NON-CONFIDENTIAL VERSION

SCOTTISHPOWER

CMA ENERGY MARKET INVESTIGATION

SCOTTISHPOWER'S RESPONSE TO THE PROVISIONAL DECISION ON REMEDIES

INTRODUCTION AND EXECUTIVE SUMMARY

ScottishPower welcomes the opportunity to respond to the Competition and Markets Authority (**CMA**)'s Provisional Decision on Remedies (**PDR**) published on 17 March 2016 in the CMA's investigation into the supply and acquisition of energy in Great Britain (**GB**) (**Market Investigation**).

The PDR generally brings forward a focussed set of proposed orders and recommendations which will address many of the issues found in the Market Investigation. The CMA has investigated a broad range of issues since June 2014 and has helpfully clarified the areas where the operation of the market could be improved, as well as those where no action is needed. Nevertheless, we are concerned about the specific proposals in a number of key respects, set out below.

(a) *Benchmarking and prepayment price cap*: we have serious concerns about the benchmarking approach used in assessing the £1.7 billion per annum consumer detriment around Standard Variable Tariffs (**SVT**) (so purporting to justify the prepayment price cap remedy) and (in a slightly different form) to set the level of the proposed cap. On the face of it, the detriment figure of £1.7 billion per annum seems implausibly high given that the CMA estimated inefficiency by the Six Large Energy Firms (**SLEFs**) as around £290 million per annum and the average supplier profits over the period were £566 million per annum. The abrupt change from the previous 'indirect' method (which now gives a much reduced figure of £660 to £1,100 million per annum in the light of previous comments) to the 'direct' method gives the impression that the CMA has changed methodology in order to achieve a larger figure.

Moreover, on examination, the approach of the CMA to the 'direct' benchmarking is itself seriously flawed, to the extent that it would be irrational to rely on that methodology to justify any detriment at all. Oxera undertook work for us in the Confidentiality Ring (see the Oxera note based on a non-confidential version of their report attached as Annex 1) which has identified serious flaws including:

(a) incorrect recognition of environmental obligations on benchmark companies;

(b) incorrect choice of benchmark companies;

(c) unrealistic assumptions about sustainability of profitability levels for benchmark companies;

(d) implicit benchmarking of wholesale costs – a process we consider to be invalid; and

(e) the effect of growth in customer numbers on the benchmarking process, including tariff mix.

These flaws collectively make it unsafe to rely on the direct methodology to justify any detriment, let alone one of the magnitude the CMA has identified.

The cap itself is proposed to be set on the basis of two relatively small companies' prices on a single day – a procedure which is highly susceptible to error and gives no assurance that the cap would be at an efficient level, since those prices may be significantly affected by factors such as customer acquisition campaigns and pass-on of significant changes in costs such as the costs of social and environmental obligations. Moreover it is susceptible to the same problems as the detriment calculation – though they manifest themselves differently because it is a one day rather than 4 year assessment. Oxera estimates that the proposed price cap is set too low by some £50 per annum because of these issues. The price cap proposals are further affected by an incorrect assessment of the cost to serve differentials; estimates by ScottishPower suggest that to correct for these, the cap would need to be raised by around £32 per annum. In total, these problems raise such significant challenges as to the proportionality of the prepayment price cap remedy and the accuracy of the cap calculations that if the CMA were to proceed to set the cap without fully addressing them, we believe that they would provide good grounds for appeal, should a party decide to take that step.

(b) *Database sharing remedy:* there are important data protection issues which need to be addressed; in particular, the CMA needs to provide clarity as to how the processing of personal data envisaged by this remedy will be compliant with UK and EU data protection law before this remedy could be considered workable. Further clarity should also be provided as to the views of the Information Commissioner's Office (**ICO**) on this remedy. We look forward to seeing this in the final report.

(c) *RMR remedies:* while we are happy with these as far as they go, a number of other impediments to competition remain. We think competition could be further strengthened if the CMA's recommendation to Ofgem encouraged Ofgem to consider removing further restrictions. We have identified some options in our response.

(d) *Restricted meter remedies:* we think these have not been fully thought through and could in their current form lead to significant consumer detriment, especially among customers whose consumption is principally at night or using the controlled circuit. From our reading of the PDR, it appears that the CMA has not identified an AEC to justify the proposal to extend the remedy to Economy 7 (**E7**) meter types. We suggest that this remedy is recast as a recommendation to Ofgem to look into the matter, including whether measures of the type suggested are appropriate.

(e) *Micro-business remedies:* while we welcome these, we think that there may be some missed opportunities where they could go further. We suggest that recommendations to Ofgem are cast so as to allow these to be followed through.

(f) *Governance remedies:* while we are generally supportive of these, some aspects may not be fully practicable.

Our response therefore starts with a discussion of the estimate of detriment, referring to the Oxera work attached as Annex 1, followed by a discussion of each of the groups of remedies.

1. CMA ESTIMATE OF CONSUMER DETRIMENT

1.1 The CMA has estimated that the detriment from excessive prices to the domestic customers of the SSLEFs was about £1.7 billion a year on average over 2012 to 2015, with a marked trend upwards year on year, reaching almost £2.5 billion in 2015.[1] This estimate is based on a 'direct' approach to assessing detriment which involves calculating the average prices offered by SLEFs and comparing these on a broad like-for-like basis to a 'competitive benchmark price', constructed as the average prices offered by the most competitive suppliers.

1.2 This finding of detriment is used to support the CMA's remedy proposals, and in particular the decision to impose a price cap on prepayment tariffs. The same 'direct' methodology is also used by the CMA to estimate the basis for the level of the proposed prepayment price cap.

1.3 On the face of it, this 'direct' estimate seems implausibly high. The level of inefficiency estimated by the CMA's indirect approach was around £290 million per annum[2] and the average supplier profits over the period were £566 million per annum.[3] The sum of these figures goes nowhere near the alleged £1.7 billion detriment.

1.4 ScottishPower has commissioned Oxera to review the CMA's analysis using data made available in the CMA's Confidentiality Ring. A note based on the non-confidential version of Oxera's report on this work is provided in Annex 1 to this response. Oxera has identified a number of areas where the benchmark used by the CMA departed from that which might be considered to be a fair benchmark that could be expected to prevail in a well-functioning market.

1.5 In particular, Oxera has found that the following features of the CMA's analysis distort the results and create artificially high overcharge estimates:

(a) *Incorrect assessment of the impact of environmental obligations on benchmark companies*: Oxera found the CMA had not adjusted ECO and WHD costs for Ovo and First Utility to reflect the small supplier exemptions from which they benefited for part of the period, nor for the fact that obligations are based on a lagged measure of market share, which reduces obligations for growing companies relative to static or contracting companies. This error alone accounts for the majority of the alleged detriment.

(b) *Omission of a valid comparator (Co-op) from the list of benchmark companies – thus biasing the overcharge estimates upwards*: Oxera considered that the CMA's concerns about the Co-op's dividend payments affecting comparability did not stand up to scrutiny because the dividend payment on a £960 annual bill would be only £4.32 and that the grounds for excluding the Co-op from the set of comparators were unconvincing – particularly given that the set of comparators would otherwise be extremely small. Again, this decision gives the impression of seeking a particular outcome.

(c) *An assumption that low or negative profitability of benchmark companies can be sustainably replicated by the entire market*: for much of the period covered by the CMA's direct benchmarking analysis, one or both of Ovo and First Utility were either making a loss or making a profit that was below the Return on Capital Employed (ROCE) benchmark that was considered reasonable by the CMA in its indirect benchmarking analysis.

(d) *Reliance on benchmarking of wholesale costs of different suppliers despite such costs being subject to volatility of wholesale market prices and thus largely uncontrollable*: The CMA's

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1 PDR para 59.

2 The CMA estimates (PDR para 3.214) that indirect costs for the Big 6 were £290 million per year higher on average (for 2007-2014) than the (lower quartile) benchmark.

3 PDR Table 3.12.

‘direct approach’ is implicitly benchmarking wholesale energy costs even though, following criticism, it removed such benchmarking from its updated ‘indirect approach’.

(e) *Failure to account for the effect of growth in customer numbers on the tariff mix of different supplier*s: A supplier that is growing rapidly by acquiring customers on its acquisition (fixed) tariffs, some of whom end up defaulting onto its SVT, is likely to have a lower share of SVT customers than a supplier that acquires new customers in the same way but does not increase its customer numbers overall; hence, assuming that acquisition tariffs are cheaper than SVTs, a growing business will have a lower weighted average tariff than one that is not growing, even if their corresponding SVT and acquisition tariffs are the same. This effect was estimated at £153 million for all customers and £24 million for prepayment customers.

1.6 Table 1 sets outs the results of Oxera’s analysis to correct for some of the issues with CMA’s benchmarking analysis identified above. It shows that, once corrections for all issues apart from the effect of growth on tariff mix (which overlaps with the insufficient profitability aspect) have been made, the annual overcharge estimates are eliminated, both for the entire market and for the prepayment segment of the market.

Table 1: Oxera adjustments to CMA’s overcharge estimates

	Annual average (£’m) - All[4]	**Annual average (£’m) - PP**
CMA estimates of overcharge	1,715	345
Adjust for cost of environmental obligations (I)	-1,315	-228
Adjusted CMA estimates of overcharge (I)	362	117
Adjust to include Co-op in benchmark (II)	-142	-19
Adjusted CMA estimates of overcharge (I & II)	220	98
Adjust for low profitability of benchmarks (III)	-724	-126
Adjusted CMA estimates of overcharge (I, II & III)	-504	-28
Adjust for differences in wholesale cost (IV)	-234	-41
Adjusted CMA estimates of overcharge (I, II, III & IV)	-738	-69

Source: Oxera (see Annex 1)

1.7 Oxera considers that the apparent negative figures for the detriment was not an indication of under-charging by the SLEFs but more a reflection of the likelihood that First Utility and Ovo were operating, especially in the earlier years, below minimum efficient scale. The appropriate conclusion is simply that the direct benchmarking approach, when corrected for the CMA’s methodological errors, fails to reveal any sound basis for concluding that there is any detriment or overcharging. If the CMA wishes to found remedies on consumer detriment, it will need to address these concerns or follow a different methodology.[5]

1.8 Oxera has not reported detriment on an annual basis because the adjustments based on differences in wholesale costs, shortfalls in profitability of benchmark companies and the costs of social and environmental obligations show a lot of year-on-year volatility in line with volatility of corresponding costs and profits. In addition, the timing of pass-on of changes in suppliers’ costs, such as the costs of social and environmental obligations, into tariffs is highly uncertain. Given the variations that can occur from year to year in company performance, it is preferable to assess performance over a number of years to ensure that conclusions are not driven by results from one particular year.

4 Based on an average 2012-2015 (with 2015 assessed as the figures for the first six months of the year, multiplied by two).

5 If the CMA were to adopt a different methodology from that set out in the PDR, it would need to embark on a further round of consultation (see section 169(1) of the Enterprise Act 2002).

2. CONTRACTS FOR DIFFERENCE (CFD) REMEDIES

"A recommendation to DECC to undertake and consult on a clear and thorough impact assessment before awarding any CfD outside the CfD auction mechanism.

A recommendation to DECC to undertake and consult on a clear and thorough assessment of the appropriate allocation of technologies and CfD budgets between pots."

Introduction

2.1 We welcome the recommendations from the CMA for DECC to increase transparency in the allocation of budgets for CfD allocation rounds and also in respect of bilateral negotiation.

DECC to undertake and consult on an impact assessment before awarding CfDs outside the auction mechanism

2.2 We appreciate that on occasion there may be a requirement for DECC to enter into bilateral negotiations to award a CfD due to the practicalities of running a competitive auction process for the projects or types of project concerned.

2.3 Whilst current regulations allow for the Secretary of State to offer a CfD on a bilateral basis, there is no guidance as to how this should be managed. This leaves developers of other potential CfD projects with uncertainty as to how such allocation may impact the budget available for future allocation rounds within the delivery period.

2.4 We therefore agree with the CMA that greater transparency should be provided, with impact assessments and consultation at two stages – prior to entering into negotiations and after strike price negotiations.

2.5 It is essential that all stakeholders have the opportunity to consider whether the bilateral CfD would be appropriate in terms of value for money to consumers and meeting long term decarbonisation targets - as well as providing visibility for developers of other technologies, so they can consider the potential impact on future CfD awards.

DECC to undertake and consult on an impact assessment before allocating technologies between 'pots' and the CfD budget to the different pots

2.6 Given the lengthy development process associated with generation assets, visibility of future allocation round budgets (included in the overall Levy Control Framework period) would be beneficial to inform developers of Government appetite and aspiration for future delivery of capacity. Once informed, developers could efficiently plan delivery of future generation projects and ensure efficient investment in development expenditure. We therefore welcome the CMA's recommendation for DECC to consult on an impact assessment prior to allocating budgets to different technology pots.

2.7 The CMA also suggests that, to ensure that potential bidders are able to make informed decisions about whether to progress a project in advance of the auction, DECC should finalise its proposals for the allocation of technologies and budgets at least one year ahead of the auction.[6] Although giving bidders early certainty would be helpful, this benefit needs to be balanced against the need for DECC to retain flexibility to respond quickly to developments - and the risk that an inflexible one year time lag could delay the auction process.

2.8 The effectiveness and efficiency of a particular budget allocation will depend in part on the wholesale energy price and the degree of competition in the auction. We would therefore consider it

[6] PDR para 18.

prudent, from the perspective of ensuring value for money for bill payers, and also recognising Government's desire to bring forward investment in low carbon electricity generation, that a degree of flexibility is retained to allow the budget to be adjusted in the intervening period.

2.9 In respect of allocating technologies to different pots, or technologies moving between pots, we agree that it will also be beneficial for the DECC to consult on such changes. The first CfD allocation rounds delivered some 500MW more capacity than had been estimated due to the introduction of competition across established and less established technologies. We would anticipate that a similar approach in future allocation rounds, given the level of price reduction seen in the first allocation round, would deliver further efficiencies, and as such value for money for consumers.

3. LOCATIONAL PRICING REMEDIES

"An order (the 'Locational Pricing Order') on National Grid (and amendments to National Grid's licence conditions) that would set out, among other things:

(i) the formula to calculate the transmission loss factors (which ultimately feeds into the imbalance charges) for this purpose;
(ii) an obligation on National Grid to create a load flow model;
(iii) an obligation on National Grid to create a networking mapping statement and collect annually relevant network data;
(iv) an obligation on National Grid to appoint third party agents to collect metered volumes data and to calculate annually the transmission loss factors pursuant to the principles set out in the order and using the models created, and information collected, pursuant to the order;
(v) an obligation on National Grid to direct Elexon, as appropriate, to update the networking mapping statement and carry out other administrative tasks that are necessary to the calculation by the third party agents; and
(vi) an obligation on National Grid to raise any consequential code modification.

A recommendation to Ofgem to support National Grid by taking necessary steps that might facilitate the implementation of the Locational Pricing Order."

3.1 We agree that the current system of uniform pricing for transmission losses creates a system of cross-subsidisation that could distort competition between generators. However, the actual level of impact that locational pricing will have on dispatch and investments decisions in practice is difficult to ascertain. Whilst the scale of potential benefits remains uncertain, implementing the remedy should lead to the impact of individual parties on transmission losses being more accurately reflected in imbalance charges.

3.2 We agree that inefficiencies in the inter-transmission system operator compensation mechanism do not invalidate the case for having a more efficient allocation of transmission losses within GB. However, we believe there is an overriding need to create a more level playing field between generators in GB and those elsewhere in Europe. If, as proposed, 100% of losses are to be borne by generators, the cross-border trade distortion would be further exacerbated. Accordingly, we believe that the CMA should include in its remedies a recommendation that Ofgem (i) conducts an assessment of cross-border network charging distortions (which include, and extend beyond, transmission losses), and (ii) takes steps to mitigate any distortions identified.

3.3 As NERA point out, given the complexity of the modelling, ascertaining the scale of the benefits of locational pricing is inherently difficult. Accordingly, we believe that additional time and analysis is required. The additional time would allow NERA to present their modelling and findings to the industry, and consider any feedback received. Areas that we believe we would benefit from further information or require further consideration include:

(a) The assumed TNUoS charges are taken from NERA's work during Project Transmit, and this assumption remains static throughout the modelling.[7] We consider that modelling the impact that generation investments will have on TNUoS charges, and vice-versa, dynamically is important. Indeed, the results obtained from NERA's work beyond 2026 have been discounted by the CMA due to the static input assumptions used.[8]

(b) NERA's capacity market price forecast is at a level well above that forecast by most industry commentators. We consider this to be important, as a considerable proportion of the consumer benefits/detriment modelled by NERA across their scenarios arises from the change in their modelled capacity market price.

3.4 More generally, we believe stakeholders would benefit from open discussion with NERA to understand how some of their results have been derived.

4. ELECTRICITY SETTLEMENT REMEDIES

"A recommendation to DECC to consult on amending the provisions of the Smart Energy Code that prohibit suppliers from collecting consumption data with greater granularity than daily unless a customer has given explicit consent to do so."

"A recommendation to Ofgem to:

conduct a full cost benefit analysis of the move to mandatory half-hourly settlement, including analysis of costs, benefits and distributional implications as well as mitigating measures;

start the process of gathering evidence for the analysis as soon as practicable;

consider the cost-effectiveness of alternative design options for half-hourly settlement such as a centralised entity responsible for data collection and aggregation; and

consider options for reducing the costs of elective half-hourly settlement, including (i) whether any of these options are likely to delay or accelerate the adoption of mandatory half-hourly settlement; and (ii) any challenges that may arise or benefits that may accrue from the existence of two settlement systems, including in particular the possibility of gaming/cherry picking behaviour.

"A recommendation to both DECC and Ofgem that they publish and consult jointly on a plan setting out:

the aim of the reform for half-hourly settlement;

a list of proposed regulatory interventions (including code changes), and the relevant entity in charge of designing and/or approving such interventions, that are necessary in order to implement the half-hourly settlement reform;

an estimated timetable for the completion of each necessary intervention; and

where appropriate, a list of relevant considerations that will be taken into account in designing each regulatory intervention.

<u>Introduction</u>

4.1 We support the broad thrust of the proposed remedies in response to the identified electricity settlement AEC. The remedies constitute a pragmatic approach, anticipating the net benefits that reforms can deliver to consumers whilst also recognising the considerable challenges that will be encountered in the process of implementing half hourly settlement.

4.2 The remedies build on existing reforms underway regarding elective half-hourly settlement led by Ofgem and appear to be consistent with Ofgem's stated approach to mandatory half-hourly

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7 PDR para 2.48.
8 PDR para 2.49.

settlement. We have identified some issues in relation to the specific remedies below which we believe should be considered with regard to implementation.

Amending the provisions of the Smart Energy Code

4.3 We agree with the principle of this remedy, but would note that if the consultation results in a relaxation of the constraints on collecting half hourly data, it will be necessary to amend the electricity supply licence as well as the SEC. Whilst it is correct that the relevant elements of the Data Access and Privacy Framework (**DAPF**) have been transposed in to the SEC, this was primarily to capture non-licensed SEC parties. The overarching obligation on suppliers is in SLC 47 of the electricity supply licence and this will also need to be amended.

Cost benefit assessment

4.4 We support the proposed recommendation regarding the framework of cost benefit analysis, which should help deliver an efficient implementation of half-hourly settlement and maximise the net benefits to consumers.

4.5 We are particularly pleased to see the inclusion of a centralised data collection and aggregation agent as we believe it is likely to deliver consumer benefits through lower costs of settlement.

4.6 Based on past experience of large and complex industry reform, we believe the way to ensure robust cost benefit analysis and timely delivery of a proportionate solution, is to limit the assessment to no more than two or three credible options and a clear set of underlying assumptions. The industry is more likely to be able to provide robust cost estimates against such a framework and Ofgem will be able more readily to assimilate information and assess the options.

