CMA
Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with Centrica on 16 July 2015

Introduction

1. Centrica said that the provisional findings and notice of possible remedies were thorough and wide ranging, and that the depth of thought and specificity of the possible remedies would permit them to engage constructively in the development of remedies.

2. Centrica supported the three principles behind the remedies, namely that of providing a framework for effective competition, facilitating widespread customer engagement, and providing safeguards for disengaged customers. However, Centrica felt that the principle of providing a safeguard to customers should only be pursued when competitive solutions could not be found. Centrica felt that the increasing numbers of energy suppliers and switching sites was evidence of a market capable of responding to competitive pressure to engage customers.

3. Centrica offered its support for many of the remedies set out in the notice of possible remedies, and believed that they could have a material and positive impact in creating the conditions for a competitive market to flourish and for consumer engagement to improve.

Profitability analysis in the provisional findings

4. Centrica expressed its disagreement with the CMA's views on profitability and consumer engagement, because it believed the market was not broken but was significantly more competitive than five years prior.

5. Centrica disagreed with the basis and conclusions of the provisional finding's profitability analysis; specifically, the calculations of profit and the capital resources necessary to generate it. Centrica said that the analysis was highly sensitive to a number of key assumptions that, in places, were inconsistent with commercial reality. Centrica thought that the profitability analysis may not stand up to independent peer review.

6. Centrica said that the profitability analysis in the provisional findings employed three methodologies (return on capital employed, competitive benchmarks, and EBIT margin analysis) which each relied heavily on a number of

assumptions that were fundamentally flawed and inter-related such that the three methodologies did not provide the independent level of comfort the CMA had suggested. Centrica also noted the sensitivity of the results to fairly small changes in the assumptions.

7. First, the CMA had created a hypothetical industry-wide intermediary fee model as an alternative to recognising the additional capital employed that would otherwise be required by a stand-alone supplier. Centrica believed the model relied on scaling up an approach used by two small energy suppliers and applying it across the market, which was not credible as it failed to identify the real level of risk capital Centrica believed would be necessary to support such an approach. Centrica noted that it had not seen the Shell contract in question and questioned whether this model would be achievable at scale without additional cost. Centrica stated that this was inappropriate to represent the reality of the marketplace.

8. Second, Centrica said the commodity cost benchmark used in the analysis did not reflect the actual costs an efficient supplier could actually achieve. It said that the lower quartile benchmark was a backward-looking construct and relied on hindsight to know which hedging strategy turned out to supply the cheapest fuel. Centrica said it therefore did not represent an achievable approach to a supplier's hedging strategy as it would not be possible to go back in time and recreate that hedging strategy.

9. Centrica also believed that the CMA assumed that suppliers had significant ability to pass through cost without exposing themselves to risk. It believed this was only true for regulated rate energy suppliers, where the risk of additional costs could be recovered after they had been incurred. It said that investors and credit rating agencies recognised this by demanding higher margins and returns from a competitive supplier compared to that of a regulated rate energy supplier.

10. Centrica said the analysis also focused on too limited a time period of data, from 2009 to 2013, and therefore excluded the entirety of the commodity cycle. It claimed that the timeframe excluded a period (prior to 2009 such as 2004/5 and 2007/8) when commodity costs reflected relative scarcity and volatility. Centrica said that the mid-tier benchmark company business model on which the CMA's calculations depended had not been tested in rising or volatile market conditions, meaning that the CMA's conclusions were not fully tested throughout the entirety of the cycle. It believed that extending the period of analysis would alter the conclusions on commodity benchmarks, margin analysis and the level of ROCE.

11. Centrica felt that these issues combined meant the CMA's profitability analysis was not sufficiently robust to support its conclusions. It believed that the EBIT margins and returns earned by Centrica were appropriate in a competitive market.

12. Centrica recognised that the small and medium enterprise (SME) market yielded higher returns; it explained that they were justified by its cost structure, bad debt, and increased risk. It felt that the SME market was in a transition due to new competitive pressures that will see the levels of profitability change.

13. Centrica believed that the higher margin for gas compared to electricity was due to greater underlying risk and more volatile return on capital in supplying gas, primarily due to weather. Centrica noted that three of the five years under review had been colder than normal. It also noted that higher returns on gas reflected its pricing strategy in a largely dual fuel market.

