



# SSE: Response to Provisional Decision on Remedies

7 April 2016



## SSE: RESPONSE TO PROVISIONAL DECISION ON REMEDIES

### **1. Introduction**

- 1.1.1 This document provides the response (the *Response*) of SSE plc (*SSE*) to the Provisional decision on remedies (*PDR*) issued on 17 March 2016 by the Competition and Markets Authority (*CMA*).
- 1.1.2 Throughout the investigation, SSE has highlighted how GB energy markets are generally well-functioning and competitive, but that more must be done to inspire higher levels of trust. Indeed, the CMA's investigation has consistently highlighted the overwhelmingly positive features of the GB energy market. SSE agrees with the CMA's findings that the market has evolved hugely since the inquiry first began; there are now over 30 suppliers competing vigorously on price, innovative tariffs, customer service and product offerings.
- 1.1.3 The PDR proposes a wide ranging and substantive package of remedies representing a serious operational challenge to energy companies, Government, Ofgem and other stakeholders. It will be important to get the detail of this package right so that the market can increase trust and deliver effectively for customers.
- 1.1.4 SSE strongly supports the remedies proposed by the CMA that will deliver good outcomes for customers. Many of these reflect existing practices which will enhance the market framework for effective competition and further help customers to engage in the market. SSE looks forward to working with the CMA to implement these remedies as practicably and effectively as possible.
- 1.1.5 SSE strongly disagrees, however, with any suggestion that prices or profits have been excessive and have led to detrimental effects for energy customers. The CMA's analysis of "competitive" prices is not founded in a realistic assessment of a well-functioning market. The analysis is undermined by a number of serious errors and produces wholly implausible outcomes. When these are addressed, it is clear that the CMA's assessment of prices and profits is significantly overstated and that there is no material consumer detriment in the energy sector.
- 1.1.6 The CMA has used its unfounded assessment of consumer detriment as a basis for a small number of intrusive, uncertain, and wide-reaching remedies in the domestic sector in particular a proposed price cap for PPM customers and a database for so-called "disengaged" customers that are not necessary or appropriate.
- 1.1.7 Whilst supportive of efforts to assist vulnerable customers, SSE has grave concerns that the PPM price cap stands out as a seriously flawed remedy which may endanger the efficacy of the rest of the package. SSE has viewed price capping as a backward step throughout the process but now is particularly concerned that an ill-defined and overly complex remedy may be implemented in a way which risks confusion and controversy.

1.1.8 These remedies risk causing more harm than good, because they would not be effective in achieving the objectives sought by the CMA and would risk bringing about material adverse consequences for competition and for GB consumers, PPM customers in particular - effects which may persist beyond the end of transitional measures.

1.1.9 In this Response, SSE has sought to highlight the issues that it believes need to be addressed and is now focussed on ensuring that the detailed remedy designs and their implementation are workable and that a lasting settlement that benefits customers can be achieved.

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1.1.10 The remainder of this Response is structured as follows:

- § Section 2 provides an executive summary of the Response;
- § Section 3 explains why the CMA’s revised analysis of detriment remains fundamentally flawed and does not provide a sufficient basis for the imposition of intrusive remedies;
- § Section 4 explains why the proposed price cap remedy for PPM customers is not a necessary or appropriate remedy;
- § Section 5 explains why the proposed database for “disengaged” customers is not a necessary or appropriate remedy;
- § Section 6 explains why the proposed Ofgem-led program for customer engagement is not a necessary or appropriate remedy;
- § Section 7 explains why the imposition of new financial reporting arrangements for the six large energy firms is not a necessary or appropriate remedy;
- § Section 8 explains why the introduction of locational pricing of transmission losses is not a necessary or appropriate remedy; and
- § Section 9 provides brief conclusions.

1.1.11 In order to support the analysis provided in the sections above:

- (a) Annex 1 provides SSE’s comments and observations on all other remedies proposed in the PDRs not otherwise analysed in this Response;
- (b) Annex 2 contains a report prepared by Frontier Economics that describes the material errors of fact and assessment contained in the CMA’s direct detriment analysis; and
- (c) Annex 3 provides additional analysis on the errors of fact and assessment in the NERA cost-benefit analysis.

## 2. Executive Summary

### 2.1 The PDR reflects the position that GB energy markets are generally competitive and well-functioning

2.1.1 The nature and scope of the PDR are consistent with the CMA's previous findings that the GB energy markets are generally competitive and well-functioning. In particular:

- (a) The PDR reflects that the key elements of the wholesale markets are working well and are highly competitive (the only proposed remedies being certain transparency improvements to the Contracts for Difference (*CfDs*) process and the introduction of additional locational adjustments for transmission losses).
- (b) The PDR reports on the significant number of positive features that the CMA has identified in the domestic supply markets. In particular, the PDR shows that suppliers are competing vigorously on price, through a wide variety of product offerings and innovative tariffs, leading to a competitive dynamic that the proposed remedies seek to further enhance.
- (c) The PDR reflects that in many cases the market developments already in train will have (and are already having) a materially positive impact on the energy sector. In particular, the proposed remedies seek to reflect, and build upon, the significant potential offered by smart meters to further increase competition within energy supply markets.

2.1.2 SSE strongly supports many of the remedies proposed by the CMA (a significant number of which reflect SSE's existing practice). These remedies will further enhance the market framework for effective competition and further help customers to engage in the market. In particular:

- (a) ***Withdrawing the simpler choices component of the RMR rules.*** The removal of these restrictions will enable suppliers to innovate and compete more effectively. This remedy will increase suppliers' ability to create packages of services that attract, retain, and reward customers and to differentiate themselves from their competitors.
- (b) ***Improving the framework for effective competition.*** Setting out a clear path, including a thorough cost-benefit analysis, for the move to mandatory half-hourly metering will help to ensure that the benefits of this system can be delivered to customers in the most cost effective manner.
- (c) ***Enhancing the ability and incentives for price comparison websites (PCWs) to engage customers.*** Giving PCWs access to the Electricity Central Online Enquiry Service (*ECOES*) and Single Centralised On-Line Gas Enquiry Service (*SCOGES*) databases will improve the switching process for customers (reducing any residual customer concerns about erroneous transfers and failed switches). Extending the

Midata programme will provide more consumers with ready access to tailored information about the choices available to them within the energy market. Critically, the Midata programme is founded on customer permission, which is essential to ensuring customer trust and longer-term engagement with the energy market.

- (d) ***Enhancing the engagement of microbusiness customers.*** Increasing the information made available to microbusiness customers will further enhance engagement and customer choice within the microbusiness sector (which will, in turn, offer even greater scope for suppliers to compete). The prohibition of “auto-rollover” contracts, which reflects SSE’s existing practice, will reduce customer confusion and remove barriers to engagement for the small proportion of customers that remain on these tariffs.
- (e) ***Improving industry governance.*** Clarifying the role of Ofgem and putting in place formal mechanisms for Ofgem and DECC to reconcile their policy objectives is likely to improve the quality of regulatory decision-making. This will, in turn, reduce the likelihood of a repeat of the well-intentioned but poorly targeted interventions in the market that have had detrimental effects in the past. Improving the governance of industry codes should similarly increase the efficiency and robustness of the code modification process.
- (f) ***Improving the allocation process for CfDs.*** Improving decision-making process and increasing transparency within the allocation of CfDs is consistent with SSE’s commitment to a fair, transparent, and dynamic energy market that rewards innovation.

2.1.3 SSE looks forward to working with the CMA to implement these wide ranging and substantive remedies as practicably and effectively as possible. (The proposed timing of such a broad package of remedies within a relatively short period of time does, however, raise some serious operational challenges and concerns around workability, which are briefly described in [Annex 1](#).)

## **2.2 The CMA’s revised measure of detriment in the retail sector remains wholly inadequate and does not support the case for intrusive remedies (see [Section 3](#))**

2.2.1 The CMA’s remedy-making powers are subject to an established rule of “*double proportionality*.” That is, where the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to be, the more detailed or deeper the investigation of the justification for that remedy must be.

2.2.2 In its assessment of the basis for the proposed remedies, the CMA does not identify any misconduct on the part of suppliers that it considers to contribute to the deficiencies alleged in the retail sector. Indeed, the vast majority of the evidence collated by the CMA shows that suppliers are competing hard for an engaged and active customer base and that new players are entering and expanding with different business models.

2.2.3 As in the Provisional Findings (*PFs*), in order to justify the proposed remedies in the retail sector, the CMA relies heavily on alleged AECs (that have not been established to the required legal standard) and its measure of consumer detriment. However, the PDR has brought a significant change in approach as the CMA has altered its previous assessment of detriment to now adopt a twin-pronged assessment. This is based on a so-called “*direct*” approach, which compares the average prices offered by the six large energy firms against a theoretic benchmark price, and a so-called “*indirect*” approach, which is an updated version of the CMA’s previous return on capital employed (*ROCE*) analysis (the preferred method in the *PFs*). The table below provides an overview of the CMA’s changing approach to estimating consumer detriment.

**The CMA’s inconsistent approach to estimating domestic detriment**

Description of approach	Estimated level of detriment (£, billion p.a.)	% of typical Dual Fuel bill	Key flaws in approach
<u>July 2015 PFs</u> (estimated detriment, of which just under half attributed to excess profit)	1.2	5	§ ROCE implies competitive margin of 1%. § Flawed analysis of efficiency detriment.
<u>March 2016 PDR</u> “ <i>Indirect</i> ” approach <b>TOTAL</b> Comprising:	<b>0.66 – 1.09</b>	<b>3 – 4</b>	§ Upper bound based on cost dispersion versus only one company ( <i>i.e.</i> , SSE). § No regulatory precedent.
1) “ <i>Indirect</i> ” approach (estimated excess profits); and	0.24	1	§ ROCE implies 1.5% margin for supplier with no capital for risk, trading collateral, regulatory collateral, peaks in working capital.
2) “ <i>Indirect</i> ” approach (estimated inefficiencies)	0.42 – 0.85	2 – 3	§ Cost dispersion ignoring different stages of suppliers in investment cycle and lacking rigour in cost benchmarking.
<u>March 2016 PDR</u> “ <i>Direct</i> ” approach	<b>1.7</b>	<b>11</b> <b>“net of network costs”</b>	§ Not profit based. Purely price dispersion compared to Ovo Energy and First Utility § Ovo Energy operates below 1.5% margin, <i>i.e.</i> , inconsistent with ROCE conclusions. Substantial amount of unexplained inefficiency in this estimate.

2.2.4 The CMA’s direct analysis is based on an assessment of possible gains from switching. The CMA had previously made clear that a gains from switching analysis was not a reliable indicator of detriment. No explanation or justification is provided for the complete reversal of this previously expressed view.

- 2.2.5 The CMA’s conclusion that there is significant detriment is, in addition, undermined by a series of serious errors of fact and assessment because the critical assumptions upon which it is based are simply not supported by the evidence. In particular:
- (a) The CMA’s choice of benchmark is wholly unrealistic, being based on a weighted average of the prices of only two suppliers – Ovo Energy and First Utility – which accounted for a minimal share of the market, and offered prices that were not sustainable, during the CMA’s benchmark period; and
  - (b) The CMA’s attempts to adjust benchmark prices to account for cost differences relating to network costs and different payment methods, in an attempt to provide a “like-for-like” comparison lack any basis in evidence, and simply serve to further distort the already extreme results.
- 2.2.6 The CMA describes the indirect analysis as a useful “*cross-check*” on its direct analysis.<sup>1</sup> Both analyses are, however, wholly inadequate and neither supports the case for intrusive remedies.
- 2.2.7 The CMA’s indirect analysis addresses a number of the flaws identified in its previous ROCE analysis (the materiality of which is underlined by a reduction in the ROCE-based detriment estimate to £240 million, which equates to barely 1% of sales to this customer group). The analysis continues, however, to contain material errors of fact, apply far-fetched assumptions, and assume characteristics of the market that did not apply over the Relevant Period.
- 2.2.8 In particular the CMA’s analysis continues to fundamentally understate the costs of managing the levels of risk associated with energy retailing through its reliance on arrangements with third party intermediaries that have no basis in evidence. The CMA’s attempts to address the previously identified deficiencies in its case are plainly inadequate, with any new evidence adduced continuing to fall far short of the kind of clear and convincing probative evidence that is required to establish the CMA’s case to the required legal standard. Errors persist relating to the level and scalability of intermediary trading fees and the CMA’s treatment of regulatory capital, risk capital, and working capital, which remain wholly unsound.
- 2.2.9 The conclusions of the CMA’s ROCE analysis suggest that suppliers should be operating with a margin of approximately 1.5%, or about £12 per customer account. This level of return would clearly be unsustainable for established and new entrant suppliers. This underlines that the outcome of the CMA’s profitability analysis is wholly implausible.
- 2.2.10 Both the indirect and direct analyses of detriment therefore contain material errors that serve to overstate the level of detriment to customers. Despite this, the CMA chooses to place more weight on the direct estimate that gives the

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<sup>1</sup> PDR, para. 3.157.

highest detriment figure. The CMA recognises that its direct estimate of detriment is “*far in excess*” of the actual net profits earned by the six large energy firms from their sales to domestic customers.<sup>2</sup> The CMA suggests that this implies a “*high degree of inefficiency in current prices.*” The CMA is, however, unable to specify where such inefficiencies exist despite the fact that these inefficiencies would apparently account for more than half of the alleged detriment. This claim is internally inconsistent and entirely without foundation; the efficiency assessment that the CMA has conducted as part of its indirect detriment calculation - while still an extreme and inappropriate interpretation of the available evidence that grossly overstates any alleged inefficiencies - produces far lower estimates.

2.2.11 It is clear, in fact, that these disparities result from the deficiencies in the CMA’s direct analysis of detriment.

### **2.3 The CMA’s unfounded and inflated assessment of consumer detriment for domestic customers results in proposed remedies that are not justified**

2.3.1 The CMA’s unfounded assessment of consumer detriment for domestic customers leads to proposed remedies that are not justified by the evidence. This is particularly the case for the more intrusive, uncertain, and wide-reaching remedies, which are therefore particularly disproportionate. Only a very real and serious AEC, where there was considerable consumer harm, could justify such an onerous remedy. The CMA has not established such an AEC in relation to “*weak customer response*” to the required legal standard and, as described above, the CMA’s assessment of consumer detriment is materially flawed.

2.3.2 These remedies risk causing more harm than good, because they are unnecessary, would not be effective in achieving the objectives sought by the CMA, and would risk bringing about material adverse consequences for GB consumers and for competition.

### **2.4 There is no basis for the proposed price cap for PPM customers (see Section 4)**

2.4.1 This proposed remedy is not necessary or appropriate. In particular:

- (a) The CMA has not established any AEC to justify this remedy to the required legal standard.
- (b) The CMA has not provided any evidence to show that non-smart PPM customers face severe and long-lasting barriers to engaging in the market. To the contrary, the CMA’s survey illustrates that these customers are engaged and active. The proposed remedy is therefore unnecessary and disproportionate to the alleged consumer detriment.
- (c) There are more proportionate and effective means of addressing the alleged AEC. In particular, to the extent that technical or regulatory

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<sup>2</sup> PDR, para. 3.227.

constraints could restrict the number of tariffs that suppliers can offer to PPM customers, these restrictions will be addressed by the CMA's other remedies (which SSE supports) to free-up slots on PPM meters and roll back the RMR rules.

- (d) The proposed remedy would have limited effectiveness in providing additional protections for vulnerable customers because PPM customers are generally a poor proxy for this type of customer.
- (e) The structure and form of the cap are fundamentally flawed and will produce a wholly disproportionate and unworkable remedy which will give rise to distorted market outcomes (in particular because the prices paid by some customers are likely to increase in practice) as a result of the cap mechanism.
- (f) The proposed cap is too tight to allow for effective competition in this segment (and risks removing PPM customers from the competitive market) due to a combination of factors: it is based primarily on introductory offers rather than standard variable tariffs; it relies on offers from just two suppliers, operating unsustainably; and - most significantly - relies on an estimated cost to serve differential which is significantly lower than has been found in any previous investigation. This low differential appears to arise from the CMA mistaking the lowest differential for the most *efficient* differential. The CMA's approach of taking the differential of the least efficient supplier, which happens to be unusually small, is clearly wrong and results in the use of a differential that is too low.
- (g) The proposed remedy also carries a serious risk of unintended adverse consequences. In particular, there is a material risk that PPM customers, who could consider themselves to be "protected" by the price cap, would be discouraged from engaging in the market. The commercial uncertainty created by the proposed mechanisms of the price cap is liable to reduce investment, deter new entry, and could lead suppliers to exit the PPM segment.
- (h) As presented, the PDR provides an incomplete specification of the price cap which could not be implemented in practice as currently framed.

2.4.2 In this response, SSE sets out in detail why it considers that the PPM price cap remedy is not necessary or appropriate, the detrimental impact it will have on competition and the serious risk of adverse consequences for customers. SSE believes that if a price cap is to be adopted, the CMA must first undertake a "root and branch" review of its proposal (enlisting the assistance of Ofgem and other stakeholders where appropriate) to achieve a revised proposal which is practical, simple, transparent and sustainable. The current version is not fit for purpose.

**2.5 There is no basis for the proposed database for “disengaged” customers**  
(*see Section 5*)

2.5.1 This proposed remedy is not necessary or appropriate. In particular:

- (a) The CMA has not established any AEC to justify this remedy to the required legal standard.
- (b) Even if the proposed remedy were justified, it raises material data protection concerns.
- (c) The CMA has adduced no evidence to establish that the proposed remedy will be effective towards increasing customer engagement. In fact, the available evidence suggests that this kind of prompt would not be well received by customers, given concerns around the use of their personal data and the receipt of a large number of unsolicited communications from third party suppliers. There is also no basis to suggest that this kind of prompt would be an attractive commercial option for suppliers. Indeed, many of the independent suppliers who might be expected to stand to benefit from the proposed remedy (such as First Utility, Ovo Energy, and Good Energy) have expressed significant concerns about it.
- (d) The proposed remedy is also disproportionate, because the claimed benefits are uncertain and the costs which it brings (which would ultimately fall on customers) are material.
- (e) Finally, the proposed remedy will have unintended adverse consequences by damaging customer trust in the market (given the widespread concerns of customer and consumer groups around the use of personal data and the receipt of large volumes of unsolicited communications).

**2.6 There is no basis for the proposed Ofgem-led program for customer engagement**  
(*see Section 6*)

2.6.1 This proposed remedy is not necessary or appropriate. In particular:

- (a) The CMA has not established any AEC to justify this remedy to the required legal standard.
- (b) Notwithstanding the absence of any AEC, SSE is committed to improving engagement in both the domestic and microbusiness segments, and would therefore be broadly supportive of effective, proportionate, and well-considered customer prompts.
- (c) The proposed remedy, however, risks causing more harm than good by potentially imposing overly-prescriptive “top down” requirements which can negatively impact the format and accessibility of customer communications.
- (d) The proposed market-wide cheapest tariff message is unworkable in practice and unprecedented in any market. The proposed remedy also

risks delaying the introduction of more effective customer-centred communications.

- (e) A more effective and proportionate remedy would therefore be to roll back the remainder of the existing RMR rules (namely the “clearer information” component which the CMA is not proposing to withdraw) and enable suppliers to tailor communications designed to engage with customers (subject to a principles-based set of rules). This approach would be more supportive of Ofgem’s current work in this area.

## **2.7 There is also no basis for the proposed new financial reporting requirements for the six large energy suppliers (see [Section 7](#))**

2.7.1 SSE has long supported increased transparency of the financial performance of suppliers and generators in the GB market, but firmly believes that the CSS introduced by Ofgem in 2010 (and which has been refined and improved over recent years) already provides an appropriate level of transparency for stakeholders and for Ofgem. SSE has provided comments to the CMA regarding further enhancements which could be achieved with more targeted changes to the current requirements.

2.7.2 This proposed remedy is not necessary or appropriate. In particular:

- (a) The CMA has not established any AEC in relation to “*the lack of a regulatory requirement for clear and relevant financial reporting*” to the required legal standard. While the proposed remedy is intended to “*provide Ofgem with information that will allow it to provide a clear and trusted assessment of the GB energy markets,*”<sup>3</sup> there is no evidence of any specific difficulties experienced by Ofgem. Indeed, by contrast Ofgem has consistently indicated that the existing reporting requirements – the Consolidated Segmental Statements (CSS) – is accurate and fit-for-purpose. Accordingly, no remedy at all is justified.
- (b) The proposed remedy would not be effective in achieving the CMA’s stated aim because it would not provide “*clear and relevant*” financial information to inform policy and regulatory decisions (or for customers and investors).
- (c) In particular, the key benefit of the current reporting system – that results can be reconciled with statutory accounts of reporting firms and properly audited – would be lost.
- (d) Limiting the scope of the proposed remedy to the six large energy suppliers would also undermine the effectiveness of the proposed remedy by limiting the relevance and comparability of results reported.
- (e) The proposed remedy is also disproportionate. The claimed benefits of the remedy are marginal (in particular because the information reported will not be robust). On the other hand, the costs that the remedy will

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<sup>3</sup> PDR, para. 10.215.

entail (in terms of unnecessary investment in internal system and additional auditing) are significant.

## **2.8 There is no basis to introduce locational adjustments for transmission losses** (see [Section 8](#))

2.8.1 This proposed remedy is not necessary or appropriate. In particular:

- (a) The CMA has not established any AEC in relation to “*the absence of locational charging for transmission losses*” to the required legal standard.
- (b) The CMA recognises that any proposal to introduce locational charges for transmission losses needs to be based on a rigorous cost-benefit analysis. The analysis provided by the CMA is, however, wholly unreliable, being arrived at through a flawed process in which the CMA’s cost-benefit analysis was effectively “outsourced” to NERA Economic Consulting (*NERA*), an adviser to one of the main parties (RWE).<sup>4</sup> The analysis produced by NERA is therefore not an independent and credible source of evidence on which the CMA is able to rely.
- (c) In any case, the analysis produced by NERA is undermined by a number of critical errors of fact and assessment, which means that the conclusions that the analysis seeks to draw cannot be supported.
- (d) The proposed remedy will not be effective in achieving the objectives sought. The purported benefits are highly theoretic, in particular because the proposed model will not determine generation patterns in the way assumed by the CMA.
- (e) In this regard, the CMA has failed to adequately explain why it has set aside the conclusion of Ofgem, as the expert regulator, which has already decided that the same measure would not benefit consumers. The CMA could only justify such a course of action where it had a particularly strong evidential base to do so (which it does not in the present circumstances).
- (f) The proposed remedy risks giving rise to material unintended adverse consequences. In particular, the proposed remedy would further distort competition between UK generators and imported generation (placing UK generation at a material competitive disadvantage).

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<sup>4</sup> A decision which was strongly criticised by SSE and one other respondent (CMA, *Notice regarding assessment methodology for losses remedy – appointment of economic consultancy*, 30 October 2015).

**2.9 To the extent that the proposed remedies are not justified by the evidence, the CMA’s approach is inconsistent with the rest of its findings and risks repeating previous mistakes in the market**

- 2.9.1 As noted above, the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to be, the more detailed or deeper the investigation of the justification for that remedy must be – this is particularly pertinent to the transitional price cap for PPM customers and the introduction of locational pricing of transmission losses.
- 2.9.2 Where the CMA’s proposed remedies are not justified by the evidence, the remedies risk causing more harm than good. The CMA’s approach is particularly surprising given that many of the other remedies that it proposes and which SSE supports (such as the roll-back of the RMR rules), are aimed at addressing concerns that arise from ill-conceived market intervention in the past.
- 2.9.3 This underlines that it is particularly important that the CMA should not intervene without a clear and convincing case for action, particularly where remedies (such as the proposed customer database) have not been properly field-tested.

**2.10 Conclusion**

- 2.10.1 SSE supports the vast majority of remedies proposed by the CMA’s substantive and far-reaching inquiry, although disagrees with its assessment of consumer detriment. SSE strongly urges the CMA to reconsider the five remedies discussed above. Their introduction is unwarranted and their implementation is likely to do more harm than good. The claimed benefits of these remedies (if any) for customers are extremely limited. The remedies would, however, give rise to material costs and unintended adverse consequences. In particular, we would expect effective competition to be distorted, if not undermined completely, by the proposed price cap, to the detriment of customers. SSE is now focused on ensuring that the detailed remedy designs and their implementation are workable and that a lasting settlement that benefits customers can be achieved.

**3. The CMA’s revised analysis of alleged detriment in retail markets remains fundamentally flawed and therefore the CMA has not set out any basis to impose intrusive remedies**

**3.1 Introduction and overview**

3.1.1 The more intrusive, uncertain, and wide-reaching of the proposed remedies in the retail sector (*i.e.*, the proposed price cap for PPM customers in particular) are founded on the CMA’s suggestion that there is substantial consumer detriment.

3.1.2 Upon review, however, it is clear that the CMA’s assessment of detriment is not robust, fails to address the available evidence correctly or at all, disregards important factual matters, and makes unreasonable assumptions based on no or little evidential support. This results in a significant overstatement of the alleged detriment within the domestic energy sector.

3.1.3 This underlines the fact that these far-reaching remedies are particularly disproportionate. Accordingly, before explaining why the proposed remedies are not necessary or proportionate, the flawed basis for the CMA’s material overstatement of detriment is described below.

**3.2 The CMA’s so-called “direct approach” does not establish that prices are excessive**

3.2.1 The CMA’s so-called “*direct approach*” to establishing and quantifying customer detriment does not establish that prices are excessive. The CMA places the greatest emphasis on its direct analysis because it considers that this provides a “*direct measure of consumer detriment.*” The direct analysis is, however, characterised by a number of significant errors of fact and assessment that produced flawed results.

3.2.2 The CMA’s direct approach consists of two stages. First, the CMA identifies the prices it considers to be the “*most competitive suppliers*” in the market. Second, the CMA adjusts those prices for “*exogenous cost differences*” relating to network costs and different payment methods in an attempt to provide a “like-for-like” comparison.

3.2.3 The CMA’s direct approach is therefore based on using the gains available from switching in the market as a measure of detriment. The CMA has, however, been quite clear throughout its investigation that the gains available from switching do not provide robust and reliable evidence of consumer detriment. For example, in the PFs, the CMA made clear that the gains from switching could not “*be relied upon to measure aggregate welfare loss associated with domestic customers not switching to cheaper tariffs,*” in particular because “*suppliers offering the cheapest tariffs may not find it sustainable to have a large proportion of customers switching to them.*”<sup>5</sup> No

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<sup>5</sup> PFs, Appendix 7.4, para. 3.

explanation or justification is provided for the complete reversal of this previously expressed view.

- 3.2.4 In addition, both stages of the CMA's analysis are undermined by a series of errors of fact and assessment which produce incorrect and misleading results upon which the CMA is not able to rely.
- 3.2.5 The key errors of fact and assessment in the CMA's direct approach are summarised below, with a more detailed analysis provided in the report prepared by Frontier Economics attached as **Annex 2** to this Response.

**The CMA's chosen price benchmark is not an appropriate standard against which to measure detriment and has no sufficient basis in evidence**

- 3.2.6 **The CMA's price benchmark is unrealistic and inconsistent with its guidance and practice.** The CMA is required to measure any alleged AEC against the theoretic benchmark of a "*well-functioning market*." As acknowledged in the PDR, a well-functioning market is one that "*displays the beneficial aspects of competition, notably rivalry between firms which seek to win customers' business through lower prices, improved quality or variety and/or introducing new or better products. It is not an idealised perfectly competitive market.*"<sup>6</sup>
- 3.2.7 The CMA's price benchmark is, however, based on an assumption that all suppliers should price exactly at the current level of the two cheapest mid-tier suppliers (Ovo Energy and First Utility). Any price differential relative to this benchmark is considered to be consumer detriment. This highly theoretic benchmark is wholly inconsistent with the CMA's guidance and established practice.
- 3.2.8 **The CMA's choice of benchmark suppliers is too "thin" and therefore lacks a sufficient basis in evidence.** The CMA's competitive benchmark is based on a weighted average of only two suppliers: Ovo Energy and First Utility. However, both suppliers accounted for only a *de minimis* share of the market during the CMA's benchmark period. The sample size for First Utility, in particular, is simply too small to base any reliable and robust benchmarking assessment upon.
- 3.2.9 **The available evidence clearly shows that Ovo Energy's prices were not sustainable during the CMA's benchmarking period.** Ovo Energy made sustained losses over the CMA's benchmark period, including a loss of £33 million in 2014. The CMA suggests that Ovo Energy's pricing is sustainable, despite these losses, because customer acquisition costs are likely to fall in the next few years, as the "*rate of customer acquisition naturally declines.*"<sup>7</sup>
- 3.2.10 This assumes, however, that Ovo Energy's customer base will become less active as the company grows, meaning that Ovo Energy will not have to fight

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<sup>6</sup> PDR, para. 3.152.

<sup>7</sup> PDR, para. 3.196.

as hard to retain existing customers. This is implausible within the kind of dynamic and competitive market that should form the baseline for the CMA's analysis.

- 3.2.11 Instead, the evidence adduced by the CMA indicates that Ovo Energy would have needed to scale up its prices significantly to have operated on a sustainable basis during the CMA's benchmark period. For example, a material price increase would have been required to enable Ovo Energy to match the margin achieved by First Utility, which was very close to the 1.5% margin that the CMA has suggested would be sustainable.<sup>8</sup>
- 3.2.12 Adjusting Ovo Energy's prices in this way materially reduces the alleged level of detriment, by £700 million. Indeed, even this estimate is highly conservative (given, in particular, that margin benchmarking evidence submitted by SSE shows that a 1.5% margin would not be sustainable).

**The CMA's claim that its direct detriment estimate implies a "high degree of inefficiency in current prices" is internally contradictory and without foundation**

- 3.2.13 As the CMA itself acknowledges in the PDR, the estimated £1.7 billion in domestic detriment is far in excess of the net profits earned by the six large energy firms from their sales to domestic customers<sup>9</sup>. This strongly indicates (consistent with the explanations that SSE provides in this Response) that there remain significant flaws in the CMA's direct detriment analysis. The CMA instead suggests, however, that "*the implication is that there is a high degree of inefficiency in current prices.*"<sup>10</sup>
- 3.2.14 Given the scale of the disparity (*e.g.*, the £1.7 billion figure being almost double the EBIT of the six large energy firms in 2014), and that the CMA considers an economically efficient EBIT margin to amount to 1.5% (or approximately £400 million across the six large energy firms), the CMA appears to be implying that it considers such "inefficiencies" to amount to at least £1.2 – 1.3 billion.
- 3.2.15 Despite this magnitude, the CMA has not been able to produce any evidence to show what these alleged inefficiencies might be. Indeed, this efficiency assessment is entirely at odds with the efficiency analysis that the CMA has simultaneously conducted as part of its indirect detriment calculation, which yields an indirect cost inefficiency estimate ranging between £400 million and £900 million (and is, for the reasons explained below, an extreme and inappropriate interpretation of the available evidence in any case).
- 3.2.16 Nor can the CMA claim that the inefficiency estimates that it has calculated on the basis of its indirect detriment analysis are in any way conservative on the basis that they only relate to indirect costs. As the CMA recognises in the

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<sup>8</sup> The magnitude of this price increase is described in the confidential version of Frontier Economics' report in relation to the CMA's direct detriment analysis.

<sup>9</sup> PDR, para. 65.

<sup>10</sup> PDR, para. 65.

PDR, it has uncovered no clear evidence of any inefficiency with regard to working capital costs, wholesale energy costs or other direct costs (even after considering these issues in some depth following the PFs). On this basis, the only reasonable interpretation of the vast disparity between the CMA's £1.7 billion detriment estimate and the outturn EBIT margin actually achieved by the six large energy firms is that the CMA's detriment estimate is a significant overstatement.

**The CMA's adjustments for "exogenous" cost differences are undermined by serious errors of fact and assessment**

- 3.2.17 **The proposed adjustments lack a sufficient basis in evidence.** The CMA's cost adjustments are based on data that the CMA acknowledges are flawed. The CMA's analysis makes no meaningful effort, however, to address these flaws or to incorporate adjustments that would guard against undue reliance on data that are plainly inaccurate.
- 3.2.18 **Many of the critical assumptions that underpin the CMA's analysis are not explained at all or not supported by the available evidence.** For example, instead of drawing from a wide range of supplier data, the CMA cherry-picks data from individual suppliers (in particular EDF and Utility Warehouse), even where there are obvious reasons why these data are not representative of what an "efficient" supplier could be expected to achieve. The CMA also places considerable weight on a "bottom-up" analysis of the differential cost to serve when it is clear that it lacks access to the accurate, highly disaggregated cost data that would be required to effectively carry out such an analysis. As a result, the analysis produced is characterised by several material errors, omissions, and inconsistencies.
- 3.2.19 **The CMA's analysis also contains a number of factual errors and inaccuracies.** The CMA's network costs analysis includes a number of material factual errors, relating to both inputs and calculations, and the results in places differ substantially from SSE's experience in the marketplace.
- 3.2.20 **The CMA's analysis materially understates the differential cost to serve both PPM and standard credit customers.** As a result of the errors of fact and assessment described above, the CMA's analysis materially understates the differential cost to serve both PPM and standard credit customers (relative to direct debit customers). This not only results in a grossly overstated measure of detriment but also undermines the basis for the calculation of the proposed cap (as described in further detail in Section 4 of this Response). In particular:
- (a) For PPM customers, a differential of at least £76 has a stronger basis on the evidence than the figure of £54 assumed by the CMA; and
  - (b) For standard credit customers, a differential of at least £99 has a stronger basis on the evidence than the figure of £82 assumed by the CMA.

3.2.21 Addressing even a limited sub-set of these errors of fact and assessment (it is not possible to address all of the errors identified using even the data available through the Confidentiality Ring) significantly reduces the estimated level of detriment.

3.2.22 For example, simply uplifting Ovo Energy's unsustainable tariffs to a level consistent with First Utility's EBIT margin and using the figures of £76 and £99 described above for the incremental cost to serve PPM and standard credit customers respectively reduces the estimated level of domestic customer detriment from £1.7 billion to £800 million.

### **3.3 The CMA's so-called "indirect approach" does not establish that prices are excessive**

3.3.1 The CMA's so-called "*indirect approach*" to establishing and quantifying customer detriment also does not establish that prices are excessive.

3.3.2 The CMA's indirect approach is a revised version of its ROCE analysis. Having maintained to date that the ROCE analysis provides a "*meaningful measure of profitability in energy retail*,"<sup>11</sup> the CMA now changes course and seeks instead to rely on a new measure (which it previously suggested did not provide a reliable indicator of detriment). The indirect analysis is now described simply as a useful "*cross-check*" on the direct analysis.<sup>12</sup> On any basis, however, the indirect analysis continues to be undermined by a number of significant errors of fact and assessment.

3.3.3 The CMA's indirect approach consists of two stages. First, the CMA conducts a ROCE analysis intended to identify profits in excess of the cost of capital. Second, the CMA conducts a comparison of the indirect cost bases of the six large energy companies to adjust for potential differences in cost efficiency. Both of these stages of the CMA's analysis are, however, undermined by a series of errors of fact and assessment and do not produce robust results upon which the CMA is able to rely.

### **The CMA's ROCE analysis is not supported by any of the additional evidence adduced in the PDR and continues to be undermined by serious errors of fact and assessment**

3.3.4 As SSE has consistently explained throughout the CMA's investigation, ROCE is, in principle, not an appropriate measure of retail supply profitability, given the asset-light nature of the business. The estimations and assumptions required to undertake the analysis are liable to lead to extreme conclusions that are detached from market reality.

3.3.5 The CMA has addressed a number of the errors in the ROCE analysis provided in the PFs. This results in a material reduction in the estimate of alleged detriment for domestic customers to £240 million, which equates to

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<sup>11</sup> See, e.g., PFs, para. 10.30.

<sup>12</sup> PDR, para. 3.157.

barely 1% of revenue from sales to this customer group. However, the ROCE analysis continues to contain material errors of fact, apply extreme assumptions, and assume characteristics of the market that did not apply over the Relevant Period, all of which leads to a material overstatement of the alleged detriment.

3.3.6 As a result of these extreme assumptions, the CMA's analysis is based on a hypothetical standalone supplier of scale that has no basis in evidence and is entirely implausible. Based on the analysis provided in the PDR, the CMA's hypothetical standalone supplier of scale:

- (a) **holds no risk capital** to allow it to cope with the risk of short-term losses resulting from volumetric shocks (even though the CMA itself now acknowledges that such shocks are a real and unavoidable feature of the energy industry);
- (b) **holds no capital for trading collateral**, but instead relies wholly on its ability to pay an intermediary to take on all the risks associated with purchasing energy on the wholesale market (even though such arrangements were not – and could not have been – available to a standalone energy supplier of scale on the terms that the CMA is envisaging during the Relevant Period);
- (c) **holds no capital for regulatory collateral**, but instead relies primarily on letters of credit (even though it is implausible that a large standalone supplier would have access to such facilities on the terms assumed by the CMA); and
- (d) **holds no capital to manage peaks in working capital requirements** (even though the CMA's own analysis shows that these peaks are substantial and can emerge quickly).

3.3.7 The CMA therefore assumes that a standalone supplier of scale would be able to withstand the substantial risks that characterise the market with the only capital employed being the (limited) fixed assets in the business, a 2% cash balance, and some limited intangible assets. This position is entirely inconsistent with the available evidence.

