Energy market investigation

Supplemental Notice of Possible Remedies

26 October 2015

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Introduction

1. On 26 June 2014, the Gas and Electricity Markets Authority in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act) (as provided for by section 36A of the Gas Act 1986 and section 43 of the Electricity Act 1989), made an ordinary reference to the Chair of the Competition and Markets Authority (CMA) for the constitution of a group under Schedule 4 to the Enterprise and Regulatory Reform Act 2013 for an investigation into the Supply and Acquisition of Energy in Great Britain (the Investigation).

2. The CMA is required to determine whether any feature or combination of features of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or a part of the UK.[1] If the CMA decides that there is such a prevention, restriction or distortion of competition, there will be an 'adverse effect on competition' (AEC).[2]

3. In its provisional findings, a summary of which was published on 7 July 2015, the CMA has provisionally found AECs and in Section 12 of the provisional findings identifies those features that the CMA provisionally finds give rise to the AECs and the resulting detrimental effects on customers (the Provisional Findings).

4. Where the CMA finds that there is an AEC, it has a duty to decide whether it should take action itself and/or whether it should recommend others to take action to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers.[3] If the CMA decides that such action is appropriate it must also decide what action should be taken and what is to be remedied, mitigated or prevented. In deciding these questions the CMA has a duty to achieve as comprehensive a solution as is reasonable and practicable to the AEC and any resulting detrimental effects on customers.

5. Consequently, alongside its Provisional Findings, the CMA also published on 7 July 2015 a Notice of possible remedies (Remedies Notice) which set out and invited comments on possible actions which the CMA might take in order to remedy, mitigate or prevent the AECs or any resulting detrimental effects on customers. The CMA invited parties to comment on the Provisional Findings and the Remedies Notice in writing, including any suggestions for

[1] See section 134(1) of the Act.
[2] As defined in section 134(2) of the Act.
[3] Section 134(4) of the Act.

additional or alternative remedies that they wished the CMA to consider, initially by 31 July 2015; subsequently extended to 5 August 2015.

6. The responses received by the CMA included two separate, but similar, proposals from Scottish Power and Centrica. As two suppliers have proposed a similar remedy, we wish to ensure that all interested parties are aware of the details of these proposals and are given an opportunity to make submissions on them. We are reviewing and considering all submissions made in response to the Provisional Findings and the Remedies Notice and will publish our updated thinking on remedies in our Provisional Decision on Remedies in due course.

7. In order to facilitate this separate consultation, the CMA has today published a Supplemental Notice of Possible Remedies (Supplemental Remedies Notice) and invites comments on these further remedies proposals (in isolation, or in combination with any or all of Remedies 3 to 11 set out in the Remedies Notice) as possible actions which the CMA might take in order to remedy, mitigate or prevent the AECs or any resulting detrimental effects on customers. The CMA invites parties to comment on this Supplemental Remedies Notice. The parties to this investigation and any other interested persons are requested to provide any views on these supplemental remedies in writing, including any suggestions for modifications or alternatives to them that they wish the CMA to consider, by 9 November 2015.

Criteria for consideration of remedies

8. When deciding whether any remedial action should be taken and, if so, what that action should be, the CMA will consider how comprehensively the possible remedy options – whether individually or as a package – address the AEC and/or its resulting detrimental effects on customers, and whether they are reasonable and practicable.[4] The CMA will assess the extent to which different remedy options are likely to be effective in achieving their aims, including when they are likely to have effect.[5] The CMA will generally look for remedies that prevent an AEC by extinguishing its causes, or that can otherwise be sustained for as long as the AEC is expected to endure. The CMA will also tend to favour remedies that can be expected to show results within a relatively short time. Where we consider that the relevant competitive dynamics of a market are likely to change materially over the next few years,

[4] *Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3)*, paragraph 330.
[5] *CC3*, paragraphs 327 & 330.

we will consider including sunset provisions to limit the duration of certain remedies.

9. The CMA will be guided by the principle of proportionality in ensuring that it acts reasonably in making decisions about remedies. The CMA will therefore assess the extent to which different remedy options are proportionate, and in particular it will be guided by whether a remedy option:

(a) is effective in achieving its legitimate aim;

(b) is no more onerous than needed to achieve its aim;

(c) is the least onerous if there is a choice between several effective measures; and

(d) does not produce disadvantages which are disproportionate to the aim.[6]

10. The CMA may also have regard to the effects of any remedial action on any relevant customer benefits arising from a feature or features of the market giving rise to the AEC.

11. In the event that the CMA reaches a final decision that there is an AEC, the circumstances in which it will decide not to take any remedial action are likely to be rare but might include situations in which no practicable remedy is available, where the cost of each practicable remedy option is disproportionate to the extent that the remedy option resolves the AEC, or where relevant customer benefits accruing from the market features are large in relation to the AEC and would be lost as a consequence of any appropriate remedy.[7]

Possible supplemental remedies on which views are sought

12. In this Supplemental Remedies Notice we describe an additional remedy proposal – based on the proposals submitted to us by Scottish Power and Centrica – which we believe might be effective in addressing the provisional AEC arising from a weak customer response on the part of domestic customers. We note that, although Scottish Power and Centrica have proposed this remedy as an alternative to Remedy 11, our current view is that it provides a means of prompting customers to engage with the retail energy markets and, as a result, should be considered as a specific proposal in the context of Remedy 10 – Measures to prompt customers on default tariffs to engage in the markets.