14. Centrica said that British Gas could be more efficient regardless of the state of the market, and that despite its large size it was currently, according to Ofgem, average in terms of efficiency.

15. Centrica said that the CMA's analysis of efficiency when comparing the larger suppliers was broadly accurate. It said that it was, however, important to draw a distinction because of differing business strategies; for example, most smaller suppliers had a different customer mix than the large suppliers, with a lower cost structure reflecting a focus on direct-debit billing, no prepayment and fewer customers with bad debt.

16. Centrica argued that companies like Shell or BP were able to charge a low trading fee to smaller suppliers because they were only using small amounts of marginal capital. It said that if they were to serve the whole market, it would need to employ very large amounts of capital and would then need to factor in the opportunity cost of drawing capital away from its core business, and either the fee would increase to compensate or the intermediary service would be withdrawn. Centrica therefore felt the CMA was incorrect in scaling up the fee for the whole market at a rate lower than it would be in the real market. Centrica noted that while it was theoretically possible for a market to form in trading these risks, few financial institutions had enough collateral capital to afford to put much into commodity trading.

17. Centrica considered the CMA's use of average tariff prices to be potentially useful in determining average price position, but felt the methodology did not take into account non price elements, dual-fuel tariffs, varied customer mixes, costs to serve and competitive strategies. Centrica recommended that the

CMA was cautious about using average tariff pricing for comparisons between suppliers.

Notice of possible remedies

Remedy 1 – 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

18. Centrica said that cost reflective pricing was sound as a principle, but that, as industry discussions had found, allocating transmission losses in a detailed, rigorous and systematic way could be complex, so there is a question around cost-benefit and its complexity – despite the validity of the principle. Centrica also noted that any scheme would need to be precise and long term because people would be making investment decisions on the back of it.

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

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

19. Centrica supported increasing transparency when DECC allocated contracts for difference (CfDs) outside the auction mechanism. It said it sympathised with the difficulty that DECC faced when having to promote certain technologies which were at a less mature phase of their development cycle. It supported increased transparency as a way for interested parties to engage in the policy-making process.

Remedy 3 – Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules

20. Centrica said that removing the cap on number of tariffs, which was part of the retail market review (RMR) rules, would help promote innovation and customer choice.

21. Centrica believed it would respond to the removal of the four-tariff limit by offering a wider product range to compete for customers they can't currently reach with limited tariff choices. [✂]

22. Centrica recommended that the CMA also considered removing current constraints on bundling tariffs with other products and relaxing the information remedies which were particularly prescriptive as to the format of how information should be provided to customers. Centrica also specifically supported the proposal to remove the ban on cash discounts, as it said they could act as a trigger for getting customers to switch supplier.

23. Centrica said that RMR had restricted route to market innovation as well as product innovation, so rolling back RMR would improve how new products reach the market, and would lead to greater flexibility in how customers would be served, for example through greater competition at the PCW level.

Remedy 4b – Removal of exemption for Centrica on two-year inspection of gas meters

24. Centrica said its exemption from two-year inspections of gas meters did not create an uneven playing field amongst its competitors. It said that to obtain the derogation it had incurred additional expenses because it invested in a specialist team to monitor theft and safety, and Ofgem had gained further assurance from the roll-out of smart meters. Notwithstanding this, Centrica did propose that other suppliers could benefit from its exemption, where it gained a customer from Centrica, by having a two year grace period to inspect that customer's meter.

Remedy 5 – Requirement that energy firms prioritise the roll-out of smart meters to domestic customers who currently have a prepayment meter

25. Centrica said it had installed over 1.5 million smart meters, and noted that consumers with smart meters were more satisfied, contacted customer service less often, and had reduced consumption on average. Centrica thought that smart metering had the potential to significantly change the market.

26. Centrica agreed with the principle that smart meters could have a significant impact on pre-payment customers. Centrica said that smart meters would entail a lower cost to serve and hence lower tariffs for pre-payment customers to levels closer to that of direct debit customers. Centrica noted, however, that prioritising roll-out for prepayment customers would have unintended consequences due to the infancy of the technology, and complexity of the infrastructure, as well as add cost to existing roll out plans. Centrica also noted that such an approach to roll out could exclude credit customers who would choose smart prepay if it were available. Centrica considered that the earlier smart meters were rolled into the data communications company (DCC), the better for developing competition.