3.3.8 **The CMA's analysis of arrangements with third-party intermediaries to manage business risk remains wholly unsound.** The CMA continues to assume that a standalone supplier of scale could avoid the need for trading collateral by entering into trading arrangements with third party intermediaries. SSE has previously explained in detail that the CMA's provisional conclusions in relation to the availability of intermediary arrangements during the Relevant Period could not be supported by the evidence that had been provided.<sup>13</sup> The PDR does not provide any additional evidence to address the material flaws in the CMA's case. In particular:

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<sup>13</sup> Response to PFs, paras. 3.5.11 *et seq.*

- (a) ***There remains no evidence that such intermediary arrangements were available during the Relevant Period.*** The CMA again provides no evidence that such trading arrangements were available during the Relevant Period. Even Shell, which is the only intermediary that has suggested that it provides such services today, has now confirmed that it only began to provide them in “*early 2013.*”<sup>14</sup>
- (b) ***The level of the intermediary fee assumed by the CMA continues to substantially understate the relevant costs of managing business risk.*** The CMA continues to underestimate the true level of notional capital required to support a standalone supplier of scale on a sustainable basis. The CMA’s key contention – that suppliers would be able to access the facility on reasonable terms in times of high market volatility – remains unsupported by the evidence. On the contrary, Shell has explicitly told the CMA that the fee it charges parties will be influenced by the level of market volatility, as well as the risk exposure of the party in question (which, for the reasons summarised above, would be particularly high for firms adopting the thinly capitalised business model that the CMA envisages could have applied over the Relevant Period). The CMA also continues to ignore the impact of the charge over assets owned by the suppliers that the trading arrangements appear to give Shell.
- (c) ***The level of the intermediary fee assumed by the CMA is not supported by the evidence.*** The CMA again provides no relevant evidence to support the assumed fee level, with the CMA setting aside evidence of actual arrangements to rely on the conjecture of a single party. The only evidence of actual arrangements adduced by the CMA shows a fee level that is considerably higher than that assumed by the CMA.
- (d) ***There remains no evidence that such intermediary arrangements would be scalable.*** The CMA again provides no relevant evidence to support the position that the intermediary arrangements that are currently in place would be scalable. As SSE has previously explained, it is not possible to simply assume that an intermediary would be able to operate at a greater scale simply by taking different positions in generation and retail supply. The sum total of the evidence upon which the CMA seeks to establish the alleged scalability of the arrangements consists of: the self-professed appetite of two firms (Shell and BP) to provide intermediary services on a larger scale; that fact that Shell provides intermediary services on a larger scale in the U.S.; and, the fact that another two firms (Morgan Stanley and Macquarie) “*are both active in this market.*”<sup>15</sup> The only available evidence suggests that Shell remains uncertain about providing such

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<sup>14</sup> Summary of hearing with Royal Dutch Shell plc on 10 December 2015, para. 1.

<sup>15</sup> PDR, Appendix 3.4, para. 60.

services to larger suppliers.<sup>16</sup> In the round, the evidence therefore falls far short of the kind of clear and convincing probative evidence that is required to establish the CMA's case to the required legal standard.

**3.3.9 The CMA's treatment of regulatory capital remains wholly unsound.** The CMA continues to underestimate the costs of regulatory collateral for a standalone supplier of scale during the Relevant Period. The CMA assumes that a standalone supplier of scale could manage its regulatory capital requirements via the use of letters of credit (*LoCs*) and a relatively small amount of cash. However, the CMA materially underestimates the fees that would apply to these *LoCs*:

- (a) The CMA appears to have arrived at its fee rate estimate of 2% by "splitting the difference" between fee estimates provided by RWE and Just Energy. This is clearly an insufficient basis to arrive at a robust and reliable fee estimate.
- (b) In fact, a fee rate of 2% is implausible for a stand-alone supplier of scale given the thinly capitalised business model that the CMA envisages could have applied over the Relevant Period.<sup>17</sup> Given the lower credit rating that such a supplier would sustain as a result of its weak balance sheet, it is unlikely that any bank would be willing to provide access to sufficient *LoCs* to allow it to meet regulatory capital requirements – even in return for a higher fee.

**3.3.10 The CMA's treatment of risk capital remains wholly unsound.** The CMA continues to understate the costs of risk capital for a standalone supplier of scale during the Relevant Period. The CMA now recognises the necessity of making provision for risk capital. However, instead of making an allowance for contingent capital, the CMA has simply reclassified the cash balance in the working capital estimated for normal operational needs as risk capital. This is incorrect because:

- (a) This cash balance was already included in the capital base set out by the CMA in the PFs and was, at that point, considered to be an appropriate cash balance for a large standalone supplier to support its operational requirements without any regard to the need for risk capital. To consider that working capital for normal operational needs should now also be classified as risk capital is implausible (given that if the capital were to be called on as risk capital, the supplier would no longer have a sufficient daily cash balance to run its business).
- (b) The estimated cash balance of 2% of cost of sales is, in itself, not supported by the evidence. This cash balance is based on an estimate provided by a single supplier (Just Energy). The CMA ignores evidence of higher cash balances from First Utility and Ovo Energy.

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<sup>16</sup> Summary of hearing with Royal Dutch Shell plc on 10 December 2015, paras. 14 and 15.

<sup>17</sup> Frontier Report, para. 2.19(a).

3.3.11 **The CMA’s treatment of working capital remains wholly unsound.** The CMA continues to underestimate the working capital that would be required by a standalone supplier of scale. The evidence of extreme volatility in the CMA’s estimates of capital employed over time for each supplier means that applying average working capital (as the CMA has done in the PDR) does not adequately reflect the working capital requirements of a standalone retailer. Applying peak working capital, a more appropriate measure of the economic requirement for capital, is both more stable and realistic.

**The CMA’s indirect cost “efficiency adjustments” are unreliable and undermined by serious errors of assessment**

3.3.12 The CMA’s efficiency benchmarking exercise is highly unrealistic because it reflects a far-fetched and wholly unjustified interpretation of the available evidence. This is underlined by the resulting range of indirect cost efficiency scores, of between 53% and 100%, which is simply too wide to be reasonably attributed to efficiency differences (absent further substantiation of the results – which the CMA does not provide).

3.3.13 **The CMA’s inefficiency estimates are based on an extreme standard that cannot be supported by the underlying data and is inconsistent with established regulatory practice.** The CMA has based its higher-end estimates of inefficiency (*i.e.*, of £850 million) on a comparison of each supplier’s unit costs relative to the supplier with the lowest reported unit costs. This is the most extreme conceivable standard, which is inconsistent with the established practice of sector regulators and could only possibly be justified if the CMA had a clear and convincing basis in evidence to support that position.

3.3.14 There are, however, material grounds for concern about the evidence upon which this benchmarking analysis is based (*e.g.*, in relation to the consistency of some of the information on indirect costs that suppliers have provided and the CMA’s treatment of this information).<sup>18</sup>

3.3.15 In such circumstances, a cautious approach to interpreting the differences in the indirect cost data that the CMA has identified is more appropriate. At most, an assessment based on upper quartile performance would be appropriate. Indeed, in some circumstances (*e.g.*, where there is, as in the present case, some doubt about the consistency of some of the data on which the assessment is based) it is more appropriate to look at average performance in the sector.

3.3.16 **The efficiency benchmarking analysis fails to reflect that different suppliers passed through different stages in their investment cycles over the Relevant Period.** The CMA acknowledges that firms will have lower unit indirect costs at certain points in their investment cycle. The CMA suggests,

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<sup>18</sup> See, *e.g.*, PDR Appendix 3.6, paragraphs 61, where it is suggested that some suppliers have updated their classification of indirect costs since the PFs. However, there appears to be no evidence in the PDR that the CMA has updated its indirect costs benchmarking analysis to take account of these changes.

however, that the Relevant Period is sufficiently long for differences in the timing of investment to even out.

- 3.3.17 This does not reflect commercial reality. The investment cycle for an energy supplier is longer than the period under consideration. For example, SSE has not made any investment in a new billing system during the last eight years and therefore the significant investment that had previously been made (and will be made in the near future) would not be reflected in the CMA's approach.

### **3.4 Conclusion**

- 3.4.1 The CMA has not adopted a consistent approach to assessing consumer detriment in the course of the inquiry. In particular, ROCE was the preferred measure of profitability in the early stages of the inquiry but has now been relegated to the status of being one element of a "cross-check".
- 3.4.2 It is notable that the excess profit estimate has been radically reduced between the PFs and the PDR and now represents barely 1% of typical customer bill. Inefficiency, which was the other component of the detriment measure in the PDRs, is a second element of the "cross-check" but amounts to no more than a crude measure of aggregate cost dispersion, lacking in rigour and ignoring different stages of suppliers in their investment cycle.
- 3.4.3 Most of the emphasis in the PDR now rests on the "direct" approach, a measure of price dispersion against a benchmark comprised of two suppliers, one of which operates below the level of profitability viewed as competitive from the CMA's ROCE analysis. Price dispersion is not an appropriate basis for measuring detriment and this appeared to be the CMA's own view earlier in the inquiry. In short, the CMA has not produced a robust and consistent estimate of detriment which justifies intrusive remedies such as the PPM cap.

#### **4. The proposed price cap remedy for PPM customers is not a necessary or appropriate remedy**

##### **4.1 Introduction and overview**

4.1.1 This proposed remedy consists of a transitional price cap on the maximum level of annual bills for domestic customers with prepayment meters, including restricted meters. The proposed cap would be based on the CMA's estimated benchmark for a competitive prepayment tariff. Accordingly, the flaws in that analysis described above, which result in a materially overstated measure of detriment, would also have a material impact on this proposed remedy because the cap would be set at a level that is too low.

4.1.2 As explained below, this remedy is not necessary or appropriate, in particular because:

- (a) The CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified.
- (b) Even if the proposed remedy were justified, there is material doubt that the remedy would be the most proportionate means of addressing the alleged AEC, as there are other less intrusive ways to address the technical or regulatory constraints faced by PPM customers.
- (c) The proposed remedy would have limited effectiveness in providing additional protections for vulnerable customers because PPM customers are a poor proxy for this type of customer.
- (d) The structure and form of the cap are fundamentally flawed. In particular, the current proposal, which is based on suppliers charging a price based on a "snapshot" of the prices of two marginal suppliers (which account for a *de minimis* proportion of the market) taken at a single point of time when they were operating with an atypical portfolio of contract types and on an unsustainable basis, is simply not credible. The prepayment cost differential used in the calculation of the price cap is also inappropriately low due to the flawed interpretation of data provided by suppliers. This will produce a wholly disproportionate and unworkable remedy that will result in damaging outcomes in the market.
- (e) The proposed remedy also carries a serious risk of unintended adverse consequences in particular by reducing PPM customer engagement [ " ].

##### **4.2 The CMA has not established any AEC to the required legal standard**

4.2.1 The CMA explicitly recognises that the proposed remedy is an "*interventionist*" measure with "*potential adverse consequences*."<sup>19</sup> In keeping with the established "double proportionality" principle applied by the Competition Appeal Tribunal (*CAT*), the more intrusive and uncertain in its

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<sup>19</sup> PDR, para 7.6

effect, or wide-reaching a proposed remedy is likely to be, the more detailed or deeper the investigation of the justification for that remedy must be.<sup>20</sup>

- 4.2.2 Accordingly, given the extremely onerous nature of the proposed remedy, only a very real and serious AEC, where there was considerable consumer harm, could justify imposing such a remedy.
- 4.2.3 The PDR suggests that the aim of the proposed remedy is to mitigate the “*residual detriment*” suffered by domestic customers due to the alleged AECs identified in relation to weak customer response and the prepayment sector, during the transitional period before smart meter roll-out.<sup>21</sup>
- 4.2.4 As explained in SSE’s response to the PFs, however, the CMA has not established either of the AECs to the required legal standard. In particular:
- (a) ***Customers are active and engaged.*** Any suggestion that customers are inactive and disengaged is wholly inconsistent with the available evidence. The CMA ignores the evidence (including from its own customer survey) that switching rates are material, non-price factors are significant drivers of choice and that a significant proportion of consumers are satisfied with their current energy supply arrangements, including within the PPM sector.<sup>22</sup>
  - (b) ***The CMA’s analysis of customer detriment does not establish that prices are excessive.*** As explained in [Section 3](#):
    - (i) the overall level of detriment alleged by the CMA is materially overstated as a result of a series of errors of fact and assessment which not only lead to material overstatement but to results and analysis that are simply not robust and therefore not suitable for the CMA to rely on; and
    - (ii) the CMA’s direct detriment estimates are particularly overstated for PPM customers, because the CMA has materially underestimated the incremental cost to serve these customers by at least £20 (and in all likelihood by an even greater amount as set out in Section 4.6 below).
- 4.2.5 In such circumstances, it is clear that the CMA has not adduced the kind of deep and detailed evidence of consumer harm that would be required to justify such an intrusive remedy.

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<sup>20</sup> See, e.g., *Tesco plc v Competition Commission* [2009] CAT 6, para. 139: “[I]t may well be sensible for the Commission to apply a ‘double proportionality’ approach: for example, the more important a particular factor seems to be in the overall proportionality assessment, or the more intrusive, uncertain in its effect, or wide-reaching a proposed remedy is likely to prove, the more detailed or deeper the investigation of the factor in question may need to be.” See also *Barclays Bank plc v Competition Commission* [2009], CAT 27, para. 21.

<sup>21</sup> PDR, para. 7.19.

<sup>22</sup> See Response to the PFs, paras. 3.2.1. *et seq.*

### 4.3 The proposed remedy would not be proportionate

- 4.3.1 **Other, more proportionate, remedies are available for the CMA.** The CMA’s guidance indicates that “*the [CMA] will not generally use remedies that control outcomes [such as a price cap] unless other, more effective, remedies are not feasible or appropriate.*”<sup>23</sup> Leaving aside whether the proposed remedy is justified at all, there are clearly more proportionate means of addressing the alleged AEC.
- 4.3.2 To the extent that technical or regulatory constraints could restrict the number of tariffs that suppliers can offer to PPM customers, these restrictions will be addressed by the other remedies proposed by the CMA. In particular:
- (a) The CMA has proposed a suite of remedies intended to address constraints in the commercial options available to PPM customers, including a new scheme for the efficient allocation of gas tariffs slots (and associated licence changes and/or supplier undertakings); and
  - (b) The CMA’s proposal to withdraw the “simpler choices” component of the RMR rules will remove restrictions on the number of tariffs that suppliers are able to offer.
- 4.3.3 Both the improved slot management scheme and rolling back on RMR rules will have an immediate positive effect on the market, addressing the concerns identified by the CMA in an effective and comprehensive manner.
- 4.3.4 **An intrusive and short-term remedy is subject to particularly stringent proportionality requirements.** As noted above, the proposed remedy is a transitional measure intended to mitigate the alleged detriment identified by the CMA pending the roll-out of smart meters.
- 4.3.5 In its *Private Healthcare* investigation, the CMA has recently clarified that where the benefits of an intrusive remedy will be short-lived (*e.g.*, because market developments that are already in train will address the alleged AEC without the need for intervention) such a remedy will not be proportionate, even though it would be effective.<sup>24</sup> This is particularly the case where there is a lack of certainty that the benefits of the remedy will outweigh its costs.<sup>25</sup>
- 4.3.6 In the *Private Healthcare* investigation, the CMA found that market developments expected to take effect by 2022 were sufficient to address an alleged AEC which would otherwise have been addressed by a remedy in 2017. In the present circumstances, the roll-out of smart meters will address the CMA’s concerns within an even shorter timescale (roll-out will be substantially complete by 2020). The short-lived (but highly intrusive) nature of the proposed remedy therefore underlines, consistent with the CMA’s approach in *Private Healthcare*, that it is not proportionate.

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<sup>23</sup> Guidelines, para. 378; Guidelines – Annex B, paras. 88 and 89.

<sup>24</sup> CMA, *Private Healthcare Investigation Remittal*, Provisional decision on remedies, para. 18.

<sup>25</sup> CMA, *Private Healthcare Investigation Remittal*, Provisional decision on remedies, para. 19.

#### 4.4 There is material doubt that the proposed remedy could be implemented effectively in a lawful manner

4.4.1 Internal Energy Market rules place stringent requirements on the conditions under which it may be permissible for governments or regulators to set end-user energy prices.<sup>26</sup> In particular, pursuant to Article 3(2) of Directive 2009/72/EC and Directive 2009/73/EC (the “*Energy Directives*”), “*obligations which may relate to (...) price of supplies (...) shall be clearly defined, transparent, non-discriminatory [and] verifiable.*” The Court of Justice’s judgment in *Federutility* clarifies the criteria that a national price regulation measure is required to comply with.<sup>27</sup>

4.4.2 The CMA recognises the constraints imposed by the Energy Directives but suggests that the proposed remedy is consistent with them. In fact, there is material doubt that the proposed remedy would be able to satisfy these requirements. In particular:

- (a) First, the CMA has not established a sufficient basis that the proposed price cap is justified in the general economic interest. The CMA suggests that the measure is justified by the alleged AECs relating to the prepayment sector and weak customer response and the “*residual harm*” incurred by domestic PPM customers while the CMA’s other remedies take effect.<sup>28</sup> However, as described above, the alleged AECs have not been established to the required legal standard and CMA’s analysis of detriment is materially overstated and therefore there is no justification for the proposed remedy.
- (b) Second, the proposed remedy is not “*necessary.*” The Court of Justice’s judgment in *Federutility* makes clear that the obligations incumbent in the price cap can only “*compromise the freedom to determine the price for the supply of [energy] only in so far as is necessary to achieve the objective in the general economic interest which they pursue.*”<sup>29</sup> This is not the case with the proposed remedy. As described above, other, more proportionate, measures are available to the CMA.
- (c) Third, the proposed cap is not clearly defined and transparent. As explained below, the mechanics of the proposed price cap raise considerable uncertainty about its operation in practice. Several

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<sup>26</sup> Directive 2009/72/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in electricity and repealing Directive 2003/54/EC; Directive 2009/73/EC of the European Parliament and of the Council of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC.

<sup>27</sup> Case C-265/08, *Federutility and Others v Autorità per l’energia elettrica e il gas*, [2010] I-03377.

<sup>28</sup> PDR, para. 7.207.

<sup>29</sup> Case C-265/08, *Federutility and Others v Autorità per l’energia elettrica e il gas*, [2010] I-03377, para. 33.

critical elements of the proposed price cap have not been defined appropriately (or defined at all).

#### **4.5 The proposed remedy would have limited effectiveness in providing additional protections for vulnerable customers**

- 4.5.1 The CMA also suggests that the proposed remedy is, at least in part, intended to protect the interests of vulnerable customers.<sup>30</sup>
- 4.5.2 The proposed remedy would, however, have limited effectiveness in providing additional protections for vulnerable customers because PPM customers are generally a poor proxy for this type of customer. For example:
- (a) Ofgem data suggest that the majority of vulnerable customers (as defined by Ofgem) use credit and DD payment methods, with only 25% of vulnerable customers paying by PPM;<sup>31</sup>
  - (b) Only 23.4% of SSE customers who received a rebate (across the Core and Broader Groups) under the Warm Home Discount (**WHD**) were PPM customers; and
  - (c) The proposed remedy will attach to significant proportions of customers who are not, in the CMA's view, "*less able to engage to exploit the benefits of competition.*"
- 4.5.3 PPM customers are also a poor proxy for so-called less engaged consumers. The available evidence shows that PPM customers are engaged and satisfied. For example, PPM switching levels are in line with those for customers with credit meters and the CMA's customer survey shows high satisfaction rates among PPM customers.<sup>32</sup>
- 4.5.4 As explained in SSE's response to the PFs, the CMA's customer survey indicates that the four most statistically significant drivers of customer switching are: (1) internet access; (2) contact from suppliers; (3) receipt of the WHD; and (4) tenure type.<sup>33</sup> (This is consistent with SSE's experience in the market.)

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<sup>30</sup> See, e.g., PDR, para. 7.266: "*In having regard to Ofgem's principal objective, we have also considered the potential impact that each aspect of the PPM Price Cap Remedy may have on protecting the interests of existing and future consumers, including vulnerable consumers. A remedy of this type has the benefit of providing direct protection to existing and future prepayment customers, many of whom are, and are likely to be, on low incomes or otherwise vulnerable, and who are suffering substantial harm, at least, from the Prepayment AEC, and also the Domestic Weak Customer Response AEC, and will continue to do so up until, at least, the roll-out of smart meters has been substantially completed (see paragraphs 7.171 to 7.181 above)(notwithstanding the implementation of our other proposed remedies concerning the Prepayment AEC and the Domestic Weak Customer Response AEC).*"

<sup>31</sup> See Ofgem, *Energy: the debate, Ofgem Roundtable Report Payment Differentials* (27 March 2015), page 7.

<sup>32</sup> See, e.g., SSE's response to the Notice of possible remedies, paras. 3.8.1. – 3.8.2.

<sup>33</sup> See Response to PFs, paras. 5.2.1 *et seq.*

**4.6 The structure and form of the cap are fundamentally flawed and will produce a wholly disproportionate and unworkable remedy which will result in damaging outcomes in the market**

4.6.1 The design of the proposed price cap remains subject to considerable uncertainty. As described below, integral elements of the proposed cap mechanism are opaque or entirely absent. Nevertheless, it is clear from the information that has been provided in the PDR and through the Confidentiality Ring that the structure and form of the cap are fundamentally flawed.

4.6.2 **The level of the competitive benchmark is too low.** The starting point for the price cap is a benchmark price that is well below the level that would arise in a well-functioning market (even after headroom has been factored in).

4.6.3 The reason for this is that there are material flaws in the CMA's direct detriment assessment, which is therefore wholly inappropriate in its current form for setting the price cap. In particular, as described in Section 3, the benchmark selected by the CMA is fundamentally flawed and the PPM differential applied is far too low. These errors will result in a price cap that is set too low.

4.6.4 Errors of fact and assessment in the CMA's analysis lead to a material understatement of the differential cost to serve of both PPM and standard credit customers (relative to direct debit customers) – this is explained in Section 3 above and in more detail in Annex 2. This undermines the basis for the calculation of the proposed cap. In particular, on the range of evidence available for PPM customers, it is clear that a differential of £76 has a stronger basis than the figure of £54 assumed by the CMA. It is also observed that the £54 differential used by CMA is not derived from the "efficient" operator level but quite the opposite, as it is associated with the six large energy firm with the *highest cost to serve DD customers*.

4.6.5 A more consistent way of assessing the uplift would be to look at the differential for the operator that is most efficient in serving both DD and PPM, which gives a differential of over £90. This differential is more consistent with SSE's experience and is also more aligned to the many pieces of analysis which have been conducted by Ofgem since the Probe in 2008. The £54 estimate from the CMA is a rogue outlier which would seriously bias the cap to be too tight and so damaging to competition.

4.6.6 On the basis of the distortions in the PPM to DD differential assessment in isolation, the cap would be too tight by between £22-36. However, there are also other factors in the CMA approach that would mean the cap would be set too tightly. The choice of only two suppliers, offering introductory prices, as the basis of the benchmark along with the fact that one of the suppliers is operating below the level of profit deemed competitive (1.5%) by the CMA, provides another clear distortion.

4.6.7 SSE's Authorised Advisers have therefore used the information made available through the Confidentiality Ring to estimate the sensitivity of the CMA's proposed price cap to these errors of fact and assessment:

- (a) The analysis that SSE's Authorised Advisers conducted was highly conservative in the sense that:
  - (i) It only adjusted Ovo Energy's tariffs to bring its margins into line with those of First Utility, which were themselves clearly too low to be sustainable.
  - (ii) It only assumed an incremental cost to serve PPM customers of £76. As indicated above, SSE considers that a more realistic estimate of the incremental cost to serve these customers would be at least £90.
- (b) Even on the basis of the limited adjustments made by SSE's Authorised Advisers, the benchmark tariff for dual fuel PPM customers would increase by an additional **£40-60**.
- (c) A more realistic adjustment on the basis of a sustainable EBIT margin for the benchmark firms and an incremental cost to serve estimate for PPM customers of at least £90 would push the price cap higher still.
- (d) On this basis it is obvious that the proposed level of the price cap is far too low. In all likelihood it would mean that energy firms would be at risk of supplying PPM customers at a loss, which – far from supporting the creation of a “well-functioning market” – would remove all incentive to compete for these customers.

4.6.8 The table below shows how these adjustments would affect the CMA's benchmark prices for different fuel combinations.<sup>34</sup>

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<sup>34</sup> The benchmark prices reported in this table do not include network costs, and do not include the additional £50 headroom proposed by the CMA. Benchmark prices have been calculated at the medium TDCV. The estimates in this table are based on data of both Ovo Energy and First Utility.

**Analysis showing revised benchmark figures**

Fuel	Original benchmark for PPM customers	Revised benchmark for PPM customers
DF (single rate)	£782	£[825-835]
DF (E7)	£724	£[775-785]
Elec (single rate)	£375	£[395-405]
Elec (E7)	£337	£[355-365]
Gas	£434	£[465-475]

- 4.6.9 The CMA assures itself that the benchmark calculation is set at a realistic level on the basis that the cheapest dual fuel PPM prices were “*generally in line with*” the level of the cap (as of 30 June 2015).<sup>35</sup> The CMA errs in assessing the proposed remedy on this basis, which in effect compares the proposed cap with the pricing of acquisition tariffs that are only commercially viable based on the modelled value over the lifetime of the customer (*i.e.*, over a period extending for several years beyond the term of the acquisition tariff).
- 4.6.10 In any case, a review of the prices on offer at the time of the CMA’s assessment suggests that there were, in most areas, typically at most only two PPM products available at the calculated level. In each case, the characteristics of the tariff mean that they do not provide a robust comparator for the tariffs that would be offered under the proposed remedy. One is a fixed-term tariff where the CMA’s analysis appears to ignore the potential impact of exit fees. The other was an Ovo Energy offer heavily discounted against its other products and targeted exclusively at internet-served customers (and, as explained above, Ovo Energy’s tariffs were not priced at a sustainable level during this period). Neither product constitutes a representative benchmark.
- 4.6.11 Even comparing the proposed price cap to this manifestly incorrect benchmark, the CMA finds a large number of regions in which the price cap would fall below the lowest available tariffs, including:
- (a) Dual fuel single rate tariffs in East Anglia, the Midlands, North Scotland, South Wales and Southern regions.<sup>36</sup>
  - (b) Dual fuel Economy 7 tariffs in all regions of the country.<sup>37</sup>
  - (c) Single fuel Economy 7 electricity tariffs in East Midlands, Midlands, North Scotland, North West, South Wales, South West, and Southern regions.<sup>38</sup>

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<sup>35</sup> PDR, para 7.169.

<sup>36</sup> PDR, Figure 7.4

<sup>37</sup> PDR Figure 7.5.

<sup>38</sup> PDR Figure 7.7.

- (d) Single fuel gas tariffs in East Midlands, North Scotland, and South Scotland.<sup>39</sup>
- 4.6.12 If any cap were to be imposed, a robust basis for the cap would have to be either calculated on a build-up of costs or at least adjusted from the existing cost base in order to reflect sustainable profit levels. As explained above, heavily discounted “acquisition” tariffs are not an appropriate reference level. The current analysis relies on a “snapshot” at a single point in time on two suppliers each with an atypical portfolio of contract types operating at a level insufficient to even earn the lower end “edge case” level of profit deemed competitive by CMA.
- 4.6.13 **The process of updating the price cap would likely compound the errors present in the starting value of the price cap.** The process for updating the price cap is also undermined by several critical flaws (which would likely compound the distortions caused by the initial price-setting process).
- 4.6.14 As a starting matter, the distortions that would arise from the way in which the cap would be updated again underline the drawbacks to the proposed remedy.
- 4.6.15 In particular, it is proposed to update the price cap once a year. Suppliers, faced with a binding price and uncertain wholesale energy costs, should theoretically seek to reduce this risk by buying their energy for PPM customers for the year ahead at the time the cap is amended (although such concentrated hedging activity may induce a short-term price distortion in the wholesale markets).
- 4.6.16 This will mean that all PPM customers will *de facto* be moved to tariffs that are fixed until the next annual price control (since to offer a tariff with prices that vary at a lower or higher frequency would raise unacceptable levels of risk). In practice, this will reduce the variety of tariffs available to PPM customers.
- 4.6.17 In addition, if wholesale prices rise between the annual setting of the price cap, suppliers will face a material disincentive to taking on new PPM customers (since they would need to purchase additional energy at higher prices, making a loss on these customers). This may dampen competition for PPM customers.
- 4.6.18 A number of the specific aspects of the updating process also raise particular concerns:
- (a) The PDR does not specify the “vintage” of data which would be used in the update. The proposed remedy lacks a mechanism to trigger a reassessment of certain costs where it is clear that costs to firms are turning out to be significantly different to those used in the cap calculation. An “asymmetric” procedure, in which lower outcomes for some variables trigger a review while escalating costs for other variables are ignored, should be avoided.

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<sup>39</sup> PDR Figure 7.8.

- (b) There would be strong grounds for Ofgem to be given the role of annually reviewing the inputs to the price cap in order to ensure that changes to government schemes, or other unexpected changes in the cost base, could be properly built into the price cap calculation.
- (c) Finally, a clear and precise timetable for updating the cap should be put in place to ensure that suppliers are able to set tariffs and notify customers in advance of the changes.

4.6.19 **The wholesale energy index proposed by CMA is not appropriate.** The indexation of wholesale costs for the price cap would be based on a single day's snapshot of wholesale costs covering the next 12 months. (This position is based on earlier theoretical work used to analyses cost pass-through.) This means that the variation in wholesale costs from year to year is effectively as volatile as the wholesale markets themselves, where hedging would normally reduce the volatility for customers. This is not a robust and reliable basis for setting a real world price cap which will have an impact on the bills paid by millions of customers. This element of the proposed cap would therefore have to be completely revised in order to allow for an appropriate hedging policy and avoid unacceptable volatility.

4.6.20 **The CMA's assessment of network costs is inaccurate.** The network costs published in the PDR contain errors and have not been clearly presented in a way which allows them to be reconciled with published sources.

4.6.21 **The treatment of policy costs could give rise to material distortions absent appropriate mechanisms for adjustment.** Policy costs are subject to material uncertainties. For example, Office for Budget Responsibility (*OBR*) estimates the cost of government schemes may not be updated to take account for the cost escalation that can arise when schemes turn out to be more problematic to deliver than originally intended. (This was the case, for example, with the Carbon Emissions Reduction Target programme.) In addition, HM Government may fail to set the precise requirements of delivering a scheme in advance of requiring suppliers to commence delivery (as in the current situation on WHD). Other policy changes can be announced unexpectedly, such as the current BIS consultation which has implications for the cost of environmental policies for domestic customers.<sup>40</sup> Such uncertainty makes accurate assessment difficult.

4.6.22 It would therefore be critical to include a mechanism for cost adjustment to be reflected (and, as noted above, the material uncertainty in these costs provides strong grounds for Ofgem to be given the role of annually reviewing the inputs to the price cap).

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<sup>40</sup> The proposed exemption for energy intensive industries from paying indirect costs relating to the RO and FiTs is estimated to lead to average domestic bill increases of around £5/yr. Given the potential state-aid challenge it is not clear at what stage suppliers will have certainty on the outcome of this policy. (See [https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/513029/EII\\_condoc\\_20160401.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/513029/EII_condoc_20160401.pdf))

- 4.6.23 In any case, the costs of the capacity mechanism have been completely excluded within the current specification. This is a clear anomaly which should be addressed.
- 4.6.24 **The current treatment of indirect costs is insufficient.** Indirect costs can also be materially affected by government policy initiatives (and so would be affected by the same uncertainty described above). In addition, the current proposal contains no proper assessment of the impact of the smart meter programme on costs over the period covered by the cap.
- 4.6.25 **The current breakdown of tariffs in the proposed remedy is overly complicated.** The current specification is unnecessarily complex and is liable to produce extreme results. There is no benefit in going beyond three tariff types (*i.e.*, electricity, gas, and Economy 7) for the purposes of administering a cap. This would help to eliminate a number of the anomalies and ambiguities in the CMA’s current proposal, including:
- (a) The dual fuel to single fuel differential which is not reflective of cost, and the arbitrary impacts on dual fuel customers with different mixes between electricity of gas from those implied by the cap;<sup>41</sup> and
  - (b) The problem of distinguishing “dual fuel” from “twin fuel,” which may introduce an unnecessary compliance risk.<sup>42</sup>
- 4.6.26 An obvious simplification, and more transparent approach, would be to set a maximum standing charge and unit rate for each tariff type in each area.<sup>43</sup> Under this approach, any calculation of a maximum standing charge should be based on a cost-plus approach. The base level of the unit rate would either be set on a cost-plus basis or would meet a required value for the bill at median consumption based on a market comparator.
- 4.6.27 **The proposed remedy fails to properly address the real impact of different consumption levels.** The CMA proposes to break the benchmark bill down into wholesale, policy and indirect cost components based on fixed percentages. The CMA’s percentages are the same for low, medium and high TDCVs.

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<sup>41</sup> The cap levels appear to be further away from retail market levels in single fuel gas than they are in electricity. It is hardly surprising that anomalies will arise as a result of the narrow basis on which the cap has been set (*i.e.*, two suppliers at a single point in time). However, the cap for dual fuel as a separate category leads to another set of arbitrary impacts on customers who in practice will have a different mix of usage between electricity of gas from those implied by the cap at each of the three consumption points

<sup>42</sup> Billing systems do not necessarily have an accurate matching of all electricity accounts with the associated gas account. This means that the problem of distinguishing “dual fuel” from “twin fuel” will introduce an unnecessary compliance risk for suppliers since the cap levels are not consistent between these categories.

<sup>43</sup> If the CMA is concerned that such a formulation excludes the possibility of returning to block rate tariffs, this could be addressed with an exemption allowing higher rates over any given block as long as they can be demonstrated to be equivalent to the capped standing charge and unit rate over a set consumption range.

- 4.6.28 In reality, the proportion of the bill that is accounted for by these different cost types will vary with the level of consumption. For example, a low bill will have a higher proportion of indirect costs (many of which are fixed with respect to consumption) and a lower proportion of wholesale costs – and *vice versa* for a high bill.
- 4.6.29 By failing to take into account these differences, the CMA’s proposed indexation may cause the “low” and “high” ends of the price cap to drift away from the level the CMA regards as sufficient. For example, if wholesale costs rose at a greater rate than indirect costs, the “high” price cap would not take this fully into account (since the weighting of wholesale costs is too low for this level of consumption), resulting in the price cap being too low.
- 4.6.30 **VAT should be accounted for separately in the price control.** The benchmark tariff measure used by the CMA is calculated to include VAT. The CMA should ensure that VAT is accounted for separately in the price control. As currently drafted, the price cap would not be updated in the event of a change to energy VAT rates.
- 4.6.31 **The proposed remedy contains a number of critical ambiguities that would require to be resolved.** There remain a number of ambiguities in how the price cap will operate. These ambiguities have a significant bearing on the level and functioning of the price cap. The PDR fails to make clear in particular:
- (a) whether the CMA proposes to update the TDCV levels used to define the price cap in line with revisions that Ofgem make to the TDCVs;<sup>44</sup>
  - (b) whether the CMA intends the price cap to bind at consumption levels below the “low” TDCV, or above the “high” TDCV;<sup>45</sup>
  - (c) whether suppliers should verify the validity of an E7 tariff with respect to the assumed 38:62 off-peak/peak split, or to each consumer’s actual split;<sup>46</sup> or
  - (d) whether suppliers should confirm the validity of their dual fuel tariffs with respect to the electricity/gas split inherent in the TDCV levels, rather than the actual electricity-to-gas proportion of each customer.
- 4.6.32 **As a result of these material flaws, the proposed remedy will produce a disproportionate and unworkable remedy that will result in damaging outcomes in the market.** As noted above, the CMA has not provided all of

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<sup>44</sup> If so, it is unclear whether this would involve: re-calculating the 2015 Q2 benchmark bills at the updated TDVCs and then rolling these on using the indices; or linearly interpolating/extrapolating the benchmark bill at the updated TDCVs from the price cap defined by the old TDCVs.

<sup>45</sup> Paragraph 7.141 of the PDR implies that it should not, although figure 7.3 in the PDR indicates that a tariff exceeding the price cap below the lower threshold *would* be problematic.

<sup>46</sup> Paragraphs 7.140 and 7.141 of the PDR suggest that suppliers would use the 38:62 split (although this should be made clearer).

the information necessary to properly assess the impact of the price cap (whether in the PDR or through the Confidentiality Ring).<sup>47</sup>

4.6.33 Notwithstanding these material omissions, the fact that the cap has been set at a damagingly tight level means that suppliers will struggle to operate in a commercially viable way in this segment. [ ] Our analysis of the constraints indicates that this could produce some undesirable distributional impacts. For example:

- (a) The CMA has calculated that the cap would have delivered an 8% reduction at the median consumption point in July 2015. It appears not to have calculated the implied changes for other consumption levels. Preliminary analysis indicates a larger decrease for high consumption levels but lower reductions and even potential increases at lower levels of consumption.
- (b) In particular, the structure of the cap favours higher standing charges. This becomes apparent once the low and high consumption points are identified. This is information which is not available to stakeholders in the PDR documents. Insofar as there is a correlation between vulnerability and usage, this is likely to have a disproportionate impact on the most vulnerable customers.
- (c) Economy 7 providers could be driven to revise pricing for day and night rates (moving towards a smaller differential between these rates). This could undermine the main rationale for the tariff (i.e., to support an electric storage heating solution) and could, more generally, also undermine the use of any time-of-use tariffs as a viable model in future.
- (d) SSE is aware that the likely requirement to introduce a standing charge to comply with the cap is a particular concern for Ebico (a white label supplier under SSE's licences). In particular, the proposed remedy would lead to a significant "bill shock" for customers currently benefitting from Ebico's zero standing charge policy.