Joint DECC/Ofgem plan for regulatory interventions

4.7 In relation to regulatory interventions, we note the preference for using the provisions in the draft Energy Bill which give Ofgem the power to modify licences in relation to half-hourly settlement and where necessary to implement the modifications in less than the statutory 56 days. We agree that it may be helpful for Ofgem to have such powers in reserve to ensure timely implementation of reforms. That said, Ofgem will need to ensure that licensees are still given adequate time for implementation, especially as they are likely to be managing a number of other complex system and operational changes at the same time.

5. GAS SETTLEMENT REMEDIES

"A recommendation to Ofgem to ensure implementation of Project Nexus by 1 October 2016 through monitoring closely the progress made by the industry in meeting intermediate milestones and to take (where appropriate) further measures to achieve this objective."

5.1 We support the broad thrust of the proposed remedies in response to the gas settlement AEC and are pleased to see that they have been refined in response to feedback on the Remedies Notice.

5.2 We agree with the assessment that the implementation of Project Nexus will go some way to addressing the gas settlement AEC, on the basis it delivers the core functionality as described in the PDR.[9] However, following Ofgem's approval of the original Project Nexus UNC modifications it subsequently approved a modification 573,[10] to defer some of Project Nexus' core functionality, on the grounds that this reduced specification was more likely to be delivered by the gas transporters by 1 October 2016. Crucially the deferred functionality delays the ability automatically to apply

[9] PDR para 5.92.
[10] See: http://www.gasgovernance.co.uk/0573.

retrospective corrections to assets and supply points. In light of Ofgem's recent open letter,[11] there appears to be a risk of further deferral of Nexus' functionality due to transporter readiness.

5.3 Before finalising this remedy we suggest the CMA and Ofgem should carry out a further assessment regarding what is likely to be delivered by Xoserve by 1 October 2016, in particular whether there is a risk that only a further partial solution may be delivered which may entail additional cost for shippers and other users to work around. If there is a risk of additional de-scoping, we suggest that the delivery date should be reassessed with the possibility of deferral to the earliest date that a full Nexus solution is possible.

"An order on gas suppliers (and amendments to gas suppliers' standard licence conditions) to submit all meter readings for non-daily metered supply points in GB to Xoserve as soon as they become available, and at least once per year, save for non-daily metered supply points with a smart or advanced meter, which must be submitted at least once per month."

5.4 We support this proposed remedy, now that it has been revised to accommodate the practicalities governing the collection and submission of non-daily meter reads. This remedy for smart/advanced meters is dependent on Project Nexus being in place to provide the capacity to accept monthly meter reads from shippers. Therefore when implementing this remedy we suggest the requirement for monthly reads should take effect after an appropriate grace period to enable the Project Nexus solution to be sufficiently capable and operationally reliable.

"A recommendation to Ofgem to:

(i) take responsibility for the development and delivery of a performance assurance framework to increase accuracy of the gas settlement process as soon as reasonably practicable, and at the latest within one year of our final report;

(ii) establish a project plan and allocate responsibility to Uniform Network Code parties to take actions for its implementation;

(iii) supervise its implementation; and

(iv) take appropriate steps to ensure that failure to meet targets

5.5 We strongly support the implementation of a performance assurance framework as an important means of reducing unidentified gas, where it is a symptom of an issue that is controllable by a party in the market. We have the following comments regarding implementation:

(a) The CMA suggests that it is left open to Ofgem to identify other components of unidentified gas that should be subject to the performance assurance regime.[12] In this respect we would expect large gas transporters, independent gas transporters and Xoserve to be included with shippers as they can also be responsible for the accuracy of inputs that can significantly contribute to unidentified gas.

(b) We agree that the performance assurance framework should be implemented within 12 months of the final report, but we would question whether this will be achievable if half of this time is given over to developing the project plan.[13]

(c) There will need to be broad tolerance on targets for performance at the introduction of the regime. The new Project Nexus arrangements will introduce new ways of working and different meter reading tolerances and time will therefore be required for teething problems to be ironed out and for shippers/transporters to become familiar with the new operating regime. However we would expect that these should, and could, be tightened over time, to

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11 See: http://www.gasgovernance.co.uk/sites/default/files/Ofgem%20Open%20Letter%20on%20Project%20Nexus%20and%20Ofgem%20sponsorship.pdf.

12 PDR para 5.1 84.

13 PDR para 5.185.

ensure that controls are put in place to address areas where parties have influence over accuracy and unidentified gas.

6. PREPAYMENT TARIFF CODE & DAP REMEDIES

"A recommendation to Ofgem to:

(i) modify suppliers' standard licence conditions to introduce an exception to SLC 22B.7(b) so as to allow a supplier to set prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff;

(ii deprioritise potential enforcement action pending the modification of SLC 22B.7(b) against any supplier to a prepayment customer that sets prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff;

(iii) take responsibility for the efficient allocation of gas tariff pages; and

(iv) take appropriate steps to ensure that changes to the Debt Assignment Protocol are implemented by the end of 2016, and in particular in areas relating to objection letters, complex debt and issues relating to multiple registrations; including setting out clear objectives and a timetable with appropriate milestones, supervising progress against such objectives and milestones, and to take all steps, if and when necessary, to ensure delivery of these changes.

The acceptance of undertakings from the Six Large Energy Firms or, absent such undertakings including the following three components:

(i) a cap on the number of gas tariff pages that any supplier can hold (at 12);

(ii) an obligation for suppliers to provide relevant information for Ofgem to monitor the allocation of the gas tariff codes; and

(iii) a condition that allows Ofgem to mandate the transfer of one or more gas tariff pages to another supplier.

Absent such undertakings, we would recommend that Ofgem introduces a new licence condition in suppliers' standard licence conditions to include the three components set out above.

Tariff code rationalisation

6.1 We support the proposed suite of actions to enable more efficient use of gas tariff codes, which are similar to the actions proposed by ScottishPower in our response to the second supplemental notice of remedies (**SSRN**).

6.2 In respect of the recommended deprioritisation of enforcement in relation to SLC22B.7(b), we think it would be appropriate for Ofgem to accept this recommendation and clarify the scope of the deprioritisation in writing, so as to provide certainty for suppliers. This could be done by Ofgem issuing an open letter.

Implementing changes to DAP

6.3 We support the proposed recommendation to Ofgem regarding implementation of changes to the Debt Assignment Protocol.

7. PROPOSED REMEDIES CONCERNING THE RMR AEC

A recommendation to Ofgem to

(i) modify gas and electricity suppliers' standard licence conditions to remove the following conditions:

— the ban on complex tariffs (SLC 22A.3 (a) and (b));
— the four tariff rule (SLC 22B.2 (a) and (b));
— the ban on certain discounts (SLCs 22B.3-6 and 22B.24-28);
— the ban on certain bundled products (SLCs 22B.9-16 and 22B.24-28);
— the ban on certain reward points (SLCs 22B.17-23 and 22B.24-28);
— the prohibition against tariffs exclusive to new/existing customers (SLC 22B.30 and 22B.31);
— make any necessary minor consequential amendments;
and introduce an additional standard of conduct into SLC 25C that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare value-for-money with other tariffs they offer;

(ii) deprioritise potential enforcement action pending the removal of the Conditions against any supplier that operates in breach of the Conditions;

(iii) remove the Whole of the Market Requirement in the Confidence Code and introduce a requirement for PCWs accredited under the Confidence Code to be transparent over the market coverage they provide to energy customers.

Introduction

7.1 We welcome the proposal to remove the RMR 'simpler choices' rules listed above from domestic supply licences, which we believe will have a positive impact on competition and innovation in the retail energy market. However, as explained below, we do not consider that the CMA's proposals go far enough. We believe the CMA should consider recommending the removal or amendment of additional licence conditions, and make it clear in its recommendation that Ofgem has discretion to go further than the CMA's proposals if it sees fit, and the fact that the CMA has not included specific elements in its list does not mean that the CMA considers they must be retained if Ofgem judges that removing them would improve competition.

7.2 We support the introduction of a new principles-based rule into the licence (possibly as part of SLC 25C) that would require suppliers to have regard in the design of tariffs to the ease with which customers can compare value-for-money with other tariffs they offer. This could perhaps be framed in terms of an objective, with a requirement that licensees take reasonable steps to achieve the objective (and not frustrate it). We note that Ofgem is separately considering, as part of its Future of Retail Regulation project, revising SLC25 (sales and marketing) to be more principles-based, and we have suggested that this could involve the introduction of a new principle to ensure that customers are provided with sufficient information in the course of a sale to understand the impact on them of their choice. A new principle around tariff comparability could complement any such new sales principle.

7.3 We also support removal of the Whole of the Market Requirement in the Confidence Code, replacing it with a requirement for PCWs accredited under the Confidence Code to be transparent over the market coverage they provide to energy customers. This remedy, in conjunction with the removal of tariff simplification rules, has the potential to expose PCWs to greater competitive pressure, which we believe is particularly important given the increasingly prominent role that they (and other intermediaries) are likely to play in the market in future.

Other RMR tariff simplification rules which should be removed or modified

7.4 The CMA has not included **SLC22A.2** in its list of licence conditions to be removed. This requires that in the case of non-time of use tariffs, charges comprise a single standing charge and/or a single unit rate. This had the effect of prohibiting two-tier 'no standing charge' tariffs which were previously a popular option (chosen by around **[CONFIDENTIAL]**% of our customers[14]), which

[14] At the time immediately before RMR came into force.

protected very low usage consumers from the full standing charge. In explaining why it has provisionally decided to retain this condition, the CMA says Ofgem explained that it was intended to prevent 'drip pricing'.[15] Whilst we have no objection to measures aimed at preventing drip pricing, the condition is clearly more prescriptive than is necessary to achieve this – as is demonstrated by the fact that it prevents two-tier 'no standing charge' tariffs, which have nothing to do with drip pricing. It also interacts awkwardly with the proposed prepayment meter price cap (see para 12.32). We therefore suggest that the CMA include a recommendation to Ofgem to review SLC22A.2 and consider whether the objective of no drip pricing can be achieved in a less prescriptive way. Our main reason for suggesting this is to avoid the situation where future tariff innovations are unintentionally restricted, rather than to enable re-introduction of 'no standing charge' tariffs (though we see no harm in their re-introduction if there is sufficient consumer demand).

7.5 The CMA has not included **SLC22B.7** (treatment of adjustments for payment methods) in its list of licence conditions to be removed – although in connection with the prepayment AEC it is recommending that Ofgem introduce an exception to SLC22B.7(b).[16] We consider that SLC22B.7(d) is unnecessarily restrictive in that it requires that the price differential is either incorporated into the standing charge or into the unit rate but not both.[17] In general, the cost differentials between payment methods comprise elements that scale with number of customers (such as metering costs) and elements that scale with consumption (such as bad debt or working capital), and we believe suppliers should have the flexibility to make the price differential as cost-reflective as possible. Accordingly, we suggest that SLC22B.7(d) should either be deleted or amended as follows, and that the CMA should make a recommendation to Ofgem to this effect.

> 22B.7 The licensee must ensure that any differences in the Charges for Supply of Electricity as between payment methods:
> [...]
> (d) are fully incorporated in:
> (i) where the Domestic Supply Contract or Deemed Contract is for a Non-Time of Use Tariff, the Unit Rate or the Standing Charge (or a combination of the two); and
> (ii) where the Domestic Supply Contract or Deemed Contract is for a Time of Use Tariff, any or all (or a combination) of the Time of Use Rates or the Standing Charge.

7.6 The CMA has not included **SLC22C.7** in its list of licence conditions to be removed, but does not appear to give a reason for retaining it. The condition requires that at the end of a fixed-term product, if the customer does not actively choose otherwise, he or she is automatically rolled over onto the cheapest evergreen tariff, which encourages suppliers to only have one evergreen tariff. As we have previously stated,[18] we believe suppliers should be allowed to roll over onto *any* tariff, so long as there are no exit fees during the whole duration of the new tariff.

7.7 The CMA has not included **SLC22C.9** in its list of licence conditions to be removed, which places a restriction on suppliers unilaterally varying the price or other terms and conditions of fixed-term contracts in any way which makes the customer worse off. The CMA says this reflects requirements of consumer law that contract terms must be fair and transparent. It also considers that these restrictions make fixed-term tariffs easier to understand and less risky for consumers by aligning offers with their expectations and mitigating concerns about auto-rollovers.[19] We would note that SLC22C.9 has the effect of banning 'tracker' or capped fixed-term tariffs (e.g. tariffs which offer a specified percentage discount off the SVT for the term of the tariff, or which link price movements to the SVT but subject to a cap for the term of the tariff). These were very popular options prior to

[15] See PDR para 5.394. Drip pricing is where an advertised headline price does not include additional fees and charges that are later disclosed incrementally in the sales process.
[16] The exemption would allow suppliers to set prices to prepayment customers on the basis of grouping regional cost variations which are applied to other payment methods within the same core tariff.
[17] Ofgem confirmed to us that this was how the licence condition was to be interpreted at the time that it came into effect.
[18] ScottishPower response to Remedies Notice, Table 1.
[19] PDR para 5.397.

RMR, and there was no suggestion that consumers considered them to be unfair or found them difficult to understand. Customers could terminate the fixed-term contract without penalty if the price increased, so there was no sense in which they were 'locked in'. We suggest the CMA includes a recommendation to Ofgem to review the need for this provision - given that unfair or difficult to understand tariffs would presumably be prohibited by the proposed new principles-based obligation. Indeed, if such contracts were prohibited by consumer law (which we doubt), there would be no need to prohibit them in the licence conditions; conversely, if they are not prohibited by consumer law there would be no reason to prohibit them in the licence conditions.

7.8 In summary, one of the main characteristics of competition is that it is a discovery process, and through rivalry the market finds the best solutions to meet the needs of consumers. In this respect, it is difficult in practice – and possibly wrong in principle – to seek to identify precisely what additional tariffs could come into play if the above RMR restrictions were relaxed. The proposed principles-based regulation around comparability of offerings should adequately mitigate any detriment to consumers that might result from increased complexity of tariffs whilst maintaining flexibility for innovation.

<u>Consequential changes to information rules</u>

7.9 We agree that it is desirable for suppliers to be released from relevant tariff restrictions as soon as possible, and support the CMA's recommendation for Ofgem to deprioritise potential enforcement action pending the removal or modification of the licence conditions. We think the volume of consequential changes will be significant, and it may therefore take some time to complete the process. As noted above (para 6.2) we think Ofgem should be encouraged to issue an open letter formally accepting the recommendation and clarifying the scope of its 'deprioritisation'.

7.10 This is particularly important because it is unclear from the PDR which licence conditions would be covered by the 'deprioritisation'. If it is only the licence conditions that are scheduled for removal, this may not be sufficient. As the CMA acknowledges, potential tariff innovations may still be incompatible with the methodologies set out in the licence for calculating 'Tariff Comparison Rates', 'Personal Projections' and 'Cheapest Tariff Messaging'.[20] We suggest that the CMA should make it clear in its recommendations to Ofgem that the 'deprioritisation' should also extend to any consequential breach of these licence conditions, until such time as Ofgem has made the necessary methodological changes. Obviously, the clearer the 'deprioritisation' signal given is, the more confidence suppliers will have to innovate on their tariff offerings while Ofgem is revising the licence; we suggest that the CMA gives some thought to that in framing its recommendation.

8. OFGEM-LED PROGRAMME

"A recommendation to Ofgem to establish an ongoing programme (the 'Ofgem-led programme') to identify, test (through randomised controlled trials, where appropriate) and implement (for example, through appropriate changes to gas and electricity suppliers' standard licence conditions) measures to provide domestic customers with different or additional information with the aim of promoting engagement in the domestic retail energy markets, including a recommendation to conduct randomised controlled trials concerning the following shortlist of measures:

(i) changes to the information in domestic bills and how this is presented including a market-wide cheapest tariff message;

(ii) changes to the specific messaging that domestic customers receive in bills once they move, or are moved, on to an SVT and/or other default tariffs; and

(iii) changes to the name of the default tariffs.

20 PDR para 5.424.

"Either the acceptance of undertakings from gas and electricity suppliers to participate in the Ofgem-led programme, or, absent a satisfactory number of undertakings being agreed with suppliers, either:

(i) a recommendation to Ofgem to modify gas and electricity suppliers' standard licence conditions to introduce an obligation on suppliers to participate in the Ofgem-led programme or requiring the provision of prescribed information;

(ii) an order on gas and electricity suppliers to participate in the Ofgem-led programme or requiring the provision of prescribed information, (including associated amendments to suppliers' standard licence conditions); or

(iii) a recommendation to DECC to introduce legislation imposing a requirement on suppliers to participate in Ofgem-led research programmes."

Recommendation to establish a programme

8.1 We have previously argued that any changes to suppliers' obligations around customer communications should be informed by rigorous customer research and trialling, and we therefore welcome this remedy in principle. We believe that there are a number of improvements and refinements that could be made to supplier obligations that would improve domestic customer understanding and engagement. Whilst we still see a role for supplier-led trials, we can also see merit in a more coordinated Ofgem-led programme, particularly in areas where suppliers may not have a strong incentive to trial changes unilaterally.

8.2 We have a number of high-level observations on the nature and priorities of the programme:

(a) Principles-based regulation: one of the problems with current customer communications is that there is too much regulatory prescription. In trialling different options, Ofgem should be encouraged to explore how a principles-based approach could be used to harness supplier creativity and innovation, in finding ways to meet different customer groups' preferences.

(b) Output-driven approach: it is important that Ofgem has a clear idea from the outset of any trial what the communication in question is intended to achieve and how success will be defined and measured.

(c) Focus on disengaged customers: in line with the main AEC (weak customer response), the focus of the trials (and communications obligations in general) should be on disengaged customers, whilst seeking to relax unnecessary obligations in respect of engaged customers. (For example, where a customer is on a fixed term tariff, we see no reason to include reminders in the bill/annual statement to consider tariff options until the renewal notice has been sent.)

(d) Industry capacity: it is clearly important that the cost of individual trials is proportionate to the potential benefits,[21] but it is also important that Ofgem schedules its programme to avoid placing excessive demands on industry capacity at a time of unprecedented change in other areas.

(e) Costs as well as benefits: Ofgem should be encouraged to gain a better insight into suppliers' cost drivers around customer communications, so that the cost of implementing any change to supplier obligations (including any disruptions to customer service) can be minimised.

8.3 In the spirit of our fifth point above, we would encourage the CMA to recommend that Ofgem conducts and consults on a cost benefit assessment before it mandates any licence changes that will impose significant costs on suppliers.

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[21] PDR para 6.36(d).

Recommended content of programme

8.4 The CMA is proposing to recommend that the programme should include randomised controlled trials of:

(a) changes to the information in domestic bills and how this is presented including a market-wide cheapest tariff message;

(b) changes to the specific messaging that domestic customers receive in bills once they move, or are moved, on to an SVT and/or other default tariffs; and

(c) changes to the name of the default tariffs.

8.5 We support the inclusion of these three items, with the exception of the market-wide cheapest tariff message on bills, which we consider is unnecessary (given other proposed remedies) and is unlikely to be practicable, and therefore could expose suppliers to an unacceptable risk of regulatory enforcement action.[22] However, if the market-wide cheapest tariff message is to be included, the CMA should make it clear to Ofgem that the recommendation goes no further than trialling it. If, in the light of the trials, there is insufficient evidence that benefits will outweigh the costs, there should be no expectation from the CMA's recommendation that Ofgem must implement something.

8.6 The CMA's rationale for including market-wide cheapest tariff message is that once SLC 22B.30 and 22B.31 are removed (requirement to make all tariffs available to new and existing customers), the existing cheapest tariff messaging may become redundant, because suppliers may restrict the availability of their most competitive tariffs to new customers.[23] We understand this rationale, but we believe there are alternative messaging options that could be researched to address this concern without going as far as market-wide cheapest tariff messaging. For example, the message could include an indication of where the current tariff sits in the market, with links to third party sources of comparison information, but without going so far as to specify a cheapest tariff. We believe the CMA's final recommendation to Ofgem should give it the flexibility to consider such options.

