the market will discover what structure best meets the requirements of customers. We believe consumers are more likely to rely on PCWs or other services to calculate their potential bill when comparing tariffs, rather than calculating the bill value themselves. Therefore we consider that the gains from allowing two-part tariffs in terms of responding to consumer need outweigh any possible benefit with respect to ease of tariff comparison that may arise from their prohibition.
- 3.15 Additionally, one consequence of eliminating the standing charge is that suppliers might not recover the full fixed costs of serving low-consuming customers, leading to a situation in which highconsumption customers cross-subsidise low consumption customers. We note that there is no straightforward link between vulnerability and low consumption, as some low consumption premises might be garages or holiday homes, whereas some high consumption premises might be energy inefficient homes or the homes of elderly or sick customers that consume more energy than average through heating.
- 3.16 This intervention could also distort the sales and marketing incentives of suppliers, who may choose to focus their efforts on more profitable high-consumption households and disregard unprofitable low consumption households. Therefore, there is no obvious social policy gain in a situation where high consumption customers cross-subsidises low consumption.
- 3.17 One of the benefits of eliminating the 'simpler choices' restrictions on tariff design is that it would allow energy suppliers to target different tariff structures at different consumer segments, based on

their level of consumption or other preferences. Should only one tariff structure be allowed, this benefit would not be available.

- 3.18 Finally, in terms of how the remedy might be implemented, if the CMA wished to impose a licence modification itself to remove the 'simpler choices' restrictions on tariffs that are currently in the licence, it would first need to draw a link between its proposed licence modifications and the content of any order under Schedule 8, EA 2002 (see our comments under Remedy 1 at paragraph 1.10 above). Potentially, the CMA might seek to rely on Schedule 8, paragraph 10(2), which allows the CMA to require a person who is supplying goods or services to supply them "to a particular standard or in a particular manner, or to do anything which [the CMA] considers appropriate to facilitate the provision of such goods or services to that standard or in that manner". In this case, the terms of any such order may require suppliers to offer tariffs 'without the limitations imposed by SLC 22A, 22B, specified elements of 22C, and 22D.
- 3.19 The alternative method of implementation, if Ofgem was amenable, which would be more convenient and avoid any possible concerns about *vires*, would be for the CMA simply to recommend to Ofgem that it (i.e. Ofgem) should make the necessary licence modifications.

4. **REMEDY 4 - MEASURES TO ADDRESS BARRIERS TO SWITCHING**

Remedy 4A "Measures to address barriers to switching by domestic customers"

- 4.1 ScottishPower supports in principle all remedies that seek to remove barriers to switching and make the market more competitive. In imposing any remedies of this type, the CMA should take due account of initiatives that are already underway and will dramatically reduce barriers to switching, including next-day switching, smart meter rollout and more convenient access to customers' data through printing QR codes on bills and access to 'Midata'.
- 4.2 In particular, we believe that the rollout of smart meters will have a very positive impact in addressing any potential barrier to switching by domestic customers. However, it is essential that the smart meters that are installed are fully interoperable in order to realise fully this benefit. In the absence of interoperability, consumers could be discouraged from switching by a concern that their smart meter might go 'dumb'. The new SMETS2⁵ design of smart meter will address this concern once the central Data Communications Company (**DCC**) data systems are live projected for the second half of 2016. However, the older SMETS1 design, which is currently the only option for rolling out smart meters, does not have full interoperability and may therefore risk effectively 'locking' customers into their current supplier. To avoid creating this potential barrier to switching, we believe that the CMA should consider limiting the roll-out of SMETS1 meters. While the CMA should permit SMETS1 roll-out at a level which enables suppliers to gain sufficient experience in installing smart meters, an upper limit will be necessary to avoid creating a potential barrier to switching.

(a) Will the roll-out of smart meters address the feature of uncertified electricity meters? If not, what additional remedies should we consider to address this feature?

- 4.3 The rollout of smart meters across Great Britain offers a significant opportunity for energy suppliers to gain voluntary access to domestic households, and in some cases achieve access to previously inaccessible meters. The new and replacement obligation that is yet to be introduced by the Secretary of State will provide further measures to promote the upgrade of the GB meter stock, including replacement of uncertified electricity meters.
- 4.4 Wherever possible statutory meter exchanges and inspections will be aligned to smart meter installation to minimise the level of customer inconvenience. However, access to all premises is not

⁵

Smart metering equipment technical specifications.

guaranteed given that domestic customers have a choice as to whether they wish to have a smart meter installed. In some cases the refusal of a smart meter will either mean that uncertified electricity meters are not replaced, or that they are replaced by a dumb meter.

4.5 There are a number of locations where it is not currently possible to install a smart meter and set up the required communications systems. Any uncertified meters in such locations would need to be replaced with a dumb meter.

(b) Will the roll-out of smart meters address the barriers to switching faced by customers with Dynamic Teleswitched (DTS) meters? If not, what additional remedies should we consider to address this feature?

- 4.6 DTS systems are normally linked to specific wiring configurations in the customer's home and are designed to support both mitigation of distribution network load in areas of high electric heating and the use of lower priced overnight power for storage heaters. In some cases the timings for DTS circuit switching are set by weather conditions. Every SMETS2 smart electricity meter will have the capability of supporting switched load tariff arrangements where configured to do so, which could in principle allow SMETS2 meters to replicate current DTS functionality. However, the economic and practical viability of such an arrangement still needs to be determined. A key concern will be to ensure, as far as possible, that customers continue to gain the benefits which make the use of their electric heating system economically viable.
- 4.7 If barriers to switching do remain for customers with DTS meters, we would expect these to be addressed through normal interventions by Ofgem, rather than requiring a specific remedy at this stage. DTS customers gain a significant benefit in their reduced heating costs arising from providing the network and supplier with the flexibility that is inherent in the DTS system. At the same time, however, the complexity in serving these customers may make them less attractive in the market.

(c) Should PCWs be given access to the ECOES database (meter point reference numbers) in order to allow them to facilitate the switching process for customers?

- 4.8 Yes, PCWs should be given access to the ECOES database, as this would reduce the frequency of duplicate sales and incorrect addresses, which often lead to erroneous transfers and product-meter mismatches. Access to the ECOES database would also enable PCWs to check meter point administration number (**MPAN**s) and meter serial number (**MSN**s) (or invite the customer to choose between options in cases where there is ambiguity), though the risk of the customer picking the wrong address would remain.
- 4.9 The ECOES database only covers electricity meters. Therefore, we recommend the CMA considers extending access to Xoserve data as well, in order to improve switching accuracy for both fuels.
- 4.10 PCWs should sign up and pay for access to ECOES individually, through the process in MAP15, which allows third-party access. It remains to be considered whether access should be granted to the screens or to the data. PCWs would be required to carry out internal monitoring to ensure compliance with the MAP15 audit requirements.

(i) To what extent would this reduce the rate of failed switches and/or erroneous transfers?

4.11 Approximately 50% of the erroneous transfers (**ET**s) where ScottishPower is the gaining supplier are due to incorrect MPANs or MPRs, generally as a consequence of an address mismatch. Within this category, around 40% of ETs occur because the customer has selected the incorrect address. Therefore, we estimate that the remainder (around 10% of ETs) could be avoided if PCWs accessed the ECOES database.

(ii) Are there any data protection issues we should consider in this respect?

- 4.12 Data contained in the ECOES database are subject to confidentiality restrictions, and suppliers can only see information relating to their own customers unless they warrant that they have the relevant consumer's permission. Assuming PCWs would require access to information on all consumers in the database, they would need to obtain permission from each consumer and be subject to the safeguards in MAP15, which would prevent them using the information contained in ECOES for their own marketing purposes and disclosing it to rival suppliers.
- 4.13 This remedy will also require suppliers to change their terms and conditions, to ensure that their customers' information can be passed on to PCWs. For example, ScottishPower's current terms and conditions do cover the possibility of sharing some information with certain third parties in certain circumstances. However, they would not currently cover information from ECOES being provided to PCWs by Gemserv (the ECOES database administrator), and we would have to change our terms and conditions to reflect whatever requirements were placed on Gemserv.

(iii) Will access to this database still be relevant once smart meters have been introduced?

- 4.14 Yes. PCWs would still need to validate the meter type and match the product, as well as ensure that the address is correct.
 - (d) Should there be penalties for firms that fail to switch customers within the mandated period (currently 17 days, next day from 2019)? How should these penalties be administered? At what level should the penalties be set? Should customers who suffer a delayed or erroneous switch receive the penalty as compensation?
- 4.15 The current maximum switching period permitted by licence conditions is 21 business days (SLC 14A), with 17 days being a voluntary target. It is unclear to us why it is thought necessary for the gaining supplier to be subject to penalties if it processes the switch slowly. It is clearly in the interest of a supplier that has just won a customer to meet the customer's expectations as to the speed of the switch. It is unclear why any requirement (other than perhaps to waive any exit payment) is needed for the gaining supplier when the customer can simply switch again if he or she is unhappy. Discussions are under way in the framework of Energy UK for the creation of a voluntary "switching guarantee" under which participating suppliers would pay compensation if, through their fault, a switch was unduly delayed.
- 4.16 We therefore do not consider that any penalty or regulatory-mandated compensation is required. However, should such a system be introduced, it would be necessary to set out the rules determining those situations in which the supplier is at fault, and those in which the delay is due to circumstances beyond the supplier's control. Possible valid reasons for delay may include:
 - the customer has requested the transfer to be completed at a later date;
 - a relevant energy supplier has objected to the proposed supplier transfer;
 - a supply exemption holder has objected to the proposed supplier transfer;
 - the licensee does not have all the information it requires to complete the supplier transfer;
 - the customer is taking supply through an exempt distribution system and the supplier is unable to start supplying; and
 - any other circumstances outside the control of the licensee, and which it has taken all reasonably practicable steps to resolve.

(e) When next-day switching is introduced, will a 'cooling-off' period still be required? Could it be avoided by requiring that no exit fees are charged within two weeks of switching?

4.17 Yes, a cooling-off period will still be required and indeed we note that a cooling-off period and the right to cancel are currently legal requirements made in pursuance of an EU directive.⁶ Removing the cooling-off period would require a change in the law, probably at the European level. We do not think that a requirement that no exit fees are charged within two weeks of switching would be sufficient to avoid having to comply with a cooling-off period. However we believe it is possible to achieve next day switching notwithstanding the requirement of a cooling-off period. In particular, we understand that as part of the faster switching process, an approach is being developed that would allow a switch to go ahead immediately, or be treated as if this has happened, but reversed if the customer exercised his or her cooling off period rights.

(f) Are specific measures required to facilitate switching for customers living in rented accommodation (either social or private)?

4.18 We are not aware of any reason why specific measures are required to facilitate switching for customers living in rented accommodation. In the great majority of cases a tenant will be the legal occupier with the right to contract for the utilities. ScottishPower does not treat landlords and tenants differently, and both follow exactly the same process to switch supplier. Furthermore, we are not able to identify whether landlord and tenant have any specific arrangement with regard to energy supply to the property, and therefore we would proceed with the switching process whenever it is requested.

In light of the introduction of smart meters, we are considering whether any other remedies may be required to address barriers to switching for domestic customers. For example:

- (a) Does the 'Midata' programme, as currently envisaged, provide sufficient access to customer data by PCWs to facilitate ongoing engagement in the market? Should PCWs with customer permission be able to access consumer data at a later date to provide an updated view on the potential savings available?
- 4.19 As currently envisaged, the 'Midata' programme will provide consumers with easy access to accurate, up-to-date information that will help them make an informed decision about switching supplier. Although we are supportive of the programme, we note that participation is currently voluntary. As the main effect of the 'Midata' programme is to assist customers in switching to another supplier, our continued participation will be dependent on participation by substantially all suppliers, to ensure a level playing field.
- 4.20 The final specification of 'Midata' is still to be agreed, but the most recent specification includes the following data items:
 - Customer reference number;
 - Post code;
 - Current provider;
 - Current electricity tariff;
 - Current gas tariff;

Consumer Contracts Regulations 2013.

- Current electricity payment method;
- Current gas payment method;
- Meter Point Administration Number (MPAN);
- Meter Point Reference Number (MPRN);
- Annual electricity usage (only available after a consumer has been with the current energy supplier for over 12 months; empty otherwise);
- Annual gas usage (ditto);
- Start date;
- Start date of the contract with the current energy supplier;
- Payload creation date;
- Last updated date;
- Estimated annual consumption;
- Estimated annual cost; and
- Contract end date.
- 4.21 On balance we believe that the 'Midata' programme will provide sufficient access to customer data by PCWs to facilitate ongoing engagement in the market, without the need for PCWs to be able to access consumer data at a later date. Ongoing consent for PCWs to access customers' consumption and tariff data might increase the accuracy of expected savings as consumption changes, and allow PCWs to reduce the frequency of communications while making them more targeted. However, good data protection practice would require limiting the processing of, and the access to, personal data to the minimum required to achieve the objective. In this respect, we are not convinced that there is sufficient need for ongoing consent, and believe that a viable alternative would be for PCWs to obtain one-off consent each time that it is required (e.g. by asking the customer to click on a link sent by e-mail).
- 4.22 If there is need for ongoing access, it is very important that customers are well informed of what granting ongoing access to their personal data entails. There is a risk that consumers may consent to ongoing access 'by default' and later forget that they have done so. This risk could be mitigated by requiring ongoing consent to be time limited (e.g. to 18 months); or requiring that PCWs ask for one-off consent and for ongoing consent separately, in two consecutive and clearly stated questions. It would also be positive for consumers to allow them to choose the frequency of communications from PCWs once they consent to ongoing access, and to make it sufficiently easy to unsubscribe ahead of the end-of-consent date (should this be time limited, as suggested above), if they no longer wish to receive updates from the PCW.
- 4.23 If consumers consider that their personal data have been misused (or their consent has been obtained in an underhand way), they are likely to blame their energy supplier for failing to protect their data. Any requirement on energy suppliers to respond to ongoing access requests would need to recognise that the supplier may have a duty, as data controller, to satisfy itself that consent has been properly obtained.

(b) Do customers need more or better information or guidance on how their new smart meters will work?

- 4.24 It is too early to assess whether additional information and guidance will be required. Communication leading up to the rollout by the UK Government and Smart Energy GB will be a key factor in terms of customers' willingness to learn and the level of understanding and insight that they have prior to, during and post smart meter installation.
- 4.25 Whilst previous rollout trials have provided considerable insight and will enable the tailoring of materials, a national rollout programme and the enduring smart market which customers will enter into may raise additional questions or challenges, which are yet to be identified. The response to these questions and challenges may require actions to be undertaken by all stakeholders, not just energy suppliers, to make the smart market appealing and one in which customers seek to maximise the benefits.
- 4.26 Installation routines continue to be reviewed in significant detail in terms of the activities that an engineer will have to undertake whilst on site and the points during the installation at which the customer can be engaged leading up to a final demonstration once their smart metering system is fully commissioned.
- 4.27 We believe that the focus of the information and guidance provided at the time of installation should be on how smart meters work. We also recognise that, over the course of time, consumers will need guidance on how the smart market functions; however, we do not consider that it is appropriate to provide this information at the time of installation, and the Smart Metering Installation Code of Practice (SMICOP) prevents us from using marketing materials during the installation.

Remedy 4B "Removal of exemption for Centrica on two-year inspection of gas meters"

(a) Would this remedy be effective in removing the distortion to competition that currently exists as a result of Centrica's derogation on the inspection of gas meters?

4.28 This remedy would have the effect of removing the distortion in the competitive market, but it would be preferable to extend the exemption to all suppliers. Ofgem has recently proposed that this should happen – indeed they suggest removing the relevant licence condition (SLC 12) for both gas and electricity.⁷

(b) Would it be preferable to remove Centrica's derogation, or extend the derogation to other suppliers?

4.29 We agree with Ofgem that the relevant licence conditions should be removed entirely for gas and electricity. As Ofgem says, the safety element underpinning the inspection requirement is already dealt with under Health and Safety Legislation. This legislation requires the duty holder to adopt a risk based approach which may (depending on the circumstances) require inspections more frequently or less frequently than the two year standard. The existing conditions do not add usefully to that obligation. The other elements underpinning the inspection requirement (around theft and accurate billing) are now dealt with in separate licence conditions that postdate the existing requirement.

(c) If Centrica's derogation were removed, should it be phased out over a period of time? If so, how long should Centrica be given in this respect?

4.30 We do not believe that the derogation should be removed, but that the relevant licence conditions should be repealed.

7

Ofgem (23 July 2015): "Reforming suppliers' meter inspection obligations" -

https://www.ofgem.gov.uk/sites/default/files/docs/2015/07/reforming_suppliers_meter_inspection_obligations_final_0.pdf.

4.31 Given the intention of removing a distortion in the market, we would expect this remedy to take effect as soon as is reasonably practicable.

5. REMEDY 5 – PRIORITISED ROLLOUT OF PREPAYMENT SMART METERS

"Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter"

- 5.1 We agree that prioritisation of smart meter rollout for domestic customers with prepayment meters (**PPM**s) is likely to be the fastest route to providing an effective remedy to the problems identified by the CMA, principally removing restrictions on such customers to engage in the market by transforming the choices available to them and their customer experience.
- 5.2 The number of non-standard tariffs that suppliers can offer to prepayment customers is currently limited by the technical characteristics of the prepayment infrastructure.⁸ If dumb meters can be replaced with smart meters within reasonable timescales, this would be a more effective and efficient solution than addressing the existing system constraints. Not only should smart meters enable prepayment customers to benefit from the range of non-standard tariff offerings available to credit and direct debit customers, but the improved customer information and experience should make it easier for customers to budget and mitigate some of the inconvenience of purchasing energy on a prepay basis.
- 5.3 Some careful thought needs to be given to the nature of the obligation to give priority to prepayment customers, so that it works effectively but does not impede the wider roll-out. It is also necessary to make sure that the systems work robustly PPMs are the most complex aspect of smart metering, with the potential for severe customer inconvenience if systems do not function as intended. This could include the loss of supply to the customer if system error prevented credits reaching the meter. In view of the CMA's findings, we believe the industry should be encouraged to prioritise the remaining work necessary to ensure that smart prepayment infrastructure is robust. This will mean, *inter alia*, having sufficient fall-back options so that customers can still top up their meters even if their electricity supply has been cut off, and in cash if their bank account is overdrawn. The system must work seamlessly across changes of supplier, so customers can benefit fully from competition. Full end-to-end technical resilience must have been proven.
- 5.4 A key enabler will be having the full function SMETS2 meters available and the DCC infrastructure live. This is due in the second half of 2016. It would be counterproductive to try to roll-out smart prepay in bulk using the older, and not fully interoperable, SMETS1 meters.
- 5.5 If the remedy is designed correctly, it has the potential quickly to bring this group of consumers into the heart of the energy market whilst mitigating the risks of disruption to the many vulnerable customers involved.

(a) Would this remedy be effective in allowing prepayment customers to engage fully in the market and benefit from a wider range of tariffs? Would it be effective in reducing the costs of supply to prepayment customers?

5.6 Yes, the second generation of smart prepayment meters (SMETS2) should be easily reprogrammable to change tariffs and/or supplier. While some suppliers have already found ways around the current technical limitations to offer limited non-standard tariffs to customers with dumb PPMs, the full range of choice cannot be offered with the current technology. With smart prepay, we would expect suppliers to take immediate advantage of the additional flexibility offered by the new technology, once a critical mass of meters has been deployed.

8

See ScottishPower response to UIS, paragraphs 5.31 to 5.33.

5.7 Once the systems have settled down, we think that the cost to serve for smart prepay should be materially less than for the existing technology.

(b) Which version of this remedy would be more effective and/or proportionate?

- 5.8 Neither of the CMA's versions of the remedy is quite workable in the terms in which it is stated. An obligation limited to new and replacement PPMs (option a) would be slow in taking effect and would cause difficulties in specific locations where smart meters cannot be installed due to customer refusal or lack of communications connectivity.
- 5.9 Stopping the entire smart roll-out until the prepay is finished (option b) would be problematic because it would be necessary to deal with refusals, failed contact, and lack of connectivity, thereby potentially delaying overall roll-out. Moreover the need to cherry pick only the PPMs would be operationally inefficient and would put at risk the achievement of the overall rollout obligation, in addition to increasing industry costs.
- 5.10 In ScottishPower's case we have a few regional 'hotspots' where the density of prepayment meters is potentially high enough to justify a prepayment-only installation campaign. However, for the majority of the country prepayment meters are relatively thinly spread and it would be highly inefficient to install prepayment meters alone without also installing non-prepayment meters. This is illustrated in **Table 2** below which shows the proportion of ScottishPower's prepayment customers by ex-PES area. We would expect similar considerations to apply to other suppliers.