4.6.34 These are only some of the potentially damaging customer outcomes that the proposed remedy will bring about. It is imperative that the CMA should conduct a full distributional analysis of the proposed remedy before its introduction. Ignoring such impacts risks significant reputational damage for suppliers and the CMA.

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<sup>47</sup> When it comes to the actual price cap, CMA indicate that they will use the E7 specific TDCV (para 7.140). However, the benchmark bills they have produced in the report do not use the E7-specific TDCV. Paragraph 3 of appendix 7.1 states that: "*In determining the impact of the price cap on customers, we have assumed that consumption for all prepayment customers is in line with Ofgem's medium Typical Domestic Consumption Value (TDCV) in effect from January 2014 to August 2015.1 We have not made a distinction between the single rate meter and Economy 7 consumption levels, and have assumed off-peak consumption for Economy 7 customers of 38%.*" Our advisors have confirmed that this is indeed the case for the CMA's data analysis in the Confidentiality Ring.

#### **4.7 The proposed remedy also carries a serious risk of unintended adverse consequences**

4.7.1 The introduction in a price cap of the form envisaged by the CMA will be highly detrimental, reducing rather than encouraging competition for PPM customers. The CMA recognises many of these risks but fails to properly take them into account in its consideration of the proportionality of the proposed remedy and fails to consider how they might be mitigated.<sup>48</sup>

4.7.2 These material unintended adverse consequences include:

- (a) ***Reducing the scope for suppliers to differentiate and compete on contract structure.*** The price cap is only updated once a year, and then binds for the rest of that year. As described above, this will lead to a reduction in customer choice and reduced incentives for firms to compete for new PPM customers if wholesale costs rise.
- (b) ***Discouraging engagement of PPM customers.*** Customers on the regulated tariff may see themselves as being adequately “protected” by the cap and therefore feel they do not need to engage with the market to find a better deal. More broadly, the cap also risks undermining customer trust in competition to deliver the best outcomes in the energy markets.
- (c) ***Reducing price competition.*** As the CMA’s own guidance recognises,<sup>49</sup> the cap may become the focal point of price competition; this risk is particularly acute if there is uncertainty that suppliers would be able to operate profitably within the restrictions imposed by the cap.
- (d) ***Undermining effective competition in the segment.*** The proposed price cap will create considerable uncertainty in the market and could potentially lead to PPM customers (or at least a significant proportion of them) becoming loss-making. As it becomes less commercially attractive to supply these customers, the cap is liable to reduce investment (including in innovation) and expansion, deter new entry, and could lead to falling customer service standards or suppliers exiting the PPM segment altogether.

#### **4.8 If the proposed remedy were nevertheless to be implemented, arrangements should be put in place to limit its adverse consequences and disproportionate effects**

4.8.1 Notwithstanding, SSE’s belief that the introduction of a price cap is not warranted, if this remedy is to be adopted, there are less damaging formulations than the option currently proposed by CMA.

4.8.2 A relative control between payment methods would be a much simpler way to achieve CMA’s desired outcome. Alternatively, a cost plus cap would

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<sup>48</sup> Guidelines, para. 333; Guidelines – Annex B, para. 88.

<sup>49</sup> See CMA’s *Competition impact assessment guidelines for policymakers* (para. 4.6 of Part II).

establish a price level which is grounded in an assessment of costs (although this also raises practical challenges). A starting value based on market experience would be a reasonable approach as long it was measured across a sufficiently broad group of suppliers, tariffs and customer groups and over a sufficient period of time. The CMA formulation is inferior in comparison to these options.

- 4.8.3 As described above, the CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified. If the CMA were nevertheless to proceed with the proposed remedy, it is clear that the version of the price cap described in the PDR is particularly unsuitable and would require substantial revision to form a proposition that could be applied in practice.
- 4.8.4 In keeping with the overall objectives of the CMA's investigation, it is critical that any price cap would be able to operate in a simple and transparent manner and could be readily understood by customers. It would be equally important that suppliers would be able to apply the cap in a robust and workable manner in order to avoid any unnecessary disruption for customers.
- 4.8.5 Accordingly, while there is no basis to introduce any price cap (and the introduction of such a mechanism would do more harm than good), the CMA should seek to minimise its negative and disproportionate effects in particular by:
- (a) Ensuring that the level of the competitive benchmark is sufficient (*i.e.*, a robust basis for the cap would have to be either calculated on a thorough build-up of costs or at least be adjusted from the existing cost base in order to reflect sustainable profit levels);
  - (b) Ensuring that there is a robust mechanism for the reassessment of all relevant costs (with Ofgem, for example, given the role of annually reviewing all inputs to the price cap);
  - (c) Applying a simpler and more transparent approach by reducing the number of tariff categories to three (*i.e.*, electricity, gas, and Economy 7) and eliminating the use of different consumption bands;
  - (d) Ensuring that all policy costs including those related to the capacity market and any other costs that may arise, as well as VAT are accounted for within the price control mechanism;
  - (e) Addressing the various factual errors and ambiguities described in Section 4.6 above;
  - (f) Conducting a thorough analysis of distributional impacts, particularly affecting vulnerable customers with low usage and customers with electric heating; and
  - (g) Ensuring that the arrangements for the termination of the proposed price cap are robust and appropriately reflect market conditions (in

particular customers who already have smart meters installed should not be eligible for the price cap).

- (h) Identifying conditions which would cause the price cap mechanism to be reopened for review to prevent damage to the market, such as:
  - (i) Falling switching levels within the PPM segment;
  - (ii) Falling numbers of tariffs available to PPM customers; or
  - (iii) A marked increase in customer complaints related to effects arising from the annual indexation process (e.g., volatile prices leading to significant price shocks for vulnerable customers).

## **4.9 Conclusion**

- 4.9.1 Whilst SSE supports helping vulnerable customers with their energy costs, PPM customers are generally not a proxy for vulnerable customers and there is not a sufficient evidence base to support such an intrusive remedy. Price caps generally have a detrimental impact on competition which is why they are being phased out across European markets. There are better ways to create further PPM competition, such as through the CMA's proposal to ensure that the availability of meter slots is made more accessible which SSE supports. If the CMA intends to continue with the proposed PPM cap then the level and design need to be adjusted to at least make it a workable and practical proposition for suppliers and Ofgem to implement. As it stands, the current design is not fit for purpose and there is a risk of unintended consequences both in terms of distribution impacts and on competition.

## **5. The proposed database for “disengaged” customers is not a necessary or appropriate remedy**

### **5.1 Introduction and overview**

5.1.1 This proposed remedy envisages that Ofgem will set up and operate a centrally managed database of contact details, available to all licensed suppliers, for customers who have been on a SVT (or other “*default*” tariff) for three years or more.<sup>50</sup> A similar database is also proposed for microbusiness customers that have been on a default contract for three or more years.<sup>51</sup>

5.1.2 As explained below, this remedy is not necessary or appropriate, in particular because:

- (a) The CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified.
- (b) Even if the proposed remedy were justified, it raises material data protection concerns.
- (c) The CMA has adduced no evidence to establish that the proposed remedy will be effective towards increasing customer engagement (and, in fact, the available evidence suggests that this kind of prompt would not work well for either customers or suppliers).
- (d) The proposed remedy is also disproportionate because the claimed benefits are uncertain and the costs and disruption which it brings (including as a consequence of the possible increase of customer complaints), which would ultimately fall on customers and taxpayers, are material.
- (e) The proposed remedy will have unintended adverse consequences by damaging customer trust in the market (given customer concerns around the use of personal data and receipt of large volumes of unsolicited communications from third party suppliers).

### **5.2 The CMA has not established any AEC to the required legal standard**

5.2.1 The PDR suggests that the remedy is justified by the CMA’s previous finding of an AEC in relation to “*weak customer response*.”<sup>52</sup> As explained in SSE’s response to the PFs, however, the CMA has not established any AEC to the required legal standard.

5.2.2 In particular, the CMA’s suggestions that customers have “*limited awareness of, and interest in, their ability to switch energy supplier*” and that “*customers face actual and perceived barriers to accessing and assessing information*”<sup>53</sup>

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<sup>50</sup> PDR, para 6.226.

<sup>51</sup> PDR, paras. 9.229 – 9.267.

<sup>52</sup> PDR, para. 6.224.

<sup>53</sup> PDR, para. 6.224.

are wholly inconsistent with the available evidence.<sup>54</sup> The CMA's own customer survey, in particular, shows that customers are aware of their own ability to switch tariff, payment method, and supplier, that switching rates are material, and that there are high levels of customer satisfaction.

- 5.2.3 The position is the same within the microbusiness sector. Indeed, even the CMA acknowledges that customers on default tariffs are “*not necessarily less engaged*” than other microbusiness customers.<sup>55</sup>

### **5.3 The proposed remedy raises material data protection concerns**

- 5.3.1 As the CMA recognises, the proposed remedy must comply with the provisions of the Data Protection Act 1998 (the *DPA*), and the Privacy and Electronic Communications Regulations 2003 (the *PECR*).

- 5.3.2 The PDR suggests that the proposed remedy draws on advice provided by the Information Commissioner's Office (*ICO*). It is clear, however, that the ICO does not necessarily consider that all possible variants of the proposed remedy would be fully compliant with all applicable law.<sup>56</sup>

- 5.3.3 Ensuring that the proposed remedy would be compliant with the DPA would require a number of formal requirements to be put in place. These requirements - which would have real costs, the materiality of which have not been tested - and effectiveness of the proposed remedy do not, however, appear to have been taken into account by the CMA. In particular:

- (a) The “*data controller*” (*i.e.*, Ofgem) would be required to take “*appropriate technical and organisational measures [...] against unauthorised or unlawful processing of personal data and against accidental loss or destruction of, or damage to, personal data.*”<sup>57</sup> The PDR makes no reference to the security systems and staff training that would be required to ensure that this obligation would be met.
- (b) Material restrictions would be required to be placed on suppliers in relation to the retrieval and use of the information provided in the database. The PDR does not explain what restrictions are necessary to

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<sup>54</sup> See Response to the PFs, paras. 3.2.1. *et seq.*

<sup>55</sup> PFs, Appendix 9.1, para. 47.

<sup>56</sup> See ICO statement in relation to Competition and Markets Authority report, 10 March 2016: “*As the regulator of the Data Protection Act, we regularly offer advice to organisations looking to use data in new ways, pointing them to the guidance we produce to explain the law. We have spoken to the CMA about this issue. Whilst we understand the desire to ensure customers get the best available tariffs, any sharing of information must be done within the requirements DPA and PECR. We have made this clear to the CMA. This may require individual consent or additional legal requirements to enable the sharing of consumer data with Ofgem or energy suppliers.*”

<sup>57</sup> DPA, Schedule 1, Principle 7 and paras. 9 and 10. For this purpose, the data controller must: (i) ensure that the relevant systems have a level of security appropriate to (a) the harm that might result from such unauthorised or unlawful processing or accidental loss, destruction or damage and (b) the nature of the data to be protected; and (ii) take reasonable steps to ensure the reliability of any employees of his who have access to the personal data.

ensure compliance with the DPA and how these would affect the cost and effectiveness of the proposed remedy.<sup>58</sup>

- (c) Because of the restrictions incumbent in the DPA, energy suppliers would only be able to contact customers on the database by post. Experience suggests that large volumes of unsolicited postal correspondence are unlikely to be effective in increasing engagement (and, as a means of communication, this is likely to be increasingly at odds with the growing “digitalisation” of energy supply).

- 5.3.4 The PDR also suggests that the database for microbusiness customers does not raise the same questions of compliance with EU and UK law because microbusiness customer data are not “*personal data*.”<sup>59</sup> This is not correct. The DPA applies to any microbusiness that is not incorporated (*e.g.*, sole traders and partnerships), which would therefore require to be treated in the same way as domestic customers.
- 5.3.5 The ICO has made clear to the CMA that the sharing of this data with other suppliers would be “*problematic*”, as it would likely result in the customers receiving a large volume of unwanted marketing communications.<sup>60</sup>
- 5.3.6 The ICO stated that: “*Direct marketing is one of the major concerns the public contact the ICO about. [...] The ICO is keen to ensure that data protection does not present an unnecessary burden to appropriate data sharing, but our initial thought is that the sharing of details of customers on a default tariff with other suppliers, or other third parties, is problematic. Any list of customers that remain on default tariffs would effectively become a marketing list, and the sharing of this list would be likely to result in those customers receiving a large amount of direct marketing communication encouraging them to switch suppliers.*”<sup>61</sup>
- 5.3.7 The ICO has also noted that it would be unlikely that customers, in particular those whose details would be likely to be included on the database, would expect to receive contact from third parties (rather than their current supplier) in relation to their energy supply and therefore that such communications are liable to cause confusion.<sup>62</sup>
- 5.3.8 Given the absence of any AEC or robust finding of material detriment, there is no basis for the CMA to impose an invasive opt-out mechanism on consumers for the purpose of enabling suppliers to bombard them with a potentially large number of unsolicited communications by post. Accordingly, even assuming that the proposed remedy would be fully compliant with all applicable law,

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<sup>58</sup> DPA, Schedule 1, Principle 2 and paras. 5 and 6.

<sup>59</sup> PDR, para. 9.258.

<sup>60</sup> The Information Commissioner’s response to the Competition and Market Authority’s “*Energy market investigation: notice of possible remedies*” paper, pp. 8 – 9.

<sup>61</sup> *Ibid*

<sup>62</sup> *Ibid*

data protection considerations (and the impact that this could have on customer trust) nevertheless weigh strongly against its introduction.

#### **5.4 The proposed remedy will not be effective in achieving the CMA's stated aim**

5.4.1 The CMA provides no evidence to establish that the proposed remedy would be an effective mechanism to increase customer engagement. In fact, the available evidence shows that it would likely not be effective in engaging customers and, as a result, is unlikely to be an attractive commercial option for suppliers.

5.4.2 **There is no basis to suggest that this kind of prompt would be effective at engaging customers.** The CMA suggests that the proposed remedy is intended to provide an effective "*prompt*" for customers to engage in energy markets.<sup>63</sup> As explained in SSE's previous submissions, appropriate prompts can be a highly effective means of increasing customer engagement. To achieve this objective, the prompts must be properly targeted and the content of the prompts must be liable to successfully encourage a sufficient number of customers to take action. Critically, any effective prompt must also avoid unintended adverse consequences that risk turning customers off from engaging in the market or increasing the costs that they face.

5.4.3 There is no basis whatsoever to suggest that letters prompted by the proposed remedy would be any more effective than other forms of customer communications at prompting the generality of consumers to engage in the market. The CMA's analysis of the effectiveness of the remedy provides no evidence whatsoever to this end. The PDR considers the effectiveness of a number of the "*key design elements*" of the proposed remedy but is silent on whether this kind of prompt would actually cause consumers to engage.

5.4.4 In fact, the available evidence shows that this kind of prompt is unlikely to be effective in engaging customers:

- (a) The history of the energy market shows that customers are unlikely to react well to unsolicited representations. The discontinuation of doorstep selling reflected similar concerns for customers. There is no evidence provided in the PDR (or previously by the CMA) that this kind of approach would be welcomed by customers. In fact, the available evidence suggests that this kind of approach would not be welcomed by customers.<sup>64</sup> The proposed remedy would therefore risk

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<sup>63</sup> PDR, para. 6.229.

<sup>64</sup> For example, in the context of the smart meter roll-out programme, DECC has carried out customer research to gauge customer sensitivity to data access issues. (See, DECC, *Smart Metering Data Access and Privacy - Public Attitudes Research*). According to this report, "[r]espondents were almost unanimous in complaining about aggressive, intrusive and frequent direct sales approaches (telephone, street marketing, doorstep calling) from energy and energy related companies and others. It was assumed that this was a consequence of some organisation or other passing on their personal details" (p. 4). The report indicates that this was the principal concern of customers, as the research found that "*the dominant concern across the sample was that personal information might be used as a source of leads for direct*

dissuading customers from engaging in the energy market, undermining the CMA's stated aim.

- (b) The proposed remedy could generate a particularly high volume of correspondence (*e.g.*, over 30 suppliers seeking to make contact with a given consumer) over a relatively short period of time. The market is already saturated with customer communications and, as SSE has explained previously, customers have indicated that the more communications energy companies send out, the less likely they are to read them in any detail.<sup>65</sup>

5.4.5 **There is no basis to suggest that this kind of prompt would be an attractive commercial option for suppliers.** Data protection legislation will impose significant restrictions on how customers on the database can be contacted by suppliers (*e.g.*, communications must be via post) and how their contact details must be handled. There is, in addition, no basis in evidence to suggest that these customers are likely to respond to unsolicited offers from third party suppliers sent by post. In such circumstances, the limited prospects of success may lead suppliers to divert their resources into other avenues for customer engagement.

5.4.6 Indeed, the views of independent suppliers, which might be expected to stand to benefit from the proposed remedy, provide no basis to support the claimed effectiveness of the proposed remedy. For example:

- (a) First Utility stated that: “[we] *do not believe increasing the level of communications from all suppliers as a result of releasing this data would be an effective or proportionate measure to increase customer engagement.*” First Utility further noted that: “[the] *disclosure of data and communications also risks causing customer concerns around privacy and risks further decreasing trust in the industry as well as that too many communications from a range of suppliers could come to be viewed as junk or spam.*”<sup>66</sup>
- (b) Ovo Energy stated that it had: “[grave] *concerns that the sharing of customer data, even with strict controls on data protection, will result in many customers receiving unwanted marketing information that may further dissuade them further from switching suppliers.*” Ovo Energy also noted that it “*consider[s] it unlikely that increasing the frequency of supplier communications to customers, in whatever form, represents*

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*marketing*” (p. 12). These results are consistent with the findings of the ICO and Ofcom on nuisance calls and messages (See ICO’s Report *Nuisance calls and messages*; and *ICO and Ofcom Joint Action Plan – Tackling Nuisance Calls and Messages*).

<sup>65</sup> SSE, Response to the Supplemental Notice of Possible Remedies, footnote 27.

<sup>66</sup> First Utility, *Response to the Second supplemental Notice of Possible Remedies and the Addendum to Provisional Findings*, p.2

*a long term solution to improving levels of engagement in the retail energy market.”<sup>67</sup>*

- (c) Good Energy indicated that the: *“measure is unlikely to be effective as it is based on the premise that suppliers want to grow their share of the PPM market and are being hampered from doing so by an inability to identify such customers.”* Good Energy also outlined particular challenges for PPM customers (e.g., a mismatch between payments and consumption and a lack of up-to-date tenant details) and concluded: *“we do not believe that the creation of this database would lead to any significant increase in switching by PPM customers.”<sup>68</sup>*
- (d) The CAB stated that it was: *“[worried] that it may not make any difference to suppliers’ limited motivation to compete for these customers. [...] There is also a very real risk that it could erode, rather than improve, consumer trust in the energy sector by facilitating unsolicited marketing.”<sup>69</sup>*
- (e) Which? has also indicated that its customer research suggest that the proposed remedy would not be effective and that: *“there is a danger that it could instead lead to a rise in unwanted marketing that would further undermine trust in the energy market.”<sup>70</sup>*

**5.4.7 The disclosure of customer details in France provides no meaningful support for the proposed remedy.** In support of the proposed remedy (and as a guide to remedy design), the CMA refers to the French competition authority’s recent order requiring a dominant incumbent gas supplier to share certain customer details with other gas suppliers.<sup>71</sup> This example does not, however, provide any meaningful support for the proposed remedy. In particular:

- (a) The CMA provides no evidence that this measure has been successful in prompting engagement and leading customers to switch, despite the seriousness of the conduct in question. The CMA suggests that very few customers opted out but gives no indication that customers have been successfully prompted to engage (e.g., by switching supplier).
- (b) The characteristics of the GB energy supply sector and the French gas supply sector are significantly different. Switching rates are considerably higher (about twice as high) in the UK market than in

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<sup>67</sup> Ovo Energy, Response to the CMA Second Supplemental Notice of Possible Remedies and Addendum to Provisional Findings, p.3.

<sup>68</sup> Good Energy, Response to Second Supplemental Notice of Possible Remedies, p.1-2.

<sup>69</sup> CAB, *Response to Addendum to Provisional Findings and Second Supplemental Notice of Possible Remedies*, p.4.

<sup>70</sup> Which?, We’re calling the CMA’s database proposal into question, 5 April 2016.

<sup>71</sup> PDR, para. 6.240 – 6.244.

France.<sup>72</sup> In contrast to the French market, it is clear that there are no material impediments to switching in GB supply markets.

5.4.8 **Data limitations would also restrict the effectiveness of the proposed remedy.** As SSE has previously explained, prepayment customers are not required to provide any personal information to their supplier.<sup>73</sup> Customers with standard credit payment arrangements may also not have provided their contact details to their supplier (or there may be a delay in their doing so). Diverting resources into writing to customers would therefore be a particularly ineffective mechanism of seeking to increase the level of engagement of these customers.

## 5.5 **The proposed remedy is disproportionate given the limited benefits and material costs**

5.5.1 The claimed benefits of the proposed remedy are therefore highly uncertain. The CMA has provided no evidence to show that customers will respond to third party prompts or that suppliers will see the benefit of investing in communicating with customers in this way.

5.5.2 In addition, the CMA materially underestimates the costs associated with the proposed remedy. The CMA appears to suggest that the costs associated with the proposed remedy are relatively modest, consisting principally of an estimated cost of £50,000 - £100,000 (which Ofgem has no budget for) to set up a secure cloud database.<sup>74</sup> The CMA appears to suggest that any additional costs imposed on suppliers, or on Ofgem, would not be material.

5.5.3 This is not correct. In fact, the costs of ensuring compliance with the proposed remedy would be significant. For suppliers, the additional communications with existing customers regarding consent (which would not be, as the CMA has suggested, simply a “routine” part of communicating with customers), making regular updates to the database, and ensuring compliance with data protection requirements would impose material costs. (For example, in the case of SSE, significant changes would need to be made to internal systems in order to be able to log and respond effectively to customer preferences in relation to whether to opt out of the proposed database.) The proposed remedy also raises a real risk of additional customer complaints, which would bring additional (unnecessary) costs and could damage the levels of service provided to customers.

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<sup>72</sup> According to the European Commission’s latest statistics, in 2012 the UK achieved switching rates of 12% for electricity and 11% for gas (materially above the EU average), whereas France had switching rates of 5.7% for electricity and 4.5% for gas (materially below the EU average). See *European Commission’s Staff Working Paper accompanying the Communication from the Commission on Progress towards completing the Internal Market* of 13.10.2014 (SWD(2014) 311 final). According to expert consultancy VassaETT, in 2013 switching rates in the UK reached 11.5%, whereas in France switching rates were under 5% (See *World Energy Retail Market Rankings - 2013 Switching Estimates*).

<sup>73</sup> SSE, Response to Addendum to Provisional Findings and Second Supplemental Notice of Possible Remedies, p. 5.

<sup>74</sup> PDR, para. 6.288.

5.5.4 Ofgem would also likely face material costs in monitoring compliance with the proposed remedy. These costs would not simply consist of setting up and maintaining the proposed database, but also in relation to monitoring and enforcing the restrictions of use attached to access to the customer database. This would require significant staff resource (and training) putting further pressure on Ofgem's budget.

5.5.5 These costs would be significant, and are particularly disproportionate given that the CMA has not established any material detriment that would justify such a remedy.

**5.6 The proposed remedy will give rise to material unintended adverse consequences**

5.6.1 As the CAB (and others) have made clear, the proposed remedy is likely to have a significant negative impact on customer trust in the market. As described above, the available evidence shows that customers are likely to have concerns about the use of their personal data in this way and are unlikely to welcome a large number of unsolicited communications from third party suppliers.

5.6.2 Undermining customer trust in the market in this way would, in turn, dissuade customers from engaging. The proposed remedy therefore risks doing more harm than good for customer engagement.

**5.7 If the proposed remedy were nevertheless to be implemented, arrangements should be put in place to limit its negative and disproportionate effects**

5.7.1 Notwithstanding that the proposed remedy is likely to have a negative effect on the market, if it were to be implemented, the mechanics of the remedy should seek to minimise the impact of the adverse consequences that it carries.

5.7.2 **The proposed remedy would have to include strict protections to safeguard customer data.** Data protection concerns will require very clear limitations on access, disclosure and use of customer data. In particular:

(a) The proposed remedy should be subject an *ex ante* Privacy Impact Assessment (*PIA*) to ensure that best practice is followed and privacy risks are minimised.<sup>75</sup>

(b) There should be a limit to the number of unsolicited communications from each third party supplier each individual customer receives in a

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<sup>75</sup> See, e.g., ICO, *Conducting privacy impact assessments code of practice*. Through a PIA, risks can be identified and addressed at an early stage by analysing how the proposed uses of personal information and technology will work in practice. This analysis can be tested by consulting with affected parties. As a result, where a PIA is required, the assessment should incorporate the following steps: (i) describe the information flows; (ii) identify the privacy and related risks; (iii) identify and evaluate the privacy solutions; (iv) sign off and record the PIA outcomes; (v) integrate the outcomes into the project plan; and (vi) consult with internal and external stakeholders as needed throughout the process.

given period in time (*e.g.*, per year). Once that number has been reached, there should be a “time out” period during which the customer cannot be contacted with marketing offers by that supplier (this should, of course, not apply to pricing information provided by the current supplier for an ongoing contract).

- (c) Customer data should only be kept by the third party supplier for the minimum period necessary for the supplier to make an offer, after which the supplier would have to securely destroy the data.
- (d) Given that customers can express their wish to opt-out at any time, and the expectation that suppliers’ take account of such wishes within a reasonable period of time that is shorter than the update frequency for the database, a maximum period must be defined for permitted use of data following a database update (perhaps restricted to two months).

5.7.3 **The effectiveness of the proposed remedy should be tested up-front and on an ongoing basis.** The lack of any evidence to support the effectiveness of the remedy, and the material doubts that surround its workability in practice, mandate that any remedy of this nature would have to be properly tested prior to full-scale implementation.

5.7.4 Indeed, Ofgem, which would be tasked with administering the proposed database, also makes clear that any scheme of this type should be subject to limited field testing, to “*directly test its impact,*” before being rolled out more widely.<sup>76</sup>

5.7.5 If the remedy were to come into effect, there should be stringent monitoring provisions and the remedy should be regularly reviewed (*e.g.*, annually) to assess its impact on customer engagement. For example, if it becomes clear that customers are not reacting in meaningful numbers to the letters sent as a result of the proposed remedy, suppliers should be released from the obligation to supply information to Ofgem and the database should be decommissioned.<sup>77</sup>

5.7.6 **Customers should not be included in the proposed database when they have a smart meter.** The CMA proposes that its order would expire after the sooner of five years or upon “*substantial completion of the smart meter roll-out.*”<sup>78</sup> In addition, in light of the potential that smart meters offer to increase engagement, contact details for customers who already have smart meters installed should not be required to be provided for inclusion in the database.

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<sup>76</sup> Ofgem, *Response to the CMA’s addendum to its provisional findings report and second supplemental notice of possible remedies*, p. 1.

<sup>77</sup> Any assessment of effectiveness should be properly benchmarked and take into account that any changes in customer engagement – however measured – would be influenced by other remedies that would be introduced around the same time.

<sup>78</sup> PDR, para. 6.276.

- 5.7.7 **Customers who have opted out of marketing communication should not be included in the proposed database.** Under Data Protection legislation, customers are entitled to opt out of all marketing communications from their current supplier.<sup>79</sup> Other customers (who have not opted out) have explicitly written to inform SSE that they do not wish to be contacted with marketing offers.<sup>80</sup>
- 5.7.8 In addition, a number of customers have signed up to services to stop unaddressed or unsolicited marketing mail (*e.g.*, Your Choice scheme or the Mailing Preference Service).
- 5.7.9 These customers have clearly expressed their preference not to receive unsolicited marketing communications and that preference should be respected. Therefore, suppliers should not be required to provide contact details for these customers for inclusion in the database, *i.e.*, those customers should automatically be treated as having opted out.
- 5.7.10 **Opting out of the proposed database should not constitute a change to existing marketing consents.** In the same vein, suppliers must be allowed to maintain existing marketing consents alongside consents for the database. If a customer chooses to opt-out of the database, this should not be applied as an opt out from marketing from their own supplier. Customers may still be happy to be contacted by their own supplier, but wish to avoid unsolicited marketing from numerous suppliers. This principle is consistent with the view that a customer's failure to opt-out of this remedy should not over-ride pre-existing marketing consent denied status with their current supplier.

## 5.8 Conclusion

- 5.8.1 Whilst SSE supports measures that encourage engagement, SSE agrees with the views of a number of consumer groups that the use of customers' personal data for unsolicited communications from third parties has numerous potential unintended consequences. This proposal raises material data protection concerns and, in any case, there is no basis to indicate that this kind of prompt would be effective in engaging customers. If the proposed remedy were nevertheless to be implemented, arrangements should be put in place to limit its most negative and disproportionate impacts on customers.

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<sup>79</sup> DPA, first principle (Schedule 1).

<sup>80</sup> DPA, Section 11. See also ICO's Direct Marketing guidance.

## **6. The proposed Ofgem-led program for customer engagement is not a necessary or appropriate remedy**

### **6.1 Introduction and overview**

6.1.1 The proposed remedy envisages that Ofgem will establish an ongoing “*programme*” to identify, test, and implement measures to provide domestic and microbusiness customers with “*different or additional information with the aim of promoting engagement in the domestic retail energy markets.*”<sup>81</sup>

6.1.2 As explained below, this remedy is not necessary or appropriate, in particular because:

- (a) The CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified.
- (b) Notwithstanding the absence of any AEC, SSE is committed to improving engagement in both the domestic and microbusiness segments. In particular, SSE is broadly supportive of prompts to customers to engage in the market so long as they are proportionate and well-considered to maximise their effectiveness.
- (c) The proposed remedy, however, risks causing more harm than good. The CMA’s own investigation has found that the format and content of customer communications can be negatively impacted by overly-prescriptive regulatory intervention (as was the case, for example, with the RMR rules).
- (d) The proposed remedy also risks delaying the introduction of effective customer-centred communications (in particular by imposing “top down” suggestions, such as the pursuit of market-wide cheapest tariff messaging, which have already been found to be unhelpful).
- (e) A more effective and proportionate remedy would therefore be to roll back the remainder of the existing RMR rules (namely the “*clearer information*” component which the CMA is not proposing to withdraw) and enable suppliers to tailor communications designed to engage with customers (subject to a principles-based set of rules).<sup>82</sup>

### **6.2 The proposed remedy is unnecessary**

6.2.1 The CMA suggests that the proposed remedy is intended to address actual and perceived barriers faced by customers in accessing and assessing information and customers’ supposed limited awareness of, and interest in, their ability to switch.

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<sup>81</sup> PDR, para. 6.12.

<sup>82</sup> The SLCs affected are: *SLC31A: Bills, statement of account and Annual Statements* and associated schedules; *SLC23: Notification of Supply Contract terms* and associated schedules; and *SLC22C: Fixed Term Supply Contracts*.

6.2.2 As stated in SSE’s response to the PFs, however, the CMA has failed to establish any AEC to the required legal standard. No further evidence on this point is provided in the PDR.

6.2.3 Notwithstanding the absence of any AEC, SSE is committed to improving engagement in both the domestic and microbusiness segments. SSE therefore strongly supports the CMA’s intention to put in place a framework through which suppliers are able to identify, test, and implement suitable prompts that will effectively encourage customers to engage further in energy markets. As explained below, however, the proposed remedy risks causing more harm than good.

### **6.3 The proposed remedy will not be effective**

6.3.1 The PDR indicates that the proposed remedy is intended to identify the most effective form of communications for customers “*that would prompt them to switch tariff or supplier.*”<sup>83</sup> The proposed remedy will not, however, be successful in achieving the objectives sought by the CMA.

6.3.2 In particular, there is no basis for a coordinated programme to be led by Ofgem, which risks an overly prescriptive approach that will impede the timely development of customer-centric and effective communications.

6.3.3 **Ofgem is not best-placed to develop effective customer communications.** The CMA suggests that Ofgem is better placed than suppliers to take the lead in a programme aimed at designing and implementing measures to promote consumer engagement. The CMA considers that this is the case because Ofgem can ensure the “*consistent*” implementation of best practices and because it will have a stronger incentive to ensure that consumers’ interests are protected.<sup>84</sup>

6.3.4 This is not correct. Suppliers are by far best placed to develop effective customer communications.<sup>85</sup> Ensuring that customers are engaged and satisfied is a key part of any supplier’s commercial strategy. Suppliers will be much quicker to respond to future market developments and customer feedback than the relatively cumbersome regulatory process the CMA is proposing. Similarly, PCWs also communicate directly with customers and play an increasingly significant role in promoting engagement; suppliers should have similar freedom to PCWs in designing more effective communications.

6.3.5 An Ofgem-led programme is not required to ensure that best practices are applied “consistently” across the market. The CMA has acknowledged that

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<sup>83</sup> PDR, para. 6.17.

<sup>84</sup> PDR, paras. 6.39 and 6.48 (b).

<sup>85</sup> For example and as highlighted in the Response to the Supplemental Notice of Possible Remedies, SSE has conducted customer testing on an enhanced annual statement with very encouraging results. This enhanced communication has the advantage of being tailor-made for customers, avoiding additional communications and of being quickly implemented and flexible to evolve in tandem with the market.

previous Ofgem-led regulatory intervention (*i.e.*, the RMR rules) had a manifestly negative effect on the market.<sup>86</sup>

- 6.3.6 Ofgem itself has previously indicated that the most effective approach to encourage innovation and competition is to apply a principles-based form of regulation that would provide more flexibility to suppliers.<sup>87</sup>

*“We are committed to removing as much prescription as possible from the licence and to setting detailed requirements only where needed to ensure prompts are given and are effective, or where consistency across suppliers is vital. This will give suppliers more freedom over the design of bills and other customer communications, to support tailoring of information and the use of new communication channels. This will be a key part of our ongoing work on the future of retail regulation.”*<sup>88</sup>

- 6.3.7 This approach is also consistent with the CMA’s own guidance to policymakers which warns of the dangers of excessive intervention and regulation.<sup>89</sup>

- 6.3.8 **An overly prescriptive approach risks producing less effective customer communications.** The CMA’s own investigation has found that the format and content of customer communications can be negatively impacted by overly-prescriptive regulatory intervention (as was the case, for example, with the RMR rules). As the CMA has recognised, this kind of regulatory approach can impede the ability of suppliers to compete and innovate.

- 6.3.9 In particular, the proposed remedy suggests that the Ofgem-led programme should include changes to the information in domestic bills and how this is presented, *“including a market-wide cheapest tariff message.”*<sup>90</sup> This kind of “top down” suggestion is unhelpful. SSE agrees with the CMA’s previous assessment of this proposal,<sup>91</sup> repeated in the PDR,<sup>92</sup> which notes that adding this information to the bill would severely undermine the effectiveness of other remedies proposed by the CMA, as it would *“not provide customers with the correct incentives to engage effectively in the market in the longer term”* and *“may weaken competition and encourage or facilitate some form of (tacit) coordination between suppliers”*.

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<sup>86</sup> PDR, para. 5.360.

<sup>87</sup> See Ofgem letter of 7 March 2016 *Improving consumer communications and the value of trials*: *“We see significant potential for innovation in communications to meet consumers’ needs more effectively, improve the consumer experience and increase the effectiveness of prompts.”*

<sup>88</sup> See Ofgem letter of 7 March 2016 *Improving consumer communications and the value of trials* (emphasis added).

<sup>89</sup> See CMA’s *Competition impact assessment guidelines for policymakers* (para. 1.7 of Part I and paras. 8.15-8.17).

<sup>90</sup> PDR, para. 6.13.

<sup>91</sup> Notice of Possible Remedies, para. 139-141

<sup>92</sup> PDR, para. 6.25.

6.3.10 Further to the concerns outlined above, this type of intervention is unprecedented in a competitive market – in no other industry do competitors advertise their rivals’ products and services. This proposal could lead to a frustrating experience for customers as it is highly likely that the pricing information will be out of date by the time they receive their bills (generally, the cheapest deals in the market are available for a limited period of time) or there may be eligibility criteria attached to the tariff which they do not meet. The proposal also takes no account of non-price factors, such as customer service levels or non-energy aspects of the tariff (*i.e.*, bundled products or services). The current Cheapest Tariff Messaging requirements (under SLC 31A) include that suppliers must include a switching reminder<sup>93</sup>; this prompt is a more than adequate nudge for customers to consider their switching options.

6.3.11 **The proposed remedy also risks delaying the introduction of effective customer-centred communications.** The PDR appears to suggest that the introduction of the Ofgem-led programme will take some time, with the first trials not expected before mid-2017.<sup>94</sup> Given the real risk that the introduction of the Ofgem-led programme would chill suppliers’ current efforts to develop more effective communications, this could lead to a material delay in the introduction of effective customer-centred communications.

6.3.12 Even once the Ofgem-led programme is set up, the process envisaged to put new communication measures in place appears to be relatively lengthy. This process will be poorly suited to allow suppliers to adapt quickly to changing market circumstances and customer behaviour or to respond to direct customer feedback on the clarity of communications.

#### **6.4 The proposed remedy is disproportionate**

6.4.1 A more effective and proportionate remedy would be to roll back the remainder of the existing RMR rules (namely the “clearer information” component which the CMA is not proposing to withdraw) and enable suppliers to tailor communications designed to engage with customers (subject to a principles-based set of rules).