8.7 We have no objection to trialling changes to the messages that customers receive in bills once they move to an SVT, but would note that suppliers do already explain the standard tariff details in a product conversion communication (email or letter) when the customer either defaults to the SVT or chooses the tariff. Therefore refinements to this should be considered before making any further changes to an already information-heavy communication such as the customer bill.

Quick wins

8.8 The CMA says it expects the Ofgem-led programme to start to improve customer engagement by 2018 and 2019.[24] We believe there are a number of quick wins regarding customer communications which could be delivered much sooner than this, without the need for trialling, and would encourage the CMA to formulate its recommendation to Ofgem in a way that does not preclude these.

8.9 An obvious example is the bill and annual statement. Our customer research (which we have shared with the CMA and Ofgem) has highlighted three items which could be dropped from the bill without any detriment to customers:

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22 For example, given the frequency with which new tariffs are launched, and the lack of any reliable central source of data on competitor tariffs, it is unclear how suppliers could be sure any recommendations were up to date and not misleading or inappropriate for the customer's circumstances. It would be highly unsatisfactory if suppliers were at risk of regulatory enforcement action in such circumstances. Our customer research suggests that customers already struggle to understand the 'cheapest similar tariff' and 'cheapest overall tariff' messages, and this will be harder still with market wide messages.

23 PDR para 5.390.

24 PDR para 8.95.

(a) gas calorific value calculations – research suggests the vast majority of consumers have no interest in the detail of this and find it confusing; it could easily be made available on supplier websites for those who are interested;

(b) postal address for gas or electricity network provider – a telephone number is sufficient; if a customer loses supply or smells gas, their first reaction will be to telephone rather than write a letter; and

(c) Tariff Comparison Rate - which consumer research suggests is not helping consumers compare their tariff with other offers in the market.[25]

8.10 Assuming there is general agreement on any or all of these points, it would be disappointing if we had to wait until 2018/19 for licence amendments to remove the obligations.

<u>Method of securing supplier participation</u>

8.11 The CMA suggests that obtaining undertakings from suppliers to participate in the Ofgem-led programme is its preferred approach, with the fall-back (if a satisfactory number of undertakings cannot be obtained) being some form of obligation (via licence condition, CMA order or a recommendation to DECC to introduce legislation).

8.12 As the CMA notes, this is a potentially resource-intensive and long-term programme,[26] both for Ofgem and suppliers, and we therefore consider it important that the burden is shared equally between suppliers. We think that 'satisfactory' should be assessed not only from the perspective of running successful trials, but also from the perspective of an appropriate burden sharing among suppliers.

8.13 Further, if suppliers are to sign up to undertakings, they cannot be put in a position of writing a blank cheque. It will be important for the CMA and/or Ofgem to provide reasonable guidance as to the likely scale of the commitment.

9. PCW AND MIDATA REMEDIES

"An order on Gemserv to give PCWs access upon request to the ECOES database on reasonable terms and subject to satisfaction of reasonable access conditions"; and

"An order on Xoserve to give PCWs access upon request to the SCOGES database on reasonable terms and subject to satisfaction of reasonable access conditions."

9.1 We support the proposed orders on Gemserv and Xoserve and agree that they have the potential to reduce erroneous transfers caused by the customer having incomplete or incorrect data in relation to their meter. Including access to SCOGES data (which was not part of the original remedies notice) will ensure that the dual fuel switching process can be improved.

9.2 With regard to implementation we note the expectation of 6 months' timescale and negligible cost. These assumptions may need to be reviewed once the design of the solutions for each database has been confirmed; it is likely the solution will involve provision of remote access to live data which may have cost and contractual impacts that will need to be considered.

9.3 As regards data protection requirements, we would expect that "reasonable conditions of access" would include requiring PCWs to comply with audit requirements regarding verification of the customer's consent for the PCW to view their data.

[25] ScottishPower submission to CMA on 17 December 2015 regarding customer research on bill design.

[26] PDR para 8.139(a).

9.4 We would expect the customer to be asked to provide the PCW consent to access their details on either database, on a "one off" basis to enable the switch of supplier at that point in time. Other data protection issues such as we have raised in the context of the customer data sharing remedy (section 9) may also apply here.

"A recommendation to DECC to make the following changes to the current specifications of Midata phase two:

Participation in Midata is mandatory for all gas and electricity suppliers.

The scope of Midata is expanded to include the following data fields: meter type, Warm Home Discount indicator, consumption data and time-of-use for those customers on Economy 7 meters or other time of use tariffs.

PCWs are given the ability to seek customer consent on the frequency with which they can access the customer's data through Midata; are required to present at least two options to a customer when seeking consent to access Midata (including one option concerning access on an annual or ongoing basis); and are given the ability to send updated tariff comparison information based on any subsequent access granted to a customer's Midata."

9.5 ScottishPower has been at the forefront of initiatives to enable customers to access their Midata, recognising the positive impact this is likely to have on customer engagement. Before the Government's Midata programme, ScottishPower had developed a pilot scheme enabling customers to download their Midata directly.

9.6 We support the principle of PCWs accessing Midata on a customer's behalf provided appropriate safeguards are in place. We are pleased that the CMA is proposing that the remedy will be mandatory, requiring the participation of all licensed suppliers, as this will enhance customer engagement and switching experience across the market.

9.7 As regards the frequency of PCW access, we consider that annual or periodic access is considerably different from ongoing or continuous access, in terms of the frequency of communications and subsequent impact on customer experience (assuming that the frequency of communications is linked to the frequency of access). We suggest that the two access options are clarified so that at least one is of a specified frequency, e.g. annual.

9.8 We do not believe it is reasonable to request a customer's consent for a PCW to access their Midata on a continuous basis unless it is clear to the customer at the time they give their consent what the full range of circumstances in which the PCW might use the Midata would be. In practice, we think this will be difficult to achieve.

9.9 We agree the proposed additional three Midata items will be helpful for customer switching, and we believe their inclusion in Phase 2 should be feasible in the timescales envisaged.

9.10 We think there is merit in adopting a similar implementation approach as is being taken for other remedies, namely the production of a plan to ensure the timely and efficient implementation of the Midata remedies. As the CMA notes, Phase 2 of the programme involves design specification, solution build and system testing,[27] and there will be other key dependencies such as data cleansing. We believe a plan developed by DECC in consultation with stakeholders would benefit all parties by helping to focus time and resources appropriately, especially as the programme will become mandatory, thus significantly increasing the number of suppliers participating.

[27] PDR para 6.192.

10. DOMESTIC CUSTOMER DATA SHARING

"An order on gas and electricity suppliers requiring the disclosure to Ofgem, subject to certain use restrictions, of (i) certain details (the Domestic Customer Data) of their domestic customers who have been on one of their standard variable tariffs (or any other default tariff) for three or more years (the Disengaged Domestic Customers), and (ii) updated Domestic Customer Data every six months, for the purposes of a creating, operating and maintaining a secure cloud database containing the Domestic Customer Data and allowing rival suppliers to access and use the data for the purpose of postal marketing. The order would also require suppliers, prior to disclosing the Domestic Customer Data to Ofgem, to send a prescribed letter to each Disengaged Domestic Customer, explaining the proposed use of the customer's details, and including an opt-out mechanism for the domestic customer, at any time, to object to and prevent the proposed disclosure and use of their details"

"A recommendation to Ofgem to (i) create, operate and maintain a secure cloud database for the purposes of holding the Domestic Customer Data; (ii) hold the Domestic Customer Data; (iii) enter into agreements with suppliers including, access to, and use restrictions concerning the Domestic Customer Data; and (iv) provide access to the Domestic Customer Data by any rival supplier that has entered into such an agreement."

Decision to impose the remedy

10.1 If the CMA is to proceed with this remedy, it is fundamental that it takes place on firm and well understood foundations concerning the data protection and privacy aspects and that these are clear to all the parties. The CMA has not adequately explained how processing of personal data envisaged by the proposed remedy would be compliant with the Data Protection Act 1998 (**DPA**), the Data Protection Directive (95/46/EC) (**Directive**) and the General Data Protection Regulation (**GDPR**), which is expected to take effect in 2018.[28] In particular, the CMA needs specifically to address and advise suppliers how it has reached the conclusion that the processing in each of the following three cases would comply with the DPA:

(a) suppliers disclosing customer data to Ofgem if required to do so by a CMA order;

(b) Ofgem operating the database and disclosing such data to other suppliers; and

(c) suppliers using customer data obtained from Ofgem to engage in postal marketing;

in each case without having obtained (opt-in) consent from the customers.

10.2 The CMA refers to advice obtained from the ICO;[29] however, our reading of what the ICO appears to have said[30] is relatively non-committal. The PDR states that the CMA has consulted with the ICO and explains that "[the] ICO has advised us that the DPA would be unlikely to prevent the disclosure of the details of Disengaged Domestic Customers…by energy suppliers to Ofgem…" and "…to prevent suppliers to prompt Disengaged Domestic Customers of rival suppliers…".[31] We think it is important that the CMA provides more clarity on the issues discussed with and views expressed by the ICO, the basis on which the ICO is apparently comfortable with the CMA's remedy proposals and whether the CMA's proposals take account of all recommendations from the ICO, as the ICO's statement dated 10 March 2016 suggests that further work is required in this area.

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28 For simplicity, references to the DPA in this section should be taken as including references to the GDPR and the Directive except where the context otherwise requires.

29 PDR paras 6.251-252.

30 See also the ICO statement of 10 March 2016: "Whilst we understand the desire to ensure customers get the best available tariffs, any sharing of information must be done within the requirements [of] 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".

31 PDR para 6.251.

Fair grounds for processing

10.3 Each of the disclosing energy supplier, Ofgem, and each energy supplier receiving and using personal data of disengaged customers must have lawful grounds for processing that personal data, in that a 'fair processing condition' must be satisfied. One of the fair processing conditions is satisfied if and to the extent that a valid consent has been obtained from the data subject. A valid consent must be freely given, specific and informed. The ICO has made clear that it must also be signified by a positive indication of the intention of the data subject, so it cannot be inferred from silence.[32] This will remain the case under the equivalent articles of the GDPR, which will provide for even more stringent requirements in relation to reliance on data subject consent as grounds for processing.[33]

10.4 As the opt-out process does not amount to consent and opt-in is impracticable, the parties would therefore need to rely on one of the other fair processing conditions under Schedule 2 of the DPA (and, when applicable, equivalent grounds under the GDPR). The CMA should explain in each of the three cases listed above (at (a) to (c) of para 10.1), which fair processing condition could be relied upon by each party and provide its detailed reasoning of why each party could rely upon those conditions.

10.5 In relation to the processing of personal data by energy suppliers concerning their disengaged customers (i.e. the disclosure), the existence of a compulsion at law to disclose the personal data would satisfy a fair processing condition and provide a lawful basis pursuant to Schedule 2, para 3 of the DPA and Article 7(c) of the Directive. A compulsion at law could be established by a valid order of the CMA, subject to ensuring compliance with Article 13 of the Directive.

10.6 However, no such compulsion at law exists to justify the disclosure, receipt, holding and sharing of personal data by Ofgem, and the receipt, holding and use (for direct marketing purposes) by the recipient energy suppliers.

10.7 A fair processing condition which might arguably be satisfied in relation to the processing by Ofgem and the recipient energy suppliers is the 'legitimate interests' condition (Schedule 2, para 6 of the DPA and Article 7(f) of the Directive), which can be relied on where processing is *necessary* to further the legitimate interests of the data controller or the recipient, of data. However, this requires the legitimate interests of Ofgem and the third party energy suppliers to be balanced against the rights and freedoms of the data subjects. If the CMA considers that Ofgem and recipient energy suppliers could rely on the 'legitimate interests' condition, the CMA needs to explain (informed by guidance of the ICO) what the legitimate interests of Ofgem and recipient energy suppliers as data controllers would be, how those legitimate interests would be balanced against the rights and freedoms of the data subjects and why the processing by Ofgem and recipient energy suppliers would be necessary to further the legitimate interests of Ofgem and recipient energy suppliers as data controllers, taking into account the considerations set out in the Article 29 Working Party Opinion on the notion of legitimate interests.[34]

10.8 The CMA has suggested a number of safeguards (including the operation of an opt-out scheme, as well as agreements to be entered into between Ofgem and the energy suppliers setting out use restrictions).[35] These are helpful but do not in themselves achieve the balancing assessment required

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[32] It is possible to imply consent under the DPA, but only in circumstances where the data subject signifies consent. ICO guidance provides as follows: "The fact that an individual must 'signify' their agreement means that there must be some active communication between the parties. An individual may 'signify' agreement other than in writing, but organisations should not infer consent if an individual does not respond to a communication – for example, from a customer's failure to return a form or respond to a leaflet." (ICO Guide to Data Protection, available at www.ico.org.uk).

[33] If and to the extent valid consent from customers has been, or will be, obtained, note that there is no 'grandfathering' of existing consents under the GDPR. As a result, as soon as the GDPR takes effect, all consents (whether obtained before or after that date) must meet the requirements set out in the GDPR in order to be relied upon.

[34] Opinion 06/2014 on the notion of legitimate interests of the data controller under Article 7 of Directive 95/46/EC, available at http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2014/wp217_en.pdf.

[35] PDR para 6.252.

for the 'legitimate interests' condition. Moreover, under the GDPR (due to apply from 2018, which is around the same time at which the proposed customer database would be available) the 'legitimate interests' condition will no longer be available to public authorities, such as Ofgem, in the performance of their tasks (Article 6(1)(f) of the draft GDPR).

10.9 Another fair processing condition which may provide grounds for processing by the disclosing energy supplier and for Ofgem is that the processing of personal data is *necessary* for the exercise of any functions conferred on any person by or under any enactment, or for the exercise of any other functions of a public nature exercised in the public interest by any person (Schedule 2 para 5 of the DPA and Article 7(e) of the Directive). If the CMA considers that this condition is applicable, it should explain in detail the extent to which each of the relevant parties is required to process personal data to perform a function conferred under an enactment, the basis on which (to the extent required) the requisite public interest test is satisfied and in both cases whether processing could be said to be *necessary* for those purposes.

Compatibility of further processing

10.10 The DPA requires, pursuant to Principle 2, that personal data must only be obtained for one or more specified and lawful purposes, and not further processed in any manner incompatible with that purpose or those purposes.

10.11 It is unlikely, however, that any fair processing notice provided to customers of energy suppliers at the time of collection of their personal data will have specified that personal information may be shared with Ofgem and other energy suppliers for the purposes of enabling marketing activities.

10.12 As a result, the data sharing remedy would involve 'further processing' i.e. the purpose of processing is not a purpose that was communicated to the data subject at the time of collection of their personal data. Principle 2 requires that further processing must not be 'incompatible' with the purposes of processing specified at collection. Processing of personal data in a way which is incompatible with the purposes specified at collection is prohibited.[36]

10.13 The DPA provides for an exemption to the compatible use restrictions under Principle 2 to the extent further processing involving a disclosure of personal data is required by or under any enactment or rule of law.[37] We accept that this could provide a lawful basis for the proposed further use by the disclosing energy supplier, to the extent the disclosure of that data is required pursuant to an order of the CMA. However, the CMA would need to satisfy itself that any such order also falls within the range of circumstances set out in Article 13 of the Directive, and the PDR provides no indication that the CMA has considered the application of Article 13.[38] We would strongly encourage the CMA to give proper consideration to this issue and to set out its reasoning in full in the final report.

10.14 As noted above no such compulsion at law exists to justify the further processing by Ofgem (for the purposes of administering the database), nor the recipient energy suppliers (for the purposes of direct marketing). As a result, any further processing by Ofgem and the recipient energy suppliers must be show not to be incompatible with the purposes of processing specified to customers at the point of collection of their personal data.

10.15 The CMA needs to explain in detail how it has reached the conclusion that the purposes of processing envisaged under the proposed remedy are compatible with the purposes of processing specified at the time of collection, including its analysis of the factors set out in the Article 29

36 Principle 2 provides that personal data must only be obtained for one or more specified and lawful purposes, and not further processed in any manner incompatible with that purpose or those purposes. It implements Article 6(1)(b) of the Directive.

37 Section 35(1) DPA.

38 Article 13 sets out the extent to which Member States may adopt legislative measures to restrict the scope of certain individual rights under the DPA, including the principle on compatibility of further processing set out in Article 6(1)(b) (as implemented by the compatible use principle under Principle 2 DPA).

Working Party Opinion on purpose limitation which should be taken into account to assess whether that further processing is compatible and lawful.[39]

<u>*Proportionality of data processing*</u>

10.16 The principles relating to data quality set out in Article 5 of Convention 108 (Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data) and Article 6 of the Directive, as transposed into Schedule 1 of the DPA, together incorporate an overarching principle of proportionality. In particular, personal data must be adequate, relevant and not excessive in relation to the purposes for which they are collected and/or further processed. Proportionality is also a requirement that appears in numerous articles of the GDPR, including recital 4 and Article 35.

10.17 The CMA needs to explain in detail how it has reached the conclusion that the proposed data sharing remedy is consistent with the proportionality principles of the DPA and the Directive, as well as the GDPR, bearing in mind the large scale of disclosure to multiple parties.

<u>*Relevance of the Direct Energie precedent*</u>

10.18 We are also concerned that the CMA appears to be placing undue weight on the *Direct Energie* precedent, as we do not believe it is properly analogous to the circumstances of the current investigation, or that the analysis of data protection issues is sufficiently clear to be relied upon. Importantly, the *Direct Energie* case was an Article 102 (abuse of dominance) case, in which the central allegation against GDF Suez was an exclusionary abuse that consisted of utilising its own database of customers on the regulated tariff, which it held in its capacity as a former monopolist, in order to gain a competitive advantage over new entrant suppliers shortly before legislative measures to abolish regulated tariffs[40] were due to take effect. Essentially, GDF Suez was alleged to be pre-emptively marketing competitive gas and electricity tariffs to these customers but refusing to allow third party suppliers to have access to the database. Direct Energie had applied to GDF Suez for access to this database but had been refused. On the facts of that case, it is not particularly surprising that the French *Autorité de la concurrence* should have been willing to entertain an application for interim measures to prevent a risk of serious and irreparable harm to smaller competitors, and thus to have imposed an access remedy on an interim basis.

10.19 That said, we are not sighted as to the basis on which the French data protection authority (**CNIL**) apparently concluded that offering customers the ability to opt-out before their data was shared with other suppliers is sufficient. If that was meant to create consent, this seems to us questionable as a matter of French data protection law and under the Directive. If fair processing was established by some other means, that is not clear. We assume that the CMA is in a position to seek clarity on this point from the CNIL and that it will do so before the final report. In addition, the case is currently on appeal to the French Supreme Court, with final judgment still awaited. Until the Supreme Court has delivered its judgment, we believe it would be premature to reach any conclusions on the compatibility of that particular regulatory intervention with data protection principles.

<u>Scope of remedy</u>

10.20 We have set out below (para 10.21 onwards) our thoughts on various aspects of the design of proposed remedy, with a view to striking an appropriate balance between consumer rights (specifically, the right to privacy), on the one hand, and effectiveness in stimulating engagement on the other. These points are however subject to the CMA reaching a satisfactory clarification of the data protection issues set out above, without which the remedy cannot proceed.

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39 Article 29 Working Party Opinion 03/2013 on purpose limitation, available at http://ec.europa.eu/justice/data-protection/article-29/documentation/opinion-recommendation/files/2013/wp203_en.pdf.

40 By 31 December 2014 for non-domestic customers with annual consumption of more than 200 MWh and 31 December 2015 for non-domestic customers consuming more than 30 MWh.

10.21 The CMA's original proposal was for this remedy to apply to prepayment customers only. Subject to the data protection issues raised above being satisfactorily resolved, we agree with the decision to extend the scope to direct debit (**DD**) and credit customers as well as prepayment, and to microbusinesses as well as domestic customers. (We comment on the equivalent microbusiness remedy in paras 13.11 to 13.14.) The incremental costs (in terms of database management etc.) are likely to be modest and, at least while the proposed prepayment price control remains in effect, we expect suppliers to have more interest in marketing to DD and credit customers.

