

ENERGY MARKET INVESTIGATION

Summary of hearing with Scottish Power on 25 August 2015

Opening statement

1. Scottish Power said that it agreed with much of the provisional findings, particularly the observations on the wholesale market and the unintended consequences of badly framed regulatory policy interventions.
2. Scottish Power believed competition would deliver the improvements required in the energy market and remedies 3 to 10 complemented this objective.
3. Remedies 3 to 10 had the potential to enhance retail competition and mitigate the issues identified for domestic and microbusiness customers. The removal of the tariff constraint, the reduction of switching barriers and the provision of better information would be effective for domestic consumers, as would measures to remove the confusion and stickiness that existed within the microbusiness market.
4. Remedies 3 to 10, in combination with market developments such as smart metering, midata and next-day switching would increase engagement and harness the power of competition to drive efficiency and stimulate innovation for the benefit of consumers, however actively a consumer chooses to engage.
5. Scottish Power believed that remedy 11, the transitional safeguard price control, was interventionist and posed a huge risk to competition. Remedy 11 appeared to have come from the alleged detriment of £1.2 billion a year for domestic customers, which was at the core of the provisional findings, and (in addition to testing the merits of the remedy in its own terms) it was important to test and validate the logic behind this calculation and whether it justified such an intrusive remedy.
6. Scottish Power had four reservations regarding the Competition and Markets Authority's (CMA) efficiency assessment. These concerned: the treatment of wholesale costs; the use of annual benchmarks; the need for the control for the payment method; and, the use of the lower quartile benchmark.
7. First, Scottish Power recognised that benchmarking wholesale costs was extremely difficult, but it did not agree with the CMA's conclusion that the

hedging strategies of the six large energy firms (SLEFs) were inefficient compared to the mid-tiers' purchasing on the spot market. Scottish Power said it could demonstrate the opposite of the CMA's findings in the case of Scottish Power by using an earlier time period to that investigated by the CMA.

8. Second, it was not appropriate to benchmark on a year-by-year basis, which risked confusing cost volatility with inefficiency: normal regulatory practice was to benchmark period averages.
9. Third, when indirect costs were benchmarked, it was essential to control for differences in payment method mix. A quarterly credit or prepayment customer was significantly more expensive to serve than a direct debit customer. A company could not avoid this differential and it applied to all firms in the market and these customers had to be served.
10. Fourth, the use of lower quartile benchmarks, as opposed to an average benchmark, predetermined a finding of inefficiency and was inappropriate for wholesale and indirect costs. Scottish Power's economic advisers believed that the CMA used an inappropriate population of mid-tier suppliers to validate the comparison. By correcting this selection, Scottish Power's results in the average indirect costs for mid-tier suppliers were very close to the average figure, not the lower quartile figure, for the SLEFs.
11. Regarding the CMA's profitability analysis, Scottish Power believed the use of return on capital employed for retail businesses was fraught with difficulty and any conclusions needed to be sense-checked against the earnings before interest and taxes margin figure. Scottish Power recommended that more thought should be given to the customer valuation component and that this was supplemented with a margin benchmark.
12. Scottish Power said that it was very difficult to replicate the models used by the CMA, but based on the evidence and analysis it had seen, the suggested overcharge of £1.2 billion was not plausible.
13. Scottish Power did not believe that the proposed price control was necessary and even with a headroom allowance, it would harm competition by reducing the incentive to switch and deter new entrants. A price control would undermine many of the benefits that would flow from remedies 3 to 10 and would fail to address the root cause of the issues the CMA had identified. If the problem concerned standard variable tariffs (SVTs), these should be abolished.
14. Scottish Power had some concerns on the detail of the other proposed remedies, but, in principle, it was broadly supportive of the recommendations

for locational charging, revised duties for the Gas and Electricity Markets Authority (Ofgem) and reform of the settlement process and code governance.

15. Scottish Power was in broad agreement with the CMA regarding those remedies it was not minded to consider further. Scottish Power did have some concerns about the small supplier exemption and felt that changes were required to the calculation used by the Department of Energy & Climate Change (DECC) so that it reflected actual market activity.