6.4.2 Removing such prescriptive requirements would lead to better outcomes for customers, as suppliers would be better able to develop communications to increase customer engagement, react more accurately and quickly to customer feedback, and introduce more innovative solutions. Ofgem’s monitoring powers would be sufficient to ensure that customers’ interests are adequately protected.

#### **6.5 Conclusion**

6.5.1 SSE is committed to improving consumer engagement and broadly supportive of prompts to engage provided that are proportionate and well-considered to

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<sup>93</sup> Schedule 1 to standard condition 31A, *SI.9 The licensee must include a switching reminder with the exact text: “Remember – it might be worth thinking about switching your tariff or supplier.”*

<sup>94</sup> PDR, paras. 6.58-6.59.

maximise their effectiveness. However, this remedy could lead to overly-prescriptive regulatory intervention on the format and content of customer communications. This remedy could cause delays in the introduction of effective customer-centred communications. A better approach would be to roll back the remainder of the existing RMR rules and enable suppliers to tailor communications designed to engage customers in the context of a principles-based set of rules.

## **7. The imposition of new financial reporting arrangements for the six large energy firms is not a necessary or appropriate remedy**

### **7.1 Introduction and overview**

7.1.1 The proposed remedy envisages that the six large energy firms will be required to provide certain standardised financial information to Ofgem (intended to enable Ofgem to “*undertake and interpret robust profitability analysis in both the generation and retail markets*”).<sup>95</sup>

7.1.2 As explained below, this remedy is not necessary or appropriate, in particular because:

- (a) The CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified. No evidence has been offered to support the suggestion that flawed regulatory or policy decisions in the energy sector have arisen out of deficiencies in firm-specific financial information.
- (b) The proposed remedy would not be effective in achieving the CMA’s stated aim because it would not provide “*clear and relevant*” financial information to inform policy and regulatory decisions (or for customers and investors).
- (c) In particular, the key benefit of the current reporting regime – the CSS – is that the results produced can be reconciled with the statutory accounts of the reporting firms. This enables the results to be properly audited and increases stakeholder confidence in them.
- (d) The proposed reporting system, however, ignores commercial reality and requires firms to report on a theoretic basis. As a result, it would be impossible to reconcile these results with the statutory accounts and there is a significant risk that the results could not be audited in the same way as the CSS results are at present (which would decrease stakeholder confidence in them).
- (e) Limiting the scope of the proposed remedy to the six large energy suppliers would also undermine the effectiveness of the proposed remedy by limiting the relevance and completeness of the results reported.
- (f) The proposed remedy is also disproportionate because the claimed benefits will not arise in practice and the costs which it brings (which would ultimately fall on customers and taxpayers) are material.
- (g) In addition, the introduction of a mandated method to benchmark energy costs would provide a strong onus for suppliers to realign their procurement activities in that way. This would, in turn, reduce the diversity of business models in the market (which would, in turn,

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<sup>95</sup> PDR, para. 10.225.

reduce the diversity of tariffs offered to customers, reducing innovation and customer choice).

## **7.2 The proposed remedy is unnecessary**

- 7.2.1 The CMA suggests that certain “*negative outcomes*” in the market caused by regulatory interventions may have been the result of factors including “*a lack of relevant financial information.*”<sup>96</sup> The CMA indicates that its remedy is therefore intended to “*ensure that decision-making relies upon relevant financial information*” and to provide “*a clear transparent understanding of key aspects of market outcomes.*”<sup>97</sup>
- 7.2.2 The CMA has, however, offered no evidence whatsoever to support the suggestion that flawed regulatory or policy decisions in the energy sector have been attributable to deficiencies in firm-specific financial information. Indeed, none of the “*negative outcomes*” identified by the CMA in the PFs and in the PDR can be attributed to financial reporting.
- 7.2.3 The proposed remedy is intended to “*provide Ofgem with information that will allow it to provide a clear and trusted assessment of the GB energy markets.*”<sup>98</sup> However, Ofgem has consistently indicated that the CSS are accurate and fit-for-purpose. No further evidence on this point is provided in the PDR. This proposed remedy is therefore not justified, proportionate, or well-targeted.

## **7.3 The proposed remedy will not be effective**

- 7.3.1 The PDR indicates that the proposed remedy is intended to enhance Ofgem’s ability to perform its functions effectively by providing it with “*clear and relevant*” financial information to inform its policy and regulatory decisions.<sup>99</sup> The CMA suggests that the proposed remedy is also intended to increase broader stakeholder confidence by making available information that is “*relevant, complete, understandable and comparable*” in order to build trust in the energy sector.<sup>100</sup>
- 7.3.2 The proposed remedy will not, however, be successful in achieving these objectives (and may, in fact, have a detrimental impact on transparency and trust within the energy sector). In particular, several aspects of the proposed reporting arrangements will make it impossible to reconcile the results produced with the statutory accounts. This will make it more difficult for the results produced to be externally audited (in direct contradiction to Ofgem’s preferred policy). As explained below, this will decrease (rather than increase) stakeholder confidence in the results produced.

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<sup>96</sup> PDR, paras. 10.40 – 10.41.

<sup>97</sup> PDR, paras. 10.41 – 10.43.

<sup>98</sup> PDR, para. 10.216.

<sup>99</sup> PDR, para. 10.226.

<sup>100</sup> PDR, para. 10. 227.

- 7.3.3 **The proposed regime for reporting along “market lines” will produce theoretic and inaccurate results.** The PDR notes that reporting in the CSS reflects the costs actually incurred in procuring energy.<sup>101</sup> However, on the basis of the (unsubstantiated) assumption that reporting energy costs in this way does not “reflect competitive market dynamics”,<sup>102</sup> the CMA nevertheless proposes that, in the interests of delivering “transparency”, the six large energy firms should report their energy costs on a highly theoretic standardised basis.
- 7.3.4 This approach consists of splitting wholesale energy costs between an “*opportunity cost*” (based on market prices for standard wholesale products) and a “*residual amount*” (consisting of the actual costs not reflected in the “*opportunity cost*”).<sup>103</sup>
- 7.3.5 As SSE has explained previously, it is critical that financial reporting should reflect the way that the market works in practice. For example, SSE has external legacy power purchase agreements (*PPA*) contracts with Seabank and Marchwood which involve real physical cash flows; these plants provide power to over one million homes. Without these PPA contracts, this plant would never have been built (and therefore their output would not be available to the GB energy market). To ignore these agreements on the basis that they are not standard products traded on open wholesale markets, or to suggest that any differential with these products at any given point in time is somehow a “residual” is manifestly misleading.
- 7.3.6 In addition, splitting real costs in this way would be highly ineffective. Being able to reconcile the results reported with the statutory accounts is critical to ensure stakeholder confidence and, as explained below, to facilitate the proper auditing of the results.
- 7.3.7 To the extent that the CMA considers that the existing reporting system would benefit from increased transparency, it would be far more effective and transparent to mandate the inclusion of trading activities as an additional area for reporting within the CSS. This would have the key benefit of reflecting firms’ actual costs, thereby avoiding the drawbacks of a theoretic reporting regime.
- 7.3.8 **Separate balance sheets for individual segments within generation and retail would produce inaccurate results that would not increase transparency.** The proposed remedy also envisages that the six large energy firms should produce separate balance sheets for generation and retail activities. The precise scope of this obligation remains unclear. The CMA indicates in some places that it intends to mandate the provision of balance sheets on a pan-generation and pan-retail supply basis,<sup>104</sup> whereas in others it

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<sup>101</sup> PDR, Appendix 10.3, para. 6.

<sup>102</sup> PDR, para. 10. 251.

<sup>103</sup> PDR, para. 10.257.

<sup>104</sup> PDR, Appendix 10.3, para. 38.

suggests that balance sheets should be provided for “*all generation markets and all retail supply markets separately.*”<sup>105</sup>

- 7.3.9 SSE is able to provide a balance sheet at total generation and total supply level. Providing more granular information separately for all generation markets and all retail markets would, however, require a number of significant estimates and assumptions to be made. The application of these estimates and assumptions would inevitably reduce the weight that can be placed on the outputs that they produce.
- 7.3.10 **Requiring SSE to provide information on a calendar year basis would be misleading and confusing.** The PDR suggests that Ofgem should consider whether SSE should be required to report, for the purposes of the proposed remedy, on a December year-end basis or to prepare an “*out-of-line*” reconciliation.<sup>106</sup>
- 7.3.11 Ofgem and BDO previously acknowledged that the process of reconciling SSE’s actual results to a calendar year presentation of results would be of no material value.<sup>107</sup>
- 7.3.12 This remains the case. The adjustments that would have to be applied would likely undermine the clarity and reliability of the results produced. Producing a second set of results also risks causing confusion for customers and investors. Again, this would clearly not be effective in achieving the objectives sought by the CMA.
- 7.3.13 **The combination of the proposed changes would make the results reported impossible to reconcile with firms’ statutory accounts and undermine the ability to audit the results produced.** The CSS is currently subject to external audit in accordance with Standard Condition 19A of the Gas and Electricity Supply Licences and Standard Condition of the Electricity Generation Licences. Ofgem has indicated that “*confidence will be best delivered by having external auditors scrutinise the companies’ statements*”.<sup>108</sup>

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<sup>105</sup> PDR, para. 10.244.

<sup>106</sup> PDR, Appendix 10.3, para. 71.

<sup>107</sup> In October 2013, Ofgem published a report on the transparency of energy companies’ profits in the context of its ongoing assessment of the impact of the RMR reforms. In this report, Ofgem concluded that the fact that SSE’s reporting period was different from other suppliers did not undermine comparability of results (the main benefit of aligning the reporting period would be contemporaneous publication, but this was not deemed critical since comparisons should account for several years of data to be meaningful) and would involve significant costs for SSE and its customers. See Ofgem, *Rebuilding consumer confidence: Improving the transparency of energy company profits* (31 October 2013), paras. 3.40-3.43. This position was re-affirmed by Ofgem in a more recent report: *The revenues, costs and profits of the large energy companies in 2013* (10 October 2014), paras. 4.15-4.16: according to Ofgem, this difference in reporting periods “*becomes less important over time, as the focus is on distinguishing and understanding trends, which will be revealed in the statements from one year to the next.*”

<sup>108</sup> Ofgem letter of 26 February 2014, *Actions to improve the transparency of energy company profits*, p.2. This importance was re-affirmed in the October 2014 report *Rebuilding consumer confidence: Actions to improve the transparency of energy company profits* (10 October 2014),

- 7.3.14 As described above, the reporting regime proposed by the CMA would be based on a wholly theoretic picture which would require a number of significant estimates and assumptions to be made. In these circumstances, it would not be possible to reconcile the results produced with SSE's statutory accounts.<sup>109</sup>
- 7.3.15 This not only increases the scope for stakeholder confusion, but also introduces a significant risk that it would not be possible to audit the results produced. In particular, the proposed reporting regime would raise significant risks that auditors would not be able to issue a "fairly presented" audit opinion (in particular because they would not be able to rely on the reconciliation to group accounts or to the actual wholesale energy trading purchase book). At best, external auditors would likely be forced to issue an opinion based upon "agreed upon procedures" (AUPs), which will not provide the same third party confidence in the results produced.
- 7.3.16 In its report on the published CSS in 2013,<sup>110</sup> at which point suppliers had voluntarily agreed to arrange for independent reviews of the CSS based on AUPs, Ofgem observed that recommendations from BDO's review and from the Energy and Climate Change Select Committee:

*"...led us to consult in late 2013 on whether a full financial audit completed before publication of the statements would deliver the desired level of confidence. We concluded that it would, and the majority of respondents agreed."*

*"[...] Importantly, our requirement to annually audit the statements will tighten the scrutiny of transfer pricing policies. This addresses the observation in the transfer pricing review that these policies should be kept under review."*

Ofgem's clear preference was confirmed when relevant licence conditions were subsequently amended prior to publication of CSS for 2014(/15).

- 7.3.17 **A continued focus on ROCE reporting would also risk undermining third party confidence in the results produced.** The CMA appears to envisage that this information will be used by Ofgem to calculate the return on capital

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where Ofgem indicated that full external audit was one of the steps taken to improve robustness of suppliers' financial statements (p.2 and paras. 3.23-3.35).

<sup>109</sup> Ofgem has previously highlighted the importance of a simple reconciliation with publicly available profit figures, stating that such reconciliation "will help ensure that the Statements can be understood in the context of an easily available profit figure" and that its aim was to "ensure that the Statements will be based on the same profit measures as those presented to the investor community and avoids the risk of different messages being presented to different audiences." (Ofgem report *Improving the Reporting Transparency of Large Energy Suppliers* (1 May 2012), paras. 3.10-3.11).

<sup>110</sup> Ofgem, *The revenues, costs and profits of the large energy companies in 2013*, 10 October 2014. (See [https://www.ofgem.gov.uk/sites/default/files/docs/2014/10/css\\_2013\\_summary\\_document\\_3.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/2014/10/css_2013_summary_document_3.pdf)).

employed (**ROCE**) on both generation and supply activities.<sup>111</sup> As SSE has consistently explained throughout the CMA’s investigation, ROCE is, in principle, not an appropriate measure of retail supply profitability given the asset-light nature of the business. As the CMA’s ROCE analysis shows, the estimations and assumptions required to undertake the analysis are liable to lead to extreme conclusions that are detached from market reality.

7.3.18 Leaving aside its methodological flaws, the CMA’s investigation has also shown that that ROCE is a relatively volatile measure of performance. The CMA’s measure of excess profitability based on ROCE across all customer groups has moved from circa £900 million to £566 million per year based on methodological changes (rather than any material changes in the underlying data). By contrast, the CSS has been able to establish a credible reputation by facilitating the reporting of financial information on a clear and consistent basis.

7.3.19 **Limiting the scope of the proposed remedy to the six large energy suppliers undermines the relevance and comparability of the proposed remedy.** The PDR indicates that the proposed remedy will apply only to the six large energy companies.<sup>112</sup> The CMA suggests that this is because the focus of the proposed remedy should be on “*understanding the financial performance of large, vertically integrated firms such as the six large energy firms.*”<sup>113</sup>

7.3.20 The PDR indicates, however, that the objective of the proposed remedy is broader: to enable Ofgem to undertake and interpret a robust profitability analysis across the generation and retail markets.<sup>114</sup> Indeed, the PDR highlights that the CMA has often found it instructive to analyse the performance of independent suppliers for the purpose of market-wide comparisons. On this basis, the proposed remedy should apply to all firms active in generation and supply (subject to a suitable *de minimis* threshold).<sup>115</sup>

7.3.21 The application of the proposed remedy to a broader set of suppliers and generators will also increase stakeholder trust. It is inconsistent for the CMA to suggest that the proposed reporting regime is critical to facilitating trust in the energy sector, but then to entirely exempt suppliers and generators that account for a material proportion of the market.

7.3.22 The CMA suggests that applying the proposed reporting regime to all energy firms would impose a “*disproportionate burden*” on smaller operators.<sup>116</sup> As

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<sup>111</sup> PDR, para. 10.242.

<sup>112</sup> PDR, Appendix 10.3, para. 74.

<sup>113</sup> PDR, Appendix 10.3, para. 75.

<sup>114</sup> PDR, para. 10.225.

<sup>115</sup> Suitable *de minimis* thresholds might exempt domestic suppliers with less than 25,000 customers, non-domestic suppliers of less than 100 MWh/year, and generators with less than 400 MW installed capacity.

<sup>116</sup> PDR, Appendix 10.3, para. 75.

explained below, the proposed remedy will impose significant costs on operators and the claimed benefits are highly uncertain. In such circumstances, the proposed remedy would impose a disproportionate burden on all operators (and not just smaller operators) and therefore there is no basis for the CMA to limit the proposed remedy to the six large energy firms.

#### **7.4 The proposed remedy is disproportionate**

7.4.1 The CMA recognises that it is “*challenging to quantify the benefits expected to arise from this proposal.*”<sup>117</sup> This is because there are none.

7.4.2 The costs of the proposed remedy are, however, material. The proposed remedy would require SSE to make significant changes to its internal systems (affecting the energy trading risk management system, the customer billing system, and other settlement systems). As SSE has previously explained to the CMA, these changes would likely cost [ ] and take around 12 to 18 months to implement.

7.4.3 In addition, the reporting outputs incumbent in the proposed remedy would likely be more difficult to audit (as explained above). The external audit process would therefore likely be materially more expensive (and also take longer to execute, which could risk delaying the timely publication of the results in practice).

#### **7.5 The proposed remedy will give rise to unintended adverse consequences**

7.5.1 The proposed remedy also carries a material risk of giving rise significant unintended adverse consequences in the market.

7.5.2 **Customer and investor confusion.** As explained above, the proposed remedy risks causing confusion for customers and investors, as the highly theoretic outputs produced will not be able to be reconciled with published accounts.

7.5.3 The CMA suggests that it does not consider that “*the segmental reporting for regulatory purposes along market lines should necessarily fully coincide with the reporting for another purposes (e.g., statutory reporting)*” but provides no explanation, let alone any evidence, to support this position.<sup>118</sup> In fact, as explained above, the opposite is true. In order to achieve the CMA’s stated objectives (*i.e.*, to provide information that is “*relevant, complete, understandable and comparable*”), it is imperative that segmental reporting for regulatory purposes should be consistent with statutory accounts.

7.5.4 **Dampening of supplier competition.** The adoption of a standardised method to measure wholesale energy costs also risks dampening competition in energy supply. In practice, the use of prescribed method to benchmark energy costs would provide a strong onus for suppliers to realign their energy procurement activities in that way. This would, in turn, reduce the diversity of business

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<sup>117</sup> PDR, para. 10.318.

<sup>118</sup> PDR, Appendix 10.3, para. 77.

models in the market (which would, in turn, reduce the diversity of tariffs offered available to customers). This would reduce innovation and customer choice and, in particular, undermine the effectiveness of the CMA's proposal to withdraw the simpler choices component of the RMR rules.

- 7.5.5 In addition, the specific methodology proposed for reporting by the CMA risks causing particularly unhelpful market outcomes. In particular, the PDR indicates that the "*opportunity cost*" of wholesale energy purchases would be fixed at the "*point ahead of which it is deemed that the six large energy firms take on the commitment to supply.*"<sup>119</sup> The CMA suggests that this would be roughly one month ahead of delivery for an SVT. This is wholly unrealistic for a prudent supplier, in particular because it appears to be based on the assumption that suppliers can change their prices on a monthly basis. By way of example, all suppliers pursuing such a policy in 2008 would likely have gone out of business due to the significant increase in the wholesale markets pushed their costs significantly higher than the competitive level of prices from suppliers following a more prudent strategy.
- 7.5.6 **Disclosure of competitively sensitive information.** As SSE explained in its response to the NPR, the proposed remedy appears to envisage the publication of certain granular information that is competitively sensitive (*e.g.*, in relation to commercial arrangements for the delivery of Energy Company Obligation (*ECO*) costs). The PDR provides no indication about how these risks will be addressed.

## 7.6 Conclusion

- 7.6.1 SSE favours measures to improve transparency and has engaged constructively with proposals on how the CSS reporting could be further enhanced. Unfortunately, the PDR proposals on financial reporting are likely to make the financial reports confusing and misleading because they will not reconcile with other financial statements and are based on a theoretical and unrealistic approach to hedging. There is no detriment warranting this measure which is likely to be step backwards in terms of improving transparency.

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<sup>119</sup> PDR. Para. 10.265.

## **8. The introduction of locational pricing of transmission losses is not a necessary or appropriate remedy**

### **8.1 Introduction and overview**

8.1.1 The proposed remedy envisages the introduction of locational pricing for transmission losses and the revision of current arrangements to ensure these charges are entirely borne by generators located within GB.

8.1.2 As explained below, this remedy is not necessary or appropriate, in particular because:

- (a) The CMA has not established any AEC to the required legal standard and therefore no remedy at all is justified.
- (b) The CMA's additional cost-benefit analysis is wholly unreliable, having been arrived at through a flawed process. This cost-benefit analysis is, in any case, also undermined by a number of critical errors of fact and assessment.
- (c) The proposed remedy will not be effective because the claimed benefits are theoretic and highly uncertain.
- (d) The CMA has failed to adequately explain why it has set aside the conclusion of Ofgem, as the expert regulator, that this measure would not benefit consumers.
- (e) The proposed remedy risks giving rise to material adverse unintended consequences including arbitrary transfers between market participants and further distorting competition between GB and interconnected generators.
- (f) The CMA ignores more proportionate alternatives to address its concerns, in particular by issuing a recommendation to Ofgem to continue this work (supported by National Grid) to properly assess the merits of the proposal, rather than risking a remedy the effects of which remain largely uncertain.

### **8.2 The CMA has not established any AEC to the required legal standard**

8.2.1 The CMA suggests that costs arising from transmission losses under the current regulatory regime are not allocated in an efficient way because generators and customers are not charged in a way that accurately reflects the losses that they are actually responsible for.<sup>120</sup> As such, the CMA suggests that the current regulatory regime therefore gives rise to an AEC because it is "likely" to distort competition, raise bills for customers, and increase costs in the short-run (because electricity could be generated more efficiently and

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<sup>120</sup> PDR, para. 2.6.

cheaply) and the long-run (because investment in generation could be more efficient).<sup>121</sup>

8.2.2 As explained in SSE's response to the PFs, however, the CMA has not established the existence of an AEC to the required legal standard. In particular, to support its position the CMA relies on theoretic assumptions or on evidence that is out-of-date or highly questionable and ignores the fact that, under the proposed methodology, customers will not be charged directly for the losses they are actually responsible for. By contrast, the available evidence shows that the current charging methodology does not distort competition and is not demonstrably less cost reflective than the proposed remedy would in reality be.

### **8.3 The CMA's additional cost-benefit analysis is fundamentally flawed**

8.3.1 The CMA has sought to fill the evidential gap in its analysis by commissioning a "new" cost-benefit analysis. This work has been effectively "outsourced" to NERA Economic Consulting (*NERA*), an adviser to one of the main parties in the investigation (RWE).

8.3.2 **Engaging NERA to carry out the CMA's cost-benefit analysis entails a very real risk of apparent bias or confirmation bias (or both).** NERA is a long-standing adviser to RWE (having been engaged for a period of at least four years up until at least May 2015) on locational pricing for transmission losses and related matters. NERA had previously made a submission to the CMA, on behalf of RWE, in which it set out its view that a system of locational pricing for transmission losses would have material benefits.<sup>122</sup> NERA relied on the same modelling framework used in previous work.<sup>123</sup>

8.3.3 One of the key tasks for the expert to be engaged by the CMA was to "*comment on the strengths and weaknesses*" of the analysis that had been submitted on the matters at issue by RWE.<sup>124</sup> Whilst this requirement was ultimately dropped from NERA's brief (because it was clearly not competent to objectively comment on its own work),<sup>125</sup> the CMA did not provide sufficient opportunity for any other party to challenge or test the robustness of the results presented by NERA on behalf of RWE.

8.3.4 Third parties, including Ofgem and its technical advisors, have previously questioned whether NERA's model performs precisely as described since it

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<sup>121</sup> PDR, para. 2.7.

<sup>122</sup> NERA, *The Welfare Effects of Locational Transmission Loss Factors in the British Wholesale Electricity Market, Prepared for RWE*, 11 May 2015.

<sup>123</sup> NERA, *Methodology for Assessing the Impact of Zonal Transmission Loss Multipliers, Prepared for the CMA*, 4 December 2015, para. 2.1.

<sup>124</sup> See Terms of Reference annexed Notice of the CMA regarding assessment methodology for losses remedy – appointment of economic consultancy (20 October 2015) (page 4).

<sup>125</sup> CMA, *Notice regarding assessment methodology for losses remedy – appointment of economic consultancy*, 30 October 2015, para. 8.

has produced results which have not been satisfactorily explained in previous proceedings.<sup>126</sup>

8.3.5 Accordingly, as SSE has consistently made clear to the CMA, it is apparent that NERA is not in a position to provide independent specialist advice on the matters at issue.

8.3.6 **The measures put in place by the CMA to “mitigate potential risks of conflict of interests” were insufficient and were not followed in any case.** The CMA suggested that any potential conflicts of interest would be addressed by the CMA’s oversight role and through putting in place a “*transparent and iterative*” process in which third parties would be able to review and scrutinise NERA’s work. In particular, the CMA indicated that it would publish and consult on the results of the cost-benefit analysis in a working paper.<sup>127</sup>

8.3.7 These additional measures put in place by the CMA were not capable of mitigating the real risks of bias raised by the appointment of NERA. Moreover, the CMA did not even adhere to the “*transparent and iterative*” process it had undertaken to follow, in particular by failing to publish a working paper with the details of NERA’s model and its results. This circumstance prevented SSE from making meaningful representations and adequately scrutinising NERA’s work at the appropriate stage of the process.

8.3.8 In sum, in light of the material process flaws described above, it is clear that the cost-benefit analysis produced by NERA is not an independent and credible source of evidence on which the CMA is able to rely as justification for the proposed remedy. The CMA’s suggestion that further scrutiny is unnecessary (because the CMA does not believe that further analysis would alter its views) is wholly unreasonable.<sup>128</sup>

#### **8.4 The cost-benefit analysis is undermined by a number of critical errors of fact and assessment**

8.4.1 Perhaps as a result of the inability of third parties to properly scrutinise and comment on NERA’s emerging work, the analysis produced is characterised by a number of significant errors of fact and assessment. The analysis places undue reliance on assumptions that are highly questionable or unsubstantiated and the sensitivity of which has not been properly tested. In particular:

- (a) The additional benefit attributed to the 100:0 split of costs is based on a flawed analysis – if the multipliers for the 45:55 split of costs were costs reflective then moving to 100% case should not alter dispatch decisions;

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<sup>126</sup> See Baringa, *CMP213: further analysis and review of consultation responses* (25 April 2014), pp. 39-40; and Ofgem, *Project TransmiT: Further consultation on proposals to change the electricity transmission charging methodology* (25 April 2014), paras. 2.15 and 2.21.

<sup>127</sup> See Notice of the CMA regarding assessment methodology for losses remedy (16 September 2015), para. 4.

<sup>128</sup> PDR, footnote 73.

- (b) Assumptions relating to capacity market (**CM**) costs and impacts are given too much weight and distort the results produced – to the extent that the modelling shows a benefit to customers, it is almost entirely accounted for by the apparent benefit relating to CM costs in just two years of the modelled period;
- (c) The model’s results beyond 2026 are dismissed on a basis that is arbitrary and not adequately justified – SSE would expect the model to show south to north flow on the transmission network as a result of the significant reduction in capacity in Scotland in the early years of the modelled period;
- (d) The DTIM model is not tested against reality so there is no evidence that the modelled results are in any way realistic – this failure to provide a sound reality check makes the modelled benefits arising from reductions in constraint management costs, for example, extremely doubtful (constraint costs constitute more than 65% of the modelled efficiency gains for all scenarios in the period 2017-2016); and
- (e) Sensitivity analysis of the following key input assumptions would be necessary in order to interpret the results on a sound basis (*e.g.*, in relation to station location, merit order of generation, dispatch of interconnectors, wind and PV generation profiles, and location and level of demand).

8.4.2 These errors of fact and assessment (which are explained in more detail in the technical report provided in **Annex 3** to this Response) undermine the robustness of the results of NERA’s modelling and the weight placed by the CMA on those results. The CMA recognises the importance of these factors (noting, for example that the marginal plant “*can change due to small changes in relative fuel costs or other factors*”) but the omission of a sensitivity analysis means that NERA’s work provides no basis to justify the proposed remedy.<sup>129</sup> Without the proper understanding of these factors, the CMA’s decision to implement locational charging for transmission losses lacks sufficient justification.

## **8.5 The proposed remedy will not be effective**

8.5.1 The CMA suggests that the proposed remedy is intended to improve the “*accuracy*” with which the avoidable costs of transmission losses are borne by those who cause them, in turn reducing waste, reducing the cost of electricity generation, and reducing total bills to end-consumers.<sup>130</sup> The claimed benefits advanced by the CMA are, however, highly subjective and are not supported by the available evidence.

8.5.2 The claimed short-term efficiency benefits are overstated and, for the reasons discussed in **Annex 3**, SSE does not consider that the CMA has established a

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<sup>129</sup> PDR, para. 2.27.

<sup>130</sup> PDR, para. 2.14.

case to the required legal standard that the proposed remedy will be more cost reflective than the current methodology. In particular, the combination of calculating loss factors in advance, adopting seasonal and regional averages and the use of *negative* loss factors in some regions means that the proposed remedy will be far from cost reflective and, in effect, result in arbitrary market distortions.

- 8.5.3 The claimed long-term efficiency benefits are also overstated, because the true cost of those losses for a specific generator will change sharply and in an unpredictable manner, making locational losses a very poor signal for investment.<sup>131</sup> The CMA correctly acknowledges that TNUoS charges “*are the main determinant of plant location decisions in the model*”.<sup>132</sup> Due consideration of the most relevant factors determining the location of new plants (e.g., policy, planning permissions, location of natural energy resources, transmission capacity) confirms that any long-term efficiency benefits of this decision would be negligible.
- 8.5.4 Any perceived environmental benefits<sup>133</sup> are more likely to arise from restrictions in output and the ultimate closure of plants that do not meet the standards required under the Industrial Emissions Directive. These benefits therefore cannot be attributed to the proposed remedy.
- 8.5.5 Finally, the CMA provides no material evidence that the proposed remedy will be effective in generating positive outcomes for customers.
- 8.5.6 As the CMA acknowledges, the short-run impact of the proposed remedy on wholesale prices – the most significant component of energy bills – is likely to be “*highly uncertain*”.<sup>134</sup> In one of the three scenarios used by NERA, consumers overall see their bills increase.<sup>135</sup> In the other two scenarios, the gains at the individual customer level are extremely limited (with customers in some regions seeing their bills increase). Even on the most optimistic basis, on average the proposed remedy will lead to a maximum reduction of less than £2 in the annual bill of each customer. Moreover, in the longer-term, NERA’s analysis suggests that the proposed remedy will result in increases in customer bills in all scenarios for the period between 2027-2035.<sup>136</sup> Any benefit to customers is therefore marginal, even up to 2026.

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<sup>131</sup> The benefit of a particular plant location in terms of lower costs due to less transmission losses would be lost as soon as generators commissioned new plants in that area as transmission loss multipliers would be recalculated, making that area more costly from that perspective.

<sup>132</sup> PDR, paras. 2.48-2.49.

<sup>133</sup> PDR, para. 2.53.

<sup>134</sup> PDR, para. 2.28.

<sup>135</sup> PDR, Table 2.3, para. 2.56.

<sup>136</sup> PDR, Appendix 2.2, Table 4.9.

## **8.6 The CMA has not set out any convincing case to overturn the previous decision of the expert regulator, Ofgem, on this issue**

- 8.6.1 Ofgem has already carried out an in-depth assessment of the impact of a project designed to introduce locational pricing for transmission losses (P229). Following this assessment, Ofgem concluded that the proposal would not be in the best interests of existing and future customers in light of: (1) the large distributional impacts between individual generators and between generators and customers; (2) the uncertainty surrounding the long-term benefits due to the changing regulatory environment; and (3) the “*relatively modest scale*” and uncertainty of the efficiency benefits in the short term.<sup>137</sup>
- 8.6.2 All of these concerns remain pertinent. As explained above the benefits of this proposed remedy are highly uncertain. In addition, when considering potential remedies, the CMA is required to consider the broader market impact. The introduction of a further locational signal relating to transmission costs is not consistent with developing EU policy in relation to Internal Energy Markets and does not account for the risk of future market splitting. As a result, the CMA has failed to gather sufficiently strong basis in evidence to set aside the conclusion Ofgem reached previously on P229.<sup>138</sup>
- 8.6.3 SSE disagrees with the CMA’s justification for imposing an order to implement this remedy on the basis that “*a recommendation by the CMA, compared with an order, would increase the risk of the proposed remedy not being implemented at all. We consider that an order by the CMA would lead to a simpler, less costly, implementation process.*”<sup>139</sup> There are sound reasons of regulatory best practice which dictate that Ofgem should follow a due process to introduce a change of this sort, to comprise appropriate consultation with industry, including an appropriate opportunity for peer review and challenge, and a proper consideration of the best available evidence.
- 8.6.4 The decision to implement a locational charging mechanism for transmission losses would have large distributional effects - and potentially large distortionary impacts on the electricity generation system. It would therefore appear imprudent for the CMA to justify avoiding due process simply because it would be a quicker, simpler and less costly process. The cost to industry of getting this implementation decision wrong would far outweigh any benefit which could be obtained from a cheaper and simpler process of considering the issues. Also, it would appear perverse for the CMA to justify a decision to circumvent proper due diligence and implement this proposal due to a concern that Ofgem, as the competent industry regulator, may potentially reach the opposite conclusion to not implement the proposal.

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<sup>137</sup> Ofgem decision of 28 September 2011 in relation to proposal P229, page 6.

<sup>138</sup> PDR, Appendix 2.3 highlights the continued need for any remedy introduced to the GB market to remain compatible with EU Network Codes.

<sup>139</sup> PDR, para. 2.123.

## **8.7 The proposed remedy will give rise to unintended adverse consequences**

### **8.7.1 The proposed remedy will exacerbate inefficiencies and further distort competition between GB generators and interconnected generators.**

The current charging system for inter-connected generation, and the fact that none of the mainland European Member States directly interconnected with the GB transmission network have locational transmission charging regimes,<sup>140</sup> provides interconnected generation with a material competitive advantage.

8.7.2 The introduction of locational pricing of transmission losses and the allocation of 100% of the cost of those losses to GB generators will exacerbate this distortive effect and place GB generators at an even greater competitive disadvantage. This is evidenced by the results of NERA's modelling which predict that one of the key effects of the measure will be to increase energy imports.<sup>141</sup> This additional reliance on interconnected capacity will also lead to wider inefficiency in plant running (*e.g.*, less efficient plant running in Continental Europe at lower cost than more efficient plant in GB) and to an increase in transmission losses across the system, as interconnected generators will remain largely unaffected by those losses.

## **8.8 In light of the material uncertainties surrounding the benefits of the proposed remedy, the CMA must pursue the other, more proportionate, remedies that are available**

8.8.1 As described above, the claimed benefits of the proposed remedy remain highly uncertain and the PDR fails to adequately deal with several material unintended adverse consequences that have been identified.

8.8.2 Where such uncertainty exists, it is not open to the CMA to impose an intrusive and wide-ranging remedy by issuing an immediate order on National Grid. Instead, if the CMA ultimately considers that remedial action is justified, the only possible course of action that could be justified by the evidence would be to issue a recommendation to Ofgem to continue this work, building on the analysis developed by NERA and/or commissioning further studies to consider the full impact of the measure with more certainty (in line with the CMA's proposed approach for electricity settlement).

## **8.9 Conclusion**

8.9.1 In conclusion, the CMA has not established an adequate AEC to justify this remedy. The additional cost-benefit analysis is unreliable having been arrived at through a flawed process. As it stands, the remedy risks giving rise to material adverse consequences including a distortion of competition between GB and interconnected generators. SSE strongly favours the CMA adopting a different approach to delivery and instead issues a recommendation to Ofgem

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<sup>140</sup> See ENTSO-E, *ENTSO-E Overview of transmission tariffs in Europe: Synthesis 2014*, (June 2014), Table 3.1. The GB market is unique in adopting negative charges for generation in areas of high demand, which serves to greatly exaggerate the price signal for investment.

<sup>141</sup> PDR, paras. 2.65 and 2.68.

to continue the analytical work to more adequately assess the potential impact of the proposal and to ensure that distortions are not introduced due to a price signal that is only partially reflective of costs.

## **SSE: RESPONSE TO PROVISIONAL DECISION ON REMEDIES**

### **ANNEX 1 – OTHER REMEDIES**

#### **1. Introduction**

1.1.1 SSE's Response focused on the proposed remedies which will have the most pervasive negative consequences for the energy markets. This annex includes SSE's comments and observations on all other remedies proposed in the PDRs.

#### **2. Contracts for Difference (CfDs)**

##### **2.1 CfDs awarded outside the auction mechanism**

2.1.1 Whilst SSE does not consider that the CMA has adduced evidence of any AEC in relation to the CfD awarding mechanism (in particular, the CMA's assessment of the FIDeR process is unsound and fails to consider adequately the transitional nature of that regime)<sup>1</sup>, SSE welcomes further transparency in relation to DECC's decision making around the allocation of CfDs outside the competitive process.

##### **2.2 Budget allocation**

2.2.1 The division of the CfD budget into pots is necessary to secure the investment required to support a broad renewables generation base. This remedy is appropriate to encourage transparency and certainty in the energy market, provided that it does not result in a delay to future CfD auctions.

#### **3. Electricity Settlement**

3.1.1 As outlined in SSE's Response to the PFs, the absence of a firm plan for moving to half-hourly settlement for the majority of domestic and microbusiness electricity customers, and of a cost-effective option for elective half-hourly settlement, does not give rise to an AEC, given that the industry is at a relatively early stage of smart meter roll-out.<sup>2</sup> Such a proposal is premature because, until the smart meter roll out is sufficiently advanced, the costs of half-hourly settlement will greatly outweigh the benefits.

3.1.2 However, SSE welcomes the CMA's recognition that a full cost-benefit analysis of the move to mandatory half-hourly settlement is required and agrees that Ofgem is best placed to carry this out. The need to consider the implications of a potential EU-wide move to adopt 15 minute settlement further confirms the reasonableness of an Ofgem-led analysis.