10.22 We agree that the CMA's proposed definition of 'disengaged' is appropriate, i.e. customers who have been on one of a suppliers' standard variable tariffs (or any other default tariff) for three years or more. However, we would suggest the CMA clarifies that, for the purpose of this remedy, 'standard variable tariff' includes dead evergreen tariffs.[41]

Permitted marketing activities

10.23 The CMA proposes that the customer data would be made available to rival suppliers for the purpose of postal marketing, and notes elsewhere that marketing by electronic communications (e.g. email or SMS) would not be permitted under data protection law (which requires opt-in consent). We assume therefore that the CMA is not proposing that the data should be used for telephone marketing purposes. As explained in our response to the Remedies Notice, we believe that unsolicited telephone marketing would be considered exceptionally intrusive by consumers – a view echoed by Citizen's Advice.

10.24 Accordingly, we suggest that the CMA should take the following steps to avoid this outcome:

(a) When the proposed data disclosure is notified to the customer,[42] the declared purpose should not include telemarketing, so that the non-objection cannot be seen as over-riding Telephone Preference Service (**TPS**) registrations.

(b) The customer's telephone number (whether fixed line or mobile) should not be included in the data transferred.

(c) The agreement between Ofgem and users of the data should prohibit use of the data for telemarketing purposes, which would include, in line with data protection principles, a prohibition on using the confidential customer data in combination with telephone numbers obtained from other sources. In other words, suppliers would still be able to carry out telemarketing where the customer's number is available from directories (or other public sources) and where the customer has not registered with the TPS – but they would not be permitted to use the confidential data obtained from Ofgem to inform or guide that telemarketing.

10.25 The CMA suggests that the 'Ofgem-led programme' could be used to trial different forms of postal communication using the customer database. We support this proposal and the implication that Ofgem may, as part of the database usage agreement, impose conditions on the nature and volume of marketing communications. Without such rules, there is a risk that a single supplier could bring the marketing arrangements into disrepute through poorly targeted or insensitive marketing communications.

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41 Under SLC22D.2, dead tariffs meeting certain criteria are exempted from the prohibition on dead tariffs introduced by the RMR.

42 Under this remedy, suppliers would be required to send a prescribed letter to each Disengaged Domestic Customer, explaining the proposed use of the customer's details, and including an opt-out mechanism for the domestic customer, at any time, to object to and prevent the proposed disclosure and use of their details (PDR para 11.10(f)).

Information to be provided

10.26 The CMA is proposing that suppliers would be obliged to provide (for non-opted out disengaged customers):

(a) the customer's full name
(b) billing address
(c) consumption address
(d) fixed telephone number
(e) current supplier
(f) meter type (e.g. unrestricted, Economy 7 etc)
(g) name of their current tariff
(h) annual energy consumption
(i) MPAN/MPRN
(j) for customers on restricted meters, consumption data by specified time periods and details of standing charges and volume rates.

10.27 We see no reason to include the customer's fixed line telephone number if, as we understand, the CMA's intention is that users would be permitted to use the data only for postal marketing (see paras 10.23 to 10.25 above). We would also note that as part of the 'prescribed letter' informing customers of the ability to opt-out, suppliers would need to specify the full list of data items of the customer to be shared . The longer the list that is provided, the more likely customers will decide to opt out on privacy grounds. We think this would be a particular risk in the case of telephone numbers – and a further reason not to include them in the list.

Frequency of database updates

10.28 The CMA is proposing that suppliers would be required to update the specified data every six months. With the exception of updates to remove individuals (see below) we think that this is a broadly sensible frequency. Most of the data items are relatively static, but if suppliers are to use the consumption data for the purpose of providing comparative quotes, the consumption data will need to be reasonably current.

10.29 It will be extremely important, to avoid customer dissatisfaction and complaints, that suppliers are able to have their customers removed quickly from the database, and for that information to be promulgated quickly to users of the data. This could be as a result of opt-out requests, or because the customer is no longer disengaged. Where customers register with the TPS, this must take effect within 28 days,[43] and we think a similar timescale would be appropriate here. We suggest that the CMA should make explicit recommendations to Ofgem in this regard.

Sunset clause

10.30 We welcome the proposal that the order requiring suppliers to comply with the remedy would expire after the sooner of five years or upon substantial completion of the smart meter roll-out.[44] This is a relatively extreme intervention in the market (with only one previous precedent worldwide, so far as we are aware) which compels market participants to behave in a way that would not be observed in any normal competitive market. As such, we believe it is essential that it has a firm end date. The CMA will need to specify what is meant by 'substantial completion' – we would suggest (based on experience with roll out of advanced meters to non-domestic users) rollout to 80% of domestic premises.

[43] See PECR 21(3).
[44] PDR para 6.264.

11. RESTRICTED METER REMEDIES

"An order on gas and electricity suppliers with more than 50,000 domestic customers (and amendments to suppliers' standard licence conditions) (i) requiring such suppliers to make all their single-rate electricity tariffs available to all (existing and new) domestic electricity customers on restricted meters (including Economy 7) and (ii) prohibiting such suppliers from making their single-rate electricity tariffs available to domestic electricity customers on restricted meters conditional upon the replacement of their existing meter.

An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions) requiring suppliers to (i) remind their domestic electricity customers on restricted meters, in their regular communications with them, that they have the option to switch supplier or to switch to a single-rate tariff without having to change their meter or incur replacement costs, (ii) provide their domestic electricity customers on restricted meters contact details for Citizens Advice, and (iii) provide, on a timely basis, Citizens Advice with the information it may reasonably require concerning customers on restricted meters in the format specified by Citizens Advice.

A recommendation to Citizens Advice to become a recognised provider of information and support to domestic electricity customers on restricted meters."

<u>Introduction</u>

11.1 We understand what the CMA is seeking to do with this remedy, but we believe (perhaps as a consequence of its not having been consulted on at an earlier stage) that this remedy has not been fully thought through and risks adverse consumer impacts. The extension to **E7** seems to be beyond the CMA's powers in the absence of a clearly identified AEC specifically relating to such meters, and the remedy could also require suppliers to meet the costs of complex metering systems without reflecting this in prices.

11.2 In terms of the risk of counterproductive outcomes, we have analysed a large subset (19,233 households) of our complex meter customers. We split them into two groups – those who consumed more than 50% of the electricity at night or using the controlled circuit (**high heating users**), and those who used less than 50% in this manner (**low heating users**). Roughly **[CONFIDENTIAL]**% of the group were high heating users. We found:

(a) Switching to the best 'top-8' single rate tariff in the market[45] was not the optimal choice for over 90% of high heating users and indeed for 64% of high heating users they would lose money compared to staying on our complex meter SVT. These outcomes would be even worse if we made an allowance for a proportion of customers failing to re-engage after a year and ending up on the competitor's single rate SVT;

(b) Conversely, switching to the best 'top-8' single rate tariff in the market was the optimal choice for nearly 94% of low heating users.

11.3 We are therefore concerned that this remedy could lead to many customers making ill-advised switching decisions that would materially increase their bills (or fail to achieve optimum reductions). This risk could be exacerbated if switching websites fail to calculate properly the effects of the use of night/controlled use, especially as the CMA might be tempted to publicise the remedy as beneficial for customers.

11.4 This risk also exists for E7 customers, who generally have access to E7 versions of the most attractive tariffs. Pointing them toward single rate tariffs could be even more adverse for those with high night time usage, significantly increasing their bills. Moreover, we do not see how the CMA

45 See para 11.8 and its footnotes for more details and methodology.

has any legal basis to impose such a remedy since we are not aware of any AEC having been found specifically in relation to E7.

11.5 Finally, there are some technical points on this remedy. We think that suppliers should be free to include additional meter rental costs in any single rate price charged to complex meter customers. While this additional cost is negligible for E7, it is higher for some other meter types. Furthermore, we have not at this stage fully addressed the systems costs and constraints involved in catering for very large numbers of possible complex meters when introducing a product. If dealing with this were to delay the process of product introduction, there could be a negative effect on competition in the wider market.

11.6 In conclusion, while we do not disagree that the CMA has identified an issue around low heating users who may not be well served by the current arrangements, we believe that the risk of detriment to high heating users is too great to move straight to an order. We therefore suggest that the CMA make recommendations to Ofgem to take forward the issue with a view to increasing access to single rate tariffs (and requiring suppliers or obtaining their commitment to make the appropriate communications) where this is likely to beneficial to consumers. This work could also usefully involve getting a better understanding of why there are a relatively large number of low heating users who still have complex meters.

<u>Restricted meter bill analysis</u>

11.7 The CMA says its restricted meter bill analysis is intended to test the claim that customers on restricted meters would generally pay higher bills if they switched from a meter-specific tariff to a single-rate tariff.[46] The total saving quoted (average £161 (~18%) saving for 69% of customers, £43m in total) is somewhat different to our own estimates. Possible sources for the difference include:

(a) the attractiveness of ScottishPower's complex meter tariffs compared to those of other suppliers;

(b) the possibility that there are deals other than SVT which are appropriate to the meter configuration – these could be much better than switching to a single rate tariff. For example, we offer a complex meter version of our Help Beat Cancer product which it likely to be a better deal than a single rate tariff in the vast majority of cases; and

(c) any inaccuracy in the CMA's adjustments for differing payment methods.[47]

11.8 As noted in para 11.2 above, we have done some initial analysis of data on ScottishPower restricted meter customers with a view to understanding the position more clearly. We looked at 19,233 non-E7 restricted meter[48] customers in the South Scotland PES area who were on our SVT, paying by DD. We used the data on these customers' consumption previously provided to the CMA to divide them into two groups – high heating users (more than 50% of consumption at night or using the controlled circuit) and low heating users (less than 50%). In each case we looked at how these customers' bills would change if they moved to:

(a) ScottishPower's cheapest meter-specific tariff (Help Beat Cancer Fixed Price Energy January 2018); or

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[46] Appendix 3.1, para 75.

[47] PDR Appendix 3.1, Annex B, para 16 implies that the benchmark against which the saving is calculated is the cheapest <u>DD</u> single-rate tariff in the market, uplifted in the case of credit and prepayment customers by the CMA's estimate of the cost to serve differential, £84 for credit (Appendix A3.6 para 124) and £54 for prepayment (Appendix A3.6 para 4). We believe that these uplifts are significantly under-estimated by the CMA.

[48] ScottishPower meters in scope of the analysis included: ComfortPlus Control, ComfortPlus White Meter, Domestic & Economy 2000, Domestic & Offpeak A, Domestic & OffPeak c and Domestic & OffPeak D. We included all the customers meeting the criteria apart from c. 3,600 (16%) where we were unable to source customer Estimated Annual Consumption (**EAC)** data.

(b) the cheapest SLEF/mid-tier single rate tariff in the market.[49]

11.9 The breakdown of the population between high heat users and low heat users is summarised in Table 2.

Table 2: Analysis of subset of ScottishPower customers on restricted meters

Customer type	Number	Percent
High heating users: consumption on night/ controlled circuit is more than 50% of total	[CONF.]	[CONF.]
Low heating users: consumption on night/ controlled circuit is more than 50% of total	[CONF.]	[CONF.]
Total customers	**19,233**	**100%**

11.10 Although clearly a minority, the low heating user category is somewhat unexpected, since the whole point of these restricted meters is to assist high heating users. Unless their circumstances are temporary, the low heating users can generally be expected to be better off on a single rate deal – because they no longer have an electricity consumption pattern appropriate to a restricted meter. This could include empty homes or homes where a gas boiler had been installed. We consider it is important to understand this category better in developing policy.

11.11 For low heating users, it appears that the CMA's remedy could well make sense (subject to the various points we make below). Our analysis does indeed indicate savings, though generally less than for other SVT customers, as the loss of the preferential night/controlled tariff will have an increasing effect as low heating users approach the 50% threshold. This is illustrated in Table 3 below:

Table 3: Savings for low heating users switching from SVT

Outcome from switching	Number	Percent	Mean[50] saving
Increase in costs or no saving	[CONF.]	[CONF.]	[CONF.]
Save on ScottishPower deal designed for restricted meter, but not on best competitor single rate tariff	[CONF.]	[CONF.]	[CONF.]
Save more on ScottishPower deal designed for restricted meter, than on best competitor single rate tariff	[CONF.]	[CONF.]	[CONF.]
Save more on best competitor single rate tariff than ScottishPower deal designed for restricted meter	[CONF.]	94%	[CONF.]
Save only on best competitor single rate tariff but not on ScottishPower deal designed for restricted meter	[CONF.]	[CONF.]	[CONF.]
Total for whom best competitor single rate tariff is best advice (assuming continued engagement)	[CONF.]	94%	[CONF.]
Total	[CONF.]	**100%**	[CONF.]

11.12 In fact, Table 3 is likely to over-state the benefits from switching to a competitor single rate tariff because a proportion of the switchers (say **[CONFIDENTIAL]**) are likely to end up on the competitor's SVT after say a year and fail to re-engage for a period. In those cases, the customer

49 We assessed this by using published assessments (Cornwall Energy Q1 2016 report) in respect of January, February and March 2016 of the cheapest tariff based on Ofgem typical consumption of 3,100 kWh from a "top-10" supplier (the SLEFs plus four largest other suppliers) that was available for sale for 5 days or more. We assessed each consumer's consumption against all three alternatives and took the cheapest. While this approach may not always identify the exact best tariff, it is likely to be close and the calculation of the cost on the identified tariff should be correct. The tariffs used in this comparison were ScottishPower CRUK Fixed Jan 2018, SSE 1 Year Fixed v6, npower Fixed Energy Online April 2017 and First Utility Fixed April 2017 v4.

50 Mean saving is the average of the maximum saving each individual customer could make based on own consumption and best tariff of the four options listed in the previous footnote.

will lose the benefit of the low rate for night-time or controlled electricity and the gains from switching to a low-cost single tariff would be short-lived.

11.13 Conversely, for high heating users, the position is reversed. Table 4 indicates that these users would generally (64%) lose out from switching to the cheapest competitor single rate tariff (even assuming 100% continuing engagement on maturity) and that for the overwhelming majority (90%) it would not be best advice to make this switch.

Table 4: Savings and losses for high heating users switching from SVT

Outcome from switching	Number	Percent	Mean saving
Increase in costs or no saving	[CONF.]	4%	[CONF.]
Save on ScottishPower deal designed for restricted meter, but not on best competitor single rate tariff	[CONF.]	60%	[CONF.]
Save more on ScottishPower deal designed for restricted meter, than on best competitor single rate tariff	[CONF.]	[CONF.]	[CONF.]
Save more on best competitor single rate than ScottishPower deal designed for restricted meter	[CONF.]	[CONF.]	[CONF.]
Save on best competitor single rate tariff but not on ScottishPower deal designed for restricted meter	[CONF.]	[CONF.]	[CONF.]
Total for whom best competitor single rate tariff is best advice (assuming continued engagement)	[CONF.]	10%	[CONF.]
Total	[CONF.]	**100%**	[CONF.]

Tariff availability remedy

11.14 A clear risk of the tariff availability remedy is therefore that high heating users (who appear to comprise the majority of restricted meter consumers) may be led into making an ill-advised decision to choose the single rate tariff when in fact they would have been better off on the SVT or cheapest multi-rate tariff. Although suppliers will seek to ensure that customers understand the implications of moving to a single rate tariff, the headline findings from the PDR (average £161 saving for 69% of customers) make it more likely (if the figures are publicised) that some customers may make a poor decision. We consider that it is of the utmost importance that further work is done on this risk before rushing into a remedy, especially as there is a high risk that switching websites may not calculate the advantages and disadvantages of a switch correctly. We suggest that the CMA does further, more robust, analysis in this area and that this remedy should be re-framed as a recommendation to Ofgem so as to allow these issues to be fully resolved.

11.15 The CMA says it would expect the incremental costs of making single rate tariffs available to restricted meter customers to be negligible: "For example, we would expect suppliers to be able to either sum consumption across different registers when calculating the bill or to be able to apply the same unit rate to different registers when calculating the bill."[51]

11.16 Although we accept that in general the costs will be relatively low (but not negligible), we are also concerned at the potential delay this obligation will introduce into our ability to launch new acquisition tariffs quickly in response to market developments.

11.17 The risk of delay arises from the possible need to configure billing systems individually for each meter type when a new product is launched (or the larger one-off exercise of altering billing systems, if practicable, to eliminate this problem). We have not been able to fully evaluate this risk in the time available but it would clearly be counter-productive if this remedy had the effect of slowing down competition in the main market. For example, we would suggest that the requirement could

[51] PDR para 3.137 and footnote 217.

include a waiver such that a supplier is not obliged to offer every tariff-meter permutation from day 1 of a new tariff being launched. In particular:

(a) suppliers should be given 5 working days' grace to launch the full set of variants for meters that they currently support; this would allow them to respond more nimbly to developments in the fast moving online acquisition tariff market;

(b) where suppliers receive a request for a meter configuration that they do not currently support, they should be given 30 days' grace to configure their systems to support the relevant tariff variant; this would avoid suppliers incurring costs in respect of obscure meter types for which they may never acquire any customers.

11.18 Neither of these waivers would significantly impair the effectiveness of the remedy but they would mitigate the cost and responsiveness impact on suppliers. We would also note that suppliers are likely to be sparing in their use of such waivers, since there will be considerable challenges in customer service terms if significant numbers of customers are affected.

11.19 Finally, we note that complex meter rental, operation and reading costs are higher than for standard single rate meters. For legacy meters (see explanation in section 12), the additional rental costs range from 1p per day for E7 to 3p per day for more complex restricted meters – the figures are likely to be higher for non-legacy meters. There are likely to be additional reading and operational costs too. It is unreasonable to require suppliers to supply through these types of meter without the ability to surcharge pricing to reflect the additional cost – likely to exceed £11/year for a legacy non-E7 complex meter. For this reason alone the proposed remedy is not proportionate in its current form.

<u>Tariff availability remedy – inclusion of E7</u>

11.20 We are particularly concerned about the CMA's decision to include all E7 meters in the scope of the single rate tariff availability remedy and would question its proportionality and indeed its legal basis. As far as we are aware, the CMA has found no evidence of a switching-related AEC relating to E7 meters, and E7 meters were excluded from the CMA's restricted meter bill analysis. Indeed, the CMA states that (emphasis added): [52]

> "our further analysis of the retail supply of electricity to domestic customers with restricted meters has confirmed our provisional view that the same features also affect domestic customers on restricted meters, and has shown that **there are additional aspects of the domestic retail electricity market concerning customers on restricted meters** that contribute to some of these features.[876]
>
> [876] (**For these purposes, we define 'restricted meters' to exclude customers with Economy 7 meters** unless otherwise specified. Ofgem found that for customers with Economy 7 meters their choice of tariff and suppliers was similar to that for customers on unrestricted meters. Ofgem presentation: Briefing on customers on restricted electricity meters for CMA, August 2015.)

The CMA also states:[53]

> "**Our provisional view is that market conditions for customers with Economy 7 meters are similar to those with unrestricted meters**. In particular: each of the Six Large Energy Firms and the mid-tier suppliers offer Economy 7 fixed-term tariffs which are advertised by suppliers and supported by PCWs and suppliers' own online search facilities. This is consistent with a recent Ofgem statement that most customers with restricted meters are on Economy 7 meters for which the choice of tariff and suppliers is similar to that for customers on unrestricted meters (i.e. meters with a single register and through which energy is continuously provided). In conducting our

[52] PDR para 6.317 and footnote 876.
[53] PDR Appendix 3.1, para 5.

investigation we have therefore focused on restricted meters excluding Economy 7 meters (and henceforth refer to this group as 'customers on restricted meters' unless otherwise specified)."