Profitability analysis in the provisional findings

16. Scottish Power said that using the benchmark wholesale cost in the profitability analysis was a very difficult undertaking as it was based on a risk profile, rather than an assessment of any inefficiencies in the market and how these costs were managed. Companies made different hedging decisions: larger suppliers hedged as they had larger and more variable customer bases, while smaller suppliers generally purchased energy on a spot basis.
17. Scottish Power understood that it was difficult to benchmark wholesale costs and had emphasised to Ofgem over a number of years that the correct way of segmental accounting was to use the transactions that were allocated to a company's trade book and transfer pricing should be avoided.
18. Different hedging strategies meant retail prices varied between suppliers. Scottish Power's retail profits had been hit because of the price paid for coal pre-2009. In contrast, a long-term position taken on gas contracts enabled it to offer the lowest standard gas solus price in the UK.
19. Scottish Power believed that the efficiency component of the excess charging found by the CMA was due to the benchmarks it had chosen. In asking the question 'is there excess charging in the market?', the benchmarks used for the major cost components were very important.
20. Scottish Power acknowledged that a range of supplier performance levels and costs existed. Different businesses may have different indirect cost elements, which reflected their cost to serve, and some may be higher not due to inefficiency but because they had chosen to service a more expensive customer segment.
21. Scottish Power did not believe that cost dispersion in itself was a good indicator of inefficiency and in a world where there were above average and below average performers, the average benchmark should be used.

22. Scottish Power said that it was very difficult to comment on competitors' costs, but it believed it had the first or second lowest direct costs in the industry. It offered competitive prices and its fixed products competed with smaller suppliers. Over the last 12 months, it was the only one of the SLEFs that had not witnessed a decline in its customer base.

Notice of possible remedies

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

23. Scottish Power did not have any concerns regarding price comparison websites (PCWs). Some simple amendments to the confidence code, to allow the grouping of similar tariffs from the same supplier, would improve the search performance for consumers.
24. The removal of the four tariff rule would drive innovation and lead to the re-emergence of tariffs that were popular pre-Retail Market Review, for example the no standing charge and capped price tariffs. Bundled products were also an area Scottish Power would like to develop, but such products did not warrant the use of one of the four tariff slots. It would also look to introduce special interest, niche tariffs, such as green tariffs.
25. Scottish Power had set out a number of changes that it felt should be made to Retail Market Review licence conditions and the most effective way for these to be enacted was for the CMA to make a licence modification recommendation to Ofgem.

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

26. Scottish Power included quick response (QR) codes on its customer bills. The QR code data contained information such as tariff name and rates and annual consumption and this would enable customers to use their smartphones to access PCWs and compare and switch energy companies.
27. Scottish Power said that the level of detail that was included on customer bills was driven by very prescriptive rules and was confusing for customers. Customers were only interested in the cost of their energy usage and how this was broken down. A simplified, standardised format for the regulatory information would be more helpful with companies designing bills that work best for customers.

28. Scottish Power said that the tariff comparison rate was not really used by its customers. The information needed to provide more accurate quotations will hopefully be available with the advent of smart metering.

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

29. Scottish Power believed that the reintroduction of doorstep selling would provide more reach into its competitors' SVT customers than was currently the case. The effective prohibition on doorstep selling had affected switching levels and the decline in SVT switching was very dramatic.
30. Scottish Power believed it had the least number of SVT customers among the SLEFs and doorstep selling was an important means of targeting that segment of customers that did not engage via the internet. Regulatory compliance made recruiting via doorstep selling very expensive, roughly [X] the cost of an acquisition via a PCW.

Scottish Power's alternative to remedy 11 – A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

31. Scottish Power believed that engagement was high when certain trigger points occurred. The key trigger in energy was product maturity, when a customer's contract ended and they had to choose a new tariff. In the current market, within three months of their contract ending, around [X]% of Scottish Power's customers left, [X]% had chosen another product and [X]% had defaulted to the SVT.
32. Scottish Power believed these figures demonstrated that engagement at the maturity point was enormous, with 70% of customers reacting.
33. SVTs were also an evergreen arrangement, where there was no end date and no natural trigger. The only prompt was a global price increase which customers were alerted to via the media and their energy supplier. The price increase would lead to an increase in switching and conversion rates and Scottish Power was keen to explore how a regular trigger point could be built into the SVT product.
34. Rather than creating more and more regulations around the SVT product, Scottish Power proposed the abolition of the evergreen SVT. Default tariffs would only last for one year, at which point customers would have to engage with the market.