3.1.3 SSE shares the CMA's cautionary stance on the benefits of elective half-hourly settlement as an intermediary step towards mandatory half-hourly settlement, given the challenges of the two running in parallel and possible

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<sup>1</sup> See Response to the CMA's Provisional Findings (*PFs*), Section 10.

<sup>2</sup> See Response to the PFs, Section 7.

delays. Industry code modifications have been proposed to facilitate narrowly defined areas of elective half-hourly settlement (for February 2017 implementation). SSE would therefore welcome a comprehensive Ofgem and DECC plan to ensure coordination and consistency, and we look forward to working with industry to deliver the optimum solution.

#### **4. Gas Settlement**

##### **4.1 Implementation of Project Nexus**

4.1.1 SSE fully expects that Project Nexus can be implemented by 1 October 2016, which means that the proposed remedy is unnecessary.

4.1.2 SSE supports the timely implementation of Project Nexus and from its own delivery perspective is currently on-track for a 1 October 2016 go-live.

4.1.3 SSE is aware that there are some risks to the current timetable and in recent weeks some changes have taken place to the governance of project Nexus which are being coordinated by Ofgem. In particular, Ofgem has been consulting with industry (shippers, GDNs and Xoserve), with support from PwC to draw up a plan with proper and realistic timescales leading up to the Project Nexus delivery date to ensure that the project is delivered successfully across industry in the best interests of customers. In light of this, and notwithstanding SSE's commitment to a 1 October 2016 go-live date, SSE considers that it would be preferable to have sufficient flexibility to address any identified issues (even if that may involve some delay in implementation) than for Project Nexus to be pushed forward to meet a specific deadline with issues continuing following implementation. Due to the potential for unintended consequences for customers and industry, SSE does not therefore consider a binding implementation date to be appropriate.

##### **4.2 Order to submit meter readings**

4.2.1 This remedy will not be necessary in view of the implementation of Project Nexus later in the year. Project Nexus will ensure that all gas is reconciled back to actual meter readings and, therefore, there will be an incentive on all shippers to ensure that AQ values are as accurate as possible to avoid imbalance costs at the moment of reconciliation.

##### **4.3 Performance assurance framework (PAF)**

4.3.1 The proposed remedy is in line with SSE's efforts to implement a PAF with an overarching monitoring framework to identify, understand and address causes of unidentified gas.<sup>3</sup>

4.3.2 However, this remedy should be accompanied by a review of the current shrinkage model, as there is sufficient evidence to challenge the current working assumptions of the model (which were set at least 20 years ago before energy markets were open to competition), particularly the impact of

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<sup>3</sup> SSE's Response to the NPRs, paras. 3.18.5.

assumptions relating to the physical properties of gas on the accuracy of measurements of gas volume.

## **5. Prepayment remedies**

### **5.1 Additional pricing flexibility (SLC 22B.7(b))**

5.1.1 In principle this proposal would allow a more efficient use of PPM tariff codes and enable suppliers to offer a wider range of PPM electricity tariffs. However, in practice, the proposed PPM price cap remedy (see Section 4 of the Response) may provide insufficient headroom for any supplier to make use of this remedy (as every PPM tariff in every region covered by such a tariff would be capped at the level of the PPM price cap in the cheapest region).

### **5.2 Efficient allocation of gas tariff pages**

5.2.1 The proposed limit on the number of gas tariff pages which any supplier can hold (at twelve) seems reasonable. The limit should not be any stricter (for example by requiring that all unused pages be returned), as this would excessively constrain suppliers' ability to offer new tariffs.

5.2.2 In terms of remedy design, it would be more efficient to seek undertakings from Siemens to ensure the efficient allocation of gas tariff pages.

### **5.3 Debt Assignment Protocol (DAP)**

5.3.1 SSE operates the Point of Acquisition (*POA*) model and is supportive of it being adopted as the standard solution across industry. An industry-wide move to a POA model will materially improve switching rates and provides a sound basis for effective competition.

5.3.2 SSE supports the timely implementation of these changes and notes that there is a timetable in place (which both Ofgem and Energy UK are aware of) to deliver these changes.<sup>4</sup> SSE expects that industry will follow the timetable currently in place for the delivery of the changes to the DAP, making the proposed remedy unnecessary.

5.3.3 The CMA indicates that objection letters, complex debt and multiple registrations are areas requiring changes to the DAP.<sup>5</sup> The CMA's assessment of these areas is not fully consistent with SSE's experience in the market. In particular:

- (a) **Objection Letters:** objection letters are necessary for any switching process (not just for those PPM customers who switch under the DAP) to ensure that the gaining supplier agrees to take on the debt. SSE does not agree that objection letters are complex or confusing and, in any

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<sup>4</sup> Key upcoming milestones include: (i) impact assessment responses to be published 21<sup>st</sup> April 2016; (ii) MRA Development Board to vote on solution and implementation on 28<sup>th</sup> April 2016; and (iii) industry to accept solution and deliver for November 2016.

<sup>5</sup> PDR, para. 5.297.

case, they will be more streamlined once POA is the standard model (at present, the letters must explain both models).

- (b) **Complex Debt:** this is not a material issue as complex debt accounts for only around 5% of DAP processes.<sup>6</sup> SSE has raised a Master Registration Agreement (**MRA**) change proposal to remove some complex debt reasons where they do not act in customers' interests.
- (c) **Multiple Registrations:** there is an MRA change proposal to limit the number of registrations a supplier can make to four. This proposal would unjustifiably constrict customer choice by restricting gaining suppliers' behaviour, reducing their ability to acquire more customers (in contradiction of the CMA's overall aim of promoting increased customer engagement).

#### **5.4 Undertakings/order on gas tariff pages**

- 5.4.1 In relation to two of the three components envisaged by the CMA (the cap on tariff pages and ability of Ofgem to mandate transfer of pages to another supplier), while undertakings could be sufficient to implement those changes, licence conditions would be the preferred option in the interests of clarity and ensuring a level playing field across industry.
- 5.4.2 As for the obligation to be imposed on suppliers to provide information to Ofgem for monitoring of tariff codes allocation, this proposal is redundant since Ofgem is already empowered to request information from suppliers. It would be more efficient for Ofgem to request data on tariff pages allocation directly from Siemens (by seeking undertakings from Siemens).

### **6. Rolling back of RMR**

#### **6.1 Modifications to SLCs**

- 6.1.1 SSE has long advocated the removal of the overly-prescriptive rules governing tariffs and thus is supportive of the proposed changes. These changes will allow greater innovation in tariff design and enable suppliers to better tailor their tariffs to customers' needs. SSE is keen that any changes to the licence will result in the best outcome for customers and competition. SSE notes that there are a small number of omissions from the CMA's proposals which may undermine the intention of this remedy.
- 6.1.2 **Complex tariffs.** The CMA's proposal to retain SLC 22A.2 without amendment will prevent suppliers from offering tiered-rate tariffs which were previously popular with customers (and which are particularly beneficial for customers with low consumption). This omission undermines the effect of the proposed removal of SLC 22A.3 (a) and (b), the intention of which SSE believes is to facilitate the reintroduction of tiered-rate tariffs. SLC 22A.2 should therefore be reworded to ensure that suppliers are not prevented from

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<sup>6</sup> Complex Debt accounts for 5% of G/D307 flows (which are the flows sent to initiate the DAP).

offering those tariffs, along the lines of the following proposal (suggested changes are marked-up in “tracked changes” format):

*“Recovery of charges*

*22A.2 In respect of supplying electricity to a Domestic Customer under a Deemed Contract or Domestic Supply Contract, the licensee must ensure that all Charges for Supply Activities are incorporated within the Standing Charge and/or Unit Rate(s).<sup>7</sup>*

~~*(a) where the Domestic Supply Contract or Deemed Contract is for a Non-Time of Use Tariff:*~~

~~*(i) a single Standing Charge; and/or*~~

~~*(ii) a single Unit Rate; and*~~

~~*(b) where the Domestic Supply Contract or Deemed Contract is for a Time of Use Tariff:*~~

~~*(i) a single Standing Charge; and/or*~~

~~*(ii) Time of Use Rates.”<sup>7</sup>*~~

6.1.3 **Fixed discount tracker tariffs.** The CMA’s current proposal to retain SLC 22C.9 will prevent suppliers from offering fixed term tariffs which track the price of the Standard Variable Tariff (SVT) but at a stated discount; these ‘tracker tariffs’ were also popular with customers as very effective acquisition tariffs.

6.1.4 The CMA should therefore include one additional exception to SLC 22C.11 (which sets out exceptions to compliance with SLC 22C.9) along the lines of the following proposal, which is drafted to ensure that customers are made aware of the potential increases/decreases in charges prior to signing up to the tariff, pursuant to SLC 23.1 (suggested changes are marked-up in “tracked changes” format):

*“Exception to compliance with condition*

*22C.11 In respect of an increase in Charges for the Supply of Electricity, the licensee is not required to comply with paragraph 22C.9 if:*

*(a) [retain as is];*

*(b) [retain as is]; or*

*(c) all of the following requirements are satisfied:*

*(i) the Domestic Supply Contract provides that variations to the Charges for the Supply of [Electricity/Gas] will occur automatically only in a manner which is fully linked to fluctuations in a Core Tariff offered by the licensee; and*

*(ii) the licensee has complied with paragraph 23.1 of standard condition 23; and*

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<sup>7</sup> “Unit Rate(s)” will cover/include Time of Use Rates, the definition of which (in SLC 1) would also need to change to allow tiered rates as, at present, it explicitly says that Time of Use rates cannot vary by consumption level.

(iii) the precise variations to the Charges for the Supply of [Electricity/Gas] are set out in the Domestic Supply Contract in a prominent position and in plain and intelligible language.”

- 6.1.5 **Dead tariffs.** The ban on creating new dead tariffs means that suppliers are restricted in their ability to offer discounted or acquisition SVTs, as it means these tariffs have to remain open for sale indefinitely in order for customers to continue to be supplied on them.<sup>8</sup> This ban restricts innovation in the SVT market and is not in the interests of customers or competition.
- 6.1.6 The following two proposed amendments would result in the ban on new dead tariffs being relaxed sufficiently to allow suppliers freedom to innovate whilst retaining the existing protection against customers being supplied on dead tariffs which are more expensive than the supplier’s live SVT.
- 6.1.7 Firstly, 22D.1A should be amended to allow for the withdrawal of a live SVT and the continuation of supply under a new dead tariff, as opposed to the current drafting which requires all customers to be transferred to another live tariff:

*“Exception for the withdrawal of Live Evergreen Tariffs*

*22D.1A Where the licensee wishes to withdraw a Live Evergreen Tariff, the licensee may:*

*(i) treat that Live Evergreen Tariff as a Dead Tariff (a “Transitional Dead Tariff”) for a period of 49 days (the “Transitional Period”) in order to ensure that all the Domestic Customers which are subject to that Transitional Dead Tariff become subject to a Live Evergreen Tariff or Live Fixed Term Tariff; or*

*(ii) subject to 22D.2, the licensee may continue to supply a Domestic Customer using a Dead Tariff.”*

- 6.1.8 The second change required is to amend the exception to the prohibition on dead tariffs in SLC 22D.2. Consumers would be adequately protected by the requirement to comply with SLC 22D.3 which ensures that the dead tariff is not more expensive than the live evergreen tariff. SSE suggests an amendment along the lines of the following:

*“Exception to prohibition on Dead tariffs*

*22D.2 Subject to paragraphs 22D.5 to 22D.19, where paragraph 22D.3 or 22D.4 applies, the licensee may continue to supply a Domestic Customer using a Dead Tariff ~~which existed before the date paragraph 22D.1 takes effect.”~~*

***New SLC to ensure ease of comparison between tariffs***

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<sup>8</sup> Dead tariffs are tariffs with no end date which are no longer for sale to any customers.

6.1.9 The existing Standards of Conduct (**SOC**), coupled with the Consumer Protection from Unfair Trading Regulations, ensure that customers will not be misled or confused by the design of the tariffs, making the proposed new SLC unnecessary. If the CMA considers it indispensable to have a specific requirement on tariff design, it should be included in the SOC but it should be made clear how compliance with this condition would be evaluated. SSE considers that customers will be able to compare tariffs readily provided that the expected annual energy costs are clearly presented (consistent with the current approach of PCWs).

## **6.2 Whole of market requirement**

6.2.1 SSE has been supportive of the “whole of market” requirement in the past and maintains that it is useful for customers to understand the full variety of tariffs available in the market. However, given the removal of the limit to the number of tariffs it seems sensible to re-evaluate the “whole of market” requirement for practical reasons.

## **7. Engagement remedies**

### **7.1 PCW access to ECOES and SCOGES**

7.1.1 SSE supports the proposal for PCWs to have access to these databases, as it will ensure that customers receive more accurate comparisons, thereby reducing the number of failed switches and improving the switching experience for more customers.

7.1.2 The industry is already taking steps to implement this proposal, as an MRA working group has been set up to assess this issue.

7.1.3 Given the risk of ECOES and SCOGES data being used for marketing purposes (which is of particular concern in the non-domestic segment where TPIs can set up as PCWs to gain access to the data), access to this data should be adequately monitored and enforced by Ofgem.

### **7.2 Midata phase two**

7.2.1 **Mandatory participation.** SSE supports participation in Midata being made mandatory for all energy suppliers. Access to Midata via PCWs should be launched simultaneously for all suppliers to ensure a level playing field.

7.2.2 **Scope of Midata.** Any changes to the data items within Midata need to be carefully considered. It is not clear exactly what is meant by “*consumption data and Time of Use*”, but it is worth noting that Midata already includes separate annual usage for each register related to time-of-use tariffs.

7.2.3 The proposal to include a Warm Home Discount (**WHD**) indicator needs to be carefully considered since DECC has not yet confirmed the rules governing WHD for 2016/17 and, in any case, this indicator could only confirm that a customer received the discount during the most recent WHD year. The WHD scheme should instead be amended to standardise the qualification criteria and the obligation should apply to all suppliers. Such improvements to the WHD

scheme would remove the need for the inclusion of a (necessarily ambiguous) WHD indicator within the scope of Midata.

7.2.4 **Customer consent for access to Midata.** SSE considers that, should PCWs be given continuous (or recurring) access to a customer's data, the following appropriate measures must be put in place:

- (a) Suitable data protection and security measures;
- (b) Customers must be required to give consent and be sure of what they are giving consent to;
- (c) Customers must be able to revoke access; and
- (d) Mechanisms for customers to know who has access to their data.

## 8. **Restricted meters remedies**

### 8.1 **Introduction**

8.1.1 The CMA has not adduced sufficient evidence of an AEC in relation to customers with restricted meters. Furthermore, the CMA's measure of detriment for restricted hours meter customers is wholly inadequate, fundamentally flawed and does not support the case for the proposed remedies.

8.1.2 The CMA's analysis of detriment in the restricted meter segment is based on comparing the bills paid by customers of the six large energy firms against the four "*cheapest single rate tariffs*" in the market at 30 June 2015.<sup>9</sup> This analysis is inadequate for the following reasons:

- (a) As acknowledged by the CMA, the analysis is based on "*a snapshot period in time and therefore does not capture the extent to which the results outlined below are due to the tariffs in place on 30 June 2015 or have been the case over time*".<sup>10</sup> As such, savings observed on that date may not have been available before or after the analysis date; and
- (b) Two of the tariffs used as a benchmark required a meter exchange which would cost the customer £70. This added cost has not been taken into account by the CMA (nor have any other one-off switching costs), thereby overstating any detriment, potentially by up to around 40%.

8.1.3 Restricted meter customers are exerting a rational choice by balancing the risks of moving to an unrestricted tariff (potential loss of functionality due to meter change with the potential for higher bills at some point in the future) with the possible gains from switching at any given point in time.

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<sup>9</sup> PDR, Appendix 3.1, Annex B, para. 16.

<sup>10</sup> PDR, Appendix 3.1, Annex B, para. 22.

8.1.4 As recognised by the CMA, the remedies are also unlikely to be effective: “we do not expect that these remedies alone will have very substantial effects in terms of reducing customer detriment”.<sup>11</sup>

## **8.2 Comments on the proposed remedies**

8.2.1 **Single rate electricity tariffs.** SSE already offers some existing customers the ability to move to single-rate tariffs without a meter exchange, however widening this flexibility to a more general provision would entail significant changes to systems and processes. The CMA should allow for certain exceptions to the proposed remedy, *e.g.*, if a customer wants to switch, the new supplier should be allowed to *recommend* a meter exchange where that would allow for a cheaper tariff to be provided.

8.2.2 **Information remedies.** SSE is confident that it already complies with the first two components, as these reflect existing requirements. However, if any additional information must be included in communications with restricted meter customers, suppliers should be given the freedom to choose the most effective and appropriate means to communicate this information (prescriptive rules should be avoided).

8.2.3 With regards to the third component, SSE is able to provide information to Citizens Advice. Nevertheless, this will largely depend on the nature of the information requested, in particular to what extent the disclosure would be permitted under Data Protection legislation.

8.2.4 **Role of Citizens Advice.** SSE supports this remedy to the extent that Citizens Advice already performs this role.

## **9. Microbusiness remedies**

### **9.1 Introduction**

9.1.1 The CMA has not adduced sufficient evidence of an AEC in relation to Microbusiness customers. In particular, the CMA’s analysis of Microbusiness customer detriment is inadequate.

9.1.2 In SSE’s view, the microbusiness segment is dynamic and innovative, with all relevant indicators showing that competition is already strong (and increasing). SSE therefore does not recognise the picture of the market that has been painted by the CMA. In short, there is no overarching feature of “*weak customer response*” that gives rise to an alleged AEC.

9.1.3 Despite the CMA’s failure to adequately establish the existence of AECs in the microbusiness segment, SSE is supportive of improvements in the market and increased customer engagement. This section comments on the inadequacy of the CMA’s detriment analysis for this segment, and then focusses on practical points that the CMA should consider regarding the proposed remedies.

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<sup>11</sup> PDR, para. 4.94.

## 9.2 The CMA’s revised measure of detriment in the Microbusiness sector remains inadequate

- 9.2.1 While SSE welcomes the CMA’s removal of its inefficiency analysis in response to comments in relation to the heterogeneity of the SME markets and microbusiness segments, the CMA is continuing to rely solely on its wholly inadequate analysis of profits in excess of the cost of capital for its assessment of detriment in the SME segment.
- 9.2.2 The CMA has acknowledged the shortcomings of this approach in its PDR, stating that “*the results should be taken to be indicative rather than precise estimates*”<sup>12</sup>. Further to this, the CMA makes an unevidenced leap to estimate the proportion of the SME detriment that covers the microbusiness segment by assuming that profits in excess of the cost of capital earned across the microbusiness segment and the larger SME markets would broadly be in proportion to their respective revenues.<sup>13</sup> This assumption is unsupported by any evidence and the CMA acknowledges in the PDR that this methodology “*may not provide a completely accurate number of profits in excess of the cost of capital.*”<sup>14</sup>
- 9.2.3 While the CMA attempts to justify the use of this approach on a lack of alternative information<sup>15</sup>, the analysis used is wholly inadequate and does not support the case for intrusive remedies. Neither can these results provide a sound basis for the assessment of proportionality of the proposed remedies.

## 9.3 Price transparency

- 9.3.1 SSE considers that its new online quoting system (currently in development) will be compliant with the remedy and will be fit for purpose, subject to the points raised below.
- 9.3.2 **Providing quotes on the basis of postcode and consumption data alone will not be workable.** The CMA envisages that customers must be able to obtain a quote based on postcode and consumption data alone, on the basis of the assumption that the postcode will allow the supplier to use data in ECOES/SCOGES to determine the MPAN/MPRN which then identifies the meter type, profile class, and other meter specific information. However, a number of meter points will be associated with one postcode (*i.e.*, all meters connected at properties with that postcode), making it impossible in practice to determine MPAN/MPRN from the postcode alone.
- 9.3.3 The most reliable approach would be for customers to use their MPAN/MPRN, which are included on the bills (customers will most likely be using bills to access their consumption information for the online quote). Alternatively, the system could operate on a postcode look-up (where a

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<sup>12</sup> PDR, para. 3.206.

<sup>13</sup> PDR, para. 9.16.

<sup>14</sup> PDR, para. 9.17.

<sup>15</sup> PDR, para. 9.17.

customer enters their postcode and then selects the full address from a drop-down list).

- 9.3.4 Even with a postcode look-up approach, postcode based quotes could lead to quotes being provided for the wrong business if there is more than one business and meter point located at one address. This could lead to customer dissatisfaction, negative switching experiences and an increase in erroneous transfers, all of which could have a detrimental impact on customer engagement and switching.
- 9.3.5 **Access to ECOES/SCOGES is a pre-requisite for this remedy.** The proposed system relies on suppliers and operators of third party tools being able to access ECOES/SCOGES to gather all the necessary data for the quote (the information in the Energylinx database does not have the same level of detail). As such, the successful implementation of this remedy is largely dependent on the implementation of the remedy on PCW access to ECOES and SCOGES.
- 9.3.6 **Half-hourly settlement for classes 1-4 risks creating excessive complexity and costs.** As currently designed, the proposed remedy will continue to apply once profile classes 1-4 move to half-hourly settlement. The requirement to include all acquisition and retention tariffs in the online quoting tool will likely prevent suppliers from using the added flexibility allowed by half-hourly settlement to introduce new tariffs (such as Time of Use tariffs) and increase choice for customers in those profile classes. Indeed, it will be too complex to include all possible tariffs in the simple online quoting tool.<sup>16</sup>
- 9.3.7 To mitigate this risk, the CMA should introduce a review clause for this remedy, ahead of the move to half-hourly settlement for profile classes 1-4 (projected for 2020), to reassess the practicality, effectiveness, proportionality and potential disadvantageous effects of the remedy.

#### **9.4 Auto-rollover contracts**

- 9.4.1 SSE (and some other suppliers) voluntarily stopped the auto-rollover of microbusiness contracts in April 2014. Nevertheless, restrictive terms in auto-rollover arrangements continue to constitute a barrier to engagement for the small proportion of customers who remain on such tariffs. Therefore, the proposed remedy supports competition by further increasing scope for engagement across the market as no customer will be restricted by auto-rollover contracts with fixed terms and termination fees.

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<sup>16</sup> This same additional complexity and cost led the CMA to exclude larger businesses from the scope of the remedy.

## **9.5 Ofgem-led programme to improve information and engagement**

- 9.5.1 SSE's comments in relation to the proposal to establish an Ofgem-led programme for domestic customer engagement also apply with respect to microbusinesses.<sup>17</sup>
- 9.5.2 With regard to microbusinesses in particular, the CMA recognises that lack of information is less of a problem in this segment and that other remedies will address any actual or perceived barriers to accessing and assessing information.<sup>18</sup> As a result, there is clearly no need or justification for the CMA to impose this remedy in relation to microbusinesses.
- 9.5.3 SSE does agree with the principle that no regulated changes to customer communications should be made without evidence of successful trials, and would support a recommendation of such to Ofgem, as opposed to the current recommendation to Ofgem to implement a programme to identify and test new communications.

## **9.6 Database of 'disengaged' microbusiness customers**

- 9.6.1 SSE's comments regarding the "disengaged" customer database remedy for domestic customers also apply with respect to microbusinesses.<sup>19</sup> In particular, paragraph 5.3.4, outlines the requirement for microbusinesses that are not incorporated to be treated the same as domestic customers in terms of the Data Protection Act (*DPA*). Because suppliers do not hold information on the incorporation of business customers, to ensure compliance with the *DPA*, it would be necessary for all microbusiness customers targeted by the remedy to be treated the same.
- 9.6.2 With regard to microbusinesses in particular, as explained in SSE's response to the PFs, the microbusiness sector is highly competitive, customer engagement is generally high and customers on default tariffs are not necessarily less engaged than other microbusiness customers.<sup>20</sup> As a result, the proposed remedy is unnecessary.
- 9.6.3 In addition, there is evidence that this segment in particular considers marketing contact (*e.g.*, from TPIs) to be at a nuisance level, and that any increase in contact could damage trust and engagement.
- 9.6.4 Further, SSE is concerned that TPIs could register as suppliers ([ " ]), primarily to use the database to access customer data for wider marketing purposes and sales activity beyond the proposed scope of the remedy. Previous conduct by some TPIs in the non-domestic market suggests that such behaviour would pose a particular risk in this market. If the remedy is

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<sup>17</sup> Response, Section 6.

<sup>18</sup> PDR, para. 9.210.

<sup>19</sup> Response, Section 5.

<sup>20</sup> Response to PFs, paras. 8.2.1. *et seq.*

implemented it will be essential that use of the data is thoroughly policed to prohibit this.

## **10. Regulatory governance remedies**

### **10.1 Ofgem's duties (amendments to Gas Act and Electricity Act)**

10.1.1 As indicated in the Response to the NPR, SSE supports this remedy insofar as it seeks to clarify Ofgem's position, since the regulatory and competitive market framework requires stability so that it works effectively for consumers, business and industry participants.<sup>21</sup>

10.1.2 However, there is a risk that the proposed remedy will not be effective in prompting an appreciable change of direction of regulatory policy in the sector. This is especially the case given that the CMA did not consider that "*competition should be given explicit priority as the preferred mechanism by which Ofgem should seek to achieve its principal objective.*"<sup>22</sup>

### **10.2 DECC/Ofgem interaction**

10.2.1 **Publication of Ofgem's views on draft legislation and policy proposals.** SSE is supportive of this remedy, but considers that the effectiveness of such a process will entirely depend on the extent to which it will be used by Ofgem.

10.2.2 **Joint DECC/Ofgem statements on policy objectives and action plans.** SSE is supportive of this remedy insofar as it should provide greater clarity to the regulatory process, streamline licence changes and implementation deadlines and improve the efficiency of strategic changes.

10.2.3 **State of the market report.** SSE has no specific comments in relation to this remedy, except to note that Ofgem has already committed to do it<sup>23</sup> and is currently in the process of collecting data for its 2016 report.

10.2.4 **Ofgem Chief Economist team.** SSE has no specific comments in relation to this remedy, except to note that Ofgem already has sufficient expertise to publish the State of the Market Report without the need for a new unit.

## **11. Industry Codes**

### **11.1 Ofgem to take a more active role in Industry Codes**

11.1.1 **Strategic direction.** SSE is supportive of this remedy as it should allow a greater focus of future changes to the codes.

11.1.2 **Oversight of annual developments.** SSE is supportive of the remedy as it should allow a greater focus on the strategic direction for codes and notes that

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<sup>21</sup> Response to NPR, paras. 3.22.1 *et seq.*

<sup>22</sup> PDR, para. 9.68.

<sup>23</sup> Ofgem response to ECCC's Fifth Report of Session 2013-14: "*In particular we are planning to produce an annual report which will provide a clear picture of the state of the market.*"

a number of codes already develop work plans and that it would not be onerous for these work plans to be co-ordinated.

- 11.1.3 **Consultative board.** SSE is broadly supportive of this remedy as it will allow the industry to focus on the necessary strategic changes. The board should be actively managed by Ofgem to ensure that the focus remains on ongoing/future strategy.
- 11.1.4 **Initiative and prioritisation.** SSE supports this remedy as it will allow Ofgem to directly propose modifications and take responsibility for their development.
- 11.1.5 **Exceptional power to take control of process.** While SSE welcomes the proposal for Ofgem to take responsibility for strategically important modification proposals, empowering Ofgem to modify industry codes without going through the modification procedures must be conditional upon: (i) this power only being used in “exceptional circumstances”; (ii) those exceptional circumstances being clearly and narrowly defined; (iii) sufficient consultation being built into the process; and (iv) appeal rights being sufficiently robust and speedy (*e.g.*, aligned with the appeal rights surrounding licences, equivalent checks and balances as in the context of the Secretary of State’s powers in relation to smart meters, or creating an appeal process to the CMA, as opposed to the standard judicial review procedure).
- 11.1.6 **Changes to licence conditions of code administrators.** Under a number of codes, code administrators already have the right to initiate modification proposals. As such, the extension of this right across all codes is a welcome proposal. The prioritisation of modification proposals requires appropriate oversight from code panels and clear criteria being set for code administrators to ensure that this power is used fairly.

## 11.2 Legislative changes

- 11.2.1 **Ofgem’s powers.** See comments above.
- 11.2.2 **Code administration.** It is not clear how this remedy will be implemented and the potential impact it will have on existing commercial relationships between code panels and code administrators.
- 11.2.3 In order for an activity to be licensed, there must be a definition of the prohibited activities under the licence. “*Code administration*” and “*delivery services activities*” are not clearly defined activities and have evolved over time. Defining those activities will be complex, as the definition must be sufficiently narrow not to inadvertently include professional services (such as accountants, lawyers etc.) but sufficiently wide to capture all relevant code administration activities. Transitory provisions may also be required to cover the novation of contracts or the transfer of assets to licensed code administrators, should licensing result in different legal entities carrying out the activities in question.

11.2.4 More importantly, rather than licensing code administration, the CMA should propose a remedy to ensure the efficient delivery of approved modifications, which the Consultative Board would probably be well placed to expedite.

## **12. Remedies the CMA is not minded to pursue**

12.1.1 SSE notes the remedies which the CMA is not minded to pursue and agrees with the CMA's decision on these remedies.

## **13. Timescales and deliverability of the remedies**

### **13.1 Introduction**

13.1.1 This section includes SSE's comments and observations on the overall deliverability of the proposed remedies package on the timescales currently envisaged in the PDR.

13.1.2 The PDR proposes a wide ranging and substantive package of remedies representing a serious operational challenge to energy companies, Government, Ofgem and other stakeholders. It will be important to get the detail of this package right so that the market can regain trust and deliver effectively for customers.

13.1.3 SSE looks forward to working with the CMA to implement these remedies as practicably and effectively as possible, and as such, SSE will engage proactively with the CMA in determining the details of them. In the interest of this, SSE has set out below a number of factors for consideration in the setting of timescales for remedies implementation.

### **13.2 Implementation before final orders/undertakings**

13.2.1 SSE is concerned by the CMA's proposal that work on implementation of a number of remedies should begin in advance of publication of the Final Order and in some cases in advance of the Final Report.

13.2.2 Any steps towards implementation taken in advance of final orders or undertakings carry material risk, as changes to the proposed arrangements could be made in order to address issues raised during the consultation period. Remedies requiring changes to IT systems and processes, in particular, require substantial scoping before implementation and therefore relatively minor changes can have a substantial impact on delivery, risking delays and customer disruption.

13.2.3 The PDR does not provide sufficient clarity and detail to allow the parties to begin work on implementation. Significantly more detail would have to be made available in the Final Report for parties to initiate implementation (even if that were appropriate in advance of final orders or undertakings).

13.2.4 With regards to the CMA's recommendation that Ofgem deprioritise enforcement action relating to licence conditions recommended for removal as part of the remedies package, SSE is concerned that any lack of clarity in this

area could lead to confusion and potentially restrict suppliers in developing new products for customers in the period until licence changes are made.

- 13.2.5 Any deprioritisation of enforcement action must be clearly set out by Ofgem alongside a set of guiding principles for the interim period until the changes to the relevant licence conditions are implemented. This will ensure suppliers are operating on a level playing field and that Ofgem can prioritise appropriately to focus on delivery of the required changes.

### **13.3 Concurrency of delivery**

- 13.3.1 The CMA must recognise that critical IT and business change projects are already underway which will underpin further evolution of competitive energy markets, for example Nexus, Smart Meter Rollout and DCC (see section 13.5 below). It is essential that these projects are successfully delivered, and so the timetable proposed for implementation of the remedies must take account of this to avoid jeopardising existing plans.
- 13.3.2 In addition, the remedies package of itself envisages the concurrent design and development of many of the proposed remedies, which will significantly increase pressure on the resource and systems of both suppliers and Ofgem.
- 13.3.3 While additional resources can be brought to bear on implementation where necessary, a number of the remedies require changes to business systems (e.g., customer service and billing systems) which will have restricted capacity for change without compromising Business as Usual delivery for customers. As such, while the timescales proposed by the CMA may be reasonable for some individual remedies, implementing the majority of the package by mid-2017 does not appear achievable, particularly as insufficient detail of the remedies has been provided at this stage to allow parties to start work, and the need to deliver on top of existing regulatory commitments. For other remedies, the timescales proposed are not deliverable, even in isolation.
- 13.3.4 Full assessment of capacity and capability restrictions will need to be carried out, but the level of detail provided in the PDR does not allow for a comprehensive assessment. SSE will continue to assess deliverability of the remedies as further detail is made available and will work constructively with the CMA and Ofgem on the determination of deliverable timescales.
- 13.3.5 A number of the remedies also require changes to industry systems and processes; these will be affected by similar constraints, causing consequential delays to implementation by parties. These interdependencies will need to be reviewed before a final view of deliverability can be provided.

### **13.4 Internal governance associated with IT scheduling and business change**

- 13.4.1 The implementation of SSE's IT projects requires a [ ]. [ ] ensures thorough testing and effective implementation. This reduces the risk that defects will result in failures in the customer journey, and so protects customers.

13.4.2 As a result, projects scheduled for implementation in April 2017 [ " ]. The CMA's intention to implement remedies within only three months of the Final Order would require complete abandonment of governance processes developed by SSE to manage risk and successfully implement programmes of this nature.

13.4.3 SSE is concerned that this would result in significant negative impacts for customers if industry and supplier system changes are not well developed and adequately tested, leading to delivery failures and undermining trust.

13.4.4 Implementation of the remedies package will also require significant operational business change including business process changes and training. Comprehensive governance processes are in place for these types of changes and they will also require sufficient time for development and delivery to ensure effective implementation, and protect the customer experience.

### **13.5 Implementation of regulatory and government policy change projects**

13.5.1 SSE fully expects that Project Nexus will be implemented by 1 October 2016, however, this relies on scheduling of IT changes for 2016 which are already in place. If parties are forced to revise this scheduling, effectively displacing Nexus projects with projects to ensure implementation of the CMA remedies for 2016 and 2017, this would put at risk the successful delivery of Nexus by 1 October 2016.

13.5.2 Similarly, [ " ]. Any additional projects for inclusion within these timescales would result in delays to this programme, potentially compromising its successful completion by regulatory deadlines, to the detriment of customers and competition.

13.5.3 In addition to these two high profile projects, in excess of [ " ] other major regulatory and government policy change programmes ( [ " ] ), require implementation during the period proposed for remedies implementation. Further major regulatory change projects are expected on top of this committed programme, including high profile projects such as Ofgem's faster switching programme, which have the potential to deliver significant benefits to customers and competition. The timescales proposed for the remedies will undoubtedly impact on delivery of these programmes.

13.5.4 [ " ].

**Annex 2: Non-confidential version of submission of SSE's authorised advisers**  
**Part 1: Evaluation of CMA's "indirect approach" detrimental analysis**

**SUBMISSION OF SSE'S AUTHORISED ADVISERS**  
**Evaluation of CMA's "indirect approach" detriment analysis**

*This paper is a non-confidential submission of SSE plc's Authorised Advisers from the Energy Market Investigation Confidentiality Ring held between 17 March and 7 April 2016, following the publication of the CMA's Provisional Decision on Remedies ('PDR'). It provides an assessment of the CMA's so-called "indirect approach" to establishing and quantifying customer detriment on the basis of the Authorised Advisers' review of the material made available in the Confidentiality Ring.*

**1. Executive summary**

- 1.1 The CMA's so-called "indirect approach" to establishing and quantifying customer detriment does not establish that prices are excessive.
- 1.2 **First, the CMA's estimate of the return on capital employed (ROCE) of the six large energy firms – which forms the basis of this assessment – contains a number of material errors of fact and assessment.** SSE recognises that estimating the ROCE of an asset-light energy supply business is an inherently difficult task and that, because of this, the results of this analysis are highly sensitive to a number of critical assumptions. Indeed, it is for this very reason that SSE has consistently advised the CMA that alternative approaches – such those based on EBIT benchmarking – can provide a more informative and reliable indicator of the economic profitability of energy suppliers than an approach founded on ROCE.<sup>1</sup> Nonetheless, if the CMA does choose to present such an analysis, it is essential that it acknowledges the intrinsic difficulties involved in estimating the capital base of large standalone supplier and accommodates this by presenting a range of ROCE estimates that appropriately reflects these uncertainties.
- 1.3 This is not what the CMA has presented in the PDR. Instead, in every instance where it has had to make an assumption about how a standalone energy retailer would cope with the challenges and risks it would face in running its business, the CMA has made an assumption that has resulted in the lowest possible value for its capital employed estimate. As a result, it has taken as a reference point an entirely hypothetical large standalone supplier that:
- **holds no reasonable amount of risk capital** to allow it to cope with the risk of short-term losses resulting from volumetric shocks (even though the CMA itself now acknowledges that such shocks are a real and unavoidable feature of the energy industry);
  - **holds no capital for trading collateral**, but instead relies wholly on its ability to pay an intermediary to take on all the risks associated with purchasing energy on the wholesale market (despite the fact that there are clear reasons to conclude that such arrangements were not – and could not have been – available to a standalone energy supplier of

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<sup>1</sup> SSE Response to Provisional Findings (*PFs*), Annex 1, para 1.3.

scale on the terms that the CMA is envisaging during the Relevant Period);

- **holds no capital for regulatory collateral**, but instead relies primarily on letters of credit (despite the absence of evidence that a large standalone supplier would have access to such facilities on the terms that the CMA has assumed); and
- **holds no capital to manage peaks in working capital requirements**, despite clear historical evidence that these peaks are substantial and can emerge quickly.

