

# Centrica response to the CMA's Provisional Decision on Remedies

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*Non-confidential version*

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## Executive Summary

1. Centrica has long been a supporter of competitive markets on the basis that they promote customer choice, provide incentives for good service and innovation, and enhance customer trust. For this reason, Centrica viewed the CMA's investigation as an opportunity to focus on competition and innovation in the energy market.
2. At the start of the CMA's process we stated that it would only be possible to restore consumer and investor confidence in the sector if the investigation encompassed all aspects of the operation of wholesale and retail energy markets. We therefore welcome the fact that the investigation has been broad in scope, and comprehensive in the issues it has considered.
3. We also note that many of the CMA's findings - firstly in the Provisional Findings, and now in the Provisional Decision on Remedies (PDR) - have confirmed that energy markets are, in the main, functioning well. In particular, that competition in wholesale electricity and gas markets is generally effective, and that vertical integration may create efficiencies that benefit consumers.
4. While it is important not to overlook these positive aspects of the PDR, there are numerous areas where we disagree with the CMA's findings on the basis of them being factually incorrect. This response sets out these areas of disagreement in detail.
5. In addition, whilst we are supportive of those remedies proposed by the CMA that are broadly consistent with more effective competition, we have a number of issues with the way in which some of them have been designed. Where this is the case, our response sets out ways in which we consider the CMA's proposed remedies could be improved.
6. We would particularly like to highlight our views that:
  - the **detriment analysis** - presented by the CMA for the first time in the PDR - fails to offer meaningful insights regarding how well competition is working and raises a number of serious process issues. The analysis is also seriously flawed in that it fails to recognise that variable and fixed products cannot be compared on a like-for-like basis. It also implicitly assumes that longer-term energy purchasing is detrimental to consumers, yet fails to test this assumption explicitly.
  - the **transitional price cap proposed for prepayment customers** has not been shown to be necessary and, as currently envisaged, is highly disproportionate; it is set at such a low level that it will damage customer engagement and result in unsustainably low supplier revenues.
  - the proposed **Ofgem database remedy** risks disengaging customers if customer consent is not secured appropriately, and as proposed appears inconsistent with the direction of data privacy regulation.
  - while we support the proposal to **remove the tariff restrictions introduced following the Retail Market Review**, we see no justification to delay their removal until 2017.
  - the concept of **market-wide cheapest tariff messaging** is impractical and fundamentally undermines the aim of some of the other remedies. The removal of tariff restrictions will enable customers to benefit from more products being offered

which are very different from each other. However market-wide cheapest tariff messaging is incompatible with such a varied range of offerings.

### ***Updated assessment of detriment***

7. The CMA has based a key element of its detriment analysis on a new and highly simplistic comparison of the (mainly SVT) prices of the large suppliers to those of OVO and First Utility (mainly FTC), while omitting prices of the other two mid-tier suppliers Utility Warehouse and Co-operative Energy over the period 2012-15. We consider such a comparison to be fundamentally inappropriate and also highly misleading.
8. These mid-tier brands entered the market relatively recently, and appear to be building customer numbers rather than achieving sustainable returns<sup>1</sup>. OVO, for example, reported a loss of £33m in 2014. Therefore the 2012-15 pricing of these suppliers cannot be portrayed as being representative of a sustainable competitive benchmark.
9. The customer mix, product mix and consumption profile of OVO and First Utility mean that the results of the analysis are distorted, and a range of obvious differences in suppliers' costs have not been appropriately reflected in the CMA's analysis. These include costs associated with ECO, bad debt and the smart meter roll out. A crude price comparison as proposed is therefore not a valid approach to estimating detriment, and can be expected to substantially overstate the level of detriment suffered by consumers.
10. Instead, the CMA's detriment calculation is largely explained by differences in approach to purchasing energy among suppliers. Of the £1.7bn of annual "detriment" alleged by the CMA in 2014, less than £0.7bn is explained by even the CMA's own analysis of excess profitability and inefficiency. This suggests that the majority of the CMA's "detriment" assessment is in fact explained by these differences in product mix and movements in commodity markets, and as such are not a reliable basis on which to set remedies.
11. Moreover, even the £0.7bn figure is substantially overstated resulting from an assessment of profitability that still fails to take proper account of the costs that a large stand-alone supplier with British Gas's customer and fuel mix would face in managing risk. We have previously explained this issue in our responses to the Updated Issues Statement and the Provisional Findings, as well as in our Oral Hearing in July 2015. CRA's Confidentiality Ring report presents sensitivities which show that under reasonable assumptions the CMA's calculation of Centrica's ROCE (and therefore detriment) would fall substantially.
12. The conclusion that detriment has increased in recent months – and as an inference that competition has softened in the market – is incorrect. Indeed, many other metrics (for example the increasing market share now held by the non-Six Large Energy Firms (SLEF) suppliers) point to the opposite conclusion. Instead, the CMA's detriment analysis is better described as a measure of whether – with the benefit of perfect hindsight – different energy purchasing strategies resulted in lower or higher prices.
13. The CMA's unwillingness to take account of product differences (and particularly differences in energy purchase cost) appears to reflect a fundamental scepticism over

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<sup>1</sup> OVO does not appear to intend to accept low or negative EBIT margins in the long term. Stephen Fitzpatrick of OVO stated in February 2014 that "We are willing to accept a lower profit margin. We aim for 3 to 4 per cent." <http://businesslife.ba.com/People/Interviews/business-life-meets-Stephen-Fitzpatrick.html>

the value of price smoothing. This is also reflected in the CMA's proposals on financial reporting. However we suggest this aversion to longer term purchasing is excessively influenced by the recent phase of the commodity cycle. There is no reason to believe consumers would be better off in a scenario where all suppliers purchase energy in short term (typically volatile) markets. In this respect, it is our view that the CMA has been unduly influenced by the commodity market conditions which have existed during the investigation. Indeed, we consider the remedies and supporting analysis would be unsound in the context of different market conditions.

14. If the CMA believes that longer term energy purchasing is detrimental to consumers it should clearly say so, in order that this hypothesis can be properly tested and subjected to a normal process of consultation and challenge. We believe that the hypothesis would not survive such a process.
15. The introduction of this new detriment methodology at such a late stage in the CMA's investigation also raises a number of serious procedural concerns. Placing such weight on new analysis in the final consultation of this two year investigation fails to give us adequate opportunity to debate the methodology and the extent of any detriment to consumer outcomes in the retail energy markets.
16. We are also extremely concerned with the suggestion that the CMA plans to include in the Final Report this alleged level of detriment split by supplier and fuel type. To publish new findings on "detriment" that are based on such a flawed and non-comparable assessment would be unjustified. It would severely damage the suppliers concerned and significantly damage trust in the market – creating a real risk that engagement would be harmed rather than supported.
17. The risk of reputational damage is particularly relevant for Centrica given the analysis fails to take account of its gas price cut in 2015, which none of the other suppliers matched, and which the CMA has not taken into account in its extrapolation of a 2015 detriment estimate. Publishing these estimates in their current form would therefore misrepresent Centrica's position in particular, as well as being misleading for the industry as a whole. In any event, we regard such publication as without justification.
18. In summary, the CMA's new analysis of detriment is fundamentally flawed, and does not provide a sufficiently robust basis for the CMA's proposed remedies. Moreover, if the CMA does not reconsider its approach, a false competitive benchmark and methodology will be established. It will inevitably influence the regulator's approach to the market in years to come - so adverse consequences will not be limited to the immediate proposed package of remedies.

### ***Transitional price cap for prepayment customers***

19. We strongly object to the principle of introducing price regulation for any segment of the retail market as it is inconsistent with the promotion of competition. Indeed, the CMA itself has stated a clear preference for remedies that enable competition rather than those that control outcomes<sup>2</sup>. Therefore the hurdle the CMA has set itself for the introduction of a price cap is high.
20. The facts presented by the CMA to support the introduction of (even a transitional) price cap do not meet this hurdle. In particular, the CMA has failed to demonstrate that the remedy is necessary, that it is non-discriminatory and that it is proportionate (as is

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<sup>2</sup>PDR paragraph 4.133.

required under EU law and related case law). Furthermore the CMA's other remedies offer an alternative, competitive solution, but would be undermined by the proposed price cap remedy.

21. There will also be severe unintended consequences of the transitional cap, particularly at the unsustainably low level proposed, derived as it is from a flawed and discriminatory benchmarking methodology. Even if the benchmarking methodology is corrected to produce a more sustainable reference price, the cost indexing methodology is also flawed so it is highly probable that the level of the price cap would become unsustainably low in the future.
22. A regulated price cap, particularly if set at the onerously low level proposed, will mean prepayment customers have little or no incentive to engage in the market to seek better offers. This effect will be compounded as suppliers and Price Comparison websites (PCWs) will have little or no incentive to compete or drive engagement with prepayment customers since the segment is likely to produce unsustainably low revenues for the majority of suppliers. This may even force some suppliers out of business.
23. The design of the transitional price cap will mean fixed price prepayment contracts (that are currently attracting many customers to switch) will be withdrawn, as will products priced on the basis of a longer term approach to purchasing energy<sup>3</sup>. This will result in a homogenous range of products for prepayment customers with prices stagnating around the level of the cap as energy purchasing strategies converge.
24. It will also expose prepayment customers to the risk of greater levels of price volatility from short term commodity market fluctuations than is the case at present. Given that many of these customers prepay in order to help manage their budgets or debts, this would be an especially unwelcome outcome.

### ***Ofgem database of disengaged customers***

25. We have consistently supported measures that will increase the engagement of customers. However, we have always been clear that such measures are only appropriate if they are designed carefully so as to ensure customers' interests are properly protected. As proposed, this proposal does not meet this criterion.
26. We have concerns that an "opt out" regime that resulted in customers experiencing excessive levels of marketing contact could negatively affect customer perceptions of the functioning of the market and adversely affect engagement. Rather than an "opt out" regime for customer consent, customers should be invited to "opt in" for inclusion in the Ofgem database. In this context, an "opt-in" regime will ensure customers have a choice in the way their data is used. In particular, it would reduce the risk of customers inadvertently providing consent for communications they do not want.
27. It is also essential that the CMA's approach to consent for this remedy is consistent with the forthcoming EU General Data Protection Regulation (GDPR)<sup>4</sup>. Any mismatch between the CMA's remedy design and GDPR requirements would severely undermine

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<sup>3</sup> Detailed analysis setting out the implications of the specific design of the CMA's price cap is provided in the Prepayment Price Cap section of this response.

<sup>4</sup> The GDPR will replace the current Directive and will be directly applicable in all Member States without the need for implementing national legislation. It is expected to come into force in the first half of 2018.

the credibility of the proposed remedy. It would also mean suppliers have no clarity regarding the data privacy obligations with which they are required to comply.

28. On an ongoing basis, Ofgem will have a critical role in ensuring the database is used appropriately. We believe the CMA should set out principles-based regulations to which suppliers with database access should adhere, in order to protect customers from an onerous level of contact. It is essential that Ofgem has clear and effective powers to remove access to the database from users who do not act in the interests of consumers. We also suggest that the CMA limits data included in the database to those fields that are strictly necessary for postal marketing – in particular we would suggest that telephone numbers are not included in the scope of this remedy.

### **Smart metering**

29. We strongly agree with the CMA that smart meters will “have a substantial, positive impact on both competition and engagement”<sup>5</sup> and remove the need for the transitional price cap. We also agree that it is “vitally important that the prescribed timetable for their roll-out is adhered to”.<sup>6</sup> We have been at the forefront of the roll-out – we started before any other supplier, have installed 1.6m meters to date and we remain committed to the programme. However the ability of suppliers to meet this timetable is severely hampered by a number of limitations which we believe the CMA should look to remedy.
30. Based on our experience, traditional incentives and marketing approaches are unlikely to secure sufficient take-up from customers, which is why we need a different set of tools and an alternative framework as soon as possible if aspirational targets are to be reached. In particular, the CMA should introduce an additional remedy to replace the current opt-in regime for smart meter installation with a mandatory regime. We believe this is warranted given smart metering technology will benefit customers, irrespective of their choice of tariff or supplier.
31. A mandatory regime could be enhanced further if it also enabled suppliers to meet their targets by counting the number of smart meters it has installed, rather than the proportion of its customers with a smart meter.

### **Removing tariff restrictions**

32. We strongly support the CMA's proposal to remove “simpler” tariff restrictions introduced as part of RMR. The remedy will enable suppliers to offer customers a richer and more varied range of innovative and engaging propositions than possible at present. Customers will be able to choose the form of offer, discount and bundle that best suits them, rather than having their choices constrained by regulation. The increased innovation enabled by this remedy is also timely, as the rollout of smart meters continues to gather pace.
33. Given this context, and the adverse impact on competition identified by the CMA that has been caused by these restrictions, we see no justification to delay their removal until 2017. Delaying implementation to next year, and recommending that changes are made by Ofgem, will only postpone the benefits of the remedy reaching end customers. Instead, we suggest the CMA introduces this remedy through direct licence modification following publication of the Final Report.

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<sup>5</sup> PDR paragraph 4.77.

<sup>6</sup> PDR paragraph 4.81, referring to SMETS2 smart meters.

34. The CMA's recommendation that enforcement of these obligations by Ofgem is "deprioritised" prior to their removal does not provide sufficient certainty. If the CMA's intent is that suppliers launch propositions that breach existing licence conditions, Ofgem should be required to make an unambiguous commitment not to enforce relevant licence conditions ahead of their removal.
35. Removal of the tariff restrictions would make many of the information remedies introduced at the time of RMR redundant. In particular the removal of the requirement to make all tariffs available to all customers will mean the Cheapest Tariff Messaging will become a less meaningful indicator of the tariffs on offer. We would also question the need for such regulatory mechanisms, given the increasing importance and prominence of Price Comparison Websites. We therefore believe these requirements should be suspended prior to the outcome of the Ofgem engagement programme in late 2018.

### ***Ofgem programme to provide customers with information to promote engagement***

36. In the PDR, the CMA explicitly welcomes Ofgem's commitment to a more principles-based approach to regulation<sup>7</sup>. However, the proposals for a new Ofgem programme to provide customers with information to promote engagement will require the regulator to determine the single best design of key customer communications for all suppliers. This proposal will result in the introduction of new highly prescriptive regulations the like of which the CMA itself has found to have had an adverse effect on competition. This is inconsistent with movement towards principles-based regulation, which the CMA acknowledges offers benefits to competition.
37. We believe the Ofgem programme will not benefit competition, but instead have the effect of increasing the regulatory burden on all energy suppliers, potentially discouraging new entrants in a way which is inconsistent with the UK Government's strategic steer. Developing new prescriptive regulations also reduces the scope for innovation and competitive differentiation among suppliers. Customers are not all the same and as a consequence respond to different stimuli. A "one size fits all" approach to information provision will therefore tend to have less impact than more tailored approaches.
38. Instead, we suggest the CMA recommends that Ofgem focuses its ongoing work on optimising the design of a principles-based framework, with trialling and testing being led by suppliers, overseen by Ofgem. This would then place the onus on suppliers to deliver competitive outcomes by providing information to customers in a way that is most engaging, without requiring a standardised approach. This proposal would also have considerable cost savings over an Ofgem-led trial process, and lead to faster implementation.
39. Of the specific measures proposed by the CMA for inclusion in the Ofgem programme we have particular concerns over the concept of a market-wide Cheapest Tariff Messaging (CTM). In a retail market as innovative and dynamic as that envisaged by the CMA, customers will benefit from being able to choose from offers that differ to a much greater extent than today. We therefore question whether such a mechanism

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<sup>7</sup> For example, see PDR paragraph 6.80



would be meaningful or needed, particularly in the context of the increasing prominence of Price Comparison Websites.

40. In addition, information regarding “in-market” tariffs will become out of date almost immediately, meaning such messaging is likely to be inaccurate and misleading by the time it reaches customers. In summary, such a proposal – which has already been considered and rejected by the CMA – is unworkable and flawed to such a degree that it would be a waste of time and considerable resource to revisit it again.

### ***Ofgem governance and resourcing***

41. The CMA envisages Ofgem taking a leading role in the implementation of the majority of the remedies set out in the PDR. Many of these remedies as described give Ofgem significant flexibility in the way in which they should be introduced – yet many of these remedies are also central to the promotion of more effective competition in the retail market.
42. Wherever possible, we would support the CMA being more specific as to the way in which remedies should be introduced. This will provide clarity for Ofgem as it determines the most appropriate way in which to implement the CMA’s conclusions. There may also be some areas in which the CMA could implement remedies by direct licence change, reducing Ofgem’s workload as a consequence (e.g. the proposed removal of tariff restrictions). This would also mean customers would benefit from this remedy sooner than early 2017 (the currently proposed deadline for implementation).
43. In implementing the CMA’s remedies, it will also be crucial that Ofgem continues to focus on delivering customer outcomes, rather than prescribing supplier actions. If implemented properly, this principles-based approach will improve Ofgem’s ability to regulate the market efficiently and effectively, and also improve suppliers’ ability to deliver products and services in a way that supports competition.
44. Given the critical role that Ofgem will play in the implementation of remedies over the next few years, we suggest the CMA takes steps to ensure that sufficient resources are in place within Ofgem to undertake this role effectively. We would support a recommendation to Government to increase the resources available to Ofgem to meet this challenge.

### ***Financial reporting requirements***

45. The CMA’s proposals for new financial reporting requirements will create significant confusion and generate mistrust rather than promote transparency as intended. Given the granular nature of the existing Consolidated Segmental Statements, it is unclear what benefit the CMA’s proposals could even deliver. On the other hand, the costs and unintended consequences of the proposals are clear.
46. The requirement for suppliers to report wholesale energy costs for retail supply on the basis of a hypothetical standardised purchasing strategy contains serious methodological flaws. We are particularly concerned by the proposal that a major part of the cost benchmark should be based on month-ahead costs, and strongly disagree with any suggestion that energy purchasing over a longer period for Standard Variable tariff (SVT) customers would be speculative, or that month-ahead purchasing for SVT customers would be appropriate.

47. As proposed, the report will only demonstrate the outcome of a supplier's energy purchasing strategy compared to that prescribed by the CMA. While the CMA states it is not its intention to suggest one purchasing strategy is preferable to another, this is precisely the effect that will result from this remedy – and could lead to a convergence towards short term purchasing leading to more volatile customer bills and potentially a lessening of competition. Focus should be on actual profits earned, rather than reporting against an artificial construct.
48. Finally, it appears to be a serious omission for these reporting requirements to apply only to the SLEFs, given that similar gains to switching are available to mid-tier suppliers' customers, and particularly given that the CMA proposes determining a competitive benchmark from the financial performance of a subset of the mid-tier supplier segment.

### ***Other remedies proposed by the CMA***

49. We support remedies which strengthen the role of Price Comparison Websites (PCWs), provided they are accompanied with appropriate consumer protection controls, in particular around the use of data. However, as these intermediaries become an increasingly critical route to market for customers, we would also suggest Ofgem considers whether mandatory regulation of PCWs may be a more effective way of protecting consumers' interests.
50. We broadly support the package of remedies proposed for microbusiness customers. The proposals relating to price transparency and the ending of onerous auto-rollover terms are welcome. However, we do not believe Ofgem's Code of Practice will be effective in delivering an appropriate level of transparency regarding commission earned by third party intermediaries.
51. Finally, the proposed legislative amendment to refocus Ofgem's statutory objectives and duties on the promotion of competition should help to refocus energy market regulation on competitive market principles. This will better serve the interests of consumers, and at the same time reduce the risk of interventions that will not benefit competition.

*The remainder of this document sets out Centrica's more detailed views on the CMA's PDR, setting out our views on each proposed remedy in turn. In addition, more detailed views on a number of issues are provided in a series of appendices (as referenced below).*

## **Consumer detriment**

52. The CMA's approach to assessing detriment in the PDR remains fundamentally flawed. While many of our comments on the profitability and efficiency benchmarking analysis have now been accepted by the CMA (at least in principle), this entire approach to assessing detriment has now been labelled "indirect" and been downplayed in favour of an extremely crude price comparison labelled a "direct" assessment of detriment.
53. This alternative analysis is an entirely new approach to calculating customer detriment, based on the gains from switching analysis that the CMA itself has explicitly recognised is not a good measure of customer detriment<sup>8</sup>. It generates results that are wholly inconsistent with both common sense and the findings of the updated profitability work that the CMA has been developing since at least December 2014.
54. The new, and apparently favoured, method suggests a customer detriment nearly three times the size of the CMA's estimates based on its previous methodology. Those previous estimates are themselves open to serious criticism as excessive. We do not believe the analysis is a safe basis upon which to diagnose competition problems – in this or any other market with fluctuating input costs – still less one upon which to base any proposed remedies.
55. Our response to the CMA's analysis of detriment is split into the following sections:
- Our serious procedural concerns regarding the development of the CMA's detriment analysis;
  - A discussion of the weaknesses of the new "direct" approach to assessing detriment (and the closely related gains from switching analysis);
  - The continuing flaws in the existing "indirect" approach to assessing detriment based on ROCE and efficiency benchmarking analyses; and
  - The way in which all these analyses are shaped by the CMA's apparent scepticism over the role of longer term energy purchasing and the smoothed price products supported by such purchasing – a scepticism which is unfounded in our view.
56. The latest CMA analysis suggests that:
- customers are failing to realise large gains from switching, well above the levels customers say they would need to make switching worthwhile,<sup>9</sup> and despite these potential gains rising over time; and
  - customers are facing substantial "detriment" through high prices and inefficient costs being incurred by the SLEFs, which is evidenced by a new pricing comparison and an updated version of the ROCE and cost inefficiency analysis.
57. We do not believe that either of these findings is due primarily to a failure of the competitive process, but rather to current conditions in wholesale commodity markets, and the resulting impact on the product offerings of mid-tier and large energy suppliers. As a result the CMA's findings on detriment are greatly overstated.

## ***Procedural issues***

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<sup>8</sup> Provisional Findings, A7.4 paragraph 3.

<sup>9</sup> The CMA's survey suggests that only 18% of customers would be prepared to switch for £99 or less and only 5% for a saving of £50 or less (See Figure 70 in the CMA's "GfK NOP customer survey report (20.2.15)").

58. The introduction at such a late stage in the CMA's investigation of a new approach to assessing detriment to that set out in the process to date effectively puts us "back to square one". Placing such weight on new analysis in the final consultation of this two year investigation raises a serious process issue as we have limited opportunity to understand the reasoning behind this new analysis (one upon which the proposed price cap remedies are based) and to explain our concerns to the CMA.
59. Moreover, presenting the analysis at this late stage leaves limited time for the CMA to take these concerns into account and update its analysis and conclusions on remedies accordingly. It also means that we have not had an opportunity to debate the CMA's analysis and assumptions in either of our Hearings, or in our further bilateral meetings with the team responsible for this analysis.
60. In relation to the analysis of profitability that was set out in the Provisional Findings, it is particularly concerning to see how little the ROCE analysis has changed, given the major changes to the CMA's assessment of the nature of the intermediary fee model compared with the Provisional Findings. Although the CMA's ROCE appendix drops many of the CMA's previous assertions in relation to the intermediary fee model<sup>10</sup>, and the evidence from Shell (in particular from its Hearing of 10th December) helpfully confirms our view that an intermediary fee would depend on supplier customer and product mix, the CMA's updated understanding of these arrangements has not been appropriately reflected in updated assumptions for its ROCE calculation.
61. Additionally, several aspects of the earlier profitability analysis (e.g. the profitability benchmarking exercise) have simply been dropped without comment, and without dealing with our comments and critiques on that analysis. Where analyses from the Provisional Findings have been retained, several of our previous comments and critiques have been taken into account in the CMA's Appendices e.g.:
- in creating a more "like for like" Scenario 3b in the gains from switching analysis, reducing available gains to £65; and
  - in accepting that efficient commodity costs cannot be benchmarked against rivals with a different product mix and using the benefit of hindsight.
62. The CMA therefore, appears to have regarded these as relevant considerations in reflecting those comments in its profitability and efficiency analyses (albeit that the resulting findings now appear to have been given little, if any, weight in the PDR). However, the CMA's new "direct detriment" analysis continues to make comparisons across products with different characteristics and different energy purchasing strategies and treats those differences as a "detriment". In contrast to the approach taken in the underlying gains from switching and efficient cost benchmarking analyses (set out below), here, the CMA appears to have *ignored* (with no explanation) those same, apparently relevant considerations in the "direct" detriment analysis.
63. We are also very concerned by the proposal to publish supplier-specific detriment estimates as part of the CMA's Final report<sup>11</sup>. To publish comparisons of "detriment" that are based on a flawed assessment would be damaging to customer decision-making and broader customer confidence in the energy market. The harm to Centrica is likely to be particularly significant given its second gas price cut in 2015 (which none of the other suppliers matched, and which the CMA has failed to take into account in its

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<sup>10</sup> For example in relation to the extent of the credit facilities offered under intermediary fee arrangements.

<sup>11</sup> PDR paragraph 1.19

extrapolation of a 2015 detriment estimate). We therefore do not believe it would be justifiable to publish these estimates in anything like their current form.