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[6] *CC3*, paragraphs 335–337.
[7] *CC3*, paragraphs 355–369.

13. Scottish Power's and Centrica's submissions are attached to this notice. We note that there are important similarities between these proposals. In this Supplemental Remedies Notice, we set out the basic outlines of the remedy put forward by both parties and explain how such a remedy could address the feature(s) we have provisionally identified as giving rise to an AEC. We invite views on the likely effectiveness and proportionality of this remedy, and on the most effective means of specifying and implementing it.

14. In addition to views on the effectiveness and proportionality of the remedy set out in this notice, we invite submissions on how it might function in combination with those included in our original Remedies Notice of 7 July. For example, would certain remedies only be effective in combination with other remedies? Alternatively, would the effectiveness of certain remedies be undermined by the imposition of other remedies set out in this notice?

Remedies to encourage customer engagement by prohibiting the use of evergreen tariffs

15. Scottish Power and Centrica have both proposed a remedy that would seek to increase customer engagement by phasing out the use of evergreen contracts and moving to a system where all contracts have a fixed term, eg one year. Under this proposal (once implemented) customers would be encouraged to engage via end of fixed-term contract notifications.

16. While their proposals have some similarities, there are also some notable differences. We have not reproduced full details of each firm's proposals in this Supplemental Remedies Notice but we encourage those parties who wish to make submissions on this remedy to review them in detail (see paragraph 13).

How the remedy would work

17. This remedy aims to increase domestic customer engagement in the retail markets by introducing an end date to the supply of energy on an evergreen basis (eg on a standard variable tariff), and providing periodic prompts to such customers in anticipation of the end of evergreen contracts and once they have transitioned to a new fixed-term contract. In contrast, current evergreen contracts, which do not have a set end date, allow customers to remain on the same tariff for a number of years without (necessarily) receiving any trigger to engage. The industry would move to a system where all customers were on fixed-term contracts, with notifications provided when those contracts came to an end.

18. Both Scottish Power and Centrica highlighted that, in their experience, domestic customers on fixed-term contracts tended to engage in significant numbers following the receipt of an end of contract notification from their supplier. This response was much greater than that seen following receipt of an annual statement or a price increase notification. They suggested, therefore, that if all domestic customers were to receive such notifications on an annual basis, levels of engagement would increase materially.

19. Customers who received a notification that their contract was coming to an end but who did not take action, would be rolled onto a fixed-term, default tariff. Both Scottish Power and Centrica suggested that this should be a one-year tariff without exit fees. As a result, customers who rolled onto it could switch to an alternative tariff at any time without penalties. They also emphasised that the level of the default tariff should be set by the energy suppliers, rather than being regulated. Once on this default tariff, customers would receive a notification at the end of each year that their fixed-term default tariff was coming to an end and would be provided with information on the range of tariffs they could choose from, including the one they would be rolled onto if they failed to make a choice. These customers could also receive additional prompts, eg quarterly or at the mid-year stage.

20. We envisage that this remedy would need to be phased in over a period of time, with energy suppliers being required to take the following steps (although not necessarily in the order set out):

(a) prohibiting the supply of energy to new and existing customers on an evergreen basis as from a future date;

(b) inform existing evergreen/SVT customers that their tariffs were being phased out and that they needed to choose a new tariff; and

(c) move those existing customers who did not respond to this prompt by selecting another (fixed-term) tariff onto the default tariff.

Within a given period of time, all evergreen tariffs would thus be removed from the market.

21. We invite parties to provide submissions on the following issues:

(a) **Would this remedy be effective in encouraging customers to engage more frequently in the market? Are there certain groups of customers who could not be covered by this remedy and, therefore, would not benefit, eg those on prepayment, DTS or other meters?**

(i) **To what extent is the higher level of engagement observed in response to end of fixed-term contract notifications[8] the result of the type of customer who has chosen those products, rather than a response to the notification itself?**

(b) **Would this remedy be effective in protecting those customers who failed to engage in the market, even after receiving prompts, from paying high prices? Would the extension of SLC 7,[9] in the manner proposed by Centrica, provide such protection?**

(c) **Should this remedy apply to domestic customers only, or should it also be extended to microbusiness customers?**

(d) **The wording of the end of fixed-term notifications appears to be critical to the effective functioning of this remedy. Should Ofgem take responsibility for developing and testing appropriate wording, or should the energy suppliers retain responsibility for this?**

(i) **If suppliers design these prompts, how can they be incentivised to maximise their effectiveness?**

(e) **Should the default tariff be fixed price as well as fixed term, or should suppliers be allowed to roll customers onto a variable price tariff?**

(i) **If the default tariff were variable price, should energy suppliers be required to roll all customers who did not take action onto the same tariff, such that in effect there was only a single variable price default tariff per supplier?**

(ii) **If the default tariff were fixed price, should energy suppliers be required to roll all customers who did not take action within a given period, eg one month, onto the same default tariff? Is there a risk that the existence of multiple default tariffs (eg one for every month) would reduce the pressure on SVT pricing that currently results from media attention on changes to SVTs?**

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[8] Scottish Power submission, paragraphs 3 & 4, Centrica submission, paragraphs 11 & 12.