11.21 As the CMA has noted, there are sufficient customers on E7 meters that suppliers find it worthwhile to offer a similar range of tariffs as they do for single rate meters, and being on an E7 meter is not a barrier to switching. On this basis, it is likely that remaining on E7 would be beneficial for customers down to a significantly lower threshold than the 50% of night time/controlled usage that we have used to define high heating users. We suspect that for E7, the great majority of customers would lose out from switching to single rate (as opposed to the best E7 offer available) and we fear that the industry would be blamed.

11.22 Finally, Smart meter functionally can be reconfigured from E7 to standard rate and therefore, once customers have a smart meter installed, the barriers to switching between single rate and E7 tariffs should be removed altogether.

<u>Information remedies</u>

11.23 We are concerned that the information remedies may encourage customers to make poor decisions, based on the analysis of ScottishPower data above, which indicates that switching to a single rate meter is a suboptimal choice in the great majority of cases for high heating users. Subject to that point, we have few other concerns on the proposed information remedies requiring suppliers to provide additional information to their customers on restricted meters and we are content to provide information reasonably required by Citizen's Advice in this area.

11.24 We also support the recommendation to Citizens Advice to become a recognised provider of information and support to domestic electricity customers on restricted meters.

12. PREPAYMENT PRICE CAP REMEDY

"An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions) requiring suppliers to ensure that the annual bills paid by prepayment customers (assuming a pre-determined consumption level) do not exceed a specified benchmark reference level, for a period until the end of 2020."

12.1 We offer our comments on this remedy under the following main headings:

(a) The decision to impose the price cap

(b) The design of the price cap

(c) The competitive benchmark level (starting values)

(d) The prepayment meter (**PPM**) vs DD cost differential

(A) <u>Decision to impose the price cap</u>

<u>Introduction</u>

12.2 ScottishPower has consistently advocated competitive solutions to the issues identified by the CMA and emphasised their advantages over regulatory options that may bring unintended consequences. Our position on this is unchanged. We have serious concerns about a price cap remedy for domestic PPM customers. We believe it would be highly damaging to competition in the prepayment segment (**PPS**) and that it is unnecessary. We consider that even a transitional cap will interfere with normal operation of the competitive market, negate other pro-competitive remedies, stifle nascent competition and deter new entrants. Further, as we explain below, we consider that the CMA has failed to make the case for such a radical intervention in the market; we see fundamental problems in the way that the CMA has assessed the level of customer detriment, which is based on a wholly unrealistic counterfactual. The CMA has given only the most cursory consideration to the risk of substantial adverse effects and unintended consequences resulting from the imposition of a PPM price cap, and has made no allowance for this in its detriment calculations. In our view the CMA's proportionality assessment is therefore seriously deficient.

12.3 As explained in our response to the SSRN, we do not believe that the issue in the PPS is one of customer engagement. A survey conducted for Ofgem by Ipsos Mori[54] suggests that current levels of engagement are in fact relatively healthy, with most recent switching rates (2014, reported 2015) as high as for DD customers and significantly higher than for standard credit (**SC**). The CMA cites evidence from its own survey which PPM switching rates 'in the last year' were somewhat lower than DD (11% vs 15%) but given the relatively small sample of PPM customers, this difference is barely statistically significant.

12.4 We do however recognise that the PPS has not yet been characterised by the keener pricing that has been seen for non-standard tariffs in the DD segment. As explained previously, we see this as being partly a timing issue and partly due to technical factors around tariff codes. Although some companies may choose to focus on the PPS from the outset, it is natural for most new entrants to focus on the DD/SC segment initially, and then invest in developing the additional systems and processes to support the PPS. While at the start of 2014, only **[CONFIDENTIAL]**% of ScottishPower's losses (technically, de-registrations) to non-SLEF suppliers were PPM, with **[CONFIDENTIAL]**% being DD), by Q4 of 2015, the proportions were almost **[CONFIDENTIAL]**.

12.5 We firmly believe the CMA should seek to build on the recent acceleration in non-SLEF market share and give space to the wide range of pro-competitive remedies it has proposed (coupled with tariff code rationalisation) to achieve the desired outcome for consumers. If the CMA proceeds with the price cap, there is a real risk that the reduced gains from switching, combined with 'endorsement bias' effects, will cause a deep reduction in the current levels of engagement, and that the resulting behavioural change will persist long after the cap has been lifted, negating the competitive benefits that smart PPMs and other remedies would otherwise bring.

Legal considerations - proportionality

12.6 The CMA argues that the very high level of consumer detriment associated with the five Domestic AECs, coupled with the fact that its pro-competitive 'enabling' remedies will take time to deliver the expected benefits, justifies the imposition of a transitional price cap for PPM customers, because PPM customers need protection in this interim period.[55]

12.7 However, the CMA's calculation of detriment using the so-called 'direct' method (based on gains from switching), which the CMA indicates it prefers to the 'indirect' method,[56] is highly problematic and appears to us to be based on the 'wrong' counterfactual (i.e. of an 'idealized perfectly competitive market' rather than the concept of a 'well-functioning market' referred to in the CMA's own guidance). In addition, Oxera's analysis (see section 1 and Annex 1) reveals major methodological flaws in the CMA's analysis, which make the CMA's chosen benchmark an unreliable proxy for conditions that could reasonably be expected to prevail in a well-functioning market. This is discussed in more detail at subsection (C) below. In combination, these factors mean that the CMA has no sound legal basis for imposing its proposed PPM price cap remedy, and that were it to do so, its decision would be characterised as irrational, leaving it exposed to the risk of an appeal. In the paragraphs which follow below, we focus first of all on certain problems that relate to the CMA's proportionality analysis.

54 Ipsos Mori, Ofgem Custom Engagement Survey (September 2015).
55 PDR Summary paras 135-136; PDR paras 7.3-7.5, 8.48.
56 PDR para 3.156.

The CMA's assessment of detriment is based on the 'wrong' counterfactual

12.8 The statutory framework for market investigation references is silent on the standard to be used by the CMA in determining whether particular features of a market should be viewed as giving rise to an AEC (i.e. the counterfactual). Accordingly, the CMA's own guidance states that:[57]

> "[i]n the absence of a statutory benchmark, the [CMA] defines such a benchmark as a 'well-functioning market' (see paragraph 30) ie one that displays the beneficial aspects of competition as set out in paragraphs 10 to 12 but not an idealized perfectly competitive market".

12.9 The difficulty in this case is that the CMA's assessment of detriment is based on a model of supplier and consumer behaviour that could never be replicated in the real world. The CMA calculates the level of detriment by reference to the average gains available to SVT customers from switching to a hypothetical benchmark supplier, constructed using the weighted average of all the (DD) tariffs offered by two mid-tier suppliers (Ovo and First Utility).[58] But these firms are 'challengers' that are seeking to grow their customer base by taking market share from the incumbent SLEFs; the CMA notes[59] that they are:

> "… competing primarily through acquisition tariffs where competition is focused on price, and where customers are acquired through PCWs, which is the main channel for the acquisition of active customers".

12.10 The CMA appears to assume that in a well-functioning market the SLEFs would have the same proportion of their customer base on such acquisition tariffs as Ovo and First Utility (presumably through a process of widespread switching, although this is not made clear). It argues that the prices of Ovo and First Utility are sustainable even though Ovo was loss-making in 2014 (having first generated a profit in 2013) and First Utility's EBIT margin was only 0.2% in 2013 and 1.9% in 2014.[60] It indicates that returns would be adequate at these price levels, but also that the prices currently offered by Ovo and First Utility can be expected to remain at these levels as the companies continue to grow.[61] No consideration is given to whether, in a steady state, these two suppliers would continue to compete primarily using acquisition tariffs, and therefore whether the so-called 'system' price (i.e. the average price paid by Ovo and First Utility customers) would remain at current levels. Similarly, the CMA does not appear to make any allowance for the fact that the bulk of Ovo's and First Utility's customers are seemingly on fixed term contracts (the CMA states[62] that these suppliers have "relatively few inactive customers"). We would expect that some of these customers may default onto (more expensive) SVTs when those fixed terms expire, thus raising the 'system' price.

The CMA has failed properly to account for likely adverse effects of the remedy

12.11 Nor does the CMA make proper allowance for the risk of a PPM price cap reducing the level of existing competition in the market (a risk that the CMA acknowledges when considering the case for a price cap extending to all SVT customers, and rejecting it on proportionality grounds, but which it dismisses in relation to PPM customers).[63] The CMA recognises the potential for such a remedy to

57 *Guidelines for market investigations*, CC3, para 320. The guidance refers to the judgment of the CAT in the *Barclays* appeal relating to the PPI market investigation, where the CAT noted the "clear distinction between a properly functioning market unaffected by an AEC and an ideal market, in which every potential supplier of the relevant product competes on a precisely level playing field". See: *Barclays v. CC* [2009] CAT 27, para 104, cited in the CMA's guidance at footnote 172.

58 PDR para 3.166.

59 PDR para 3.169(a).

60 PDR paras 3.169(c) and 3.192-3.197.

61 *The Financial Times* reported on 27 September 2015 that although Ovo grew its customer base from 137,000 to 408,000 over the last year it suffered a pre-tax loss of over £37 million in the process. See: http://www.ft.com/cms/s/0/5ff803aa-650d-11e5-9846-de406ccb37f2.html#axzz42si7Ei1a.

62 PDR para 3.169(b).

63 PDR paras 7.15-7.18.

reduce the potential benefits of competition and thus to dampen the effectiveness of its other proposed remedies.[64] But it argues that because the other proposed remedies will not take effect in the short term (and therefore will not increase competition in the short term), it does not expect the PPM price cap to have any adverse effect on competition during this initial period.[65] It also says that it does not expect the PPM price cap to have any material adverse effect on the effectiveness of its other remedies during this interim period, given that they will not have come into force by then.[66]

12.12 However, by concentrating its analysis on whether a price cap would reduce the effectiveness of its other remedies, the CMA has focused on the wrong question. The CMA only examines in cursory fashion the possibility that the PPM price cap could reduce the level of existing competition, both during the lifetime of the PPM price cap and afterwards. It considers the risk that the PPM price cap could reduce customer engagement but says it cannot "reliably quantify" the likelihood of this;[67] an extraordinary admission given the emphasis that the CMA places on its detriment calculations. Effectively, the CMA is acknowledging that there could well be a material impact on its detriment calculations, but then refusing to make the necessary adjustment to reflect this. Instead, the CMA considers the possible consequences of widespread disengagement among PPM customers during the lifetime of the remedy. It dismisses the risk of harm on the basis that there is currently only "limited competition" in the PPM segment, so that "the marginal impact of any disincentivisation resulting from the PPM Price Cap Remedy, relative to the current status quo, may be relatively small".[68] Again, this is wholly unconvincing: if such adverse effects could arise, they need to be weighed against the detriment identified by the CMA as the justification for the remedy, but the CMA has effectively ascribed a nil value to such effects. The CMA acknowledges that "in the counterfactual scenario competition in the prepayment segments may intensify such that the marginal impact of a price cap would be more significant". But it dismisses this risk without giving proper reasons, simply noting that "based on the evidence of detriment available to us and our assessment of the counterfactual we believe it is appropriate to implement a price cap remedy" (para 7.240). That is an essentially subjective judgement, unsupported by any coherent explanation.

12.13 As regards the period beyond the lifetime of the PPM price cap the CMA notes that levels of customer engagement could remain low if customers have lost the habit of engaging, due to the price cap. Against this, the CMA notes that its engagement remedies and the introduction of smart metering are likely to increase levels of engagement, potentially significantly, "particularly if these attract tariffs below the cap".[69] The problem here is that the CMA has failed to give proper consideration to the risk of the PPM price cap having a material and long-lasting effect on customer engagement. Our expectation is that many PPM customers will take the view that there is no point engaging with the market given that their prices are protected by regulation. Our concern is that many PPM customers will continue to hold this view even once the PPM price cap is lifted. At a minimum, we would expect there to be a significant time lag between the end of the PPM price control and any gradual increase in levels of engagement. The CMA has simply not addressed this.

The CMA's proportionality assessment is accordingly flawed

12.14 As a result, the CMA's proportionality assessment is seriously deficient: the CMA has failed to take account of relevant considerations that call into question the validity of its detriment calculations. It appears to us that the CMA is in danger of falling into the same trap that its predecessor, the Competition Commission (**CC**), fell into in the PPI market investigation. The CC's mistake was to opt for a radical remedy (the point of sale prohibition) without adequately considering the risk that the resulting loss of convenience for customers would lead to reduced take-up of PPI. The judgment

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64 PDR para 8.51.
65 PDR para 8.52.
66 PDR para 7.220.
67 PDR para 7.238.
68 PDR para 7.239.
69 PDR para 7.241. This assumption may be questionable, depending on the level at which the price cap is fixed.

of the CAT in the *Barclays* appeal provides a salutary reminder of the importance of fully considering the risk of unintended consequences associated with highly intrusive remedies:[70]

> "It could hardly be doubted that a remedies package which produced a theoretically perfectly competitive market for PPI, but at the expense of driving a majority of potential purchasers from the market place, would not be reasonable, proportionate, or for that matter, effective."

12.15 By the same token, it could hardly be doubted that a PPM price cap remedy that protected PPM customers in the short term, but at the expense of reducing customer engagement in the longer term, would not be reasonable, proportionate, or for that matter, effective.

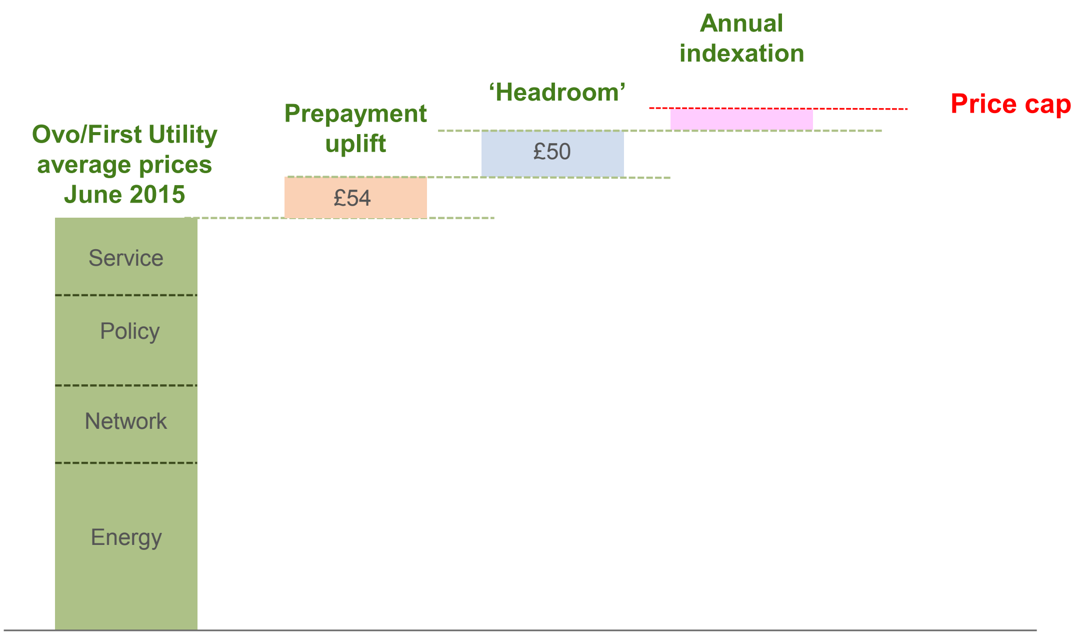
12.16 Without prejudice to our contention that a PPM price cap would not be justified, we comment below on a number of issues relating to the design of the proposed remedy.

(B) Design of the price cap

Introduction

12.17 The CMA is proposing a 'hybrid reference price and cost index' approach to setting the price cap, in which the initial level is set based on the CMA's competitive benchmark analysis plus headroom and then adjusted over time according to movements in exogenous cost indices. This is illustrated in Figure 1 below.

Figure 1: Design of price cap



12.18 Our provisional view is that this approach is preferable to the alternative 'external reference price' approach set out in Appendix 7.1 of the PDR, since it will be more transparent and predictable for suppliers and may require less discretion on the part of Ofgem in determining annual adjustments.

12.19 Our two most significant concerns with the CMA's proposed approach relate to proposed values for the reference level and prepayment uplifts. It is vitally important that these are set appropriately, since there will no opportunity to adjust for errors at a later date, and we have provided our detailed critique of these values in separate subsections (C) and (D) below. In the remainder of this subsection we consider other aspects of the remedy design.

70 *Barclays v. Competition Commission* [2009] CAT 27 at para 136.

Headroom

12.20 We agree that headroom should be provided, but based on experience of price controls in the New South Wales (**NSW**) market; we consider that £50 is too little. As we explained in our response to the Remedies Notice,[71] in the 2007-10 price control period, the level of 'incentive' in NSW (a measure of headroom in the price cap) was relatively low. In the next price control period 2010-2013, the incentive was increased four-fold (to approximately 10% of total costs), resulting in a looser price control. This caused price dispersion to widen from 4-5% to 5-15% (in 2012/13), the switching rate to increase by 50% and the number of customers on regulated tariffs to fall from 59% to 40%. This suggests that increasing the headroom from a low value to around 10% is likely to be necessary to mitigate the adverse impact of the price control on competition. On that basis, we would suggest that a headroom allowance closer to £100 would be appropriate.

12.21 We agree that the headroom should be split equally between electricity and gas, in the interests of simplicity, and to provide balanced incentives for suppliers to compete for the different fuels.

12.22 It is unclear from the PDR whether the CMA intends that the headroom would be incorporated into the standing charge or unit rate (or equivalently, how it would be incorporated into the consumption-related price caps). We think that it should be included in the unit rate rather than the standing charge, as this will reduce the risk that suppliers may change their tariffs in response to the price cap in a way that leaves some lower-consuming customers worse off. If this were to happen, it could give rise to unhelpful perceptions amongst some customers that the CMA's price cap had caused their bills to go up.

Cost indexation

12.23 The CMA is proposing that the 2015 starting tariff values would be divided into three components, customer service, wholesale energy, network and policy costs, and that each of these components would be subject to separate annual indexation. We consider that this approach to indexing is broadly sensible, subject to the caveats below.

12.24 The base tariff levels that will be indexed should not be drawn from tariffs on a single particular day. This is unlikely to be a reliable basis for a price cap that would apply over a number of years. Tariffs on one day may be significantly affected by factors such as customer acquisition campaigns. In addition, because businesses are likely to pass on changes in costs such as those associated with environmental and social obligations and wholesale market hedging over a period of time, choosing a tariff on one day runs the risk of not adequately capturing these relevant costs in the benchmark, particularly if that day falls in a period when such costs are subject to significant change.

12.25 It is important to base the indexation of costs on the correct split of benchmark tariffs into the various components. This is important because using an incorrect split initially could result in distortions to subsequent indexation. For example, if the percentage assigned to wholesale costs is lower than the actual share of wholesale costs in the tariffs of benchmark companies, subsequent increases in wholesale costs could result in insufficient compensation for suppliers subject to the price cap.

12.26 In order to perform the wholesale cost indexation it will be necessary to assume a particular hedging profile. It is important that the hedging profile used for the indexation matches the hedging profiles implicit in Ovo/First Utility starting values. So, if the Ovo/First Utility starting values were based on a short hedging position that benefited from a falling market, and the market starts to rise at some point in the future, this would be reflected in a higher indexation uplift than if a longer hedging profile had been used.

[71] ScottishPower response to Remedies Notice, para 11.10.

12.27 As far as we are aware, the CMA has not explained how it would make allowance in the electricity policy cost indexation for policy costs that were not reflected in the starting values. The DECC forecasts cited by the CMA[72] relate only to renewable energy costs and do not include:

(a) costs of ECO and Warm Home Discount – the CMA mentions these in the context of the gas policy indexation, but not electricity;

(b) capacity market supplier obligation costs, which are expected to be levied on suppliers with effect from 1 October 2017.