1.4 The CMA is therefore assuming that a standalone supplier of scale would be able to withstand the substantial volumetric- and price-related shocks that characterise the market (not to mention other risks such as those driven by policy developments), with the only capital employed being:

- the fixed assets in the business – which the CMA acknowledges are limited for standalone energy suppliers;
- a 2% cash balance; and
- limited intangible assets.

1.5 This is an extreme – and wholly implausible – interpretation of the available evidence. Despite this, the CMA’s ROCE analysis only identifies detriment in the region of £240 million a year across the six large energy firms. This equates to less than 1% of the average domestic energy bill<sup>2</sup>. If the CMA were to have undertaken a more balanced analysis of the available evidence, it would have found the industry as a whole to be making normal profit.

1.6 **The CMA’s indirect cost “efficiency adjustments” are also based on errors of fact and assessment.** The CMA argues that the actual level of detriment is considerably higher than £240 million a year because there is evidence that the majority of suppliers operate with inefficiently high levels of indirect costs. However:

- the “efficiency benchmarking” analysis that the CMA has presented to support this proposition in the PDR is unreliable, and
- the CMA’s inefficiency estimates are based on an extreme standard (the most efficient company) that is wholly disproportionate, given the limitations of the underlying data, and that is out of keeping with established regulatory precedent for this type of analysis.

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<sup>2</sup> The weighted average domestic bill (assuming median levels of consumption) per customer account for customers of the six large energy firms over the relevant period was £[“ ”] Over the same period, the six large energy firms combined had on average [“ ”] customer accounts (measured on a quarterly basis). Taken at face value, the CMA’s analysis would therefore imply that the detriment they have calculated represented £[“ ”] or [“ ”] % of each annual bill (i.e. per single or dual fuel account).

- 1.7 This is underlined by the resulting range of indirect cost efficiency scores, of between approximately 50% and 100%, which is simply too wide to be reasonably attributed to efficiency differences (absent further substantiation of the results – which the CMA does not provide).
- 1.8 For all these reasons – which are explained in greater detail below – the CMA’s “indirect approach” analysis provides no clear or reliable evidence of customer detriment.
- 2. The CMA’s calculation of ROCE contains material errors of fact and assessment**
- 2.1 SSE recognises that the CMA made certain changes to the ROCE analysis presented in the PDR to take on board comments made regarding the analysis set out in the PFs. In particular, it has rightly revised its ROCE calculation for SSE to reflect several of the factual errors previously highlighted by SSE in relation to the incorrect treatment of ROCs and balancing costs. In addition to this, the PDR rightly acknowledges the need to take both regulatory collateral and risk capital requirements into consideration<sup>3</sup>.
- 2.2 Notwithstanding this, the assessment of ROCE set out in the PDR still contains a number of substantial errors of fact and assessment. In particular:
- (a) the assessment continues to rely heavily on the assumption that a standalone supplier of scale could rely on “intermediary trading arrangements” in lieu of holding trading collateral, but the assumptions that the CMA has made about these trading arrangements have been informed by a highly selective and, in places, baseless interpretation of the available evidence;
  - (b) although the PDR now acknowledges the need to consider regulatory collateral requirements, its assessment of these requirements is based on material errors of assessment;
  - (c) similarly, although the CMA now recognises the need to hold risk capital, it has not made sufficient allowance made for risk capital in the PDR; and
  - (d) the PDR does not address the errors that SSE has previously identified regarding the CMA’s treatment of working capital.
- 2.3 The PDR consequently contains material errors of fact and assessment that have the effect of over-estimating both the ROCE and the resulting level of detriment.

**The CMA’s analysis of arrangements with third-party intermediaries to manage business risk remains wholly unsound.**

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<sup>3</sup> PDR, Appendix 3.4, paras.75-76, 116-125 & 126-128; analysis performed by SSE’s Authorised Advisors

The CMA's assumption that a standalone supplier of scale could avoid the need for trading collateral by entering into an arrangement with a third-party supplier remains a key driver of its ROCE-based detriment estimate. In its response to the PFs, SSE explained that such arrangements did not exist over the relevant period and could not have been made available to a large standalone supplier then (or indeed today) on the terms envisaged. Although the CMA has referred to some of these problems in Appendix 3.4 of the PDR, it has not addressed them in a satisfactory fashion with robust evidence.

*The PDR does not address SSE's previous comments about availability of the intermediary arrangements in the Relevant Period*

2.4 In its response to the PFs, SSE highlighted that the CMA's analysis failed to consider whether such trading arrangements would have been available during the Relevant Period.<sup>4</sup> As a matter of fact, no such intermediaries existed over the period that could have offered the services that the CMA describes to a supplier operating on the scale of the six large energy firms. Had such intermediaries existed, it is inconceivable that SSE would not have been aware of them.

2.5 The CMA has not addressed this in the PDR. It simply states that:

*"the purpose of our assessment of this model is to understand what costs a firm would be likely to have incurred in purchasing such services in the market on an arm's length basis, in order to understand the value of the services that were actually provided to the Six Large Energy Firms' retail businesses by the rest of their groups over the relevant period".<sup>5</sup>*

2.6 This is not an adequate response to the points raised. First, in the absence of these intermediary fee arrangements over the Relevant Period, the costs associated with this model cannot therefore have acted as a cap on the costs that a standalone supplier would have incurred in purchasing energy. Second, the current level of the fee does not provide a reliable insight into the fee that the large standalone supplier would have faced had such services been available. The conditions under which power was bought and sold were very different to those that prevail today, and the greater illiquidity of the market during the Relevant Period would have led to the services being offered at higher fees and/or more demanding terms and conditions than currently.

*The level of the intermediary fee assumed by the CMA substantially understates the relevant costs of managing business risk*

2.7 In the response to PFs, SSE drew attention to the fact that:

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<sup>4</sup> SSE Response to the PFs (para 3.5.16). It is also a particularly relevant question in this case because the characteristics of the wholesale market that currently prevail are quite different to those that prevailed over the Relevant Period.

<sup>5</sup> PDR, Appendix 3.4, para.72

- (a) First, the CMA’s analysis of the intermediary arrangements failed to take sufficient account of all of the risks that a standalone supplier of scale would still face, given:
- (i) the significant mark-to-market exposures created by purchasing energy in forward markets that open up if the wholesale market then declines;<sup>6</sup>
  - (ii) the risk of losing substantial numbers of customers if prices are set on the basis of forward wholesale energy costs that subsequently turn out to be uncompetitive; and
  - (iii) the cost to the intermediary of supporting a financially distressed energy supplier in such scenarios, which – even if it is not a cost that the supplier itself directly faces – must still be factored into the required capital base for the ROCE analysis.<sup>7</sup>
- (b) Second, the CMA did not take into account the impact of the charge over assets owned by the supplier that the trading arrangements appear to give Shell.<sup>8</sup>

2.8 Taking these points together, SSE argued that the CMA had substantially underestimated the true level of notional capital required to support a standalone energy supplier of scale on a sustainable basis.

2.9 The CMA has not addressed these points adequately in the PDR.

- (a) In relation to the first point, the CMA states that “*we observed that these agreements did not allow Shell to revoke the facility unless there was a breach of the terms (including covenants)*”.<sup>9</sup> Furthermore it

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<sup>6</sup> As shown in SSE’s previous submissions, the sizes of mark-to-market exposures that opened up in 2009 and again at the start of 2015 were substantial. [“ ”] In addition, no provision appears to have been made for the material costs that a supplier would be likely to face in such a situation.

<sup>7</sup> If the intermediary were to use its balance sheet strength to support an energy supplier, this would come at a cost. Yet this balance sheet strength – despite being wholly analogous to what vertically integrated large energy suppliers draw on in similar situations – has not been valued by the CMA.

<sup>8</sup> The CMA considers that this charge over assets would not impose a cost on the independent supplier because it is assumed that the supplier would be entirely equity funded. This is, however, an extreme assumption. As SSE explained in its response to the PFs, an independent supplier operating at scale may well wish to take on some debt (and it is unreasonable simply to assume that this would not be the case). More importantly still, the charge on assets would increase the risks that an investor takes on when investing in an energy supplier because, in the case of default, the investor would recover a smaller proportion of its investment than would be the case in the absence of the charge on the supplier’s asset. This increase in investment risk would either raise the WACC for that supplier, for a given level of capital employed, or require additional capital to be made available. Furthermore, [“ ”].

<sup>9</sup> PDR, Appendix 3.4, para.71

asserts that [redacted].<sup>10</sup> The CMA therefore concludes that there would not have been a problem for the suppliers to access the facility in times of high market volatility. However, this misses the fundamental point that SSE set out in the Response to the PFs— namely that in times of extreme market volatility where terms (including covenants) are likely to be broken (e.g. required financial metrics such as EBIT margin), Shell has the right to revoke the facility. The fact that it has never done that to date does not constitute evidence that this is not possible.

- (b) In relation to the second point, the CMA states that [redacted].<sup>11</sup> This is clearly not a sound justification for omitting the value of these warrants altogether, and it appears that the CMA is ignoring relevant evidence that would have made the estimate of ROCE lower.

2.10 Consequently, it remains the case that these errors in the CMA’s analysis remain and have not been addressed in the PDR.

*The CMA’s estimate of the intermediary fee is flawed*

2.11 The CMA has not presented sufficient evidence, either in the PFs or in the PDR, on how the exact trading fee of [redacted]% is estimated to be appropriate for the six large energy suppliers. The CMA states that “[redacted]”.<sup>12</sup> A review of the information made available to the parties and External Advisors reveals that this is the only evidence on which the CMA bases its estimate of [redacted]% trading fee. This evidence is based on the conjecture of a single party instead of the trading fees actually observed in the Relevant Period. Alternative evidence is either disregarded or not presented:

- (a) the PDR states that Ovo energy “[redacted]”.<sup>13</sup> It is clear that the CMA’s estimate of [redacted]% trading fee falls below this observed level;
- (b) the PDR does not present the fee level of either First Utility or Just Energy in percentage terms of its wholesale energy cost.

2.12 The conclusion on the level of the fee set out in the PDR is therefore based on conjecture and the selective use of largely anecdotal evidence. This is wholly inadequate for a consideration of such importance to the CMA’s indirect detriment estimate.

*The CMA has not adequately addressed SSE’s previous comments about the scalability of the intermediary fee*

2.13 In its response to the PFs, SSE argued that the CMA was wrong to believe that the intermediary arrangements that are currently in place would be scalable. In making this claim the CMA relied heavily on the assumption that an

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<sup>10</sup> PDR, Appendix 3.4, para.71

<sup>11</sup> PDR, Appendix 3.4, para.64

<sup>12</sup> PDR, Appendix 3.4, para.30

<sup>13</sup> PDR, Appendix 3.4, Supplement 2, para.1(d)

intermediary taking different positions in generation and retail supply would be able to diversify risk, such that it could operate at greater scale. However, this is not a sound assumption, since:

- (a) the nature of the arrangements in place – to the extent that it is possible to determine from the limited information provided – does not appear to enable Shell to offset risks by finding opposing positions in relation to generation and retail supply;<sup>14</sup> and
- (b) there is also uncertainty in Shell’s evidence as to whether it would be possible to enter into arrangements with generation companies in a way that would balance its arrangements with suppliers, as generators and retail suppliers face different types of risk.<sup>15</sup>

2.14 The CMA has not addressed these points satisfactorily in the PDR. Instead, it simply makes three observations:

- (a) first it states that “*Shell told us that it was keen to grow its intermediary activities in the UK and that it would be prepared to offer such services to an energy retail supplier of the scale of one of the Six Large Energy Firms*”<sup>16</sup>, and relies on this as one of its primary sources of evidence for the scalability of the service;
- (b) second, the CMA notes that “*there were a number of other firms active in this area (including Morgan Stanley and Macquarie), with others expressing an interest to enter this market (eg BP)*”<sup>17</sup>; and
- (c) third, the CMA notes that [“ ”].

2.15 On the basis of these three observations, the CMA concludes that the service is scalable for a large independent supplier of size. However:

- (a) the first two of these observations are based solely on anecdotal expressions of interest by individual parties rather than a reasoned analysis of whether these parties would be likely to act in this way in

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<sup>14</sup> Shell would be able to take a balanced position (in that it buys energy from generators in quantities roughly equal to that which it will need to sell), but would still be exposed to negative shocks affecting the ability of the party on one side of the transactions to pay.

<sup>15</sup> On the generation side, the value at risk is the spread between the input (fuel) costs and output (power) prices (“spark spread”). At the same time, energy suppliers face power and gas price risk along with volume risk. These risks for generators and suppliers are not well correlated with each other and consequently cannot perfectly offset each other. For example, in the context of depressed demand, a generator’s exposure could be increasing as spark spreads fall, but this can still coincide with a supplier’s exposure increasing if gas prices and power prices are also falling at the same time. As a consequence, it would not be possible for an intermediary to grow in scale through diversification, which is the sole route that the CMA envisages.

<sup>16</sup> PDR, Appendix 3.4, para.111

<sup>17</sup> PDR, Appendix 3.4, para.111

reality. The fact remains that no such arrangements exist for – or are available to – any of the current six large energy firms; and

- (b) the third observation is unclear in its nature and relevance, since the details of Shell’s arrangements in this regard are confidential and have not been made available to either SSE or its Authorised Advisers.

**The treatment of regulatory collateral in the PDR is based on material errors of assessment**

- 2.16 SSE recognises that the CMA has now taken regulatory collateral into consideration in the PDR. However, a proper assessment of the available evidence indicates that a standalone supplier of scale would not have full access to letters of credit (LoC) on the terms the CMA assumes.
- 2.17 The CMA states in the PDR that a large standalone energy supplier would manage its regulatory capital requirements via the use of LoCs and a relatively small amount of cash (based on evidence submitted by FTI Consulting on behalf of RWE and the experience of Just Energy in the US). The CMA then estimates the expected fees incurred on these LoCs by taking the midpoint between RWE's submission & Just Energy's fees (2%), multiplied by the midpoint of the six large energy firms’ estimates of the scale of the LoCs (£300m.), resulting in an annual cost of £6m per firm.<sup>18</sup>
- 2.18 This approach is inappropriate for the following reasons:
  - (a) It assumes that independent suppliers have sufficient access to LoCs to cover their regulatory capital requirements in full, at a low fee rate of 2%. However, the six large energy firms only have access to LoCs due to the favourable credit rating that they enjoy and, as such, there is no guarantee that an independent supplier of scale would have access to such LoCs on the same terms. Indeed, it is inconceivable that they would have access on these terms, since the CMA appears to be envisaging a standalone supplier operating on a scale similar to that of the six large energy firms without posting any collateral, while having no capital base to point to other than the limited fixed and intangible assets in the business and a 2% cash balance. Had this supplier experienced severe shocks during the Relevant Period, it would have had no capital to put up in order to convince a bank to write LoCs for regulatory collateral. For these reasons, the 2% fee estimate on the LoCs would appear wholly inadequate, particularly given the historically high failure rate of standalone suppliers together with the thinly capitalised business model that the CMA envisages could have applied over the Relevant Period.
  - (b) Second, the CMA’s fee estimate is based on just two isolated observations. It is therefore impossible to conclude that this provides a

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<sup>18</sup> PDR, Appendix 3.4, para.128

robust and reliable estimate of the fees that a standalone supplier of scale would need to pay in order to gain access to these LoCs.

- 2.19 For these reasons, the CMA has understated the costs of regulatory collateral faced by stand-alone suppliers in the Relevant Period.

**The allowance that the CMA has made for risk capital is not sufficient**

- 2.20 In its response to the PFs, SSE noted that energy supply businesses carry materially more risk than traditional retailers. The primary sources of risk are associated with volumetric risks, which comprise weather uncertainty, uncertainty around underlying household consumption volumes, and customer churn. These risks imply a need for a large standalone supplier to hold sufficient capital on its balance sheet to be able to sustain shocks.

- 2.21 The CMA has acknowledged this argument in the PDR, recognising that “*the retail supply of energy may entail a greater risk of incurring one-off losses as a result of shocks to the business than many other industries*” and that “*an energy supplier would wish to ensure that it had a reasonable level of resilience in the face of such shocks*”.<sup>19</sup> However, instead of making an allowance for the contingent capital needed for these purposes, the CMA has simply reclassified the cash balance in the working capital estimated for normal operational needs as risk capital. This is wholly inappropriate for the following reasons:

- (a) The 2% cash balance was already included in the capital base reported as part of the PFs, and was deemed to be the appropriate cash balance of a large standalone supplier for the operational needs to run the energy supply business without any regard to the need for risk capital. Arguing that this now serves the purpose of risk capital is ignores the fact that, when the capital is called on as risk capital the supplier would no longer have sufficient daily cash balance to run its business, which cannot be a viable position.
- (b) The estimate of 2% for the cash balance itself is not based on sound evidence. The CMA based this estimate solely on one of the many observations from the independent suppliers, namely Just Energy. However, the CMA has also been presented with the evidence that First Utility held an average cash balance that was approximately [ ]% of its cost of sales, while Ovo Energy held an average cash balance of around [ ]% of its cost of sales in 2015. It is clear that the CMA has based its estimate on selective evidence without sound justification.

- 2.22 Therefore, even though the CMA has now acknowledged the importance of risk capital, it remains the case that the CMA has significantly underestimated the provision for risk capital in its indirect detriment analysis.

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<sup>19</sup> PDR, Appendix 3.4, para.117

**The PDR does not address SSE’s previous comments about the CMA’s inadequate treatment of working capital**

- 2.23 As SSE has made clear in previous submissions,<sup>20</sup> in order to assess the capital required for the supply business in an economic sense, the CMA should reflect the need for contingent capital to meet possible peak requirements (of risk capital, trading collateral, regulatory collateral or negative working capital) over the Relevant Period.
- 2.24 The analysis of the materials made available in the second Disclosure Room for the response to the PFs shows evidence of extreme volatility in the CMA’s estimates of capital employed over time for each supplier.<sup>21</sup> As SSE noted in its response, this highlighted that suppliers must have capital to ensure they can meet peaks in capital requirements which can emerge quickly<sup>22</sup> - e.g. when the working capital balance moves to a net liability position. The analysis of SSE’s Authorised Advisers in response to the PFs indicates that when peak working capital is included in the capital base, the overall capital employed is more robust to the peak capital requirements of the business; and the resulting ROCE for SSE would fall substantially.<sup>23</sup>
- 2.25 The CMA has re-estimated the working capital requirement in the ROCE analysis in the PDR. However, despite SSE’s reasoned submissions, the only adjustment that the CMA has made is to take the average working capital position as opposed to year-end position used in the analysis in the PFs. The CMA analysis therefore continues not to capture the peak working capital requirements of a stand-alone retailer, as considered on a monthly basis.

**3. The CMA’s indirect cost “efficiency adjustments” are erroneous and do not meet the standards set by regulatory precedent**

- 3.1 The efficiency benchmarking undertaken by the CMA in the PDR is neither realistic nor robust, and the application of the results of this analysis to determine the scale of inefficiency is inappropriate. We find that:
- (a) the CMA has applied an extreme standard (the most efficient company) that is wholly disproportionate given the limitations of the underlying data and out of keeping with established regulatory precedent for this type of analysis;
  - (b) the indirect costs data that the CMA has relied on for its efficiency benchmarking analysis differ – in some cases materially – from the data that it has used for other aspects of its PDR analysis without justification;

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<sup>20</sup> SSE’s response to the CMA’s PFs, Annex 1, para.1.37

<sup>21</sup> SSE’s response to the CMA’s PFs, para.3.5.10

<sup>22</sup> SSE’s response to the CMA’s PFs, para.3.5.10

<sup>23</sup> SSE’s response to the CMA’s PFs, para.3.5.10

- (c) the analysis set out in the PDR makes no allowance for the fact that indirect costs inevitably rise and fall over the course of a supplier's investment cycle, and the justification that the CMA has provided for ignoring this fact is not sound;
- (d) the resulting range of indirect cost efficiency scores – of between approximately 50% and 100% – is simply too wide to be reasonably attributed to efficiency differences without a thorough assessment of the quality and comparability of the data and the assumptions underpinning the analysis, which the CMA has not undertaken.

3.2 We explain each of these findings in turn below.

**The CMA's inefficiency estimates are based on an extreme standard that cannot be supported by the underlying data and is inconsistent with established regulatory practice**

3.3 The CMA has based its higher-end estimates of inefficiency (*i.e.*, of £850 million) on a comparison of each supplier's unit costs relative to the supplier with the lowest reported unit costs. This is an extreme standard, which is inconsistent with the established practice of sector regulators and could only possibly be justified if the CMA had a clear and convincing basis in evidence to support that position. There are, however, material grounds for concern about the evidence upon which this benchmarking analysis is based (*e.g.*, in relation to the consistency of some of the information on indirect costs that suppliers have provided and the CMA's treatment of this information).<sup>24</sup>

3.4 In such circumstances, a cautious approach to interpreting the differences in the indirect cost data that the CMA has identified is more appropriate. At most, an assessment based on upper quartile performance would be appropriate. Indeed, in some circumstances (*e.g.*, where there is, as in the present case, some doubt about the consistency of some of the data on which the assessment is based) it is more appropriate to look at average performance in the sector.

**The indirect costs data that the CMA has relied on for its efficiency benchmarking analysis differ from the data that it has used for other aspects of its PDR analysis**

3.5 Our analysis of the data made available in the Confidentiality Ring indicates that the CMA has used different indirect cost data sets for its "direct" and "indirect" approaches to estimating detriment. The scale of these differences between the total indirect costs used across the two exercises ranges between [" "] and [" "] for [" "] and between [" "] and [" "] for [" "] over the 2012-14 period. The CMA has provided no justification for this apparent inconsistency.

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<sup>24</sup> See, *e.g.*, PDR Appendix 3.6, paragraphs 61, where it is suggested that some suppliers have updated their classification of indirect costs since the PFs. However, there appears to be no evidence in the PDR that the CMA has updated its indirect costs benchmarking analysis to take account of these changes.

**The CMA has not recognised that different suppliers passed through different stages in their investment cycles over the Relevant Period**

- 3.6 In its response to the PFs, SSE explained that it would expect to have lower unit indirect costs than other firms, as it is at a different point in its investment cycle for domestic customers relative to other suppliers. [“ ”].<sup>25</sup>
- 3.7 The CMA acknowledges this in the PDR, but claims that the period being considered is long enough for differences in timing of investment to even out. However, this is not factually correct: the investment cycle is longer than the period under consideration ([“ ”]). Consequently, the CMA’s approach lacks proper justification.

**The resulting range of indirect cost estimates across the six energy firms is simply too wide to be reasonably attributed to efficiency differences**

- 3.8 The variation in unit indirect costs among the six large energy firms is from £[“ ”] per customer to £[“ ”] per customer and the differential between them is [“ ”]%. This implies an efficiency range of approximately 50% to 100%. This is simply too wide a range to be reasonably attributed to efficiency differences without a thorough assessment of the quality and comparability of the data and the assumptions underpinning the analysis. As explained above, the CMA has not undertaken such an exercise in the PDR.
- 3.9 The CMA also draws attention to the stated intentions of the suppliers themselves to justify its claims regarding inefficiency. For example, it cites [“ ”]<sup>26</sup>; and [“ ”]<sup>27</sup>. However, [“ ”]. In addition, [“ ”]. Consequently, these statements do not provide any support for the scale of the indirect cost “efficiency adjustments” applied by the CMA in the PDR.

**The CMA has made a computational error in its calculation of the potential efficiency gains**

- 3.10 The CMA states that it has deflated the companies’ indirect costs using the CPI index, before calculating unit costs. This has been confirmed by SSE’s Authorised Advisers, who have reviewed the unit costs and underlying data presented in Appendix 3.5. However, when the CMA calculates the potential efficiency gains, for inclusion in the indirect detriment calculation, it appears simply to have used nominal costs.
- 3.11 This appears to be an oversight on the CMA’s part, since the primary reason for performing an inflation adjustment would be to remove the effect of general inflation on indirect costs, so that it is easier to identify true potential cost efficiency savings. On the basis of calculations carried out by SSE’s Authorised Advisors, it would appear that correcting this error would reduce the potential cost efficiency savings results by £308m over the whole period,

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<sup>25</sup> SSE response to provisional findings, Annex 1, p25, paragraph 1.75–1.79.

<sup>26</sup> PDR, Appendix 3.5, para.17(a).

<sup>27</sup> PDR, Appendix 3.5, para.17(c).

or equivalently £39m per annum (assuming all other parts of the calculation remain unchanged).

**Annex 2: Non-confidential version of submission of SSE's authorised advisers**

**Part 2: Evaluation of CMA's "direct approach" detrimental analysis**

# NON CONFIDENTIAL VERSION

## SUBMISSION OF SSE'S AUTHORISED ADVISERS

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Evaluation of CMA's "direct approach"  
detriment analysis

7 April 2016



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# 1 EXECUTIVE SUMMARY

- 1.1.1 This paper is a non-confidential submission by SSE plc's Authorised Advisers on the basis of the Energy Market Investigation Confidentiality Ring held between 17 March and 7 April 2016, following the publication of the CMA's Provisional Decision on Remedies ('*PDR*'). It provides an assessment of the CMA's so-called "direct approach" to establishing and quantifying customer detriment on the basis of the Authorised Advisers' review of the material made available in the Confidentiality Ring. The "competitive benchmark" price produced by using this analysis also forms the basis of the CMA's proposed price cap for prepayment meter ('*PPM*') customers.
- 1.1.2 The CMA's "direct approach" detriment analysis involves two stages:
- a. first, the CMA identifies the prices offered by what it considers to be the "most competitive suppliers" in the market;
  - b. second, the CMA adjusts these prices for "exogenous cost differences" relating to network costs and the costs associated with different payment methods "to ensure the comparison is on a broad like-for-like basis". This produces a "competitive benchmark price" that the CMA compares to the prices offered by the six largest energy firms (collectively the '*SLEFs*') in order to estimate the level of detriment resulting from "excessive prices" charged by these six firms.
- 1.1.3 In summary, the information made available through the Confidentiality Ring confirms that both of these stages of the CMA's analysis contain significant errors of fact and assessment. Consequently the CMA's "direct approach" to establishing and quantifying detriment does not reliably establish to the required legal standard that the prices charged by the six large energy firms during the Relevant Period were excessive.
- 1.1.4 The **first stage** of the CMA's analysis is undermined by the following errors of fact and assessment.
- a. While the CMA is required to conduct its assessment against the benchmark of a "well-functioning market", its analysis is instead founded on an idealised perfectly competitive market in which:
    - i. competition focuses solely on price;
    - ii. large and small suppliers alike face no capacity constraints; and
    - iii. customers can switch in unlimited numbers without affecting the market price.

The CMA has previously explicitly recognised that these assumptions are unrealistic in the context of the GB energy retail market, and yet they are fundamental tenets of the detriment analysis that the CMA has presented in the PDR. Applying a genuinely realistic "well-functioning" energy market as a benchmark, as the CMA is required to do, would substantially reduce the CMA's detriment estimate.

- b. The CMA's 'competitive benchmark' is based on a weighted average of the prices offered by only two suppliers, Ovo Energy ('**Ovo**') and First Utility. However:
    - i. An analysis of the available data provides clear evidence that the prices charged by at least one of these suppliers – Ovo – are simply too low to be sustainable. The CMA argues that – notwithstanding Ovo's substantial losses – Ovo's prices are sustainable because the firm's customer acquisition costs will decline over time. However, this assumes that Ovo's customer base will become less active as it grows – meaning that Ovo would have to fight less hard to retain existing customers – which would be inconsistent with the counterfactual market the CMA is attempting to approximate with Ovo's current prices. Our analysis of the evidence made available in the Confidentiality Ring indicates that Ovo would have needed to increase its prices substantially over the Relevant Period – without losing any customers – to have earned a margin that would be sustainable.
    - ii. [ ] only accounted for only a very marginal part of the market (only [ ]% of single fuel electricity and [ ]% single fuel gas customers during the years covered by the CMA's analysis). This sample size is simply too small to generate a reliable "competitive benchmark" price for single fuel customers. Moreover, there is no evidence that [ ]'s financial position would be sustainable if a larger number of customers used these tariffs.
- 1.1.5 The **second stage** of the CMA's analysis, which adjusts for "exogenous cost differences" relating to payment method and network costs, contains further errors of fact and assessment that significantly compound those made at the first stage. Because of this, the CMA's analysis does not provide a firm basis on which either to measure detriment or set the proposed price cap for PPM customers. The errors fall into three categories.
- a. Much of the input data that the CMA has relied on to inform its analysis is unreliable and inconsistent – the CMA has itself acknowledged this, and yet does not appear to have made any allowance for this either in its detriment analysis or when calculating the proposed PPM tariff cap.
  - b. A number of the critical assumptions that underpin the CMA's analysis are inappropriate, given the lack of reliable data, and other assumptions are either not explained and/or not supported by the available evidence (either within the PDR and its appendices or within the information made available through the Confidentiality Ring).
    - i. In particular, in relation to the adjustment made for PPM customers:
      - there is no basis in evidence to place undue weight on the observed cost differentials of two individual firms, [ ] and [ ], when it is clear that the reported costs of individual firms vary to a very considerable extent;
      - similarly, no reliance can be placed on the CMA's bottom-up exercise given the arbitrary and inconsistent way in which it has been constructed – for example, the CMA has summarily dismissed

potentially relevant costs actually incurred by suppliers without adequate justification.<sup>1</sup>

- ii. In relation to the adjustment for the cost to serve standard credit customers, the PDR similarly places undue weight on the observed cost differential of a single firm, [ " ], when the data is insufficiently robust to allow this. In addition, the CMA's bottom-up approach makes an entirely unreasonable assumption regarding the efficient level of bad debt, which is not substantiated by any evidence, and assumes a number for debtor days that is not achieved by any of the six large energy companies.
- c. We have identified a number of factual inaccuracies and errors in the CMA's calculations, relating to both its network cost estimates and its estimate of the incremental cost to serve PPM customers.

We describe and explain the errors under each of these headings in the main body of our report.

1.1.6 Collectively, these errors materially undermine the CMA's analysis in two key ways.

- a. First, the CMA has systematically understated the incremental cost associated with serving both PPM and Standard Credit ('**SC**') customers.
  - i. The CMA has assumed that the incremental cost of serving a PPM customer (relative to a direct debit ('**DD**') customer) is £54. However, after correcting for the errors described above, a more realistic and robust estimate would be at least £76.
  - ii. Similarly, the CMA has assumed that the incremental cost of serving a SC customer (relative to a DD customer) is £82. However, after correcting for the errors described above, a more realistic and robust estimate would be at least £99.
- b. Second, the CMA has not applied the correct network costs, further undermining the reliability of its results.

1.1.7 We have not been able to correct for all of the errors of fact and assessment that we have identified on the basis of the information made available in the Confidentiality Ring. However, it is clear that even addressing a subset of these errors has the effect of substantially reducing the estimated level of detriment. For example, we have re-run the CMA's detriment analysis with the three following changes:

- i. applying an uplift to Ovo's bills that is sufficient to bring its overall EBIT margin closer to that earned by First Utility, which the CMA considers to be sustainable;
- ii. using a £76 incremental cost to serve PPM customers (rather than £54); and
- iii. using a £99 incremental cost to serve standard credit customers (rather than £82).

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<sup>1</sup> See, for example, CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 86(c).

1.1.8 These three changes alone substantially reduce the estimated level of domestic customer detriment from £1.7 billion to approximately £0.8 billion. This estimate is still likely to overstate the level of detriment because:

- i. the uplift we have applied to Ovo's bills would – at most – only allow Ovo to have achieved an EBIT margin in the region of [" ]% over the period covered by the CMA's analysis, but for reasons explained by SSE in previous submissions, the available evidence clearly indicates that a [" ]% margin would itself be unsustainably low;
- ii. the incremental costs to serve PPM and standard credit customers that we have used are still conservative estimates; and
- iii. no adjustments have been made to correct the errors we have identified with regard to the calculation of network costs.

1.1.9 For these reasons, the CMA's analysis does not provide a robust and reliable basis on which either to measure customer detriment or set the proposed price cap for PPM customers because it materially overstates the alleged level of detriment and therefore underestimates the appropriate level of the proposed cap.

## 2 ANALYSIS OF CMA'S CHOICE OF COMPETITIVE BENCHMARK

2.1.1 The first stage of the CMA's 'direct' analysis of consumer detriment is based on comparing the average prices charged by the Six Large Energy Providers to a hypothetical 'competitive benchmark', which consists of a weighted average of Ovo and First Utility tariffs. This 'competitive benchmark' also forms the basis of the price cap for PPM customers. Our analysis of the CMA's choice of competitive benchmark, based on the materials in the Confidentiality Ring, points to two conclusions:

- a. **First, the CMA has chosen an inappropriate theoretical standard against which to benchmark the market.** While the CMA is required to conduct its assessment against the benchmark of a "well-functioning market", its analysis is founded on the relevant benchmark for quantifying detriment being an idealised perfectly competitive market. Focusing on a genuinely realistic "well-functioning" energy market as a benchmark would substantially reduce the CMA's detriment estimate.
- b. **Second, the CMA's choice of benchmark suppliers is inappropriate.** An analysis of the available data provides clear evidence that the prices charged by at least one of these suppliers – Ovo – are simply too low to be sustainable. Moreover, the sample size of the First Utility tariffs is too small to generate a reliable competitive benchmark price for single fuel customers. Adjusting the "competitive" benchmark to reflect prices that can more reliably be described as sustainable would reduce the CMA's detriment estimate further.

2.1.2 We explain each of these conclusions in turn.

### 2.2 The CMA has chosen an inappropriate theoretical standard against which to benchmark the market

2.2.1 As noted above, the CMA is required to conduct its assessment against the benchmark of a "well-functioning market". The CMA recognises that this is the applicable legal standard in the PDR, in which it reiterates that "*a 'well-functioning market' is one that displays the beneficial aspects of competition, notably rivalry between firms which seek to win customers' business through lower prices, improved quality or variety and/or introducing new or better products. It is **not an idealised perfectly competitive market.***"<sup>2</sup> [Emphasis added.]

2.2.2 However, for the purposes of its calculation of the 'competitive benchmark', the CMA has assumed that all suppliers must price *exactly* at the current level of the two cheapest mid-tier suppliers (Ovo Energy and First Utility). This means that any price differential relative to this benchmark is counted as consumer detriment.

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<sup>2</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.152

2.2.3 This approach is only valid under an idealised perfectly competitive market characterised by:

- a. homogenous goods;
- b. no capacity constraints; and
- c. a perfectly elastic supply curve.

Only under these conditions would prices be expected to be identical in equilibrium, and equilibrium prices to equal the lowest prices found in the current market. Put differently, in order to justify its approach it has taken, the CMA must assume that:

- a. suppliers compete only on price;
- b. the cheapest suppliers could accommodate any number of customers who wanted to switch (thereby putting pressure on other suppliers to lower prices to the same level); and
- c. that an increase in customers switching would not raise market prices.

2.2.4 The evidence that the CMA has adduced in its investigation does not justify these assumptions. On the contrary, the available evidence indicates that these are not valid assumptions.

- a. **The available evidence does not indicate that suppliers compete only on price.** SSE has previously drawn the CMA's attention to the significant body of evidence that clearly demonstrates that, for many customers, quality of service also plays an important role in determining the choice of supplier. For example, in the CMA's own customer survey, more than a fifth (22%) of customers did not consider prices to be very important when choosing an energy supplier.<sup>3</sup> Further, a significant proportion of customers considered non-price factors to be essential or very important, including customer service (83%), brand (30%) and other services provided such as boiler maintenance (25%).<sup>4</sup> Based on the available evidence, competition takes place along more than one dimension, which means that there is no reason to expect suppliers to match each other exactly on price in a well-functioning market.<sup>5</sup>
- b. **The CMA's assumption of no capacity constraints is not supported by the available evidence.** For this assumption to hold, the cheapest suppliers must be able to accommodate any customers wishing to switch, thereby forcing all other suppliers to lower their prices to the same level at the threat of losing their customers. This is inconsistent with the evidence: the two 'benchmark' suppliers combined account for [" "]% of dual fuel, [" "]% of electricity, and [" "]% of gas customers across the years considered. Although these suppliers have seen their customer numbers grow in recent years, the CMA has provided no evidence to support the proposition that the suppliers in

<sup>3</sup> GfK, *Energy Market Investigation: A report for the Competition and Markets Authority by GfK NOP*, February 2015, Figure 31, p.35.

<sup>4</sup> Ibid.

<sup>5</sup> Note that we are not arguing that energy is a particularly heterogeneous product. However, for the CMA's analysis to hold, energy has to be *perfectly homogeneous*, which is clearly not the case. Therefore it is not the case that any price differential can be counted as consumer detriment.

question could continue to accommodate substantial increases in customers on the basis of their existing business models.

- c. **The CMA's assumption that increases in switching volumes would not affect market prices explicitly contradicts its previous statements on this issue.** The CMA's benchmarking approach assumes that a large increase in customer switching volumes would not affect the equilibrium price, but instead that the price would remain at the *current* price level of the two cheapest mid-tier suppliers. This is only possible under a perfectly elastic supply curve – a strong assumption for which the CMA has provided no evidence. In fact, in the Gains from Switching working paper published in February 2015, the CMA explicitly states:

*“We do not consider that the result of our analysis can be relied upon to measure aggregate welfare loss. This is because **equilibrium prices in the retail gas and electricity markets would be likely to change if all customers who are currently paying higher prices switched.**”*<sup>6</sup> [Emphasis added.]

Despite this, the CMA has now used the same approach that it has used to inform its Gains from Switching analysis to calculate consumer detriment. The CMA has not explained why it has now chosen to ignore the wholly valid concerns that it previously expressed about adopting such an approach.