Region	% of ScottishPower's PP customers by region			
East Anglia	[CONFIDENTIAL]%			
East Midlands	[CONFIDENTIAL]%			
London	[CONFIDENTIAL]%			
Merseyside & North Wales	[CONFIDENTIAL]%			
Midlands	[CONFIDENTIAL]%			
North East	[CONFIDENTIAL]%			
North Scotland	[CONFIDENTIAL]%			
North West	[CONFIDENTIAL]%			
South East	[CONFIDENTIAL]%			
South Scotland	[CONFIDENTIAL]%			
South Wales	[CONFIDENTIAL]%			
South West	[CONFIDENTIAL]%			
Southern	[CONFIDENTIAL]%			
Yorkshire	[CONFIDENTIAL]%			

Table 2: ScottishPower's prepayment customers by ex-PES area

- 5.11 Our proposal would be to approach the matter differently. Ofgem could be recommended to set targets for suppliers to achieve particular percentages of smart meters in their PPM base in successive years, starting from the year after full DCC and SMETS2 functionality is available. The targets should be aimed at an ambitious but efficiently achievable roll-out, and should be set supplier by supplier by Ofgem taking account of their wider roll-out plans.
- 5.12 Once there is some momentum behind the rollout of smart prepayment meters it is likely that suppliers' natural commercial incentives may take over. Suppliers will be keen to reduce their exposure to stranding associated with traditional PPMs, and they will also face commercial incentives to scale down the traditional PPM infrastructure and reduce the associated operating costs.

- (c) Would any additional or alternative measures be required to ensure that this remedy comprehensively addressed the overarching feature of weak customer response arising in particular from those with prepayment meters?
- 5.13 Subject to ScottishPower's views set out in response to question (b) above as to the most effective and proportionate version of this remedy, ScottishPower considers that it would be important for Smart Energy GB to run a carefully tailored engagement and education programme targeted at pre-payment customers. The objectives of this programme should be to:
 - (a) communicate the benefits of smart meters for prepayment customers so that such customers will agree to have smart meters installed; and
 - (b) educate customers on how to utilise the smart meter, and in particular how they can change their tariff and what choices are available.

(d) What issues may arise as a result of prioritising the installation of smart meters in the homes of customers who currently have prepayment meters?

- 5.14 The most important issue will be to ensure that the smart prepay systems have been sufficiently robustly tested so that customers are able to maintain a regular supply of energy with minimum inconvenience. Beyond that:
 - (a) the DCC should go live in August 2016, and it is expected that it will be able to enrol only limited numbers of smart meters until it is fully stabilised by 2017; and
 - (b) the Communications Service Providers (**CSP**s) will still be establishing the communications networks so there will be significant pockets without WAN coverage.
- 5.15 In order to mitigate these risks, suppliers will wish to start the smart prepay roll-out on a relatively small scale to allow any problems to be addressed at a manageable scale, before rapidly moving up to full scale deployment.

(e) Would it be more effective and/or proportionate to require energy suppliers to accelerate the roll-out of smart meters across the retail markets as a whole, in order to facilitate engagement more broadly, rather than focusing on customers on prepayment meters?

- 5.16 No. As a result of delays to the smart meter implementation programme and, notably, the recent delays to the planned go-live date for the DCC, the existing rollout targets faced by suppliers are already extremely challenging. We do not believe it would be technically feasible for suppliers to accelerate the roll-out across the market as a whole any faster than is currently planned.
- 5.17 The only way in which a slight acceleration of the rollout could realistically be achieved would be to shift the focus towards deployment of older SMETS1 meters rather than the full featured SMETS2 meters. However, there are questions of interoperability about SMETS1, with the risk that customers may lose smart benefits on switching. This could be detrimental to customer engagement. In addition, SMETS1 meters do not meet the Government's recommended data security approach, with the attendant risks of loss of privacy or a malicious intervention.
- 5.18 A widespread SMETS1 roll-out would have a number of other issues:
 - (a) uncertainty as to which meters will be adopted by the DCC with the risk of asset stranding;
 - (b) based on current DCC policy, SMETS1 meters will not be enrolled by the DCC until towards the end of rollout resulting in the possibility of a two-tier smart metering experience; and

- (c) where SMETS1 meters are not enrolled, a further smart metering installation would have to be undertaken before the completion of rollout, i.e. 2020.
- 5.19 We think it would be a serious mistake to roll-out huge numbers of inferior SMETS1 meters which could entail risks to competition and data security in order to save a few months on the roll-out. Sensible but testing targets for smart prepay priority should enable the problem of insufficient choice for that market segment to be effectively addressed without disrupting the wider roll-out.

6. REMEDY 6 – INDEPENDENT PRICE COMPARISON SERVICE

"Ofgem to provide and independent price comparison service for domestic (and microbusiness) customers"

- 6.1 We can see the merit of considering whether there should be some independent source of advice, though it is unclear how easy it would be for customers to cross reference back to the PCWs. We wonder whether, instead of giving Ofgem the responsibility for providing the service, it might be more in keeping with the role of Citizens Advice, which is already trusted to provide impartial advice direct to consumers. Citizens Advice has offices in which customers could discuss their access to PCWs face to face with an adviser, rather than relying on remote communications with a body such as Ofgem (with whom they are much less familiar). In this respect, ScottishPower notes that Citizens Advice is already "at the initial stages of exploring with Ofgem how to better collate comparative information around customer service and price comparison to better inform consumers".⁹ However, as discussed in more detail in response to question (g) below, the CMA would need to give careful consideration as to the appropriate level and source of funding for a remedy of this nature.
- 6.2 Subject to the above caveats, we agree that Remedy 6 is worth considering further and agree that it could potentially be a proportionate response to current low levels of consumer trust in PCWs. However, we would note that trust does not appear to be an obstacle to consumers engaging with PCWs for other types of comparison (such as car insurance) and the need for such a remedy may decline over time as more consumers become familiar with using PCWs. We therefore consider that this remedy, if adopted, should be subject to a sunset clause.

(a) Would this remedy be effective in increasing customers' trust in PCWs and thereby encourage engagement in the markets and switching?

6.3 We believe it is possible that this remedy could help to increase trust in PCWs, and encourage more (and better informed) engagement in the market. However, there is also a risk that the creation of a new Government-sponsored website could send a signal that commercial switching sites are not to be trusted.

(b) Should this service be online-only, or should it also operate over the telephone for those customers without access to the internet?

- 6.4 We believe this service, if provided, should also be available over the phone, in order to reach the most disengaged and vulnerable consumers, who are less likely to be comfortable with online services.
- 6.5 It may also be worth considering the development of other platforms for this service, for instance a smartphone application.

⁹

Summary of hearing with the National Association of Citizens Advice Bureaux operating as Citizens Advice, and the Scottish Association of Citizens Advice Bureaux operating as Citizens Advice Scotland, on 14 October 2014, at paragraph 13.

(c) Is there a risk that such an independent service could undermine the development of other PCWs in the energy sector? How could this risk be mitigated?

- 6.6 Yes, if this service was allowed to process the switch, we believe it could undermine the development of other PCWs in the sector, since they rely on commission from switching for much of their revenue. We therefore consider this service should provide independent price comparisons (and other relevant information) only, without processing any switches.
- 6.7 Although there is currently more of a gap in the market for PCWs targeted at microbusinesses, the CMA should be cautious about introducing a new publicly-funded service that might discourage the emergence of equivalent commercial services. In the long run, healthy competition in the provision of commercial price comparison services (subject to appropriate codes of practice) is likely to deliver greater innovation and a better outcome for consumers than a service run by the public sector.

(d) Should the Ofgem website quote the energy suppliers' list prices only? Or should it seek to provide full details of all quotes available on the market (including on other PCWs), ie function as a meta-PCW?

- 6.8 As noted above, we believe an independent price comparison service should be provided by a body such as Citizens Advice rather than by Ofgem.
- 6.9 The service should provide a complete view of the market, and therefore not limit itself to quoting energy suppliers' list prices, but rather quote all tariffs available on the market, whether these are directly from suppliers or from other PCWs.
 - (e) How could we ensure that an Ofgem price comparison service was robust in terms of offering all tariffs available on the market? Should there be an obligation on retail energy suppliers and/or PCWs to provide information to Ofgem on their tariffs?
- 6.10 Consumers would expect that a price comparison service provided by the public sector is complete, transparent and up to date. However, suppliers might be wary of providing information on new tariffs ahead of their launch (a lead time of up to 48 hours is typically needed if a new tariff is to appear on a PCW at the time of launch) unless there were clear arrangements to maintain confidentiality. If the new site were trusted by consumers, suppliers would be anxious to be listed there and agree the necessary arrangements, which suggests that an obligation to provide tariff details is not necessary.
 - (f) Should any price comparison service operated by Ofgem be transactional, ie be able to carry out switches for consumers, or should it provide information only?
- 6.11 As noted above, we believe an independent price comparison service should be provided by a body such as Citizens Advice rather than by Ofgem.
- 6.12 The price comparison service should be limited to the provision of information, and should not be able to carry out switches on behalf of consumers.
 - (g) What would be the likely costs to Ofgem of offering this type of price comparison service? Would Ofgem need additional funding and/or statutory powers in order to provide this type of service? If so, where should this funding come from?
- 6.13 PCWs will be better placed to indicate the costs faced by the body offering an independent price comparison service. However, we expect this service to be relatively expensive, as it involves powerful IT systems, regular updates in prices, etc.

- 6.14 The service should be publicly funded, to avoid the situation where it competes for revenues with commercial PCWs. The nature of the public funding will depend on whether Ofgem or Citizens Advice (or some other body) provides the service. If the service were to be provided by Ofgem (which we do not believe would be the best solution), it may be possible to recover the costs through licence fees, which are paid by network companies.
 - (h) How should customers be made aware of the existence of this service? Should information be provided by energy suppliers on bills/during telephone calls? Should PCWs be required to provide links to the Ofgem website during the search process to allow customers to cross-check prices?
- 6.15 Customers should be made aware of this service during the sales process, perhaps through requiring links from the PCW websites as suggested in the question. We would not favour publicising it by means of the domestic bill as the bill is already over-loaded with information and would be unlikely to prompt consumers to engage.
- 6.16 It would also be worth considering running cost effective awareness campaigns across various channels such as radio, tabloid ads, citizen advice websites, product maturity communications, etc.

(i) Is there any additional information that Ofgem should provide on its website relating to energy suppliers and/or tariffs to facilitate the customer search and switching process?

- 6.17 As noted above, we believe an independent price comparison service should be provided by a body such as Citizens Advice rather than by Ofgem.
- 6.18 This service should also provide information on customer service ratings, additional benefits of the tariff (e.g. boiler cover), fuel mix, additional service offerings by the supplier (e.g. digital apps), etc.

7. REMEDY 7 - REDUCE BARRIERS TO ACCESSING AND ASSESSING INFORMATION

"Measures to reduce actual and perceived barriers to accessing and assessing information in the SME retail energy markets"

Remedy 7A "Introduction of a new requirement in the licences of retail energy suppliers to provide price lists for microbusinesses on their own websites and to make this information available to PCWs"

- 7.1 This remedy is (correctly in our view) focused on microbusiness customers rather than SMEs, which can include some larger energy users with specific needs. In our response to the Updated Issues Statement (**UIS**) we drew attention to the practical difficulties in defining a microbusiness, which will be necessary to address for this and other remedies which seek to focus on microbusinesses rather than SMEs.
- 7.2 Although there are existing general definitions of microbusiness, including at the EU level, these refer to turnover, balance sheet and employee numbers, all of which are not visible to energy suppliers. As a practical matter, we consider that the distinction between microbusiness and SME is best defined in terms of meter classes and annual consumption limits. Suppliers would be free to define the boundary more widely for internal compliance purposes, if they wish, provided that all customers satisfying the definition benefit from the microbusiness market rules. Our initial suggestions are set out below in **Table 3**.

	Electricity	Gas
Definition of	All the customer's meters supplied by the	The licensee supplies (or would

Table 3: Proposed definition of microbusiness

microbusiness	licensee are in Profile Class 3-4, and the	supply) the customer with less
customer	licensee supplies (or would supply) the	than 150,000 kWh of gas per
	customer with less than 50,000 kWh of	year in aggregate.
	electricity per year in aggregate.	

- 7.3 We consider that Remedy 7A is likely to be a proportionate response to the high search costs faced by microbusinesses in engaging in the market and, subject to review of the detailed rules that are proposed, would support its introduction. However, as noted above, it will be important to formulate a satisfactory definition of microbusiness.
- 7.4 We consider that this remedy should be supplemented by reforms to the transfer objection rules for microbusiness. At present, this is delegated to the terms of the contract which allows losing suppliers to block transfers for early termination (rather than charge a reasonable termination fee) and also if potentially complex notice-giving procedures have not been properly complied with. The rules also fail to allow objection for debt on deemed contracts, which increases the cost of these contracts. It would be appropriate to conform the objection rules for microbusiness to those which apply to domestic customers which (apart from certain technical issues) limit objections to debt only whether on express or deemed contracts and which do not require notice for switching.
 - (a) Would this remedy be effective in increasing price transparency for microbusiness gas and electricity tariffs? Would it serve to make comparisons between different suppliers easier, either directly or by encouraging the development of PCW services for microbusinesses? If not, are there other measures that would encourage this development either as an alternative to this remedy or in conjunction with it?
- 7.5 Yes, we believe this remedy would increase transparency in the microbusiness segment, and would make direct comparisons between different suppliers easier.
- 7.6 It would be very helpful for PCW services to develop for the microbusiness market, and we see no reason why, with adequate transparency of pricing, this segment could not develop, for example as an add-on to the existing services. Our current thinking is that an independent price comparison service (Remedy 6) for microbusiness might stifle the growth of commercial PCW services. If the CMA is minded to introduce a remedy here, we suggest that this should be in the form of a recommendation to Ofgem to keep the matter under review.

(b) Do microbusinesses have sufficient access to the information they need (for example on their meter types) in order to engage effectively in the search and switching process?

7.7 The configuration of meters used by most microbusiness customers is very similar to that of domestic meters so access to information on meter types should not be a barrier to switching in most cases (complex metering is more common among larger SMEs). The main barriers to search and switching are: (a) the time cost of this process, given the limited transparency over tariffs currently available in the market; (b) the narrow switching windows and notice requirements that some outgoing suppliers insist on; and (c) the sometimes significant commissions and poor advice charged and given by some Third Party Intermediaries (**TPI**s). Because of the complexity, microbusinesses often rely on TPIs to search on their behalf but they are not always well served.

(c) How long should energy suppliers be given to provide the required information?

7.8 Details of tariffs should be published on a supplier's website as soon as the tariff is launched. It is not clear to us that any specific obligation is needed to provide information to PCWs as suppliers should have an incentive to do this. Such an obligation could also lead to difficulties in agreeing commission levels. It should be up to suppliers to decide which PCWs to contract with and to agree the necessary confidentiality arrangements that would allow the details of new tariffs to be provided in advance; PCWs currently require around 48 hours to process information on new domestic tariffs

into a form that can be included in their comparisons, and we think they are likely to require a similar period for microbusiness tariffs.

- (d) Should energy suppliers be permitted to fulfil this requirement by providing an automated quoting service on their websites (where microbusinesses can put in their details in order to obtain quotes) rather than a list of prices?
- 7.9 No. While an automated quoting service would be likely to be beneficial (and something that suppliers would have an incentive to provide once they publish tariffs), it would not be sufficient on its own. In order to allow PCWs to function, it is necessary to create and supply to the PCWs a price list that enables the PCW to generate quotes; if pricing is hidden within a supplier's 'black box', this will not work. Publication of prices ensures that a supplier is not tempted to forego the benefits of being listed on a PCW in order to retain a fully bespoke pricing system which may also try to take the customer part way through the contracting process before offering a price, so making a wider search harder. The search cost of finding a number of company websites and going through a quotation process on each one would be significantly greater than accessing a PCW.
- 7.10 A further complication arises in relation to credit scoring. Tariffs offered to domestic customers are not dependent on credit score (though other terms, such as requests for security deposits may be); it is unclear whether suppliers will wish to have credit dependent pricing for microbusiness customers. If suppliers choose to do this, it may be that their published tariffs will need to be limited to reasonable credit scoring businesses.
- 7.11 Credit scoring can be undertaken at the point of quotation or sale, but it is worth noting that repeated credit scoring can itself affect credit ratings. This is another reason why published tariffs applicable to standard metering configurations and credit profiles are needed to reduce search costs. In the event that the customer fell outside the standard credit profile, the supplier could offer an alternative price if appropriate.

Remedy 7B "Introduction of rules governing the information that TPIs are required to provide to microbusiness customers"

- 7.12 We consider that Remedy 7B is likely to be a proportionate response to the difficulties faced by microbusinesses in engaging in the market and, subject to review of the detailed rules that are proposed, would support its introduction.
 - (a) Would this remedy be effective in improving transparency over incentives and trust in TPIs in the energy sector? How could the CMA ensure that this remedy was enforced, ie that TPIs were providing the specified information?
- 7.13 Yes. The CMA's provisional findings dated 7 July 2015 (**Provisional Findings**) note the lack of transparency around TPIs, and we believe this remedy could be effective in addressing this. We are concerned that some microbusiness TPIs are charging very large commissions and are not necessarily getting the best deal for the customer.
- 7.14 In the domestic market, these issues are largely addressed through the use of published tariffs and the Confidence Code which provides guidance on how PCWs should give good guidance to consumers. We think that a similar approach should work for the microbusiness market.
- 7.15 We therefore believe the best approach would be for Ofgem to accredit TPIs to a code of conduct, which TPIs would need to demonstrate their compliance with by means of periodic independent audits. Consideration could be given as to whether it would be necessary for there to be a licence condition requiring suppliers to deal only with accredited TPIs. However, this has not yet been found necessary in relation to PCWs.

(b) What information should be provided by TPIs to microbusinesses in order to enable them to make informed choices?

- 7.16 In our view TPIs should disclose to their microbusiness clients as a minimum:
 - (a) whether their comparison service covers the whole of the market (i.e. any tariff whose details have been provided to the TPI by a supplier) or only a subset of suppliers and/or tariffs;
 - (b) key non-price terms, such as length of contract, whether early exit is possible, and any termination fees in such a case;
 - (c) which tariffs they will be paid a commission for switching the client to; and
 - (d) on what basis the offers presented to the client will be filtered and ranked.
- 7.17 Microbusiness customers may also be interested in other factors such as the quality of customer service and support, but these do not seem to be matters that are suitable for disclosure by TPIs in the equivalent of the Confidence Code as they run more to experience and reputation than hard facts and therefore may be difficult to capture in any disclosure requirement.
- 7.18 We note that there is a growing trend among TPIs to get customers to consent on an evergreen basis for the TPI to make renewal and switching decisions on their behalf, which ultimately excludes consumers from the decision-making process. Therefore, it is also important to establish appropriate regulations around this practice, particularly on providing customers with sufficient and clear information about what this entails, so that they are able to understand on what basis these decisions will be made and have suitable prompts and opportunities to re-engage themselves in the market.

(c) Could the provision of certain types of information have unintended consequences (eg customers choosing tariffs based on commission rates rather than total price)? If so, are there any steps that could be taken to mitigate this effect?

7.19 A controlled experiment by the US Federal Trade Commission, reported in 2004,¹⁰ showed that when consumers were made aware of the level of the commission for mortgage products, this information could distort their choice in favour of the lowest commission product rather than the lowest overall price. Therefore, although we believe it is important that customers are aware that there is a commission associated with the price they are offered, it should not necessarily be required that customers are made aware of the amount of that commission.

(d) Should the specified information be provided to customers in writing or orally (or both)? At what stage in the sales process should this information be provided?