35. Implementation of the proposal would see all SVT customers put on a one-year, fixed-price, no termination fee product, around 19 million households would be affected and given the systems and technology work that was required, the product would need to be phased in over 12 to 18 months. Scottish Power did not believe that its existing hedging would impact on this timescale.
36. At the end of the first year, the customer would switch or choose an alternative product. If they did neither, they would default to another one-year tariff and the process would start again. Customers could switch at any time they wished.
37. Scottish Power saw two benefits of its proposal:
 - At the end of the first year, customers would receive a letter stating that their contract has come to an end. The incumbent would work hard to retain that customer as competitors, PCWs and smaller suppliers would target them, as they did with their fixed-price products, and this would lead to increased switching.
 - Movements in underlying input costs would be reflected much quicker in prices, which was evident in the fixed-price product market; when wholesale costs changed, within a month fixed-priced products changed.
38. Scottish Power noted that industries such as car or home insurance, where an annual trigger existed, had higher switching rates than energy.
39. SVT prices moved only once or twice a year due to the hedging undertaken by suppliers and because around 19 million households were affected by a price change. In contrast, the one-year, fixed-price default tariff could be changed as frequently as a supplier required and customers were not tied to the product for one year and could leave without incurring exit fees.
40. The price of the one-year, fixed-price default tariff would be determined by the market. Licence conditions existed to ensure that a supplier could not charge an unduly onerous price to those disengaged customers that found themselves on a deemed tariff.
41. The alternative remedy would allow companies such as Scottish Power to acquire SVT customers from other large competitors. Scottish Power believed its proposal would complement the other remedies and lead to a more innovative approach to products and information provision to attract customers whose contracts were maturing. PCWs would also adapt their strategies to cope with these new customers.

42. Scottish Power also believed the proposed remedy should not be limited to those whose contracts had ended and should also capture a broader range of customers, such as house movers.
43. Scottish Power hoped that the market would protect to some extent that group of inactive customers that persistently did not engage, but for engagement to be worthwhile, there had to be a penalty for being inactive. It was hoped that the alternative remedy would make that group much smaller because of the trigger point.
44. Scottish Power believed that suppliers were best placed to identify what tariffs were needed to meet the needs of a variety of customers. Customers should be allowed to respond to market incentives and failure to do so would distort the process.
45. Suppliers actively pursuing customers would also increase and the levels of commission per customer that suppliers paid to PCWs would be expected to decrease due to the higher number of customers they processed.
46. Scottish Power had figures that showed that, of those customers who defaulted to an SVT, within a year, around [X] had moved to another tariff or switched. It also noticed a big uplift in switching following a price rise.
47. Scottish Power had a 'with freedom' clause in its products, which meant customers faced no penalty for moving to another Scottish Power product and internal switching in response to price changes had increased.
48. When the price of its one-year, fixed-price product decreased, customers moved to other products, with some moving [X] times. In one instance, Scottish Power had forwarded purchased energy for [X] customers, but when wholesale prices dropped, only [X] customers remained on the fixed-price product.

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

49. Scottish Power noted the success of the DECC 'Power to Switch' campaign and the reach it had into SVT customers. But it felt that such campaigns could only achieve a small amount of success as they only alerted people to the possibility of switching and did not provide the trigger that would encourage consumers to engage.
50. Scottish Power believed that in a market that was inherently changing, the safeguard regulated tariff (SRT) would dampen the incentives for people to

engage and switch as they would believe they were on a government protected tariff.