64. More broadly it appears to us that the CMA's approach to the detriment analysis is underpinned by an implicit scepticism over the value that consumers place on smoothed price products, and therefore the value of the longer term energy purchasing that we use to support the provision of such products. If this is correct it is vitally important that this is brought out more clearly – and particularly that the CMA's reasons for this scepticism are clearly set out – so that we can properly respond to them.
65. In our view many customers do place a high value on avoiding too much volatility in their energy bill and like to be able to budget effectively against a relatively smooth retail energy price path. In practice longer term energy purchasing is a vital part of how the market meets the needs of these customers. Indeed, our current approach to energy purchasing has been directly influenced by our experience in the wake of volatile commodity prices in 2008/9 (which the independent suppliers have yet to experience), resulting in very large price increases for our customers which were deeply unpopular and difficult for many households to deal with.
66. We do not believe that market interventions pushing the market towards less long-term energy purchasing and more volatile retail prices would serve these customers well. Of course some customers will wish to take advantage of lower priced short-term offers when commodity costs are falling – but many prefer the smoothed price path offered by an SVT product. In our view both groups of customers should be able to select the product that best suits their needs. It is our view that the CMA has been unduly influenced by the particular commodity markets conditions which have existed during the investigation and that much of its analysis would have looked very different in rising commodity markets.
67. We are particularly disturbed by proposals that SVT prices should be benchmarked against month-ahead costs – as we set out in greater detail in relation to Financial Reporting remedy below. If this reflects a belief on the part of the CMA that customers would be better off being supplied under terms that fluctuated with monthly variations in commodity costs, we would view that as entirely misguided. The reasons for any such view (and therefore the justification for the financial reporting remedy) are currently unclear.

### ***Drivers of the “direct” assessment of detriment and gains from switching***

#### **Overview**

68. Our concerns are particularly strong in relation to the CMA's latest focus on a new top-down analysis of detriment (termed “direct” by the CMA) – which is essentially a simple comparison between the average price paid by customers of the SLEFs and average prices paid by customers of First Utility and OVO. This results in an alleged detriment of £1.7bn per annum (rising to £2.5bn based on an extrapolated view of 2015)<sup>12</sup> or £94 per dual fuel customer account.<sup>13</sup>
69. We note that this approach appears strongly related to the gains from switching analysis, which the CMA has previously clearly stated is not a good measure of

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<sup>12</sup> Average detriment to domestic customers per annum 2012-2015, PDR 3.190.

<sup>13</sup> Average bill difference at Ofgem 2014 medium Typical Domestic Consumption Values (TDCV), averaged across 2012-2015 – PDR Table 3.9 page 164.

consumer detriment. Specifically the CMA previously stated in relation to its gains from switching analysis that:<sup>14</sup>

*“We do not consider that the results of our analysis can necessarily be relied upon to measure aggregate welfare loss associated with domestic customers not switching to cheaper tariffs, as suppliers offering the cheapest tariffs may not find it sustainable to have a large proportion of customers switching to them.”*

70. We agree with the CMA’s previous position on this, and do not understand why this earlier position has now been dropped. The approach also has a number of other flaws, and fails a number of basic sense checks:
- The CMA’s measures of gains to switching and detriment have increased sharply in recent years, despite the increasing importance of new entrants and increased levels of switching in the market.
  - The detriment is calculated at around double industry profits (suggesting a huge amount of cost inefficiency), and nearly three times the detriment implied by the CMA’s (already flawed) ROCE and inefficiency analysis.
71. The key driver of this inconsistency is that the CMA’s new “direct” measure of detriment (as with the CMA’s preferred formulation of the gains from switching analysis) benchmarks against the prices of suppliers that:
- supply fundamentally different products to the SLEFs and with quite different cost structures;
  - are “cherry picked” from among the mid-tier suppliers for reasons that are not well explained; and
  - are in a growth phase, in the case of OVO earning a negative EBIT as an investment in winning customers, with a longer term margin aspiration above the levels identified by the CMA as “competitive.”<sup>15</sup>
72. We are also concerned over the CMA’s choice of time period for this detriment analysis. It reflects pricing that has only been possible because of very specific commodity market conditions, allowing short term energy purchasing to undercut longer-term purchasing strategies. We note that the CMA has accepted in the case of the ROCE analysis the need to use a longer time-frame that covers an entire commodity cycle (and in particular goes back to 2007/8) – but the same principle has not been applied to this “direct” detriment analysis. The extrapolation of detriment in 2015 will also overstate calculated detriment in relation to British Gas, which was the only large supplier to cut its prices in the second half of 2015.
73. The rest of this section spells out these concerns in more detail.

### **Results primarily reflect product mix rather than competition**

74. The CMA’s detriment analysis is based on a comparison of the *average* prices paid by customers – with no account taken of product type (so that these weighted averages are calculated across all product types). This results in a comparison which is very far from “like for like”: Centrica has a majority of SVT customers for whom we hedge on a multiple year rateable basis in order to smooth future prices for our customers. The

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<sup>14</sup> See footnote 8

<sup>15</sup> The Chief Executive of OVO has previously identified a 3-4% EBIT margin aspiration: for further details see our detailed comments on the profitability exercise at Appendix 3.4.

benchmark suppliers have a greater proportion of one year fixed tariff customers hedged over a shorter period of time, and a greater proportion of customers on “online only” tariffs.

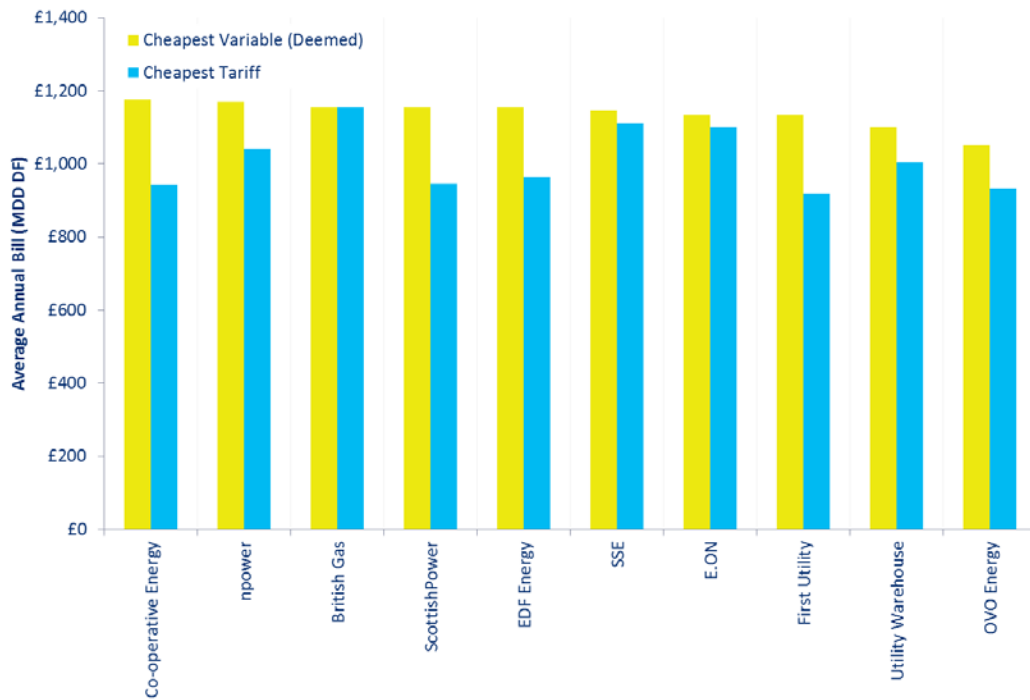
75. As we have set out before, SVT and fixed price contracts are fundamentally different offers in terms of price level and volatility, with fixed price contracts also tending to require customers to pay exit fees.<sup>16</sup> Although some customers will switch between these product types, it is certainly not valid to expect all rational customers to switch from SVT to 1 year fixes (e.g. they may appreciate the smoothing offered by SVT without having to constantly shop around for the best fix).
76. Even if rationality dictated that customers would switch much more readily than they do in fact, suppliers must (and do) operate in accordance with market reality, not some hypothetical construct with customers who have some idealised greater switching propensity. To that end, we hedge the demands that we expect our customers actually to have, and on the basis of smoothed retail pricing.
77. Longer term energy purchasing can be costly when commodity prices are falling. But purchasing energy well in advance, or purchasing only contractually committed (as distinct from actually expected) demands would expose a supplier to intolerable levels of risk.<sup>17</sup> The CMA analysis continues to pay insufficient attention to this fundamental aspect of retail energy supply.
78. If we compare the prices of variable price products across mid-tier and large energy suppliers, we see far more similar prices for similar offerings. What drives the difference in average prices between First Utility/OVO and British Gas therefore is not primarily the prices on offer, but the products that their respective customers choose. Whereas the typical First Utility or OVO customer will be on a short term fixed price product (with a commensurately short energy purchasing horizon), the typical SLEF customer is on an SVT contract (for which energy tends to be purchased over a longer period).

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<sup>16</sup> Although these fees are in practice sometimes waived, if more customers were to switch the suppliers would be forced to impose fees to cover the costs of the stranded commodity procurement.

<sup>17</sup> We note that the CMA at PDR paragraph 10.253 agrees with this point in principle, nothing that “for a retail supplier to purchase all the volumes it requires at, or near the time of delivery, could constitute an imprudent approach to managing the risk of adverse price movements concerning wholesale energy. We note that such an approach historically has been a major contributory cause of several retail suppliers, both large and small, going bankrupt.” It is unclear how, in light of this, the CMA can also hold the view that purchasing beyond a month ahead for SVT customers is speculative (PDR A3.4-50 paragraph 8).

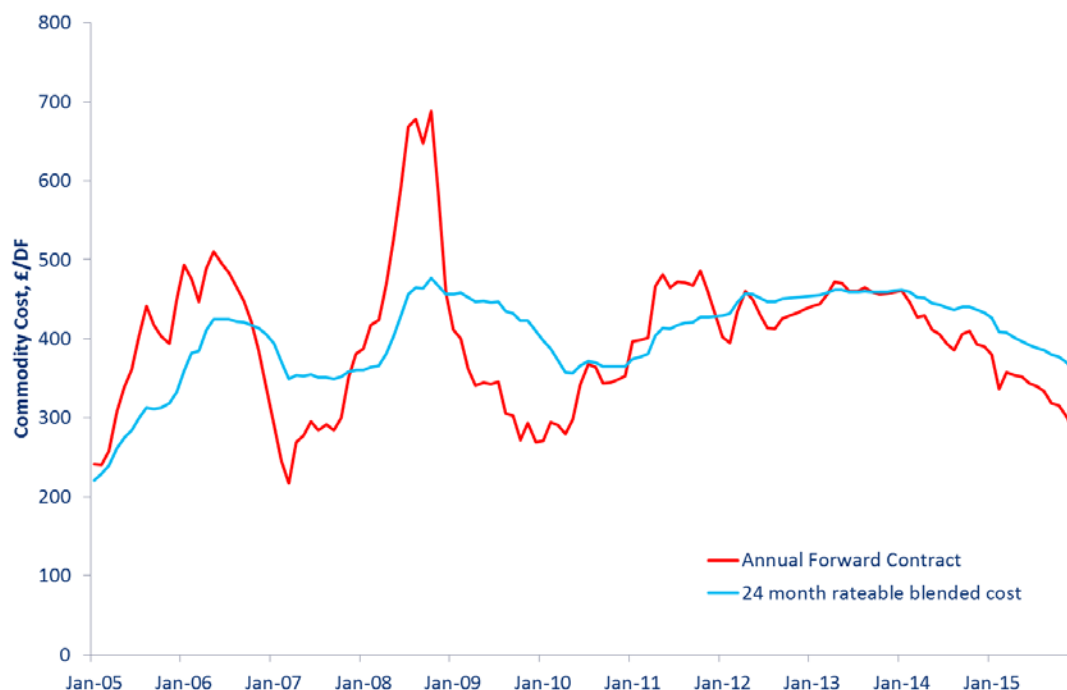
Figure A - Typical bill comparison: cheapest variable tariff and cheapest tariff (July 2015)



79. This means the CMA’s analysis of “detriment” will largely reflect the difference between short-term fixed product prices and more smoothed SVT prices, and in turn the costs of the longer term energy purchasing strategies that underpin these products. As can be seen from the figure below, while recently the 1 year fixed price contracts have been relatively low cost to procure for, in earlier times this was not always the case. In particular such products would have exhibited very volatile pricing (and we assume uptake) had they been prevalent during the period 2005-2011. It is only since 2012 (precisely the period of the CMA’s “direct” detriment analysis) that annual forward procurement has been consistently cheaper than longer term energy purchasing.



Figure B - 12 month fixed term contract versus 2 year rateable purchasing commodity costs 2008-15



80. This makes the analysis of detriment highly sensitive to what is going on in the wholesale markets for the period of the review and places too great a reliance on today's low priced commodity market with no regard to how different it would be if prices had been rising (putting less hedged products at a price disadvantage). The weakness in wholesale prices over the period the CMA examined created a particularly good environment for the competitive strategy of the mid-tier suppliers with their SLEF rivals having hedged at higher wholesale cost levels.<sup>18</sup>
81. Had commodity prices instead been escalating over the period analysed, the CMA's conclusions would have been entirely different. This level of sensitivity to the direction of commodity prices illustrates just how deeply flawed this measure of detriment is.
82. If the CMA had controlled for product type to take account of this difference in price smoothing and energy purchasing cost then the measure of detriment would have been much lower. For example, if we take SVT customers (as the focus of the CMA's concern) and calculate "detriment" based on benefits available from switching to mid-tier SVT products, detriment falls from the CMA's estimate of £1.7bn per annum to £330m per annum (around an 80% reduction)<sup>19</sup>. Clearly this shows a very high degree of sensitivity to assumptions, and in particular the degree to which the CMA's detriment calculation relies on assuming that customers are necessarily better off if they have a lower bill, regardless of the characteristics of the product (in particular the degree of price smoothing, but also for example whether they have access to paper bills or are allowed to contact their supplier by telephone). It also simply assumes that the mid-tier suppliers' tariffs would remain at the same price, even if millions of customers were to switch to them: an assumption the CMA has itself said is not valid.

### Basing the benchmark bill on two mid-tier suppliers is not valid

<sup>18</sup> The last sentence of PDR paragraph 10.261 notes this vulnerability of a supplier that has hedged.

<sup>19</sup> See CRA's Confidentiality Ring analysis for details.

83. Another driver of the inconsistency between the “direct” and “indirect” approaches is that the “direct” price comparison is based on a particularly selective set of comparators. Not only has the CMA selected just two of the four mid-tier suppliers as the basis for its comparison, but more generally all four mid-tier suppliers are investing in growing their customer base as opposed to earning sustainable profits. Their prices cannot therefore be seen as representing a stable competitive outcome which would be sustainable over the longer term. Specifically:
- Neither of the two mid-tier suppliers selected (OVO or First Utility) has consistently earned even the CMA’s view of competitive EBIT margins over much of the period considered. In fact OVO made a loss in 2014 of £33m (£22m net) and also made losses in 2011 and 2012 (while the 2013 profit that the CMA refers to was extremely small)<sup>20</sup>. These brands are still building market position, apparently foregoing profits to gain market share.<sup>21</sup> The remaining mid-tier suppliers (Utility Warehouse and Co-Operative Energy) have not been selected for the benchmark, apparently because they have had less keen pricing strategies than OVO and First Utility over the period analysed. However, this is precisely the reason why they are in fact a (relatively) more appropriate comparator. Including these two firms in the comparison would already reduce the calculated detriment substantially (see CRA’s Confidentiality Ring report for details).
  - The products offered by the two benchmark firms are not comparable to those chosen by SLEF customers – not only in relation to their price smoothing qualities, but also in relation to their other characteristics. In particular, OVO requests advance direct debt payments, essentially making customers pay in advance for their energy. Most OVO and FU customers (around 90%) are also on “online only” deals – earning a discount in return for being restricted to online contact only. Therefore the price comparison is not comparing products of equal value. We would note that the CMA has accepted in its Gains from Switching analysis that these products are not directly comparable (in its development of Scenario 3b), but has not reflected this lack of comparability in the detriment analysis; an apparent logical inconsistency. Comparing like for like products would substantially reduce the calculated detriment (see CRA’s Confidentiality Ring report for further details).
84. Therefore the selected benchmark cannot be said to represent a sustainable competitive outcome that could be repeated across the market. Indeed, as noted above the CMA itself stated that it did not view the Gains from Switching analysis as a good measure of customer detriment<sup>22</sup>, but now treats an even cruder price comparison exercise in precisely that way.

### **The analysis fails to take into account obvious differences in suppliers’ costs**

85. A range of obvious differences in suppliers’ costs have not been appropriately reflected in the CMA’s analysis:

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<sup>20</sup> PDR paragraph 3.195.

<sup>21</sup> OVO does not appear to intend to accept low or negative EBIT margins in the long term. Stephen Fitzpatrick of OVO stated in February 2014 that “We are willing to accept a lower profit margin. We aim for 3 to 4 per cent.” <http://businesslife.ba.com/People/Interviews/business-life-meets-Stephen-Fitzpatrick.html>

<sup>22</sup> Provisional Findings, A7.4-1 paragraph 3 states “We do not consider that the results of our analysis can necessarily be relied upon to measure aggregate welfare loss associated with domestic customers not switching to cheaper tariffs, as suppliers offering the cheapest tariffs may not find it sustainable to have a large proportion of customers switching to them.”

- **ECO costs.** OVO and First Utility have only been fully obligated to deliver energy efficiency measures under ECO (Energy Company Obligation) from 2015 onwards and even then will, as at June 2015, have ECO costs set by reference to the start of 2015 notwithstanding significant growth during 2015. The analysis has not adjusted for their lack of comparative costs in previous years.
- **Bad debt.** While the CMA argues that the 2 mid-tier suppliers would have relatively more expensive customers to serve due to their more active customer base we note that the level of bad debt per customer for OVO and First Utility is considerably smaller than for many other suppliers as they have so few customers paying by quarterly cash or cheque<sup>23</sup>. The large number of customers with a strong preference to pay in arrears by cash/cheque should not be refused that opportunity – but meeting the needs of these customers does entail higher costs, which need to be taken into account. This difference is worth around an estimated £10 per dual fuel account.
- **Smart roll out.** British Gas has taken the lead in the roll out of smart meters to make every effort to meet the industry targets for 2020. As a result we have incurred greater relative metering costs than those of our competitors, whilst the mid-tier firms used for benchmarking have a base of smart, not dumb, prepayment meters and , and fewer prepayment customers joining them by moving into a property they serve, leaving them with minimal embedded debt repayment in their prepayment base. Although not of great impact during 2012-14, as the roll-out of Smart gathers pace this will have a major impact on the future calculation of “detriment” following the CMA’s methodology.

86. These substantial differences in costs provide yet more evidence why a crude price comparison with First Utility and OVO is not a valid approach to estimating detriment: and specifically can be expected to substantially overstate the level of detriment suffered by consumers.

### **Non comparability of findings across suppliers**

87. The CMA’s 2015 analysis has extrapolated 2 quarters of bill data for a full year to reach the £2.5 billion headline detriment figure. This extrapolation incorrectly fails to take into account the 5% price cut British Gas made to all of its gas customers on the 27<sup>th</sup> August 2015. This is especially relevant as the CMA states that “the gap between the benchmark and supplier prices for single fuel gas customers is considerably higher than for single fuel electricity customers.”<sup>24</sup> We estimate taking the British Gas price cut into consideration would reduce the estimated 2015 detriment by £0.2billion, and reduce any apparent gap between gas and electricity single fuel customers, and reduce detriment associated with British Gas relative to its rivals.

88. More generally, we note that the CMA has excluded significant numbers of customers from its analysis on the basis that either the available data was unreliable, or they were on tariffs not covered by the analysis. We understand from the work done by CRA in the Confidentiality Ring that the missing accounts are simply excluded from the detriment analysis. As the proportion of accounts dropped in this way varies both over time and across suppliers (as set out in CRA’s Confidentiality Ring report), detriment calculations by supplier will again not be comparable.

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<sup>23</sup> Source: [https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage\\_q4\\_2014\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage_q4_2014_0.pdf)

<sup>24</sup> PDR paragraph 3.182

89. We are therefore extremely concerned not only with the CMA's aggregate approach to the assessment of detriment but also with the further suggestion that the CMA plans to include in the Final Report this alleged level of detriment split by supplier and fuel type. Given the flaws in the analyses on which any such comparison would be based, and particularly the many respects in which these analyses are not comparable across suppliers, we do not believe that any results presented at supplier level can be viewed as reliable or providing any meaningful insight into the relative competitiveness of suppliers' pricing policies.
90. For both reasons we do not believe that detriment calculations split by supplier can be considered a valid comparison.

### **Gains from switching analysis**

91. The CMA's gains from switching analysis is based on the same dataset as the detriment analysis, and suffers from many of the same problems.
92. The main body of the CMA's PDR continues to rely on an analysis of gains from switching (Scenario 5x) which assumes that customers are indifferent between product type except for the cost: simply adding exit fees to estimated bills does not fully control for the differences in customer experience and perception of an evergreen smoothed price offer and a short term offer that will result in a need to "shop around" again in a year's time (or of other product differences such as payment by DD or cash/cheque or online only accounts).
93. Using the CMA's own Scenario 3b, which has now been updated to provide a more "like for like" comparison that restricts customers to switching to the same product type, reduces gains from switching from the figure of £164 reported in the main PDR conclusions to £65 for SLEF customers (and £72 for customers of mid-tier suppliers).<sup>25</sup>
94. Moreover, as shown in CRA's Confidentiality Ring report, using Scenario 3b (contrary to the CMA's assertion) gives rise to a completely different pattern of gains from switching over time for SLEF customers: whereas Scenario 5x shows a significant increase in gains from switching over time, no such pattern is seen in Scenario 3b. This suggests that the increase seen in Scenario 5x is entirely driven by switches between products with different characteristics. In particular, it will be driven by different prices for products with different hedging strategies and therefore different "price smoothing" properties. This means the increase in gains under Scenario 5x – just as the increase in the "direct detriment" analysis – is primarily driven by movements in commodity costs, rather than changes in the intensity of competition.
95. The CMA has not explained why this is not a more appropriate measure of gains from switching or responded to our previous arguments on this point.

### ***Continuing weakness of the CMA's ROCE analysis***

96. As noted above, the "direct" assessment of detriment generates a vastly higher estimate of customer detriment than the "indirect" approach based on ROCE and efficiency benchmarking that the CMA has been developing since December 2014 (subject to consultation with third parties, including Hearings and specific technical level meetings).<sup>26</sup> We have detailed comments on the CMA's ROCE analysis (in

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<sup>25</sup> PDR page 7 paragraph 32 and A3.2-10 Tables 2 and 3.

<sup>26</sup> CMA "Approach to financial and profitability analysis" 8th December 2014.

Appendix 3.4 to the PDR) which are set out in full in our ROCE appendix<sup>27</sup>, and summarised here. CRA have also set out the sensitivity of the ROCE findings to reasonable changes to the CMA's assumptions in their Confidentiality Ring paper.

97. In particular, we highlight our concerns that:

- ROCE remains a poor basis for assessing profitability. The CMA now appears to have dropped its EBIT benchmarking exercise (without responding to our comments on the version contained in the Provisional Findings), and continues to rely on what we regard as a fundamental misinterpretation of a single Centrica document to justify its reliance on ROCE as a relevant measure for the retail supply business.
- While the CMA has stepped back from some of its assumptions in the Provisional Findings which caused us most concern, it has not updated its analysis accordingly. Evidence relied on to support continuing with the previous approach is flawed, and results in a significantly overstated ROCE.
- Specifically, the CMA continues to assume a very low intermediary fee, one that does not:
  - Take account of the costs of scaling up the intermediary fee model;
  - Take account of the impact of customer, fuel and product mix on the intermediary fee (factors which Shell has acknowledged would influence the fee level); or
  - Take account of the other costs and benefits associated with the intermediary agreement beyond the fee (e.g. warrants, interest payments, opportunities to trade around the supplier's position)

98. We continue to believe that an intermediary fee of around  $\times$  % would be necessary even to account for a simple route to market service for a stand-alone British Gas (i.e. without any form of additional credit facility, shaping services, etc.), with an overall fee of  $\times$  % required.<sup>28</sup> These estimates are based on standard approaches to estimating the costs of risk management, and we believe are consistent with the evidence provided in the CMA's report.

99. The CMA also assumes a very low cost of dealing with peaks in working capital, specifically:

- Understating the extent of peaks in working capital requirements;
- Assuming access to a free credit facility for which there is no evidence; and
- Allowing only a  $\times$ % cash cushion to manage the resulting peaks in working capital requirements, which is insufficient.

100. In order to allow its hypothetical stand-alone supplier to meet these peaks in its working capital requirements the CMA would need to allow for a higher intermediary fee (if the intermediary is postulated to be the source of credit facilities), a higher cash holding, and/or a higher WACC (if such financing is postulated to be obtained from a bank, in circumstances where the intermediary would already have a charge over the supplier's assets).

101. Furthermore a number of the CMA's assumptions will create differences in assessment between suppliers, resulting in profitability estimates which cannot be compared

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<sup>27</sup> See Appendix 1: "ROCE"

<sup>28</sup> "Centrica Discussion on ROCE" slides presented to the CMA 22<sup>nd</sup> May 2015 and "ROCE meeting follow up" letter of 27<sup>th</sup> May 2015.

between suppliers. Most fundamentally, insufficient distinction is made between suppliers to account for differences in the cost of managing risk and working capital peaks depending on customer and product mix.