7.20 We think that this information should be provided in writing (including electronically), as part of the sales process, and before any quotations are provided to the client.

(e) Should this remedy be introduced in addition to Ofgem's proposed code of conduct? Or should only this remedy (or only Ofgem's code of conduct) be introduced?

7.21 Only one or the other remedy should be introduced. It would be inefficient and confusing to have two overlapping (and potentially conflicting) measures in place at the same time.

¹⁰

Lacko, J., and J. Pappalardo (2004) for the Federal Trade Commission: *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment* – <u>https://www.ftc.gov/sites/default/files/documents/reports/effect-mortgage-broker-compensation-disclosures-consumers-and-competition-controlled-experiment/030123mortgagefullrpt.pdf</u>.

- (f) Are there any additional measures that should be implemented alongside this remedy to enhance its effectiveness?
- 7.22 No.

8. **REMEDY 8 – PROHIBITION OF AUTO-ROLLOVER**

"Introduction of a new requirement into the licences of retail energy suppliers that prohibits the inclusion of terms that permit the auto-rollover of microbusiness customers on to new contracts with a narrow window for switching supplier and/or tariff"

- 8.1 ScottishPower considers Remedy 8 would be a proportionate response to the problems that currently limit some microbusinesses' ability to engage and would support its introduction. Any auto-rollover contracts should enable the customer to switch without penalty.
 - (a) Would this remedy be effective in allowing microbusiness customers greater opportunity to engage (by removing the narrow window in which they can choose not to roll-over automatically)?
- 8.2 ScottishPower's policy is already in line with the proposed remedy and we would support its introduction. In our view the remedy would provide consistency across the market, providing greater confidence to microbusinesses that they will not be penalised by a new supplier for failing to act within the window, and thereby reducing a potential barrier to engagement.

(b) Are there any means by which energy suppliers could circumvent this remedy to continue to lock customers into energy tariffs that they have not chosen for extended periods of time?

- 8.3 We are not aware of any means by which suppliers could circumvent this particular remedy. However, as noted in response to Remedy 7 above, the potential for switching could be enhanced by conforming the transfer objection rules for microbusinesses to those which apply to domestic customers.
 - (c) What is the minimum or maximum notice period that customers should be required/allowed to give in order to exit a contract that they have been rolled on to?
- 8.4 We believe customers should not be required to give more than 30 days' notice to exit an autorollover contract. Indeed, we have suggested in response to Remedy 7 that the requirement to give notice on switching could be abolished for microbusinesses, as it has been in the domestic sector.
 - (d) Should energy suppliers be required to inform customers that they are nearing the end of their contract and prompt them to switch?
- 8.5 Yes, this should be the standard procedure in both the domestic and the microbusiness markets.

9. **REMEDY 9 – DIFFERENT OR ADDITIONAL INFORMATION**

"Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information"

9.1 Remedy 9 is not yet sufficiently well-defined for us to comment on its effectiveness or proportionality. However, we agree that it is worth considering measures to provide domestic and microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information.

9.2 One development that is already underway is that ScottishPower and other suppliers will soon be providing QR codes on domestic customers' bills (in compliance with SLC 31A.2(i)). These will enable the tariff and consumption data which is provided on bills and is needed to provide an accurate quotation to be scanned into a smartphone for use in a switching app. We expect that these smartphone apps could be developed by switching websites or indeed suppliers and that the QR code will enable quotes to be obtained online without the need to key in data. We expect that, for many customers, this development will significantly simplify the process of using their information to engage with the market.

(a) Does the current format and content of energy bills facilitate engagement by customers? Is there additional information that should be included on bills? Should the quantity of information on bills be reduced to enhance clarity?

- 9.3 We believe that there are a number of improvements and refinements that could be made to the regulation requirements around communications to improve customer understanding and engagement and we would support the need for further review and consultation in this area.
- 9.4 Having made significant changes to our bills to meet RMR requirements, we are now undertaking customer research on our bill design and the value/use of the information presented, with results due later in the year. We would be happy to share these results with the CMA if it is of interest. We would recommend that in the process of determining any information remedy, comprehensive consumer research is considered, recognising that different segments of customers can have different needs and preferences.
- 9.5 There are a number of information requirements that, without wishing to pre-empt the outcome of the research, we believe are areas that could be improved upon:
 - (a) the Tariff Comparison Rate which in our view is not helping consumers compare their tariff with other offers in the market;
 - (b) the level of regulatory prescription as to the format (as opposed to content) of bills may be contributing to some customers being disengaged it is important that suppliers have the ability to innovate and to design communications that meet different customer groups' preferences; and
 - (c) the length of the bill repeated regulatory interventions have added a great deal of required information to the bill, which now has to be spread out over several pages preliminary evidence from our research suggests that customers generally do not wish to receive such extensive paper communications from us, and therefore it is necessary to ensure that regulatory requirements are streamlined so that customers get just the information they need.
- 9.6 The effectiveness of a communication is generally greater when it is not trying to fulfil multiple purposes; ideally, each communication would have one key purpose. However this needs to be balanced against sending customers too many different communications which can be costly and lead to communications being ignored.
- 9.7 Another practical consideration is the need to make sure that the format of communications is not changed too often. The concern here is not only that this results in costs to implement but importantly consumers need time to become familiar with the key elements of the content to support engagement with, and understanding of, it.

- (b) When customers seek to switch tariffs, are they given enough/too much information on the terms and conditions of their new contract?
- 9.8 Again, we believe that there are a number of improvements and refinements that could be made to the regulation requirements around these communications to improve customer understanding and engagement and support need for further review and consultation in this area.
- 9.9 Similar to the bills, we feel that the level of information provided, driven by prescriptive regulation (particularly around Terms and Conditions), and the concerns about legal or regulatory challenge, have tipped the balance away from it being useful or understandable for consumers.
- 9.10 We would recommend that before any remedies are developed for communication, comprehensive research should be undertaken to ensure communications meet customers' needs, and are not losing their attention and therefore not providing the protection intended. Similarly, suppliers should be allowed the freedom to design these communications to meet different consumer segments' preferences.
 - (c) Should customers be prompted to read their meters (quarterly or annually), either by information on their bill or by a phone call from their energy supplier? Would this increase engagement by improving the accuracy of billing?
- 9.11 It is in suppliers' interests to obtain meter readings and ensure their accuracy, as this helps reduce the cost of dealing with customer queries. Suppliers already prompt customers to read their meters via a range of channels including:
 - (a) emails;
 - (b) bill prompts;
 - (c) card drops when a meter reader is unable to gain access to the premises; and
 - (d) requesting reads when customers query bills, request changes to direct debit payments, etc.
- 9.12 In addition ScottishPower continues to be innovative when seeking solutions to this challenge, making it easier than ever for consumers to provide a reading. Examples include streamlining the process for meter reading updates on the website, and offering customers an app which includes torch and camera functionality to allow them to get readings from meters in less accessible locations.
- 9.13 We do not currently call customers and we would consider this an expensive and inefficient solution for this issue. The call would need to be timed at a moment that is convenient for the customer to provide their reading. A random call is most likely to catch the customer at a moment when they do not have access to their meter reading.
- 9.14 Looking ahead, remedies along these lines will not be relevant in a smart energy market, and therefore we consider that efforts to increase consumer engagement should be focused elsewhere.
 - (d) Once customers reach the end of a contract period, should subsequent bills highlight that they have now been moved onto the standard variable tariff and/or other default tariff and encourage them to check whether they are on the most appropriate tariff for them?
- 9.15 SLC 31A already requires suppliers to set out on the first page of bills a section entitled "Could you pay less?" which presents details of the saving that could be made by switching to a different tariff from the supplier or an affiliate (both on a narrow search same meter and choice of online/offline management and on a wider basis). This must be accompanied by text reading "Remember it might be worth thinking about switching your tariff or supplier". The exact tariff name must also be

stated. It follows that substantially all of the suggestions above are already in place, with the exception of wording to identify that a customer is *newly* on SVT. It is not clear that this additional requirement would add much and it could be difficult to set up because it would presumably need to be programmed to appear on one bill only.

9.16 In any event, we would not wish to use the phrase "default tariff" with customers as this could cause some customers to be concerned that they had broken a rule.

10. REMEDY 10 – PROMPTS FOR CUSTOMERS ON DEFAULT TARIFFS

"Measures to prompt customers on default tariffs to engage in the market"

- 10.1 Remedy 10 is not yet sufficiently well-defined for us to comment on its effectiveness or proportionality. However, we are broadly in agreement that ensuring that there are adequate measures to prompt customers on default tariffs to engage in the market should be an area of focus for the CMA in defining remedies.
- 10.2 In this context, it is useful to consider what is already required under RMR. Suppliers are already required to present on the first page of every bill a "cheapest tariff comparison" which gives indications as to the amount the customer could save by changing deal with the current supplier. See paragraph 9.15 above. This remedy should therefore be directed at providing any necessary improvements to what is already in place.
- 10.3 It is also worth noting that, prior to RMR, suppliers had the option of moving customers who did not express a preference at the end of a fixed term deal onto a new product which reflected their previously expressed preferences. These renewal offers were often more attractive than SVT. While it is right that any such auto-rollovers should not have termination fees, we think that the benefit of defaulting customers on to SVT, as suppliers are now required to do, is at best questionable.
 - (a) What information should be included in the prompts to customers on default tariffs in order to maximise the chances that they are acted upon?
 - (i) Should customers who have failed to engage be informed that they are 'no longer under contract for energy', that they have been 'rolled onto a safeguard tariff', or an alternative message, for example, emphasising how many customers in their area have switched in the last year?
- 10.4 This suggestion seems to be aimed at customers that are 'intermittently engaged' (in the sense that they have come to the end of a fixed term tariff) rather than customers that have failed to engage altogether. To the extent that a message is needed in addition to the exact tariff name, some kind of message describing the standard variable tariff would be preferable to a message along the lines of being 'no longer under contract for energy'. Whilst this latter choice might seem more likely to prompt consumers to act, it could:
 - create unnecessary concern for some consumers who may misinterpret the message as meaning they are at risk of disconnection; and
 - mislead customers to believe that they do not have a contract (when in fact they do).
- 10.5 As per our response to Remedy 9, whilst we recognise that changes in the language used in customer communications may increase engagement, we would strongly recommend that any solution in this area should be thoroughly tested on a representative consumer sample to determine its effectiveness. Different customer segments may not only have different preferences as to the channel used (e.g. letter, text messages, etc.) but may also respond differently to different choices of language. We are

concerned that the use of the phrase 'safeguard tariff' might discourage customers from searching, on the basis that they believed themselves to be 'safeguarded' from having to engage in the market.

(b) How should prompts be communicated to customers? For example, there is some evidence from the financial sector that text prompts are particularly effective at raising awareness in terms of overdrafts etc.

- 10.6 There are many methods of prompting customers and we would advise against the CMA being overly prescriptive as to the means of communication, and instead leave suppliers to use the full list of available communications channels, creating greater flexibility to match channel to the customer's own preferences. It is important to note that the cheapest tariff comparison presented on the front page of every bill does provide a visible prompt for all customers who receive paper bills.
- 10.7 We believe the single most effective channel for prompting disengaged customers to engage would be face to face selling. The withdrawal of the Six Large Energy Firms from doorstep selling and most venue selling (e.g. supermarket forecourts) coincided with a pronounced fall in switching rates, and survey evidence suggests that many of the currently disengaged fall into the categories who would previously have been engaged in this way.¹¹
- 10.8 We have suggested in previous submissions that the CMA should give careful consideration to measures that could facilitate a return to face to face selling in a way that gives adequate protection from mis-selling.¹² We continue to believe that face to face sales were an effective way of engaging with customers who have a lower propensity to switch their energy supply (e.g. those without internet access or who are not comfortable with using the internet and do not wish to engage in telesales calls). Advances in technology and the growth of intermediaries mean that face to face selling could now be conducted differently from the way it was done in the past, with significantly improved consumer choice and protection, but we believe there are still barriers (both regulatory and reputational) that may be impeding this.
- 10.9 Although the CMA says that it is not currently minded to consider remedies that would relax Ofgem's required standards of conduct in relation to doorstep sales, we do not agree with the CMA's statement in the Remedies Notice that it has not received any submissions raising concerns regarding the impact of Ofgem's rules on doorstep selling.¹³ In fact, ScottishPower's response to the CMA's UIS noted that "Suppliers withdrew from doorstep selling and in practice almost all face-to-face sales in response to two drivers: intense political and media pressure and the difficulty of complying fully with the requirements of amended SLC 25 (Marketing to Domestic Customers) and Ofgem's interpretation of those rules. Although it was clearly necessary for Ofgem to introduce stricter rules given the poor sales practices that were being employed by some suppliers at that time, and to take enforcement action when those rules were not followed, it is not clear to us that the correct balance was struck in determining how stringently those rules should be enforced. However well a supplier trains and manages its sales agents, it is impossible to achieve 100% compliance in every sale. If suppliers believe the risks of non-compliance are too great, this may result in a sub-optimal level of face-to-face sales activity from the perspective of consumers as a whole".¹⁴ Similarly, Stephen Littlechild's submission to the CMA of 11 January 2015 reviews Ofgem's regulation of marketing including doorstep selling, and its impact on competition. He concludes that "The present marketing licence condition (SLC 25) and its interpretation have thus restricted and distorted competition in several respects, to the disadvantage of customers, particularly vulnerable customers. Anv suggested countervailing benefits – such as the cessation of doorstep selling or the desirable aims of the policy – do not warrant the CMA not taking steps to address these adverse effects on competition."

¹¹ 12

The GfK survey for the CMA Energy Market Investigation, paragraph 68, for instance, found that "three fifths (59%) of households with no internet access had not considered switching supplier compared with around a quarter (28%) of households who had internet access." ScottishPower response to Updated Issues Statement, paragraphs 5.54 to 5.58.

¹³ At footnote 12.

¹⁴ At paragraph 5.55.

- 10.10 We therefore continue to think that the CMA should consider carefully SLC25 and the manner in which it has been implemented with a view to facilitating face to face selling going forward in a manner that adequately protects consumers.
- 10.11 We understand that a particular problem facing TPIs is that SLC25 holds suppliers accountable for the actions of their 'representatives', and a TPI wishing to offer multi-supplier price comparisons will need to reach agreement with each supplier individually as to the adequacy of its arrangements for SLC25 compliance. This can be almost impossible if (as is likely) suppliers wish to impose differing procedures reflecting their individual SLC25 compliance approach. We have proposed a solution to this to Ofgem in which TPIs are accredited by Ofgem and suppliers are granted a 'safe haven' exemption from any mis-selling by the TPI, provided that the TPI is accredited and the breach was not the result of any act or omission on the part of the supplier.

(c) What should be the timing and frequency of prompts in order to balance effectiveness in terms of encouraging engagement with the cost and potential irritation that might arise from repeated prompts?

- 10.12 It is important to strike the right balance between informative communications and irritation, to maximise consumers' likelihood of acting upon the prompts and not becoming dismissive of them. This will vary based on consumer characteristics, and therefore a 'one size fits all' approach may not be appropriate.
- 10.13 At present, licence conditions require all customers, including those that do not receive bills, to receive an Annual Statement which is designed to act as a prompt to consider whether the customer is on the correct tariff and supplier. We think that this may be around the right frequency; to the extent that a different approach to prompts is taken forward by the CMA, we would suggest that this replaces the existing Annual Statement, rather than being added to it.

(d) Who should provide the prompts: customers' energy suppliers, Ofgem or another party?

10.14 In the case of any mandatory prompts delivered as part of this remedy, we believe it would be most appropriate for the prompt to be provided by the energy supplier. If suppliers are seen to be helping their customers find the right deal, this would be positive in terms of improving trust in energy companies – and as noted above, suppliers are best placed to tailor the nature of the communication to the customer's preferences. This would not preclude other bodies such as PCWs sending prompts as part of their normal marketing activity.

(e) Are there particular groups of customers who should receive prompts at specific points? For example, should house-buyers be prompted to engage with the market on completion of their purchase?

- 10.15 Home moves, whether by home owners or renters, are a known trigger for market engagement and are a focus point for customer retention and acquisition activity by suppliers. This would be a good point to deliver a prompt although it would need to be coordinated with other activity.
- 10.16 In addition, many other life events can also be a trigger for customers to assess their energy needs, both in terms of provider and costs. Examples include retirement or changes in family size or dynamic, or changes in employment status; however from a practical level our ability to identify these is more limited.
- 10.17 When specifying any remedies in this area, the CMA should consider the impact of sending customers too many different communications, which can be both costly and ineffective. As noted above, we would recommend that any decisions on frequency and point of contact should be grounded in solid customer research.

- (f) Is there benefit in others in the markets, such as rival energy providers or TPIs, being made aware of which customers remain on default tariffs (or have been rolled on to the safeguard tariff)? In this respect, data protection issues would need to be carefully considered. The ability of other market participants to identify inactive customers, however, has the benefit of potentially encouraging the customer to switch tariffs once out of contract.
- 10.18 We would question whether mandatory sharing of customer information would be a proportionate response. Providing this information would potentially enable TPIs and others to target their marketing more accurately; but given that around 70% of customers of the Six Large Energy Firms are currently on default tariffs¹⁵, we do not believe the modest improvement in targeting accuracy would be sufficient to justify the intrusive nature of this remedy. Customer information is normally regarded as highly commercially confidential.
- 10.19 In any event, we share the CMA's concern that such sharing of customer information is likely to be prevented by data protection rules under the Data Protection Act 1998 (**DPA**) which implements the Data Protection Directive (Directive 95/46/EC)¹⁶. In the case of domestic customers, suppliers would need to obtain their customer's opt-in consent before they could share this information. While it might be possible to obtain this consent as part of the sales process for a proportion of new customers, these are the customers who are least in need of a prompt. Obtaining opt-in consent from disengaged customers is likely to have a very low success rate. In the case of microbusiness customers, any customers who are sole traders would also be caught by the data protection rules. We do not believe it would be practicable for suppliers to determine which of their disengaged microbusiness customers are not sole traders.¹⁷

11. REMEDY 11 – TRANSITIONAL 'SAFEGUARD REGULATED TARIFF'

"A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers"

- 11.1 We have serious concerns about the proposed 'safeguard regulated tariff' (**SRT**). This is an extremely interventionist measure which we believe will damage investor confidence in the UK energy market, weaken the incentive for consumers to engage in the market, and harm competition to the detriment of consumers as a whole. It runs contrary to the direction of regulatory policy in the EU, Australia and many other countries, which recommends lifting of price regulation in favour of competition. The UK has been at the forefront of liberalising energy markets, often acting as a pioneer in using competition to drive innovation and value in retail energy and setting an example that has led to dynamic benefits in many other jurisdictions. Given its historical leadership position, a reversal in the form of a return to price regulation may have an impact beyond the UK, putting those gains at risk.
- 11.2 Although the remedy is proposed to be 'transitional', the remedy itself risks undermining the market developments which would render it unnecessary over the coming years. Even without the CMA's other proposed remedies, consumer engagement can be expected to improve substantially in the next few years. Next day switching will greatly improve the switching experience and lower the perceived cost of switching which may currently deter many of the disengaged. Smart meter rollout will make consumers more aware of their energy consumption and provide a platform for

¹⁵ Summary of Provisional Findings, at paragraph 23.

¹⁶ [1995] OJ L281/31.

Furthermore, we do not believe that the CMA has the power to make an order effectively over-riding the DPA and specifically the 'nondisclosure provisions' of the DPA. Pursuant to the Data Protection Directive, Member States may only adopt legislative measures restricting the scope of the 'non-disclosure provisions' in certain limited circumstances. In broad terms, these circumstances are where such a restriction is necessary to safeguard: (a) national security; (b) defence; (c) public security; (d) the prevention of crime; (e) an important economic or financial interest of a Member State; (f) a monitoring, inspection or regulatory function connected with the exercise of official authority in cases referred to (c), (d) and (e); or (g) to protect the data subject or the rights and freedoms of others. We do not see how the CMA could credibly argue that any order under Schedule 8 EA 2002 would meet any of these tests.

innovation and new business models. Printing of QR codes on bills and the development of associated switching apps will lower the barrier to search and switching for those with smartphones. The 'competitive fringe' of energy suppliers which has grown from 2% to 10% in the last two years is increasingly seen as a viable alternative to the incumbents.