[9] Centrica told us that 'The CMA could apply elements of existing regulation Standard Licence Condition 7, relating to deemed tariffs, to the default tariff (ie a requirement that such terms must not be unduly onerous). This would mean that competition in the market for non-default FTCs would exert price pressure on the default tariff by ensuring that:

- revenues would not significantly exceed the licensee's costs of supplying energy to the premises of default tariff customers; and
- margins earned on default tariff customers would not significantly exceed margins earned on the supply of energy to the generality of domestic customers.'

(f) **How should this remedy be implemented in order to ensure it is effective and proportionate?**

(i) **How long should energy suppliers be given to phase existing customers off their SVTs?**

(ii) **Should the remedy be phased in starting with customers who have been on the SVT longest? Alternatively, should it be organised geographically in order to facilitate marketing by competitors and support from consumer groups in later years? For example, energy suppliers might be required to move all SVT customers in a region to the default tariff in the same month, such that the following year energy suppliers, PCWs and other TPIs would know that a large number of customers in that region might be looking to move in that month.**

(iii) **Should energy suppliers be required to provide contact details for all SVT customers or a subset of SVT customers (eg those who have been on the default tariff for several years in a row, eg three or five years) to Ofgem, which could then seek to contact them with further prompts? Alternatively, should suppliers be required to place the contact details of these customers on a shared database, available to all licensed energy suppliers, in order to allow targeted marketing to these customers? We note that GDF has been required to share such information on those of its customers who remain on the regulated tariff in France.**

(g) **What should the default tariff be called? Should it be the 'emergency' tariff to further prompt engagement or would some other wording be more appropriate? Is there a risk that certain customers will be concerned that their energy supply will be cut off if they do not engage following an end of contract prompt?**

(i) **How should the CMA assess the costs of such potential distress to customers?**

(ii) **Are there means by which this distress could be avoided or mitigated?**

(h) **Should Ofgem monitor the proportion of customers on default tariffs, their average tenure and/or the pricing of default tariffs (eg with a view to publishing summary information)?**

(i) **Should all energy suppliers be subject to the prohibition on evergreen tariffs?**

(j) **Would any energy suppliers have the ability to circumvent the remedy? If so, how could they do this?**

(k) **Could this remedy give rise to unintended consequences and, if so, what these might be and how they might be prevented or mitigated?**

(l) **Are there any relevant customer benefits to which we should have regard as being affected by the proposed remedy?**

(m) **What are the relevant costs and benefits that we should take into account when considering the proportionality of this remedy?**

(n) **Are there any alternative remedies that would be as effective as the proposed remedy in addressing the provisional AEC and that would be less costly and/or intrusive?**

(o) **Should the CMA seek to implement this remedy itself via an order (eg to make a licence modification), or whether it should make a recommendation that another body, such as Ofgem or DECC, implement the remedy?**

Next steps

22. The parties to this investigation and any other interested persons are requested to provide any views in writing, including any suggestions for additional or alternative remedies that they wish the CMA to consider, by 9 November 2015 either by email to energymarket@cma.gsi.gov.uk or in writing to:

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Energy Market Investigation:

Alternative remedy 11 proposal

Contents

Introduction

1. At the request of the CMA we are making a further submission relating to the alternative remedy that we proposed in our response to the CMA's Provisional Findings (PF) and Notice of Possible Remedies (PR)[1]. This is focused on the domestic market only.

2. In making this submission it is important to note that our proposal was made within the context of a broader response. In that response we demonstrated why we disagree with a number of the CMA's provisional findings, in particular the existence of unilateral market power (UMP) over, and excessive profits from, customers on standard variable tariffs (SVT).

3. Within this context, the purpose of our proposal was to demonstrate that, should the CMA nonetheless confirm its provisional finding of UMP deriving from a lack of consumer engagement, there are more effective ways of addressing competition concerns than the introduction of a regulator-determined "Safeguard Tariff" cap.

4. As we set out in our response to the PR, a Safeguard Tariff Cap has a number of fundamental challenges including:

   - Setting the price would be extremely complex and subject to severe unintended consequences, whether via a 'cost plus' or a 'market-based' pricing approach[2].
   - Even if this hurdle could be overcome, a key decision relates to the level at which prices are set – the "headroom' problem as the CMA itself recognises (PR paragraph 95). In order to 'safeguard' there may be a temptation to set prices at a relatively "low" level to 'protect' disengaged customers. This, however, would be counterproductive and at odds with the other remedies designed to stimulate engagement as it would reduce the incentive to engage;
   - Furthermore, a regulated price cap would create a 'safe haven' effect with customers reluctant to switch away from a 'protected' tariff. This has been observed in Australia where even a relatively *high* regulated price had this effect[3];
   - There are therefore no good grounds to suggest that the CMA is right to think that such a remedy would be "transitional" or could easily be removed. In contrast, we believe it likely the safeguard tariff would become a long-term feature of the regulatory framework, to the lasting detriment of competition.

5. Instead, we support practical measures that have the prospect of improving engagement further, and which promote the continued development of effective competition in the retail market.

6. In particular, we believe that, instead of introducing a regulated 'safeguard' cap, which would blunt engagement, there is a natural pro-competitive remedy that would promote

[1] The CMA published their Notice of possible remedies on 7 July 2015 and published Centrica's response on the 7 Sep 2015.