102. The result of these failings in analysis is a “mix and match” approach, where partial facts and observations from different intermediary fee agreements and credit facilities are pulled together to create a “patchwork” business model – one which could not (and does not) exist in reality and therefore does not constitute a valid basis for the ROCE calculation.
103. It is simply not credible to assume that a stand-alone supplier could use an intermediary fee model to manage commodity risk (where the evidence suggests that intermediaries will take a charge over assets) while also accessing an effectively free overdraft facility (from the intermediary or a third party) with only a very small cash cushion. The CMA cannot point to even a small or mid-tier supplier that operates in line with the assumptions underlying its ROCE model – let alone a large stand-alone supplier with a focus on gas customers and a large SVT customer base.
104. Finally there is the question of what cost of capital (WACC) should be used as a comparator for the resulting ROCE levels. The cost of capital used in CMA’s analysis remains at 10% despite agreement by CMA that this is an inherently risky industry and our own analysis suggesting that 8% would be a more appropriate cost basis for comparison.
105. These concerns are spelled out in more detail in the sections below (and in full detail in our ROCE appendix to this document, which sets out in detail our views on the CMA’s latest ROCE analysis as set out in appendix 3.4 to the PDR).
106. The second element of the CMA’s “indirect” assessment of detriment is their efficiency benchmarking analysis. We agree with the CMA’s findings that constructing an efficient benchmark wholesale cost on an ex post basis is misleading and it is right that the CMA no longer plans to consider wholesale cost benchmarking in this way. However, as noted in the previous section, it is precisely this type of comparison of essentially non-comparable procurement costs that drives the CMA’s new and seemingly preferred “detriment” measure.<sup>29</sup>
107. This is yet another example of internal inconsistency in the CMA’s analysis of detriment. While conceding the principle that wholesale costs cannot be used as an efficiency benchmark in the “indirect” profitability analysis, at the same time the CMA’s “direct” detriment findings are driven by precisely this implicit assumption (i.e. that the costs and prices associated with a year ahead energy purchasing strategy should have been available to customers who chose an SVT product hedged over a longer time-scale). This is logically inconsistent and further demonstrates the flawed and unreasonable nature of the direct approach.

### **The invalidity of a ROCE approach for a retail supply business**

108. Despite the CMA’s claims to the contrary, it remains the case that Centrica does not use ROCE to assess the performance of its retail business in the normal course of business, and we continue to view this analysis as inappropriate in this market, given

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<sup>29</sup> We also continue to have concerns over the use of lower-quartile cost benchmarking more generally. On this approach all industries with any variation in supplier costs would be found to be subject to inefficiency. In reality variation in supplier costs cannot be treated as evidence of inefficiency.

the difficulty of correctly identifying the risk capital and financing costs associated with the retail business on a stand-alone basis. The reasons why these references are inappropriate is set out in more detail in our ROCE appendix.

109. By contrast our internal documents and normal business practices show that we *do* use EBIT to assess performance of the retail business. Despite this evidence the CMA appears to have dropped its profitability benchmarking exercise: an exercise which in our view would clearly indicate that competitive EBIT profits should be 4-6%, rather than the CMA's suggested level of 1.5% (or even lower, based on the "direct" detriment analysis).

### **Changes in the CMA's characterisation of the intermediary fee model**

110. It is striking that in the most recent iteration of its ROCE analysis the CMA has apparently dropped many of the flawed assumptions on which its previous findings were based. In particular:

- It no longer appears to claim that the intermediary fee arrangement includes a large free credit facility that can be used for managing more general business risks, instead claiming only that suppliers under these arrangements have access to similar payment terms to the SLEFS;
- It no longer appears to claim that intermediaries could offer such services with access to little or no risk capital;
- It recognises that there are additional points of value in the intermediary fee arrangements, beyond the fee itself (in particular the inclusion of warrants and/or interest payments for credit in certain agreements).

111. Despite these (and other) material changes to the assessment on which the CMA's ROCE analysis is based, the analysis itself has changed remarkably little. In our view this supporting evidence remains extremely weak, and leaves the CMA's ROCE analysis substantially overstating the industry's (and particularly our) profitability. Specifically:

- The costs of risk management are understated, particularly for Centrica, as no account is taken of the additional costs associated with offering the intermediary fee service at scale, or offering it in relation to gas, SVT and microbusiness customers<sup>30</sup>;
- Average working capital requirements are understated as they continue to be based on the creditor terms of vertically integrated suppliers, and not standard industry terms or the terms embedded in intermediary fee arrangements (creating an internal inconsistency with the intermediary fee assumption); and
- In relation to peak working capital requirements, the costs of accessing overdraft facilities cannot be assumed to be captured by a 3% trading fee, and the 3% cash cushion allowed to manage the peaks in working capital requirements is certainly insufficient to meet those peaks.

These points are set out in more detail below, and in full in our ROCE appendix.

### **The CMA's assumed intermediary fee is too low**

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<sup>30</sup> See the CMA's "Summary of hearing with Royal Dutch Shell plc on 10 December 2015", particularly paragraphs 13 and 22

112. We understand that the CMA has assumed an intermediary fee of 3% of commodity cost, based on the recent outturn costs of intermediary fee agreements for a number of mid-tier suppliers<sup>31</sup>. We believe this fee level will substantially understate the actual fee that a stand-alone British Gas would have to pay to access such an agreement (if it could do so at all).
113. First, the fee takes no account of scalability. As a matter of principle we would expect that higher fees would be necessary to bring further supply onto the market, given that the scale of operations would increase from one that could be integrated with the intermediary's own existing portfolio of exposures, to one that would be substantial in its own right and would need to be allocated capital in competition with other uses. The CMA appear to confirm that there is only a very limited list of suppliers interested in offering such a service, and none of them have committed to being able to supply one or more large stand-alone suppliers for a 3% fee. Despite in several places citing US experience as relevant (particularly in relation to Just Energy) the CMA has disregarded the experience of Centrica's own subsidiary, Direct Energy, in attempting to access collateral free trading arrangements in the US and finding that it can only do so at limited scale.
114. Second, the fee takes no account of differences in different suppliers' product and customer mix. Shell was very explicit at its Hearing with the CMA that factors playing a role in determining the level of the fee would include<sup>32</sup>:
- Product mix which will impact approach to energy purchasing (i.e. proportion of SVT versus FTC customers);
  - Market volatility (which will be different for gas versus electricity);
  - Different customers and fuel types, which will again impact a supplier's energy purchasing strategy; and specifically
  - The microbusiness sector, which Shell saw as carrying particular risks.
115. Third, the CMA's assumed fee covers only the cost of the fee itself, and not the other costs (and opportunity costs) associated with these arrangements. Most notable among these is the role of warrants, which have a clear opportunity cost to the supplier's shareholders and a clear value to the intermediary. The CMA's latest paper also implies that interest payments may be payable, and continues to take no account of e.g. opportunities to trade around the supplier's requirements which are transferred from the supplier to the intermediary under such agreements.
116. It is clear in light of these comments (set out in greater detail in our ROCE appendix, and with reference to the confidential version of the CMA's Appendix 3.4 in CRA's Confidentiality Ring report) that the fee faced by a stand-alone British Gas would be higher than for other retailers (and particularly compared with fees charged to mid-tier suppliers). This has not been taken into account in the CMA's analysis. The CMA's estimate of ROCE for a stand-alone British Gas is therefore too high, and even taking account only of the higher intermediary fee that British Gas would need to pay would already fall considerably – as set out in CRA's Confidentiality Ring report.

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<sup>31</sup> See A3.4-64 paragraph 62, which states that "the evidence was consistent with fee levels remaining at around 3% even where these services were offered at significantly larger scale."

<sup>32</sup> See the CMA's "Summary of hearing with Royal Dutch Shell plc on 10 December 2015", particularly paragraphs 13, 18, 19 and 22



## **The assumptions underlying the CMA's analysis would not allow average or peak working capital requirements to be met**

117. The CMA's analysis of the cost of meeting working capital requirements is another area where the costs associated with the retail supply business are materially understated.
118. In relation to working capital we understand that the CMA continues to base its analysis of average capital requirements on the creditor days of the large energy firms, rather than those that would be available to a stand-alone supplier operating under an intermediary fee arrangement. As CRA's Confidentiality Ring analysis shows, adjusting to standard arms' length industry payment terms and/or terms embedded in the mid-tier supplier's intermediary fee agreements would already strongly reduce the CMA's estimate of the ROCE that would be earned by a stand-alone British Gas.
119. Moreover, no allowance is made for peak requirements, with average working capital still used as a basis for the working capital requirement despite suppliers' need to maintain sufficient capital to meet peak requirements. This is especially relevant to Centrica with a higher proportion of gas customers, with the peak in gas debtors (due to sensitivity to variations in season and weather) being almost twice the annual average. Instead working capital requirements are calculated at average levels, with peaks left to be met through a combination of (unpriced) credit and (insufficient) cash.
120. Instead the CMA makes various references to credit facilities being available from banks and to the credit facilities available to Just Energy in the US.<sup>33</sup> However, there is no indication that the CMA has taken any account of the cost of these facilities. This is particularly important as, given that intermediary fee agreements involve the intermediary taking a charge over the assets of the supplier, any further credit facility would have to be unsecured. As the evidence of Just Energy's unsecured credit facilities clearly demonstrates (and as set out in more detail in our ROCE appendix), this would be extremely expensive.
121. Given that the CMA has not made any allowance for the costs of accessing such credit facilities (or for the fact that these credit facilities tend to dry up at times of market stress), this leaves peak working capital requirements to be met through cash.
122. The CMA has agreed that gas requires greater costs of risk management than electricity, and has adjusted Centrica's cash balances as a percentage of cost of sales by up to 3%.<sup>34</sup> However a simple comparison of this level of cash with Centrica's variations in working capital requirements demonstrates that this remains entirely inadequate to deal with our peak working capital requirements, as is shown in more detail in CRA's Confidentiality Ring analysis.
123. Therefore in our view the CMA's assumptions on the level of both average and peak working capital required are too low – resulting in a substantial overstatement of ROCE. The CRA Confidentiality Ring analysis shows the sensitivity of the CMA's findings to these mistaken assumptions.

### ***The CMA's implied view of energy purchasing***

124. The CMA's PDR only rarely mentions energy purchasing and appears sceptical over the benefits that longer term energy purchasing offers, and in particular the value that

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<sup>33</sup> PDR A3.4-76/77, paragraphs 23-28.

<sup>34</sup> PDR A3.4-41 paragraph 125.

some customers place on smoothed energy prices. For example, in addition to disregarding the product differences between SVT and FTC products, the CMA suggests, in its proposed regime for financial reporting, that competitive SVT procurement costs should be modelled on the basis of 1 month ahead purchasing.<sup>35</sup>

125. This is a deeply theoretical and unrealistic (essentially unhedged) benchmark and ignores what actually happens in retail energy markets through an entire commodity cycle (i.e. during rising as well as falling wholesale commodity markets).
126. If SVT products were in reality procured and priced on an unhedged basis it would result in extremely volatile customer prices for any customers who remained on SVT terms. In reality customers do not (and do not want to) switch suppliers every month, and therefore responsible suppliers must hedge even in the absence of exit fees/restrictions to ensure they can serve customers without forcing huge swings in prices on them
127. If customers did in fact shop around monthly to select the best price for the month ahead the entire basis for the operation of the market would have to be fundamentally different: it is very unlikely that many customers would accept highly volatile pricing patterns implied by the CMA's proposed cost benchmark – some form of longer term hedged product (with contractual commitment/exit fees) would need to be developed.
128. There is no reason to believe consumers would be better off under these hypothetical scenarios. Customers who do not value smoothed price products are already able to purchase products embodying shorter term purchasing patterns: but we do not believe it is right to assume that all customers would do so in a competitive market. In any event, such hypothetical scenarios have little relevance to the *actual* workings of competition.
129. Similarly, we strongly disagree with the CMA's assertion that "to the extent that an energy supplier purchases energy for a longer period than it has fixed its retail prices, this activity is (strictly) speculation rather than hedging".<sup>36</sup> This would imply that purchasing more than a month ahead in relation to a supplier's SVT customers would represent "speculation". To the contrary, in our view *failing* to do so would be speculative for the reasons set out above.
130. If the CMA disagrees and believes that longer term energy purchasing is bad for consumers it should say so and (critically) *explain why*, in order that this hypothesis can be properly tested and subjected to a process of consultation and challenge. We believe that the hypothesis would not survive such a process.

### **Conclusion on detriment**

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<sup>35</sup> PDR paragraph 10.265.

<sup>36</sup> A3.4-50 paragraph 8.

131. We therefore continue to view the CMA's assessment of detriment as severely flawed. This is particularly the case in relation to the CMA's new "direct" approach to detriment assessment, which is not only crude but also entirely inconsistent with both the development of competition over time, and the CMA's own "indirect" assessment. Moreover, even this "indirect" assessment remains a very material overstatement of detriment, given the flaws in the CMA's underlying ROCE analysis and the problems with the lower quartile approach to indirect cost comparison.
132. An adjusted approach, taking account of the reality that many customers do care about their product type and about smoothed pricing, and that the types of customers disproportionately served by British Gas (SVT, gas and SME customers) are relatively high cost to serve in terms of managing risks and dealing with peaks in working capital, would show far lower gains from switching, far lower "detriment" and far lower "excess" profits.
133. As noted above, it is vitally important that the CMA's assessment of detriment is based on an accurate assessment of the market because the CMA's methodology will inevitably become part of the regulatory "toolkit" for the future assessment of competition in this market. As that methodology currently stands the future regulation of the industry will be guided by measures of "detriment" that in fact will not be strongly related to the intensity of competition or the efficacy of the CMA's remedies, but instead will be dominated by movements in the wholesale energy markets. Particularly at a time when the energy markets face so many challenges in meeting the energy "trilemma" this would serve not only the industry but also energy consumers poorly.

## Transitional price cap for prepayment customers

134. We strongly object to the principle of introducing price regulation for any segment of the retail market as it is inconsistent with the promotion of competition. Indeed, the CMA itself has stated a clear preference for remedies that enable competition rather than those that control outcomes. Therefore the hurdle the CMA has set itself for the introduction of a price cap is high.
135. The analysis presented by the CMA to support the introduction of a price cap does not meet this hurdle. In particular, the CMA has not demonstrated that the remedy is necessary, that it is proportionate and that it is non-discriminatory (as is required under EU law and related case law<sup>37</sup>). Furthermore the CMA's other remedies offer an alternative, competitive solution, but would be rendered entirely ineffective for the customers affected by the proposed price cap remedy.
136. There will also be severe unintended consequences of the cap, particularly at the unsustainably low price level proposed, which is derived from a deeply flawed benchmarking methodology. Even if the benchmarking methodology is corrected to generate a more sustainable reference price, the cost indexing methodology is also flawed so it is highly probable that the level of the price cap would become too low (or too high) in the future.
137. Our detailed response to this proposed remedy follows and is split into the following sections:
- Justification for the proposed price cap;
  - Unintended consequences;
  - Benchmarking methodology; and
  - Cost indexing methodology.

### ***Justification for the proposed price cap***

#### **A cap is not necessary and is not in the general economic interest**

138. The CMA is proposing a highly interventionist price control remedy with the stated aim of mitigating “the residual detriment suffered by domestic customers on prepayment meters” and ensuring PPM customers are supplied with energy at “reasonable prices”.<sup>38</sup> However the basis upon which the CMA justifies this remedy is unfounded because its analysis of customer detriment is fundamentally flawed (as we have set out above in the “Customer detriment” section). The CMA has not shown that PPM customers are currently paying unreasonable prices; the fact that the PPM price cap may reduce the prices paid by certain customers does not demonstrate the necessity for a PPM price control as required by EU law.
139. In particular it is inappropriate to base a price cap remedy on an analysis of detriment that fails to take into account the substantial differences between the customer and product mix of the suppliers in the benchmark and that of the market as a whole. This issue is made more serious by the CMA basing its benchmark on a non-representative set of customers and failing to properly account for legitimate differences in the cost

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<sup>37</sup> Case C-265/08 Federutility and Others v Autorità per l'energia elettrica e il gas, para 46

<sup>38</sup> PDR paragraph 7.19 and 7.206.

base of suppliers and for sustainable profit margins (as we explain in more detail later in our assessment of the CMA's Benchmarking Methodology).

### **A price cap remedy is not proportionate**

140. The imposition of any price cap is inconsistent with the promotion of competition, and in particular is fundamentally incompatible with the CMA's objective of stimulating customer engagement. We, like the majority of other stakeholders including independent experts, raised these concerns in response to the Provisional Findings and Possible Remedies. Indeed the CMA itself acknowledges that a price cap risks "undermining the competitive process, potentially resulting in worse outcomes for customers in the long run... through a combination of reducing the incentives of suppliers to compete and reducing the incentives of customers to engage"<sup>39</sup>.
141. The CMA has proposed other remedies by which the barriers to competition for customers on prepayment meters can be removed. Allowing prepayment pricing at a national (or grouped region) level and the redistribution of tariff pages will enable the prepayment infrastructure to handle hundreds of new tariffs. This, combined with remedies that enable more tariffs, bundles, cash credits and PCW deals along with the smart meter roll out, provides the opportunity for a step change in engagement for prepayment customers in advance of the roll out of smart meters.
142. However the price cap remedy will render these remedies entirely ineffective for prepayment customers (and potentially also for some customers not currently prepaying) for the following reasons (which are covered in more detail below):
- Customers will be disincentivised from engaging in the market due to the safe haven effect<sup>40</sup> of a regulated tariff (and this could have repercussions for the success of the smart meter roll out);
  - Suppliers and PCWs will do as much as they can to limit their exposure to this market segment due to the negative or low returns and high risk of market distortion (due to the benchmarking and indexing methodologies);
  - Rateably hedged tariffs, fixed price products and innovative propositions will not be offered to prepayment customers as the methodology limits the type of products that can be efficiently hedged and prevents sustainable returns; and
  - The design generates 210 variants<sup>41</sup> of the price cap, completely negating the remedies designed to overcome the limitations of the prepayment infrastructure and adding a huge level of complexity and administrative burden for customers, suppliers and Ofgem.
143. These issues are likely to arise as a result of any price cap, but are greatly increased if it is set at the onerously low level proposed. The Court of Justice of the European Union (CJEU) has accepted that a measure which ensures fair remuneration for suppliers and allows them to recover their costs can be proportionate. As we demonstrate later in the Benchmarking Methodology section, the proposed cap risks being loss-making for many suppliers and so the proposed remedy risks being incompatible with EU law.

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<sup>39</sup> PDR, paragraph 146

<sup>40</sup> PDR paragraph 7.24-5

<sup>41</sup> See section "Cost indexing methodology" below

144. Furthermore we note that the CMA acknowledges that “a cap covering a relatively restricted proportion of customers, such as prepayment customers [about 16%], is likely to be less prone to adverse consequences than a cap covering a broader group”<sup>42</sup>. However the CMA has failed to take into account that the proportion of customers prepaying may eventually increase significantly as a result of this remedy and also with the roll out of smart.
145. We describe these issues in more detail in the section titled “Unintended Consequences” below.

*The proposed cap fails to meet the requirements of EU law on temporal limitation*

146. In addition, even if a cap were deemed necessary the principle of proportionality requires that such an intervention “must be limited in duration to what is strictly necessary in order to achieve its objective”<sup>43</sup>. The fact that an intervention has been labelled as “temporary” in national law is not in itself sufficient for a finding that it is of proportionate duration.<sup>44</sup>
147. Further, in *Federutility* the CJEU regarded it as crucial that there is periodic re-examination at close intervals as to the need for, and the suitability of, intervention measures such as a price control. It does not appear to us sufficient in this regard that the cap is reviewed in April each year – as it appears to be proposed that this review will simply consider the level of the cap and not its continued necessity per se.
148. It therefore seems to us that any cap must have a specified limit, must also only operate for a reasonably short period of time and be set at a level that is no more restrictive than is necessary for serving the general economic interest in question or would otherwise be contrary to Article 3(2) of the Directives and EU law.
149. The CMA does not give any grounds for the cap being removed except the extent of the smart roll out (regardless of the ongoing necessity or effectiveness of the remedy). Furthermore it acknowledges there is “uncertainty about the possibility of a price cap being in place beyond 2020”<sup>45</sup> and that it may give Ofgem discretion based whether the smart roll out is complete. If a single customer refuses to allow access for a smart meter exchange then this could be used to justify a continuation of the cap, particularly given the risk of political pressure to maintain the cap<sup>46</sup>. This risk is exacerbated if the cap is set at the extremely low level proposed as once the cap is removed prices are likely to increase in order to return to a sustainable level.
150. In this respect, we regard the proposal that this cap apply until 2020 with one (limited) review taking place in 2019 is disproportionately long time against the background of a competitive market and possibly a range of other remedies being implemented. In our view, it would require a compelling justification for this approach to be lawful.

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<sup>42</sup> PDR paragraph 4.121

<sup>43</sup> Case C-265/08 *Federutility and Others v Autorità per l'energia elettrica e il gas*, para 35. “intervention “must be limited in duration to what is strictly necessary in order to achieve its objective, in order, in particular, not to render permanent a measure which, by its very nature, constitutes an obstacle to the realisation of an operational internal market in gas”.

<sup>44</sup> Case C-265/08 *Federutility and Others v Autorità per l'energia elettrica e il gas*, para 35.

<sup>45</sup> PDR paragraph 7.180.

<sup>46</sup> As we and others have raised, see PDR 7.254. This could be somewhat mitigated if the CMA were to introduce remedies to help enable the timely roll out of smart meters, as we raise in the Executive Summary.

151. As a separate matter, the CMA does not consider a derogation procedure is needed to dis-apply the price cap temporarily, suggesting that the price cap can be challenged by market participants by appealing of the Final Report.<sup>47</sup> Centrica does not believe this properly reflects the need for a temporal limitation as required by EU law. The fact that suppliers can appeal the Final Report in 2016 provides no safeguards that the measure is or remains necessary until 2020 and hence also fails to meet the EU law Third Package requirements.

### **The cap proposed is discriminatory**

152. The CMA's remedy (whilst applicable to all suppliers with PPM customers) imposes a disproportionate and discriminatory financial burden on certain suppliers and, as such, is contrary to established case law<sup>48</sup>. This burden arises because some suppliers have a higher proportion of prepayment customers than others, as illustrated below. Since different suppliers are, for this objective reason, in a different position, the measure will likely give rise to discrimination unless regard is paid to those objective differences in the design of any price cap.

*Table A - Analysis of prepayment customer base across suppliers*

<b>% of base on PPM (Dec 14)<sup>49</sup></b>	<b>Elec</b>	<b>Gas</b>
<b>Utilita</b>	99.4%	98.8%
<b>British Gas</b>	21.2%	16.6%
<b>Industry Avg.</b>	16.6%	15.1%
<b>OVO</b>	6.2%	6.1%
<b>First Utility</b>	0.1%	0.0%

153. The burden also arises from the Benchmarking Methodology which produces a cap that is not representative of a sustainable prepayment price that allows for the efficient recovery of costs. The Cost Indexing Methodology also risks discriminating between suppliers, particularly as it is predicated on bills being split into each cost element in a particular proportion that does not reflect the reality for all suppliers. It also fails to allow for certain costs that are likely to increase substantially in the future (such as the cost of smart roll out and the capacity mechanism).

154. Both elements of the methodology therefore discriminate against those suppliers with a higher than average proportion of prepayment customers since they will be able to recover proportionately less of their costs than others.

### **There are other, less onerous options available**

155. We believe that the broader package of prepayment remedies already proposed by the CMA (notably enabling more prepayment tariffs, bundles and cash credits) will be effective in removing barriers to competition that currently exist in the prepayment sector. When considered alongside our concerns regarding the CMA's detriment analysis, we therefore consider the price cap to be unnecessary and counter-productive.

<sup>47</sup> Para 7.143.

<sup>48</sup> Case C-265/08 Federutility and Others v Autorità per l'energia elettrica e il gas, para 46.

<sup>49</sup> Source: [https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage\\_q4\\_2014\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage_q4_2014_0.pdf)

156. Furthermore, given that the CMA has provisionally concluded that some form of remedy aimed at protecting prepayment customers is warranted, there is a range of other potentially less damaging interventions the CMA could have considered. It is unclear from the PDR whether all these have been properly considered or consulted upon. As such, we have serious concerns that the process followed by the CMA in its development of the prepayment price cap proposal is flawed. Other remedies that we would have expected the CMA to test include:

- **Restricting the prepayment price cap to only those customers who had a prepayment meter at a given point in time** (for example on the date the PDR was published). This would limit the scope of the price cap remedy to the 16% of the market that the CMA is targeting, rather than the much larger proportion of the market that it may capture as a result of the smart roll out (which enables customers to switch to prepay more easily and cheaply) or of other customers switching to a prepayment meter in order to obtain access to the regulated price cap.
- **Restricting the prepayment price cap to only customers who have a dumb prepayment meter.** This would also limit the scope of the price cap remedy to the 16% of the market that the CMA is targeting (with the proportion impacted reducing over time with the roll out of smart meters). This would also prevent customers with smart meters from becoming disincentivised from engaging in their energy supply, thereby ensuring that the benefits of smart are achieved as quickly as possible.
- **Restricting the prepayment price cap to only customers on SVT or 'default' tariffs.** Customers on fixed term contracts have, by the CMA's definition, engaged in the market recently and so should not need 'safeguarding'.
- **A prepayment price cap based on a more rational approach to benchmarking and cost indexing.** This would require the CMA to address a range of concerns that we describe later.