## 2.3 The CMA's choice of benchmark suppliers is inappropriate

- 2.3.1 The CMA's 'competitive benchmark' is based on a weighted average of only two suppliers, Ovo and First Utility. Both suppliers are relatively recent entrants in the market, and only accounted for a small share of the market during the period covered by the CMA's analysis ([•] % across the years considered – see Exhibit 1 below).

**Exhibit 1. 'Benchmark' suppliers as percentage of all accounts**

	All years	2015
Electricity	[ " ]	[ " ]
Gas	[ " ]	[ " ]
Dual fuel	[ " ]	[ " ]
<b>All</b>	[ " ]	[ " ]

- 2.3.2 These observations point to two questions:

- a. First, can the CMA be confident that the prices charged by these two suppliers are sustainable – or does the available evidence suggest that these

<sup>6</sup> CMA, *Energy Market Investigation: Analysis of the potential gains from switching*, February 2015, Paragraph 6.

suppliers are currently setting prices at unsustainably low levels with a view to establishing a foothold in the market and growing their business?

- b. Second, do these two suppliers provide a sample size large enough to generate a robust and reliable set of benchmark prices?

2.3.3 **The available evidence clearly indicates that Ovo's prices were unsustainable during the period of study.** Ovo has been making sustained losses over these years, including a loss of £33 million in 2014.<sup>7</sup> The CMA argues that despite these losses, Ovo's pricing is sustainable because customer acquisition costs are likely to fall in the next few years, as the *"rate of customer acquisition naturally declines"*.<sup>8</sup> The CMA's reasoning on this point is not sound nor realistic.

2.3.4 Significantly, the CMA has selected its 'benchmark' suppliers precisely on account of their share of what it considers to be active customers:

*"For the purpose of choosing our competitive benchmark we have **focused on suppliers whose average prices best reflects prices paid by active customers** as we expect those customers to be on competitively priced tariffs."*<sup>9</sup>  
[Emphasis added.]

2.3.5 The CMA goes on to claim, however, that Ovo's prices can only be sustained if its customer acquisition rate falls.<sup>10</sup> This assumes that Ovo's customer base will become less active as it grows – meaning that the Ovo would have to fight less hard to retain existing customers – which would not be the case in the well-functioning market that the CMA is applying as its benchmark (or would make Ovo unsuitable for benchmarking purposes in the CMA's view).

2.3.6 For these reasons, it is clear that the CMA must scale up Ovo's prices to a level that would have been sustainable during the period of study if these are to be used as a benchmark for the purposes of its detriment analysis.

2.3.7 We have therefore used the information made available in the Confidentiality Ring to attempt to estimate what the likely size of this uplift should be. Our estimates are based on the following methodology.

- a. First, we replaced Ovo's actual customer acquisition costs with the average amortised customer acquisition costs of the SLEFs (as per the CMA's ROCE analysis) in order to understand the financial performance of Ovo absent the effect of its rapid growth in customer numbers.
- b. Second, we made the same adjustment to First Utility's data to understand its financial performance absent the effect of any significant growth in its customer numbers.

<sup>7</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.195.

<sup>8</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.196. We note that the CMA also cites that Ovo may benefit from potential economies of scale as it grows as another reason why it may be able to earn greater profits without increasing its prices. However, the CMA provides no evidential support for this proposition.

<sup>9</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.168.

<sup>10</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.196.

c. Finally, we estimated the revenue uplift that Ovo would need to achieve in order for its EBIT margin over the period 2011 to 2014 to be at a similar level to First Utility's.<sup>11</sup>

2.3.8 The results of this analysis indicated that, Ovo's revenue would need to increase by at least [" ]% in order for it to match the financial performance of First Utility (which the CMA considers to be sustainable). This level of revenue increase would result in Ovo achieving an EBIT margin of [" ]% over the period 2011 to 2014. We note that the CMA argues that a 1.5% margin would be consistent with the sustainable levels of margin implied by its ROCE analysis.<sup>12</sup> However, for the reasons that SSE has outlined in its main PDR response paper, the CMA's ROCE analysis suffers from a number of material errors of fact and assessment that have led it to overstate the ROCE of the SLEFs, which will mean that the CMA has underestimated what would be a sustainable EBIT margin.

2.3.9 If Ovo raised its prices it would be expected to lose a proportion of its customers. This suggests that any price rise (in percentage terms) would be different to required increase in revenue (in percentage terms). However, as we have no information on price elasticity of demand for Ovo's customers, we have assumed that Ovo would need to increase its prices by the same percentage as any required increase in revenue.

2.3.10 On the basis of this assumption, a price increase of [" ]% would have been required to enable Ovo to achieve a margin of [" ]%. On the basis of the information made available through the Confidentiality Ring, we have estimated that scaling up Ovo's prices by this amount single-handedly reduces the estimated level of detriment by approximately £0.7 billion (see Section 4 below for further information). Moreover, we consider this to be a highly conservative estimate, since margin benchmarking evidence previously submitted by SSE clearly demonstrates that a [" ]% margin would not be sustainable.<sup>13</sup>

2.3.11 An alternative to scaling up Ovo's prices to a sustainable level would be to remove Ovo from the CMA's set of benchmark tariffs altogether. However, this would mean that the CMA's competitive benchmark would be based solely on the tariffs set by First Utility. This would give rise to sample size difficulties, [" ].

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<sup>11</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.193.

<sup>12</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.193.

<sup>13</sup> See, for example, SSE: *Response to Provisional Findings*, 5 August 2015, pp.33-35.

**Exhibit 2. [ " ] [ " ] accounts**

	Total accounts			% of all accounts		
	Electricity non-E7	Electricity E7	Gas	Electricity non-E7	Electricity E7	Gas
Q1 2012						
Q2 2012						
Q3 2012						
Q4 2012						
Q1 2013						
Q2 2013						
Q3 2013						
Q4 2013						[ " ]
Q1 2014						
Q2 2014						
Q3 2014						
Q4 2014						
Q1 2015						
Q2 2015						
<b>Total</b>						

2.3.12 For these reasons, it would not be appropriate to use First Utility as a benchmark on its own. However, if the CMA were to focus solely on First Utility, it would need to focus on its [ " ] (for which the available sample size is slightly larger). This approach would again substantially reduce the estimated level of ‘detriment’:

- a. excluding Ovo from the competitive benchmark, for [ " ], the estimated level of ‘detriment’ would fall by over £300 million, that is, by 26% (as Exhibit 3 below shows);
- b. extrapolating to all fuel types implies that excluding unsustainable suppliers from the ‘competitive benchmark’ calculations could reduce the overall annual average ‘detriment’ by over £400 million, from £1.7 billion to £1.3 billion.

**Exhibit 3. Average annual detriment including and excluding Ovo**

	CMA	Excluding Ovo
Total	1,185	882
As % of CMA estimate	100%	74%

### 3 ADJUSTMENTS TO PRICE BENCHMARK FOR EXOGENOUS COST DIFFERENCES

- 3.1.1 The second stage of the CMA's analysis adjusts the competitive price benchmark derived from the weighted average DD prices of First Utility and Ovo to reflect "exogenous cost differences" facing other suppliers. There are three such adjustments considered necessary by the CMA, namely:
- i. cost differences for PPM customers;
  - ii. cost differences for SC customers; and
  - iii. differences in network costs dependent on the location of suppliers' customers.
- 3.1.2 The proposed adjustments set out in Appendix 3.3 and 3.6 of the PDR are not a robust and reliable basis for reaching the conclusions drawn by the CMA on the level of detriment existing or for setting a price cap. This is because the CMA's analysis set out in these Appendices contains further errors of fact and assessment that result in the alleged detriment being materially overstated, compounding the errors described in the previous section.
- a. The assessment of the higher cost for PPM customers relative to DD customers places inappropriate weight on cost differentials for two firms where there are obvious reasons why the data for these firms is not representative of what an "efficient" supplier could be expected to achieve. In addition, the CMA places undue weight on a bottom up exercise that contains material errors and has not been validated. The result is that the CMA has markedly understated the cost to serve differential for PPM customers relative to an appropriate assessment of the available evidence. In our view, an uplift of at least £76 per dual fuel account would be more appropriate than the £54 used by the CMA.
  - b. The assessment of the higher cost for SC customers relative to DD customers contains arbitrary assumptions regarding bad debt and debtor days, which are used in place of actual data from the suppliers and without any evidential support regarding the applicability of these alternative assumptions. Furthermore, the CMA seeks to make these adjustments to reflect the costs incurred by an efficient supplier, but fails to recognise that any inefficiency associated with bad debt and debtor days operates, in fact, to the benefit of consumers. Seeking to correct for a perceived inefficiency in the costs of serving SC customers should therefore correctly be viewed as a transfer of value from customers to the SLEFs, and these adjustments should not form part of the detriment calculation (as that inefficiency would ultimately "benefit" customers). The CMA has also materially understated the cost differential for SC customers, which instead should be informed by the average level of the cost differential observed for the SLEFs of at least £99 per account.
  - c. The CMA's network costs analysis includes a number of material factual errors relating to both calculations and inputs, and the results in places differ

substantially from SSE's own view of what these figures should be. Given the tightly binding price cap envisioned by the CMA, and the significant differences in network costs between regions, it is essential that these calculations are carried out correctly.

- 3.1.3 The sections that follow provide a more detailed explanation of each of the three errors raised above, with reference to the materials that we have reviewed in the Confidentiality Ring.

## 3.2 Adjustment for PPM customers

- 3.2.1 The CMA's conclusion regarding the higher costs for PPM customers relative to DD customers rests on four pieces of evidence:
- a. an analysis of the average cost differential across the SLEFs;
  - b. the differential for [" ],
  - c. the differential for Utility Warehouse, the mid-tier supplier with the largest number of PPM customers; and
  - d. the CMA's own bottom up analysis.<sup>14</sup>
- 3.2.2 The table below summarises how the CMA has used this analysis, and how we would interpret it.

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<sup>14</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 88.

**Exhibit 4. Summary of the CMA's evidence on PPM/DD cost differential**

	<b>CMA interpretation</b>	<b>Frontier interpretation</b>
An analysis of the average cost differential across the SLEFs	Yields a total cost differential of <b>£62.30</b> , <sup>15</sup> although this is not necessarily the most efficient cost of performing these activities.	Given the quality of the cost data, averaging SLEF figures will provide a more robust estimate of cost differentials than relying on a single estimate for a single firm. However, the CMA has made certain arbitrary adjustments to reported costs, which cannot be supported by the evidence available. Without these adjustments, we obtain a total cost differential of <b>£76.41</b> .
The cost differential observed for [" ]	Yields a total cost differential of <b>£54.01</b> . <sup>16</sup> As the minimum SLEF differential, this can be regarded as an efficient benchmark.	The low differential is caused by high DD costs for [" ] and not efficiency. [" ] has the highest cost to serve DD customers (of the SLEFs) and a cost to serve PPM customers that is "in the pack". A more consistent way of assessing the uplift would be to look at the differential for the SLEF that is most efficient in serving both DD and PPM customers ([" ]), yielding <b>£90.76</b> . However, while we understand that using a single firm is not an approach to be recommended for obtaining a robust central estimate, we believe this is an important indicator of where the efficient level of differentials may lie.
The cost differential observed for Utility Warehouse	Yields a total cost differential of <b>£41.61</b> . <sup>17</sup>	The Utility Warehouse data contains obvious inconsistencies (in particular in relation to sales and marketing) that would suggest it is not an appropriate benchmark for the SLEFs. These have not been investigated by the CMA in the same way that inconsistencies in the data have been investigated for the SLEFs and adjustments made. For both this reason and the other reasons explained below, <b>no weight should be placed on this analysis.</b>
The CMA's own bottom-up analysis	Produces a total cost differential range of <b>£50 - £66</b> . <sup>18</sup> The CMA has chosen a point estimate that falls almost at the bottom of this range.	The bottom-up analysis contains numerous errors of fact and analysis, and inconsistencies, many of which will bias this analysis to producing a low figure. <b>No weight should be placed on this analysis.</b>

Source: Appendix 3.6, PDR.

Note: Frontier Analysis.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid.

- 3.2.3 As summarised in the table, there are material errors of fact and assessment associated with the CMA's analysis concluding that an appropriate uplift in the cost to serve PPM customers is £54. Taking a more accurate view of the available evidence would suggest an overall cost differential of at least **£76.41** (£28.79 for electricity, and £47.62 for gas) is the most justifiable figure. In particular:
- a. Given the limitations of the data provided by the SLEFs and other suppliers, the most robust estimate is likely to be one that averages across a number of sources, particularly in the light of the fact that the CMA has provided no evidence to suggest inefficiency in the costs of serving PPM customers.
  - b. The efficient cost differential may be even higher. When comparing the lowest DD and PPM costs across the SLEFs (both [" "]), we obtain a differential of £90.76. This suggests the £76.41 is conservative. While we understand that using a single firm is not an approach to be recommended for obtaining a robust central estimate, we believe this is an important indicator of where the efficient level of differentials may lie.
  - c. Although this figure is somewhat above the "high end" of the CMA's bottom-up analysis (of £66), this is likely to reflect the significant flaws in that analysis that are described below.
  - d. We believe that it is inappropriate to compare this figure to either [" "] (which has a low price differential due to [" "] rather than efficiency) or [" "] ("[" "]), and includes implausible data that the CMA does not appear to have investigated).
- 3.2.4 We discuss each of these four points below.

### Analysis of PPM cost data from the SLEFs

- 3.2.5 The CMA raises a number of concerns with the data that it has received from the SLEFs regarding the costs of serving customers using different methods of payment.<sup>19</sup>
- 3.2.6 The most appropriate way to work with the data given these inconsistencies is to draw on a wide range of suppliers' data. This will unambiguously provide a more robust assessment of the cost to serve differential for PPM customers than picking data points from individual suppliers, such as [" "] and [" "] where it cannot be substantiated that the cost differentials of these firms are at the "efficient" level.
- 3.2.7 The CMA suggests that the average level of the PPM differential for the SLEFs cannot be relied upon for the following two reasons, neither of which is supported by the available evidence.
- a. First, the CMA claims that "...[the average differential] *is not necessarily the efficient cost of performing these activities*".<sup>20</sup> The CMA provides no evidence to substantiate this point. As evidenced elsewhere, SSE strongly rejects any

<sup>19</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraphs 49 to 63.

<sup>20</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 88.

suggestion that it is not operating at an efficient level of costs. Moreover, notwithstanding this, any inefficiencies would be expected to increase both the level of costs incurred for direct debit and PPM customers any effect on the cost differential would, at most, be second-order.

- b. Second, the CMA states that “...one of the mid-tier suppliers that is comparable (Utility Warehouse) reports a much lower cost differential.”<sup>21</sup> Using a single firm to cast doubt on average figures derived across six firms is not appropriate given the data quality issues that the CMA has described in relation to the cost data. Moreover, for the reasons described below, there are obvious inconsistencies between the cost data for Utility Warehouse and those of the SLEFs that make Utility Warehouse an inappropriate benchmark.

3.2.8 On the basis of the information provided in the Confidentiality Ring, we believe that the CMA has made material errors of fact and assessment in attempting to adjust the cost data for the SLEFs, which has resulted in the alleged level of detriment being materially overstated. In particular:

- a. Rather than using the £29.49 differential in gas metering costs that is implied by the data, the CMA has used a £23.97 figure, derived from published National Grid charges.<sup>22</sup> National Grid is just one Meter Asset Manager (MAM) among 32,<sup>23</sup> and its charges are not necessarily reflective of the broader market. Moreover, the CMA does not explain why all of the SLEFs would incur additional costs above £23.97 if it is possible to achieve gas metering costs at this level. In seeking to benchmark costs, it is not appropriate to choose a benchmark that is not obtained by any supplier.
- b. The CMA has excluded the differentials reported by a number of the SLEFs for both sales and marketing and certain central overheads. In each case this has been done without the CMA providing any reasoning or evidence to support its position.<sup>24</sup> Different suppliers will vary in their cost structure and, if the CMA believes that the actual figures provided by a supplier are not reasonable, the onus should be on the CMA to justify why this is not the case.

3.2.9 Adding back in these charges, we find that the average difference between the cost to serve PPM and DD customers across the SLEFs (excluding RWE<sup>25</sup>) is:

- i. £28.79 for electricity (cost to serve £13.07 + metering £18.36 – bad debt associated with DD £2.64)
- ii. £47.62 for gas (cost to serve £20.69 + metering £29.49 – bad debt associated with DD £2.56).

<sup>21</sup> Ibid.

<sup>22</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 69.

<sup>23</sup> See: <http://www.lr.org/en/energy/utilities-and-building-assurance-schemes/spaa-meter-asset-managers-registration-scheme/mamcop-search.aspx>.

<sup>24</sup> In paragraph 86, the CMA asserts that it considers that “general sales and marketing activity is most reasonably applied evenly across the customer base”, but gives no evidence for this. It also asserts that other central overheads should not vary by payment type, but again provides no evidence to support this assertion.

<sup>25</sup> [“ ”]. See CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 68.

- iii. £76.41 in total (cost to serve £33.76 + metering £47.85 – bad debt associated with DD £5.20).

### The differential in PPM/DD costs for [" ]

- 3.2.10 [" ] is the supplier amongst the SLEFs that reports the lowest differential in the cost of serving a PPM and a DD customer.<sup>26</sup> The CMA therefore considers that the data supplied by [" ] can be used to inform its analysis of the differential cost of serving PPM and DD customers for a cost-efficient supplier.<sup>27</sup>
- 3.2.11 The conclusion is based on a false premise. Unless the CMA is able to satisfy itself that the costs reported by [" ] for serving DD and PPM customers are in and of themselves at an efficient level, it cannot logically conclude that the difference between them represents the level that would be achieved by a cost-efficient supplier. In fact, the data contained in the Confidentiality Ring shows that [" ] is the least efficient (i.e. highest cost) SLEF supplier, by some margin, in serving DD customers, and ranks more closely alongside other SLEF suppliers for the costs of serving PPM customers. The low PPM/DD differential for [" ] therefore indicates its comparatively high costs for serving DD customers rather than any superior efficiency in serving PPM customers.
- 3.2.12 Specifically, data in the Confidentiality Ring shows that [" ] has:
- a. the highest DD costs of the SLEFs, both for electricity (£67.49 compared to the minimum cost of £47.44 obtained by [" ]) and for gas (£79.78 compared to the minimum cost of £53.05 obtained by [" ]);<sup>28</sup>
  - b. average PPM costs. [" ]'s £90.81 for electricity is the third highest of the SLEFs (with [" ] again lowest), while its gas PPM costs of £110.47 are the third lowest (after [" ] and [" ]).<sup>29</sup>
- 3.2.13 The CMA cannot therefore reasonably conclude that using [" ]'s differential represents the differential that should be achievable by an efficient supplier.
- 3.2.14 An alternative method of characterising the efficient cost differential from the SLEF data, which is not subject to these difficulties, would be to consider the cost differential on a consistent basis, always comparing the costs of the most efficient firms. This method yields:
- a. an electricity differential of £25.01 (the difference between [" ]'s PPM and DD costs);<sup>30</sup>
  - b. a gas differential of £52.63 (the difference between [" ]'s PPM and [" ]'s DD costs);<sup>31</sup>

<sup>26</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 88.

<sup>27</sup> Ibid.

<sup>28</sup> See "Summary" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>29</sup> Ibid.

<sup>30</sup> Frontier analysis of "Summary" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>31</sup> Ibid.

- c. a total differential of £77.64 (when calculated as the sum of electricity and gas differentials); and
- d. a total differential of £90.76 (when calculated – as the CMA have done for [" ] – on combined gas and electricity costs, and taking the difference between [" ]'s PPM and DD costs).

### The differential in PPM/DD costs for Utility Warehouse

3.2.15 The CMA cites the data provided by Utility Warehouse on the cost of supplying its PPM and DD customers as supportive of its findings.<sup>32</sup> Specifically, the CMA concludes that the differential of £41.61 reported by Utility Warehouse indicates that it has been conservative in using a value of £54 per customer to reflect the additional cost of serving a PPM customer.

3.2.16 There are four material flaws with this approach:

- a. First, as discussed above, the CMA raises significant concerns regarding the quality of the data reported. Given this, the CMA should place less emphasis on results from one supplier (Utility Warehouse) than on the averaged results for the SLEFs. The fact that one observation lies outside the average cannot be used to question whether the average is correct, certainly not without detailed scrutiny of the single firm in question.
- b. Second, the information available on Utility Warehouse's customer numbers suggests that any comparison of its costs with the SLEFs should be interpreted extremely cautiously. Utility Warehouse has an extremely small number of PPM customers (just over [" ] across both electricity and gas) – small in both absolute terms, and in relative terms, with a much lower proportion of its customer base on PPM ([" ]%) than the market as a whole (16%).<sup>33</sup>
- c. Third, our examination of the Utility Warehouse data has uncovered the following potential flaws in the data, which the CMA appears not to have investigated:
  - i. unlike all of the SLEFs (which report sales and marketing costs per PPM customer at the same or a higher level than for DD customers), Utility Warehouse reports no sales and marketing costs for these customers.<sup>34</sup> Given the [" ]<sup>35</sup> in Utility Warehouse's [" ] (albeit from low levels), it seems inconceivable that no sales and marketing costs would be allocated to these customers, despite the fact that many customers are signed up via partnerships.
  - ii. Utility Warehouse's gas metering costs are implausibly low, particularly for PPM meters. In 2014, they report total gas metering costs of £[" ] per

<sup>32</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 88.

<sup>33</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 35.

<sup>34</sup> See "UW A" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>35</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 47.

customer per year for these meters.<sup>36</sup> This is far below the £37.84 annual rental payment charged by National Grid<sup>37</sup> and almost three times less than the lowest reported figure from the SLEFs (£[" ], from [" ]).<sup>38</sup>

The fact that the CMA appears not to have investigated these issues to attempt to achieve comparability (as it has done for the SLEFs), despite knowing that there are considerable difficulties in ensuring consistency of the data from different suppliers, represents a material error in its assessment.

- d. Finally, and contrary to the CMA's statement that "...the differential costs of metering and payment [for Utility Warehouse] should be of direct comparison to the Six Large Energy Firms",<sup>39</sup> Utility Warehouse's business model seems sufficiently different so as to imply a lack of comparability. We note that this conclusion is consistent with the view expressed elsewhere in the PDR by the CMA, which explains the way in which the Utility Warehouse business model (which will affect its cost structure) differs from the SLEFs:

*"Utility Warehouse acquired the majority of its existing customers through a deal with RWE npower rather than acquiring them through competition by offering keenly priced tariffs in the way Ovo Energy and First Utility have done. We also note that Utility Warehouse does not advertise its tariffs through PCWs where customers can compare and identify the most competitively priced tariffs. Instead, it works in a partnership with independent (and part-time) distributors (known as 'Partners') who receive a small share of the revenues from each new customer they introduce. Another reason as to why Utility Warehouse may not be suitable for our benchmark is because their business model is focused on providing bundled services (energy and telecoms). It would therefore be more difficult for us to compare on a like for like basis their prices with those of the Six Large Energy Firms."*<sup>40</sup>

- 3.2.17 For all these reasons, the CMA should place no weight on the Utility Warehouse results.

## The CMA's bottom up analysis

- 3.2.18 The results of the CMA's bottom analysis of the differential cost between serving PPM and DD customers is set out in Table 6 of Appendix 3.6 of the PDR. This is reproduced in the table below.

<sup>36</sup> See "UW A" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>37</sup> National Grid metering charges from 01 April 2014.

<sup>38</sup> [" ].

<sup>39</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 47.

<sup>40</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Paragraph 3.171.

**Exhibit 5. The CMA's bottom up analysis of PPM/DD differentials**

Item	Electricity		Gas		Total	
	Low	High	Low	High	Low	High
Cost to serve						
Bad debt						
NTS payment						
PPMIP						
Meter rental				[ " ]		
Meter maintenance						
Meter installation						
Meter reading						
<b>Total</b>						

Source: Table 6, Appendix 3.6. PDR

3.2.19 It seems inconsistent for the CMA to have attempted to conduct a bottom-up analysis that relies on having access to accurate, highly disaggregated cost data, when a substantial proportion of Appendix 3.6<sup>41</sup> is devoted by the CMA to explaining what it sees as the poor quality of the data it has been supplied with. Even taking account of the fact that the CMA has been able to incorporate some information from third parties (such as National Grid), the primary source for this analysis remains the submissions of the SLEFs which the CMA considers to suffer from numerous shortcomings.

3.2.20 To the extent possible within the Confidentiality Ring we have reviewed the evidence and reasoning underlying the CMA's bottom up analysis (as reproduced above). This review has identified numerous errors and inconsistencies within the CMA's analysis. The net effect of the errors and inconsistencies is that the CMA's bottom up analysis is unreliable and materially understates the additional costs associated with serving a customer on a PPM.

3.2.21 The errors and inconsistencies we have identified with the CMA's bottom up analysis are set out below.

**a. Costs to Serve:**

- i. The CMA cites a piece of analysis from [ " ] to suggest that PPM customers may not have greater call centre costs. We have not had access to the underlying raw data used by [ " ], and have not been able to assess the robustness of this analysis (despite requests to the CMA for further information on the [ " ] data).<sup>42</sup>

Based on the information we have been provided with, this analysis appears to compare [ " ]'s PPM customers to the rest of its customer base as a whole (DD and SC customers), while the appropriate comparison here would be to DD customers alone. If calls from SC customers are more expensive to handle than calls from DD customers, it could well be

<sup>41</sup> At a minimum Paragraphs 49 to 60 and 95 to 102 of Appendix 3.6, CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, which relate to the CMA's commentary on quality of the data submissions.

<sup>42</sup> In an email received from the CMA on 29 March, it was explained that the CMA had access to the aggregate call volume data, but there was no indication that it had access to the calculations underlying this.

the case that the figures from [ ] reported by the CMA understate the differential in call handling costs between DD and PPM customers.

In any event we note that the [ ] reported that [ ]% of calls by volume relate to PPM-specific issues, but allocated c. [ ]% of call costs to PPM customers.<sup>43</sup> This would suggest that PPM customers are more expensive to handle calls from than other customers (as the allocation of costs to them is higher than the proportion of call volumes they account for).

For these reasons we consider that the [ ] data does not provide an adequate basis to support the conclusion that calls from PPM customers are less costly to handle than those from DD customers. In fact, the CMA's description of the [ ] data suggests the exact opposite.

- ii. The CMA dismisses evidence from two suppliers that calls from PPM customers are more expensive to handle with no adequate justification.<sup>44</sup>
  - iii. The CMA concludes that a 10p differential on each fuel would be adequate to fund the additional call centre staff necessary to cover the additional costs associated with handling calls from non-PPM customers (i.e. that PPM customers are cheaper to handle calls from than DD customers). This assumption has no evidential basis and is directly contradictory to the evidence presented by the suppliers including [ ].
- b. NTS payment:
- i. We have not been able to validate the "low" differential of £[ ] for electricity meters.<sup>45</sup> The CMA's differential breakdown spreadsheet indicates that this is the average for the SLEFs. However, the CMA's calculations provide a figure of £[ ].<sup>46</sup>
- c. Meter rental:
- i. The "low" bottom-up estimate of meter capital costs is based on data from three suppliers ([ ], [ ] and [ ]), with one of the suppliers ([ ]) providing an extremely large range of costs (e.g. £7 to £25 for an electricity credit meter).<sup>47</sup> It is unclear to us why the CMA places a greater weight on these specific estimates, than the averages from across the SLEFs discussed above.
  - ii. The "high" bottom-up estimate of meter capital cost is based on an average of SLEF reported figures.<sup>48</sup> However, there is an inconsistency between how the CMA has calculated the differential for electricity and gas. For electricity, the CMA has averaged the cost differential across the SLEFs (yielding a differential of £12.40).<sup>49</sup> However, for gas, the CMA has

<sup>43</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 75.

<sup>44</sup> Ibid.

<sup>45</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Table 6.

<sup>46</sup> In cell C104 of the "CTS" tab of the "*Data analysis indirects by payment type - for data room.xlsx*" Confidentiality Ring document.

<sup>47</sup> See "*1c - meter rental costs.xlsx*" Confidentiality Ring document.

<sup>48</sup> See "*1a - ppm differential breakdown.xlsx*" Confidentiality Ring document.

<sup>49</sup> See "Meter cost" tab of "*Data analysis indirects by payment type - for data room .xlsx*" Confidentiality Ring document.

carried out this calculation (which yields a differential of £22.63), and then averaged this with the [" ] figure, to produce a final value of £21.57.<sup>50</sup> There is no explanation for why this further adjustment is carried out. Carrying out averages on a consistent basis results in "high" differentials of £12.40 and £22.63 for electricity and gas respectively. A similar issue affects the "low" estimate for gas meter maintenance costs.<sup>51</sup>

d. Meter installation:

- i. The "low" differentials in the CMA's analysis (£0.82 for electricity and £1 for gas) appear to differ from the "high" differentials only in that they do not include [" ]'s "other" differential.<sup>52</sup> We do not know why the CMA has allocated this "other" differential to installation (and not elsewhere), but without this correction the "other" differential is entirely omitted from the analysis. The "low" differential should therefore be discounted.
- ii. As with meter rental, there is an inconsistency between how the CMA has calculated the "high" differential for electricity and gas. For electricity, the CMA has averaged the cost differential across the SLEFs (yielding a differential of £1.49).<sup>53</sup> However, for gas, it has carried out this calculation (which yields a differential of £2.73), and then averaged this with the [" ] figure of zero, to produce a final value of £1.36.<sup>54</sup> There is no explanation for why this further adjustment is carried out.
- iii. Three of the SLEFs ([" ],[" ] and [" ] – as described above, RWE have provided an "other" cost that the CMA have used) have not included any installation costs.<sup>55</sup> We have assumed that the installation costs for these firms will be aggregated within their reported rental payments. Since the "low" meter rental figures provided by the CMA only include the capital cost of meters, the appropriate "low" installation figure should include a full allowance for installation costs.
- iv. We note that Paragraph 83 of Appendix 3.6 downplays the need for any meter cost differential at all. While this is consistent with SSE's experience, other suppliers (which may have different processes) on average report an increased cost for meter installation, and the CMA cites submissions from Centrica and Co-operative energy in support of this. A robust bottom-up analysis needs to treat evidence from all suppliers in the round, rather than picking those individual elements which are consistent with lower costs.
- v. The CMA argues that additional costs of warranted entry are generally recovered from the specific customer.<sup>56</sup> However, the costs cited by

<sup>50</sup> Ibid.

<sup>51</sup> Ibid.

<sup>52</sup> This appears to be inconsistent with the CMA's file "1a - PPM differential breakdown.xlsx" (Confidentiality Ring document) which states that the high basis for the installation cost differential is "Av SLEFs (ex RWE SP)".

<sup>53</sup> See "Meter cost" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>54</sup> Ibid.

<sup>55</sup> Ibid.

<sup>56</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 83.

Centrica do not relate to warranted entry, but rather to the additional costs caused by a higher number of meter installation jobs being aborted. The CMA's argument is therefore erroneous.

- vi. The CMA also argues that the additional costs of installing PPM meters relate to debt that has arisen under credit meters and are not a cost of PPMs.<sup>57</sup> However, PPM meters will also be installed when older PPM meters break-down or reach the end of their certification. It is therefore inaccurate to claim that all of the additional costs of installing PPM meters relates to debt that has arisen under credit meters.
  - vii. It is also notable that National Grid's charges (which the CMA cite elsewhere), include a £12.26 differential between the transactional charge for installing a domestic credit gas meter (£86.78) and a domestic prepayment gas meter (£99.04).<sup>58</sup> This figure is significantly in excess of those used by the CMA within their bottom up analysis. For example, using the same assumptions as those used by the CMA to estimate the annual capital cost of a new meter, this £12.26 differential in one-off transaction charges would equate to an annual installation costs of prepayment gas meters being £3.23 higher than those for credit gas meters. We note that this figure is significantly in excess of the range of £1.00 to £1.36 used by the CMA.
- e. Meter removal costs:
- i. The CMA has not assumed any differential in meter removal costs, consistent with submissions from the majority of the SLEFs. However, it is notable that the one SLEF to indicate a differential in removal costs (of [" ] in 2014 for prepayment gas meters) is Centrica, which has a highly significant gas metering operation and therefore considerable experience in this area.<sup>59</sup> The CMA has not presented any evidence that it has consulted with Centrica to understand the rationale for this difference.
- f. Sales and marketing / central overheads:
- i. The CMA has not included sales and marketing costs on the grounds that it "...considers that general sales and marketing activity is most reasonably applied evenly across the customer base."<sup>60</sup> Similarly, the CMA disagrees with the differential in central overheads applied by two suppliers, on the grounds that "...the major cost differentials are in the cost of payment collection activity and cost of metering. These costs are therefore all external activities and we do not therefore agree that there should be a differential for such central overhead costs".<sup>61</sup>

As described in the section "Analysis of PPM cost data from the SLEFs" above, there is no evidence (whether in the PDR or the material available within the Confidentiality Ring) that the CMA has either engaged with

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<sup>57</sup> Ibid.

<sup>58</sup> National Grid Metering Charges, From 1 April 2014. Section 2.3.

<sup>59</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 86.

<sup>60</sup> Ibid.

<sup>61</sup> Ibid.

suppliers to justify this reasoning, or produced other sources of evidence. Without such evidence, these assertions are unfounded.

- 3.2.22 Even taking the CMA's "low" and "high" figures as given, the CMA has chosen to use a differential of £54 which is almost at the bottom of its range of £50 - £66. The only justification for this appears to be the analysis of [" ] and Utility Warehouse which, as described above, should not have any weight attached to it. Indeed, the spot estimate of £18.22<sup>62</sup> for the gas meter price differential that the CMA uses in its central estimate is below even the "low" end of £21.10.
- 3.2.23 For the reasons set out above the CMA would err if it was to use its bottom up analysis to support a head room of £54 per customer.

### 3.3 Adjustments for Standard Credit customers

- 3.3.1 The CMA's conclusion on the difference in the cost to serve SC and DD customers is based on four pieces of evidence:
- the use of tariff differentials previously reported by Ofgem;
  - an analysis of the average cost differential across the SLEFs;
  - the differential for Centrica; and
  - the CMA's own bottom up analysis.<sup>63</sup>
- 3.3.2 The table below summarises how the CMA has used this analysis, and how we would interpret it.

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<sup>62</sup> As indicated in cell M25 of sheet "Range" of the file "1a - PPM differential breakdown.xlsx" (Confidentiality Ring document).

<sup>63</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 123.

**Exhibit 6. Summary of the CMA's evidence on SC/DD cost differential**

	<b>CMA interpretation</b>	<b>Frontier interpretation</b>
The use of tariff differentials previously reported by Ofgem	Gives tariff differential of <b>£75</b> . <sup>64</sup>	This relates to tariffs, not costs. <b>As such limited weight should be placed on this evidence.</b>
An analysis of the average cost differential across the SLEFs	Yields a cost differential of <b>£136.84</b> (including working capital; <b>£96.72</b> without working capital). <sup>65</sup>	This is likely to be the most robust figure, since it averages over a number of SLEFs. The figure with working capital ( <b>£136.84</b> ) is appropriate.
The differential for Centrica	Yields a total cost differential of <b>£69</b> . <sup>66</sup>	The low differential is caused by relatively high DD costs, not efficiency. A more appropriate way of proxying for an efficient differential is to compare the supplier with the lowest costs for DD ([" ]) with that with the lowest SC costs ([" ]), yielding <b>£107.49</b> . If electricity and gas are considered separately, this figure falls to <b>£99.43</b> .
The CMA's own bottom up analysis	Produces a total cost differential range of <b>£64 - £105</b> . <sup>67</sup> The CMA has chosen a point estimate that falls below the middle of this range.	The adjustments made to bad debt and working capital are inappropriate. Without these, this approach essentially collapses to the two approaches described above. <b>No weight should be placed on this evidence.</b>

Source: Appendix 3.6, PDR.

Note: Frontier Analysis.

- 3.3.3 On the basis of this analysis, the CMA concludes that it would be appropriate to assume a cost differential for SC customers of £82. The CMA does not explain the precise basis for reaching this figure. However, we note £82 is the (unweighted) average of the results from the four approaches outlined above, if – incorrectly – the figure for the second approach without working capital is used.<sup>68</sup> Adopting the same methodology, but using the correct figure for the second approach that includes working capital, produces a figure of £90.
- 3.3.4 This would indicate that the CMA believes that it is appropriate to place equal weight on the results of each of the four approaches outlined above. However, for the reasons summarised in the table and explained below, little or no weight should be placed on the first and last approaches listed in the table. Moreover, the CMA's analysis in relation to the second and third approaches in the table contains flaws that have resulted in it materially underestimating the cost differential for SC customers. Correcting these errors produces three cost

<sup>64</sup> Ibid.

<sup>65</sup> Ibid.

<sup>66</sup> Ibid.

<sup>67</sup> Ibid.

<sup>68</sup> i.e. The average of £75, £96.72, £69, £64 and £105 is £81.94.

estimates, ranging between £99.43 and £136.84. For the purposes of the analysis presented later in our report, we have assumed a cost differential at the very bottom of this range, i.e. **£99.43** (£45.20 for electricity and £54.23 for gas). However, it should be emphasised that this is a highly conservative (i.e. low) estimate of the differential. Moreover, we consider that the figure of £136.84 that includes working capital and is based on the average of data from the SLEFs is likely to be a more reliable estimate of the differential costs of serving DD and SC customers.