[2] For example: "Cost plus" removes all elements of market-driven pricing and is severely detrimental to competition. It is also difficult to see how single price could be set given the structural differences in supplier procurement, capital and operating costs. Pricing "based on other retail prices" creates a significant risk of unintended consequences, including "gaming" by market participants in order to affect competitor price levels, and challenges for supplier risk management (e.g. due to impact of different hedging approaches and lack of price change predictability).

[3] St. Vincent de Paul Society, New South Wales Tariff-Tracking Project, May Mauseth Johnston, August 2013; as referenced in Review of Competition in the Retail Electricity and Natural Gas Markets in New South Wales, AEMC, 3 October 2013, p.ii (highlighting a $300-$400 saving on a bill of c.$2,500)

it - ending evergreen tariffs. This would transform the energy market into one which is based entirely upon 'fixed term contracts' (FTCs) and would directly address the issue the CMA has provisionally identified by removing evergreen SVT products from the market. While such a remedy would be a bold, we believe it would avoid the material distortions to competition associated with the Safeguard Tariff.

7. This remedy would have the potential to create a step change in customers' attitudes towards energy, such that they see it as a product in which they should (and must) engage on a regular basis as is the case, for example, with insurance products.

8. An important aspect of this remedy would be the competitive activity, advertising and media coverage that we anticipate would accompany the mass roll-off from evergreen contracts. This effect would be driven by the intertwined effect of this remedy being phased in just as the restrictions on customer propositions and tariff design introduced under Ofgem's Retail Market Review (RMR) are removed, and the anticipated growth in customer engagement prompted by the rollout of smart meters is realised.

Proposal for an alternative to the CMA's safeguard remedy 11

9. Our proposed alternative to Remedy 11 is summarised below (for further details please refer to our full response to PF and PR[4]):

- **No new evergreen tariffs**
    - Suppliers would be banned from acquiring new customers onto evergreen contracts (as of a specified date after a suitable period of implementation); and
    - After this point, all new acquisitions, and customers that switch internally, could only be offered fixed term products, with either a variable price (VP) or fixed price (FP).
- **Phase out existing evergreen contracts**
    - All customers currently on SVT would be notified that their contract is coming to an end and that they need to choose an alternative fixed term contract;
    - This notification process would be phased over 24 months, starting with those who have been on evergreen tariffs the longest;
    - Once any given customer has received this notification, they would have one year to choose another tariff (during which time they would receive additional prompts); and
    - At the end of this period, if a customer had still not switched supplier or tariff, they would be switched to a Default Tariff (described below) to ensure continuity of supply.
- **Default tariff**
    - For customers who are out of contract, it will be necessary to have a default mechanism to enable them to continue to receive energy.
    - In our response we have used the term "default tariff", but the CMA should carry out research to determine if there is a more appropriate name (that encourages customers to switch away from it and does not imply it is a "safe haven" product);

[4] https://assets.digital.cabinet-office.gov.uk/media/55eda64eed915d14f3000001/Centrica_resp_to_PFs.pdf, pp. 75 – 80..

- The CMA may wish to define a principles based framework for the design of default tariffs, but we do not believe the CMA should be overly prescriptive as this could limit the ability of suppliers to adapt to market conditions and to differentiate;
- We have suggested a potential design for a default tariff comprising the following features (described in more detail later in this document):
  - Supplier set;
  - Variable price;
  - One year fixed term; and
  - No exit fees.

10. The CMA could also consider adding some of the following complementary elements to the default tariff design, though we do not believe that they are all necessary, for the reasons we outline later.

- Supplier prompting;
- Monitoring of default tenure;
- Monitoring of default pricing; or
- Extending SLC 7[5] to default tariffs such that terms of default contracts are not permitted to be unduly onerous[6].

Why we believe this remedy would be effective at engaging customers

11. We believe that once SVT customers are required to move on to FTCs that many will begin to adopt the switching behaviour of existing FTC customers, of whom up to 60% contact us to discuss their options at roll-off and around 20% switch externally by the end of their contract. This is supported by recent Ofgem research which found that:

- "Of the routine communications, we found that end of fixed-term notices were most likely to prompt action: 43% of consumers checked the features of the tariff they were on, 34% looked into switching tariffs with their own supplier, and 24% looked into switching supplier"[7]

12. We anticipate a step-change in market switching rates (both externally between suppliers and internally between products) as a result of the interrelationship between the ending of evergreen contracts and the following market developments:

- The removal of restrictions on tariff and proposition development introduced under the RMR, driving enhanced differentiation by suppliers and PCWs (remedy 3);
- The growth in customer engagement prompted by the rollout of smart meters;
- The removal of actual or perceived barriers to engagement (remedies 4 and 9);
- More effective prompting of customers (remedy 10); and
- The continued growth of independent suppliers, collective switching and PCWs.

[5] See paragraphs 7.3 and 7.4 of both the Standard conditions of electricity supply licence and the Standard conditions of gas supply licence.
[6] See the final section of this document for more details.
[7] Ofgem's "Retail Market Review 2015 Survey" https://www.ofgem.gov.uk/ofgem-publications/96565/rmrsurvey2015reportforpublication-pdf

13. We believe the market developments listed above will stimulate external switching rates materially. These rates will then be further increased by the shift to a FTC-only market. The impact on internal switching rates will be similarly significant.