12.28 The PDR is silent on how any change in VAT would be treated under the price control. We consider the most appropriate approach would be to set the price cap exclusive of VAT. This would mean that changes in VAT could be reflected in prices as soon as the rate of VAT changes. If the price cap is inclusive of VAT, changes in VAT would need to be reflected in the index and suppliers would potentially have to for up to 12 months before they can pass on an increase in VAT.

<u>Structure of price cap</u>

12.29 The CMA is proposing that the price cap would be structured as 210 individual price caps, corresponding to 5 fuel/meter combinations,[73] 14 PES regions and 3 consumption levels. The need to define the cap at three different consumption levels apparently arises from the fact that the three price caps may not be collinear when the cap is plotted against consumption level. The CMA further suggests that the curve connecting the points will be concave, i.e. the medium consumption cap would be below the straight line joining the low and high consumption caps, as shown in Figure 7.2 of the PDR.

12.30 However, if the three consumption-related price caps are not collinear, it seems to us more likely that the curve would be convex rather than concave, i.e. the medium consumption cap would be *above* the straight line joining the low and high consumption caps. This is because low consuming customers are more likely to opt for tariffs with lower standing charge and higher unit rate, and higher consuming customers for tariffs with higher standing charge and lower unit rates. Hence, if the caps are based on a weighted average of tariffs chosen by baskets of low, medium and high consuming customers,[74] we would expect the line between the low and medium points to have a steeper gradient than the line between the medium and high points.

12.31 The scenario with a convex curve is illustrated in Figure 2, which also shows the maximum compliant tariff consistent with SLC22A.2 (requirement that tariffs comprise a single standing charge and/or a single unit rate), and based on the CMA's proposed rule that a tariff would be compliant if:

(a) the annual cost at the high, medium and low consumption levels is less than the price cap (in the relevant region, for the relevant meter-tariff type); and

(b) the annual cost between these consumption levels is less than the price that would be on the straight line between the price cap levels at the consumption thresholds.[75]

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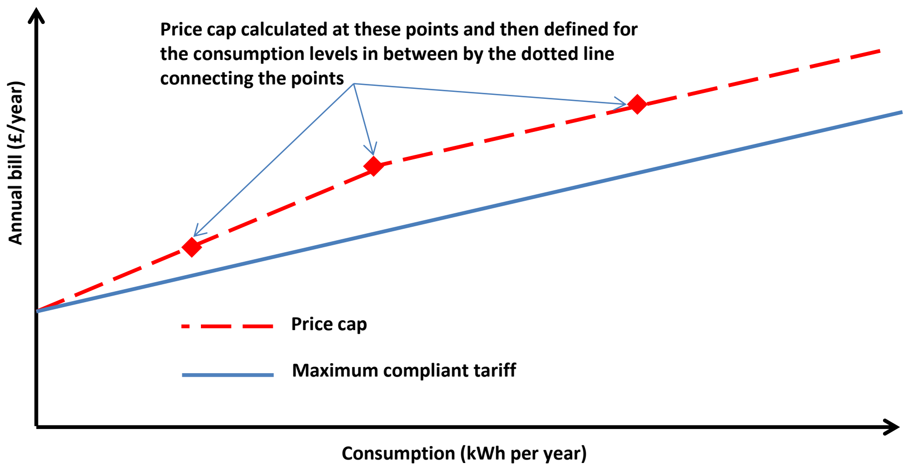
72 PDR paras 7.119-7.120.

73 Dual fuel, single rate electricity meter; dual fuel, Economy 7 electricity meter; solus electricity, single rate meter; solus electricity, Economy 7 meter; and solus gas.

74 It is unclear from the PDR how the CMA intends that these separate caps would be calculated, but this appears to us to be the most obvious approach.

75 PDR para 7.141.

Figure 2: Price cap for different consumption levels



12.32 The effect of these rules is equivalent to having separate caps on the standing charge and unit rate elements of the tariff, since the standing charge cannot be greater than the 'maximum compliant tariff' nor can the unit rate. Unless SLC22A.2 were to be relaxed, suppliers would not have the flexibility to offer a variety of tariffs as suggested by the CMA,[76] nor would they be able to price their tariffs up to the level of the cap. It is unclear to us at this stage how material any non-linearity may be, but we would note that if it is material, this could represent a significant 'hidden' reduction in the headroom available to suppliers.

<u>Scope of price cap</u>

12.33 We agree with the provisional decision not to extend the remedy to microbusiness customers, as the costs would be disproportionate to the very small number of customers involved.

12.34 We suggest there should be a transitional exemption from the price cap in respect of customers on existing fixed price fixed term tariffs entered into by the date of the CMA's final report. In these cases, the customer will have engaged with the market and it is appropriate to respect the choice that has been made by both parties. For example, one of our PPM special offer tariffs entails donations to Cancer Research UK; it is unreasonable to cap tariffs with this or indeed any other bundled feature at the same level as a tariff that does not have such features, especially once agreements have been entered into.

12.35 In addition, the current proposed design of incorporating fixed price deals within the cap is likely to create a barrier to suppliers offering fixed price fixed term tariffs. While there are a number of factors in the updating formula that are likely to rise from one year to the next, it is not possible to rule out the risk of a fall in a particular year. Suppliers would have no certainty that a fixed price deal below the cap at the time of offer would remain below over the duration. This creates an asymmetric risk, whereby suppliers cannot pass through increases in costs (because the tariff is fixed) but must pass through cuts. The risk is therefore that competitive activity in the PPS dries up during the period of the control. This could in principle be mitigated either by setting a more generous cap or if the CMA had included **SLC22C.9** in the licence conditions to be removed as part of the "simpler choices" remedy, allowing suppliers to offer tariffs that are linked to their SVT rates.

12.36 We believe the tariff cap should not apply to customers with SMETS2 smart meters.[77] Once customers have moved to smart PPMs, suppliers will no longer be constrained in their ability to offer

76 PDR para 7.146.

77 As alternative, all smart meters could be exempted. We suggest that only SMETS2 meters are exempted because this may provide an additional incentive on suppliers to roll out SMETS2 in preference to SMETS1, and because it is more likely that suppliers would be wishing to experiment with alternative tariffs by the time that SMETS2 meters are being installed in significant volumes.

a wide range of tariffs and they should be encouraged to take advantage of this increased flexibility. It is possible that the presence of the tariff cap could discourage this, and we see no reason to run that risk. Suppliers will have a strong incentive to ensure that PPM customers on SMETS2 meters, even if they are not subject to the cap, are offered as good, if not better, deals than customers on dumb meters. If this were not the case, customers might be reluctant to have a smart meter installed, and suppliers would find their smart roll-out progress put at risk. Given the risks of enforcement action if rollout targets are missed, this is not a risk that suppliers would wish to run.

Sunset clause

12.37 We welcome the fact that the remedy is seen as transitional and agree there should be a hard end date. However we believe the end date should be 31 December 2019 rather than 31 December 2020. By that time smart roll-out will be well underway, and competitive conditions can be expected to have improved sufficiently that there is no ongoing need for any cap.

12.38 The CMA also proposes to conduct a focused mid-term review in January 2019 of the progress that has been made concerning the roll-out of SMETS2 smart meters, and in the event that the roll-out of SMETS2 smart meters was materially ahead of schedule, would consider whether to terminate the price cap early (i.e. early termination provision would be included).[78] We agree there should be a mid-term review.

12.39 The CMA goes on to say that if, at the date of the mid-term review, the roll-out of SMETS2 smart meters does not appear likely to be completed by 31 December 2020, it would consider whether to encourage Ofgem to review the situation and take whatever action it considers appropriate (including whether to introduce a similarly structured price cap in the PPS as from the start of 2021). We believe that the CMA should be extremely wary of making such a recommendation, as the longer the price cap is left in place, the more 'habituated' customers will become and the harder it will be to move them back to a more engaged mind set. If it does make such a recommendation, this should include clear guidance as to the maximum additional duration.

(C) Competitive benchmark level

Overview

12.40 The CMA proposes to use as the starting point for the prepayment tariff cap the same 'competitive benchmark price' as it used in its 'direct' approach to assessing consumer detriment. A key difference is that the detriment calculation is assessed over a four year period, whereas the competitive benchmark price is based on the average prices offered on 30 June 2015 to direct debit customers by 'the most competitive suppliers', which the CMA considers to be Ovo and First Utility. To set a price cap based on two relatively small companies' prices on a single day is highly susceptible to error and gives no assurance that the cap would be at an efficient level.

12.41 As noted above (para 1.3), ScottishPower commissioned Oxera to review the CMA's analysis using data made available in the CMA's Confidentiality Ring, and a note based on the non-confidential version of Oxera's report on this work is provided in Annex 1 to this response. Oxera identified a number of areas where the approach used by the CMA departed from that which might be considered to be a fair benchmark that could be expected to prevail in a well-functioning market.

12.42 In particular, Oxera found that the following features of the CMA's analysis distort the results (for more detail see para 1.5 and Annex 1):

(a) incorrect assessment of the impact of environmental obligations on benchmark companies:

78 PDR para 7.180.

(b) omission of a valid comparator from the list of benchmark companies – thus biasing the overcharge estimates upwards;

(c) an assumption that low or negative profitability of benchmark companies can be sustainably replicated by the entire market;

(d) reliance on benchmarking of wholesale costs of different suppliers despite such costs being subject to volatility of wholesale market prices and thus largely uncontrollable; and

(e) failure to account for the effect of growth in customer numbers on the tariff mix of different suppliers.

12.43 It is arguable that the tariff mix issue overlaps with the profitability issue and therefore Oxera did not include it in the final calculations. Nevertheless, the adjustments demonstrate that the 'direct' method did not provide a sound basis for concluding that there was any consumer detriment.

12.44 The CMA's assessment of the benchmark for the purpose of the price cap is susceptible to the same problems as the detriment calculation – though they manifest themselves differently because it is a one day rather than 4 year assessment. Table 5 sets outs the results of Oxera's analysis to correct for the issues with the CMA's benchmarking analysis identified above. It shows that, once corrections for all issues apart from benchmarking of wholesale costs (where it is difficult to assess whether there would be a difference on a forward looking basis) and the growth effect on tariff mix (which was estimated at £14 but may overlap with profitability) have been made, the estimated direct debit annual bill value excluding network charges is increased from £735 to £785, an increase of some £50 per annum.

Table 5: Oxera adjustments to CMA's benchmark price estimates

	Annual dual fuel direct debit bill (£) at Q2 2015, calculated at Ofgem 2014 Medium TDCV
CMA estimate of bill (excluding network charges)	735
Adjust for cost of environmental obligations (I)	+7
Adjusted CMA estimate of bill (I)	742
Adjust to include Co-op in benchmark (II)	+9
Adjusted CMA estimate of bill (I & II)	751
Adjust for low profitability of benchmarks (III)	+34
Adjusted CMA estimate of bill (I, II & III)	785
Adjust for difference in wholesale cost (IV)	n/a
Adjusted CMA estimate of bill (I, II, III & IV)	785

Source: Oxera (see Annex 1)

12.45 Should the CMA proceed with this remedy, it is essential that the methodological issues identified by Oxera are addressed and the starting level for the price cap is adjusted accordingly. As matters currently stand, it is clear that the CMA's detriment calculations are fundamentally unsound and that the CMA would therefore be acting irrationally if it used those calculations to justify a decision to impose a PPM price cap remedy.

(D) <u>PPM cost differential</u>

12.46 We believe that the CMA has significantly underestimated the cost to serve differential between PPM and DD, which in turn will result in the price cap being set too low. Whilst the CMA estimates the difference at £54 per year per dual fuel customer, the corresponding actual cost difference faced by ScottishPower for these cost items is circa £**[CONFIDENTIAL]**. Table 6 shows a detailed breakdown of CMA cost estimates compared with ScottishPower's actual cost data for 2014 previously submitted to the CMA. As discussed further below, the CMA has excluded certain cost items including customer acquisition costs; when these are included our total estimated cost to serve difference for 2014 is around £**[CONFIDENTIAL]**.

Table 6: PPM vs DD cost to serve difference: CMA point estimate assumptions and ScottishPower indirect cost data (2014)

	Electricity		Gas		Total		
	CMA	SP	CMA	SP	CMA	SP	Delta
Call centre	£0.00	[CONF.]	£0.00	[CONF.]	£0.00	[CONF.]	[CONF.]
Collections activity	-£0.12	[CONF.]	-£0.12	[CONF.]	-£0.24	[CONF.]	[CONF.]
Billing/statements	-£0.10	[CONF.]	-£0.10	[CONF.]	-£0.20	[CONF.]	[CONF.]
Bad debt	-£2.50	[CONF.]	-£2.50	[CONF.]	-£5.00	[CONF.]	[CONF.]
NTS payment	£6.84	[CONF.]	£5.99	[CONF.]	£12.83	[CONF.]	[CONF.]
PPMIP	£5.03	[CONF.]	£6.11	[CONF.]	£11.14	[CONF.]	[CONF.]
Metering costs	£12.61	[CONF.]	£22.47	[CONF.]	£35.08	[CONF.]	[CONF.]
Total	**£21.76**	[CONF.]	**£31.85**	[CONF.]	**£53.61**	[CONF.]	[CONF.]

12.47 The two most significant cost categories, in terms of the variance between the CMA's estimates and ScottishPower's actual costs, are call centre costs and metering costs. We explain below the reasons behind these cost differences and why we do not consider these differences can be seen as the result of inefficiency on the part of ScottishPower. We also explain why there is a significant difference in customer acquisition costs and why we consider this should also be included in the cost to serve differential. The updated ScottishPower estimates are summarised in in Table 7, and suggest that the CMA has under-estimated the cost differential by around £32, implying that the overall cost differential allowed in the price control should be around £86 (£54 + £32).

Table 7: Key areas where CMA has underestimated PPM vs DD cost differential – updated ScottishPower estimates

	PPM vs DD cost to serve difference for dual fuel customer		
	CMA point estimate	SP revised estimate (see below)	Difference
Call centre	£0.00	[CONF.]	[CONF.]
Meter rental[79]	£28.51	[CONF.]	[CONF.]
Customer acquisition		[CONF.]	[CONF.]
Total	£28.51	£60.34	£31.83

<u>Call centre costs</u>

12.48 The CMA assumes zero difference in call centre costs for DD and PPM customers. The CMA explains that although RWE commented that PPM calls were more complicated and took longer than calls from other customer types, they decided to disregard RWE's evidence because the results of the RWE methodology were very different to the submissions of the other SLEFs where "call centre costs relating to PPM customers were mostly lower than those for DD customers".[80] We find this comment surprising as ScottishPower's indirect cost data submitted to the CMA suggested that PPM costs were £**[CONFIDENTIAL]** greater than for DD.

79 Meter rental is a separate line item within overall metering costs in the CMA's analysis; hence the CMA estimate of £28.51 for meter rental is less than the overall figure of £35.08 shown in Table 6. These separate metering cost line items are not reported separately in ScottishPower's IT system, and we were unable to give a precise value for the meter rental cost difference in our previous submissions.

80 PDR Appendix 3.6, para 54.

12.49 We have undertaken further analysis to substantiate this cost difference, which we believe is likely to affect all suppliers to a greater or lesser extent. Table 8 summarises the statistics for calls from ScottishPower DD and PPM customers over the 6 months September 2015 to February 2016.

Table 8: ScottishPower call statistics for DD and PPM

Month	DD		PPM	
	Calls offered	Average call handing time (s)	Calls offered	Average call handing time (s)
Sep-15	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Oct-15	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Nov-15	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Dec-15	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Jan-16	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Feb-16	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Average	[CONF.]	[CONF.]	[CONF.]	[CONF.]

12.50 Table 9 shows the relative costs of handling calls from DD and PPM customers. The main driver for the cost difference is the number of calls per customer, with PPM customers generating just over [**CONFIDENTIAL]** as many calls per service as DD. The cost per call is also [**CONFIDENTIAL]**% higher for PPM customers. This partly reflects the average length of call (**[CONFIDENTIAL]**% longer) but also the fact that calls from PPM customers are significantly more complex (often focused on technical issues to do with PPM infrastructure) and accordingly charged at a higher unit price by our outsourced call handling agents.

Table 9: Call centre cost difference DD vs PPM

	DD	PPM	Difference
ScottishPower services (approx.)	[CONF.]	[CONF.]	
Average calls per month (Sep 15 to Feb 16)	[CONF.]	[CONF.]	
Average call handing time (Sep 15 to Feb 16)	[CONF.]	[CONF.]	[CONF.]
Calls per service per year	[CONF.]	[CONF.]	[CONF.]
Cost per call	[CONF.]	[CONF.]	[CONF.]
Annual cost per service†	[CONF.]	[CONF.]	[CONF.]
Dual fuel difference			[CONF.]

† Call costs reflect contract costs rates with Kura - suppliers of both DD and PPM services.

12.51 Based on the analysis above, the difference between PPM and DD for a dual fuel customer is **£[CONFIDENTIAL]**. (This is a forward looking estimate, whereas the £**[CONFIDENTIAL]** in Table 6 relates to 2014.) We consider that this is likely to be representative of the industry as a whole, since we would expect PPM customers to generate more (and more complex) calls as a result of the practicalities of this payment method. Compared with DD, there is much more scope for things to go wrong, and when they do go wrong, customers need more urgent support, making it more likely that they will call their supplier (rather than, say, emailing or visiting the website). Even where the matter is not urgent, we find that prepayment customers are more likely to call us than DD customers. Typical reasons for PPM customers to call us (that would not generally apply to DD customers) include:

(a) lost key or card;

(b) key or card not working;

(c) vending issues such as credit not added to meter; and

(d) issues relating to the customer's financial circumstances and any associated vulnerability.

12.52 It is essential that the CMA reconsiders its assessment of the cost difference in the light of our evidence above and the evidence from RWE referred to in the PDR.

Meter rental costs

12.53 The CMA's point estimate of the difference in meter rental costs between PPM and DD is £28.51 for a dual fuel customer. The derivation of this point estimate is summarised in Table 10. The CMA's low estimates are derived from the difference in capital costs for PPMs and credit meters (assumed to be £39 for electricity and £80 for gas), a 5 year lifetime and 10% cost of capital.[81] For electricity, the point estimate is the same as the low estimate and for gas it is £2.88 less than the low estimate, for reasons that are not made clear in the PDR.

Table 10: CMA estimates of meter rental cost differential

	Difference in meter rental - PPM vs credit		
	Electricity	**Gas**	**Total**
CMA low estimate	£10.29	£21.10	£31.39
CMA high estimate	£12.40	£21.57	£33.97
CMA point estimate	£10.29	£18.22	£28.51

Source: non-confidential output from Confidentiality Ring analysis conducted by Oxera for ScottishPower

12.54 In our view the CMA's point estimates are substantially too low and do not reflect the reality of current market rental prices. We find it surprising, when there is ample evidence available of rental prices for both price controlled and competitive metering segments, that the CMA should disregard this evidence and instead substitute its own 'back of the envelope' calculation. We have not been able to critique the CMA's calculation in detail, but we would note that one obvious objection is that it assumes the same lifetime for credit meters and PPMs. Given the higher frequency of meter exchange in the PPS and the greater complexity and opportunities for wear and tear, it would not be surprising if the effective lifetime (for the purpose of determining rental rates) was shorter for PPMs than for credit meters. It is also based on the cheapest single rate meter types and does not take account of more expensive multi-rate meters.

12.55 A robust assessment of rental cost differences would need to take account of actual market rental prices, for both 'legacy' (price controlled) and 'non-legacy' (competitive) segments of the market, the relative proportions of legacy and non-legacy meters in the credit and prepayment segments, and the mix of single rate and multi-rate meters. We have provided such an analysis in respect of ScottishPower's meters in Table 11 below. The table shows estimated average annual rental values for two categories of meter provider, 'legacy' and 'non-legacy',[82] based on analysis of actual costs incurred by ScottishPower in November 2015.[83] The weighted average difference in meter rental costs is £**[CONFIDENTIAL]**, some £**[CONFIDENTIAL]** more than the CMA's estimate. We would expect some variation between suppliers depending on the proportions of legacy and non-legacy meters and their choice of competitive provider, but this cannot possibly explain a difference of this magnitude.