51. Scottish Power identified direct debit customers as among the least disengaged. Many customers on fixed tariffs used this method of payment and direct debit customers were generally easier for competitors to reach. If an SRT were introduced Scottish Power believed that it should only apply to highly disengaged customers – those paying by a method other than by direct debit who had been on an SVT for longer than three years.
52. Addressing the restrictions that limit the number of tariffs available in the prepayment market was another way of reaching the most disengaged. Scottish Power would view removal of the ban on cashback promotions as a positive move as it had previously used cashback incentives to acquire a number of customers on prepayment meters.
53. Scottish Power believed the SRT would squeeze both margins and dispersion, reducing the incentive for suppliers to compete. It had undertaken some modelling and initial results had shown that under an SRT, the differential between SVT and non-standard tariffs dropped from £125 per customer to about £87 per customer, equating to around a 40% reduction in switching.
54. Scottish Power believed that the SRT could have unintended consequences, in that it may not just affect those customers at which it was aimed. It might capture consumers who have defaulted into the SRT, who might be deterred from engaging by the fact they were on a government regulated tariff, designed to protect consumers.
55. A further unintended consequence was the creation of barriers to entry for new suppliers. There would be fewer customers to target and customers would be less likely to engage as they believed they were on a protected tariff.
56. Suppliers would also be fearful that, as in many other European jurisdictions, what was intended as a temporary measure became permanent and what was a price to beat became a price that could not be beaten.

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

57. Scottish Power believed Citizens Advice was best placed to manage an independent PCW due to the consumer interface it already had. Scottish Power was unsure as to the usefulness of an independent PCW for retail and microbusinesses and did not believe it would massively increase engagement

or trust. It was important to have PCWs for microbusinesses, but it believed an appropriate solution should be delivered by the private sector.

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

58. Scottish Power believed there was an incentive to prioritise prepayment customers due to their high service and payment network costs. It believed that the roll-out plans that suppliers were obliged to submit to Ofgem could be modified to include sub-targets such as prepayment customers, which Scottish Power believed would fulfil the objectives of the remedy.
59. Scottish Power was not currently engaged in mass scale smart meter deployment. It intended to focus on installing SMETS-2 meters rather than SMETS-1, and was planning to wait for the Data and Communications Company to enable the installation of the SMETS-2 meters. It did not make commercial sense to install the SMETS-1 model at large scale when it would be replaced by SMETS-2, and DECC was aware of this concern. Scottish Power believed it could still meet its obligations under the current timetable for the installation programme.
60. Regarding microbusinesses, Scottish Power believed that these could be defined as profile 3 and 4 customers, with a cap of 50,000 kilowatt hours a year for electricity and 150,000 kilowatt hours a year for gas.
61. Scottish Power believed that the microbusiness sector should replicate the domestic sector with regard to the provision of price lists, published for fixed-price deals, a 28-day switching rule and no need to give advance notice of termination. These rules would not apply to larger businesses due to the higher cost of procuring energy for these customers and their greater ability to negotiate their own terms.
62. Removing these restrictions would increase the switching rate for small businesses. Third party intermediaries (TPIs) would enter the market and their published prices would increase transparency and engage small businesses.
63. Scottish Power believed that negotiated prices would invalidate the prices advertised by PCWs. Whilst special rules would need to exist around odd meter configurations or credit issues, if the aim was to engender confidence among consumers, the price advertised should reflect the final price.
64. Scottish Power did not believe it was difficult to provide appropriate tariffs for profile 3 and 4 customers and disagreed with the proposition that debt profiles and usage patterns were more difficult to profile.

65. The development of TPIs would move the market away from the use of brokers and individually negotiated tariffs. The rules governing microbusiness TPIs should be similar to the TPI confidence code in the domestic market.
66. Scottish Power customers that rolled-over to a one year, fixed-price tariff could leave that tariff within 28 days. The ability to exit rollover contracts and the increased transparency via the price comparison tables would increase engagement.

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

67. Scottish Power was in favour of Project Nexus and would implement it within the planned timetable. Agreement between industry participants was essential and RWE npower had proposed a Uniform Network Code modification, which would impose liquidated damages on Xoserve and gas transporters that did not deliver on time. It was supportive of the modification and believed that Ofgem would approve it.
68. Scottish Power had concerns regarding the constituents of the Uniform Network Code panel and for a number of years had argued that it was unfairly dominated by gas transporters and suppliers to large customers, with domestic users underrepresented. Scottish Power had engaged in a prolonged battle on Nexus and gas settlement reform and it believed both Ofgem, the CMA and Xoserve now recognised that change, via licence modification on the gas transporters, was necessary.