14. We recognise that a relatively small proportion of customers may remain classified as ‘inactive’ if, after intensified prompting in the market including the ending of evergreen, they have failed to actively switch to a new tariff or supplier after their SVT tariff comes to an end under our proposed phased roll-off. However we anticipate this could be as few as 7% of British Gas customers once the remedies are fully established over 4-5 years (with a further 11% of customers ‘active’, but temporarily on the default, such as after a home move).

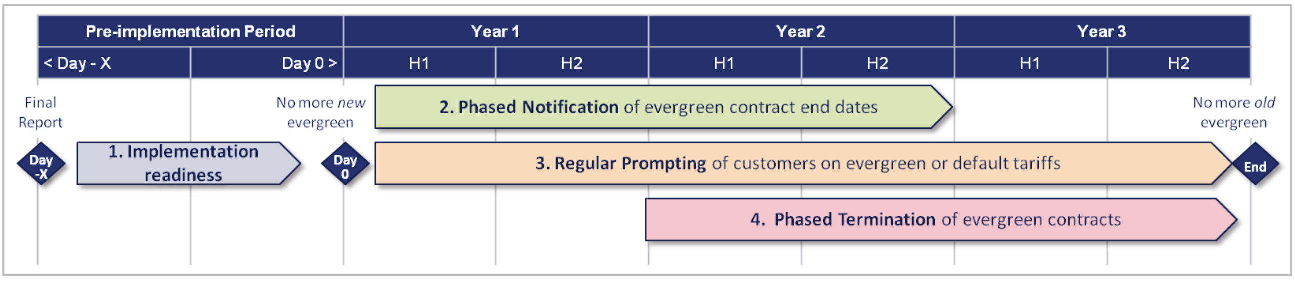
15. At this point these customers would go onto a supplier set Default Tariff. Their supplier would notify them that they have been put onto a Default Tariff, remind them that they have a choice and recommend other products. They would then receive additional prompting during the period they are on the default, including an annual end of contract prompt if they remain on it for over a year.

16. We consider that the proposals outlined above will ensure that the size of this segment is no larger than would be expected in a well-functioning competitive market and far fewer than under a regulated tariff cap. We would also note that social policy measures provided by Government will complement this model by providing specific assistance for the financially vulnerable.

Why we believe that a phased implementation period is required

17. An important feature of our proposed alternative to Remedy 11 is a phased implementation. An implementation profile for this proposal we consider appropriate is illustrated below:

Figure A - Illustration of the proposed implementation phasing



18. **Implementation readiness:** After the CMA publish their Final Report, if this remedy is deemed necessary, suppliers will need to be given a period of time in which to prepare for implementation, for example:

- To design, build, test new products (including a default tariff) and associated processes, prompts, reports etc.; and
- To increase resource and system capacity to cope with a FTC only market with all customers renewing periodically.

19. **Phased Notification:** All customers currently on SVT would be notified that their contract is coming to an end in 12 months time and that they need to choose an alternative fixed term contract. This notification process would be phased over years 1

to 2 (with termination in years 2 to 3), starting with those who have been on evergreen tariffs the longest, as illustrated in the example below.

Figure B - Illustration of how SVT notification and termination could be phased by tenure[8]

Tenure (years on SVT at Day 0)	Year 1		Year 2		Year 3	
	H1	H2	H1	H2	H1	H2
15+	Notification	Prompting	Contract End	Ongoing prompting + annual contract		>
6-14		Notification	Prompting	Contract End		>
3-5			Notification	Prompting	Contract End	>
0-2				Notification	Prompting	Contract End

20. This would also give time for more smart meters to be rolled out, which will both increase engagement levels and reduce the cost to the industry associated with a FTC only market with higher switching and renewals.

21. **Regular Prompting:** Once any given customer has received this notification, they would have one year to choose another tariff, during which time they would receive additional prompts.

22. **Phased Termination:** At the end of this period, if they have still not switched supplier or tariff, they would be switched to their supplier's Default Tariff to ensure continuity of supply.

23. We believe that this approach is necessary for the following reasons:

- to maximise the opportunity of the end of evergreen, by allowing time for the inter-relationship between the ending of evergreen and the CMA's other remedies to take full effect, so that suppliers and PCWs can compete more effectively to attract current evergreen customers with engaging products and prompts; and
- to avoid dramatic spikes in customer contact and switching that would have the potential to harm levels of customer service and trust severely, and add substantial industry costs.

24. A rapid phasing (e.g. notifying all evergreen customers within 3 months) would increase contact levels far beyond that which could be handled today. To maintain even a basic level of customer service in this scenario, suppliers would need to open new contact centres (which could take up to 18 months before they were fully operational with trained staff). In addition some supplier and industry systems may need upgrading to cope with such spikes.

25. To give an indication of the scale of the challenge, if 60% of our SVT customers contacted us regarding the end of their SVT contract (which was the actual contact rate of a recent FTC roll off) within a 3 month implementation window, then we would need to double our contact centre capacity to maintain current service levels. This scale of change would be impossible due to recruitment timelines and training requirements.