27. Centrica said that having in-home displays provide information in currency, rather than in an industry value, promoted understanding and completely changed the way customers engage with energy.

Remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

28. Centrica said that it did not see a role for Ofgem in operating its own price comparison website.

29. In relation to microbusinesses, Centrica supported suppliers providing more information to price comparison websites. It said that transparent and binding prices would encourage PCWs into that market.

30. In relation to the domestic market, Centrica supported price comparison websites (PCWs) being a force to sharpen competition by negotiating with individual suppliers. It believed that suppliers were chosen on PCWs based largely on price position and branding, and thus customer behaviour would force suppliers to assess their market position more frequently.

31. Centrica expressed concern that supplying PCWs with customer data, such as the end date of contracts, would require express consent and might complicate the market rather than promote engagement.

Remedy 7 – Measures to reduce actual and perceived barriers to accessing and assessing information in the SME retail energy markets

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

32. Centrica said that the Ofgem TPI code of practice was a positive initial step but was not prescriptive enough, especially around informing the customer of commission amounts and market coverage of brokers in the microbusiness market.

Remedy 8 – 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

33. Centrica believed that ending auto-rollovers in the SME market was the right outcome for both the customer and market alike, which is why it ended the practice. Centrica said, overall, this led to a significant increase in customer engagement and fundamentally changed its relationship with customers.

Remedy 9 – 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

34. Centrica said its research indicated that the complexity of bills was a barrier to engagement. It said that 70% of what was on a bill as prescribed, which led to cluttered information, and that it wanted to test a simplified bill that it thought would significantly improve engagement. In addition, Centrica noted that customers did not engage with the tariff comparison rates and personal projections, especially on the phone. Centrica felt that the way it communicated with customers should be a source of differentiation and competition amongst suppliers.

Remedy 10 – Measures to prompt customers on default tariffs to engage in the market

Remedy 11 – A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

35. Centrica believed that it did not have market power over customers that were disengaged, nor that those customers were exploited, but rather that consumers valued and actively chose the standard variable tariff as it reduced price volatility. Centrica recognised, however, that it had been unable thus far to systematically prove the motivation of customers to choose the standard variable tariff to the satisfaction of the CMA, although Centrica did note that a significant proportion of its new customers joined on SVT.

36. Centrica believed that implementing a transitional safeguard regulated tariff would be difficult to introduce at the market level without unintended consequences.

37. Centrica had concerns regarding the possible remedy of a regulated safeguard tariff, which it felt risked undermining engagement in the market by providing false assurances for customers who would default onto it. It also said that determining the price of a safeguard tariff would be complex and contentious. Centrica believed that this remedy should only be pursued if the market was so broken that other remedies did not work, as it would be difficult to implement and risked resulting in unintended consequences.

38. Centrica said that over the preceding seven years there had been periods of significant price advantage for customers on a standard variable tariff, and that it was concerned that the CMA had undervalued the potential benefits of the tariff by basing its assessment on a two to three year period of unusually benign market conditions.

39. [✂]

40. Centrica expressed its broad support for remedy 10 (measures to prompt customers on default tariffs to engage in the market). It said that the market was changing with lots of new entry, citing PCWs and smart meters as an encouraging example of how new technological innovation can improve consumer engagement.

41. Centrica suggested that, rather than some form of safeguard regulated tariff, ending all evergreen tariffs and initiating a regime of multiple prompts would be a non-distortive remedy that, alongside some of the other remedies around giving information to customers would increase the level of customer engagement.

42. Centrica said, under this proposal, no new customers would be placed on an evergreen tariff in order to prompt consumers to engage. Centrica said that the evergreen tariff should then be withdrawn gradually from the market for existing customers, starting with the longest-serving. This would allow time for the other CMA's other remedies to take effect, would help avoid large spikes in customer contact, and would also give time for more smart meters to be rolled out. Centrica suggested that those who did not engage or switch when their product was withdrawn should be placed onto a one-year tariff, at the end of which they would be prompted to switch again. Centrica said that this tariff should be set by suppliers to enable the price to reflect material, structural differences in supplier cost bases. It should also be permitted to be a variable price in order for suppliers to be able to manage risk efficiently.