### **Unintended consequences**

157. A price cap, particularly if set at the unsustainably low level proposed, will have severe unintended consequences that will render the remedy ineffective and disproportionate. It will reduce customer engagement, stifle innovation and result in severe financial harm to suppliers. Specifically, the damaging unintended consequences that can be expected include the following (which we describe in more detail below):

- Reduction in the incentive for suppliers and PCWs to compete;
- Volatile prices year on year risk harm and distress to prepayment customers;
- New volumetric risk;
- Withdrawal of fixed price contracts and stifling of innovation;
- Reduction in prepayment customer engagement;
- Negative impact on the smart meter roll out; and
- Cost to the industry of withdrawing existing products and hedges.

### **Reduction in the incentive for suppliers and PCWs to compete**

158. The CMA states that it is necessary to set the "price cap at a sustainable level" to reduce the "likelihood that suppliers seek to limit their exposure to the market or that



they feel it necessary to try to reduce the quality of service in order to save costs”.<sup>50</sup> The CMA has not set the cap at a sustainable level (as we explain in the Benchmarking section below) and therefore the likelihood of these outcomes is extremely high.

159. As currently designed, the prepayment price cap will have the following impacts (described further below):

- The prepayment market segment will not provide sustainable revenues;
- Suppliers will seek to avoid acquiring and retaining prepayment customers; and
- PCWs will have little or no incentive to serve prepayment customers.

160. If such perverse and uncompetitive outcomes are to be limited, then the cap would need to be set at a level at which a reasonable proportion of suppliers and PCWs are able to continue to compete.

*The prepayment market segment will not provide sustainable revenues*

161. The CMA states that it has aimed to “help preserve suppliers’ (both existing and new entrants’) incentives to compete and mitigate the risk that suppliers are not able to earn adequate revenues under the cap”.<sup>51</sup> However the current design fails to achieve this and, in fact, results in a price cap that has the opposite effect: it *removes* the incentive to compete and the vast majority of suppliers will *not* be able to make adequate revenues.

162. At the price cap level proposed we estimate that revenues from the supply of prepayment customers will become unsustainably low for the majority of the market and loss making for many suppliers. This will weaken competition and may even see some companies exiting the market entirely.

163. The unsustainably low level of the cap is clearly apparent when one considers the impact it would have on OVO’s prepayment prices. Regulations require the difference between PPM and DD prices to be cost reflective, and so we would also expect OVO’s prepayment prices to be “competitive” according to the CMA’s logic. It therefore seems perverse that the supplier whose DD prices have been used to derive the benchmark should be required to drop their PPM prices by such an extent (particularly as the cap is supposed to be £50 *above* the reference price to allow for headroom).

164. Independent analysis by Bernstein<sup>52</sup> also concludes that  $\llcorner$ .<sup>53</sup>

165. These issues are the result of the CMA taking an unrepresentative sample of customers for the benchmark and then failing to make the adjustments necessary to correct this flaw. We explain this further in the Benchmarking Methodology section below.

*Suppliers will seek to avoid acquiring and retaining prepayment customers*

166. In recent years we have competed vigorously for new customers in the prepayment sector. In December 2015, for example, we launched a new product (available to all customers including PPM customers) with a fixed price until July 2018.

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<sup>50</sup> PDR paragraph 7.170.

<sup>51</sup> PDR paragraph 7.21.

<sup>52</sup> See the independent view of Bernstein market analysts in Appendix 3: “Bernstein price cap assessment”

<sup>53</sup> We would note that the Bernstein analysis estimates a level of the price cap of  $\llcorner$ , compared to the  $\llcorner$  suggested by our analysis. We believe this difference is largely driven by our use of the updated Typical Domestic Consumption Values (TDCV) which took effect on 1 September 2015.

167. Furthermore, with the CMA's other remedies (notably the removal of RMR tariff restrictions and of technical limitations on the number of prepayment tariffs that suppliers can offer) the level of competition for prepayment customers would increase significantly (in the absence of a cap).
168. However the introduction of the price cap as proposed will remove the incentive for suppliers to offer such products or seek to acquire new PPM customers. In the absence of sustainable revenues, economically rational suppliers will have an incentive to reduce their share of the PPM market, and withdraw from this market segment as far as is possible under the terms of the supply licence. Suppliers can be expected to curtail marketing and acquisition activity for PPM customers and the focus for this segment will instead shift to the minimisation of cost and risk exposure.
169. This undermines the effectiveness of the other remedies being introduced by the CMA specifically aimed at increasing the ability of suppliers to engage customers (e.g. the removal of tariff restrictions).

*PCWs will have little or no incentive to serve prepayment customers*

170. This will have a knock on impact on PCWs as suppliers have little or no incentive to acquire prepayment customers, so they will both stop (or substantially reduce) commission payments to PCWs for prepayment acquisitions and exclude prepayment customers from the exclusive PCW deals that the CMA is trying to encourage.

*Increased cost of debt write offs*

171. Prepayment meters are often used as a means by which customers can manage the repayment of debts. The negative or low margins available from prepayment customers, however, will mean that suppliers have less incentive to recover debt in this way. Instead they are likely to write off more debt than before and to pursue more costly debt recovery methods. This could add cost to the industry that would otherwise not have existed without a price cap.

**Volatile prices year on year risk harm and distress to prepayment customers**

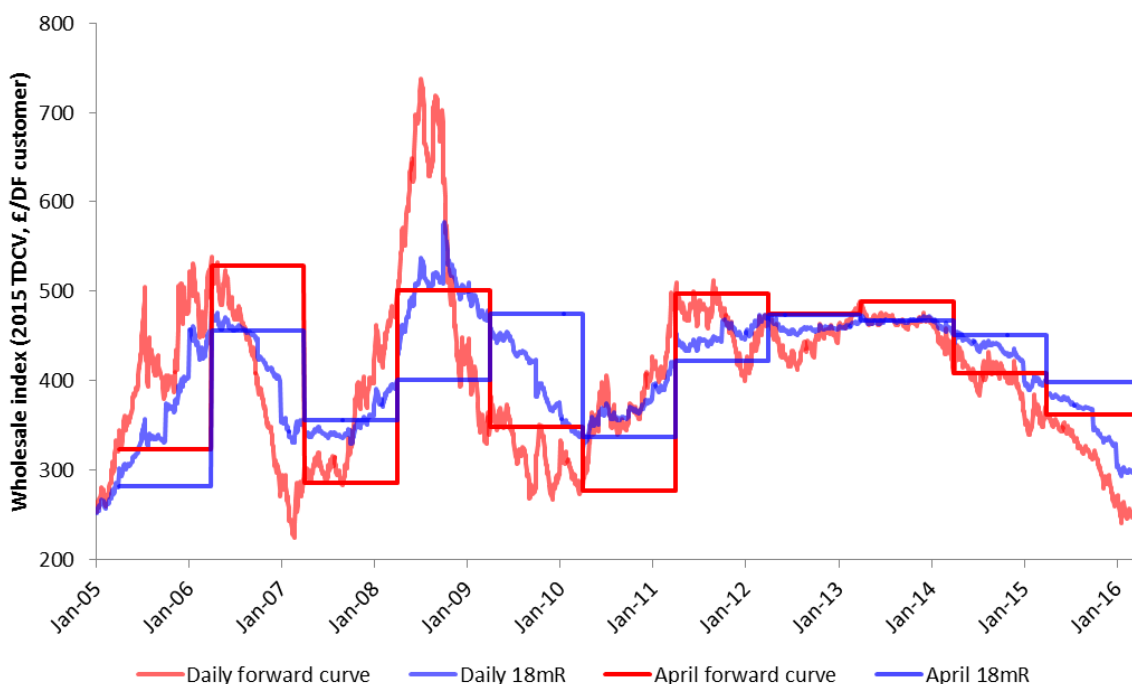
172. The CMA's approach is likely to result in customers experiencing more volatile retail prices because it appears to base the commodity index on a short period of time (possibly only a single day - 1 April). This index does not align with the current market in which the majority of prepayment customers are on products that are variably priced and rateably purchased<sup>54</sup>. The current rateable approach has had a smoothing effect on prices that limits the price volatility to which prepayment customers are exposed.
173. Under the price cap, however, suppliers will not be able to offer rateably purchased products. Instead suppliers are likely to seek to purchase 100% of forecast volume when the price cap is set in order to remove the risk of not being able to change prices in response to movements in wholesale costs. Suppliers can therefore be expected to all follow the same purchasing strategy - purchasing back-to-back with the index to ensure their costs are reflective of the index (regardless of whether that is the best outcome for consumers).

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<sup>54</sup> Rateable purchasing is the process of building up the commodity required over time in advance. For instance, an 18 month rateable strategy will start buying 18 months ahead of each delivery period. This has the benefit of smoothing commodity-driven price changes and spreading the liquidity requirement for a large portfolio of customers.

174. To illustrate the effect this will have on the volatility of the retail price, we have created a potential commodity price index using quarterly forward gas prices and seasonal forward baseload and peak power prices<sup>55</sup> (paras 7.110) then shown how these would have varied since 2005 and the impact of pricing on the day on 1<sup>st</sup> April each year.
175. The chart below shows that an index pricing on a given day (“April Forward Curve”) would have resulted in more volatile consumer prices than an equivalent rateable purchasing strategy (“April 18mR” - a proxy for the wholesale component of a standard variable tariff)<sup>56</sup>. For example under the market conditions experienced in 2008, prepayment customers under the proposed cap would have seen prices rise by £210 (for the commodity component of the bill alone), costing customers £160 more than if they had been on SVT product with, for example, an 18m rateable purchasing strategy.

*Figure C - Comparison of potential power cost indices*



176. Moreover, if the price cap had been in place at the time, it is likely that the historic volatility on 1 April each year would have been far greater than it was (and than is shown in the chart above). This is because suppliers, acting rationally, would seek to minimise risk by purchasing commodity for all PPM customer on this pricing day, placing severe pressure on market liquidity (requiring over ten times the typical daily liquidity for front winter season power for example). This will expose customers to even greater volatility year-on-year.
177. Given that many of these customers are on prepayment meters to help them manage expenditure and / or debt, this could have a particularly harmful effect – resulting in higher debts and distress for some customers as well as a fall in consumer trust in the market.
178. Furthermore, for long periods of the commodity cycle a rateably priced product, such as SVT, would have been cheaper than the price cap. This suggests that the price cap

<sup>55</sup> Seasonal power price constructed from quarterly prices to maintain consistency with gas methodology

<sup>56</sup> The chosen 18mR uses the same price indices and fixes the energy cost not advanced purchased on an 18mR on the day the price is set (approximately 40% of the 12 month cap period).

could be detrimental to customers as it removes the possibility of suppliers offering such tariffs due to the risks involved (as we explain below).

179. There are several ways the index could be improved to reduce the impact of pricing volatility on consumers. We discuss each of these in more detail in the Cost Indexing section below and in Appendix 4: “Price cap energy purchasing”.

### **New volumetric risk**

180. As explained above, suppliers will look to buy up to 100% of their forecast commodity requirements for the cap period. This introduces a volumetric risk with uncertainty over the amount of volume actually required by suppliers due to potential changes in customer numbers, consumption and weather. This risk is exacerbated by the cap period running from April to April, because demand (and therefore risk) is highest in the winter months which fall towards the end of the cap period, furthest from when the initial commodity cost was set.
181. The CMA fails to allow for the cost of managing this new risk therefore the CMA must do one or more of the following:
- Increase the price cap to allow for the cost of managing this risk;
  - Use a rateable hedging index rather than the price on a day; or
  - Change prices every six months rather than annually.

### **Reduction in customer engagement and the withdrawal of fixed term and innovative products**

#### *Withdrawal of fixed price contracts and price convergence*

182. The proposed commodity index proposed by the CMA means that the price of the cap could increase or fall on the 1st April each year. This will result in the withdrawal of fixed price products (other than a one-year tariff each April 1st). Each supplier can be reasonably expected to fully hedge customer demand for the capped period in order to minimise price risk as they would not be able to recover any potential commodity price increases until the next annual review.
183. For example, if a supplier was to offer a fixed price product that ran from October to October, it would bridge two cap periods. This presents at least two challenges:
- The supplier may not be able to procure commodity at a level comparable to that used in setting the cap for the first 6 month period if commodity prices have increased; and
  - For the second 6 months (in the new cap period) the commodity index may fall below the level it was when the product was priced. The supplier would then be exposed to the commodity price risk as they would be obligated (by the imposition of the price cap) to reduce the tariff price below the cap and absorb the losses.
184. This also means that any new products that would have been launched as a result of the CMA’s other remedies (e.g. removal of the 4 tariff limit and freeing up of meter slots) will not be offered. As a result there is a serious risk that the market will stagnate and converge around the same hedging strategy and price (around the level of the cap).

185. This will have the further impact of all prepayment customers changing price (by a potentially highly volatile amount) on 1 April every year. This is likely to create major spikes in customer contact that will be costly to handle. It will also mean messages being sent to every prepayment device on the same day every year, which could take many months to fully process given the infrastructure limitations that the CMA has itself identified as an issue<sup>57</sup>.

#### *Stifling of innovation*

186. In addition it is likely the price cap will mean PPM customers will fail to benefit from the innovation that will be enabled by the CMA's other remedies. For example there will be little or no incentive for suppliers to offer exclusive PCW deals, tracker products or time of use tariffs. These latter tariffs (such as our current "Free Time" tariff) can be extremely low cost for customers who are willing and able to adjust their consumption profile<sup>58</sup>.

187. Innovation is further stifled by the lack of tariff slots available on dumb prepayment meters. Whilst the CMA has remedies to help increase the number of slots, the price cap creates 210 different price points so the issue will arguably remain (and worsen).<sup>59</sup>

#### *Disincentivisation of customer engagement*

188. The existence of a regulated tariff (particularly set at the extremely low level proposed) will reduce the incentive for prepayment customers to engage in the market. Many respondents (including Centrica) have previously presented evidence that price caps can have a 'safe haven' effect, with large numbers of customers remaining on their current tariff (either actively or passively), despite the presence of more competitive offers. Ofgem agrees that there is a "risk that the tariff could reduce incentives to engage and switch tariff or supplier"<sup>60</sup> and the CMA itself admits a cap "is likely to reduce the potential benefits of competition".<sup>61</sup>

189. Also, crucially, the increase in engagement that would have ensued as a result of the other proposed remedies (particularly the removal of RMR tariff rules and the freeing up of prepayment tariff slots) will not occur if the price cap remedy is imposed. As above, this will be compounded by PCWs and suppliers having little or no incentive to drive engagement from prepayment customers (e.g. by offering FTCs or innovative tariffs).

#### **Negative impact on the smart meter roll out**

190. The price cap has damaging implications for the rollout of smart meters: it will slow down the roll out and potentially increase the costs and reduce the benefits, as described below.

#### *Pace of smart roll-out*

191. The price cap, at the low level proposed, will reduce the price differential between tariffs for smart and dumb prepayment meters because it is unlikely that suppliers will be able to reflect the full cost difference in the dumb prepayment price whilst remaining

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<sup>57</sup> PDR paragraph 7.107

<sup>58</sup> However if the customer does not modify their behaviour they might end up paying more than the cap allows. If the supplier is liable for this breach, then they will not offer such tariffs.

<sup>59</sup> See Cost Indexing Methodology section below

<sup>60</sup> PDR paragraph 7.25

<sup>61</sup> PDR paragraph 8.51

under the cap. This will reduce the incentive for prepayment customers to switch to a smart meter by eliminating most or all of the gains to switching. This will be compounded by the “safe haven effect” whereby customers on dumb prepayment meters will become less engaged in the market, feeling less inclined to consider switching meter (or tariff or supplier).

192. The incentive for suppliers to win or convert customers with dumb *credit* meters to smart meters will be reduced, as once a customer has a smart meter it is very easy for them to switch to prepayment. If they make this switch then they will become subject to the cap, and generate a loss / unsustainably low margin for most suppliers. This would represent rational customer behaviour, for example, if commodity prices escalate rapidly within-year, and uncapped tariffs increase above the PPM cap. Similarly the incentive for some suppliers to win *new* smart prepayment customers may also be reduced by the low price cap (if they would be acquiring unsustainably low margin customers).
193. As well as dampening competition and prolonging the existence of the price cap, these outcomes are concerning because they would hamper the speed of the smart roll out, thereby delaying the customer benefits.

#### *Cost of smart roll-out*

194. Suppliers *may* have more of an incentive to convert their *existing* PPM customers to smart meters in order to reduce the cost to serve of such customers (although they may focus instead on reducing market share to stem losses). However this would increase the overall cost of the smart roll out by introducing inefficiency i.e. suppliers will no longer be incentivised to roll out in a way that would have been optimally efficient in the absence of a cap. As the CMA itself has stated a targeted approach to the smart roll out would be “detrimental to the efficiency of the overall roll-out”.<sup>62</sup>

#### *Benefits of smart roll-out*

195. Even customers who have smart prepayment meters may not receive the full benefits of smart due to the “safe haven” effect, whereby they feel they do not need to concern themselves with reducing their bills by shopping around or managing their consumption because the regulator is doing it for them. This will severely undermine the benefits case for smart meters and prevent the step-change in engagement and innovation that the CMA itself expects.

#### **Cost to the industry of withdrawing existing products and hedges**

196. Some suppliers, including British Gas with our July 2018 product, have fixed price products in market for prepayment customers that end after the proposed date on which the price cap will come into effect.
197. If the price cap is applied to these existing tariffs at the onerously low level proposed, then we estimate that we would lose  $\pounds$  as a result (as the commodity has been bought in advance). If commodity prices fall further then this cost would increase (since the cap would force the price down even lower). We cannot mitigate this risk as we need to hold the commodity we have already purchased so that, in the event that commodity prices rise, we can still honour the price that we promised our customers.

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<sup>62</sup> CMA's Second Supplemental Notice of Possible Remedies, para 61

198. Our July 2018 product was launched at a highly competitive price – it was the cheapest fixed price product available to prepayment customers in the market (and its DD equivalent was the 4<sup>th</sup> cheapest tariff that could be fixed for more than 1 year) – and the large number<sup>63</sup> of customers who switched to it were clearly engaged. It would therefore be entirely disproportionate and discriminatory for the CMA to require us to reduce the price of this product in line with the cap and incur such a loss.

### ***Benchmarking methodology***

199. As provisionally designed the benchmark methodology will result in a price cap that is not representative of a sustainable price. If the proposed remedy is implemented, the level of the cap must be increased if it is to enable the efficient recovery of costs and to provide adequate revenues (as is the CMA's stated intent)<sup>64</sup>.

200. The benchmark methodology leads to an unsustainable price because it is based on the DD prices of two cherry picked suppliers who have very different mix of customers and products than the market average, with very few prepayment customers (e.g. only 0.1% of FU's base). By taking this approach the CMA has failed to accurately account for the following components (which are described further below):

- Loss recovery;
- Gross margin contribution due to consumption levels;
- Cost advantage due to growth;
- Prepayment uplift; and
- Sustainable profits.

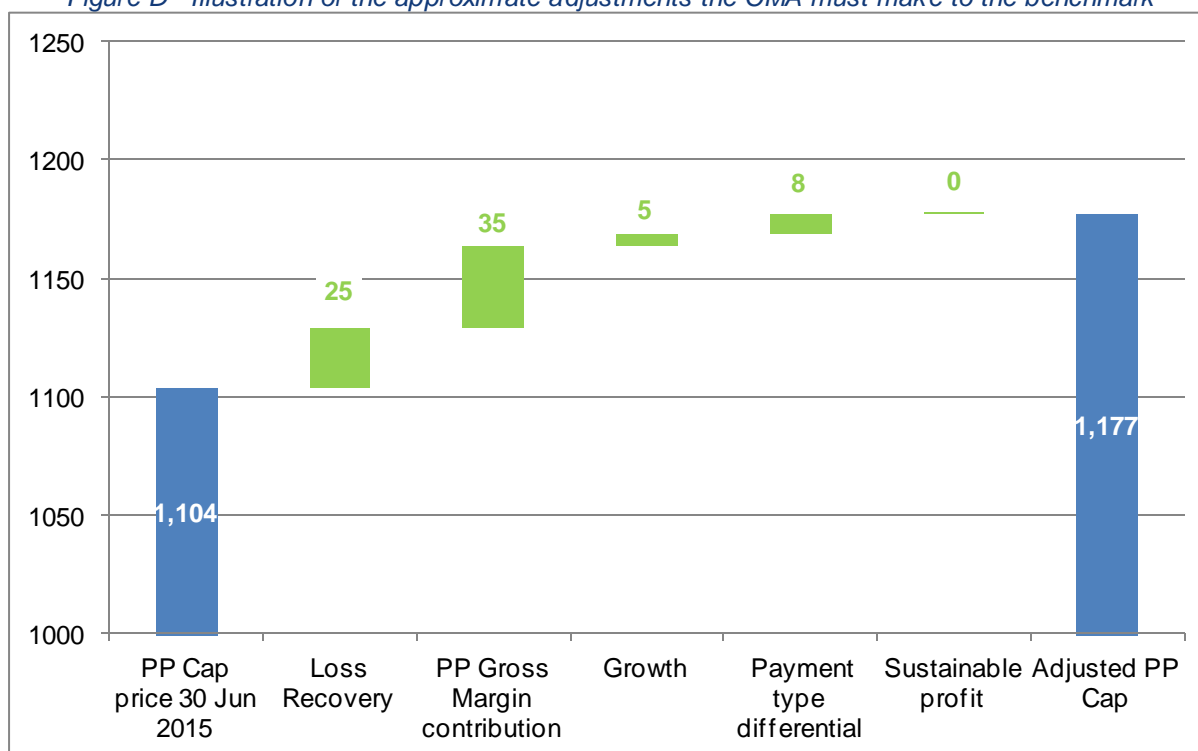
201. To illustrate the impact of these components we have produced the following graph based on high level analysis of the limited information to which we have access. If the CMA were to properly adjust for these legitimate differences in cost bases then the price cap benchmark from June 2015 would be £73 higher (excluding profit). It does not allow for sustainable profits incremental to headroom.

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<sup>63</sup> ✂

<sup>64</sup> PDR paragraph 7.21

Figure D - Illustration of the approximate adjustments the CMA must make to the benchmark



202. The CMA could account for the differences by adjusting the benchmark up based on industry averages. This does not mean building in an allowance for inefficiency (which presumably the CMA is seeking to avoid), but rather basing the uplift on what it would cost the suppliers in the benchmark to serve an industry average customer base.
203. This would still be far from perfect, as the customer mix of a given supplier relative to the industry average will give them a relative advantage or disadvantage, but it would be considerably better than the current approach which is based on a particularly skewed customer mix.

### Loss recovery

204. OVO made a loss in 2014<sup>65</sup> of £33m (£22m net) equating to a loss of approximately £25 per customer. They have publically stated their aspiration to make higher profits in the future<sup>66</sup>, whereas currently they are sacrificing margin for growth (with customer numbers nearly trebling in 2013-14).
205. Having made a loss in 2013, FU made a £11m profit in 2014, but as well as rapid growth they apparently experienced difficulty in maintaining service levels (announcing £20m of investment in customer service improvements in November 2014).<sup>67</sup>
206. For the industry as a whole therefore, the profitability of these suppliers does not represent a sustainable, competitive benchmark. A price cap based on this level of profitability is wholly unsuitable as it will harm competition and the likelihood of suppliers entering or remaining in the market.

### Gross margin contribution due to consumption levels

<sup>65</sup> 2015 profits yet to be published.

<sup>66</sup> <http://businesslife.ba.com/People/Interviews/business-life-meets-Stephen-Fitzpatrick.html>

<sup>67</sup> <http://www.moneysavingexpert.com/news/utilities/2014/11/first-utility-faces-customer-backlash-as-complaints-double>



207. OVO and FU have an overall average consumption per customer that is far higher than the industry average.<sup>68</sup> For a given bill cost, relatively high consumption allows lower unit prices.
208. The CMA must therefore adjust the price cap to allow the same level of Gross Margin as was earned in the benchmark (as well as making the other adjustments described in this section), in order to allow fixed costs to be recovered at typical consumption levels, consistent with a sustainable market outcome.

### Cost advantage due to growth

209. The rapid growth of OVO and FU compared to the majority of the market (by share) dilutes costs that are set based on a suppliers' size at a particular point in time.<sup>69</sup> For example WHD and ECO obligations are set at the start of each year, so any growth during that year will reduce the cost per customer of delivering the obligation (whilst any reduction in market share will increase the relative cost).
210. For OVO and FU who grew significantly in 2015 (in part because they have sacrificed sustainable margins for growth) this has provided a significant cost advantage of approximately £5 per account that should be adjusted for within the price cap.