3.3.5 We describe and explain the relative merits of each of the different sources of evidence in greater detail below.

### Analysis from Ofgem

3.3.6 The CMA cites analysis from Ofgem indicating a tariff differential of around £75 per customer per year.<sup>69</sup> However, only limited weight should be placed on this for a number of reasons:

- a. First, the use of the Ofgem figure here is inconsistent with the CMA's omission of a similar figure when justifying its prepayment differential. Ofgem state that the tariff differential from DD is £75, both for SC and for PPM.<sup>70</sup>
- b. Second, the Ofgem analysis relates to *bills*, not *costs*, and can only inform costs if it is accepted that bills are cost reflective. Moreover, to the extent that many of the costs that may differ between DD and SC customers are semi-fixed and fixed costs (for example, the billing infrastructure to support SC customers, or call centre costs), there is no reason why these semi-fixed and fixed cost differentials would feed through to tariff differentials in a direct manner.

### Analysis of data from the six large energy firms

3.3.7 The CMA presents a differential of £136.84 based on an average of the SLEF data (if the reported working capital differential is included), or £96.72 (without the working capital differential).<sup>71</sup>

3.3.8 The CMA uses two arguments to downplay the significance of this result:

- a. First, the CMA states that it has reservations about the quality of the data underpinning these numbers.<sup>72</sup> Given the inconsistencies in the way that different suppliers have reported figures, as discussed in the section above regarding PPM customers, we consider that this strengthens the case for taking an average across all the SLEFs rather than picking individual data points.

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<sup>69</sup> Ibid.

<sup>70</sup> Ofgem, *Retail Energy Markets in 2015*, September 2015, Paragraph 6.21.

<sup>71</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 123.

<sup>72</sup> Ibid.

b. Second, the CMA states that this may not represent the most efficient cost differential, though it does not provide evidence to substantiate this point.<sup>73</sup>

3.3.9 The evidence we have reviewed in the Confidentiality Ring does not support the CMA's assessment of this data as being of limited value. Moreover, we do not accept the exclusion of working capital for SC customers, given that this constitutes a genuine economic cost for suppliers and the CMA appears to have provided no reasoning or evidence to justify its exclusion.

### The Centrica differential

3.3.10 Centrica is the supplier amongst the SLEFs which reports the lowest differential between the cost of serving a SC and a DD customer.<sup>74</sup> The CMA therefore considers that the data supplied by Centrica can be used to inform its analysis of the differential in the cost of serving SC and DD customers for a cost-efficient supplier.<sup>75</sup>

3.3.11 This conclusion is erroneous for the same reasons as those set out above in paragraph 3.2.11: based on the data in the Confidentiality Ring, Centrica [" ]; its electricity and gas costs of £[" ] and £[" ] respectively, including working capital, are higher than those of [" ],[" ] and [" ]. By contrast, [" ].<sup>76</sup>

3.3.12 An alternative method of characterising the efficient differential from the SLEF data, which is not subject to these difficulties would be to consider the differential between the lowest-cost SC firm and the lowest-cost DD firm. This method yields:

- a. an electricity differential of £45.20 (the difference between [" ]'s SC and [" ]'s DD costs);
- b. a gas differential of £54.23 (the difference between [" ]'s SC and DD costs);
- c. a total differential of £99.43 (when calculated as the sum of electricity and gas differentials); and
- d. a total differential of £107.49 (when calculated – as the CMA have done for [" ] – on combined gas and electricity costs, and taking the difference between [" ]'s SC and [" ]'s DD costs).

### The CMA's bottom-up analysis

3.3.13 The CMA's bottom-up analysis includes three components:

- a. a differential in cost-to-serve;
- b. a differential in bad debt costs; and
- c. a differential in working capital costs.

3.3.14 The vast majority of the differential is accounted for by the latter two components, and both have been significantly underestimated as part of the bottom-up

<sup>73</sup> Ibid.

<sup>74</sup> Ibid.

<sup>75</sup> See "Summary" tab of "Data analysis indirects by payment type – for data room .xlsx" Confidentiality Ring document.

<sup>76</sup> Ibid.

analysis, due to the use of inappropriate adjustments. The CMA's analysis that underlies both of these pieces of evidence is based on assertion and a misunderstanding of the context in which energy suppliers operate. Moreover, the CMA makes a number of assumptions within the analysis that are inconsistent with the approach it has adopted in other parts of this inquiry, most notably in its work on economic profitability.

- 3.3.15 In any event, leaving aside the issue of whether the adjustments the CMA has made to bad debt and working capital can be justified, it is difficult to understand why any alleged inefficiency with respect to these costs should be considered a source of consumer detriment. Both of these items relate to the terms on which consumers pay for their energy. A reduction in bad debt costs or working capital implies that consumers have paid more quickly for their energy than would otherwise be the case. Such a change represents a higher cost for consumers, rather than a source of benefit (conversely, an alleged inefficiency would actually benefit customers).
- 3.3.16 Without these adjustments, the "bottom-up" analysis effectively reduces to:
- a. an average of the SLEF figures<sup>77</sup> (discussed above) – this is used for the CMA's "high" end estimate of the cost-to-serve and bad debt costs, and its "low" end estimate of working capital; and
  - b. the use of Centrica, the SLEF with the lowest differential (again, discussed above) – this is used for the "low" end of cost-to-serve and bad debt costs, and the "high" end of working capital.
- 3.3.17 The bottom up analysis does not add any new information to other metrics in the table. Our view, based on the evidence in the Confidentiality Ring, is that relying on the average for the six large energy firms would be the more reasonable interpretation of the data.

### Bad debt costs

- 3.3.18 The CMA makes two adjustments to energy suppliers' bad debt costs to arrive at the differential between SC and DD customers that it considers to be efficient:
- a. First, it scales down overall bad debt costs to a level consistent with that observed for council tax;<sup>78</sup> and
  - b. Second, it reallocates 5% of the bad debt costs that suppliers had allocated to SC customers to DD customers instead.<sup>79</sup>
- 3.3.19 Neither of these adjustments are supported by the evidence presented by the CMA.
- a. The scaling down of bad debt costs is based on the CMA's view that bad debt costs for energy suppliers are high compared to those typically observed for housing associations, the collection of council tax and water companies (who

<sup>77</sup> The bottom-up analysis does not include differentials in cost to meter, sales & marketing, central overheads and "other", although these are always zero or negligible compared to the other sources of differential.

<sup>78</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 116.

<sup>79</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 117.

cannot disconnect their customers).<sup>80</sup> The CMA therefore concludes that it would be reasonable to reduce the bad debt costs reported by energy suppliers from £77.01 to £61 (£26 for electricity and £35 for gas), so that they are closer to the level observed for the collection of council tax.<sup>81</sup>

There is no rational basis for this adjustment. Not paying council tax carries the potential of a three month custodial sentence, being forced to sell your house or being made bankrupt. Not paying an energy bill while on a SC contract, will potentially result in having a pre-payment meter installed. It is therefore unsurprising that rate of bad debt for energy suppliers is higher than that for council tax.

Further to this, as set out in Ofgem's *September 2015 Consumer Vulnerability Strategy Progress Report*.<sup>82</sup>

- i. Licence conditions 27.10 and 27.11 prevent the disconnection of pensioners during winter months and oblige energy suppliers to take all reasonable steps to prevent the disconnection of vulnerable customers over the same period;
- ii. Under the same licence conditions energy suppliers are obliged to provide Ofgem with data on debt and disconnections, which it uses to “*monitor companies’ compliance with protections which are designed to safeguard customers in vulnerable situations*”;
- iii. Ofgem asks energy suppliers to justify every single disconnection they make; and
- iv. all of the SLEFs adhere to Energy UK’s voluntary code Safety Net.

In 2014 only 233 customers were disconnected, a figure which Ofgem attributes directly to its actions. In practice, therefore, energy suppliers look far closer to water companies (who cannot disconnect customers) than councils (who can have their debtors sent to jail). The CMA has presented no evidence to suggest how energy suppliers would be able to reduce their bad debt rates whilst complying with the regulatory obligations they face. The CMA’s approach to bad debt therefore errs by ignoring the context within which energy suppliers operate.

- b. In addition to scaling down bad debt costs the CMA allocates 5% of the costs that energy suppliers have attributed to SC customers to DD customers on the grounds that there could be “allocation errors” in suppliers data.<sup>83</sup> While it certainly is the case that allocation errors can occur, there is no basis in fact for the arbitrary adjustment made by the CMA. The CMA has presented no evidence on either the scale or direction of any allocation errors, either for individual firms or the SLEFs collectively and certainly none that would support the approach it has chosen to adopt.

<sup>80</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 114.

<sup>81</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 118.

<sup>82</sup> Ofgem, *Consumer Vulnerability Strategy Progress Report*, September 2015, Pages 54 to 58.

<sup>83</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 117.

- 3.3.20 For the reasons set out above the CMA has erred by adjusting the data on bad debt costs reported by the SLEFs. We therefore use the unadjusted figure of £77.01.
- 3.3.21 The CMA has used a figure of £33 per customer for the low end of its differential, based on data from Centrica.<sup>84</sup> However there is no evidence that the CMA has carried out any analysis of *why* Centrica's figure is this low – whether it reflects a different customer mix, or may simply be the result of misallocations in the data. We would therefore place little weight on this figure.

### Working capital

- 3.3.22 The CMA's approach to estimating the cost of working capital associated with SC customers has no basis in fact and is inconsistent with the approach adopted by the CMA elsewhere within the PDR (including within Appendix 3.6), resulting in the costs of working capital being materially understated (and therefore the alleged detriment being materially overstated).
- 3.3.23 There are two sources of error:
- a. First, the CMA assumes that the debtor days associated with SC customers should be no more than 90 days.<sup>85</sup> The CMA therefore has adjusted the working capital that the SLEF's allocated to SC to reflect this view.

Exhibit 4 below shows that no SLEF has a debtor day of less than 90 days for either their SC Gas or their Electricity customers. As such we consider that the CMA's 90 day assumption has no factual basis to support it. We therefore consider that the adjustment the CMA makes to the working capital the SLEF's have allocated to their SC customers based upon it is unwarranted and erroneous.

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<sup>84</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 121.

<sup>85</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 119 to 120. Our understanding is that the 90 day assumption is based upon the following reasoning:

- if all SC were billed quarterly then the average time between a customer consuming energy and the supplier receiving payment would be 45 days (i.e. the midpoint of each quarterly period);
- assuming consumption is uniformly distributed across the 90 days period and that there are no changes to prices over this period, then the average (bill-weighted) time between a customer consuming energy and the supplier receiving payment would also be 45 days;
- allowing a period of 30 days for issuing and receiving payment on any bill; and
- allowing for 90% of all bills to be paid on time, with the remainder paid on average within 225 days of the date the energy was originally consumed on, then the average debtor days for the SLEF's SC customers would be 90 days.

**Exhibit 7. Debtor days outstanding for SC customers**

Supplier	Electricity	Gas
Centrica		
EDF Energy		
E.ON	[ " ]	
RWE		
Scottish Power		
SSE	[ " ]	[ " ]
Average	141	154

Source: Table 11, Appendix 3.6, PDR.

Note: Figures in parentheses relate to negative numbers.

- b. Second, to calculate the cost of working capital the CMA uses the cost of capital (i.e. a WACC) net of corporation tax (to reflect the fact that interest costs are tax deductible).<sup>86</sup> This means that the CMA uses a figure of 8% rather than 10% to calculate the implied cost of the working capital necessary to serve SC customers.

We consider that this approach is erroneous and inconsistent with the CMA's analysis elsewhere in the PDR.

- i. The CMA's approach assumes that the working capital allocated to the SLEF's SC customers is entirely debt financed, as only debt interest costs are tax deductible. The CMA has presented no evidence to support this conclusion and therefore no evidential basis for using a WACC of 8% rather than a WACC of 10%.
- ii. A 10% WACC is used elsewhere within Appendix 3.6 and more widely within the PDR.<sup>87</sup>

3.3.24 For these reasons the CMA has materially understated the costs of working capital associated with SC customers.

## 3.4 Adjustments for network costs

3.4.1 The CMA's network cost analysis includes a number of errors relating to both calculations and inputs, and in parts differ substantially from SSE's own view of what these figures should be. Given the tightly binding price cap envisioned by the CMA, and the significant differences in network costs between regions, it is essential that these calculations are carried out correctly.

3.4.2 Within the time available during the Confidentiality Ring, we have not been able to entirely reconcile the CMA's network cost analysis to the figures used by SSE, but have determined that the CMA's methodology contains at least the following inaccuracies.

- a. TUoS payments for Economy 7 (profile class 2) customers have been calculated incorrectly. The CMA's methodology applies the same peak share

<sup>86</sup> CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 121.

<sup>87</sup> See for example CMA, *Energy Market Investigation: Provisional decision on remedies*, March 2016, Appendix 3.6, Paragraph 79.

to total consumption as used for non-E7 (profile class 1) customers. Instead, the CMA should apply a peak share specific to profile class 2, to the proportion of power consumed during the peak period.

- b. There are inconsistencies between the transmission prices used in the CMA's analysis and the published figures from National Grid. For example, in 2015 quarter 2, the CMA obtain an energy consumption tariff for Northern Scotland of 3.25p/kWh. However, the published figures from National Grid relating to that period<sup>88</sup> indicate that the correct figure is 3.39p/kWh.
- c. The LDZ exit charges used by the CMA appear to relate to the quarter before the quarter in which the analysis is being carried out. For example, in 2015 Q2, a value of 0.0001p is used for the Scottish SC4 region, rather than the correct value of 0.0002p. This error appears to result from line 119 of the file "data\_charges\_gd.do" (Confidentiality Ring document).
- d. There are other minor inconsistencies between some of the input figures used in the CMA's analysis and the published statements of charges. For example, the CMA uses a capacity charge of 0.1994p for the Scottish region in 2015 Q2, rather than the 0.1992p found in the relevant statement of charges.<sup>89</sup>

3.4.3 For the purpose of any price control, it will be essential that the CMA makes its calculations available to all suppliers so they can verify them.

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<sup>88</sup> Available at: <http://www2.nationalgrid.com/UK/Industry-information/System-charges/Electricity-transmission/Transmission-Network-Use-of-System-Charges/Statement-of-Use-of-System-Charges/>.

<sup>89</sup> Available at: <https://www.sgn.co.uk/uploadedFiles/Marketing/Pages/Publications/Docs-Network-Pricing/SGN-Scotland-LDZ-Transportation-Charges-Final-Notice-Apr-2015-.pdf>.

## 4 IMPLICATIONS FOR THE CMA'S DIRECT MEASURE OF DETRIMENT

- 4.1.1 In this section we consider the sensitivity of the CMA's detriment estimates to the errors of fact and assessment explained in Sections 2 and 3 above. While we have not been able to correct for all of the errors on the basis of the information made available in the Confidentiality Ring, it is clear that even addressing a subset of these errors has the effect of substantially reducing the estimated level of detriment.
- 4.1.2 To illustrate this, we have adapted the CMA's analysis to produce adjusted 'detriment' figures that take account of two of the most significant of these errors, namely:
- a. the use of Ovo tariffs which are clearly unsustainable in producing the competitive benchmark; and
  - b. the use of inappropriately low payment method differentials from direct debit to PPM and standard credit which are not justified by the available evidence.
- 4.1.3 Below, we describe how we have corrected for these errors, and present the impact that these adjustments have on the resulting detriment estimates, both independently and in conjunction with one another.
- 4.1.4 For clarity, this analysis does not account for all of the errors in the CMA's approach, most notably the mistaken assumption that any difference between the prices charged by the SLEFs and the CMA's 'competitive benchmark' (after adjusting for 'exogenous cost' differences) should be interpreted as a consumer 'detriment'. Instead the aim of this analysis is merely to illustrate that the sensitivity of the CMA's analysis to correcting for the errors of fact and assessment that underlie the CMA's calculation (to the extent that we have been able to do so within the Confidentiality Ring). The results presented below should therefore not be interpreted as supporting the view that there is a consumer detriment, but rather that the results the CMA has presented using its 'direct approach' are highly sensitive to correcting for the errors of fact and assessment that the CMA has made within its analysis.

### 4.2 Sustainability

- 4.2.1 For the reasons explained in Section 2, the available evidence clearly indicates the tariffs charged by Ovo during the period of the CMA's study were unsustainable, and therefore not a suitable basis upon which either to calculate detriment or to use for a price control.
- 4.2.2 We have therefore carried out two alternative adjustments that attempt to remove the effect of using unsustainable tariffs as the basis of the benchmark. These are:
- a. removing Ovo from the benchmark calculations; and
  - b. uplifting Ovo bills by a level that is consistent with a sustainable margin.
- 4.2.3 These results are presented below.

4.2.4 It should be emphasised that, even after such an adjustment is made, there are a variety of significant problems with the use of mid-tier suppliers as a benchmark (for example, that the CMA is hypothesising a perfectly competitive market in which all suppliers must match the low prices of a subset of the cheapest suppliers). As a result, the restatement of detriment below will still be substantially overstated. The two values calculated below therefore do not represent “low” and “high” ends of a range – they are both likely to be overestimates.

### Removing Ovo from the benchmark calculations

4.2.5 We have re-run the CMA’s analysis with only First Utility used to generate the benchmark prices.<sup>90</sup>

4.2.6 [“ ”]. As a result, to the extent that it is appropriate to use First Utility as a benchmark at all, the detriment can only be estimated directly using First Utility’s [“ ”]. When this approach is applied, the [“ ”] customer detriment falls from £1,185m to £882m, a drop of 26%.

4.2.7 If this 26% decrease for [“ ”] customers were applied to the overall detriment figure of £1.7bn (in the absence of being able to estimate the level of detriment for [“ ”] customers directly, for the reasons explained in the previous paragraph) it would reduce the estimated level of detriment to approximately **£1.3bn** (i.e. a reduction in the region of **£400m**). This powerfully illustrates how significantly the chosen competitive benchmark affects the CMA’s detriment figures.

### Uplifting Ovo bills

4.2.8 As an alternative approach, we have applied an uplift to Ovo bills of [“ ”]%.<sup>91</sup> The rationale and methodology for this approach is set out in detail in Paragraphs 2.3.6 to 2.3.10 of our report. Applying this adjustment on its own results in an estimate of the detriment using the direct approach of approximately **£0.96bn** (a reduction of approximately £700m).

## 4.3 Payment methods differential

4.3.1 For the reasons explained in Section 3, above, the second stage of the CMA’s analysis, which adjusts for “exogenous cost differences” relating to payment method, contains further errors of fact and assessment that significantly compound those made at the first stage. Exhibit 4 lists the incremental cost to serve PPM and SC customers assumed by the CMA, and a set of differentials that we consider to be more robust and reliable in view of the errors identified in Section 3. As was also explained in Section 3, even these corrected estimates

<sup>90</sup> To do this, we have edited the CMA Stata scripts “*helper\_benchmark\_bill\_df.do*” (Confidentiality Ring document) and “*helper\_benchmark\_bill\_sf.do*” (Confidentiality Ring document) to only include First Utility observations in the weighted bill.

<sup>91</sup> This has required adjusting the CMA’s Stata scripts in three places. In the file “*detriment\_computation.do*” (Confidentiality Ring document), the variable `bill_tdcv_F` is scaled up by [“ ”] if the supplier is Ovo. Similar adjustments have been made to `bill_actual_con` in the script “*helper\_benchmark\_bill\_sf.do*” (Confidentiality Ring document), and `bill_actual_con_elec` and `bill_actual_con_gas` in the script “*helper\_benchmark\_bill\_df.do*” (Confidentiality Ring document).

are highly conservative and are likely to underestimate the true cost differentials (and therefore overestimate any detriment) by a substantial amount.

#### Exhibit 8. Updated payment differentials for analysis

	CMA differential	Corrected differential
DD – PPM (elec)	£22	£28.79
DD – PPM (gas)	£32	£47.62
DD – PPM (both)	£54	£76.41
DD – SC (elec)	£35	£45.20
DD – SC (gas)	£47	£54.23
DD – SC (both)	£82	£99.43

Source: *Frontier analysis and CMA PDR*

4.3.2 We have updated the CMA's benchmark price analysis with these new differentials.<sup>92</sup>

4.3.3 This single change has the effect of lowering the overall detriment (measured on the CMA's "direct" basis) from **£1.7bn** to **£1.5bn**.

## 4.4 Combined effect

4.4.1 We have carried out a combined analysis that includes both the sustainability adjustment (using both methodologies outlined above) and the payment method differential adjustment.

### Removing Ovo from the benchmark calculations

4.4.2 If Ovo is removed from the benchmark calculation, and the payment differentials are amended as described above, the overall "direct" measure of detriment across the SLEFs for dual fuel customers decreases from £1,185m to £762m, a decrease of 36%. If this percentage decrease is applied to the overall detriment figure of £1.7bn, it results in a decrease to around **£1.1bn**.

### Uplifting Ovo bills

4.4.3 If Ovo bills are uplifted by [ ]%, and the payment differentials are amended as described above, the overall "direct" measure of detriment across the SLEFs decreases from £1.7bn to around **£0.78bn**.

## 4.5 Sensitivities

4.5.1 We have carried out three further sensitivities to assess the robustness of our results:

- a. First, we have left the payment method differentials unchanged but have used the tariffs of Utility Warehouse, Ovo (unadjusted), First Utility and Co-Op to calculate the benchmark bill.

<sup>92</sup> By adjusting the constants held within the "\_progs.do" (Confidentiality Ring document) script to our corrected differentials.

- b. Second we have uplifted Ovo's bills by [" ]% and used higher payment method differentials when calculating the benchmark bill.
  - c. Third, we have uplifted both Ovo and First Utility's bills so that they both achieve a sustainable [in the region of 4]% margin, and used higher payment method differentials (as set out in Exhibit 8) when calculating the benchmark bill. This involved uplifting Ovo's bills by [" ]% and First utility's bills by [" ]%.
- 4.5.2 The results of these scenarios support our finding that the CMA's direct approach materially overestimate detriment.

### All mid-tier suppliers

- 4.5.3 If data from Ovo, First Utility, Utility Warehouse and Co-Op is used to estimate the benchmark bill and the same payment method differentials as in Exhibit 8 are used, the overall "direct" measure of detriment across the SLEFs decreases from £1.7bn to around **£1.06bn**.

### Uplifting Ovo and higher payment method differentials

- 4.5.4 If data from Ovo (uplifted by [" ]%) and First Utility is used to estimate the benchmark bill and the same payment method differentials set out below in Exhibit 9 are used (which are based on the results of Exhibit 4 and Exhibit 6), the overall "direct" measure of detriment across the SLEFs decreases from £1.7bn to around **£0.69bn**.

#### Exhibit 9. Updated payment differentials for analysis

	CMA differential	Corrected differential
DD – PPM (elec)	£22	£25.01
DD – PPM (gas)	£32	£66.75
DD – PPM (both)	£54	£90.76
DD – SC (elec)	£35	£45.20
DD – SC (gas)	£47	£62.30
DD – SC (both)	£82	£107.49

Source: Frontier analysis and CMA PDR

### Sustainability adjustments for both Ovo and First Utility

- 4.5.5 If data from Ovo (uplifted by [" ]%) and First Utility (uplifted by [" ]%) is used to estimate the benchmark bill and the same payment method differentials set out above in Exhibit 8 are used, the overall "direct" measure of detriment across the SLEFs decreases from £1.7bn to between **£200m** and **£300m**.

## ANNEX A

A.1.1 Our analysis of the First Utility and Ovo tariff data in the Confidentiality Ring indicates that:

a. [" ]; and

b. [" ].

A.1.2 [" ].

A.1.3 Reweighting First Utility and Ovo tariff types in line with the SLEF weightings reduces the overall detriment to 619m, with SSE's proportion falling to [" ] if SSE weights are applied.



## SSE: RESPONSE TO PROVISIONAL DECISION ON REMEDIES

### ANNEX 3: DISCUSSION OF TECHNICAL ASPECTS OF MODELLING OF LOCATIONAL TRANSMISSION LOSSES

#### **1. Introduction**

- 1.1. This annex presents comments on technical elements of NERA's modelling<sup>1</sup> and on aspects of the discussion of the results presented in the PDR.<sup>2</sup> SSE has stated that numerical modelling of the impact of zonal transmission loss multipliers is an intrinsically complicated issue which needs to be considered carefully.<sup>3</sup> SSE is disappointed that the treatment of this topic in the PDR indicates that undue reliance has been placed on the modelling results demonstrating the "right answer", without properly questioning (or seeking to better understand) the impact of important assumptions which underpin the analysis.
- 1.2. SSE strongly recommends that a more robust impact assessment is undertaken and consulted upon before the proposed remedy can be implemented with any degree of confidence that the cost of unintended consequences would not outweigh any potential societal benefits. Such an exercise would provide a robust framework to address the significant technical issues highlighted below (this list is not exhaustive). In particular it is critical that the performance of the models developed by NERA and ICL are suitably challenged to establish whether the models actually perform as advertised. This would require corroboration from at least one *independent* source.
- 1.3. The CMA has not explicitly assessed the proposed remedy against relevant objectives of the BSC; SSE considers that the proposal conflicts with objectives b) and c) in particular:
  - (a) ***The efficient, economic and co-ordinated operation of the GB transmission system:*** departures from cost reflectivity in determining loss factors leads to inefficient outcomes; and
  - (b) ***Promoting effective competition in the generation and supply of electricity:*** this remedy will lead to large distributional transfers between market participants which are disproportionate to perceived benefits.

#### **2. Discussion of technical elements**

- 2.1 **The biggest impact of this remedy is the introduction of large and arbitrary transfers between generators, partly based on historic decisions.**

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<sup>1</sup> PDR, Appendix 2.2.

<sup>2</sup> PDR, paras. 2.46-2.71.

<sup>3</sup> SSE response to notice of zonal losses assessment methodology, 14 December 2015.

SSE considers that the modelling conducted to date by NERA and Imperial College provides nothing more substantial than an indicator of a *potential* benefit of locational charging for transmission losses. The modelled impact of this proposal on certain generators is sufficiently large that it would not be appropriate for the CMA to move directly to implementation without properly probing the potential outcomes (e.g., the modelled social benefit for the period to 2026 varies between £151 million and £190 million compared to a reduction in revenue for EdF of up to £294 million).

- 2.2 **The provisional remedy will not significantly improve the cost reflectivity of the charging for locational losses.** The motivation for the implementation of locational charging for transmission losses was to deliver a system in which charges are levied in a manner that is more cost reflective than the status quo. Such an outcome would be supported by SSE and more widely by other market participants if it were achievable in practice. The controversy around the topic of locational losses stems from the fact that it is not possible to implement a truly cost reflective charging mechanism which would also provide a signal to which market participants can respond.
- 2.3 There are three significant simplifying steps in the CMA's approach which, in combination, lead to a remedy which is not demonstrably more cost reflective than the status quo:
- (a) transmission loss factors are calculated ex ante and are therefore not reflective of the specific costs of actual load flow on the transmission network;
  - (b) transmission loss factors are based on seasonal and regional averages which are not reflective of the specific costs due to particular generating technologies at specific locations on the network (as actual losses can change sharply over time in an unpredictable way); and,
  - (c) the proposed G:D split of 100:0 necessarily means that charges are not reflective of the specific costs of fixed losses due to the location of *demand*.
- 2.4 In SSE's view the first two simplifying assumptions are a pragmatic approach required in any attempt to arrive at a methodology which is practicable and which would facilitate a locational signal to which market participants can respond. However, these two steps constitute a significant compromise which militates against achieving a cost reflective outcome.
- 2.5 The departure from cost reflectivity is exacerbated by the adoption of negative loss multipliers and further compounded by the new proposal that all costs due to transmission losses are recovered from generation. It is conceivable that on certain days of the year, under the CMA's proposed remedy, all of GB demand could be met by a combination of generation in zones of negative loss multipliers and by embedded and interconnected generation not subject to transmission loss charges. Clearly, on such occasions, transmission losses would persist and would still account for 2% of energy in the system; it cannot

be argued that it would be cost reflective for the costs for such losses to be recovered from other generators which were not running at the time.

- 2.6 From the point of economic principle, a price signal which is only partially cost reflective can deliver an outcome which is less efficient than providing no price signal at all. Therefore if locational losses charges are only *partially* cost reflective, then they can become an additional source of market distortion for generation dispatch decisions which can in turn deliver a worse result for society than the current arrangement of providing no locational price signal. A key test of the proposal is whether the use of locational losses may solve more market distortions than it creates, although it is not possible to answer this question from the modelling results provided by NERA.
- 2.7 **The proposal to recover 100% of the cost of transmission losses from generators is the consequence of a flaw in NERA’s modelling methodology.** The proposed adoption of a Generation: Demand split of 100:0 to replace the established split of 45:55 is unexpected.<sup>4</sup> It is justified by the surprising modelling result that the social benefit is *increased* in the 100:0 scenario. The CMA notes that this option is “*simulated to be worth between £14 million and £31 million*” more than Option A in the period 2017-2026.<sup>5</sup> SSE considers that this result is indicative of a flawed methodology.
- 2.8 If, as intended, cost reflective loss multipliers were actually calculated under Option A (with a 45:55 split of costs) then moving to Option B (100:0 split) should not have increased the social benefit. Indeed, for the calculated benefit to increase in this way, the loss multipliers must have been transformed *multiplicatively* rather than *additively* between Option A and Option B. The applied methodology increases the gradient between loss multipliers applicable in different zones and therefore affects dispatch decisions; NERA has effectively exaggerated the scale of the simulated benefit and this result is simply a modelling artefact. The more correct approach would have moved the cost curve for all generators up, but the relative positions of each generator would not have changed (i.e., the move to 100:0 should not have changed any dispatch decisions relative to the 45:55 case).
- 2.9 Under this flawed methodology it is possible that introducing an explicit subsidy for demand by levying a charge equivalent to 200% or 400% of the cost of transmission losses would increase the simulated ‘social benefit’ yet further.
- 2.10 SSE has inferred this flaw in the methodology from the discussion of the modelling results but the issue would be more transparent if the loss multipliers for all modelling scenarios based on a 45:55 split had been published alongside the multipliers for the CMA’s preferred option. In any

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<sup>4</sup> SSE notes that this scenario was not included in the CMA’s various notices relating to the planned methodology for the assessment of locational transmission losses, nor was it covered in the slides presented by NERA at the industry workshop. See *NERA/ Imperial Zonal Losses Modelling: Briefing on our Approach*, 15 December 2015.

<sup>5</sup> PDR, para 2.52.

case, the results for the 100:0 scenario are highly suspect and this error casts doubt on the validity of the 45:55 scenario results.

- 2.11 **The modelling results are highly uncertain and are driven by uncertainty of key assumptions and input parameters.** NERA observed that “*the distributional effects between and amongst British producers and consumers are volatile, and appear very sensitive to changes in fundamental assumptions*”<sup>6</sup>, yet these fundamental assumptions are not carefully considered, despite the advice of a number of parties (including Ofgem) on the importance of examining all assumptions very carefully.<sup>7</sup> This volatility and sensitivity of results to input assumptions highlight the need for the CMA to proceed with extreme caution as this remedy could inadvertently introduce further AECs.
- 2.12 For instance, it is apparent under all scenarios that the modelling results are highly dependent on the forecast impact on Capacity Mechanism (CM) costs in particular. SSE considers that the base case and modelled savings are very high under all scenarios.<sup>8</sup> Given the apparently critical dependence on the impact of assumption relating to the CM it would be reckless to proceed to implementation without first investigating thoroughly the sensitivity of outcomes to plausible variations of these factors.
- 2.13 Given the sensitivity highlighted by many stakeholders in the consultation on proposed methodology and NERA’s own observations, the CMA’s position that the “*order of magnitude of the results appear stable and robust, in that the estimated benefits are not very sensitive to our scenario input assumptions*”<sup>9</sup> is simply not credible. Indeed this statement indicates a lack of appreciation of the sensitivity of the modelling results, potential inaccuracy in the analysis and a gross over-simplification of the uncertainty due to such factors as future commodity prices and CM costs. Further modelling is required which probes a greater range of scenarios before conclusions can be drawn with any confidence.
- 2.14 It is notable that whilst the commodity price scenarios are by no means extreme<sup>10</sup>, the simulated total aggregate impact on consumer bills ranges between a reduction of £1.2 billion to an increase of £3.0 billion in the period to 2035 (a variance of £4.2 billion between scenarios).
- 2.15 **The CMA’s dismissal of modelling results beyond 2026 is arbitrary and cannot be properly justified.** The CMA completely ignores the modelled impact of locational transmission losses beyond 2026 based on the concern that “*the results essentially model a system which is the inverse of the system*

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<sup>6</sup> PDR, Appendix 2.2, Section 4.6.

<sup>7</sup> PDR, Appendix 2.1.

<sup>8</sup> PDR, Appendix 2.2, Figures 4.8 and 4.29 - 4.34.

<sup>9</sup> PDR, para. 2.51.

<sup>10</sup> PDR, Appendix 2.2, Figure 4.7.

*we see today*”<sup>11</sup> with the South becoming an exporting region. This is described as a “modelling artefact” (driven in part by the TNUoS charges employed) yet the results up to 2026 are equally a modelling artefact (driven in part by the CM assumptions discussed above). It is arbitrary for the CMA to selectively scrutinise and discount ‘unhelpful’ results without similarly scrutinising the results which support the case for implementation.

- 2.16 SSE would expect the modelling to show that the North becomes an energy importing region in due course, the only question is whether this might happen sooner than 2026 (given the closure of Longannet and the expected closure of two nuclear power stations in 2023).
- 2.17 This evolution in the generation mix has been considered under the transmission charging mechanism introduced through Project TransmiT. The Peak Security (*PS*) element of transmission charges is calculated based on a scenario of meeting peak demand at a time of no wind generation. The forecast level of the PS element for Scotland in the coming years is *negative* (i.e., flexible conventional generation will receive a locational benefit).<sup>12</sup> The Year Round element of the charge reduces the impact of this signal yet there is clearly an expectation that Scotland will in due course become an importing region for some portion of the year; this observation in the modelling is therefore not sufficient reason to dismiss the results.

### **3. The modelling framework**

- 3.1 **The adopted methodology does not test the model against reality.** Transmission losses are extremely complex and include an element which is highly variable both temporally and spatially. This makes a realistic assessment of the level of losses on the transmission system a non-trivial problem. Imperial College’s DTIM model is used to derive a “losses function” which relates demand, wind and losses at modelled locations to estimate the change in total losses due to incremental generation. This losses function therefore drives the entire modelling approach, yet the results of the model are not tested against reality. There is therefore no check on whether the modelled losses function is reflective of the actual system; in SSE’s view it is not.
- 3.2 The failure to adequately test the losses function means that there is no opportunity to quantify discrepancies or to assess in any way the impact on the modelled results of this simplified approach. It is extremely risky to neglect such simplifying assumptions when interpreting the output of the models – the CMA has made the serious error of assuming that the model is ‘right’ and that it can be used to determine the true impact on losses of changes in generation dispatch.

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<sup>11</sup> PDR, para. 2.47.

<sup>12</sup> National Grid, *Forecast TNUoS Tariffs From 2018/18 to 2020/21*, 11 February 2016.

3.3 **There is insufficient transparency regarding a number of important issues which precludes any detailed comment.** To allow stakeholders to comment in the modelling on a well-informed basis the following details would need to be transparent:

- (a) **Commodity prices:** It is not clear what assumptions have been used for commodity prices (gas, coal, EUA, CPSR). Sources are provided but there is some scope for interpretation and it is not clear precisely what approach has been taken.
- (b) **Absolute levels:** NERA only report difference vs “Uniform Case”, but they do not show the absolute levels either for the Uniform Case or for the locational losses results.
- (c) **How loss factors are calculated:** NERA do not show, or explain:
  - (i) how factors are calculated to combine: 1) Locational signal with 2) making sure the correct total net losses are applied at seasonal or annual resolution;
  - (ii) loss factors for the 45:55 cost sharing scenario; or
  - (iii) how over- or under-recovery of costs would be resolved? Where loss multipliers are set in advance, then on any resolution examined, they will not net-off to 1 - i.e., the combination of positive and negative charges will lead to an over/under collection in any given HH, day, month, season, or year (c.f. losses are currently charged ex post so that each HH adds up correctly). This would lead to a situation where generation in one season may be paying charges to cover for an under collection in a different season when they may not even have been generating.

3.4 **Further work is required to fully test the sensitivity and robustness of the models used.** The modelled scenarios included looking at a three fuel prices scenarios – whilst this work could be expanded to provide a more complete analysis there are many other factors which need to be tested, each of which could substantially change the results:

- (a) **Station location:** the technology and location of plant mix could, in reality, be very different from the modelling assumptions.
- (b) **Station merit order:** determined by a number of station specific parameters, including efficiency and other performance data, fuel delivery costs etc. The assumptions used here can change the merit order and therefore the result, which is highly dependent on the location of the marginal plant. The assumptions used are subjective and not transparent.
- (c) **Dispatch of interconnectors:** this is very subjective and is based on a simplistic approach to interconnector pricing. This is material to

expected flows and therefore to output from GB generators and the level of distributional effects between GB and EU.

- (d) ***Wind and PV profiles:*** all wind is modelled against the same profile whereas, in reality, there are often significant north/ south or east/ west differences in output levels. In addition, actual load factors differ significantly for wind farms across the country with higher load factors for offshore stations in the south. It is not clear whether the model considers PV generation at all but this is increasingly significant and exhibits a strong north/ south split.
- (e) ***Demand level:*** there is no clear evidence of the sensitivity of modelled results to demand levels, but this will be material to the analysis.

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