43. Centrica drew a distinction between customers who were actively disengaged and those who were unable to engage – it noted that there were limits to encouraging those who simply, for whatever reason, did not want to engage/change tariffs, and that government social policies should provide for truly socially vulnerable customers. Centrica claimed that two different sets of solutions could in theory be pursued; one focusing on competition and promoting engagement, and the other on prescriptive regulatory intervention such as price regulation. However, Centrica considered the market to be favourably positioned to respond to the stimuli of competition and engagement and advised against pursuing prescriptive regulation.

44. Centrica said this proposal would lead to an intense period of competition arising from the ending of evergreen contracts, but felt they could compete to win other suppliers' customers in a competitive environment.

45. In relation to the method of prompting customers, Centrica said that customer bills were not necessarily the best way to prompt engagement, and that other

methods of communication such as email and SMS should be considered. Centrica noted that the level of engagement at the end of a fixed term contract was quite significant. Centrica also noted that prompting too frequently risked lowering engagement. It said that the timeliness and relevance of prompts ere key to successfully triggering engagement.

46. Centrica suggested that a prompt from a regulator was unlikely to have as much impact as from an energy supplier, as a regulator could not provide a customer with a product. It also thought that a regulator taking on such a role would counteract the CMA's stated goal of getting the market to operate more efficiently on its own.

47. Centrica disagreed with the principle of the safeguard tariff, it felt that pricing in components such as the network charges and certain obligations costs (eg the Warm Home Discount) would be relatively mechanistic and uncontroversial but the Energy Company Obligation (ECO) and operational costs would be more difficult.

48. Centrica felt that protecting certain sub-categories of vulnerable customers, such as the disabled or those with little educational background, was primarily the responsibility of the government to resolve rather than the market or supplier.

49. Centrica noted that other sub-categories of vulnerable customers were those tied to energy deals via some landlords and some housing associations, and pre-payment customers who had a more restricted choice of tariffs.

Remedy 16 — Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

Remedy 17 – Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

50. Centrica expressed its agreement with the provisional findings' focus on the impact of regulatory policy and decision-making on competition in the energy industry. Centrica said that for a competitive market to thrive, the regulatory regime should be clear, create stability, and prioritise competition over other policy objectives.

51. Centrica believed that regulatory interventions had impeded competition and restricted the number of products and services it could offer customers.

52. Centrica said that it had concerns that undue regulatory intervention plus a focus by Ofgem on equality of outcomes across customer segments was stifling innovation and harming effective competition. It said that it supported refocusing Ofgem's obligation to consider first and foremost the promotion of a competitive market, as it was before 2010.

53. Centrica broadly supported the delineation of the different roles of Ofgem and DECC. Centrica said that DECC had strayed from being the principal policy maker at a high level to micro-managing the industry at a low level.

54. Centrica said that the government had too great an influence over Ofgem, and that Ofgem's independence should be strengthened to avoid politicisation. It said this led the industry into the domain of politics rather than solving issues with competition and engagement.

Remedy 12a – Requirement to implement Project Nexus in a timely manner

55. Centrica supported requiring energy suppliers to implement Project Nexus to the deadline of October 2016.

Remedy 13 – 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

56. Centrica said that half-hourly settlement for electricity would require extensive changes to the system, and it did not feel there was enough evidence of its benefits to warrant its support. Centrica said it already offered time of use tariffs based on a static profile settlement, and questioned whether a dynamic system based on real time would be a worthwhile investment until the smart infrastructure was more developed.

Remedy 14 – Remedy to improve the current regulatory framework for financial reporting

57. Centrica expressed its support for the transparency of financial information and noted that it was the first supplier to voluntarily submit its segmental statements audited. However, Centrica did not support Remedy 14 as proposed. Specifically, Centrica expressed concern that moving to a new theoretical construct for publication of this information would not increase trust because suppliers would have to reconcile those figures back to their actual performance (as they already had to with the SMIs).

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

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

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

58. Centrica said that the re-engineering of the industry's infrastructure was a one-off opportunity to simplify code governance. It also believed that a mechanism to limit the amount of time discussions could be held for would be appropriate due to the current lengthy process to make changes.

59. Centrica noted that Ofgem already had a role as an independent code adjudicator, and felt that the focus should be on better use of existing powers rather than simply shifting them to a similar but new body.