*Table B - Analysis of ECO cost savings per account*

<b>FU + OVO 2015</b>	<b>Accounts acquired (000's)</b>	<b>ECO costs <i>not</i> incurred for new accounts<sup>70</sup></b>	<b>Avg. no. of accounts (000's)</b>	<b>Saving per account</b>
<b>Gas</b>	260	£ 2,874	1,124	£ 2.56
<b>Elec</b>	305	£ 3,372	1,259	£ 2.68
<b>Dual fuel</b>				£ 5.24

### Prepayment uplift

211. The level of uplift (£54) assumed by the CMA is below the recognised level of cost. In coming up with this value the CMA has disregarded the £80 figure recognised by Ofgem based on a significant level of consultation and analysis. It is even below the level derived from the CMA's own bottom up analysis.
212. The CMA's paper first sets out a "top down" analysis of payment type differentials, comparing the difference between costs to serve DD and PPM customers across suppliers. After adjustments the CMA states that this range is £34-127, with a mid-point of £80.50 (prior to any weighted averaging).
213. In contrast the CMA's bottom-up analysis provides a range of £50-£66. However it is not clear whether bad debt charges (BDC) have been properly accounted for in this range. The CMA's approach is to reduce the level of the differential by DD BDC, before applying the resulting net differential to the DD prices of OVO/ FU DD. To obtain an accurate benchmark it is essential that this difference is derived from the actual level of OVO / FU's DD BDC costs (as it is OVO and FU's DD FPP prices, which will most

<sup>68</sup> Largely due to having very high proportions of direct debit customers (who are typically higher consuming than PPM customers) and due to having an acquisition and pricing strategy targeted at high consuming customers more generally.

<sup>69</sup> e.g. ECO is set based on a suppliers' share of total volume of electricity supplied as of the start of each year

<sup>70</sup> Derived from <https://www.gov.uk/government/collections/household-energy-efficiency-national-statistics>

strongly reflect their own bad debt costs). If instead the CMA has used a market average BDC differential then it will have reduced the uplift by too much since FU and OVO have lower levels of customer debt than the market average.<sup>71</sup>

214. The CMA then decides to take into account the “top-down” data supplied by just one supplier (Utility Warehouse) to extend the lower end of the “bottom-up” range to £42-£66, disregarding the evidence of all other suppliers. It then takes the mid-point of this new hybrid range (£54).
215. The fact that this proposed level is below the cost differential of all but one of the large suppliers is further evidence that it is clearly too low. We do not believe the CMA is correct to treat this low differential as an “efficient” benchmark,<sup>72</sup> as to do so relies on the idea that any difference in *differential* between DD and PPM costs are an indication of lack of efficiency, but this is not the case as:
- A higher differential is driven not only by higher costs for PPM customers, but also lower costs for DD customers (e.g. lower bad debt levels<sup>73</sup>): clearly the latter cannot be considered an inefficiency; and
  - There is also no evidence that higher costs in relation to PPM customers represent inefficiency: there are a wide range of “real” reasons why these could differ (e.g. payment technology chosen by customers, geographic spread of customers, relative scale of the PPM and DD customer segments) as well as “accounting” reasons why they could differ (e.g. due to different categorisation of costs) that have nothing to do with supplier efficiency.
216. Without any evidence that some suppliers are substantively inefficient, and that this inefficiency drives the differential, we believe it is more appropriate to base the allowed differential on an average of the actual costs experienced by suppliers. Whilst we do not have access to the data required to derive this figure, we note the CMA believes this average (after its adjustments) to be £62.30 for the SLEF, so we would expect this to be a reasonable benchmark.

### **Sustainable profits**

217. The adjustments above provide a breakeven price cap for the allegedly most “competitive” supplier plus £50 of headroom. The price cap would therefore need to increase if the price is to allow a sustainable margin and headroom.

### **Cost indexing methodology**

218. There are serious flaws in the cost indexing methodology which could lead to material inaccuracy and volatility over time (as well as complexity). These flaws exist in every element of the indexing methodology (Overall Approach, Wholesale Costs, Network Costs, Policy Costs, Indirect Costs, and Prepayment Uplift). We address each of these in turn below.

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<sup>71</sup> Although we do not know OVO and FU’s bad debt charge for their DD customers, public information provided by Ofgem makes clear that their overall levels of customer debt are far smaller than the market average: [https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage\\_q4\\_2014\\_0.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2015/09/externalreportpage_q4_2014_0.pdf).

<sup>72</sup> PDR A3.6-24 paragraph 88(b).

<sup>73</sup> Each supplier will have a different distribution of risk in its customer base – suppliers with a higher than average % of financially strained customers or higher proportion of customers from Change of Tenancy will have more customers in debt and therefore incur more cost as a result.

219. In order to help assess the validity of the CMA's indexing approach we believe it should run the benchmarking analysis on other dates to provide actual prices against which to compare the derived price that the index produces. For example, the CMA could compare the price produced by the actual bills of OVO's and FU's DD customers<sup>74</sup> on each of 31 December 2014 and 31 December 2015 and compare the result to the prices that the index predicts they would have been when applied to the current 30 June 2015 benchmark. Furthermore, if the indexing approach is valid then it should be possible to apply it to other suppliers' data to compare predicted versus actual prices paid by their customers. The CMA should carry out such a test as well.
220. We do not believe that the current indexing approach would stand up to such testing due to the issues outlined below. The CMA must demonstrate that its final design does stand up to such analysis.

## Overall Approach

### *Proportion of bill*

221. The CMA indexing approach relies on an assumed proportion of bill components based on "analysis of the components of a typical domestic energy bill for financial year 2014". As such these proportions will not align to the actual proportions of the OVO / FU bills used in the June 2015 benchmark nor, more generally, to the proportions of a prepayment bill. Furthermore the CMA does not allow a proportion for profit nor does it take into account the fact that the proportions will change at different consumption levels.
222. If these proportions are not correct, then the index will become less and less accurate over time. This is a view shared by Bernstein:
- "The methodology rests on a number of assumptions including applying a notional split of the benchmark tariff which may not correspond to the actual split. This is problematic as the future indexation is based on an inaccurate split of the starting point"*<sup>75</sup>.
223. The sensitivity of these proportions can be seen, for example, if one considers the Wholesale Cost component. For example if the CMA's proportions are out by 10%<sup>76</sup>, then the 26% fall in commodity prices between the June 2015 benchmark and 31 March 2016<sup>77</sup>, would result in the price cap being nearly £20 higher or lower than it should be. This approximately equates to either £80m customer detriment or £80m supplier losses across the market.

*Table C - Bill proportion sensitivities*

	Proportion	Benchmark Cap 5/4/16	Wholesale cost	Index cost change %	Index cost change £	Difference per d/f bill
<b>CMA level</b>	59%	£728	£430	-26%	-£112	£0
<b>+10% error</b>	69%	£728	£502	-26%	-£131	-£19
<b>-10% error</b>	49%	£728	£357	-26%	-£93	£19

<sup>74</sup> Or the equivalent set of customers if the CMA decides to base the benchmark on a more representative set of customers as we argue for above.

<sup>75</sup> See the independent view of Bernstein market analysts in Appendix 3: "Bernstein price cap assessment"

<sup>76</sup> Which is highly plausible according to our analysis of the limited detail supplied by CMA

<sup>77</sup> As estimated based on our attempt to replicate the CMA's methodology

### *Fixing proportions regardless of consumption*

224. Not all costs have a linear relationship with the volume of energy sold e.g. fixed T&D or metering costs are proportionately higher at lower consumption levels. This means that the starting assumptions regarding the proportion of the bill for each cost element will be inaccurate at lower and higher consumption points. This issue will distort the price cap and will become worse over time as the indexing is repeatedly applied. The issue could be somewhat mitigated if the CMA were to publish different proportions for each consumption point.
225. Furthermore the CMA's approach of referencing three consumption points with straight lines in between, will mean that certain levels of consumption will be generate far more profit or loss than others. This will result in cross-subsidisation between different customers and distort competitive behaviour by suppliers (e.g. targeting specific customers more than others in a way that would not have been the case without such a cap). The CMA also does not provide any means by which to calculate the level of the price cap below the lower consumption point or above the higher point.

### *Complexities of having 210 variations of the price cap*

226. The methodology creates 210<sup>78</sup> different price points for the price cap. This will incentivise suppliers to match as many of these price points as possible with variations of the same product, taking up most if not all the available tariff slots for just one product. This will mean that the remedies to make "better use of the available tariff codes"<sup>79</sup> designed to aid competition will instead result in the unintended consequence of enabling more variation of the same tariff.
227. Moreover it will be onerous to administer for suppliers, and for Ofgem to monitor compliance. It will also create confusion for customers and increase the number of messages that need to be sent to devices across the prepayment infrastructure.
228. To help mitigate this, the CMA should group regions or have a national average price cap. This would be in keeping with the CMA's other remedy to soften SLC 22B.7 to enable pricing to be done in this manner<sup>80</sup>.
229. The CMA should also remove the dual fuel price cap and instead just have the two single fuel price caps, with a dual fuel discount applied separately. This would align with how pricing works today and avoid significant complexity. If the separate dual fuel cap remains then if a customer were to switch from being single fuel to dual fuel or vice versa this would require multiple price changes for customers and multiple messages to be sent to devices.

## **Wholesale costs**

### *Volatility and liquidity (see Appendix 4: "Price cap energy purchasing" for further details)*

230. As explained above<sup>81</sup> suppliers under the proposed PPM cap, acting rationally, can be expected to seek to minimise risk by purchasing commodity for all PPM customer on day the price cap is set (1 Apr). This will place severe pressure on market liquidity

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<sup>78</sup> 14 regions x 3 consumption points x 5 fuel and meter combination (gas, electricity, dual fuel and economy 7 for both electricity and dual fuel). Given how low the proposed cap is, suppliers are likely to try to cover as many price points as possible, thereby restricting suppliers to potentially only one product.

<sup>79</sup> PDR paragraph 5.197

<sup>80</sup> See PDR paragraph 5.208

<sup>81</sup> See section on "Volatile prices year on year that risks harm and distress to prepayment customers"

(requiring over ten times the typical daily liquidity for front Winter season power for example). This will expose the price cap to even greater volatility (year-on-year).

231. This could be mitigated by including one or more of below:

- Use a rateable purchasing index rather than the price on a day;
- Allow a pricing-in period for the index;
- Change prices every six months rather than annually (based on an annual forward cost view, to avoid unnecessary volatility).

232. Building up the index rateably over a period of time would address concerns about market liquidity and vulnerability to increased price volatility due to the large volumes coming to market. We regard this as the best alternative to the CMA's proposal.

233. If such an approach is not considered suitable, then at the very least it would be necessary to "price-in" the index over a period of time. A pricing-in period of three or six months would keep a closer link to current wholesale prices, but reduce the liquidity risk. This has the advantage of allowing suppliers to purchase their requirements for customers over a longer period of time, leaving the index less prone to short-term impacts and more resilient to short term market movements/spikes.

234. The CMA could also reconsider a six-monthly price cap update based on the full year forward price (to overcome the CMA's concerns about seasonality).<sup>82</sup> This would create more price changes but they would typically be smaller and would follow the underlying wholesale price more closely. This would also reduce the volume risk for suppliers described earlier.<sup>83</sup>

235. Regardless of the hedging approach, there will need to be a lag between the end of the pricing-in period and the delivery period of at least a month to allow the index formula to be validated and for suppliers' systems to be updated. Once each customer's new price was known then, as per the regulations, suppliers would need to give customers 30 days' advance notice (of a price rise). Therefore, if this regulatory requirement were to be maintained, then a two month lag would need to be built into the indexation approach.

236. Taking all of these elements together, were the CMA to proceed with this remedy, we consider that the distortions we have identified with the operation of the CMA's index would be minimised if the CMA's chosen methodology had the following features:

- Based on a 12 month rateable hedging strategy;
- A one month pricing-in period;<sup>84</sup> and
- A lag before delivery to allow sufficient time to validate the index and to pre-notify customers of price rises.

237. This approach provides a balance between relatively lower volatility for retail prices and a minimal time lag to the prevailing market prices.

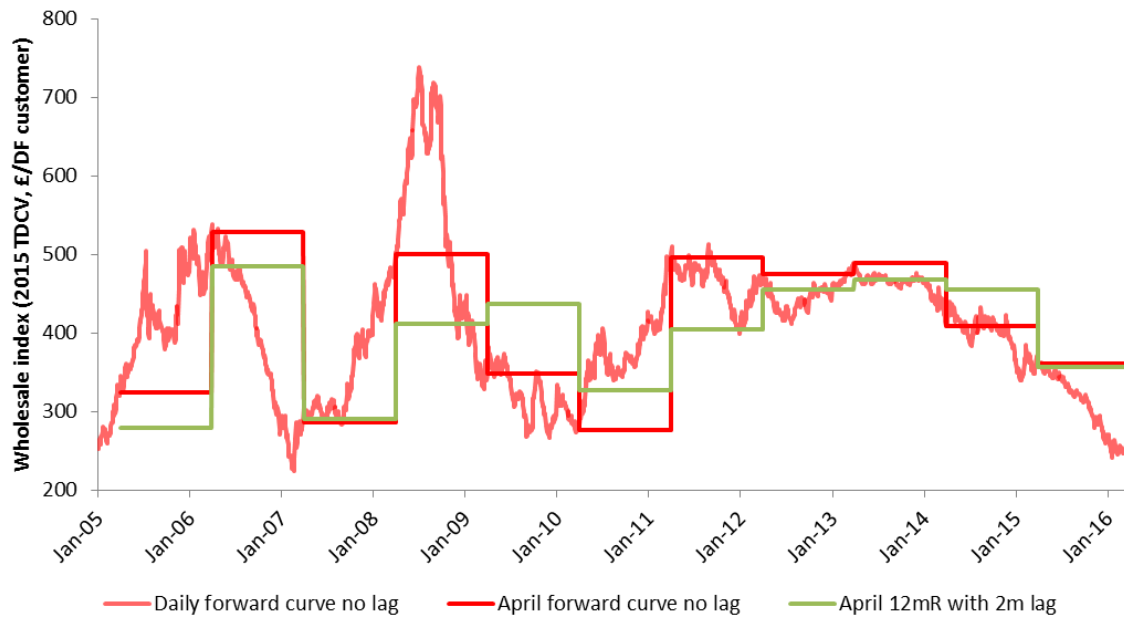
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<sup>82</sup> PDR 7.104

<sup>83</sup> See section on "New volume risk"

<sup>84</sup> In a pure 12mR strategy, c. 50% of the demand for the coming year remains unhedged at the start of delivery so this still presents some liquidity constraints which a 1-month pricing-in period helps to alleviate.

Figure E - Illustrative price indices



### Shaping and balancing

238. As currently indicated in the PDR, the methodology does not accurately recognise shaping and balancing. In particular:

- The approximation for the residential demand shape using season and quarters does not reflect the impact of seasonality of demand for either gas or power;
- Using a ratio of 30% working day peaks and 70% baseload (as proposed by the CMA) will not fully reflect changes in cost of residential supply as illustrated below; and
- The proposed ratio fails to capture low overnight prices and demand and does not adequately capture evening peaks (which are only partially in the standard traded peak period on weekdays and traded peak products do not cover weekends at all).

239. These factors could all lead to an over- or under- calculation of the changing costs to supply customers with gas and electricity.

### Network costs

240. The methodology for determining Network Costs should be based on published cost data where available, rather than forecasts which result in inaccuracies. It is not clear why the CMA has chosen not to use actual published cost data.

241. Published prices will be available by the end of each year for the following April 1<sup>st</sup> for the vast majority of T&D costs (note as an example that Electricity Distribution prices for April 2017 are already available now). The published prices include both a pence per day for fixed and a pence per unit for variable costs. These should be used to separately index the fixed and variable elements of the network costs as each element typically moves by different amounts.

242. There are a number of reasons why using the approach currently proposed by the CMA, using the revenues published by Ofgem in the December of each year, does not provide an accurate view of changes in domestic costs, including:

- The revenues, calculated by Ofgem, do not include many of the items (e.g. incentive payments, pass-through items) recovered through network charges. This would typically result in revenues being understated.
- These revenues are presented by Ofgem in real terms. An appropriate adjustment would be required to allow for inflation (the Retail Price Index is used by Ofgem for network costs).
- Electricity Transmission costs for customers increase by more than the increase in revenues. Electricity Transmission charges paid by *generators* are fixed (at the level of a cap stipulated by EU legislation). This means all increases in transmission revenue fall on customers, with customers therefore paying an increasing proportion of transmission revenues. For example, domestic transmission charges for 2016/7 increased by around 24% on average, relative to an increase in revenues of around 18%.
- The proportion of revenue allocated to domestic customers will also routinely change from year-to-year (meaning charges will move differently to revenues). This is due to changes in input data or the charging methodology affecting the charging models used by the network companies.

243. Further problems with the proposed approach to indexing Network Costs include:

- A proposal is to allocate the revenues of the Scottish Transmission companies to only those regions (i.e. North and South Scotland separately). However, in practice revenues are pooled across GB. This is likely to mean that the revenues used for indexation for the Scottish regions will be overstated (and understated elsewhere). For example, the revenue collected through transmission charges from Scottish users in 2016/7 is expected to be less than half of the revenue allowed for the Scottish companies (of just over £600m).
- Revenues for Offshore Transmission are not referenced and are expected to increase sharply over the next few years. National Grid's most recent 5-year forecast for transmission charges shows Offshore revenues increasing from £261m in 2016/7 to £875m in 2020/1<sup>85</sup>.
- It is stated that for the purposes of the indexation calculation the revenues of the system operators are ignored. However, it is expected that these system operator revenues will increase at a very different rate to the other revenues.

### Policy cost

244. The CMA must provide a mechanism that allows for the inclusion of:

- New policy costs arising in the future. For example the CMA has failed to account for the increasing cost of the capacity mechanism and yet this is expected to cost billions of pounds by 2020 in order to keep the lights on (as DECC has identified the need to increase capacity, which in turn will increase the future exit price above current levels).
- Under / over recovery of the outturn of costs such as CFD costs which are dependent on both the level of wholesale costs and the amount of qualifying generation making the cost hard to predict in advance. The cost of CFD's while small today is likely to increase substantially over the cap period (from £0.1bn in 2015-16 to £3.1bn in 2020-21 according to OBR projections).

<sup>85</sup> <http://www2.nationalgrid.com/UK/Industry-information/System-charges/Electricity-transmission/Approval-conditions/Condition-5/>

- Under / over recovery of the outturn of policy costs such as ECO, which historically have sometimes varied substantially to forecast.<sup>86</sup> DECC's original impact assessment identifies a range of scenarios with costs varying by over 70%.<sup>87</sup>
- The impact of Government proposals to exempt, from 2017/18, Energy Intensive Industry from RO, FiT and CfDs costs, for up to 85% of their demand. This means that a greater proportion of policy costs will fall on domestic customers from that point. The OBR projections do not allow for this.

### Indirect costs

245. The CMA methodology assumes that indirect costs will only rise with inflation. This is not the case. In particular the CMA has failed to account for the cost of the smart meter roll out. This will result in an increase to opex initially, before an eventual decrease as efficiency benefits of the new technology are realised. If the CMA does not account for this cost then the burden (and eventual cost savings) of the roll out will fall disproportionately on non-prepayment customers.
246. Furthermore the level of these costs will vary each year for each supplier depending on its strategy and level of success. The CMA needs to carefully consider the impact that its cap (which effectively caps the level of opex each year per prepayment customer) might have on a suppliers' ability to efficiently meet its smart roll out targets (since each supplier will have already planned on a particular roll-out / cost profile).
247. There may also be other exceptional indirect cost impacts on the industry over time so the CMA must provide the means by which these can be taken into account.

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<sup>86</sup> A simple review of DECC's forecast of past ECO costs suggests a high degree of accuracy, however this masks the high unit cost of HHCRO and SWI measures combined with low CERO and CSCO volume delivery early in ECO. The cost forecast was accurate, but only on the basis of material volume and price forecast variances that happened to net off. There is no guarantee this will be the case in the future.

<sup>87</sup> DECC Final Stage Impact Assessment Green Deal Energy Company Obligation (p59) sets out scenarios showing how the cost of obligation delivery can vary from the central forecast driven by uncontrollable factors. DECC suggest that costs could be c.70% higher than the central case in one scenario; for the stated £1.35bn central cost forecast this equates to an additional £1bn of cost or £38/yr difference per DF customer. Additionally the scenarios are not exclusive and could be combined to imply a cost variation of >100% of the central case.



## Creating a framework for effective competition

### Withdrawal of the simpler choices component of the RMR rules

248. We strongly support the CMA's provisional decision to remove the "simpler choices" component of the RMR rules. This will address a number of key barriers which currently prevent suppliers from developing propositions that drive customer engagement in the market. In particular, we believe that:

- removing the simpler tariff rules will improve the effectiveness of competition and increase customer engagement;
- the CMA should also remove the RMR's information remedies until such time as they can be replaced;
- the proposed Market-wide Cheapest Deal remedy is unworkable; and
- implementation should be fast-tracked, and Ofgem's position on enforcement in the interim clarified urgently.

### ***Removing the simpler tariff rules will improve the effectiveness of competition and increase customer engagement***

249. The package of changes proposed by the CMA will enable suppliers to develop a richer, more varied range of innovative and engaging propositions than is possible today. This will in turn enable suppliers to target the customers of other suppliers more effectively.

250. In particular, the remedy as proposed will allow suppliers to be far more creative with their tariff design, and allow suppliers to tailor products to meet specific needs, developing new innovations and realising the benefit of new technologies such as smart meters. Importantly, it will also mean that customers are able to choose the form of propositions, discounts and bundles that best suits them, rather than having their choices constrained by regulation.

251. For example, the removal of the simpler choices component of the RMR will also enable suppliers to focus on developing innovative non-price factors within their propositions. These changes will enable suppliers to emphasise that more effectively in the design of their propositions.

252. This increased innovation is also timely, occurring just as the rollout of smart meters continues to gather pace. The market will continue to evolve rapidly in coming years, given the proven ability of smart meters to accelerate customer engagement and change the fabric of underlying industry systems and processes. As we detail below, this places particular emphasis on ensuring that the remedy is implemented as soon as possible.

253. In order to get the full benefit from this proposal, the CMA should mirror the changes made in SLC22B with changes to SLC31D; the licence condition that applies the simpler choices component of the RMR to white label suppliers. Without doing this, white label suppliers would remain subject to regulations such as the four tariff cap when other suppliers are not. The CMA should also review SLC22C.9 which prevents

suppliers from unilaterally increasing the price of fixed term contracts, in effect prohibiting all but a narrow range of tracker tariffs<sup>88</sup>.

254. We also agree with the CMA that the simpler tariff component of the RMR has acted as a barrier to PCWs negotiating deals with specific suppliers. Removing these restrictions will further increase competition within this sector, and should improve customer engagement still further by increasing the numbers of customers using PCWs.
255. Whilst the benefits of the proposal are material, the costs of implementation are small. We therefore agree that the proposed remedy is no more onerous than is needed to achieve its stated aim. We also believe that there are no better alternatives to resolving the problems created by the RMR, but there are a number of ways in which it could be improved and made more effective. These are set out below.

***The CMA should remove the RMR's information remedies until such time as they can be replaced***

256. As Ofgem itself points out, removal of the 'simpler choices' element of the RMR has repercussions for some of the information remedies also introduced by the RMR. In particular, we believe these changes make the CTM and Tariff Comparison Rate (TCR) increasingly misleading and redundant. For example, these reforms will mean that suppliers can be expected to develop tariffs that include a wide variety of products and services in an attempt to win new business, including the non-price factors referenced above. In such a world, metrics that focus solely on the headline price, such as the CTM and TCR, will be increasingly misleading when used to compare the value of deals available across the market.
257. We do not agree that these metrics can be adequately updated to take account of these developments. Instead, the CMA should recommend Ofgem remove, and not redesign, both the CTM and TCR swiftly after the publication of the Final Report.
258. For example, it is not possible to communicate accurately within the CTM the 'value for money' a standard variable tariff offers compared against a dynamic Time of Use (ToU) tariff with conditional discounts and reward points for a customer with variable demand and in a market with volatile underlying commodity prices. Without information about the customer's past and likely future behaviour, the number of assumptions required when including such a tariff in the CTM would be likely to make the resulting savings claim inaccurate.
259. In some cases the product that a customer might value most, such as a tariff that has a slightly higher headline price but comes with other products and services that cannot be expressed in those terms, may not be apparent to the customer. We also expect the removal of the simpler tariffs component of the RMR will result in tariffs offered which are exclusive to certain customer groups, something which the CTM cannot easily accommodate.
260. Furthermore, the issues associated with the TCR today will only get worse as suppliers look to launch more varied, innovative, tariffs in to the market. This metric is already inaccurate today for any customer not consuming precisely the 'average' annual amount of energy, does not include any ToU tariffs, and has the potential to lead to

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<sup>88</sup> These exceptions are specified in SLC22C.11.

poor quality switching decisions. In future, it will not be able to accommodate the type of complex tariffs envisaged by the removal of SLC22A, nor reflect the value of the more varied and innovative tariffs that will be offered more generally following the removal of the simpler tariffs component of the RMR.