- 11.3 All these developments can be expected to drive disengaged customers to move from SVTs to nonstandard products. The CMA's Remedies 3 to 10, which seek to work with the grain of the market, will accelerate this progress. As these improvements come through, price dispersion can be expected to fall as the equilibrium between the gains and the perceived costs of switching settles at a lower level. Although there is good reason to be optimistic, the process of improving customer engagement has been blown off course in the past by ill-judged regulatory interventions. By reducing incentives to shop around and creating a false sense of security for those on the regulated tariff, the SRT risks turning 'transitional' into permanent. The CMA should heed the lessons of SLC25A and the RMR tariff rules and be extremely cautious of a further setback to competition caused by regulation.
- 11.4 A regulated tariff, even if positioned as 'transitional' and a 'safeguard', will increase the perceived regulatory risk. This will damage investor confidence in the UK energy market and may increase the cost of capital for supply businesses. Investors will be aware of the problems caused by price controls in other markets in 2012 there was evidence of permanent or temporary 'tariff deficits' in at least 11¹⁸ of the 17 EU Member States that regulate tariffs in some form¹⁹ and will be wary of the 'slippery slope' that has often caused 'price to beat' tariffs to morph into 'price below cost' tariffs. If these risks were to come to pass, there is an obvious concern that investors would look to withdraw from the UK market and deploy their capital elsewhere.
- 11.5 Price control remedies are rightly seen by economists and competition authorities as a remedy of last resort, to be adopted only when other pro-competitive remedies will not achieve the desired effect. In view of the potential risks to competition, it is considered that the scope of any price controls (both in application and duration) should be limited to that which is strictly necessary. Indeed, we note that in the Competition Commission's (CC) own guidelines on market investigations (subsequently adopted by the CMA)²⁰ these drawbacks are explicitly recognised. Price controls are mentioned as the most obvious example of remedial measures to address customer detriment directly, "for example where effective remedies aimed at introducing competition by addressing the AEC are unavailable or will not bear fruit in the short term...". The CC goes on to say, however, that "such measures to control outcomes are not likely, by their nature, to provide a solution to the underlying problem and may also give rise to distortion risks, if retained over a long period. For these reasons... remedial action to control outcomes will not generally be preferred as a long-term solution.". Elsewhere in the same document the CC outlines other risks associated with price controls (and certain other forms of behavioural remedy):²¹

"... this type of behavioural remedy can be complex to implement and monitor, given informational asymmetries between the parties and the authorities and the associated risk of circumvention. There is also a risk that such controls create market distortions, particularly if they are kept in place over a long period. Ensuring that measures to control outcomes remain fit for purpose in the light of market developments may involve costs for monitoring and enforcement agencies as well as for the parties subject to them".

11.6 We agree with these observations and consider that the threshold for introducing price controls in the GB energy market is not met. We note also that similar reasoning underpinned the CMA's decision

²¹ *Ibid*, at paragraph 378.

A. J. Linden *et al.* for the European Commission (2014): "*Electricity Tariff Deficit: Temporary or Permanent Problem in the EU*?", Economic Papers 534.
 The Linden *et al.* report commissioned by the European Commission finds that 16 Member States fully regulate tariffs and that Comment.

¹⁹ The Linden *et al.* report commissioned by the European Commission finds that 16 Member States fully regulate tariffs, and that Germany regulates the renewables account only (which has led to subsequent temporary deficits since the creation of this account). The report also counts Northern Ireland as a regulated territory, and therefore cites a total of 18 Member States that regulate tariffs.
²⁰ Chiddling for mergetst invite and the procedure account of the procedure account

²⁰ Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3), at paragraph 389.

not to opt for price control in the *Private Healthcare* market investigation, where the CMA put matters in the following terms:

"12.67 ... we thought that the existence of price caps may generate distortion risks over time by discouraging innovation and the introduction of new and better treatments and procedures. They would also discourage new entry into an area subject to a capping regime, unless the potential new entrant could be certain that the fact of its entry would result in the removal of price caps in that area...

12.68 We considered that, while price caps might appear to address the immediate customer detriment in single hospital areas, the cost of setting up and administering such a regime would be considerable and, over time, would result in customer detriment through distortions creating lower quality of service and reduced innovation. We therefore decided that a price-capping regime would not be effective in the long term, and would not be proportionate."

11.7 While there are of course many differences between energy and private healthcare, including that healthcare is a differentiated product and energy has a sector regulator, the general thrust of the CMA's observations in the *Private Healthcare* investigation, and the CC's comments in its guidelines, are equally relevant to energy: price controls will in our view discourage innovation, will distort competition and may deter entry. In addition they would be complex to implement and costly to monitor. We develop these themes below.

Weakening of competition

11.8 There is a significant risk that an SRT will weaken competition and undermine other pro-competitive remedies that the CMA is considering. The risks are explained in a recent paper by *Armstrong et al*:

"... a price cap which protects consumers from bad deals may be a mixed blessing. The direct effect of the regulation is positive for consumers because high pricing is prevented. But the policy reduces price dispersion and blunts incentives to become informed about the available prices, which in turn weakens the competitive pressure on firms to offer low prices. This indirect effect of regulation weakening competitive market forces goes against its direct effect in curbing high prices."²²

11.9 The paper, which builds on similar results obtained by Fershtman and Fishman²³, also raises the spectre of the Diamond Paradox, which is that in the presence of a tight-enough price cap, it is not in the interest of any consumer to become informed and regulation takes over from competition as the prevailing mechanism that determines the price that is subject to the price cap. While the paper does not claim that price caps are detrimental to consumer welfare under all circumstances, it does imply that competition and price regulation are not compatible given the conditions under which each of these is optimal from consumers' perspective.²⁴ This puts into serious doubt that a price cap can be used as a 'back-stop' measure in an otherwise competitive market.

²² Armstrong, A., Vickers, J. and Zhou, J. (2009), "*Consumer protection and the incentive to become informed*", Journal of the European Economic Association, 7:2–3, pp. 399–410, http://else.econ.ucl.ac.uk/papers/uploaded/314.pdf.

²³ Fershman C. and A. Fishman (1994): "The Perverse Effects of Wage and Price Controls in Search Markets," European Economic Review, 38(5), 1099-1112.

²⁴ Outside of the area where market pricing converges to the price cap and consumers stop searching (Diamond Paradox), the paper identifies the condition under which a price cap may increase consumer welfare. This is a condition on the search costs of the marginal consumer, in the sense that the consumer's decision on whether to become informed or not is marginal. The condition states that search costs must be strictly increasing in the proportion of consumers who decide to become informed, with the rate of increase being above a certain threshold. What this implies is that the difference in search costs between different consumers must be sufficiently large, such that search costs could be prohibitively high for a significant body of consumers. If this condition holds, it is doubtful that competition could be made to work together with a back-stop price cap because the cost of engaging with the market and becoming informed may be too great for a significant body of consumers.

11.10 Recent experience of domestic energy price regulation in the New South Wales (NSW) market shows a pattern which is consistent with price controls reducing price dispersion and weakening competition. As shown in **Table 4: Retail price controls in New South Wales**, in the 2007-10 price control period, the level of 'incentive' (a measure of headroom in the price cap) was relatively low and the number of customers opting for regulated as opposed to 'market' prices actually decreased over the period. In the next price control period 2010-2013, the incentive was increased four-fold (to approximately 10% of total costs), resulting in a much looser price control. This caused price dispersion to widen from 4-5% to 5-15% (in 2012/13), the switching rate to increase by 50% and the number of customers on regulated tariffs to fall from 59% to 40%.

	2007 Determination Period			2010 Determination Period			
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Incentives in regulated prices ²⁵ (\$/MWh)	5.1	5.1	5.1	29.0	25.3	24.3	22.0
Incentive as % of total costs ²⁶		2.8%			10.3%		7.0%
Market offers (% discount on regulated price)	4-5%	4-5%	4-5%	5-10%	5-12%	5-15%	
Switching rates	9%	10%	12%	13%	16%	19%	
% of customers on regulated prices	64%	68%	65%	59%	50%	40%	

Table 4: Retail price controls in New South Wales

Source: IPART report (2013-2016 Price Determination)²⁷

- 11.11 Similar conclusions can be drawn from US experience. Based on a review of regulation in a number of different US states, Kiesling (2014)²⁸ considered that a price to beat might have a deterrent effect on market entry.
- 11.12 We have commissioned Oxera to build a model of consumer switching behaviour. Work on this model is still under way but initial results, subject to further validation, indicate that implementation of Remedy 11 could lead to a very substantial reduction in switching, even based on the SRT being no lower than the lowest SVT of the Six Large Energy Firms in each supply area.
- 11.13 ScottishPower has been at the forefront of the drive to increase consumer engagement in the market and has grown its market share at a time when other large integrated suppliers have been losing ground to independent suppliers and to us. We have achieved this mainly by pricing our fixed tariffs aggressively in order to entice other firms' customers to join us and for our existing customers to stay with us. Introducing the SRT would reduce engagement and make it harder to attract new customers, thus penalising the firms that are driving competition in the energy retail market.

Regulated prices x/MWh above the efficient cost of supply. This incentive was mainly introduced through the CARC, but refers to the total level above the competitive price allowed in regulated tariffs.

²⁶ ScottishPower estimates (total cost to serve includes total N and R values). This estimate is calculated based on the incentive level and the variable R values for each determination period (the R values are extracted from each determination period, i.e. using information from the three corresponding IPART reports). The incentive level is calculated as a percentage of the variable R values. Then, according to the information contained in p. 55 of IPART (2013), which states that variable R costs (total energy cost allowance) makes up for around 40% of total costs, the percentage correspondence of the incentive level to total costs is estimated.

²⁷ Independent Pricing and Regulatory Tribunal of New South Wales (IPART) (2013): "*Review of Regulated Retail Prices and Charges for Electricity*", p. 144 (table 9.2).

 ²⁸ Kiesling, Lynne (2014), Incumbent Vertical Market Power, Experimentation, and Institutional Design in the Deregulating Electricity Industry, The Independent Review 19 (2), p. 239-264.

Consumer preference for regulated tariffs

- 11.14 A further concern with the SRT remedy is that consumers may be more attracted to safeguard tariffs than they currently are to SVT in the knowledge that they are price-regulated. Consumers may display an 'endorsement bias' in their preferences- i.e. they may (mistakenly) believe that because the tariff has been capped by Government, it must be a good deal, and therefore be less likely to search or switch. This would have a similar (and additional) effect as reduced price dispersion in weakening competition.
- 11.15 We note that similar concerns motivated the CMA's decision not to impose a price cap in the Home Credit market investigation, in which the CMA recognised the problems that would occur if, "customers and lenders consider these prices [under the proposed price cap] to be legitimized in some way – limiting price competition".²⁹
- 11.16 By effectively incentivising consumers to stay disengaged, and thereby diminishing competitive pressure in the market, this remedy could harm, in the long-term, the very people that it is meant to protect.

Risk of tariff deficit

- An important risk for safeguard or 'price to beat' tariffs is that, despite initial good intentions, tariff 11.17 increases fail to keep pace with increasing costs - e.g. because it is too difficult politically to increase tariffs by the necessary amount. This can lead to situations where there is insufficient headroom for unregulated tariffs to compete, or ultimately to a 'tariff deficit' position where costs exceed the regulated price.
- 11.18 Tariff deficits have been a recurring problem in countries that regulate tariffs. In 2012 there was evidence of permanent or temporary deficits (including those arising from the imposition of 'social tariffs') in at least 11 of the 17 EU Member States that regulate tariffs in some form.³⁰ In Annex 1 we have provided brief case studies of three European countries where tariff deficits have arisen, France, Spain and Portugal. In the case of France, the price control was intended to be a 'price to beat' tariff but from around 2009 became unbeatable, acting as a barrier to competition. In recognition of this problem the French regulator CRE has made increases to the regulated tariff since August 2013, and the French authorities have agreed that the amount of the deficit will be paid back to EDF by the end of 2018 with interest. In order to improve levels of competition, regulated tariffs will be phased out by the end of 2015.
- The European Commission conducted an empirical analysis of what drives the probability of tariff 11.19 deficit, using a logistic regression model.³¹ It found that GDP growth reduces the probability of incurring a tariff deficit, while increasing Government debt or deficit increases the risk. Higher shares of renewables in the energy mix, increasing oil prices, and higher consumption under regulated prices also increase in the probability of deficit.
- 11.20 However secure the independence of the body responsible for setting an SRT in GB, the history of price controls in other countries means that investors will be more wary than they would be in the absence of a regulated tariff. In the worst case, an SRT could result in energy suppliers being unable to recover their costs. Even though the risk of this may be remote, it is likely to be a material concern for investors and may lead to an increase in the cost of capital for supply businesses.

²⁹ Home Credit, Final Report, at paragraph 9.139.

³⁰ A. J. Linden et al. for the European Commission (2014): "Electricity Tariff Deficit: Temporary or Permanent Problem in the EU?", Economic Papers 534. 31

Ibid, pp.39-46.

Compatibility with EU policy

11.21 We would note that the thrust of EU energy policy has been to discourage retail price controls. Indeed, as recently as 2010 the European Court of Justice emphasised that state intervention in the pricing of retail energy products is not permitted unless it is consistent with the requirements of the current Internal Energy Market Directives.³² The recent Energy Union communication³³ notes that regulation of retail prices can represent a 'particularly strong barrier to effective competition' and that

> " ... regulatory interventions such as price caps, price regulation, distortive taxation and other state interventions result in prices that do not provide signals and value for consumers to participate in the market. Thus the potential for optimal demand response remains untapped. Accordingly, neither households, businesses nor industry are currently sufficiently incentivised to participate in electricity markets."

- 11.22 In considering the merits of an SRT, it will be important for the CMA to consider its compatibility with EU energy policy, in particular in light of the binding requirements of the Internal Market Directives mentioned above. In addition, we consider that the CMA should carefully take the Commission's comments into account from the perspective of the leadership position the UK has historically held in developing energy markets and getting consumers engaged in them.
- 11.23 Finally it will also be important for the CMA to consider the compatibility of an SRT with EU consumer protection policy, in particular the EU Consumer Rights Directive.³⁴

Proportionality

- 11.24 The CMA rightly dismisses a return to full price regulation on the ground that it "*would remove any prospect of reaping the benefits from the competitive process both now and in the future*".³⁵ However the SRT that is currently under consideration by the CMA would be little better and would fail to deliver on two out of the CMA's three 'key principles' underlying the package of remedies, namely to provide a framework for effective competition and to facilitate widespread customer engagement.³⁶
- 11.25 We recognise that the CMA has yet to carry out a full cost/benefit analysis of Remedy 11 and we assume that this will be done before publication of the Provisional Decision on Remedies. But our view is that the CMA's SRT proposal would fail a 'double proportionality' assessment (requiring a particularly high degree of analysis in order to justify such an extreme and intrusive remedy).³⁷ This is principally because of the substantial adverse effects of Remedy 11, discussed above, which in our view would outweigh any of the claimed benefits identified by the CMA. But it is also because, as we demonstrate in our response to the Provisional Findings, the CMA's assessment of the features

³² Judgment of the Court (Grand Chamber) of 20 April 2010 (reference for a preliminary ruling from the Tribunale Amministrativo Regionale per la Lombardia—Italy)—Federutility, Assogas, Libarna Gas SpA, Collino Commercio SpA, Sadori Gas SpA, Egea Commerciale, E.On Vendita Srl, Sorgenia SpA v Autorità per l'energia elettrica e il gas (Case C-265/08).

European Commission, COM(2015) 340 final: "Communication from the commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Launching the public consultation process on a new energy market design", page 8. – http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0340&from=EN.
 ³⁴ Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive

³⁴ Directive 2011/83/EU of the European Parliament and of the Council of 25 October 2011 on consumer rights, amending Council Directive 93/13/EEC and Directive 1999/44/EC of the European Parliament and of the Council and repealing Council Directive 85/577/EEC and Directive 97/7/EC of the European Parliament and of the Council.

³⁵ Remedies Notice, at paragraph 34.

Remedies Notice, at paragraphs 35-36.

See Tesco v Competition Commission [2009] CAT 6, at paragraph 139, where the CAT put the matter in the following terms: "the more important a particular factor seems likely to be in the overall proportionality assessment, or the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to prove, the more detailed or deeper the investigation of the factor in question may need to be." See also Barclays Bank v Competition Commission [2009] CAT 27, at paragraph 21, where the CAT stated that the 'double proportionality approach' is "simply a convenient label for the common sense proposition that, within a wide margin of appreciation, the depth and sophistication of analysis called for in relation to <u>any particular relevant aspect of the inquiry</u> needs to be tailored to the importance or gravity of the issue within the general context of the Commission's task" (emphasis added). The 'double proportionality approach' is also mentioned in CC3, at paragraph 349.

giving rise to the AEC, which Remedy 11 is intended to address, is itself highly questionable: the evidence supporting an alleged weak customer response and lack of engagement is not robust, and the CMA's efficiency benchmarking and profitability analysis contain methodological flaws.³⁸ The case for such radical intervention is therefore not made out and the CMA cannot legitimately seek to impose Remedy 11 on the basis of the reasoning and evidence as currently set out in the Provisional Findings.

(a) Should the safeguard tariffs be set on a cost-plus basis, or should they be related to other retail prices?

- 11.26 As noted above, we have serious concerns about the imposition of any form of SRT. Without prejudice to those concerns, if the CMA concludes that it is appropriate to adopt an SRT, one option is to set the cap on a cost-plus basis, where the 'plus' includes a reasonable profit margin plus sufficient 'headroom' to avoid damaging competition. In the case of New South Wales, the profit margin was set at 5.7% of earnings before interest, tax, depreciation and amortisation (**EBITDA**) and additional headroom (referred to as 'incentives') was provided for by making generous cost allowances in areas such as customer acquisition and retention costs.
- 11.27 The alternative suggested by the CMA, where SRTs are set by reference to other retail prices, could take the form of a 'price dispersion limit', which caps the difference in price between (say) a supplier's cheapest and most expensive tariff. This would avoid the risk that a 'tariff deficit' could arise, whereby increases in the regulated price do not keep pace with increases in costs, and companies can no longer recover their costs from revenues. However, care would need to be taken in formulating the remedy so that it did not unnecessarily restrict competition. As changing SVT prices is inevitably a slow process, there is a risk that a dispersion limit could leave companies unable to respond to short term market movements in NST prices, thereby reducing the competitive pressure to lead or match NST price reductions. This could be partly mitigated by applying the limit as an average over time rather than day by day. Another disadvantage of this approach is that some suppliers might simply withdraw or increase their discounted prices without changing their SVT pricing, as happened under SLC 25A. This would not be a good result either for consumers or competition.
- 11.28 An alternative approach might be to set the SRT cap at a suitable margin over some weighted average measure of market-wide non-standard tariff (**NST**) prices. This would have the advantage that in most circumstances a tariff deficit would be unlikely to arise and it would have a lesser effect in dampening NST competition than a dispersion limit. It would also be relatively simple to operate. However it could lead to unexpected and unsatisfactory results in volatile wholesale markets, with NST products generally hedged on a different timescale to SVT, and the setting of the margin would be very difficult.

(b) If the safeguard tariffs were set on a cost-plus basis, which approach(es) we should consider to determining the wholesale energy cost element of the tariffs? What are the relative merits of the proposed approach(es) in the context of the purpose of the safeguard price cap?