26. It is also not just an issue for the larger suppliers, since smaller suppliers would also experience major spikes as they seek to acquire customers rolling off SVT (and later off FTCs). As has been observed recently, many smaller suppliers are already

[8] The appropriate phasing will depend on the volume of customers by tenure as of the start of the notification phase, which will vary by supplier.

struggling to maintain service levels during their rapid growth, as observed by Citizens Advice's head of retail markets Gillian Cooper in relation to recent complaints data:

- "If you look at all the small suppliers, most of them have been growing quite rapidly. Some of the independent companies at the bottom of the table have taken on large numbers of new customers and that may be causing some teething problems with complaints."[9]

27. The unintended consequences of failing to implement this change effectively could be extremely harmful to customer satisfaction with, and trust in, the switching process and the market in general.

Why we believe that the CMA should avoid highly prescriptive prompting

28. The CMA, under remedy 10, propose introducing regulations that mandate supplier prompting. We would urge the CMA to avoid prescriptive regulation due to the potential for unintended consequences such as those which the CMA itself has identified regarding the 'clearer' element of the RMR regulations (see Remedy 9).

29. Instead the CMA should provide a framework with boundaries (such as a minimum number of prompts) within which suppliers have freedom to determine, based on customer research, the most effective approach to prompting in terms of content, format, channels and timing.

30. This would provide a source of competitive differentiation as suppliers use their own insight to compete to find the most effective way to prompt their customers, learn from customer response, adapt to evolving consumer preferences, and improve communication to enhance engagement and satisfaction. It would also future-proof the remedy as technologies continue to advance and enable different communication methods.

31. Any elements that the CMA does prescribe (e.g. the name of the "Default Tariff") should themselves be rigorously tested with consumers to maximise effectiveness. Many approaches that might be assumed to increase engagement could in fact have the opposite effect (as the FCA has found).[10]

32. Our recent small scale survey[11] found that the prompts which are most effective at persuading customers to consider switching are those which tell customers that they are on an expensive tariff or that tell them how much they (specifically) could potentially save by switching.

33. However, the best product to offer customers as an alternative will vary depending on their needs. Our research shows that when customers are offered a portfolio of four

[9] http://utilityweek.co.uk/news/fast-growth-drives-up-complaints-against-independents-says-citizens-advice/1173802

[10] The FCA is advanced in using Behavioural Economics to guide them. It is noteworthy that in the first field trial of framing they concluded that "field trials...are especially useful in overcoming conventional wisdom and challenging policymakers' own prior beliefs about useful interventions" for example: "counter to our expectations, CEO signature reduced response rates by 0.3 percentage points" http://www.fca.org.uk/static/documents/occasional-papers/occasional-paper-2.pdf

[11] Online survey of 2044 customers from multiple suppliers conducted by Decision Technology, July 2015

tariffs in a realistic choice task, each tariff appeals to someone due to customers' different needs and preferences.[12]

34. While the product with the cheapest unit rate will appeal to many customers, others will respond better to products which include upfront cash discounts or vouchers, energy efficiency products or cost saving features such as Time of Use tariffs. As well as being more appealing, these products may well result in the best financial value for the customer over the term of their contract, but they may not appear to be the cheapest tariff as defined by Ofgem's Cheapest Tariff Messaging rules.

Why we believe our proposed default tariff structure is appropriate

35. Unlike most other markets (such as insurance) where customers can be out of contract (and therefore not receive the product or service), energy is an 'essential good'. Whilst it is possible to withhold supply (through disconnection) it is an extreme course of action that, rightly, is rarely taken and only as a last resort. So there will always be the need for a mechanism by which suppliers can charge out of contract customers for the energy that they continue to use.

36. Whilst a default mechanism is required, we do not believe it would be necessary for the CMA to put in place highly prescriptive regulations for the design of this mechanism.

37. Instead, we believe it would be preferable for any oversight of the default mechanism to be more "principles-based." This would limit the unintended consequences that prescriptive regulation could bring in a dynamic and evolving market. However, for the purposes of illustration, we set out the core elements of a possible Default Tariff design for domestic customers[13] below. In particular, we believe the Default Tariff would operate most effectively if it had the following features:

- a supplier set price;
- a variable (rather than a fixed) price;
- a one year fixed term; and
- no exit fees.

38. The Default Tariff price would be set by suppliers and not capped by the regulator.

- Each supplier should set the Default Tariff for each fuel type[14] in order to reflect the actual costs and market forces that they face.
- Unlike a regulator-set or capped tariff, this would enable the price to reflect material, structural differences in supplier cost bases, driven by a range of factors including customer mix (region, pay type, consumption levels), hedging approach, Government exemptions and smart meter rollout strategy.

39. The Default Tariff would have a variable price.

[12] 'Tariff Lab III', Decision Technology - Feb 2014 (4,502 customers) - Submitted to CMA in response to the SQ.
[13] If the CMA also believes that Remedy 11 is necessary for microbusinesses then there are additional considerations. For example, fixed prices are the norm for business customers, so an alternative approach may be required to avoid dissatisfaction or confusion (which may otherwise make it harder to engage them).
[14] A Default Tariff would be required for dual fuel and each single fuel with the usual cost-reflective adjustments for region and payment type (and meter type, consumption and Deemed if applied to microbusinesses)

- We believe the risks of purchasing commodity for the Default tariff would be best managed through variable pricing. The nature of the Default tariff means that both the number and tenure of customers on the tariff is uncertain and likely to vary significantly. This unpredictability creates material uncertainty as to the volume of commodity suppliers should purchase for customers on the default tariff. It is therefore highly unlikely that suppliers would be able to purchase all of its commodity requirement (as it will be unknown) at the time of setting the Default Tariff price and would therefore need the flexibility to re-price as incremental commodity was bought or sold.
- To manage these risks through fixed price tariffs would not only result in higher prices to cover the risks, but also multiple Default Tariffs, possibly as frequently as monthly. This could result in some customers on the Default Tariff paying a materially higher or lower price than others simply because they happened to drop on to it at a time when underlying costs were higher. Given they have not chosen this product such a disparity may result in confusion and lower trust – which could harm levels of engagement.
- Fixing the price would also eliminate price changes within each annual contract, which would lose an opportunity for a further, powerful prompt.