81 PDR Appendix 3.6, paras 78-80.

82 We use the term 'legacy provider' to refer to companies who provide legacy meters at price controlled rates (DNOs or their successors in electricity, and National Grid Metering in gas) and 'non-legacy provider' to refer to companies who provide meters wholly at commercial rates. Note that 'legacy providers' may also provide non-legacy electricity meters at commercial rates.

83 For NGM and some other providers the invoice includes installation and maintenance charges which are not invoiced separately from rental.

Table 11: ScottishPower PPM vs credit meter annual rental differences

	Credit meters		Prepayment meters		Cost difference PPM vs DD
	Split of meters	Average annual rental	Split of meters	Average annual rental	
Electricity meters					
Legacy provider	[CONF.]	[CONF.]	[CONF.]	[CONF.]	
Non-legacy provider	[CONF.]	[CONF.]	[CONF.]	[CONF.]	
Average		[CONF.]		[CONF.]	[CONF.]
Gas meters					
Legacy provider	[CONF.]	[CONF.]	[CONF.]	[CONF.]	
Non-legacy provider	[CONF.]	[CONF.]	[CONF.]	[CONF.]	
Average		[CONF.]		[CONF.]	[CONF.]
Dual fuel		[CONF.]		[CONF.]	[CONF.]

12.56 To check the robustness of the above analysis, we repeated the exercise using rental price list data instead of average actual spend. For this purpose we assumed that all meters were single rate (ie disregarding multi-rate and other complex meter types) and that all electricity meters rented from legacy providers were at legacy rates (which are lower than commercial rates in view of the longer assumed lifetime.) This exercise gave broadly similar results, with a PPM versus DD cost difference of around £**[CONFIDENTIAL]**. This suggests to us that if the CMA were to conduct its own exercise using price list data from the major providers, this would be likely to yield a reasonably robust result.

Electricity

12.57 The difference between legacy and non-legacy meters arises from the process of meter deregulation. Historically, public electricity suppliers (PES) were the monopoly meter provider in their regions. In 1998 competition in meter service provision was introduced by enabling third parties to become approved meter operators and installers, and at PES separation in 2000, the meter businesses were transferred to the DNOs. To facilitate increased competition, DNO meter rental rates were subject to regulatory controls, which set rental rates based on assumed asset lives, typically of between 12 and 18 years. The controls were lifted at the end of 2006, when Ofgem determined that competition was sufficiently developed. From 2007 onwards, DNOs were free to set their rental rates on any meter installed or exchanged after this date ('non-legacy' meters), albeit subject to certain licence requirements. Meters installed by third party meter providers were never subject to controls and are therefore also regarded as non-legacy. Meters installed or exchanged by a DNO prior to 2007 and subject to the tariff control are referred to as 'legacy' meters. DNOs generally assumed shorter asset lives in their non-legacy rental rates, anticipating smart meter roll-out, and as a consequence non-legacy rental rates were much higher than the legacy rates. In the run up to smart meter rollout, third party meter providers competed with DNOs on the basis of non-legacy rental rates. Almost all DNOs have now ceased to offer new non-legacy meters ahead of smart meter roll-out. [84]

12.58 A more detailed breakdown of electricity meter rental costs is given in Table 12. The average rental rates for legacy providers represent a mix of legacy and higher non-legacy rates, depending on whether meters were installed before or after 2007.[85] (The proportion of non-legacy meters is likely to be higher for PPMs which are more likely to have been subject to meter exchanges than credit meters.) The rental rates for non-legacy providers represent commercial rates for non-legacy meters. In general it is not practicable to switch non-legacy meters between third party providers as we wish to avoid the customer inconvenience and additional costs involved, but we seek to manage the rental costs of our non-legacy portfolio where possible by negotiating with the relevant meter provider.

[84] ScottishPower Distribution is one of two DNOs still offering new non-legacy meters; their current non-legacy PPM rental rate is approximately 80% higher than the legacy PPM rate.

[85] **[CONFIDENTIAL]**

Table 12: Annual rental difference PPM vs DD for electricity meters

Electricity meter provider	Scottish Power credit meters	Credit average meter annual rental	Scottish Power PPMs	PPM average annual rental	Annual rental difference PPM vs DD
Legacy					
SSE	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
ScottishPower	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Northern Powergrid	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Electricity North West	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Western Power Distribution	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
EON Energy Services	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
UK Power Networks	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Non-legacy	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Others	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
All meters	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]

Gas

12.59 Competition in gas meter provision was initiated in 1996, and as with electricity meters, the incumbent provider, British Gas (now National Grid Meters (**NGM**)) was subject to tariff control. An important feature of the controls is an imposed limit on the credit meter/PPM rental differential whereby the credit rental rate is increased above cost in order to cross subsidise and reduce the PPM rental rate. The CMA reports that this cross subsidy is worth £1.25.[86] That is to say, National Grid's credit meter/PPM rental differential is set below the underlying costs. In contrast to electricity, Ofgem has not judged competition sufficiently developed to remove National Grid's tariff controls and they will remain in force until smart meter rollout is completed.

12.60 The breakdown of our gas meters is shown in Table 13 below. We have been proactive in engaging third party meter installers over the last few years, **[CONFIDENTIAL]**, as a means to reduce our meter costs below what can be achieved with National Grid. Under the framework we have established, we are able to secure competitive rates with installers **[CONFIDENTIAL]**, and their meters are then adopted by our meter asset manager, **[CONFIDENTIAL]**, who charges us a competitive rental rate which compares well with NGM's rental rates (even before adjusting for cross-subsidy). The remainder of our third party gas meters are meters we have gained through customer churn where we have less opportunity actively to negotiate the associated rental rates.

[86] PDR Appendix 3.6, para 80.

Table 13: Annual rental difference PPM vs DD for gas meters

Gas meter provider	Scottish Power credit meters	Credit meter average annual rental	Scottish Power PPMs	PPM average annual rental	Annual rental difference PPM vs DD
Legacy					
NGM	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Non-legacy					
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
Others	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]
All meters	[CONF.]	[CONF.]	[CONF.]	[CONF.]	[CONF.]

Early termination fees

12.61 NGM and third party gas and electricity meter providers will typically charge an early termination fee if their traditional meter is replaced by a smart meter, before the end of the assumed life of the traditional meter. This fee may for example be set at a level to recover the number of outstanding annual rental payments (relative to the assumed lifetime on which the rental is based). In our view, a sustainable PPM vs DD cost to serve differential should also include a factor reflecting the likely exercise of early termination fees, which we have not been able to quantify at this stage.

Conclusion

12.62 In conclusion, we estimate that the weighted average meter rental cost differential faced by ScottishPower is currently around £**[CONFIDENTIAL]** per annum, around £**[CONFIDENTIAL]** more than the CMA's point estimate. Furthermore, the differential for electricity meters may increase in the next few years, given the exit of nearly all the DNOs from the market, and the absence of a meter provider of last resort as in gas (NGM). It is essential that the CMA undertakes a more thorough assessment, taking into account actual market rental rates and distributions of legacy and non-legacy meters.

<u>Customer acquisition cost difference</u>

12.63 The CMA has chosen not to include differences in customer acquisition cost in the PPM versus DD cost differential. As indirect cost data previously submitted by ScottishPower shows, the average cost to acquire a PPM customer is significantly higher (approximately £**[CONFIDENTIAL]** for a dual fuel customer, £**[CONFIDENTIAL]** electricity and £**[CONFIDENTIAL]** gas) than a DD customer, as a result of the different mix of sales channels used. This mix is largely determined by the preferences of the two categories of customer – which are outside the control of suppliers.

12.64 Table 14 shows direct sales commission costs incurred in 2014 for customer acquisition, together with the approximate mix of sales channels for DD and PPM. The majority of PPM sales are made via **[CONFIDENTIAL]** which is a relatively expensive channel when compared to **[CONFIDENTIAL]**. The direct cost per sale is £**[CONFIDENTIAL]** higher than for DD customers. (This compares with a difference of around £**[CONFIDENTIAL]** in the indirect cost data submitted to the CMA, which also included business overhead activity to support sales channels.)

Table 14: Customer acquisition costs for DD and PPM

Sales channel	Unit cost	DD	PPM	Delta
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	
[CONFIDENTIAL]	[CONF.]	[CONF.]	[CONF.]	
Weighted average		[CONF.]	[CONF.]	[CONF.]

12.65 If the CMA wishes competition to remain dynamic and suppliers to try to win new customers, it will be necessary to make additional allowance in the headroom for the increased acquisition costs.

(E) <u>Conclusion</u>

12.66 In summary, we do not believe that it would be proportionate for the CMA to adopt a price cap remedy. However, should the CMA choose to proceed with this remedy, we believe that the proposed starting level for the tariff cap is substantially too low. As explained in the sections above, we believe adjustments are required in respect of the estimated benchmark bill level, the PPM vs DD cost differential and the headroom allowance, as summarised in Table 15. To the extent these adjustments in aggregate take the cap above current PPM prices, that is further evidence that the remedy itself would not be justified.

Table 15: Summary of adjustments to starting level for the tariff cap

	CMA PDR proposal	Adjustment	ScottishPower view
Estimated bill excluding network charges	£735		
Environmental obligations adjustment		£7	
Inclusion of Co-op adjustment		£9	
Low profitability adjustment		£34	£785
PPM vs DD cost differential	£54		
Call centre costs		[CONF.]	
Metering rental costs		[CONF.]	
Customer acquisition costs		[CONF.]	£86
Headroom	£50	£50	£100
Total	**£839**	**£132**	**£971**

13. MICROBUSINESS REMEDIES

"An order on gas and electricity suppliers (and amendments to suppliers' standard licence conditions):

(i) requiring suppliers to disclose the prices of all available acquisition and retention contracts to non-domestic customers falling within a defined category (the 'Proposed Segment') either through an online quotation tool made available on their website, or through one or more third party online platforms (and including a web link on their own website to direct non-domestic customers to such third party online platform(s));

(ii) requiring suppliers to disclose the prices of all their out of contract and deemed contracts on their websites;

(iii) prohibiting the inclusion of conditions in their existing and future auto-rollover contracts with microbusiness customers that:

- ***prohibit the microbusiness customer from giving a termination notice up to the last day of the initial fixed-term period;***
- ***prohibit the microbusiness customer from giving a termination notice up to the last day of the fixed-term roll-over period; and***
- ***impose a termination fee and/or no-exit clause for the roll-over period;***

(iv) prohibiting the transfer of microbusiness customers that have given a termination notice during the rollover period of an auto-rollover contract to a higher priced contract during the notice period; and

(v) prohibiting the inclusion of a condition in their existing and future out-of-contract, and evergreen contracts with microbusiness customers that include termination fees.

A recommendation to Ofgem to make any necessary minor consequential amendments to the suppliers' standard licence conditions.

A recommendation to Ofgem to establish an ongoing programme to identify, test (through randomised controlled trials, where appropriate) and implement measures to provide microbusiness customers with different or additional information with the aim of promoting engagement in the microbusiness segments of the SME retail energy markets.

An order on gas and electricity suppliers requiring the disclosure to Ofgem, subject to certain use restrictions, of (i) details of certain of their microbusiness customers that have been on a default contract for three or more years (the 'Microbusiness Customer Data'); and (ii) updated Microbusiness Customer Data every six months, for the purposes of creating, operating and maintaining a secure cloud database containing the Microbusiness Customer Data for the purpose of postal marketing.

A recommendation to Ofgem to (i) create, operate and maintain a secure cloud database for the purposes of holding the Microbusiness Customer Data; (ii) hold the Microbusiness Customer Data; (iii) enter into agreements with suppliers including, access to, and use restrictions concerning the Microbusiness Customer Data; and (iv) provide access to the Microbusiness Customer Data by any rival supplier that has entered into such an agreement.

<u>Introduction</u>

13.1 Although we agree that the strength of competition in the microbusiness segment is less than in the domestic market, we do not believe the level of detriment is as high as estimated by the CMA. Nevertheless we consider that the remedies proposed by the CMA for the microbusiness market are a proportionate response to the high search costs faced by microbusinesses in engaging in the market and, subject to final details of the remedies, support their introduction.

13.2 ScottishPower agrees that the microbusiness market would benefit from a more domestic-like approach and that these customers will be better served by having a simple, transparent market model rather than by having an ability to negotiate.

13.3 We encourage the CMA to reconsider our submission about objection rules (see para 13.17 below).

<u>Price transparency remedy</u>

13.4 We welcome the price transparency remedy and believe it has the potential to significantly reduce search costs and improve competition in the microbusiness segment.

13.5 The proposed remedy would require suppliers to disclose 'all available acquisition and retention contracts' either via a quotation tool or third party website. The CMA goes on to say that 'suppliers would be permitted to quote the prices of negotiable contracts and offer price and non-price discounts through online and offline (telephone) channels.'[87] If this simply means that suppliers can offer channel-related discounts (to incentivise customers to use lower cost channels), we have no concerns with this suggestion.

13.6 However, if the CMA intends that the prices disclosed on the quotation tool or third party website would not be final (so that customers could negotiate discounts on the disclosed price), we would be concerned that this may undermine the effectiveness of the remedy. Suppliers could potentially circumvent the remedy by disclosing relatively high prices and then offering lower prices in the form of discounts to customers who choose to negotiate. Microbusinesses may then feel less confident using PCWs, since they cannot be sure that the PCW is quoting the best deal – and the net result is that search costs are not reduced in the way intended by the remedy.

13.7 We agree that the remedy should be limited to a segment of the microbusiness population since, above a certain consumption level, microbusinesses can be expected to have the skills and resources to negotiate with suppliers, in some cases through formal tendering processes. A "domestic like" online quotation tool approach is best fitted to the truly small / microbusiness customer. In our view, the gas consumption threshold has been set unnecessarily low at 73,200 kWh per year and a threshold of 150,000 kWh per year would have been more appropriate.

Auto-rollover remedies

13.8 We welcome the proposal to extend the window for serving notice to the end of an initial fixed term period (instead of having to serve notice at least 30 days before the end) and the proposals to end the use of termination/ cancellation fees on 'out of contract' and 'default/auto-rollover' contracts.

13.9 However, we do not believe the CMA's proposal goes far enough. We believe the CMA should also prohibit clauses in contracts that require a microbusiness to give notice of termination separately from signing up with a new supplier. In other words, in circumstances where a microbusiness is entitled to give notice under the contract, their request to transfer their supply to a new supplier should be sufficient, and should be accepted by the losing supplier in lieu of a notice of termination – as is the case in the domestic market. A large proportion of microbusiness transfers are currently objected to on the basis that a proper termination notice has not been received (see para 13.20 below), and this is an entirely unnecessary source of 'friction' in the switching process.

Ofgem-led programme to trial changes to communications

13.10 As with the similar remedy for the domestic segment, we are happy to support a proportionate and fully researched programme around customer communication changes that provide appropriate prompts at appropriate times, using appropriate channels (bills, emails etc.). Our comments on the domestic remedy (see section 8) also apply to the microbusiness remedy.

Database of disengaged customers

13.11 In our comments on the domestic database remedy (see section 10), we raised a number of data protection issues which will need to be resolved in order that that remedy could be effectively applied. If these matters can be resolved, the resolution of them can easily be carried across to the micro-business version of the database remedy.

13.12 The CMA argues that, "as the Microbusiness Customer Data does not involve personal data, we consider that the proposed remedy would be in compliance with UK and EU data protection legislation".[88] However, we think that in many, perhaps most cases, personal data will be present. This could arise in many ways:

87 PDR para 9.74.
88 PDR para 9.258.

(a) Some sole traders will trade in an individual's name;

(b) Others will use a 'trading as' business name (e.g. Jim Smith T/A Brightwhite Laundry) – it is usual to capture the individual's name since the 'trading as' entity does not legally exist and cannot for example be sued; and

(c) For small corporate entities, the data retained will often include the full name of a director or other official along with additional identifying information.

13.13 Accordingly, in order to proceed with this remedy the CMA would need to ensure that the data protection issues we have identified in the context of the proposed domestic database remedy are adequately and fully addressed and that their resolution is applied also to the microbusiness database remedy.

13.14 We would also refer the CMA to our comments in section 10 on scope of remedy, permitted marketing activities, information to be provided, frequency of updates and sunset clause. These are equally applicable to this proposed remedy, but in the interests of brevity are not repeated here.

<u>TPI code of practice</u>

13.15 The CMA says it has provisionally decided not to pursue the third party intermediary (**TPI**) information disclosure remedy because it believes the price transparency remedy will partly address the identified problems and because it has received inconclusive evidence regarding alleged TPI malpractice, in particular as regards microbusinesses, in relation to which Ofgem is considering implementing its draft Code of Practice (**CoP**), which seeks to address similar areas to those proposed under this possible remedy.[89]

13.16 We continue to believe that there are significant differences between price comparison websites and the brokers operating in the microbusiness market, some of whom take large and non-transparent commissions from customers. A well-structured TPI CoP, supported by licence conditions requiring or incentivising suppliers to pay commissions only to those TPIs signed up to the Code in relation to domestic or micro business marketing, would be a positive step in limiting this bad practice. If the CMA considers that the evidence is not sufficiently conclusive on this point, it will be important that the CMA's final report leaves Ofgem able to take the matter forward including consideration of a TPI CoP.

<u>Transfer objection rules</u>

13.17 We argued in previous submissions[90] that these remedies should be supplemented by reforms to the transfer objection rules for microbusinesses, to match more closely the objections regime that applies in the domestic market. At present, the licence conditions delegate objections rules to the terms of the contract, which means that losing suppliers can block a transfer on the grounds that it would constitute early termination and also if potentially complex notice-giving procedures have not been properly complied with. The licence conditions also fail to allow objection for debt on deemed contracts, which increases the cost of these contracts. We argued it would be appropriate to conform the objection rules for microbusiness to those which apply to domestic customers which (apart from certain technical issues) limit objections to debt only – whether on express or deemed contracts – and which do not require notice for switching.

13.18 The CMA says that, having sought further views from Ofgem and suppliers, its provisional view is not to amend the licence conditions in relation to objections in the way we proposed. This is because most objections made by suppliers related to attempted transfers within a fixed term, and debt owed by the non-domestic customer to the supplier. These did not impact the restrictions concerning the

89 PDR para 9.273.

90 E.g. ScottishPower response to Remedies Notice, para 7.4.

roll-over period, which the CMA has sought to address.[91] Further, other parties considered that the grounds for objections were fair and provided evidence that the overwhelming majority of objections related to debt owed by a microbusiness and transfers within a fixed-term period. Ofgem said that most of the complaints it received, and suppliers it had investigated in relation to objections, did not relate to the grounds for objections highlighted by ScottishPower, and that it regularly monitored the grounds for objections to assess whether they were unfair.[92]

13.19 Our reason for suggesting this supplementary remedy was not because we considered the current objections arrangements to be unfair (or contrary to licence obligations) but because we see them as a significant and unnecessary impediment to switching (at least for smaller microbusiness customers where the commercial risks to suppliers of early termination are small). In the same way as faster switching is expected to improve engagement by domestic customers, we would expect smoother switching (fewer objections) to improve engagement by microbusiness customers. We are not surprised that Ofgem says the current practices do not give rise to many complaints or investigations – since they are allowed by contract and licence condition – but this does not mean that they are not an impediment to switching.

13.20 To put this in context, in the first three quarters of 2015, ScottishPower objected to **[CONFIDENTIAL]**% of electricity and **[CONFIDENTIAL]**% of non-domestic gas transfer requests made by other suppliers.[93] Table 16 shows the breakdown of objection reasons for a sample of these objections. We do not have access to equivalent data for other suppliers, but we have no reason to believe it would be significantly different. It shows that 79% of objections were because the customer had failed to give proper notice to terminate the contract or had given insufficient notice, whereas only **[CONFIDENTIAL]**% related to debt - the only ground on which domestic transfers can be objected to. Removing or reducing the categories of objections that account for 79% of the total would remove a significant source of 'friction' in the switching process.