- 11.29 This question highlights the very significant challenges involved in implementing a price control that achieves the desired objective without distorting incentives and creating opportunities for gaming. Price controls are generally highly complex processes involving huge volumes of documentation and administrative effort the cost of which is ultimately borne by the consumer.
- 11.30 We can see two main options in principle for determining the wholesale energy cost element of the tariffs:

³⁸

As set out in more detail in ScottishPower's Response to the CMA's Provisional Findings...
- (a) Ofgem or the CMA estimates the energy wholesale costs that a typical supplier will incur over the coming year based on an assumed hedging profile and this forms part of the cost stack on which the price cap is based.
- (b) Wholesale energy costs are regulated on a cost pass-through basis. In other words, the CMA sets a cap on the price that can be charged for non-pass-through elements, and suppliers then ensure that their overall tariff does not exceed the sum of the regulated element and pass-through costs.
- 11.31 Option (a) has the disadvantage that the CMA would be required to gather and analyse significantly more information than option (b), and would be required to make judgements about the optimum hedging profile. Suppliers have an incentive to minimise risk and would therefore be likely to adopt the same hedging profile that the CMA has assumed, even if they consider it to be suboptimal. This approach could therefore blunt the incentives of suppliers to minimise hedging costs and lead to higher costs than those in place without regulation. There are clearly complications around existing contractual positions that would need to be addressed, suggesting that the benchmark could not be applied for some years.
- 11.32 In option (b) the task of setting the tariff is easier, and there are precedents for suppliers making an estimate of the cost to be passed through which is subsequently compared with the out-turn audited cost and the difference, adjusted for time value of money, applied to the future price cap. But this may not work well for a transitional arrangement that is envisaged in this case, and the CMA would need to set the rules for allocating wholesale energy costs between different tariffs (which may be relatively complex) and specify the scope and methodology for the audit. A key issue would be ensuring that the costs to be passed through reflect market conditions based on the information available to the supplier at the point in time that they were incurred without creating a risk for investors that costs incurred in good faith may not be accepted for pass-through. This places further importance on the detailed regulatory design around tariff setting. One possible approach would be for Ofgem to approve an economic purchasing plan put forward by the supplier and for pass-through to be guaranteed for wholesale costs incurred in accordance with that plan or incurred under existing arm's length contracts.
- 11.33 We consider that the cost pass-through approach is likely to be preferable, since it is potentially less burdensome administratively, will result in lower monitoring costs and preserves the incentive of suppliers to find the optimum hedging strategy (though the competitive pressure to do so would be reduced). A cost pass-through approach could also be adopted for network costs and social and environmental obligation costs.
 - (c) Could the imposition of a transitional safeguard price cap result in energy suppliers reducing the quality of service offered to customers on this tariff? Is this risk reduced by customers' ability to choose alternative, unregulated tariffs?
- 11.34 It is highly unlikely under any circumstances that a supplier would intentionally fail to give adequate and efficient customer service. While some less critical elements of service could be cut back to save money, the core elements will need to be provided in any event. However, in the longer term, the opportunity for companies to build their business by innovating and delivering exceptional service will be compromised by the weakening of customer engagement and switching caused by the SRT (a concern similar to that noted by the CMA in rejecting a price control in the *Private Healthcare* market investigation).³⁹
 - (d) Should all domestic and microbusiness customers on default tariffs be rolled onto the safeguard tariff, or should this remedy only apply to a subset of these customers? If this

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Private Healthcare, Final Report, at paragraph 12.67.

remedy should not apply to all customers, why? And how should energy suppliers identify those customers who should be covered?

- 11.35 As noted above, an SRT remedy would be an extremely interventionist measure which we believe would damage investor confidence in the UK, weaken the incentive for consumers to engage in the market, and harm competition to the detriment of consumers as a whole. Without prejudice to those concerns, we note that the stated purpose of the SRT remedy is to provide direct protection to *disengaged* customers, or vulnerable disengaged customers. In view of the highly intrusive nature of retail price control remedies, it is important that they are imposed only where it is necessary to do so. If the purpose is to protect disengaged customers, it would not be necessary to apply the SRT to customers who have shown evidence of recent engagement with the market, since there is no evidence that such customers require protection. We would therefore suggest two categories of customer on SVTs should be excluded from the scope of the SRT protection:
 - (a) Intermittently engaged customers: These are customers who default back to the SVT when their fixed term tariff matures and then become re-engaged within a reasonable period (we would suggest 3 years) and switch to a new fixed term tariff. We estimate that around [CONFIDENTIAL] (excluding pre-payment) of our SVT customers fall into this category (see ScottishPower Updated Issues Statement response, paragraph 5.24). We do not believe it would be proportionate to apply a price control to these customers - and indeed it could be counterproductive to do so, if it converts them from intermittently engaged to disengaged.
 - (b) *Direct debit customers*: Customers who pay by direct debit will need to have engaged with their supplier to set up direct debit arrangements and are likely to be capable of engaging again to switch to a non-standard tariff. They are also likely to be in a more stable financial position than customers who pay by standard credit or prepayment meter and hence less in need of protection. (If a customer's direct debit payments are repeatedly blocked by their bank they will typically be moved to credit or prepayment.) We do not believe it would be proportionate to apply a price control to direct debit customers.
- 11.36 Again, without prejudice to our concerns as to the harm that would be caused by the imposition of an SRT, the impact on competition could be limited further by focussing the SRT on customers that are both disengaged and vulnerable. This would be consistent with the key factors relied upon by the CMA to justify the SRT remedy for domestic customers: (i) that energy bills are a significant proportion of household expenditure (especially for those on low incomes); and (ii) the claim that vulnerable customers are among the most disengaged and inactive.⁴⁰ This could be assessed using an approach similar to that of the Warm Home Discount core group: after disengagement has been properly defined, suppliers would share annually a list of disengaged customers with Government, which would return the file, marking those disengaged consumers that are also economically disadvantaged. Those customers would then have their price reduced to the SRT level by suppliers.
- 11.37 The CMA proposes that the safeguard regulated tariff would be the *default tariff* for customers who do not actively choose a new tariff at the end of their existing contract, and that no other evergreen tariffs would be allowed⁴¹, i.e. the SVT would have to become the same as the regulated default tariff. This definition is problematic, in that it links the SRT to intermittently engaged customers, who are one of the categories we do not consider it would be proportionate to include. A more effective and proportionate remedy than applying the SRT to such customers would be to relax the rule introduced by Ofgem that suppliers must move customers who do not express an alternative preference to SVT at the end of a fixed offer, and instead allow suppliers to move customers to any successor tariff that does not have an exit fee.
- 11.38 Accordingly, we believe that a different approach would be required, whereby:

⁴⁰ Remedies Notice, at paragraph 38.

⁴¹ Remedies Notice, at paragraph 92.

- (a) all SVT customers (or all vulnerable customers only, per our further proposal above) who are deemed to be disengaged (e.g. those who have been on an SVT for at least 3 years and do not pay by direct debit) are moved to a new evergreen SRT;
- (b) the SVT is allowed to remain as an unregulated evergreen tariff, but the only customers on the SVT would now be those who pay by direct debit or those who are intermittently engaged i.e. those who do not actively choose a new tariff at the end of their fixed term contract but do so within 3 years (or, per our further proposal above, those customers who either are not vulnerable, pay by direct debit or are intermittently engaged.
- 11.39 An advantage of this approach is that it avoids blunting the incentives of those who have shown an ability or propensity to engage in the market, and hence reduces the adverse impacts on competition. At the same time it provides protection to those it is intended to protect.
- 11.40 However, we note the concerns set out above around the effect of price regulation in reducing incentives for consumer engagement and the potential for a temporary 'price to beat' tariff to become permanent and priced below cost, albeit for a smaller group of customers who are currently less engaged.
- 11.41 Finally, as we note in our response to the Provisional Findings, we do not accept that customer disengagement is a feature of the market giving rise to an AEC in relation to supply to microbusinesses. Rather, we believe that low switching rates among microbusinesses are due to a lack of price transparency, complexity in the switching and notice processes and an underperforming TPI sector. To the extent that this is considered to merit intervention by the CMA, we consider that Remedies 7 and 8 adequately address the concerns identified. We also note that the key factors relied upon by the CMA to justify the SRT remedy for domestic customers (namely: (i) that energy bills are a significant proportion of household expenditure (especially for those on low incomes); and (ii) the claim that vulnerable customers are among the most disengaged and inactive⁴²), simply do not apply in the case of microbusinesses.
- 11.42 For these reasons, we consider it would be wholly disproportionate to include microbusinesses within the scope of any SRT remedy.

(e) How should the headroom be calculated to provide the right level of customer protection while not unnecessarily reducing healthy competition?

- 11.43 The difficulty of finding the optimum point and the risks of getting it wrong are one of the key reasons why we believe the CMA should not adopt such a remedy. As the CMA notes, there is a delicate trade-off between customer protection and preservation of competition. Finding the optimum balance between them is a formidable challenge, which in part involves weighing up the short term interests of the protected customers against the longer term interests of the wider group of customers who stand to benefit from healthier competition.
- 11.44 Although the task can be approached in a number of different ways, we think the example of New South Wales cited by the CMA is informative. In the 2010-2013 price control period, the headroom was set significantly higher than in the previous period, resulting in wider differentials between regulated and 'market' tariffs, and substantially greater switching. Whereas in the 2007-2010 price control period, the proportion of customers on the regulated tariff remained around 65%, in the 2010-2013 period it fell from 60% to 40%, leading to complete withdrawal of the price control in 2014.
- 11.45 The experience of NSW suggests that the detriment from setting the price too low is likely to outweigh the detriment from setting it too high, and it would be prudent to err on the side of a more

⁴² Remedies Notice, at paragraph 38.

generous cap. In the 2010-2013 NSW price control period, where customer engagement really took off, the cap was based on a reasonably generous profit margin (5.7% EBITDA) plus additional headroom (or 'incentives') which appear to have been equivalent to around 10% of costs.

(f) What regulatory information would be required to set the safeguard tariffs?

11.46 The body setting the SRT would need access to detailed information on each supplier's costs over a period of time for each relevant cost category, in order to allow it to predict future costs. In the case of costs that are subject to pass-through arrangements, there would potentially be a need for information on costs actually incurred and average prices charged over the relevant period.

(g) How long should the safeguard price caps be kept in place? Is it appropriate to include a specific sunset provision, or should there be a commitment to review the need for and level of the safeguard price caps after a certain period of time?

- 11.47 We welcome the fact that the remedy is seen as transitional and believe this must be hard-wired into the implementation. We think there should be a sunset clause such that the price control lapses at a particular date (or when a well-defined milestone has been met). In the unlikely event that an extension is required, it would be for Ofgem to propose a licence modification to effect it.
- 11.48 We believe an appropriate date would be the end of 2018. By that time smart rollout will be well underway, and competitive conditions can be expected to have improved sufficiently, such that no further control is required (although as noted above, the presence of an SRT is likely to impede progress in that respect). Given the amount of time that the implementation of an SRT would be expected to take and the proximity of the possible implementation date to completion of the smart meter roll-out, we strongly believe that the interests of consumers would be best served by remedies targeted at increasing consumer engagement with the market in preparation for the smart meter roll-out.

(h) How frequently – if at all – would the level of the cap need to be reassessed? If the cap is set on the basis of directly passing through wholesale and network costs, then it may not be necessary to revisit the safeguard price level.

11.49 As noted above (paragraph 11.33), we believe that wholesale energy, network and social and environmental obligation costs should all be subject to the cost pass-through approach. If so, it may be sufficient to review the operational costs on a two to three year basis – although we would hope that the price control would not need to be extended beyond the first two years of operation.

(i) Which energy suppliers should be subject to the safeguard cap, and why? Should it be restricted to the Six Large Energy Firms, or should all retail energy suppliers be covered?

- 11.50 All suppliers should be subject to the safeguard cap. Given that the highest SVT prices are frequently charged by new entrant suppliers, consumers may find it confusing if the scope of the SRT is limited to the six large energy firms.
 - (j) How should the transition from the current arrangements be managed? We note that an immediate requirement to change the prices for all customers on standard variable tariffs, rollover, evergreen, deemed and out-of-contract tariffs might put pressures on certain suppliers more than others. Should there be, therefore, a period over which the safeguard price cap is phased in? If so, how long should this period be and how should the transition work?
- 11.51 The safeguard price cap may need to be phased in over a period of time sufficient to allow suppliers time to rebalance, where necessary, their standard and non-standard tariffs. Non-standard tariffs are mainly fixed price fixed term deals, so suppliers would need to wait until existing non-standard

tariffs had reached maturity before they could adjust them. Some phasing would naturally occur if the CMA accepted our suggestion that the SRT would only apply to people who had been on SVT for three years or more.

- 11.52 It would also be necessary to allow sufficient time for the necessary detailed business processes to be defined and the IT implementation completed.
 - (k) Would energy suppliers have the ability to circumvent the remedy, for example, by encouraging disengaged customers to switch on to less favourable, unregulated tariffs, and how such risks could be mitigated?
- 11.53 We would expect that the majority of non-standard tariffs would be cheaper than the regulated tariff and would therefore not be directly affected by the cap. However, there may be exceptions – for example, at a time of rising prices, suppliers may wish to offer longer term fixed price tariffs which are initially more expensive than the default tariff – and it would be undesirable for the price cap to prevent such exceptions.

(l) Should the CMA set the level of the safeguard price caps itself, or should make a recommendation to Ofgem to do so?

- 11.54 Ofgem has a good record of undertaking price controls independently in the networks area and is in principle well placed to deal with the ongoing operation of any SRT including any calculations, uprating etc. In that field, they have been reasonably robust in basing controls on tough efficiency targets together with recognition of the need to earn a return. We have a good degree of confidence that Ofgem would be able to set the level of the SRT without political interference.
- 11.55 However, the task here is more complicated in that the proposal is to introduce a 'price to beat' in a previously unregulated market with the aim of assisting rather than hindering the development of competition. (Indeed, it may be impossible to attain the right balance.) Therefore, it would make sense for the CMA to set the initial parameters for the control, including the necessary headroom, before handing the detail of actually setting the level of the SRT over to Ofgem. This could reduce the temptation for political intervention in the headroom level, for example.
- 11.56 Nevertheless, it must be recognised that setting and running this control would be likely to be extremely difficult given the conflicting aims of protecting disengaged customers and not restricting competition.
 - (m) Are there any potential unintended consequences of setting safeguard price caps, for example, in terms of their potential impact on the level of other, unregulated tariffs?
- 11.57 As discussed above (paragraphs 11.8 to 11.20), there are a number of potential unintended consequences of setting safeguard price caps, including:
 - (a) reduced price dispersion in the market, blunting incentives to search and switch and, in turn, weakening the competitive pressure on firms to offer low prices;
 - (b) customers on the regulated tariff believing that because the tariff has been capped by the Government, it must be a good deal, and therefore opting not to search or switch;
 - (c) the risk (as has happened in a number of other countries) that price to beat tariffs fail to keep up with costs, leading ultimately to 'tariff deficit' problems;

- (d) companies being deterred from entering the market because of the presence of price regulation (a factor noted by the CMA in rejecting a price control in the *Private Healthcare* market investigation)⁴³ and the perceived risk of tariff deficits; and
- (e) the occasioning of excessive costs as a consequence of the complexity imposed by the process of establishing and managing the SRT.

12. REMEDY 12 – NEXUS AND AQ UPDATES

Remedy 12A "A requirement to implement Project Nexus in a timely manner"

- 12.1 Project Nexus is intended to replace the legacy gas settlement system, UK Link, and reform the associated industry processes to deliver Rolling AQ and site specific reconciliation for all supply points, whilst incorporating independent gas transporters ('iGTs') into the central system. As such, Project Nexus is a key step in enabling the benefits of smart meters to be realised in the retail gas market, and in removing the problems and potential competitive distortions resulting from the current gas settlement inaccuracies. It is therefore vital that it is delivered in a timely manner.
- 12.2 The expected implementation date for Nexus is now 1 October 2016. It is of great importance that this new timetable is met. The principal responsibility for the timely delivery of Nexus lies with the gas transporters, acting through Xoserve, an agent that they own and control. Xoserve must facilitate the development of the necessary Uniform Network Code (UNC) modifications for Nexus and implement the required new central system to time and specification. The main role that gas shippers play in Project Nexus is building their internal systems to interface with the central system.
- 12.3 It is important that there are sufficient disciplines imposed on gas transporters, and their agent Xoserve, to ensure that this new timetable is met. As the transporters are not main parties to this investigation, it may be more appropriate for the CMA to proceed by way of a recommendation to Ofgem. Such recommendation should be to implement licence changes or support UNC modifications that would have the effect of imposing liabilities on transporters if Nexus is late. We consider that this would be a proportionate and effective measure, given the issues that continue to arise under the existing system.

(a) How long should the parties be given to implement Project Nexus?

- 12.4 Following considerable delays, Ofgem wrote to the gas transporters⁴⁴ reminding them of their obligations and urging them to ensure Project Nexus was expedited and delivered for 1 October 2015. However, that date is now not achievable. It has been recommended by the Ofgem Project Nexus Steering Group that Project Nexus should be implemented on 1 October 2016. This date was proposed by PwC, Ofgem's Project Nexus Assurance Manager, based on information provided by Xoserve on how quickly they can deliver the full central solution. An urgent modification to change the 1 October 2015 date in the UNC has been raised by National Grid Distribution through MOD0548.
- 12.5 ScottishPower considers that gas transporters and Xoserve should be required to deliver the whole Nexus solution (including the "retrospective" and "unique" aspects of the functionality) by the revised date of 1 October 2016.⁴⁵ At the present time, although Xoserve have advised that they will deliver the whole solution for 1 October 2016, they are proposing stage gates on retrospective and unique, as they independently decided to stop working on these parts of the solution in March 2015 and need to fully assess their ability to deliver.

⁴³ *Private Healthcare* Market Investigation, Final Report, at paragraph 12.67.

⁴⁴ https://www.ofgem.gov.uk/sites/default/files/docs/2012/07/open-letter-to-gas-distribution-networks-on-project-nexus-gas-settlementreforms.pdf.

⁴⁵ Shippers have been asked by Ofgem to continue, so far as possible, to build their internal systems by 1 October 2015. We believe that 1 October 2016 should be the latest date for full delivery. There is concern that Xoserve will try to decouple retrospective and unique.

- (b) Should the CMA implement this remedy directly (eg via an order and/or a licence modification) or should it make a recommendation to Ofgem to implement the remedy?
- 12.6 As the transporters are not main parties to this investigation, it may be more appropriate for the CMA to proceed by way of a recommendation to Ofgem. However it is important that there are binding obligations on Xoserve, through the transporters, to hit the 1 October 2016 date and any recommendation to Ofgem should propose taking action to that effect.

Remedy 12B "Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory"

- (a) Is it proportionate to require the mandatory monthly updating of AQs? Would it be more proportionate to require less frequent updating of AQs? Would less frequent updating still be effective in terms of removing the scope for gaming of the system?
- 12.7 ScottishPower fully supports the timely update of AQs and has raised a number of proposals to improve the AQ Review process since its inception. However, the suggested remedy may not work in precisely the terms set out. We suggest below how it could be adapted to be more proportionate and effective.
- 12.8 The current legacy UK-Link system allows users to select sites to propose a change to the AQ through the amendment and appeal phases, whilst Xoserve takes business as usual readings to update AQs once per annum. Under the current system there is a constraint on the number of meter readings that UK-Link can accept, which will not be the case post-Nexus. This was one of the drivers for the introduction of Nexus, in allowing the gas market to use readings from smart meters. Accordingly it is not practicable to require AQ updates more frequently than annually prior to Nexus, as the current system is incapable of accepting the necessary volume of readings. In view of the proposed implementation date of Nexus, the CMA may conclude that no remedy relating to UK-Link would be effective.
- 12.9 Under Nexus, more frequent meter readings are permitted and once readings are available more than 9 months and a day apart, they will be used to fine tune the AQ. All readings submitted to Xoserve, which pass validation, will enact a site-specific reconciliation for the meter point. Therefore post-Nexus the impact of AQs on settlement outcomes is reduced. However, unlike in electricity, there is currently no requirement for meter readings received by a supplier to be uploaded to Nexus.
- 12.10 Finally, only where a smart meter is fitted will it be feasible to take monthly readings. Accordingly, we think that imposing the following obligations on shippers would be feasible:
 - (a) For shippers to upload promptly any meter reading taken (including customer reads) in relation to a non-daily metered site; prior to the replacement of UK-Link by Nexus, this would be subject to an exception for readings that would not be processed because of UK-Link restrictions.
 - (b) For shippers to upload monthly meter readings to Nexus for non-daily metered sites where a smart meter is installed and working.
- 12.11 Because Nexus will reconcile each site to actual usage for settlement purposes, any inaccuracy in AQs will have a less significant impact than it did under UK-Link. Nevertheless it should be possible to ensure that up to date information is submitted to the central systems and we suggest that the CMA considers recommending to Ofgem that Ofgem address this.
- 12.12 Absent the reforms mentioned above, there is still the opportunity to choose which readings are submitted to Xoserve to the advantage of the shipper, or timing out reconciliation by not providing a reading before the settlement window closes out. Under the electricity model there are a number of

controls around settlement that do not feature in the new Nexus arrangements – the requirement to submit all readings to settlement and a Performance Assurance regime to assure settlement accuracy.