40. All customers on the Default Tariff would be on one year fixed term contracts.

- Whilst the price will not be fixed, the term will be fixed. Customers would receive an annual fixed term contract to provide a guaranteed powerful prompt at the end of the contract (in addition to other prompts throughout the term). This will also help shift consumer attitudes so that they view the energy market as one with which they should engage on a regular basis (in the same way that they do in other markets, such as insurance).

41. There would be no exit fees for the Default Tariff.

- The absence of exit fees will avoid a potential barrier to switching. In the longer term, other market developments (smart meters, next day switching) should add further to the ease of switching.

42. In developing this proposal we considered some alternative design features, such as those listed below, however we believe that each have issues (described in brackets):

- **Annual fixed price default** (the price would need to include a significant risk premium due to the uncertainty over the number of customers on the default at one time);
- **Quarterly annual defaults** (more complex with a new default tariff launched each quarter such that different customers paying a different default price depending on which quarter they first dropped on to the default);
- **Three-month rolling fixed-price tariff** (customers would be exposed to seasonality and wholesale volatility such as was seen in Pennsylvania during the Polar Vortex when customers on short term products saw bills jump 300 to 600 percent).
- **Tracker product:** (there is no obvious index against which to track, even for the wholesale cost element. For example the Heren price is an average future price and does not equate to the actual price that was paid, nor does it include the cost of energy procurement).

43. We would encourage the CMA to consult more widely on alternatives and also to give suppliers a degree of flexibility in how they design their default in order to allow for changing market conditions and for competitive differentiation (whilst being mindful of any need to compare different suppliers' default tariffs).

Why we believe that the price of default tariffs will be competitive

44. We consider suppliers will be under strong pressure to ensure default tariffs are set competitively. If prices are set at too high a level, customers will be more inclined to switch to a competitor in response to the engagement prompts they receive, rather than to another of the supplier's tariffs.

45. This pressure will be substantial given that we anticipate that a significant proportion of the customers on the default tariff will be on it only temporarily (as they are active switchers, but in-between products, such as after a home move). As outlined above, this will be in addition to the broader step-up in engagement we anticipate, due to the inter-relationship between the ending of evergreen, the CMA's other remedies aimed at prompting engagement and wider market developments such as the rollout of smart metering.

46. While we do not believe that further regulation of the default tariff is necessary, for the purposes of consultation, we would highlight two additional options:

- *Enhanced regulatory reporting*. The CMA could consider introducing measures to require suppliers to submit data to Ofgem on the pricing of the default tariff, and the tenure of customers on this tariff as part of an expanded form of regulatory reporting.
- *Application of regulations that currently apply to deemed tariffs.* The CMA could apply elements of existing regulation Standard Licence Condition 7[15], relating to deemed tariffs, to the default tariff (i.e. a requirement that such terms must not be unduly onerous). This would mean that competition in the market for non-default FTCs would exert price pressure on the default tariff by ensuring that:
    - revenues would not significantly exceed the licensee's costs of supplying energy to the premises of default tariff customers; and
    - margins earned on default tariff customers would not significantly exceed margins earned on the supply of energy to the generality of domestic customers.

47. Finally, it should be noted that the few remaining customers on default tariffs will also benefit from the enhanced competition resulting from the step-up in market-wide engagement following the ending of evergreen. By contrast, the safeguard cap of Remedy 11 risks blunting incentives for engagement, and hence competition, to the long term detriment of customers across the marketplace. In short, the regulated cap would go against the grain of competition whereas ending evergreen and prompting engagement would, in comparison, enhance it.

[15] See paragraphs 7.3 and 7.4 of both the Standard conditions of electricity supply licence and the Standard conditions of gas supply licence

ENERGY MARKET INVESTIGATION

SCOTTISHPOWER PROPOSED ALTERNATIVE REMEDY

Introduction

1. [**CONFIDENTIAL**] remedy 11 is in our view an unjustified and disproportionate intervention in the market, and we agree with the CMA that "there are always risks with controlling outcomes in markets"[1]; our alternative proposal avoids those risks.

2. Our alternative is a radical measure: evergreen standard variable tariffs (SVTs) would be rapidly phased out for existing SVT customers and their use as default tariffs prohibited. The replacement default tariff (which suppliers could also offer proactively) would be a one year fixed term (and initially fixed price) contract, after which there would be an active renewal cycle. We consider that this remedy would complement and support possible remedies 3 to 10, harnessing the power of competition to achieve efficient pricing and stimulating innovation for the benefit of consumers.

Increased consumer engagement

3. We have observed that a contract renewal process is a very effective driver of engagement, both in the energy market and more widely. Comparison between sectors shows that car and home insurance, which have annual renewal processes, have higher switching rates than energy. Our own experience suggests that engagement rates when fixed term energy products come to an end are much higher than at other times – including SVT tariff increases.