261. There is a risk that, if prescriptive information remedies such as the CTM and TCR remain in market following the conclusion of this review, suppliers will continue to face incentives to focus on developing tariffs which suit the CTM and TCR. This would favour the type of tariffs that we see in the market today, such as single unit rate and standing charge propositions, with restrictions on the type of additional benefits that detract from the 'headline' tariff rate. Innovations such as dynamic ToU pricing, bundled products that cannot be incorporated in to the headline price, conditional discounts incentivising cost saving behaviour and reward points would in effect continue to be disincentivised.
262. We also note that the CMA has argued that prescriptive regulations can limit "suppliers' ability and incentives to compete and innovate in designing tariff structures"<sup>89</sup>, and that this has created an AEC. We agree with this conclusion, and highlight the inconsistency between that and the decision to retain prescriptive measures such as the CTM and TCR which similarly limit incentives to innovate in tariff design.
263. If the CMA continues to believe that revised information remedies are required, the only possible solution will be to replace these prescriptive rules with something more principles based. This would at least allow suppliers to innovate with ways that help their customers understand and engage with the products available in ways which did not constrain the design of tariffs, but still delivered a particular consumer outcome.
264. We would also suggest that the CMA considers the timing of the changes in rules relating to the information remedies carefully. Retaining the RMR "clearer" information remedies while the "simpler" tariff restrictions are removed risks creating customer confusion which could undermine the effectiveness of the CMA's remedies aimed at creating a more effective framework for competition. Instead the rules relating to the "clearer" information remedies should be set aside by Ofgem in the same way and at the same time as is planned for the "simpler" tariff restrictions, at least until an appropriate principles-based approach to information provision can be introduced. In the meantime, the clarity and content of information suppliers provide to their customers will still be bound by the requirements of the supply licence (including standards of conduct), and broader consumer protection legislation.

### ***The proposed Market Cheapest Deal remedy is unworkable***

265. The CMA has recommended that Ofgem trials market wide CTM, something that has previously been considered (and rejected) at an early stage under both RMR and this investigation, with the CMA itself concluding such a remedy "would not provide customers with the correct incentives to engage effectively in the market in the longer term."<sup>90</sup>
266. Setting aside our concerns about the proposal for Ofgem to trial and test various engagement remedies<sup>91</sup>, we believe this concept, previously known by Ofgem as the

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<sup>89</sup> Provisional Findings and Notice of Possible Remedies, section 12.

<sup>90</sup> See Paragraph 141 of the CMA's Notice of Possible Remedies, July 2015

<sup>91</sup> See our response regarding the "Ofgem programme to provide customers with information to prompt them to engage" later in this document.

Market Cheapest Deal (MCD), is seriously flawed to such a degree that it would be a waste of considerable time and resource to revisit it again and to do so at such a late stage in this market investigation, without any indication why it has been reconsidered.

267. In a retail market as innovative and dynamic as that envisaged by the CMA following the removal of the tariff restrictions, and assuming the MCD will be based on publicly available information, the time lag between extracting data and the delivery of customer communications means such messaging is highly likely to be inaccurate and misleading by the time it reaches customers. This may particularly be the case if exclusive PCW offers and time-bound collective switch offers are included within the scope of any MCD. The effect of advising customers of a particular tariff, only for them to find that it is no longer available is likely to be an increase in disengagement and a deterioration in levels of trust (as well as an increase in the cost of handling associated queries and complaints).
268. We also have concerns about the lack of detail about how the tariff information necessary for the MCD to operate would be shared between suppliers. For example, the regular sharing of tariff data bi-laterally between suppliers could give rise to concerns under competition law.
269. Furthermore, it is not clear how a supplier would best take into account the value of non-price factors when making the calculations, or indeed reflect both the costs associated with a low headline unit rate and standing charge as well as the impact of fees such as exit and late payment charges. It is also difficult to build in the type of complexity that ensures customers only see tariffs appropriate to them.
270. Importantly, the cheapest deal in the market at any one time may also be with a supplier that is exempt from delivering a number of Government schemes. This could mean customers are encouraged to transfer to a supplier that would not continue to pay their Warm Home Discount<sup>92</sup> - making any such advice inaccurate for that customer. Whilst changes could be made to the design of the MCD in an attempt to accommodate WHD variations, the value of other schemes varies on a customer to customer basis. For example, the value of free energy efficiency installations delivered under the Energy Company Obligation (ECO) is specific to an individual customer's circumstances. It would not be possible to show the value of potential ECO benefit a customer could lose by switching to an exempt supplier.
271. Finally, we do not consider it is possible for a MCD to show, with a sufficient degree of accuracy, the best value tariff over the lifetime of the contract on offer. Crucially, FTC customers are purchasing energy not at a point in time, but over a one, two or even three year period. It is not possible to show how the value of an energy tariff will change over the period of the contract within a MCD metric, meaning the best deals may not be displayed and customers may be encouraged to make poor switching decisions. For example, in a rising market the best deal may well turn out to be a long term FTC with a headline rate above the cheapest in market at the point of comparison.
272. Whilst complications such as these can be addressed at least to some extent by suppliers within their own tariff range, this becomes impossible when all suppliers need to follow a standard methodology. This will also be increasingly difficult once the RMR

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<sup>92</sup> The Warm Home Discount is currently valued at £140/annum.

'simpler tariffs' components are removed, and tariffs become increasingly varied and innovative.

273. We therefore strongly oppose the introduction of the MCD, and believe it would not only be ineffective at encouraging engagement, but would, to the contrary, act to disengage customers by promoting inappropriate tariffs and encouraging poor quality switching decisions. From a process point of view, the CMA has not explained why it is seeking to revive a proposal previously considered and dismissed. Instead, we believe the CMA should focus on remedies which encourage use of price comparison websites, where more tailored and accurate quotations can be provided.

***Implementation should be fast-tracked, and Ofgem's position on enforcement in the interim clarified***

274. Given the material consumer benefits associated with this remedy and the ease with which it could be implemented, the removal of the simpler choices component of RMR should be implemented sooner than 2017. We are concerned that, as proposed, the implementation of this remedy will be unnecessarily delayed, potentially undermining the benefits it will bring to both competition and consumers. The sooner this remedy is introduced, the sooner the benefits will be realised – and we see little reason why, given how straightforward it will be to remove the simpler tariff rules from licence, that it could not be implemented immediately following the CMA's Final Report.
275. In addition, we suggest that the CMA implements this remedy directly rather than recommending Ofgem do so. The CMA has sufficient powers to take a more direct approach to implementation<sup>93</sup>, and the precise conditions that need to be removed are known. Given the clear consumer benefits from an early implementation, and the CMA's ability to ensure this happens with the publication of the Final Report, we recommend the CMA take the lead on implementing this remedy.
276. This has the potential to increase competitive pressures in the market reasonably quickly. Not only is this the preference of the CMA<sup>94</sup>, it also raises the possibility that, freed from these restrictive licence conditions, suppliers will be able to compete more effectively across all customers groups, including prepayment customers.
277. Finally, if the CMA does decide it is appropriate for Ofgem to implement this change, we are concerned that the recommendation that Ofgem "deprioritises enforcement action" fails to provide the certainty suppliers need in order to launch propositions that are prevented today. The CMA should instead recommend that Ofgem publically state, as soon as possible following the publication of the CMA's Final Report in June, that it does not intend to enforce these SLCs while the changes are being made.

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<sup>93</sup> Schedule 9 of the Enterprise Act enables the CMA to modify, by order, licence conditions in regulated markets (paragraph 93, CC3 (revised)).

<sup>94</sup> Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3), paragraph 330 of CC3 (revised).

## Settlement reform

278. We agree that profile based settlement leads to a less accurate allocation of costs than settlement based on actual consumption. We also agree that profile based settlement dilutes the incentives on suppliers to encourage their consumers to change consumption patterns through, for example, dynamic ToU tariffs.
279. We therefore broadly support the CMA's remedies in this area, and consider that they will help improve the accuracy of settlement, and support the shift towards more dynamic pricing. In particular, we believe that:
- Half Hourly (HH) electricity settlement should be introduced as soon as there is a net customer benefit;
  - Suppliers should have access to more granular smart meter data;
  - Project Nexus should be delivered as soon as feasibly possible; and
  - Meter read submission standards and a gas Performance Assurance Framework will both benefit the accuracy of settlement.

### ***Half Hourly (HH) electricity settlement should be introduced as soon as there is a net customer benefit***

280. The introduction of HH settlement in electricity is central to improving the accuracy of cost allocation in the domestic and SME sectors. We also agree that HH settlement could facilitate load shifting, and agree with the CMA that the benefits of this include reduced short run marginal costs of generation, reduced capacity requirements, lower investment requirements for the distribution network, and improved environmental performance of the sector.
281. Whilst the CMA is correct to identify that HH settlement is a prerequisite of load shifting, it does not follow that this will naturally occur once HH settlement is implemented. Instead, this will be dependent on the demand for dynamic ToU tariffs, which is in itself dependent on a range of factors such as customer understanding and acceptance, as well as the spread between peak and off peak pricing. Modelling the customer demand for dynamic ToU tariffs should be central to Ofgem's cost benefit analysis.
282. Whilst we therefore support the principle of HH settlement for all electricity meters, we are concerned to ensure that it is not implemented before the point at which a full impact assessment shows the benefits case is net positive for consumers, allowing for a reasonable implementation period. We therefore welcome the CMA's provisional decision to recommend Ofgem completes a cost benefit analysis before proceeding with implementation. This analysis must be carried out separately for the domestic and microbusiness markets.
283. As part of this analysis, Ofgem should consider the distributional impacts of HH settlement on customers and the market, what benefits can already be realised today, for example through "chunking", what impact an initial move to elective HH settlement would have, what controls may be needed to protect those vulnerable customers who may be penalised under such a regime, when the benefits case turns net positive, how long should a reasonable implementation programme take (and therefore the optimum start date), a post-implementation review of the benefits of P272 and the opportunity cost of deploying resources to the HH settlement project (e.g. on diverting industry

resources from other programmes such as ‘Faster and More Reliable Switching’ or smart metering). Finally, Ofgem should also consider quantifying the benefits to competition flowing from more accurate settlement, as well as considering how these impacts vary between the domestic and SME sectors, where the costs, benefits and distributional impacts are likely to be different.

284. We also suggest that, as part of this remedy, the CMA includes a recommendation that Ofgem ensures the development of HH settlement is not completed until the point at which a full impact assessment shows the benefits case is positive, allowing for a reasonable implementation period – even if that delays its introduction beyond the “reasonable” period of time the CMA currently envisages. With this one caveat, we believe that this remedy will be effective at addressing the issues identified and proportionate to the materiality of those issues.
285. We agree that elective HH settlement creates a number of issues, for example the risk of gaming by suppliers and the distributional impacts associated with all customers paying for a system that only some can use. We therefore welcome the proposal that an assessment of these risks against the benefits of early implementation of elective HH settlement should form part of the cost benefit analysis it is proposed Ofgem will complete.
286. We also agree with the CMA’s proposal for Ofgem to agree a joint plan for the introduction of HH settlement. In doing this, it will be important to set out clearly their respective responsibilities, the deliverables each will provide, a timetable against which they aim to provide them (subject to the cost benefit analysis), and how market participants should engage with the work.
287. Finally, we agree that an Ofgem-led process for the assessment and delivery of HH settlement is preferable to the normal code modification route. Any decision taken by Ofgem on the implementation of HH settlement, including its design, should be subject to both a full impact assessment and a right of merits based appeal to the CMA. We note, for example, that DECC is currently proposing to remove any right of appeal to the CMA over the implementation of HH settlement. Good regulatory practice is a vital component in a robust regulatory regime, and impact assessments and merit-based appeals to the CMA are important checks and balances in the system. Without these there is a possibility that modifications could be made which could negatively impact consumers.

### ***Suppliers should have access to more granular smart meter data***

288. We are pleased that the CMA has provisionally decided to address the barriers suppliers face in accessing granular smart meter data. Access to this data is central to suppliers’ ability to realise the benefits envisaged above, for example dynamic ToU tariffs. Specifically, without access to this data suppliers will not know customers’ demand profiles and will not be able to accurately design and target tariffs that incentivise load shifting.
289. Notwithstanding this, we agree that controls on access to customer data need to be agreed, and that a DECC consultation exercise is an appropriate way to take this forward. We note however that the issue of consent here, for a narrowly controlled release of data needed for the efficient management of a customer’s energy requirements, can be distinguished from the more general release of customer data to a large database that can be accessed by a significant number of parties.

### ***Project Nexus should be delivered as soon as feasibly possible***

290. As we outlined in our response to the CMA's Provisional Findings, we also agree with the CMA that Project Nexus is central to resolving many of the current issues with gas settlement. We are keen to see the project implemented as soon as possible, and are supporting Ofgem and Xoserve in their efforts to deliver this by 1 October 2016. We therefore welcome the CMA's proposal that Ofgem take more control over the delivery of the programme, and recognise Ofgem's recent decision to act on this proposal early.
291. Notwithstanding these positive developments, we would like any recommendation to Ofgem to also provide them with the flexibility to delay the implementation further if they believe it is absolutely necessary<sup>95</sup>. The systems that Project Nexus is replacing are critical to the functioning of the gas retail market, for example the management of the change of supplier process. We would not therefore support proceeding with implementation on 1 October 2016 if, for example, the changes to the new systems had not been fully tested.

### ***Meter read submission standards and a gas Performance Assurance Framework will both benefit the accuracy of settlement***

292. We welcome the proposal to implement a Performance Assurance Framework (PAF) for gas settlement. Centrica has been central to industry efforts to develop this, for example by raising the original proposals for increased assurance of gas settlement performance<sup>96</sup>. We also support the development and implementation of both UNC MOD0506V<sup>97</sup> and MOD0520<sup>98</sup>, and continue to contribute to the ongoing work to develop the associated committees and their terms of reference.
293. We are also pleased that the CMA has recognised the disproportionate cost monthly meter read submissions would entail. The revised proposal for readings from traditional meters to be submitted annually, and meter readings from smart meters to be submitted as soon as possible and at least monthly, are reasonable and should be effective at achieving the CMA's aim of improving gas settlement accuracy. We note that in practice however, it is highly unlikely that any party will achieve 100% meter read collection over a given period of time. For example, some customers may refuse entry to their property. Any obligation in this area should allow suppliers to fulfil it by taking "reasonable steps", as the Ofgem licence condition<sup>99</sup> in this area does.
294. We agree with the CMA that "the main cause of inefficiency in the gas settlement process arises from the process of allocating unidentified gas between suppliers"<sup>100</sup>. The scale of unidentified gas, and the implicit cross subsidy that the SSP provides the LSP sector, is a material distortion of competition between suppliers that operate in

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<sup>95</sup> We note that in their recent open letter on Project Nexus implementation, Ofgem said that "We are focussed on the outcomes for consumers from this programme: success will be the delivery of new end-to-end systems which do not have negative impacts on consumers". See <http://www.gasgovernance.co.uk/sites/default/files/Ofgem%20Open%20Letter%20on%20Project%20Nexus%20and%20Ofgem%20sponsorship.pdf>

<sup>96</sup> For example, please see UNC MOD0379, "Provision for an AQ Audit": [http://www.gasgovernance.co.uk/sites/default/files/Modification%200379%20v6\\_0.pdf](http://www.gasgovernance.co.uk/sites/default/files/Modification%200379%20v6_0.pdf)

<sup>97</sup> UNC MOD0506V: "Gas Performance Assurance Framework and Governance Arrangements". <http://gasgovernance.co.uk/0506>

<sup>98</sup> UNC MOD0520 "Performance Assurance Reporting". <http://gasgovernance.co.uk/0520>

<sup>99</sup> SLC21B.4

<sup>100</sup> PDR paragraph 5.96.



these sectors. We therefore strongly welcome remedies which seek to address this issue. In particular we welcome the proposal to recommend that Ofgem develop the PAF in such a way as to ensure that unidentified gas is both efficiently allocated between shippers, and reduces over time. We agree that Ofgem is best placed to oversee the implementation of this new framework.

## **Remedies to address constraints on competition for prepayment customers**

295. We agree with the CMA that ageing and inadequate central industry infrastructure acts as a constraint on competition in the prepayment sector. In particular, this inefficient infrastructure adds cost and complexity to the supply of prepayment customers, and does not provide enough capacity to support a sufficient number of tariffs in the market. These issues will however be resolved in full and in a timely fashion by the CMA's proposals.
296. As we set out in our response to the CMA's Addendum to the Provisional Findings and Second Supplemental Notice of Possible Remedies, the smart meter roll out will also drive fundamental change in the prepayment sector. It will replace the central industry infrastructure, enable a far wider number of tariffs and propositions to be offered to prepayment customers, as well as reduce the costs of supply for prepayment customers.
297. Notwithstanding this, we welcome the CMA's decision not to proceed with the proposal to prioritise the roll out of smart prepayment meters. Although we are committed to delivering smart meters to all our prepayment customers as soon as possible, there are a number of technological and logistical challenges to this at an industry level which complicate this, for example the communications infrastructure within tall buildings. Prioritising prepayment meters within the smart meter roll out would have increased the costs of the programme and put prepayment customer experience at risk.
298. Instead, we believe the CMA is correct to focus on remedies which will ensure that the current prepayment infrastructure, particularly in gas, is more efficiently used for the remaining time the industry needs to operate with it.
299. Whilst we believe there should also be an onus on Siemens to provide infrastructure that adequately supports the changing needs of the market, in principle we support CMA's proposals which:
- allow scope for more national prepayment pricing;
  - more efficiently allocate existing tariff slots; and
  - place more control of the system in the hands of Ofgem.

### ***Allow scope for more national prepayment pricing***

300. Whilst we generally believe that the costs of energy to a particular customer should reflect the costs of supply to their geographic area, we recognise that this increases the number of tariff codes any particular supplier needs. We therefore welcome the proposal to amend SLC22B.7(b) as this will enable suppliers to 'group' prepayment customers in regions with similar costs together under one retail tariff, reducing the need for tariff codes and thus improving the efficiency with which the current infrastructure is used.
301. We appreciate that this will create small cross subsidies between customers in different geographic regions, and note that the distributional impacts of this remain unclear. However, we would expect the materiality of this effect to be relatively small.
302. We do have concerns that interactions between this remedy and the proposed prepayment tariff cap have not been fully considered by the CMA. Specifically, the

price cap remedy creates 210 price points (of which 126 relate to gas) so suppliers will only be able to stay under the cap (particularly if it is set low) by seeking to have a variation of a prepayment tariff that aligns to as many of these combinations as possible. Therefore the slots freed up by this remedy will be entirely used up by just one tariff, rendering it completely ineffective at achieving its aim. However we consider this issue to be a defect of the design of the prepayment tariff cap rather than a flaw in the way in which the proposed national prepayment pricing remedy has been specified. Indeed we believe that this remedy (along with the remedy to redistribute existing tariff slots and the removal of RMR tariff restrictions) removes the need for any prepayment price cap.

### ***More efficiently allocate existing tariff slots***

303. Given the limited overall number of tariff pages available in the market, and the impact that scarcity has on other parties, in principle we support this remedy. However we believe that - given there are 14 different regions - the cap should instead be set at 14 pages per supplier rather than the proposed 12. This would enable those suppliers that wanted to do so, to continue with regional pricing.
304. We appreciate that this would decrease the number of pages potentially available for allocation under the CMA's remedy. However we note that not all suppliers use their full allocation of tariff pages today. We would therefore support the introduction of 'use it or lose it' principle to the allocation of tariff pages. We believe such a mechanism would ensure sufficient tariff page capacity was available, and make a cap of 14 tariff pages workable.
305. Were the CMA to proceed with capping the number of tariff pages any one supplier can hold at 12, we would need sufficient implementation time to migrate customers from their existing tariffs pages to new tariff pages. This would require approximately 30m messages<sup>101</sup> to be sent via the Siemens communications system; a volume which would need to be staggered to avoid impacting either the integrity of central industry systems or those customers expecting messages sent in relation to the normal BAU industry processes. The implementation period would also need to allow sufficient time for customers to 'collect' the message from their payment outlet and download it to their meter.
306. We are conscious that this proposed remedy, and indeed the existing industry infrastructure, is incompatible with the proposal to set the prepayment tariff cap at a local level. As we set out above, doing this would require each supplier to use 126 gas tariff codes just to support a single prepayment tariff, limiting suppliers to only one prepayment tariff.
307. Given the impossibility of managing so many tariff codes with the current industry infrastructure, we believe this highlights a problem with the proposed prepayment tariff cap, rather than the proposal to more efficiently allocate existing tariff slots. We cover this point in more detail in our response to the prepayment price cap proposal.

### ***Place more control of the system in the hands of Ofgem***

308. We agree in principle that Ofgem should take on the role of managing the allocation of tariff pages. We are however concerned at the lack of detail regarding how this will

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<sup>101</sup> Each tariff change message has three separate components, and is sent to the three most common payment outlets that the customer uses. This means a total of 9 messages per tariff change per customer.

happen, and what process Ofgem will follow in order to achieve that allocation. Similarly, we are also concerned at the lack of detail about how any changes to a supplier's allocation will operate in practice.

309. For example, there is a risk that if a supplier attempts to migrate all customers off a tariff page before it is reallocated, not all the customers concerned will download the new tariff information from their payment outlet in time. This could result in a customer being placed on the wrong tariff, meaning they would be paying the prices of another supplier's tariff while still being charged based on their current supplier's prices. A detailed set of processes to handle such problems is needed setting out how these problems will be overcome before a full assessment of this proposal can be made. The guidelines covering this activity should be drafted by Ofgem or the CMA as soon as possible, and then be subject to industry consultation.
310. Furthermore, whilst we are happy in principle with the proposal that suppliers send Ofgem relevant information necessary for monitoring the allocation of tariff codes, there is insufficient detail about this proposal for us to comment on it more comprehensively. The specific data items and frequency of data refresh is critical to understanding whether this proposed remedy is proportionate or not.
311. We welcome the provisional decision to reject the RWE proposal for central management of both the gas tariff codes and their price. This would restrict suppliers' ability to set their own prices, reduce differentiation in the market and would harm competition in the prepayment sector. We note that these are inherent disadvantages of any form of price regulation in a competitive market, as we also set out above in response to the prepayment price cap proposal.
312. Finally, we also support the ongoing industry work with Ofgem to reform the Debt Assignment Protocol (DAP). Whilst the resolution of issues such as objection letters, complex debt and multiple registrations are not straightforward to resolve, we believe it is reasonable to assume that an Ofgem led programme could deliver changes in these areas by the end of 2016. It will be important to ensure that any changes delivered in this area are subject to both an impact assessment and consultation process. For example, changes to the definition or operation of complex debt will have a direct impact on suppliers' ability to recover debt acquired under the DAP, with the potential for suppliers with better control of credit risk to fare worse than those with poor control of credit risk.

## Helping customers engage to exploit the benefits of competition

### **Ofgem programme to provide customers with information to prompt them to engage**

313. Testing is central to our own approach of designing customer communications, and we believe that it is of fundamental importance when considering how best to structure messages to drive engagement.
314. Whilst we therefore agree with the intent of the CMA's provisional decision in this area, we have a number of significant concerns with this proposed remedy, specifically:
- An Ofgem led testing programme would be ineffective; and
  - the CMA has underestimated the impact and costs of an Ofgem led testing programme on supplier systems and resources.

#### ***An Ofgem led testing programme would be ineffective***

315. In its Provisional Decision on Remedies, the CMA explicitly welcomed Ofgem's commitment to a principles based regulation approach to regulation<sup>102</sup>. However, the proposals for a new Ofgem programme to provide customers with information to promote engagement will result in Ofgem determining a single design of key customer communications for all suppliers; in effect introducing new highly prescriptive regulations.
316. The proposed remedy appears to assume that there is one single best format for communications, across all customers and suppliers, and that this is best determined by Ofgem. Whilst this approach can benefit competition in limited instances where standardisation is a prerequisite (for example, in the design of the letter to customers for the proposed database remedy), in the context of broader customer communications such as the bill or annual statement, it is wholly inappropriate and likely to lead to ineffective prompts.
317. We believe that standardisation of key customer communications has been an important driver of customer disengagement since 2009<sup>103</sup>. Ofgem now specifies the format, style and content of the majority of the bill, even down to the font size that should be used. Such interventions fail to recognise that customers are not a homogenous group that respond to messages in a common way. Instead, individuals have very different wants and needs. We therefore believe imposing centrally managed engagement messages on all customers will be ineffective at stimulating engagement – just as it has been for the last seven years.
318. For these reasons, we do not accept that the proposed remedy would be effective at identifying the most appropriate form of information included in routine communications from suppliers. We also do not consider that the CMA's analysis justifies providing Ofgem with further intervention powers in this manner.

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<sup>102</sup> PDR paragraph 6.80.

<sup>103</sup> The year Ofgem's Energy Supply Probe concluded, introducing a number of controls on the communications suppliers sent to customers, such as the provision of an Annual Statement containing largely regulated messages.

319. Instead we suggest that the competition benefits identified by the CMA can best be delivered by recommending Ofgem oversees a principles-based regime for enhancing customer communications. This would allow Ofgem to define the customer outcomes they want to see in the form of principles, and allow suppliers to deliver those outcomes in ways which they can demonstrate work for them and their customers.
320. Such an approach would be consistent with the CMA's remedies elsewhere, such as the "greater use of principles rather than rules in addressing potential adverse supplier behaviour". For example, suppliers could be obligated to ensure that customers were aware of their right and ability to switch, and found their communications sufficiently engaging. This would ensure that the aim of the remedy is delivered, whilst also enabling suppliers to differentiate their communications, establish a brand and compete with each other more effectively.