- 12.13 In 2012 ScottishPower proposed that a Performance Assurance regime post-Nexus was necessary to ensure that the benefits expected from Nexus were delivered and proposed that a Performance Assurance Workgroup was set up. This was agreed by the UNC MOD Panel and the group has been working on the scope and framework of the regime since that time. There are currently two modifications for the framework in development MOD506 and 506A from ScottishPower and SSE respectively.
- 12.14 We are however concerned that progress on the development of these modifications and the regime overall has been slow and whilst Ofgem has often called for a regime to be developed, additional support in the form of a CMA recommendation could give greater impetus in this area. We believe that a robust performance assurance regime, coupled with a requirement to submit all readings into settlement, is necessary to improve the accuracy of settlement and deliver the benefits for Nexus. In addition we believe that it is important that the current 3-4 year settlement period needs to be looked at to reduce the cashflow risk to shippers and that the Performance Assurance regime ensures that a reading is provided into settlement before the window closes.

13. REMEDY 13 –ELECTRICITY SETTLEMENT USING HALF HOURLY DATA

"Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters"

- 13.1 Use of half-hourly consumption data in the settlement of domestic electricity meters (profile classes 1 to 4) will be essential to realising the wider benefits of smart meters in terms of time-of-use (**ToU**) tariffs and demand side response (**DSR**). It is therefore sensible for the CMA to consider whether any additional regulatory intervention is required to ensure that the industry delivers this objective in a well-planned and cost-effective manner.
- 13.2 The reference to cost-effectiveness is important. The system changes required to support half hourly settlement (both at a central level and for individual suppliers) are complex and will require significant capital investment. To reconcile each of (say) 26 million electricity meters every half hour would require some 450 billion reconciliations to be performed each year. If the systems are delivered too late, there will be a societal cost in terms of foregone benefits from ToU tariffs, DSR etc. If systems are delivered too early, there is a risk that accelerated timescales can lead to higher implementation costs, higher levels of problems and consumer disruption and the opportunity cost of investing earlier than is required.
- 13.3 In defining a plan for introduction of half hourly settlement, two key dates will be:
 - (a) the earliest date at which the systems for half-hourly settlement are available and suppliers can elect to settle individual customers based on half hourly consumption; and
 - (b) the date by which suppliers are obliged to settle customer based on half hourly consumption⁴⁶ i.e. the date at which the whole market effectively moves to half hourly settlement.
- 13.4 Based on our experience of US markets, we believe that an appropriate target date for availability of half hourly settlement would be the completion of smart meter rollout, with the whole market moving to half hourly settlement around 1 year after the completion of smart meter rollout.⁴⁷

⁴⁶ With the exception of the rump who are still on dumb meters.

⁴⁷ In the ISO-NE market in New England in the US, smart meter deployment was completed in June 2012 and the market moved to using hourly data for settlement in May 2013, a year or so after the completion of smart meter rollout.

NON-CONFIDENTIAL VERSION

- 13.5 As noted in our response to the UIS⁴⁸, a potential barrier to the early widespread adoption of halfhourly settlement is the Data Access and Privacy Framework (**DAPF**) for smart metering. The DAPF was developed by DECC with the aim of addressing consumer concerns about privacy whilst allowing proportionate access to data by authorised parties so that benefits could be delivered. The regime currently prohibits licensees from collecting metering data with greater granularity than daily unless the customer has opted in or unless there is a regulatory obligation to collect it. This may make it difficult for the industry to implement a phased move to half-hourly settlement, which would be a sensible implementation approach for a project as large and complex as this. These issues have been recognised by DECC, which has committed to reviewing the DAPF at an appropriate point, probably around December 2018. This will therefore be a key dependency in any plan to move the whole market to half hourly settlement.
- 13.6 Ofgem already has a programme underway with the industry to consider the transition to half hourly settlement, which is likely to deliver a proposed way forward. We would suggest that a binding and cost effective plan of the type described is brought forward in consultation with the industry. As the parties that would have a key role in such a plan (such as the DCC) are not main parties to the investigation it may be more appropriate for the CMA to make a recommendation to Ofgem to take action to this effect.

(a) Would this remedy be effective in stimulating tariff innovation, in particular in terms of time-of-use tariffs?

13.7 Yes, the existence of a binding plan is likely to give suppliers and other market participants the confidence to invest in developing new tariffs and service offerings to exploit half hourly settlement. However, it is unclear how material a difference it will make: given the need to compete for early adopters, it may well be that suppliers will be willing to invest, regardless of whether there is a binding plan. If the CMA wishes to proceed with this remedy it would be helpful to gather evidence in this area.

(b) How long should the parties be given to agree this plan?

13.8 We believe it would be expedient to use the period up to April 2017 to develop the plans, with a three year implementation phase. This would coincide with the period in which the majority of smart meters are likely to be installed. This timescale would also allow the development of such plans to factor in Ofgem's DSR flexibility strategy expected in late 2016 and the implementation of half hourly settlement for profile class 5 to 8 consumers, which is due to be completed by April 2017. April 2017 is also when the DCC systems are likely to be stable and capable of processing in bulk.

(c) What are the principal barriers to the introduction of a cost-effective option to use halfhourly consumption data in electricity settlement for profile classes 1 to 4? How could these be reduced?

- 13.9 There are a number of prerequisites to half-hourly settlement, agreed during Ofgem's Smarter Markets Programme half hourly Settlement Workgroup, whose findings are to be addressed through Ofgem's DSR flexibility work. These include;
 - (a) arrangements for the transition to half-hourly settlement;
 - (b) collection and preparation of data for settlement;
 - (c) settlement timescales; and

48

Addendum to ScottishPower's Response to the Updated Issues Statement, paragraphs 2.18 to 2.19.

- (d) estimation of half-hourly data when it is unavailable.
- (d) Should the use of half-hourly consumption data in settlement for these profile classes (or certain of them) be optional for energy suppliers, or should it be mandatory? What are the advantages/ disadvantages of each approach?
- 13.10 We think that it would be unwise to move to mandatory half hourly settlement for all customers straight away, given the scale of the proposed change. A more prudent approach would involve early tests with opt-in customers, perhaps trialling time of use tariffs; then amendment of the DAPF (see paragraph 13.5 above) to allow suppliers to access data for non-mandatory settlement purposes; then progressive roll-out with ever larger groups of customers. This may suggest that earlier amendment of the DAPF could be considered if that would otherwise be on the critical path. Whether it is appropriate to make half hourly settlement mandatory for all customers is a matter that would be best considered as the detailed plan is developed and there is better sight of the technical issues, rather than now.
 - (e) Are there any distributional considerations that we should take into account in relation to time-of-use tariffs? For example, might vulnerable customers end up paying more if they fail to change their consumption patterns? Or will the decline in the required generation capacity outweigh any increase in peak prices?
- 13.11 We would expect the overall impact of consumers responding to ToU tariffs to be a shifting of demand away from peak price settlement periods so that average prices are cheaper for all consumers. However more detailed impact assessments are required to determine whether this effect would offset the negative distributional effects on consumers who are unable or unwilling to change their consumption in response to ToU tariffs (or fail to understand how to interact with a ToU tariff) and the extent to which vulnerable consumers might fall into this group. The uncertainties over distributional impacts, and the need to give consumers time to become familiar with ToU charging, point to a reasonably long period between the first introduction of half hourly settlement (on a voluntary basis for early adopters) and any possible move to mandatory half hourly settlement for the whole market.
 - (f) When should the (optional/mandatory) use of half-hourly consumption data replace settlement based on assumed customer profiles? Is it necessary to wait until 2020 when all domestic customers have smart meters installed? Alternatively, could the use of halfhourly consumption data be phased in for those customers with smart meters prior to 2020?
- 13.12 If, as outlined above, the industry can develop its plans and approach up to April 2017, this would lead to a three year period in which suppliers would implement half-hourly settlement. A significant amount of this time will be spent implementing the systems to support half-hourly settlement, and time will also be required to analyse a reasonable trend of half-hourly data for the different profiles of domestic customers e.g. to deal with situations where the supply of half-hourly data is not available (e.g. remaining traditional meters, loss of communications on smart meters). Furthermore there will be a number of external dependencies such as uncertainty about what proportion of customers actually take smart meters by 2020 (experience from other programmes suggests that there will be a significant core of non-adopters) as well as other major changes in 2018-19 such as next day switching.
- 13.13 Taking these factors into consideration we would expect that suppliers could start to roll-out half hourly settlement in 2018 and 2019, subject to the necessary DAPF changes, and that large numbers of customers could be on half hourly settlement by 2020. It seems unlikely that the process will be complete by then, not least because we can expect a significant residue of people who have chosen not to adopt smart meters or are otherwise not focussed on making or keeping an appointment for them to be fitted.

14. REMEDY 14 – REGULATORY FINANCIAL REPORTING

"Remedy to improve the current regulatory framework for financial reporting"

- 14.1 We continue to support transparent and robust financial reporting of the industry. We have reported across the value chain of generation, trading and supply and can see benefits in terms of increased transparency if this is applied across the industry.
- 14.2 We also support reporting on clear divisional basis, building on the statutory accounts of the various entities, and pricing inter-affiliate transactions based on market prices applicable at the time each transaction was done. This is consistent with the Trade Book Structure which ScottishPower implemented in 2011. We also support the need for the financial information to be relevant and reliable as well as having a clear and accessible basis of preparation.

(a) Should the scope of the individual areas reported on align with the scope of the markets as set out for generation and retail supply in our provisional findings? For example, should a requirement to report wholesale energy costs on the basis of standard products traded on the open wholesale markets be imposed?

- 14.3 The CMA states that, based on its analysis to date, its provisional view is to consider the following relevant markets:⁴⁹
 - (a) the wholesale electricity market in Great Britain (including trading);
 - (b) the wholesale gas market in Great Britain (including trading);
 - (c) the retail supply of electricity to domestic customers in Great Britain;
 - (d) the retail supply of gas to domestic customers in Great Britain;
 - (e) the retail supply of electricity to SMEs in Great Britain, comprising, at least, a microbusinesses segment; and
 - (f) the retail supply of gas to SMEs in Great Britain, comprising, at least, a microbusinesses segment.
- 14.4 We agree that the individual areas reported on within the consolidated segmental statement (**CSS**) should broadly align with the above markets, but we do not believe they should be identical. For example, the above list excludes retail supply to larger industrial and commercial (**I&C**) customers because the I&C segment is outside the scope of the market investigation reference. For the purpose of the CSS, we believe it remains appropriate to split retail supply between domestic and non-domestic (i.e. including both SME and I&C).
- 14.5 ScottishPower was the first voluntarily to include a column in the CSS for trading as we believe that this aids transparency. This should be encouraged as it is consistent with the CMA's recommendation for a "*clear and consistent demarcation of activities between generation, trading and retail*".⁵⁰
- 14.6 We note the CMA's suggestion that Ofgem should develop a 'market-oriented' regulatory accounting framework. ScottishPower already prepares its CSS using a 'market based' approach which means that wherever possible, internal trades are priced based on the market price applicable to the tenor of the trade at the time the transaction is done. Conversely, it would not be appropriate

⁴⁹ Provisional Findings, at paragraph 3.45.

⁵⁰ Remedies Notice, at paragraph 107.

to prepare accounts based on an assumed hedging approach different to that actually employed, as this would neither reflect reality nor be readily reconcilable to the statutory accounts.

(b) What regulatory reporting principles would be particularly relevant to the preparation of regulatory financial information in this sector?

- 14.7 We consider the following principles key to ensuring that regulatory financial information is robust, transparent, accessible to stakeholders and facilitating regulatory policy, principally monitoring competition in the GB energy markets:
 - (a) the regulatory financial reporting should provide full disclosure of a company's activities in all relevant GB energy markets;
 - (b) regulatory reporting should be as closely aligned as possible to a company's statutory accounts, preferably accounts for a corporate entity that covers all GB activities; and
 - (c) all transactions included within the scope of regulatory reporting, should be based on market prices.

(c) Would summary profit and loss account and balance sheet information for each area be sufficient to enable the effective regulation of the sector and the development of appropriate policies? Or should the large domestic and SME energy suppliers be required to collect and submit additional, more granular financial information?

- 14.8 We believe that a summary profit and loss account for generation, trading and supply, if clearly reconciled to statutory accounts, and with clearly delineated lines, would provide sufficient financial information to enable effective regulation and development of appropriate policies. We would like to understand more about the suggestion of adding balance sheet information (which is not currently required by Ofgem); this is difficult to present on a segmental basis without making judgmental splits of balance sheet items, and the regulatory value is less clear.
- 14.9 Significantly more granular data than is published in the CSS was provided to the CMA during this investigation. Much of this information was sourced and developed specifically for these requests, and in many cases it was necessary to make somewhat judgmental assumptions for allocations. These assumptions were disclosed to the CMA and we were happy to provide this data on the basis that CMA was able to understand the implications of these assumptions. We would not be inclined to support publishing on our website (where we have no control over who may read or use the information) data based on such assumptions. Any proposal for publication of further, more granular, information must be considered in the light of the regulatory benefits and recognising the need for the data to be available and robust.

(d) Should Ofgem require that the summary profit and loss and balance sheet information be audited in accordance with the regulatory reporting framework?

- 14.10 The current regulatory requirement⁵¹ is for companies to include in the CSS an audited opinion as to the extent to which the company has 'properly prepared the CSS in accordance with this licence condition and the Guidelines.
- 14.11 The most important concern of an audit of regulatory financial information should be to verify the reconciliation to statutory accounts, so stakeholders can be confident that the information is robust. It should also be possible for such audits to verify compliance with regulatory requirements to the extent they are set out by Ofgem. We consider the current regulatory requirement achieves this balance.

51

SLC 19A.10 of the supply licences and SLC16B.10 of the generation licence.

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- 14.12 Careful consideration should be given to an increased scope of audit as this is likely to substantially increase the associated cost and time required to perform the audit. We would recommend that views are sought from the leading audit firms as to the appropriateness and scope of further audit activity.
 - (e) Should this remedy apply to the firms that are currently under an obligation to provide Ofgem with Consolidated Segmental Statements? Or should it apply to a larger or narrower set of firms?
- 14.13 The obligation to prepare CSS currently applies to companies which supply energy to more than 250,000 customers and also hold a generation licence.
- 14.14 Given the Provisional Findings do not attribute any AECs to vertical integration, it is not clear that the obligation needs to be targeted at vertically integrated companies. To provide greater transparency across the industry the obligation should be extended to companies supplying more than 250,000 customers regardless of whether they (or a member of their group) hold a generation licence.

(f) What would be the costs of imposing such a remedy? We note that some firms' reporting systems are not currently capable of providing information on such a 'market-orientated' basis and that our remedy could require significant additional system requirements.

14.15 From ScottishPower's perspective our financial reporting system records Profit and Loss and Balance Sheet information that is aligned to the relevant markets namely generation, supply (for P&L this is also split by Domestic and Non-Domestic) and trading. All energy transactions are priced, to the extent possible, on open market evidence for the tenor of the transaction at the time it is done. We are not currently able to report on a hypothetical basis that differs materially from this. The cost of attempting to do this or of further, more granular, reporting would need to be evaluated once the detailed requirements are understood.

(g) Should the CMA implement this remedy by way of licence modifications or by way of a recommendation to Ofgem?

- 14.16 We believe the best approach would be to make a recommendation to Ofgem so it can consider how to implement any changes that are aligned to its future regulatory policy requirements.
- 14.17 Some of the changes that may be under consideration by the CMA (in particular increased granularity or increased scope of audit requirements) could have significant impacts on the length of time required to publish accounts. Ofgem and the industry have recently made efforts to reduce the time from 6 months to 4 months after the year end as it was considered that providing the CSS on a more timely basis would enhance their usefulness to stakeholders. Ofgem will be best placed to strike the appropriate balance.

(h) To what extent should this financial information on performance be published?

14.18 We are happy to publish regulatory reports that are aligned to our present scope and content of our present CSS. We would need to consider the detail of more granular reporting requirements but it is likely that this information would be commercially sensitive and not appropriate for publication.

15. REMEDY 15 – ASSESSMENT AND COMMUNICATION OF POLICY IMPACT ON BILLS

15.1 We agree with the CMA's assessment that there have been a number of occasions where policy decisions could have been improved with more effective assessment of the trade-offs underlying policy (viewed against key objectives), as well as to ensure a coherent policy framework across the landscape. We also agree that there is scope for the Government to improve its communication

around the impact of policies on prices and bills. A key aspect of this is providing more transparency around the underlying assumptions that are being used.

15.2 By way of example, we would highlight the recent publication by the independent Office for Budget Responsibility (**OBR**) of its forward projections under the Government's environmental levies alongside the Chancellor's Summer Budget 2015. This showed that the LCF support for low carbon generation was projected to be some £2.4 billion higher in 2019/20 than had been estimated at the time of the Government's March 2015 Budget. However, there is very little transparency around the underlying assumptions that have been provided to the OBR by the Government to account for this very significant increase. Without this detail, it is very difficult for the industry to assess and test the overall position in a way that could help to inform efficient decision-making around investment.

(a) Are such assessments of the impacts of policies on prices, bills and on the trilemma tradeoffs carried out to a sufficient extent currently? Are there specific areas where such assessments are not currently carried out, or might be undertaken more comprehensively?

15.3 As stated in the paragraph above, we consider that a key failing that we have seen on occasion in terms of Policy Impact Assessments from DECC relates to a lack of clarity or transparency around the underlying modelling assumptions. By way of further example, we would highlight the Impact Assessment published in respect of DECC's original proposals for an Energy Companies Obligation (ECO) aimed at ensuring delivery of energy efficiency measures to households by obligated suppliers. In particular, there was limited transparency around the assumption made about customer contributions arising from Green Deal financing plans taken out by consumers. Without this transparency, it was difficult to test the robustness of the analysis and, in particular, the possibility of optimism bias. (It became clear at a later stage that Green Deal finance contributions were very much less than had been projected and accordingly the cost of ECO to consumers had been underestimated.)

(b) Are the assessments sufficiently scrutinised?

- 15.4 We understand that the Government's Policy Impact Assessments are generally subject to internal scrutiny by officials across Whitehall prior to assessment by the Regulatory Policy Committee (**RPC**) and, in turn, the industry and stakeholders as part of a formal consultation exercise.
- 15.5 However, we have observed variable practice over the years and from this we would highlight:
 - (a) the risk that Impact Assessments are written with a clear objective of supporting a policy that had already been identified, combined with limited openness to evidence that might question the wisdom of such policies;
 - (b) the importance of the Cabinet Office ensuring that there is a proper and robust crossgovernment process whereby other departments are involved in the scrutiny of policy at a formative stage;
 - (c) the need for an adequately resourced RPC to fulfil its role; and
 - (d) the importance of sufficient transparency of modelling assumptions to facilitate effective scrutiny by the industry and other stakeholders.
- 15.6 In the light of this we believe that the CMA should consider whether it would be possible to create a framework where Impact Assessments could be independently and objectively reviewed and the results published in the same way as the OBR critiques the Treasury's forecasts. This might lead to Impact Assessments being considered more carefully in Government and debated more thoroughly externally.

- (c) Are the assessments sufficiently disseminated to interested parties? Which parties need to be informed about these assessments?
- 15.7 The publication of assessments online on Departmental websites as part of formal consultation processes, as happens at present, should be sufficient for the purpose of dissemination.
 - (d) Is there an additional role for either Ofgem and/or DECC in carrying out assessments of the impacts of policies and trilemma trade-offs, or communicating the results of them?
- 15.8 In our view, it is already part of the role of both Ofgem and DECC to carry out assessments of the impacts of policies and trilemma trade-offs, and to communicate the results of them. As the CMA has pointed out, there is room for improvement in the way that these functions are carried out.

(e) Should further, authoritative analysis be published to assist the public discussion? What form might this take? Which existing bodies are best positioned to undertake this role?