4. The significance of an "end of deal" prompt should not be underestimated. In our experience, within 3 months of a tariff maturity, [**CONFIDENTIAL**]% of our customers have made an active choice: around [**CONFIDENTIAL**]% have decided to leave us and around [**CONFIDENTIAL**]% have chosen another product with us; only [**CONFIDENTIAL**]% have made no choice and are therefore on the default standard variable tariff.

5. Furthermore, under our alternative remedy, we would expect the increased volume of tariff maturities (around three times the present number) to concentrate competitive activity. Not only would consumers receive notifications (in a format prescribed by Ofgem) from their own supplier, but rival suppliers and PCWs would seek to target their marketing efforts at these maturing customers.

6. By contrast, the only trigger point at present for SVT customers is a global price increase. In the last 20 months, when SVT prices have been falling, there has been no trigger point at all, and when SVT prices do increase, consumers may be discouraged from switching by the expectation that all suppliers will be increasing their tariffs. Indeed where a company raises its SVT prices after others have already announced increases, the direct consumer reaction can be quite mild – perhaps an order of magnitude lower than on a product maturity. Of course, the flow of "business as usual" customer losses, and switches to discounted products, continues to place competitive pressure on SVT pricing.

7. While part of the higher engagement on product maturities may reflect differences in attitudes between "SVT" and "product" customers, we think that there is good evidence that the nature of the offering is highly material. Not only is there a body of intermittently engaged customers who tend to engage more actively at a product maturity than when on

[1] *Notice of Possible Remedies* para 91.

SVT, but the demographics of (non-PPM) SVT and product customers are similar. Other initiatives, such as the prompt payment discount, show that SVT customers can show significant engagement in the right circumstances. Accordingly, whilst we do not suggest that engagement levels for ex-SVT customers at tariff maturity would be as high as [**CONFIDENTIAL**]%, we are confident they would be substantially higher than at present.

<u>Protection for consumers on default tariff</u>

8. We propose that suppliers would be free (as at present) to set the level of the default fixed term tariff. However, the significantly greater level of engagement created by the annual end-of-contract cycle would be likely to increase the proportion of 'intermittently engaged' customers. As we have previously explained, it is these intermittently engaged customers who exert the main downwards competitive pressure on SVT tariffs. If the proportion of intermittently engaged customers increases, we would expect the price gap between default and 'special offer' tariffs to reduce accordingly.

9. Suppliers would be required to use the same default tariff for legacy SVT customers, deemed contracts, change of tenancy and product expiry. This would ensure that the pool of intermittently engaged customers is maximised and that all types of customer on the new default tariff benefit from the competitive pressure on the product. It would also mitigate any risk of "adverse selection" whereby only deeply disengaged customers are left on the new default tariff.

10. A further advantage of changing the default tariff from SVTs to fixed term tariffs is that the tariff could respond more quickly to falls in input costs. Suppliers could adjust the price of the default tariff frequently (perhaps as often as monthly) since the price change would apply only to customers entering onto the tariff, not to the entire base of SVT customers. This improves the risk/reward ratio of making a price cut in order to win or retain customers.

<u>Implementation</u>

11. Our thinking on how the alternative would work in practice is continuing to develop, and we look forward to discussing the detail and mechanics of implementation with the CMA. At this stage we see the alternative working broadly as follows:-

    a. We anticipate that moving customers onto fixed term products would need to be staggered over 12 months to ensure that the number of customers maturing in any given month is manageable. In addition, a preparation period of at least 6 months would be needed before the new system starts in order for suppliers to get ready and adjust their hedging positions.

    b. At the start of the process, all affected SVT customers would receive a personalised communication informing them that their existing SVT was being withdrawn and explaining that (unless they chose another product) they would be moved onto the new default one year tariff.

    c. One year later, the customer would go through a maturity process (similar to the 'fixed price end of tariff notification' today) which constitutes a clear "call to action". The customer would either switch to a new fixed term contract (internally or externally) or do neither.

    d. If the customer did not make a choice, he/she would move onto a new one-year default tariff, and the process would continue with another maturity cycle at the end of the next year.

12. We consider that fixed term default tariffs should not be subject to an early termination fee, and the additional risk faced by suppliers in this regard would be covered by the premium relative to 'special offer' tariffs (which are more likely to be subject to such fees).

13. We envisage that the fixed term default tariff would be on a fixed price for the first three years, in order to achieve the necessary change in customer thinking. By then, however, there will be 24 hour switching and widespread use of smart meters. Together, these developments will enable much more innovative approaches to the sale of energy as well as significantly raising the hedging risk of fixed price no exit fee tariffs.

14. Accordingly, we would recommend that from 2019 it would be desirable to give suppliers freedom to use other forms of one year contract (including capped 'tracker' or variable discount tariffs) as an alternative. This could both promote longer term innovation and offer protection in less benign wholesale markets where fixed price no exit fee products could be unsustainable. This is a matter which may merit further consideration.

15. It will be necessary to exempt PPM customers who do not have a smart meter from this approach because of the tariff code limitations which we have previously described. While there could be some form of annual prompt, they will need to remain on SVT for all practical purposes until a smart meter is installed. Suitable arrangements may be needed to ensure that SVT PPM customers also benefit from the increased competition that will apply in respect of other payment methods.

ScottishPower

17 September 2015