### ***The CMA has underestimated the impact and costs of an Ofgem led testing programme on supplier systems and resources***

321. We recognise that, were the CMA to proceed with this remedy, some form of obligation would be needed to ensure suppliers participated with any Ofgem trial programme. We are however concerned about the lack of detail in the CMA's proposals on how this would operate in practice. For example, we would expect to see included in any recommendation to Ofgem, instructions to ensure the procedures developed around this provided for any trials to not place undue burden on one or more supplier in particular, and information on how the costs of any trial support will be shared equitably between all suppliers.
322. Furthermore, we believe that – in order to ensure the burden of any testing regime broadly fell proportionately on all suppliers – participation should not be left to those suppliers that provide undertakings to Ofgem. For example, we anticipate that under the CMA proposal as drafted, Ofgem would need the participation of at least one or two small suppliers in the scheme to ensure that any messaging would also be effective for their customers – regardless of whether they provided undertakings or not. It is not clear how this would happen within the current proposal. We therefore believe that, notwithstanding the concerns set out above, if the CMA did proceed with this remedy regardless, an obligation should be placed on all suppliers to participate in trials as and when Ofgem required.

### ***This remedy should not be applied to microbusinesses***

323. The CMA has provisionally decided that this remedy is not critical to the success of its package of proposed remedies aimed at promoting engagement in the microbusiness segments. Consequently, it has provisionally decided not to make participation in this programme mandatory for microbusiness suppliers. We therefore believe that any programme should be carried out simply as part of Ofgem's usual schedule of work and that it could be reasonable for Ofgem to conclude that no further specific change is needed in the microbusiness segment.

## Use of principles concerning the comparability of tariffs

325. We support the use of principles based regulation (PBR) wherever appropriate, however we strongly oppose the proposal to extend PBR to cover the design of supplier tariffs. Indeed, we note that the CMA has neither found an AEC that requires such an intervention, nor justified why this is considered appropriate. The proposed remedy is therefore disproportionate in its effect.
326. If the CMA believes that regulatory restrictions on what suppliers can offer limits their “ability and incentives to compete and innovate in designing tariff structures”<sup>104</sup> then we suggest it should maintain that logic consistently throughout its package of remedies, instead of replacing the simpler tariff components of the RMR with a rule that will have a similar effect.
327. We agree with the CMA that removing the simpler tariff component of the RMR will be effective, based on the behaviour of suppliers prior to the RMR, and the submissions made by suppliers on how they would behave were the tariff rules to be removed. The CMA has failed to appreciate however that by introducing restrictions that were not in place before the RMR, and thus limiting which products suppliers can launch following the removal of the simpler tariff rules, the effectiveness of this remedy will be undermined.
328. Indeed, a rule requiring suppliers to have regard in the design of tariffs for the ease with which customers can compare “value-for-money” could limit our ability to launch the “more innovative bundles of products” we informed the CMA we would look at. The proposal to impose an additional rule concerning the design of tariffs would therefore undermine the effectiveness of removing the RMR simpler tariff rules.
329. We note that suppliers already have an incentive to ensure that customers can identify which tariff they offer meets a customer’s needs, both in terms of attracting new customers and retaining existing customers. We are also aware of the benefits PCWs bring – and will continue to bring - for customers wanting to compare tariffs right across the market. We therefore argue that, in addition to undermining the effectiveness of other, the proposal to extend PBR to the design of tariffs is also unnecessary.

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<sup>104</sup> Provisional Findings report, section 12

## Enhancing the ability and incentives of PCWs to promote customer engagement

330. We support remedies which strengthen the role of PCWs, provided they are accompanied with appropriate consumer protection controls, in particular around the use of data. Specifically, we believe that:
- proposals to strengthen MiData could be effective in improving customer engagement;
  - there should be appropriate oversight of the conduct of PCWs;
  - the 'whole market view' requirement of the confidence code should be repealed; and
  - PCW access to ECOES and SCOGES will add little value, but create new risk.

### *Proposals to strengthen MiData could drive customer engagement*

331. We welcome the CMA's proposals to strengthen the MiData programme, and increase PCWs' ability to use this to drive consumer engagement. When combined with other proposed remedies, such as the roll-back of tariff restrictions and the development of further engagement prompts, this remedy could have a positive impact on competition. We also believe this remedy would be both effective and proportionate, provided it is accompanied with appropriate consumer protection mechanisms.
332. In particular, there is a strong case for making participation in the MiData programme mandatory for all suppliers. This would address the first mover disadvantage currently faced by MiData suppliers, and boost customer engagement still further. We therefore support the CMA's recommendation in this regard.
333. We also broadly support the CMA's proposal to expand the range of data items held within MiData and believe that most of the data items to be included will improve the PCWs ability to both encourage switching and provide an accurate quotation. We do however have concerns about the proposal to include half hourly consumption data. This would materially increase the scale of data transmitted, with fundamental implications for the cost and complexity of MiData. Instead, we highlight that annual consumption data would be sufficient for third parties to provide accurate quotations to approximately 84% of customers<sup>105</sup>.
334. We also note that data about the tariff a customer is on should also include both non-price items and discounts, charges and bundles. Without this, a PCW will be unable to provide a true comparison of how other deals compare to the customer's existing deal. As with all customer data however, the provision of MiData needs to be subject to tight control, and only released with express, opt-in, customer consent.
335. Finally, we are conscious that the data security arrangements of MiData were designed for the current limited range of data items. Increasing the amount of data available on MiData, and including more sensitive personal data such as a Warm Home Discount indicator, should also prompt a review of the security arrangements of the scheme.
336. We also support in principle the CMA's recommendation to allow PCWs longer access to MiData, provided this is only done with the customer's express consent. In particular, we believe that there will be benefit from PCWs being able to recontact

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<sup>105</sup> Assuming all Profile Class 1 electricity meters are not on a ToU tariff, and all Profile Class 2 electricity meters are on a ToU tariff. Data source: Elexon, 7 March 2016.



customers as they approach the end of their FTC and update them with the latest deals available in the market.

337. We do not believe enduring consent is appropriate or necessary for this purpose however, and have concerns that enabling this may be disproportionate. Instead, we would support PCWs gaining access to MiData for the period of the customers' contract plus a reasonable period immediately after – say 45 days – or in the case of an evergreen contract, not more than one year for example. This would enable the benefits of the remedy to be realised with more proportionate controls on the use of customer data. This would not preclude the PCW refreshing customer consent at any stage – itself a positive thing. Suppliers should be involved in the design of this solution so that they can ensure that data is only released to those PCWs with consent.
338. The CMA should also ensure that this remedy is consistent with today's data protection law, and the direction of future European regulations in this area. It should also ensure that separate explicit consent is required from the customer for a PCW to enter in to any contract with a supplier on their behalf each and every time this occurs. Such a measure will not only preserve customer engagement, but will also ensure customers are fully aware and consent to the switching of their account, which will avoid confusion and potentially complaints.

### ***There should be appropriate oversight of the conduct of PCWs***

339. In recent years, PCWs have played an increasingly important role in engaging customers in the retail energy market. For example, the proportion of customers who used a PCW to search for information last time they switched supplier increased from around a quarter in 2010 to around 40% in 2014. We believe the CMA's remedies, in particular the increased freedom they will have to develop exclusive offers with suppliers and their enhanced access to MiData, will accelerate this trend and give the PCWs an increasingly central role in the domestic and micro business markets.
340. Unlike suppliers, PCWs are not subject to regulation by licence. Instead, PCWs may choose to be regulated through the voluntary Confidence Code, meaning Ofgem has comparatively little scope to take action against PCWs who act against the interests of consumers, aside from withdrawing accreditation from the Code. As PCWs become an increasingly critical channel for customers, we would suggest Ofgem considers whether such a light touch regulatory framework remains appropriate, or whether mandatory regulation may be a more effective way of protecting consumers' interests<sup>106</sup>. The CMA should recommend that Ofgem reviews the regulatory framework PCWs are subject to as part of their work assessing Third Party Intermediary regulation<sup>107</sup>.

### ***The 'whole market view' requirement of the confidence code should be removed***

341. As we set out in our response to the CMA's Provisional Findings, we recognise that the Confidence Code obligation on PCWs to provide a 'whole market view' could act as a barrier to competition. We therefore support the removal of the 'whole market view' requirement.

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<sup>106</sup> The Energy Act 2013 specifically makes provision for Ofgem to licence PCWs.

<sup>107</sup> As detailed in the Ofgem Forward Work Programme 2016/17.

342. However, we consider that if the requirement on PCWs to provide a ‘whole market view’ is removed, additional protections will be necessary to ensure customers are aware of how much market coverage a PCW is providing. This would enable customers to take an educated decision on which PCW and which tariff to choose, as well as enabling competition on market coverage between PCWs.
343. We recognise this may increase search costs in the market, as customers may need to perform searches across different PCWs to identify the best deal. We consider that this can in part be mitigated however by the ‘whole market view’ provided by independent bodies such as Citizens Advice.
344. Finally, we welcome the provisional decision not to continue with the proposed Ofgem PCW. We believe this would have had a material and negative impact on existing PCWs and their ability to compete in the market, damaging their ability to promote engagement as well as increasing pressure on Ofgem resources. We also recognise that the Citizens Advice operated PCW mitigates the need for this type of service.

***PCW access to ECOES and SCOGES will add little value, but create new risk***

345. We support industry efforts to reduce the frequency of erroneous transfers, and believe that changes such as the introduction of the ECOES industry database have helped to improve the switching process for customers.
346. However we believe that, as suppliers already complete checks against ECOES and SCOGES before completing an acquisition, an additional check by the PCW is unlikely to reduce the number of erroneous transfers in the market. However, we do recognise that there would be a benefit to suppliers from reducing the number of PCW sales passed to them that fail validation, therefore marginally reducing acquisition costs.
347. Set against this, we remain concerned that providing PCWs with access to customers’ personal data creates risks of misuse. Whilst we recognise the CMA’s desire to see the use of this data controlled, we believe that – in practice – the design of ECOES and SCOGES will make it difficult to assess whether data has been accessed appropriately or not. On balance therefore, we do not believe that this remedy would be either effective or proportionate.

## Creating an Ofgem-controlled database of ‘disengaged customers’ on default tariffs

348. We have consistently supported measures that increase the engagement of customers. It is vital however that, in designing remedies to boost engagement, customers’ interests are adequately protected. Failure to do this could not only undermine the effectiveness of the remedy concerned, but also damage existing engagement in the market, harming the effectiveness of competition.
349. We have concerns that an “opt out” regime that resulted in customers experiencing excessive levels of marketing contact would negatively affect customer perceptions of the functioning of the market and adversely affect engagement. Rather than an “opt out” regime for customer consent, customers should be invited to “opt in” for inclusion in the Ofgem database. This “opt-in” regime would reduce the risk of customers inadvertently providing consent for communications they do not want.
350. As proposed, the proposal to create an Ofgem-controlled database of ‘disengaged customers’ on default tariffs does not adequately protect customer interests. In particular, we consider that:
- the proposal could serve to decrease customer engagement;
  - there are a number of legal issues with the proposed remedy;
  - the costs of the proposal have been materially underestimated; and
  - the Engie case does not provide a relevant precedent.

### *The proposal could serve to decrease customer engagement*

351. Not only is such an intrusive remedy inappropriate in a competitive market, there are insufficient safeguards in place to prevent a large volume of marketing materials being sent to consumers. Even if each supplier sent only one marketing approach to a customer per annum, it could still mean a customer receives an average of more than three approaches each and every month.
352. The volume of marketing materials the CMA is proposing therefore is significant, and – when combined with the fact that the marketing material will be largely unsolicited - risks disengaging customers from the market, rather than engaging them. We note that many of our customers will have already opted out of receiving marketing from us.
353. These concerns have been widely echoed by a range of other parties since the publication of the CMA’s Provisional Decision. An independent report by Bernstein<sup>108</sup> highlights the issues arising from this proposed remedy. Similar concerns were also expressed in response to the CMA’s narrower proposals to share prepayment customer data<sup>109</sup>. We are disappointed to see the CMA has not acknowledged these legitimate worries, and not adopted a principle that such a release of data should happen only when the customer consents to it.
354. As a minimum we believe the CMA should set out the principles-based regulations to which suppliers with database access should adhere, in order to protect customers from an onerous level of contact. It is also essential that Ofgem has clear and

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<sup>108</sup> See Appendix 5: “Bernstein database assessment”

<sup>109</sup> Remedy 19, as set out in the Second Supplemental Notice of Possible Remedies.

effective powers to remove access to the database from users who do not act in the interests of consumers.

355. We also note that there are few controls to prevent third parties from misusing the data available, and approaching customers using other channels, for example by telephone. It is not clear how, for example, Ofgem could effectively determine whether a customer had been telephoned by a third party as a result of misuse of database information, or from information obtained via another source. It is important, therefore, that the CMA should only require the data necessary for sending postal communications.
356. As detailed above in relation to the proposals for an Ofgem-led testing regime, we oppose the proposal for Ofgem to test the content and form of marketing material sent to customers. Such a proposal implies that the content of such mailings would be standardised by Ofgem – something we consider would make them less effective. As we argue above, remedies which assume consumers are a homogenous group are likely to fail (as had been observed with elements of RMR - which has limited the number of products that a supplier can offer and the means by which they can engage). If the CMA does decide to proceed with this remedy, they should allow suppliers to design the form and content of these marketing messages.

#### ***There are a number of legal issues with the proposed remedy***

357. The proposed database remedy faces numerous legal and operational difficulties, and it is far from certain that it will deliver the desired benefits. We believe that a much more detailed legal analysis should be carried out by the CMA, in order to demonstrate that the scheme created by the proposed remedy is legally robust. Proceeding with a scheme of uncertain legality would not be a proportionate response, particularly given the fact that legal challenges to mass databases held by Public Authorities are entirely foreseeable.
358. The proposed remedy involves a number of discrete data processing operations that need to be considered both separately and collectively. The principal ones are:
- the energy companies will be ordered to write to customers, to invite them to opt-out from the scheme;
  - the energy companies will be ordered to disclose customers' data to Ofgem;
  - Ofgem will be asked to receive the customers' data and to build and maintain a Cloud-based database;
  - Ofgem will give third parties access to the customers' data;
  - third parties will be able to send postal communications to customers, to prompt switching; and
  - third parties will be able to send communications to customers, to invite them to give permissions for the receipt of electronic communications about switching.
359. At best the PDR identifies possible legal grounds under the Data Protection Act (DPA) for some of the processing operations. It does not identify possible legal grounds for the receipt of data by Ofgem, the maintenance of the cloud-based database, the accessing of the database by rival suppliers, or the sending of communications by rival suppliers for the purposes of gaining consent for electronic marketing. Where legal grounds have been identified, they are based upon the hypothesis that the CMA has the power to make orders for opt-out letters and disclosure of data to Ofgem, but the scheme in the round is not supported by any statement of legal powers.

360. We also continue to have concerns that data sharing on such a scale as this, without an explicit customer opt in, may conflict with the forthcoming EU General Data Protection Regulations (GDPR), as set out in our response to Provisional Findings and Notice of Possible Remedies. These regulations, which will need to be transposed in to UK law within the next two years will place more stringent requirements on companies to obtain the customers express opt in consent to the sharing of their data. It is vital that before proceeding with this proposed remedy, the CMA ensures that it can operate effectively beyond the introduction of the GDPR. We note that the advice the CMA has received regarding the impact of existing data protection law on their proposal does not cover these future developments, hence our concerns remain unresolved. We are not clear on why the CMA is not seeking to take this change in regulatory provisions into account.
361. We also note that, in its response to this proposed remedy, the Information Commissioner's Office (ICO) highlighted the possibility that the existing UK data protection regulations may require "individual consent or additional legal requirements to enable the sharing of consumer data with Ofgem or energy suppliers"<sup>110</sup>.
362. It would be irrational for a remedy proposed by the CMA to expose suppliers or Ofgem to ICO enforcement action. Indeed, in the face of such threats, suppliers would have no clear best option – either facing enforcement action for failing to comply with a CMA remedy or enforcement action for breaching data protection rules. Given these concerns, we are not convinced that the data protection implications of this remedy, as drafted, have been properly considered by the CMA. As such, it fails for not taking in to account all relevant considerations.
363. If the CMA continues to believe that a database remedy would be an appropriate mechanism to enable consumers to be approached by other suppliers with relevant offers, we consider there it can only realistically done by obtaining customers' specific opt in to be part of the database. This will have the following benefits:
- It will ensure the database remedy is future proofed against any change to the data protection regime arising from the manner in which the UK implements the GDPR;
  - It will reduce the risk of customers inadvertently consenting to receive marketing communications they do not want to receive; and
  - Whilst it may result in a smaller number of customers who do opt to go onto the database, those who do appear on it, may be more likely to be responsive to any approaches made by other suppliers.
364. Finally, and again only if the CMA believe that this a database remedy would be an appropriate way of stimulating customer engagement, a more prudent way forward would be to trial this solution beforehand with a smaller group of customers. This would enable Ofgem to measure the impact on customer privacy, the potential different application of the remedy in the domestic and SME sectors and its overall effectiveness. It would also enable the logistical design of the remedy to be adjusted before any launch on the wider customer population.

### ***The costs of the proposal have been materially underestimated***

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<sup>110</sup> <https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2016/03/ico-statement-in-relation-to-competition-and-markets-authority-report/>

365. The suggested cost to Ofgem of between £50-100k significantly underestimates the costs of setting up a database of this size and sensitivity. For example, Ofgem will need to be equipped with procedures and resources to grant and manage access to the database, monitor use of the data and remove access for suppliers who misuse it or otherwise fail to act in the interests of consumers. They will also need to invest in ensuring that the database adequately protects the accuracy and security of what is very sensitive personal data about a large number of customers. We note that a number of other large database proposals have been impacted by the cost associated with protecting large volumes of sensitive customer data<sup>111</sup>.
366. Furthermore, the CMA is wrong to give little regard to the costs suppliers will incur through this remedy. For example, it is likely that suppliers will incur material costs associated with managing customer consent for the database. Anecdotally, we have already received a number of contacts from customers worried about the sharing of their data, and seeking to opt out of the database. We are therefore already, to a small degree, bearing costs as a result of this proposal. As a minimum, the CMA should also seek to understand (and include in their impact assessment) the supplier costs associated with extracting and securely transmitting data to Ofgem, both initially and with six monthly refreshes.
367. Finally, we agree with the CMA that any database of the type proposed will not be needed once the roll out of smart meters is substantially complete. To this end, it is important that the CMA specifies from the outset a clear sunset date for the automatic removal of this requirement by 2020, if not before. Given the cost, complexity and impact on customer data, and the fact that the remedy will only be in place for approximately four years, we also consider the costs and impacts of this proposal to be disproportionate to the level of alleged detriment identified.

### ***The Engie case does not provide a relevant precedent***

368. The CMA is wrong to rely upon the Engie case in France to justify recommending a similar form of intervention in the UK market. The French case is very different as it involved a remedy placed on a single market participant, found to have abused its dominant position in the market, and moreover to have done so in relation to its use of customer data held by it. The remedy was therefore highly focused on remedying the abuse by giving other suppliers access to those specific data. This is highly distinct from the situation in the UK where no such abuse has been identified and the CMA is considering market wide remedies. We do not therefore believe the CMA is justified in seeking a similar remedy in the UK.
369. Notwithstanding our view that the Engie case is not relevant to this CMA investigation, we consider the (historical) requirement placed on Engie to be inconsistent with the proposed GDPR. This is because it failed to require customers to explicitly “opt in” consent to the use of their data. As a consequence, we do not consider it safe for the CMA to rely on the Engie example to support this remedy.

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<sup>111</sup> The NHS patient record system for example: <http://www.theguardian.com/society/2013/sep/18/nhs-records-system-10bn>

## **Making all single-rate tariffs available on restricted meters**

370. We agree that competition for customers with restricted meters is currently not as strong as in other market segments. The more complex and varied nature of these metering systems mean that such customers see less benefit from competition. For example, they have less access to tariffs, see less innovation, and face additional barriers when looking to switch supplier.
371. There are operational challenges with charging restricted meter customers on a single rate tariff. In particular, the varied nature of restricted meters and the relatively small number of customers with them, mean that it is impractical to either accommodate the meter type within a billing system or automate the process of aggregating all registers to generate a single consumption value. The billing process therefore requires manual intervention and is consequently more expensive.
372. Notwithstanding these costs and complexities, we believe that the CMA's proposal to require suppliers to supply any restricted meter customer on any single rate tariff they offer is proportionate to the problems these customers face, and would also be effective at addressing them. We therefore support the proposed remedy.

## **Remedies for microbusinesses**

373. We strongly disagree with the CMA's conclusions on detriment in the microbusiness sector and, as we have set out in detail in the Consumer Detriment section above, the new detriment analysis is fundamentally flawed. Specifically in respect of the microbusiness analysis of "detriment", the inclusion of data from earlier years skews the assessment of microbusiness profitability, as it is based on a period when this sector of the market operated substantially differently to the way it works today (i.e. prior to the broad cessation of the use of auto-rollover contracts) and the sector was making unsustainable profits. Therefore, to properly reflect the current market, the analysis should be focused on more recent years.
374. In spite of these concerns, we broadly support the package of remedies proposed for microbusiness customers. The proposals relating to price transparency and the ending of onerous auto-rollover terms are welcome. However, we have concerns regarding the speed with which the Ofgem Code of Practice might be implemented without a clear recommendation from the CMA. We believe the CMA should also recommend that the Code of Practice delivers an appropriate level of transparency regarding the commission that will be charged by TPIs.
375. This section contains our response to the following PDRs relating to microbusinesses:
- Price transparency;
  - TPI transparency and information disclosure; and
  - Auto-rollover
376. The following remedies also impact microbusiness customers, but we cover our views on these remedies from both a domestic and non-domestic perspective in the relevant sections elsewhere in this document:
- Ofgem programme to provide customers with information to prompt them to engage;
  - Creating an Ofgem-controlled database of 'disengaged customers' on default tariffs;
  - Settlement reform.

### **Price transparency**

377. We are supportive of measures to improve price transparency for microbusiness customers and we believe that this remedy goes a long way to achieving this aim. This remedy will promote transparency of supplier prices and thereby effectively reduce consumers' search costs. However, we do not believe it will address the issue of price transparency for TPI services. We address these two aspects in turn.

### **Price Publication**

378. We support the publication of prices online, for the proposed segment of microbusiness customers, using suppliers' own online quotation tools, or by using third party platforms. Subject to our recommendations below being addressed, we believe this will enable customers to more quickly and easily access and assess prices from suppliers. We similarly support the requirement to clearly publish deemed and out of contract prices online, which we have voluntarily done for a number of years. We believe these measures will also have the consequential benefit of encouraging the emergence of PCWs in this sector.



379. We consider the timescales suggested for the implementation of these changes to be achievable, provided that half-hourly settled customers are excluded from the scope as discussed below. Also, consistent with good regulatory practice, and in order to ensure that the remedy is neither onerous nor disproportionate, we recommend the inclusion of a sunset clause aligned with any mandatory implementation of half-hourly settlement for profile classes 1 to 4.

### ***Requirement to disclose prices for 'all available' contracts***

380. While we do support this remedy, we have concerns about it achieving the aim of reducing search costs if suppliers are required to show prices for 'all available' contracts based on the proposed primary inputs alone (postcode and consumption). Depending on the interpretation of 'all available' contracts, this requirement could result in an extremely long list which would not be helpful for customers; we explain this in detail below.

381. If we were required to provide 'all available' contracts, then based solely on our currently available microbusiness products, and limiting it to simple meters only, we would be required to display prices for at least  $\times$  basic product structures, if all other contractual features were excluded. This limited list would only show our discrete products (e.g. a one-year fixed-term contract) and permutations of those products arising from payment type (e.g. Direct Debit versus cash or cheque) and inclusion/exclusion of a Standing Charge element.

382. This list would increase exponentially if all permutations of possible contractual features (e.g. payment term), product bundles (e.g. service & repair contracts) and discounts (e.g. dual fuel, multi-site or online) - applicable to each of those basic structures - were required to be shown as discrete products. The result would be a very long list of potentially hundreds of products. In addition, it would constrain the ability to provide tailored services to meet any individual customer's bespoke requirements (e.g. different billing arrangements) as we would first have to make it available online.

383. There is, therefore, a clear trade-off between very simple customer inputs on the one hand and an easily navigable and transparent display of products and prices on the other. We believe that a more appropriate balance of input and output would facilitate price comparison across suppliers and this can be achieved in two ways:

- Either by limiting the number of products suppliers are required to show from the primary inputs; or
- By allowing suppliers to increase the number of primary inputs, allowing products to be tailored to reflect customer choice at the start of the search process.

384. These are described in turn below.

### **Limiting the number of products suppliers are required to show from the primary inputs**

385. We suggest that, based on primary inputs alone, suppliers should be required to show only their one-year fixed-price contract with Standing Charge and payable by Direct Debit. We recommend this because the majority of customers on fixed-term contracts choose this product and it would be very simple to tailor it to reflect customer preference using secondary information. However, importantly, this would not limit suppliers' discretion to show more products in the initial results than the minimum requirement alone. The initial contract offer would be accompanied by clear notes

indicating that the price could be negotiable depending on different contractual features and other customer requirements, and that could be done using the secondary inputs or via direct contact.