15.9 As stated above, we consider that the most important thing is to ensure greater transparency of the assumptions underlying existing analysis. For example, greater visibility around the assumptions and calculations behind the OBR's recent forecast of environmental levies would help promote regulatory certainty and investor confidence.

(f) Is there a sufficient case to justify creating a new, independent body tasked with scrutinising the impact assessments of policymaking bodies and/or providing authoritative analysis to inform the public debate?

15.10 We think this would be an interesting option to explore. We are neutral as to whether the authoritative review of impact assessments is carried out by an existing or a new body, so long as that body is independent and has sufficient weight to enable its conclusions to be capable of improving policy. In addition, we think a way needs to be found to improve the quality and transparency of analysis, both in impact assessments but also in the cost and budget figures produced by the OBR which are now having a significant impact in driving energy policy.

16. REMEDY 16 – REVISION OF OFGEM'S STATUTORY OBJECTIVES AND DUTIES

"Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition"

- 16.1 We agree with the CMA that changes made in the Energy Act 2010 to Ofgem's statutory objectives and duties may have led Ofgem to carry out inefficient trade-offs between competing objectives, and that this might in turn have led to decisions that adversely impact competition.
- 16.2 We would support the CMA making a recommendation that Ofgem's statutory objectives and duties be revised in order to increase the emphasis on Ofgem's responsibility to promote competition as a primary objective.
 - (a) What specific changes should be made to Ofgem's statutory objectives and duties in order to ensure that it is able to promote effective competition in the energy sector?

(i) For example, would it be possible to revert to the role of competition that existed before the introduction of the Energy Act 2010?

16.3 We think that reverting to the objectives and duties as respects competition that existed prior to the particular Energy Act 2010 changes singled out by the CMA would be a good starting point. As the CMA notes, the particular changes introduced by the Energy Act 2010 highlighted in the Provisional Findings and Remedies Notice might be taken to suggest that less emphasis should be placed by

Ofgem on competition when pursuing consumers' interests. Remedying this concern would in practice mean repealing section 4AA(1C) of the Gas Act 1986 and section 3A(1C) of the Electricity Act 1989, together with making the appropriate consequential amendments.

- 16.4 We are also concerned that the 'policy outcomes' element of any future Strategy and Policy Statement (**SPS**) for Ofgem (designated under the Energy Act 2013) could create additional uncertainty around Ofgem's roles and duties. Other elements of the SPS mechanism do not seem as problematic. We would encourage the CMA to consider how the SPS may interact with any recommendation it makes in this area. Provisions for DECC to designate an SPS were enacted under the Energy Act 2013. DECC consulted on a draft SPS in autumn 2014 but the SPS was never laid before Parliament or designated.
- 16.5 In our response to DECC's consultation on the draft SPS⁵² we noted that our most significant concern related to the Policy Outcomes section at paragraph 28. Given that section 132(2) of the 2013 Act puts furthering the delivery of the policy outcomes equal to or ahead of all the existing statutory duties (other than the principal objective duty), we considered that without very careful drafting there was a real prospect of the specified policy outcomes creating new uncertainty around Ofgem's role and duties, with the risk of negative unintended consequences (because delivery of the policy outcomes mixes the specific proposals of the Secretary of State with general principles laid down by Parliament). We were also concerned that some of the policy outcomes picked out particular facets that DECC considered would contribute toward effective competition without waiting for the outcome of the CMA's market investigation.
- 16.6 We would also encourage the CMA to consider whether it may wish to recommend to DECC a more fundamental review of Ofgem's statutory objectives and the scope of its activities. At present, OFGEM has three core activities in its scope:
 - (a) regulation of the competitive energy market retail and generation;
 - (b) regulation of the monopoly parts of the market electricity transmission & distribution and gas transmission & distribution, including both price controls and decisions on code modifications; and
 - (c) administration of schemes to support Government policies delivered by Ofgem E-Serve.
- 16.7 These three activities are quite different and there may be significant inefficiencies in undertaking them all together in one organisation. The requirements and skills needed in each area differ and in particular are very different for E-Serve than for the rest of Ofgem. This can lead to a loss of management focus.
- 16.8 Furthermore, with E-Serve being part of Ofgem, there is a continuous dubiety between administration and regulation. Market participants and Ofgem find it difficult to discern between the two and this can complicate interactions between firms and E-Serve, with the risk that firms take an unduly conservative approach, increasing compliance costs that eventually get passed onto consumers. This problem would be avoided by using an independent outsourced administrator (in the private sector) for these schemes.
- 16.9 We recognise that primary legislation would be needed to allow outsourcing for those schemes which specifically name Ofgem as the administrator.

52

https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/343314/SPS_consultation_paper_.pdf .

17. REMEDY 17 – MECHANISM TO ADDRESS DECC-OFGEM POLICY DISAGREEMENTS

"Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently"

- 17.1 As the CMA notes, there have been a number of occasions where Ofgem has taken contentious regulatory decisions (e.g. implementation of SLC25A and RMR tariff rules) where the Government appears to have let it be known that it was minded to intervene itself if Ofgem did not do so. That said, the precise timing and history of any Government influence on Ofgem is unclear. In the case of SLC25A, it is possible that the Government may have influenced the findings of Ofgem's 2008 Probe, which raised concerns about price differentials in and out of area, and led to the introduction of SLC25A. However, in the case of the RMR tariff rules, it is clear that the interventions had been developed by Ofgem over a period of time and were already Ofgem's favoured policy position.
- 17.2 Government support coming relatively late in the day may have made it easier for Ofgem to sell the RMR intervention to stakeholders ('if we don't implement it, Government will') but we believe it is unlikely that Ofgem would have acted differently in the absence of such support. Accordingly, as there was no fundamental disagreement at the time between Ofgem and DECC, it seems unlikely to us that a remedy of the form proposed would have prevented this particular intervention, and it is not obvious that it would have prevented SLC25A either.

(a) In which circumstance should Ofgem have the right or duty to express views on DECC's policies and DECC/Ofgem strategy for their implementation? What format should such views take? Should DECC have a duty to formally respond?

- 17.3 Ofgem has a duty under section 34(4) of the Gas Act 1986 and section 47(3) of the Electricity Act 1989, to give information, advice and assistance to DECC where it considers it expedient or is requested by DECC. It also has a function under section 35(1) of the Gas Act 1986 and section 48(1) of the Electricity Act 1989 to publish advice and information which would promote the interests of consumers. Taken together, these provisions indicate that Ofgem already has the ability to express views publicly and privately on DECC's policies and strategies for implementation, in so far as those policies and strategies relate to matters of, for example, economic regulation.
- 17.4 We consider it would generally be appropriate for Ofgem, as an independent regulator, to express views on any DECC policy which has a bearing on Ofgem's regulatory functions. In particular, if Ofgem considers that such a policy is incompatible with its principal objective⁵³, it should express that view together with any evidence or arguments necessary to support it. In the interest of transparency, such views should normally be made public though this should not preclude informal dialogue between Ofgem and DECC while such policies are being formulated.

(b) In what circumstances should Ofgem have the right to seek a formal direction from Ofgem to implement a certain policy?

- 17.5 We can see some merit in encouraging a greater degree of transparency and formality in the dialogue between DECC and Ofgem on policy matters. However, we do not believe that DECC should be given the power to issue formal directions to Ofgem.
- 17.6 Such a power could legitimise a greater level of Government interference in the work of the independent regulator than occurs at present. As the CMA notes, DECC has a number of direct and indirect powers which it can exercise to influence Ofgem's function and operation, but short of regulating a particular area by way of statutory instruments, there are no formal powers for DECC to direct Ofgem to implement a specific change. For many years, Ministers and officials went out of

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To protect the interests of existing and future consumers where, taken as a whole, those interests include the reduction of greenhouse gases and security of supply.

their way to respect the independence of the regulator, however this approach may have been followed somewhat less strongly since 2008. The attitude of the new Government is as yet unclear.

- 17.7 Were DECC to have a power of direction, this would substantially lower the threshold for intervention, and could radically change the relationship between DECC and Ofgem. If the power were used, this could in turn undermine Ofgem's status as an independent economic regulator, which would be highly likely to increase the cost of capital for investors in the industry.
- 17.8 It is unclear whether licensees would have the same rights to appeal licence modifications that were imposed following a DECC direction, but if not, this would be remove an important safeguard which exists at present.

(c) Would DECC's formal direction undermine (or appear to undermine) Ofgem's independence?

17.9 As noted above, we believe that the proposed remedy would be likely to undermine Ofgem's independence. The CMA would need to consider whether a power for the Government to direct the regulator to take particular regulatory actions would be compatible with European requirements for regulatory independence.

(d) Would other measures be effective in promoting the independence of regulation?

17.10 The independent status of Ofgem is generally accepted by the UK Government and the principle of independent economic regulation is supported by European policy and in fact required under the EU Third Energy Package: Article 35(4) of the Electricity Directive requires Member States to guarantee the independence of the national regulatory authority and ensure that it exercises its powers impartially and transparently.⁵⁴ The extent to which Ofgem is able to act independently, and foster an internal culture of independence, will depend on the respect it commands and the calibre of its leadership and staff.

18. REMEDY 18 – INDUSTRY CODE GOVERNANCE

- 18.1 Remedy 18 is intended to respond to the provisional finding of an AEC in respect of the industry's ability to stall innovation, preventing the energy sector keeping pace with market developments and wider policy objectives. Specifically in paragraph 11.161 the findings are summarised;
 - (a) parties' conflicting interests and/or a lack of incentives to promote and deliver policy changes; and
 - (b) Ofgem's inability to influence the code modification process.
- 18.2 Our experience across the gas and electricity codes is that their rules and arrangements generally reflect an appropriate level of checks and balances to ensure that code modifications are technically sound and implementable in industry systems. They generally safeguard the interests of all industry parties and stakeholders whilst enabling the implementation of complex changes. In addition Ofgem has sufficient powers via the significant code review (SCR) process to direct modifications to be raised where Ofgem considers there are significant policy objectives that might be impeded by conflicting industry interests. Our observation is that the SCR process has led to the timely and efficient raising and implementation of the directed modifications. The primary cause of delays has been Ofgem taking time to develop the required policy guidance and respond to consultations.
- 18.3 The only example cited where there were delays to policy implementation is Project Nexus. We do consider that the governance of the Uniform Network Code (UNC) is weak with high levels of

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Directive 2009/72/EC, [2009] OJ L211/55. There are corresponding provisions in Article 39(4) of the Gas Directive (Directive 2009/73/EC, [2009] OJ L211/94).

influence for the gas transporters and the shippers to large supply points. The result of this is that the voice of domestic customers or their suppliers is not heard as loudly as it should be. Recently, Ofgem has been using its influence to ensure that the process is given an appropriate degree of focus; it would have been open to it at an earlier stage to use its SCR powers to ensure that Nexus was developed and implemented in a timely manner, as noted in the Provisional Findings.

18.4 We consider that there is scope to deliver some improvements to code governance, especially in relation to the UNC and some other codes (such as the grid code) in order to ensure that the codes are managed in a way that is sensitive to the needs of system users and consumers, and able to respond proactively to regulatory requirements. There could also be better arrangements for addressing cross-code issues. However we think that the specific remedies suggested are not appropriate in their current form and therefore we suggest some adjustments below so that they have the desired effect.

Remedy 18A "Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity"

- 18.5 This remedy appears to rest on two aspects of the Provisional Findings. The first element as noted above, was the lengthy gestation of Project Nexus. However, this was largely due to limited appetite on the part of the parties controlling the UNC panel⁵⁵ and the Code Administrator to deploy the resources needed to address the issue in a timely way and a concern that Ofgem, until recently, did not put enough impetus behind the matter. The case study on Project Nexus in the Provisional Findings noted that Ofgem could have supervised the project more closely by using its powers to lead an SCR, but Ofgem chose not to do this.
- 18.6 Secondly there is a concern that certain Code Administrators have not implemented the common code modification timescale in the Code Administrator Code of Practice (**CACoP**) and further Code Administrators could obstruct cross-code modifications all of which may present problems for the implementation of EU Network Codes. Our understanding is that Ofgem already has powers from the EU 3rd Package to implement changes required by ACER and EU Directives which would cover the EU Network Codes.
- 18.7 We believe there is much more scope to drive Code Administrators' performance through public sharing of best practice and performance statistics. CACoP Principle 13 aims to achieve this through promoting early identification of cross-code issues and coordination of change process and implementation timetables with a view to presenting related code changes to the Authority as a single package of changes.
- 18.8 We do see some potential disadvantages with this remedy (which would in any event require changes to primary legislation to implement). In particular:
 - (a) Safeguards may need to be considered to ensure that Ofgem's regulation of code administrators does not lead to the misalignment of their objectives with the panel. It could be unclear what a code administrator should do if the panel and Ofgem were at odds as to how a proposal should be developed.
 - (b) It may not be appropriate for Ofgem to direct the creation and analysis of a modification which it would then be sitting in judgement over (together with alternatives) at the approval stage. This could risk suggestions of bias in the assessment process.
 - (c) It is unclear who would pay Ofgem's fine in the event of a breach of the Code Administrator licence. The Code Administrator would need to look to code parties to pay this but the code parties might not have been responsible for the breach.

55

UNC panel members are not specifically required to act independently and impartially.

- (d) It is unclear whether Code Administrators represent a sufficient element of the value chain for licensing to be necessary.
- 18.9 Accordingly, we wonder whether this remedy might be better refocussed in terms of monitoring, strengthening and improving CACoP and ensuring that Code Administrators comply with it, together with improvements in Code Governance for the codes that need it.

(a) Is this recommendation likely to result in a positive change in the initiation, development and/or implementation of code changes that pursue consumers' interests?

18.10 This remedy could deliver some benefit if it ensured the objectives of the Code Administrator are aligned to those of the code panel, principally by ensuring the former's adherence to the CACoP. There is a risk that by separately regulating the Code Administrators, their objectives become misaligned with those of the code panel, potentially acting as a barrier to certain modifications and reducing the scope for reform and innovation. It might therefore be more proportionate and effective to improve the governance for those codes where it remains weak.

(b) Would this remedy be more effective if certain functions currently carried out by code panels and/or network owners (eg setting up working groups) were transferred to code administrators?

18.11 A key aspect of most panels is their accountability to the code parties. We do not consider there is sufficient justification to reduce this accountability in order to make this remedy a more viable proposition. Provided the terms of reference of each panel are constructed so that panel is tasked with ensuring all proposed modifications are progressed in a timely manner and the panel members are independent, there should not be a problem leaving these functions under the oversight of the panels.

(c) Would this remedy be more effective if Ofgem or DECC were to impose stricter requirements relating to the selection (eg competitive tender), financing and/or independence of code administrators (and/or delivery bodies)?

18.12 We consider that there may be merit in imposing such requirements on delivery bodies to ensure they face an appropriate commercial imperative to discharge their functions efficiently and to reasonable service targets. It is our observation that such arrangements are in place for entities such as Elexon and MRASCo but currently lacking for Xoserve which we believe may account for some of the problems with the timely delivery of Project Nexus. In addition to refocussing Xoserve's contractual framework to enable its services to be subject to competitive tender, we believe that there should be incentives placed directly on Xoserve regarding cost efficiency and charges for its non-transporter services. These reforms may be possible following the conclusion of the Xoserve Funding, Governance and Ownership programme, however based on present timescales, such changes could not be implemented for at least another 2 years.

Remedy 18B "Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes"

18.13 The rationale for this remedy appears to have its basis in the comparison of the electricity balancing and gas security SCRs in the provisional findings. In particular, Ofgem observed it was able to utilise powers under the Gas Act 1986 in relation to security of supply to quicken the code modification process for the Gas SCR relative to the electricity balancing significant code review (EBSCR), with the result that it was fairly straightforward on the gas SCR to achieve code modifications that closely reflected Ofgem's SCR conclusions. We note that electricity balancing is more complex than gas balancing, not least because of the much shorter time periods over which actions must be taken, the much larger number of electricity sources and the fact that much

electricity generation is intermittent. The greater complexity of the issues could be expected to require more thinking time in finalising the outcome of the SCR.

18.14 Our observation is that in the context of the overall timescale for both SCRs, the differences in code modification and implementation was relatively small and substantially offset by the Ofgem-led development phases of both SCRs. Furthermore, it would appear that the approved code modifications for both SCRs achieved Ofgem's conclusions. Our understanding of the Remedies Notice is that this proposed remedy is seeking to replicate Ofgem's powers on security of supply under the Gas Act 1986, for all code modifications associated with an SCR. Given the outcomes we have described, there appears little justification for this remedy to grant Ofgem greater powers with the scope for limited benefits over what Ofgem can deliver within its existing powers to direct and implement changes to the industry codes. Indeed, there are greater risks that without sufficient safeguards this remedy could lead to changes that have not taken sufficient account of industry requirements and therefore deliver the benefits anticipated, or may even undermine existing industry arrangements.

(a) Is this recommendation likely to result in a positive change in the development and/or implementation of code changes that pursue consumers' interests?

18.15 Taken together with its SCR powers this remedy could enhance benefits where Ofgem's intervention leads to quicker development of changes that benefit competition. However, we consider that this remedy would introduce a greater risk that Ofgem might exercise these powers to push through code changes which are misconceived or have unintended consequences. If investors felt that the value of their investments could be altered by imposed code modifications without proper checks and balances, this could increase the cost of capital and therefore act to consumers' disbenefit. If such a remedy were implemented, it would be essential that there was proper and adequate consultation of code parties (together with provision of an impact statement) before pressing ahead with any particular modification.

(b) Would this undermine the principle (and effectiveness) of industry-led code changes?

18.16 Yes. The effectiveness of the code modification process could be undermined, especially the review and assessments of the proposed modifications. As noted in the Provisional Findings, the Code Administrators observed that the code modification processes had identified issues and problems in the SCRs that Ofgem had not anticipated in the development phase. This essential review capability might be undermined if Ofgem set an unduly short time for the modification proposal to be raised and implemented.

(c) Should this power be limited to the completion of certain elements of the development or implementation phase (eg consultation, setting up working groups)

18.17 We think this remedy, if adopted, should be focussed on implementation to ensure reforms that improve competition are not delayed. It would be important that the remedy should not be used to prevent proper assessment of the merits of the proposal and any unintended effects.

(d) Should Ofgem's ability to use this power be limited to defined circumstances (eg modification proposals which are relevant to Ofgem's principal objectives) or should it be left to Ofgem's discretion?

18.18 If this remedy were to be taken forward the circumstances in which Ofgem would exercise these powers should be clearly set out and tightly defined to avoid undermining industry arrangements for all industry parties including potential new entrants. We are working on the assumption that the powers granted under this remedy could only be applied to an SCR. This being the case we recommend that Ofgem is required to indicate at an early stage of the SCR whether it intends to exercise these powers so that stakeholders can consider their engagement in the SCR process

accordingly. We would consider that a limitation to matters relevant to Ofgem's principal objectives is for all practical purposes no limitation at all, since any modification is likely to have some impact on the interests of consumers, even if it is simply a minor improvement in efficiency.

Remedy 18C "Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute"

- 18.19 Our understanding of the rationale behind this remedy is that the adjudicator would prioritise competing modifications for a given industry code, thus avoiding congestion of modifications and ensuring changes to achieve key policy objectives. The most obvious problem with this proposed remedy is that it would appear to be counter to Ofgem's power conferred on it from the EU Third Package to have jurisdiction in this area.
- 18.20 Placing substantive power over which modifications get addressed in the hands of an adjudicator inevitably raises questions over who would set the objectives of the adjudicator, what its governance would be and what the arrangements for appeal against its decisions would be. There would be a need for consequential changes to the appeal regime under the Energy Act 2004 and it would be necessary to address what happens if Ofgem and the adjudicator disagree.
- 18.21 Furthermore some Code Panels are already undertaking this function within the context of the existing governance. When MAMCoP was moved from Ofgem into SPAA a number of very serious disputes were very quickly raised. This would suggest the Codes are better placed to arbitrate with appropriate legal / technical support. These principles for managing "modification congestion" could be added to the CACoP.
 - (a) Are there benefits in terms of independence, impartiality and/or industry know-how of an independent code adjudicator that are not available with Ofgem, given its other responsibilities, when undertaking the adjudicator role?
- 18.22 Subject to our comments in response to Remedy 17 above relating to Ofgem's independence, we cannot identify any benefits in the above areas that an independent adjudicator would possess over Ofgem.