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

69. Scottish Power believed that gas shippers should be obligated to submit meter readings in a timely manner and that a performance assurance framework, as existed for electricity, should exist for these readings. This lack of governance created incentives to game the system.

Remedy 13 – Requirement that domestic and small and medium-sized enterprise 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

70. Scottish Power was in broad agreement that the move to half-hourly settlement would be essential to derive the full benefit of smart meters and dynamic time of day pricing. Given the costs of implementing the smart meter roll-out, Scottish Power wanted to ensure that the introduction was cost effective. It had undertaken a smart meter roll-out programme in New

England, where half-hourly settlement was introduced one year after the roll-out was completed, which it felt was an appropriate timeframe.

71. Scottish Power was not concerned that half-hourly settlement had taken such a long time to implement and said the absence of smart meters was a key factor. There was a need to agree an implementation within the next two years.

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

72. Scottish Power said that whilst the proposed remedy addresses competition between different parts of Great Britain, it was really important to address the suboptimal position of Great Britain generation versus European generation, because of the massive import subsidies that existed in the market.

Remedy 2a – DECC to undertake and consult on a clear and thorough impact assessment before awarding any Contract for Difference (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

73. Scottish Power supported improved and transparent impact statements for the allocation of CfDs. It also noted that, given current circumstances, DECC and HM Treasury may not be in a position to allocate large sums of money to the different pots. It did believe, though, that the money would be used efficiently and had no concerns about the allocation.

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

74. Scottish Power explained that its financial reporting system was based on a trade book structure with a trade book for each business. Wholesale costs were allocated between trade books based on the relevant trading positions. Scottish Power did not have a transfer price as such; the price reported reflected the market price. This system of reporting permeated both its financial and regulatory reporting and it was keen to maintain this to ensure all bodies received the same information.

75. Scottish Power had provided data to the CMA that was based on judgements and at a more granular and disaggregated level than Scottish Power currently used in its reporting. It was concerned that if this data was reported, users would not understand the judgements and granularity. Through the CMA exercise, Scottish Power had attempted to provide consistent information that could be utilised by all stakeholders.
76. Scottish Power had changed its trade book structure in 2011 and included its energy management division in its segmental reporting in 2013. Both changes were an attempt to reflect actual costs, not a transfer price. Its trade book structure reflected the total purchases and sales for its customer base. It also reported on its energy management business, which, because of the low-risk approach that was adopted, made very little money as it basically operated on behalf of the retail and generation businesses.
77. In other companies, the transfer price from a separate trading division, which was totally separate from the core business and resided in another country, was evident in the financial reporting. Scottish Power was not in favour of this approach and believed the divisional structure it used should be adopted industry wide.
78. Scottish Power had recommended to Ofgem that companies should show the price that was paid for the wholesale cost for gas and electricity. If a company did not look at the actual cost for gas and electricity and instead used the transfer price, how did it know if it had made any money?
79. Scottish Power put a lot of data into its consolidated segmental statements and believed that this would be sufficient for Ofgem to publish and address issues of transparency around costs and prices. If other information was identified, that was not confidential, Scottish Power would consider including this. But the consolidated segmental statements should reflect actual transactions, rather than transfer prices.
80. Scottish Power noted that the transparency issue had benefited from the launch of market publications that gave rolling 12-month averages and provided an independent price not dissimilar to a normal commodity price.

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

81. Scottish Power was in favour of amending Ofgem’s statutory objectives to increase its ability to promote effective competition and had proposed a review that went further than that suggested by the CMA. It believed Ofgem’s

duties had increased through successive rounds of legislation and there were a number of conflicting policy objectives which lacked an overall coherence.

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

82. Scottish Power was not in favour of giving Ofgem more power to push through code amendments without properly considering the concerns and advice of market participants. It was important that that process was not spun out unduly. But in the current environment, delays with code amendments tended to lie with Ofgem and Scottish Power was not sure that without proper scrutiny and debate Ofgem would always make the correct decision.