### **Allowing suppliers to increase the number of primary inputs**

386. The number of primary inputs could be expanded to allow customers to choose a small number of preferences, such as payment type and contract type (e.g. fixed-term or variable). This would allow customers to be selective at the start of the search process and would result in the display of a shorter, more appropriate list of products and prices. This could then be refined using secondary inputs.
387. Irrespective of how the primary search methodology is designed, suppliers need to retain flexibility to use secondary input fields of their choice to refine the product characteristics to better reflect customer requirements including such things as payment term, discounts, product bundles, service & repair bundles and different billing arrangements. We believe that this would provide customers with access to full information in the simplest manner possible without curtailing innovation or the ability to tailor offers to meet customer preferences.

### ***Inclusion of Half-Hourly customers***

388. We are also concerned by the proposed inclusion of customers who have previously migrated to half-hourly settlement. The CMA suggests that following the change to half-hourly settlement of customers within profile classes 1 to 4, suppliers could continue to use historical profile class data, rather than half-hourly data, to produce prices.
389. We strongly disagree with this proposal because suppliers cannot determine the historical profile class of newly acquired customers who moved to half-hourly settlement while with their previous supplier. The data received by an acquiring supplier is insufficient to identify the historical non-half-hourly profile class. Consequently, we would not have the estimated consumption profile (using the historic Profile Class) nor would we have actual half-hourly data and so it would not be possible to provide an accurate or cost-reflective price.
390. Notwithstanding that, we believe that using old profile class data would be a retrograde step which would fail to capture the benefit, in terms of cost-reflective pricing, of half-hourly data. In particular, without access to the half-hourly data, suppliers will not know customers' actual consumption profiles and will not be able to accurately design and target tariffs which incentivise load shifting.

### **TPI transparency and information disclosure**

391. In respect of TPI transparency and information disclosure, we note that the CMA has based its provisional decision - to not recommend specific remedies - partly on the basis that Ofgem is considering implementing a TPI Code of Practice. It should be noted, however, that work to draft the current Ofgem Code of Practice began in early 2013 and when Ofgem formally halted their work on it over two years later (March 2015) due to the CMA's investigation, it was still only a partial draft and Ofgem expected a further 12 months of consultation and implementation before it would be operational.

392. We are strongly of the view that the CMA should not assume that the Code of Practice will necessarily be implemented in a timely manner and it should make a recommendation to Ofgem regarding implementation timescales. We suggest that implementation should be within 12 months of the CMA's Final Report.
393. Further, we do not consider the need for information disclosure to be as a consequence of TPI malpractice, but rather to address the need for transparency; only by making commission levels explicit will customers have the full information set on which to make an efficient choice, with commensurate benefits to competition. While consumers could check suppliers' online quotes and make a comparison to those provided by TPIs as suggested by the CMA, this would negate the search cost efficiencies of using TPI services. Therefore, we believe that the CMA's recommendation to Ofgem should also seek to ensure that minimum requirements on transparency are included within the Code of Practice. In particular, and at the very least, TPIs must be required to clearly show the commission being charged (directly or indirectly) as well as how they are paid, e.g. a separate charge or through the energy charge.
394. Moreover, while we would not support the direct licensing of TPIs by Ofgem, we believe the Code of Practice must operate within a robust governance and enforcement framework, and as such Ofgem must have the ability to impose proportionate sanctions.

## **Auto-rollover**

395. We believe that the ending of auto-rollover contracts by many suppliers has helped to promote greater consumer engagement as their options and ability to switch are not foreclosed. We also believe that this has helped to reduce the barriers and create the right conditions for PCWs to emerge, because the previously short window of opportunity for customers to switch supplier before being automatically rolled onto a new contract has been removed. We are consequently supportive of the proposed remedy, in particular the prohibition of termination fees and 'no-exit' clauses which are the key negative characteristics of most auto-rollover contracts.
396. However, the CMA states that it has provisionally decided not to recommend modifications to the licence conditions in relation to grounds for objections that suppliers can raise for non-domestic customers seeking to transfer their energy supply to another supplier. We suggest that the CMA clarifies this further and recommends that Ofgem should not consider entirely removing non-domestic suppliers' ability to object. The CMA has found no evidence to suggest that the ability to object negatively impacts competition and to remove the ability to do so would constitute a major change to an otherwise functioning market with potentially significant negative impact on its competitiveness.

## Remedies relating to the governance of the regulatory framework

### **Ofgem's statutory objectives and duties**

397. We strongly support this proposed remedy, for the reasons set out in our earlier response to the Notice of Possible Remedies. In our view, the proposed legislative amendment should help to refocus energy market regulation on competitive market principles which will better serve the interests of consumers, whilst at the same time reducing the risk of interventions that will not benefit competition. These are supported by the CMA's findings and recommendations relating to the 'simpler choices' element of RMR rules.
398. We would therefore be keen to see DECC legislate for the recommended changes at the earliest reasonable opportunity and we welcome the Government's Budget Day announcement in this regard.

### **Relationship between DECC and Ofgem**

399. There are two proposed remedies in this regard and we support both of them; namely a process by which Ofgem can comment publicly on material policy and legislative proposals, and provision for detailed joint statements by DECC and Ofgem in cases where parallel activities are required.
400. In our view there are likely to be two principal benefits arising from these proposals:
- greater clarity around the DECC/Ofgem interface and more effective co-ordination of their activities; and
  - improved transparency, at an early stage, as regards the likely impact of significant energy sector policy and legislative proposals.
401. It is not clear to us whether and to what extent these proposals will require legislative underpinning, but we would welcome early progress with their implementation as far as possible ahead of any new legislation.
402. However, we believe that more needs to be done to strengthen Ofgem's position as an independent energy sector regulator and protect the legitimate appeals rights of parties affected by Ofgem's decisions.
403. We propose that the Government designates an enhanced Strategic Policy Statement (SPS) to clarify the limits of Government policy intervention and so help to reinforce the position of Ofgem as an independent regulator. We believe that the CMA has correctly identified two symptoms of a wider problem that Ofgem is not perceived as independent from DECC. The CMA has cited two examples of DECC creating this perception by "taking powers – or stating its readiness to take powers – to implement changes in primary legislation in the event that Ofgem did not act"<sup>112</sup>.
404. Perhaps more importantly, such steps negate the legitimate appeal rights of parties affected by Ofgem's decisions and thereby undermine confidence in the regulatory regime. We therefore believe that DECC should use the SPS amongst other things to

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<sup>112</sup> See paragraph 179 of the CMA's "Energy PDR Summary March 2016"

clarify as far as possible where it will avoid intervening so as to maintain Ofgem's independence and protect legitimate appeals rights.

405. We also suggest that Ofgem is given a clear duty to comment on DECC's proposals, rather than the current remedy that recommends DECC establishes a process through which Ofgem is able to publish opinions on DECC policy proposals. Ofgem is free to comment publicly on DECC's proposals today, and it is unclear how the proposed remedy in its current form would result in a step change in transparency in this area.

## **Annual State of the Market Assessment**

406. This proposed remedy is to some extent a formalisation of recent practice, but we welcome the indicated focus on the impact of different factors (including policy initiatives) on the evolution of consumer prices and bills. As previously observed, this is an area in which levels of public understanding have often been low. Accordingly, we consider that Ofgem should consult in advance on the key indicators it proposes to use for the market assessment. Especially given our fundamental concerns about the CMA's approach to calculating 'detriment', a robust and soundly-based approach on the part of Ofgem will be essential to help restore public confidence.
407. However, we believe the remedy would be more effective if it was strengthened to require Ofgem to undertake robust quantified impact assessments of all proposed policies that will have a material impact on the operation of the market, the activities of market participants and ultimately on energy customers. This will ensure that every material policy issue is subjected to the same rigorous level of transparent impact assessment. The annual Ofgem report should also present, in a transparent manner, the impact of each major factor (including policies, wholesale energy price movements and network charges) on the changing level of consumer bills.
408. We strongly support the proposal that Ofgem establish a new analytical unit (such as a Chief Economist team/role) to support delivery of the annual State of the Market Assessment. It has long been our contention that an enhanced economic/analytical capability within Ofgem would be beneficial and we also support a broader definition of that role, e.g. to support the delivery of consistent, high quality impact assessment across a range of significant issues in regulatory policy and industry code development.

## Regime for financial reporting

409. The proposals to introduce additional financial reporting requirements on the SLEFs are disproportionate (introducing significant cost for little or no benefit), and indeed risk reducing, rather than promoting, an understanding of financial performance. Our primary concerns are that:

- **transparency** will be reduced and **comparability** between SLEFs will be limited;
- the proposals would be **highly complex** (technically and practically) to introduce;
- compliance with the requirements would require the disclosure of **commercially sensitive data**;
- implementation and ongoing compliance would have onerous cost **implications**; and
- excluding intermediate and smaller suppliers from the remedy is unjustified and **discriminatory**.

### *Transparency*

410. At present, the Consolidated Segmental Statements (CSS) can be reconciled to our Annual Report and Accounts (ARA). Indeed, Centrica has been an advocate of the CSS since their introduction. We note that “the focus of the revised reporting regime for the purpose of our proposed reporting remedy should be on making sure that any internal transactions between the generation and retail supply markets (respectively) and the trading market are market based.”<sup>113</sup> We believe this is already satisfied by our published financial results in the CSS each year, so it remains unclear what issue this remedy intends to address. We are concerned that the remedy will undermine this existing transparency for a number of reasons.

411. A primary concern is the requirement to split out purchase “opportunity cost” and “residual cost”. Creating a hypothetical construct such as this will fail to evaluate the risk (existing at the time forward purchasing took place) that had been mitigated. As proposed, the report will instead demonstrate – with the benefit of perfect hindsight – what would have been a highly speculative approach to energy purchasing for SVT customers.

412. The conclusion drawn from the report will be entirely dependent on the movement of commodity prices over the year in question, and the period leading up to it. Over periods when commodity prices rise, a strategy of buying well in advance will appear highly profitable. Over periods when commodity prices fall, such an approach will appear highly inefficient. Indeed, to the extent that hedging strategies evolve over time, the proposed split of commodity costs in any year would not reflect the current hedging strategy in isolation, thus limiting any insight about a supplier’s current or future approach to hedging.

413. Reporting against an artificial construct will only serve to distract attention from actual profitability, and instead focus debate on hypothetical profits if firms had known in advance what commodity markets were going to do. In our view this has the potential to seriously damage trust – particularly with regard to assessing profitability for vertically integrated energy companies. Such an outcome would be particularly

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<sup>113</sup> PDR A10.3 paragraph 28

unfortunate given the CMA's provisional finding that vertical integration is likely to benefit consumers.

414. Transparency will also be damaged by the requirement to prepare statements on a "stand-alone business" basis. We assume this requirement may extend to capital structures and cost bases as well as interaction between these "stand-alone businesses", and therefore:
- require artificial adjustments in to profit and loss (P&L) statements and balance sheets to take into account the working capital and contingent capital requirements; and
  - adjust for Centrica's synergies/efficiency benefits that would not exist if each P&L "by market" were stand-alone businesses.
415. It is unclear how these adjustments would be undertaken in a way that would be transparent and consistent across energy companies, undermining confidence in any direct comparability between SLEFs. This is complicated further by the proposed inclusion of exceptional items in the P&Ls. We do not see how the proposals are consistent with individual P&Ls and balance sheets aggregating back up to a consolidated view that is consistent with statutory results (both Centrica ARA and British Gas Trading Limited statutory accounts).
416. Finally, we have concerns regarding proposals for prior year comparatives and restatements. Prior year comparatives would drive a significant increase in disclosure notes than for the CSS currently to explain year-on-year movements, and would be further complicated by any prior year restatements (as we would have to explain why the prior year figures have changed, e.g., changes to accounting standards, as well as why they have moved year-on-year). This is likely to result in far more complex and opaque – not clearer – financial statements.

### ***Highly complex***

417. In terms of practical complexity, the requirement to split the energy commodity costs between the purchase opportunity cost and the residual cost will be highly complex to implement and operate on an ongoing basis. These factors would make accuracy of this split of commodity costs uncertain and risk undermining the comparability between SLEFs.
418. In particular we would highlight:
- the calculation of the split at a disaggregated level by broad tariff type would be both onerous and open to considerable judgement, given the portfolio approach taken to hedging; and
  - no account has been taken of contingent capital, or how the strength of the balance sheet/credit rating of individual market participants would affect their ability to trade.
419. The proposals are also technically highly complex. Movements in the balance sheet would need to agree with the P&L. This is not straightforward as some balance sheet movements do not map across to the relevant P&L figure, and risks the "reported" balance sheet diverging from the "actual" balance sheet over time. For example:
- EBIT/operating profit does not include exceptional items, tax or interest, but these would clearly contribute to the balance sheet movement;

- Accounting items, such as actuarial pension movements, are booked straight to Equity/Reserves, and therefore affect the Balance Sheet but never appear in the P&L; and
- Cash flow hedges (e.g. foreign exchange hedges) are held in Equity/Reserves, and do not pass through the P&L until settled. We would expect this to materially undermine like-for-like comparability between SLEFs.

### ***Commerciality sensitive data***

420. The proposals will require the SLEFs to produce P&Ls for each individual “market”. There is also suggestion that this might be extended to product class. Assuming it is possible, such granular disaggregation will inevitably lead to disclosure of commercially sensitive material. For example:

- provisions for risks and commercially confidential information would become apparent. This would mean such reports would not be appropriate for publication unless heavily edited – which in turn would further reduce transparency;
- the reports would also reveal key aspects of our approach to hedging, and could provide insights on confidential commercial arrangements for specific cost types; and
- exceptional costs (e.g. redundancy costs or asset write-downs) may be revealed in detail. This would be particularly the case once such costs are split down to domestic/non-domestic and fuel type - and more so if split further (e.g. by product class and payment type). Redundancy costs would be highly sensitive, and asset write-downs would reveal insights on strategic choices that may be market sensitive.

### ***Cost implications***

421. The requirements of this remedy would be onerous in terms of resource (headcount), time and incremental audit costs. It would require additional processes and controls to track the financial measures required by the remedy, including artificial adjustments to split out “stand-alone businesses”. A high-level estimate suggests the remedy would lead to incremental operating costs of  $\pounds$  annually (payroll and external fees). The divergence of the reporting needed for the remedy from our core reporting requirements for statutory purposes would add an unnecessary layer of complexity to the external audit process, replacing the well-established CSS process, which is both transparent and efficient.

422. The calculations needed to split energy commodity costs between “purchase opportunity cost” and “residual cost” would depend on regular “snapshots” of the state of our customer base, i.e. the extraction and storage of large data sets at the individual customer level from our live billing system (or a derivative system linked to our live billing system). As well as the initial development cost of this additional functionality, regular updates would be required in the future to remain up-to-date with other changes to our systems as they evolve.



## **Governance of industry codes**

423. There are eight separate elements in the remedies package proposed in this area. We generally support them, albeit with qualifications in some instances, and we set out our position on each element in turn below. Many of these remedies (alongside other key elements of the CMA's overall PDR proposals) will rely on Ofgem for their implementation and the proposed 'strategic programme management' of major industry change presupposes an enhanced level of capability in that respect. We therefore urge the CMA to specify very clearly where and on what timescales Ofgem has to act, so that the regulator is able to seek additional resources where necessary, in a timely manner.

### ***Strategic Direction***

424. We support the proposal that Ofgem should publish a cross-cutting Strategic Direction for code development. This is likely to be especially helpful as regards complex retail energy industry change which cuts across a number of industry codes, such as a move to accelerate customer switching or the simplification of industry processes which we expect to be facilitated by the wider roll-out of smart metering.

425. The quality of this document will be crucial, since a number of other remedies within the Code governance package will depend on it. It needs to include a statement of objectives and principles sufficient to 'steer' the co-ordinated delivery of major change, but should avoid being unduly prescriptive in a way which could pre-judge the detailed industry arrangements required to put them into effect. It would also be good regulatory practice to issue the Strategic Direction in draft form for consultation before it is finalised and we would support a specific CMA recommendation to this effect.

### ***Code-specific work plans***

426. We also agree with the proposal that Ofgem should oversee the annual development of code-specific work plans, where this is necessary to deliver the Strategic Direction. Again, we consider that the principal focus of this should be on major industry change which cuts across a number of industry codes – rather than Ofgem becoming unduly involved in the detail of Code administration and delivery services.

427. In order for Ofgem to fulfil this role effectively, we consider that it is likely to require an enhanced programme management capability, more regular engagement of senior staff and a consistent high standard of impact assessment to which the proposed Chief Economist function (or comparable new analytical function) could contribute materially.

### ***Consultative board***

428. In our view, the proposal to establish a consultative board of relevant stakeholders is a very positive one. We suggest there should be a duty on Ofgem to take its views into account, not just on the implementation of cross-cutting change but in the development of the Strategic Direction and related code-specific work plans.

429. Apart from a relevant cross-section of energy industry, consumer representative and Code administration stakeholders, we consider that it would also be useful to include an external specialist in the management of complex energy industry change programmes.

### ***Initiate and prioritise code modification proposals***

430. The suggested power for Ofgem to initiate and prioritise code modification proposals which are necessary to deliver the Strategic Direction is potentially helpful, subject to the following provisos based on our experience with the SCR process to date:

- The powers should be linked to a tightly defined set of Strategic Direction objectives which are genuinely strategic and relate to cross-cutting industry change. This should not become a *carte blanche* right for Ofgem to initiate 'ordinary' modification proposals which only affect a single code.
- Ofgem should seek and take into account stakeholder feedback before finalising its proposals, including input from the proposed consultative board.
- Such proposals should be subject to a full, robust impact assessment with sufficient scope for stakeholder input and feedback.
- The additional Ofgem powers should be matched by an extension to the normal rights of appeal 'on the merits' – since these only triggered when Ofgem overturns a Code Panel recommendation and that is unlikely to apply in this case.
- Ofgem will need to be properly resourced, with enhanced programme management and capabilities, in order to exercise these powers effectively.

### ***Direct control of strategically important ongoing Code modifications***

431. The recommended power for Ofgem to take direct control of strategically important ongoing Code modifications could, in our view, help to 'unlock' strategically important industry change. Our support is subject to provisos similar to those mentioned above, i.e. the modification must be genuinely strategic, Ofgem should seek input from the consultative board before exercising these powers, there needs to be a robust Impact Assessment and this should trigger broader stakeholder appeal rights 'on the merits' of the proposal.

### ***Amendment of code administrators' licence condition***

432. We support the proposed remedy which envisages an amendment of code administrators' licence conditions where necessary to facilitate delivery of the Strategic Direction or improve the efficiency of code governance. This presupposes that all code administration and delivery will be covered by licences, as discussed below.

### ***Exceptional powers for Ofgem to modify industry code***

433. As the CMA has indicated, exceptional powers for Ofgem to modify industry codes are ultimately a matter for Parliament to approve and we note the Government's stated intention to legislate. We support this proposal provided that:

- the circumstances are truly exceptional and tightly defined in law;
- the proposed modification is subject to a full impact assessment as set out above; and
- the additional Ofgem powers are accompanied by an extension of stakeholders' 'on the merits' appeal rights to the CMA.

434. The Energy Act 2011 - which paved the way for the gas supply security (emergency cash-out) SCR – is both the principal energy sector precedent and an example of good practice in this regard. We note that DECC's latest legislative proposals do not as yet follow the 2011 appeals precedent and we would welcome a CMA recommendation that they should do so.

### ***Make code administration and delivery services a licensed activity***

435. Finally, we support the proposal to make code administration and delivery services a licensed activity and we welcome the Government's Budget Day commitment to legislate for this purpose. A number of existing code arrangements (e.g. UNC, BSC) effectively derive from obligations set out in the relevant transporters' licences, whilst other codes sit outside the current licensing framework.
436. In our view, a comprehensive licensing policy should help to ensure consistency in code governance and help to raise overall standards of delivery to a best practice level. If it seems likely that the relevant legislation might be subject to some delay, it could be worth considering a voluntary 'code of practice' which would in due course become the basis for the new administrators' licence conditions.

## Wholesale electricity market remedies

### Allocation of Contracts for Difference

438. As set out in our response to the Notice of Possible Remedies, we support these two proposals as promoting cost-effective carbon abatement without placing an undue burden on consumer bills.
439. We understand that DECC is committed to holding a further competitive CfD auction before the end of 2016. This suggests that the second of the recommended DECC consultations (regarding the allocation of technologies and CfD budgets between 'pots') will be required at an early stage following the CMA's Final Report, in order to ensure a sound basis for the forthcoming auction.
440. We also support the first recommendation, since in our view a competitive auction should be the default mechanism for allocating CfDs unless there is an exceptional and well substantiated public interest case to the contrary. This consultation may be less urgent, but in the interest of investor confidence it should take place well in advance of any proposed further non-competitive allocation of CfDs.

### Locational adjustments for transmission losses

441. We support the principle of cost-reflective network charging in the interests of encouraging economically efficient investment/location decisions and promoting efficient plant dispatch. In order for the proposed locational losses remedy to be proportionate and effective, the detailed design needs to ensure that it is genuinely cost-reflective.
442. We note that the CMA proposes to place a Locational Pricing Order obligation on National Grid which, depending on its terms, is likely to limit the scope for effective stakeholder feedback. We have a concern that this process is inconsistent with the 'better regulation' principles which appear to have motivated some of the CMA's other proposed remedies (e.g. RMR or the future regulatory framework).
443. Instead, we suggest implementation of this remedy is via the normal BSC modification route. This would facilitate wider stakeholder scrutiny and engagement, and reduce the likelihood of unintended consequences from the remedy's implementation.
444. Should the CMA proceed with its favoured implementation route, it is essential that key detailed design issues are addressed in the Locational Pricing Order itself – rather than leaving them to subsequent determination by National Grid. In our view, it would be appropriate for the CMA to consult on the content of the Locational Pricing Order before issuing its final report.

### ***Against that background, we have the following key observations to make:***

445. The process by which National Grid creates a load flow model and network mapping will need to be much more transparent and sophisticated than the NERA modelling to date. Specifically, NERA's proprietary '16 zone' DTIM model is a relatively crude representation of the electricity transmission system and it is not clear how individual generating plant have been mapped onto those zones.

446. It is evident from the NERA report (their Appendix B) that seasonal transmission losses in many zones are highly variable, both within year and over a longer period of years. This suggests that they are also likely to vary considerably within seasons, e.g. depending on the level of wind generation at a particular time – in which case it is debatable whether seasonal loss allocations would actually send the right signals for efficient plant dispatch on any day.
447. Neither the NERA report nor the CMA's PDR are clear as regards the proposed treatment of offshore transmission losses – though NERA's analysis may implicitly assume they are borne entirely by the offshore wind farm owners. A major flaw in the previous P229 proposals rejected by Ofgem in 2011 was the fact that high offshore transmission losses would have 'polluted' the loss allocation to onshore generation located in the same transmission zone as the offshore cable landing point. Under a cost-reflective locational loss arrangement, offshore generators should bear the full transmission losses which are attributable to them.
448. The CMA's favoured approach is to move the allocation of transmission losses from the current 45/55 split between demand and generation to one in which 100% is allocated to generation. We do not consider that the '100% G' locational loss proposal can possibly be cost-reflective, for the following reasons:
- A material proportion of total transmission losses are essentially fixed (unrelated to the level of generation output).<sup>114</sup> They typically relate to the role of transformers and are thus driven by serving transmission offtakes / demand. These fixed losses are clearly unrelated to the location of generating plants.
  - The level of variable (load-related) transmission losses is affected both by generation dispatch and the level of demand which is controllable via on-site generation or other demand-side response.
  - A proposal which allocates all losses to generation on a locational basis will therefore fail to send the right price signals at either end of the system.
449. Currently, demand side management initiatives and decentralised generation 'behind the meter' are effectively rewarded for the reduction in transmission losses to which they give rise. This is generally equivalent to a 'revenue bonus' of around 2%. Under the CMA's proposals, the incentive to undertake such demand side measures will be reduced in a manner which cannot be consistent with economic efficiency or the broad direction of government policy for the sector. Particularly as our previous comments highlighted the growing importance of decentralised energy, we were disappointed to see that neither the CMA nor NERA have had any material regard to the impact of these proposals in that respect.
450. The NERA report considers the Capacity Market (CM) impact of these proposals and assesses the extent to which generators will seek to recover 'missing money' through their CM bids. Since the 2018/19 and 2019/20 CM auctions have already taken place in year 'T-4', there will be no scope for generators to respond to the locational loss proposals within the duration of those CM contracts. In the meantime, the transmission losses proposal is likely to have an adverse impact on the viability of some financially marginal generating plants. Neither the CMA nor NERA appear to have taken this into account, but there is a good case for transitional loss arrangements or a complete 4

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<sup>114</sup> <http://www2.nationalgrid.com/WorkArea/DownloadAsset.aspx?id=36718>

year deferral of their implementation once the detail allocation mechanism has been designed by National Grid.

451. As yet, there has been no opportunity to clarify with NERA and the CMA a number of important points on which the report in Appendix 2.2 to the PDR does not 'speak clearly for itself'. We have separately forward to the CMA a list of key questions on which we are seeking clarity.
452. As regards market splitting (the National Grid paper set out in Appendix 2.3 to the PDR), we welcome the CMA conclusion that it does not intend to pursue that alternative remedy at this stage. There are fundamental wider issues with market splitting – not least the impact on wholesale market liquidity and cash-out from the fragmentation of pricing points and trading locations – which would need full assessment before concluding that such a scheme would be beneficial to the competitive market and consumers.