(b) Would there be unintended consequences, arising for instance from an increased lack of coordination between code modification governance, licence modifications and legislation?

18.23 There is certainly an increased institutional risk caused by introducing an additional body and interfaces into industry governance. It is conceivable that such a body and Ofgem could become misaligned in the interpretation of their duties with the risk of imposing conflicting objectives on the industry.

19. REMEDIES THE CMA IS NOT MINDED TO CONSIDER FURTHER

- 19.1 We agree with the CMA position that they are not minded to consider further the remedies set out in paragraphs 131 to 154 of the Notice of Possible Remedies.
- 19.2 In particular, we think remedy A which constitutes a system of price regulation, is right to be discarded, both for the reasons provided by the CMA, with which we agree, and because of the other negative effects of price regulation that we set out in response to Remedy 11.
- 19.3 We agree with the CMA's intention not to consider remedies B to E further in the course of this investigation. These remedies would not increase consumer engagement or allow for greater innovation, and are unlikely to increase the level of competition in the market.

NON-CONFIDENTIAL VERSION

19.4 We agree that remedy F appears to avoid some of the dangers of price control that we have highlighted in response to remedy 11. But, as the CMA says, it might have little impact at all and would also clearly not be proportionate in light of its considerable complexity.

ANNEX 1

EXPERIENCE OF RETAIL PRICE CONTROLS IN OTHER COUNTRIES

A.1 Introduction

- 1. This annex provides a brief description of the experience of retail price regulation in four other countries:
 - (a) New South Wales, Australia
 - (b) France
 - (c) Spain
 - (d) Portugal

A.2 New South Wales, Australia

- 2. The New South Wales energy market has three incumbents (Origin, AGL, and EnergyAustralia), that as of 2014 accounted for approximately 94% of market share in electricity (down from 96% in 2011), and 97% in gas. There are currently about 20 authorised electricity suppliers. Until retail price regulation was lifted in July 2014, consumers were either on regulated tariffs or unregulated 'market' tariffs.
- 3. Regulated tariffs were set by the Independent Pricing and Regulatory Tribunal (**IPART**). IPART also regulated the maximum level, and restrictions on the applicability, of non-tariff charges, such as security deposits, late payment fees, and dishonoured cheque fees. An explanation of the approach to price regulation is given below, based on an IPART report from June 2013.⁵⁶
- 4. Retail price regulation was lifted in July 2014 on the grounds that "*removing electricity price regulation will promote greater competition in the market, encourage more retailers to operate in NSW and offer better electricity deals.*"⁵⁷ Transitional arrangements were put in place for customers who were still on the regulated tariff by July 2014, which would see them being rolled onto their supplier's unregulated default tariff at the end of the transition period on 1 July 2016. The NSW government acknowledged that price regulation imposed constraints on competition and on market entry, and that in a competitive market, price regulation was unnecessary. At June 2013, only 40% of customers remained on regulated tariffs and by March 2015 the proportion had reduced to 32%.⁵⁸
- 5. IPART regulated retail tariffs using a weighted average price cap (**WAPC**) that allowed suppliers to set individual regulated tariffs subject to this cap. The regulator determined a maximum average percentage by which each retailer could increase their regulated tariffs in each year. The retailer could then adjust the level and the structure of their regulated tariffs as they considered appropriate, subject to the average of these tariffs not increasing more than the maximum percentage allowed. This gave suppliers flexibility to adapt their prices in response to changes in their cost base.

 http://www.resourcesandenergy.nsw.gov.au/energy-consumers/energy-sources/electricity/removal-of-electricity-price-regulation-faqs.
 IPART (2015): "Review of the Performance and Competitiveness of the Retail Electricity Market in NSW" (Draft Report), p. 26. http://www.ipart.nsw.gov.au/Home/Industries/Electricity/Reviews/Retail_Pricing/Retail_electricity_market_monitoring_2015/20_Jul_201
 <u>5</u>-Draft_Report/Draft_Report_- Review_of_the_performance_and_competitiveness_of_the_retail_electricity_market_in_NSW_-_from_1_July_2014_to_30_June_2015.

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[&]quot;Review of regulated retail prices and charges for electricity (From 1 July 2013 to 30 June 2016", June 2013, New South Wales Independent Pricing and Regulatory Tribunal (IPART).

- 6. The WAPC was formed of:
 - (a) **N values** (network costs): based on actual network charges imposed by the network service providers (and approved by the Australian Energy Regulator, AER)
 - (b) **R values** (non-network costs): based on efficient supplier cost allowances (determined by IPART); these are:
 - Total energy cost allowance
 - Retail margin allowance
 - Retail operating cost allowance
 - Customer acquisition and retention cost allowance
 - (c) Quantities to weight prices:
 - Fixed components actual customer numbers (as at 31 December of previous year)
 - Variable components estimated consumption (MWh over previous year)
- 7. The WAPC was calculated according to the following formula:

$$\sum_{i=1}^{n} \sum_{j=1}^{m} P_{ij}^{t} \times q_{ij}^{t-1} \leq \sum_{i=1}^{n} \sum_{j=1}^{m} C_{ij}^{t} \times q_{ij}^{t-1} + PT^{t}$$

where *n* is the number of regulated tariffs for each supplier, and *m* is the number of components of the tariff (fixed or variable); P_{ij}^t is the price proposed by the supplier for each component of the tariff; q_{ij}^{t-1} is the relevant quantity (customer numbers or kWh); C_{ij}^t is the regulation price control set by IPART, and constitutes the sum of the N values and the R values; and PT^t is the cost pass-through amount, that enables suppliers to pass through incremental and efficient costs associated with defined regulatory or tax changes.

- 8. Since **N values** were based on actual network costs, IPART did not estimate this component; it simply accepted the values approved by AER.
- 9. The **Total Energy Cost Allowance** represented approximately 40% of the total (retail and network) costs incurred, and included four components:
 - (a) energy purchase cost allowance (EPCA) –cost of energy, carbon price, and cost of managing risks;
 - (b) green energy cost allowances;
 - (c) allowances for market fees and ancillary charges;
 - (d) allowances for costs associated with energy losses.
- 10. The approach for estimating the EPCA was as follows:
 - (a) Forecasting the regulated load of each standard retailer over each year of the determination;
 - (b) Developing other input assumptions needed for estimating energy costs, included capital and fuel costs of generation, and WACC⁵⁹;

⁵⁹

WACC for various gas businesses: 6.6-8.8% (real, pre-tax); for coal mining: 8.4% (real, pre-tax); for electricity generation: 8% (real, pre-tax); and for electricity retailing: 9.5% (real, pre-tax; which is equivalent to 7% post-tax).

- (c) Deciding how to take account of carbon pricing mechanism (which was finally included in the long-run marginal cost LRMC, and the market-based costs of generation);
- (d) Modelling the LRMC of electricity generation to meet the forecast regulated load this is done using a least-cost generation system to meet regulated load ('stand-alone' or 'greenfield' approach);
- (e) Modelling the market-based cost of purchasing electricity to meet regulated load;
- (f) Calculating the energy purchase cost allowance price floor which is a weighted average of 75% of the LRMC, and 25% of the market-based cost;
- (g) Determining the appropriate energy purchase cost allowance for each supplier subject to the price floor and no lower than the market-based cost.
- 11. The **Retail Margin Allowance** was set at 5.7% of EBITDA and was:
 - (a) expressed as a fixed percentage of each supplier's total cost to serve (N + R); and
 - (b) calculated in dollar terms for the purpose of setting the value of regulated R values, and recalculated at each annual cost review so the dollar amount remained consistent with the 5.7%.
- 12. This retail margin acknowledged the following systematic risks faced by suppliers:
 - (a) Variation of regulated load profile;
 - (b) Variation in wholesale electricity spot and contract prices; and
 - (c) General business risk.
- 13. The allowed margin only included systematic risks, as it was considered that specific risks were already accounted for in other cost allowances.
- 14. Three alternative approaches were used to determine an appropriate retail margin allowance range, and the allowed margin of 5.7% resulted from a simple average of those ranges:
 - (a) <u>Expected returns:</u> estimates expected cash flows that a retailer will earn, and the systematic risk associated with these cash flows; then determines a retail margin that will compensate investors for this systematic risk.

Range: 3.9-4.8%

(b) <u>Benchmarking: examines the reported margins of comparable listed firms to establish a</u> <u>range of</u> retail margin; used different retailers (not only energy) from Australia, the US, the UK, Canada and New Zealand.

Range: 6.3-6.6%

(c) Bottom-up: starts from an assumed investment base and cost estimates, then determines earnings and revenue which would allow the retailer to earn an expected return equal to its estimated cost of capital.

Range: 5.7-7.1%

15. The Retail Operating Cost Allowance was estimated based on a variety of approaches including bottom-up, benchmarking, and other regulators' decisions on retail operating cost allowances.

Costs included	Costs excluded
Customer service (e.g. operating call	Depreciation and amortisation
centres, billing and collecting revenue)	Transitional costs
Finance	
IT systems	
Regulation (e.g. paying licence fees)	

- The Customer Acquisition and Retention Cost Allowance (CARC) was explicitly used by IPART 16. as the mechanism for ensuring that it set regulated prices at a level that facilitated the continued development of competition in the long-term interests of consumers of electricity.⁶⁰
- IPART estimated that an efficient supplier faced direct acquisition costs of \$150⁶¹ per new customer 17. (or approximately \$40⁶² per customer pa) and indirect costs (ongoing market discounts) of \$150 per customer pa. This required setting the CARC at around \$29/MWh⁶³ in order to recover these costs over 4 years. From that \$29/MWh, IPART subsequently discounted the value of other cost allowances that already provided a margin above efficient costs, resulting in a range of \$0-\$15.19/MWh⁶⁴ of CARC allowance, depending on supplier and year.
- The report observes⁶⁵ that as higher CARC incentives were allowed, the competitive pressure also 18. increased, as can be seen by the development of market offer discounts on the regulated tariff and the switching rates over time:

	2007 Determination Period			2010 Determination Period			
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Incentives in regulated prices ⁶⁶ (\$/MWh)	5.1	5.1	5.1	29.0	25.3	24.3	22.0
Incentive as % of total costs ⁶⁷		2.8%			10.3%		7.0%
Market offers (% discount on regulated price)	4-5%	4-5%	4-5%	5-10%	5-12%	5-15%	
Switching rates	9%	10%	12%	13%	16%	19%	
% of customers on regulated prices	64%	68%	65%	59%	50%	40%	

Retail price controls in New South Wales

Source: IPART report (2013-2016 Price Determination)

Equivalent to £24.39, based on June 2013 average of GBP to AUD exchange rates.

⁶⁰ IPART report, p. 108. 61

Equivalent to £91.46, based on June 2013 average of GBP to AUD exchange rates. 62

⁶³ Equivalent to £17.68/MWh, based on June 2013 average of GBP to AUD exchange rates. 64

Equivalent to £0-£9.26/MWh, based on June 2013 average of GBP to AUD exchange rates.

⁶⁵ IPART report, p. 114.

⁶⁶ Regulated prices \$x/MWh above the efficient cost of supply. This incentive was mainly introduced through the CARC, but refers to the total level above the competitive price allowed in regulated tariffs. 67

ScottishPower estimates (total cost to serve includes total N and R values). See footnote 3 for detail.

A.3 France

- 19. In France, the historical suppliers (incumbents), EDF and GDF, together with some local suppliers (22 for gas, 160 for electricity) still serve 91% of electricity consumers and 75% of gas consumers. Market tariffs still coexist with regulated tariffs, which apply to the historical suppliers and local suppliers. These regulated tariffs are set by the energy regulator (CRE) and are meant to cover production costs, supply costs, network costs, and marketing costs that companies incur to supply consumers, plus 'a reasonable' margin.⁶⁸ The CRE sets the regulated tariff formula for each of these suppliers.
- 20. The remaining 9% of electricity consumers and 25% of gas consumers are customers of the 18 alternative electricity suppliers and 21 alternative gas suppliers and pay market tariffs for their energy.⁶⁹
- 21. In 2013, six years after competition was introduced in the domestic retail market, only 53% of French consumers knew they could switch their electricity supplier (55% for gas), with differences by socioeconomic group.⁷⁰ This has resulted in continued dominance of the incumbents: together, EDF and GDF account for about 95% of the supply market.⁷¹
- 22. The main barrier to greater competition, as acknowledged by the CRE, has been that regulated tariffs were set at levels below the true energy supply costs,⁷² which not only turned the regulated tariff effectively into an unbeatable 'price to beat' since ~2009, but was also against the law.⁷³ In recognition of this, the CRE has made increases to the regulated tariff since August 2013, and the French authorities have agreed that the amount of the deficit will be paid back to EDF by the end of 2018 with interest.⁷⁴ In order to improve levels of competition, regulated tariffs will be phased out by the end of 2015.⁷⁵
- 23. Additionally, an obligation to provide social tariffs applies to all suppliers and consists of a specific discount in euro on the regulated tariff, depending on the number of people in the household and on the contracted power (kVA). These tariffs are available to customers whose incomes entitle them to specific social benefits, and specific low income ranges.

A.4 Spain

- 24. There are 5 incumbents in the Spanish energy market (Endesa, Iberdrola, Gas Natural Fenosa, EDP and E.ON), which account for about 80% of the market⁷⁶. Although the process of market liberalisation started in 1997, with full liberalisation of the domestic retail market in 2009, tariff regulation in Spain has not yet been fully removed.
- 25. Spain is another example of how price regulation can lead to tariff deficit. The Spanish tariff deficit started in the mid-2000s, and economic and political conditions have extended the problem until recently. Despite multiple attempts, until 2014, consecutive governments did not manage to eliminate the structural deficit, and its elimination has been achieved, among other things, through

⁶⁸ Article L.337-6 of the [French] Energy Code.

⁶⁹ Commission de Régulation de l'Énergie. *Activity Report 2013*.

⁷⁰ Commission de Régulation de l'Énergie. *Activity Report 2013*.

⁷¹ <u>http://www.datamonitorenergy.com/2013/03/12/edf-and-gdf-still-dominate-the-french-retail-power-market/</u>

⁷² The origin of the tariff deficit is spread out across different components of the 'Contribution to the Public Electricity Service' (CSPE), which covers: support to renewables and co-generation; subsidies to costs in Corse and other islands; and the social tariff. Major cost increase in recent years on renewables account.

⁷³ Commission de Régulation de l'Énergie (2013). Analyse des coûts de production et de commercialisation d'EDF dans le cadre des tarifs réglementés de vente d'électricité.

 ⁷⁴ A. J. Linden *et al.* for the European Commission (2014): "*Electricity Tariff Deficit: Temporary or Permanent Problem in the EU*?", Economic Papers 534.

⁷⁵ Commission de Régulation de l'Énergie (2014). Délibération de la Commission de régulation de l'énergie du 30 octobre 2014 portant avis sur le projet d'arrêté relatif aux tarifs réglementés de vente de l'électricité.

⁷⁶ Share of market tariffs, at end of 2013.

the imposition of high taxes on generation, and cuts on networks revenue, which in the long run may cause a problem of underinvestment.

- 26. The deficit originated in the mismatch between forecast and actual costs, mainly in respect of renewables. However, Spain did not initiate on time a mechanism to close the gap in the subsequent year(s), as Germany did, generating a structural deficit that had accumulated around €30bn in debt to the parent groups of the Spanish 'Big 5', which was later 'securitised' (i.e. sold to financial firms, and therefore no longer owed to the 'Big 5').
- 27. Spanish authorities set regulated tariffs based on estimates of energy costs, system costs, and a gross margin in electricity of approximately €4/MWh (equivalent to €15/customer/annum).⁷⁷ System costs constitute a binding commitment for the authorities to pay a pre-defined quantity to all the involved parties.⁷⁸ The supplier collects tariff revenue, retains its margin and pays energy costs directly to the generators. The rest of the revenue is transferred to a centralised 'clearing house'. This pot should then cover the system costs and this is when any forecasted/real costs mismatch⁷⁹ becomes apparent. Until 2014, if there was any missing money, the clearing house was entitled to demand payment from the 'Big 5^{x80}, given that the clearing house has a binding obligation to pay for system costs⁸¹. At this point, the clearing house acquired a new commitment to the 'Big 5' parent groups: the tariff deficit. Although the tariff deficit could have been eliminated through the introduction of a corrective element in the tariff (that accounts for the deficit originated in the previous year), at the time when the government became aware of this issue, it was politically unfeasible to increase energy prices, which has led to the accumulation of the deficit over the financial crisis years (and of the substantial interest accumulated on this deficit).



Figure 1 – Summary diagram of Spanish tariff deficit

Mainly due to unexpected increases in renewables costs, but also from other cost concepts.

In the past, suppliers were also entitled to a risk-based margin, but this was eliminated on the grounds that regulated activities are risk-free.
 These costs are: distribution, transmission, capacity payments, renewable energy, domestic coal support, non-mainland generation, repayments of previous deficit (recently introduced), and other costs of the system.
 Mainteenergy domestic costs of the system.

⁸⁰ It is currently not determined what would happen in case the clearing house had a surplus, but the debate is expected to occur at the end of 2015 or during 2016.

⁸¹ The new arrangements to eliminate the tariff deficit create only a *temporary* deficit, where the clearing house's debt is in favour of system participants (generators, network operators, etc) and not the 'Big 5' parent companies.

28. All of the 'Big 5' are required to offer the regulated price to most domestic consumers⁸² alongside their market tariffs, as well as a social tariff,⁸³ which represents a 25% discount on the regulated tariff. Despite the regulated tariff being lower than the market tariffs, around half of Spanish consumers are on a market tariff. This can be explained by the fact that the regulated tariff is a variable tariff (which can be very volatile⁸⁴) and suppliers offered initial fixed-term discounted tariffs (and often a fixed monthly amount with yearly settlement) to consumers to incentivise them to switch. Consumers then ended up in a more expensive market tariff⁸⁵ after the end of the fixed-term contract.

A.5 Portugal

- 29. Competition is still very limited in the Portuguese market, with a regulated tariff that has been consistently below the total costs of supply. The Portuguese (regulated) 'integral tariff' is intended to cover energy costs, network costs, taxes, levies (including renewables support), and other relevant costs, but increasing energy costs and renewables support costs, which have not been matched by corresponding increases in the regulated tariff, have resulted in an accumulated tariff deficit that is as high as 2.6% of national GDP.
- 30. The integral tariff is gradually being phased out between January 2013 and December 2015, although network costs and the social tariff will continue to be regulated.



Figure 2 – Portugal electricity market shares in terms of number of customers (left) and consumption (right)⁸⁶

31. The regulated and the social tariff are offered by the 'suppliers of last resort' (EDP and some suppliers that operate only locally for electricity; and GALP, EDP, Sonorgás and Tagusgás, for gas). There are three cumulative⁸⁷ social tariffs (STs): the electricity ST, the natural gas ST, and the 'additional social support for the energy consumer' ST (the ASECE). While the first two apply a specific discount in EUR/kVA on the regulated tariff, the ASECE applies a 13.8% discount on the bill (excluding tax and other social discounts).

⁸² All domestic consumers with contracted power below 10 kW.

Applies to vulnerable customers that fulfil at least one of the following: <3kW contracted in regular home; Over age 60 and living on certain State benefits; Family with 3 or more dependent children; and/or Family with all members unemployed.

⁸⁴ The price for electricity is calculated hourly; therefore the average price that the final consumer is charged for each month's consumption varies on a monthly basis (however bills are issued every two months, which implies that consumers experience a change in rates every two months).
⁸⁵ A the effect of the effect of the entropy is in the every t

At the end of the offer period, the customer remains in the same contract but without the agreed initial discount (there is no such thing as a default tariff or auto-rollovers at the end of the period).
 Entitled a Regulatory day Services Energy (2014). Regume Information: Manada Liberalizada. Electricidada.

⁸⁶ Entidade Reguladora dos Serviços Energéticos (2014). Resumo Informativo: Mercado Liberalizado – Eletricidade.

⁸⁷ i.e. that can be combined if the degree of vulnerability of the customer requires so.