Table 16: Breakdown of microbusiness transfer objections made by ScottishPower[94]

Objection reason	
No termination notice from customer	[CONF.]
New supply start date too early	[CONF.]
Debt	[CONF.]
Other	[CONF.]
Total	100%

13.21 Even if the CMA decides not to pursue this remedy, we would encourage it avoid making any statements in its final report which would discourage Ofgem from considering such reforms in the course of its non-domestic objections review.

14. GOVERNANCE REMEDIES

"A recommendation to DECC to initiate a legislative programme with a view to deleting paragraph 1C from both sections 4AA of the Gas Act 1986 and 3A of the Electricity Act 1989"

14.1 We fully support this recommendation, and note that the Government has already committed to implement it.

91 PDR para 9.153.

92 PDR Appendix 9.2, paras 77-79.

93 Based on ScottishPower's response to an Ofgem information request on non-domestic objections, submitted on 17 December 2015.

94 The source is a sample of 100 non-domestic objections submitted to Ofgem on 17 December 2015 in response to an information request. The sample relates to the period 1 Sep 2015 - 30 Sep 2015 and was based on a random sampling schemed specified by Ofgem. We have excluded 23 objections which did not relate to microbusinesses and 4 where the objection was at the customer's request, giving a net sample size of 73. The percentages are consistent with other results we have derived using larger sample sizes.

"A recommendation to DECC to initiate a legislative programme with a view to set up a clear and established process for Ofgem to comment publicly, by publishing opinions, on all draft legislation and policy proposals which are relevant to Ofgem's statutory objectives and which are likely to have a material impact on the GB energy markets"

14.2 As noted in previous submissions, we are unsure that this remedy is necessary. It appears to us that Ofgem already has scope within its powers and duties to comment on draft legislation and policy proposals which are relevant to its statutory objectives and which are likely to have a material impact on the GB energy markets. However, if CMA decides to proceed with this recommendation, we would suggest that the legislation should confirm that Ofgem has the power to publish opinions, but to refrain from making this a mandatory requirement.

"A recommendation to DECC and Ofgem to publish detailed joint statements concerning proposed DECC policy objectives that are likely to necessitate parallel, or consequential, Ofgem interventions, setting out (i) a proposed action plan for the regulatory interventions needed and responsibility for these, (ii) an estimated timetable, and (iii) where appropriate, a list of relevant considerations in designing the policy"

14.3 We can see some circumstances in which it may be helpful for DECC and Ofgem to publish joint statements, but there may be other situations where Ofgem might feel this circumscribes its independence – or where the need to publish a detailed joint statement gets in the way of swift policy action. An example of the latter is DECC's recent consultation on reforms to the capacity market, where DECC had identified an urgent policy need to remove distortions favouring embedded generators over CCGTs. DECC was able to secure Ofgem's agreement to undertake a review, and mention this in the consultation, in a much shorter time than it would likely have taken to publish a detailed joint statement. Therefore, if this recommendation is make, we think it should leave sufficient flexibility for DECC and Ofgem to tailor their approach to the circumstances.

"A recommendation to Ofgem to publish annually a state of the market report (the 'State of the Market Report') which would provide analysis regarding issues such as (i) the evolution of energy prices and bills over time, (ii) the profitability of key players in the markets (eg the Six Large Energy Firms), (iii) the social costs and benefits of policies, (iv) the impact of initiatives relating to decarbonisation and security of supply, (v) the trilemma trade-offs, and (vi) the trends for the forthcoming year"

14.4 We can see some merit in a recommendation that Ofgem publish a regular State of the Market Report. However, we would note that such activities can be resource intensive (both for Ofgem and regulated firms) and should be kept tightly focused. There is a risk that if this is seen as one of the main *raisons d'être* of the office of the chief economist, it could lead to resource being diverted to this activity that could be better used elsewhere.

14.5 As regards the scope of the State of the Market report, we would be concerned that a requirement to consider the social costs and benefits of policies, the impact of initiatives relating to decarbonisation and security of supply or trilemma trade-offs could take Ofgem into new areas which would divert scarce resource and potentially duplicate activity already undertaken by DECC or other bodies. For example, a report commenting on the impact of initiatives relating to decarbonisation would be likely to overlap with the annual progress report produced by the Committee on Climate Change, which also has a duty to take costs into account.

14.6 It would be useful to consider the frequency of this report. Given the resources needed, it may well be that annually is too often and a report every second year would be sufficient. If the CMA feels it is necessary to specify the frequency (and there could be arguments for leaving this open), it will be important to assess the costs and benefits of different reporting intervals.

"A recommendation to Ofgem to create a new unit (eg an office of the chief economist) within Ofgem, which would build expertise across the different areas of the energy markets with a view to publish annually the State of the Market Report"

14.7 We have previously noted that some of Ofgem's most harmful regulatory interventions were made at a time when there was a dearth of professional economic representation on the GEMA board. On that basis, we welcome recommendations to ensure that there is a strong centre of economic expertise in Ofgem, which is able to provide a challenge function to new policy proposals. We understand that Ofcom and FCA both have a Chief Economist (as does DG COMP), while the CMA has a Chief Economic Adviser, and that these roles have a similar review and challenge function for the rest of the organisation, and we believe that this should be the main function of such a role at Ofgem. As noted above, we do not believe that publishing the 'State of the Market Report' should be seen as one of the main *raisons d'être* of the office of the chief economist, and we think the CMA should be wary of intervening in too much detail in matters of internal Ofgem organisation.

15. SEGMENTAL REPORTING REMEDY

"A recommendation to Ofgem to modify the licence conditions of the Six Large Energy Firms' generation and supply licences by introducing requirements to:

- ***report their generation and retail supply activities on market rather than divisional lines;***
- ***report a balance sheet as well as profit and loss account separately for their generation and retail supply activities;***
- ***disaggregate their wholesale energy costs for retail supply between a standardised purchase opportunity cost and a residual element; and***
- ***report prior year figures prepared on the same basis."***

Introduction

15.1 We continue to support transparent and robust financial reporting of the industry. We also support the need for the financial information to be relevant and reliable as well as having a clear and accessible basis of preparation. Building on this approach, we are supportive of remedies that would provide Ofgem and other stakeholders with additional information to support robust assessments and decision making in relation to the profitability and overall financial performance of the industry.

15.2 In this context and based on the information provided we consider that the proposed remedies can be implemented, subject to certain issues being clarified which we address below. We do however, believe that there is a risk that some of the information provided has the potential to be misinterpreted and therefore considerable thought needs to be given to how the information should be analysed, interpreted and presented, (for example where this might feed into future assessments of the "state of the market").

Reporting along market lines

15.3 We do not oppose the proposal to report activities along market lines irrespective of where the relevant activities are undertaken within an organisation. However, depending on precisely what changes are made, implementing this remedy could make it more complicated and necessarily less transparent to link the segmental accounts back to the statutory accounts of the subsidiaries. The link back to statutory accounts helps build confidence that the figures are robust and mitigates audit costs. Accordingly, the CMA may wish to give Ofgem sufficient latitude to develop a proportionate and efficient approach to this remedy that enables a meaningful link back to the legal entities involved.

Balance sheet reporting

15.4 On the assumption that the required disclosure can be tied back closely to statutory accounts of the relevant legal entities, we see no difficulty in providing balance sheets for generation and supply in order to complement the information in the corresponding P&L accounts. It is significantly more difficult to create balance sheets for entities that do not exist. The CMA notes this remedy does not preclude Ofgem needing occasionally to adjust items on balance sheets as part of its interpretation of profitability.[95] We would note in this context that it will be important for stakeholders to have clarity regarding the basis of any such adjustments.

Disaggregated wholesale costs

15.5 The proposal to disaggregate wholesale costs will produce a set of stylised opportunity and residual costs. It is not clear to us that it will be straightforward to draw any conclusions regarding the strength of inter-firm rivalry without making a significant number of assumptions. The difference between opportunity and residual costs will not simply reflect the different market purchasing strategies, there will also be differences due to system imbalance, demand forecasting, hedging costs etc, all of which make a comparison of opportunity and residual costs across firms potentially complicated. The creation of such a regulatory benchmark may also have the potential to influence the purchasing behaviours of the SLEFs, for example encouraging them to follow closely the prescribed hedging policy. This may have unintended consequences, such as restricting the ability of competition to discover more efficient approaches, or drawing liquidity from forward markets towards spot markets and prejudicing the initiatives Ofgem has pursued over a number of years aimed at increasing forward market liquidity. We therefore caution against this aspect of the proposed segmental reporting remedy

15.6 If this aspect of the Remedy is to proceed, it is necessary to consider the appropriateness of the benchmarks. Whilst we recognise the intention here is to derive benchmarks that are practicable for the SLEFs to report, we think it is also important that such benchmarks reflect as far as possible prudent purchasing strategies. We consider the proposal for standard fixed term products broadly achieves this balance, however we believe the proposed approach for SVTs is too "short" to represent a sustainable purchasing strategy. Instead we would suggest a more sustainable approach is to make purchases over a longer duration, e.g. 18 months ahead of the point of supply, with the volume purchase spread evenly over this duration, e.g. monthly.

15.7 Suppliers will need to assess the system changes needed to enable the required reporting and the implications of this for implementation timescales.

Reporting prior year figures

15.8 We are content to include prior year comparatives, reported on the same basis as the current year, though this will make the CSS document longer and potentially less accessible to the reader. A side-by side presentation of the comparatives (which had originally been suggested by Ofgem for the CSS) would be particularly complex, but other presentations may be feasible.

16. INDUSTRY CODE REMEDIES

"A recommendation to Ofgem to:
- ***(i) publish a cross-cutting strategic direction for code development (the 'Strategic Direction');***
- ***(ii) oversee the annual development of code-specific work plans for the purpose of ensuring the delivery of the Strategic Direction;***
- ***(iii) establish and administer a consultative board that would bring stakeholders together for the purpose of discussing and addressing cross-cutting issues;***

[95] PDR para 10.245.

(iv) initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the Strategic Direction;
(v) in exceptional circumstances, intervene to take substantive and procedural control of an ongoing strategically important modification proposal, as appropriate; and
(vi) modify the licence conditions of code administrators to introduce the ability for the administrator to initiate and prioritise modification proposals that, in its view, are necessary for the delivery of the Strategic Direction or to improve the efficiency of governance arrangements

Introduction

16.1 We remain of the view that the industry code rules and arrangements generally reflect an appropriate level of checks and balances to ensure that code modifications are technically sound and implementable in industry systems. They generally safeguard the interests of all industry parties and stakeholders whilst enabling the implementation of complex changes. In addition we consider that Ofgem has sufficient powers via the significant code review (**SCR**) process to direct modifications to be raised where it considers there are significant policy objectives that might be impeded by conflicting industry interests. In our experience the SCR process has led to the timely and efficient raising and implementation of the directed modifications.

16.2 We recognise that there is scope for further improvements in the present industry code governance arrangements and we note the potential for the proposed remedies to deliver such benefits. However some of the remedies may introduce potential risks and unintended consequences that require careful consideration in implementation. We discuss these issues in relation to the specific proposed remedies below.

Backstop executive ‘call in’ power

16.3 We note the stated intention that the remedies proposed to address the Codes AEC should lead to Ofgem taking a higher level role influencing the development of industry codes through the Strategic Direction and Consultative Board.[96] Therefore we appreciate that it is intended that Ofgem would seldom use the backstop executive ‘call in’ powers or the powers to initiate changes to industry codes. Nevertheless we agree with the CMA that such powers need to be subject to robust procedural and judicial safeguards.[97] In addition to Ofgem producing guidance regarding its exercise of such powers, we believe there would be merit in DECC including a definition of ‘exceptional circumstances’ as part of the legislation required to provide Ofgem with the powers. We consider that the examples put forward[98] should be additive, such that circumstances necessitating Ofgem’s intervention would reflect the following:

(a) the modifications would be expected to deliver substantial and material benefits to consumers directly or through increased competition, in line with the Strategic Direction; and

(b) the nature of the modification(s) are complex either due to the number of relevant code modifications involved or the required solutions are by their nature, difficult to design and codify, and therefore without intervention by Ofgem such changes would not be implemented in a timely manner; and

(c) the views of industry code parties can be sufficiently taken into account.

96 PDR para 10.422.
97 PDR para 10.426.
98 PDR para 10.427.

16.4 We consider that Ofgem should be required to consult on whether these criteria are met in a particular case. We also believe that as part of the safeguards it is appropriate that code modification proposals produced as result of Ofgem's exercise of such powers remain appealable to the CMA.

16.5 We note the CMA's assessment that these powers are an effective substitute for the Significant Code Review powers.[99] However, we are unsure as to whether it would be desirable to modify relevant licences and codes to remove the SCR powers. It may be that retaining the SCR option would lead to fewer 'call-ins' of the more important issues by providing opportunities for Ofgem to use the SCR process to steer the process without being fully hands-on.

Code Administrator initiated modifications

16.6 We agree that there may on occasion be benefits from code administrators initiating modification proposals to deliver changes in line with the Strategic Direction or to improve the efficiency of governance. It is important that such powers are defined in the code administrator's licence so that they are limited to these specific circumstances and are not left open ended. Furthermore, we believe it would be helpful for Ofgem to develop common guidance across all industry codes regarding code administrators' exercise of these powers, to ensure consistent practice.

Consultative board

16.7 We believe consideration should be given to how the consultative board would feed into the industry codes. We note that some codes already have change overview boards set up to identify cross code and strategic issues arising from UK and European legislation; it is therefore desirable to avoid any duplication in establishing Ofgem's consultative board.

16.8 We think there is merit in including a requirement for post-implementation evaluations of modifications to assess the benefits realised and the outturn implementation costs. Such information is likely to help inform Ofgem and the consultative board in developing more effective Strategic Directions. We understand that assessments are currently undertaken in relation to certain modifications, but these assessments are not publicly disclosed.

"A recommendation to DECC to initiate a legislative programme with a view to:
(i) giving Ofgem the power to modify industry codes in certain exceptional circumstances; and
(ii) making the provision of code administration and delivery services activities that are licensed by Ofgem and specifying that such licence conditions will include appropriate targets to incentivise code administrators to take on an expanded role to be able to deliver pursuant to the Strategic Direction."

Ofgem initiated code modifications

16.9 We have suggested safeguards that should be in place regarding Ofgem's exercise of powers to modify or takeover an existing modification proposal (see paras 16.3 to 16.5 above).

Licensing code administrators

16.10 We understand the rationale for licensing code administrators and delivery bodies in order to assist Ofgem in achieving the Strategic Direction, but implementation of this remedy will require careful consideration of several issues, as we discuss below.

16.11 First, these entities must be licensed in a way that minimises the risk that they act out of self-interest, for example promoting modification proposals that may be commercially advantageous to themselves.

[99] PDR para 10.429.

16.12 Secondly, we consider competitive tendering of code delivery services is an important tool in ensuring efficient governance costs, and tendering may be complicated if the entities concerned are subject to licences. We have encountered similar issues when considering whether Elexon could tender for provision of performance assurance services in gas[100] and this may provide useful lessons to consider when designing the new code administration licence regime. We believe a potential model could be the approach used to establish the Gas Safe Register[101] registration scheme (previously CORGI). This licensing regime was implemented under the oversight of the HSE, and enabled services to be tendered in a way that facilitated continuation of service provision and also ensured continuity if the service provider were to change in the future.

16.13 Finally, the scope of code administrators and delivery bodies varies across the industry codes. Where code administration is a “thin” function (e.g. CUSC) there may be a need for a transfer of functions and resources currently provided by related organisations (e.g. National Grid for CUSC), to enable the code administrator to fulfil its licence obligations.

16.14 Additional issues that should be considered in the implementation of this remedy include:

(a) whether the code administrator should hold a level of capital and who should fund this;

(b) how funding is provided to the licensee - for example, should funding continue to be provided through the price control arrangements?

(c) who is liable if the code administrator is in breach of its licence. To the extent that the code administrator’s resources come from code users, it would be problematic if users, who were inconvenienced by an administrator’s failings, then found themselves paying the fine for want of there being anybody else to pay it.

100 BSC Modification proposal P330 https://www.elexon.co.uk/mod-proposal/p330/.
101 See : http://www.hse.gov.uk/gas/domestic/newschemecontract.htm.

Critique of CMA direct benchmarking analysis

A note for ScottishPower based on a non-confidential submission to the CMA

12 April 2016

1 Overview

1. The CMA uses the results of its direct benchmarking analysis in support of its Provisional Decision on Remedies (PDR), and in particular the proposed decision to impose a PPM price cap. The analysis estimates overcharge by the Six Large Energy Firms (SLEFs) by comparing their average weighted tariffs to Direct Debit (DD) tariffs of Ovo and First Utility, after adjusting for differences in cost to serve by payment method. The same methodology is also used by the CMA to estimate the basis for the level of the proposed prepayment price cap.

2. Oxera has reviewed the CMA's analysis using data made available in the CMA's Confidentiality Ring, particularly with a view to establishing whether the benchmark used by the CMA in evaluating the tariffs charged by the SLEFs is a fair benchmark price that could be expected to prevail in a well-functioning market. Below, we focus on the key departures of the benchmark used by the CMA from what might be considered to be a fair benchmark. These include the following issues:

- incorrect recognition of environmental obligations on benchmark companies
- choice of benchmark companies
- low profitability of benchmark companies
- benchmarking of wholesale costs
- effect of growth in customer numbers on the tariff mix

2 Cost of environmental obligations

3. Para 3.177 of the PDR explains the treatment of the cost of environmental obligations in the CMA's direct benchmarking analysis.

In relation to the costs of environmental and social obligations, as set out in Appendix 7.1 of our provisional findings report, both First Utility and Ovo Energy were fully obligated under the Energy Company Obligation from the beginning of 2015 and were partially obligated in previous years. Therefore, while their prices may reflect some differences in their cost bases in earlier periods, their 2015 prices will reflect a similar cost base in terms of environmental obligations. For this reason, and the fact that in more recent years both Ovo Energy and First Utility have been operating at a larger scale, we place greater weight on the results of the detriment analysis in more recent years.

4. The paragraph quoted above suggests that the CMA's direct benchmarking analysis does not take into account differences in cost of environmental obligations on different suppliers. It also suggests that the CMA deems those differences to be negligible as of 2015.

5. The analysis conducted by Oxera in the CMA Confidentiality Ring suggests that the impact on the results of the CMA's direct benchmarking analysis of properly accounting for differences in cost of environmental obligations on different suppliers is significant, with results for 2015 also being affected. This is primarily because the cost of such obligation is lower for suppliers with a lower number of customers, and the size of the obligation for a given supplier depends on the number of customers/volume of energy supplied in the previous calendar year, which means that there is a time lag effect: a business that grows its customer base over time is subject to lower costs per customer.

6. The CMA's argument that it places greater weight on results from later years does not in any way mitigate the failure to take full account of differences in cost of environmental obligations on different suppliers. Significant reliance cannot be placed on time series data pertaining to a short period, especially if the data is subject to significant variation and persistence over time, because any observed deviation from a hypothetical 'norm' is unlikely to be statistically significant if it is observed over a short period. Company performance and profits are subject to significant variation over time, and deviations in performance from the mean can last for long periods. The results from this assessment will be significantly more reliable as measures of excess returns if they are calculated over the entire period covered by its analysis.

2.1 Cost of environmental obligations for Ovo and First Utility

7. This section presents Oxera's estimates of the cost of environmental and social obligations for Ovo and First Utility, which are used by the CMA to create the competitive benchmark, and the SLEFs. Differences in these costs per customer between different suppliers arise because some of these obligations, namely (i) the Carbon Emissions Reduction Target (CERT), (ii) the Community Energy Saving Program (CESP), (iii) the Energy Companies Obligation (ECO) and (iv) the Warm Home Discount (WHD), provide for either a lower obligation rate or an exemption for smaller suppliers. In addition, the fact that certain environmental obligations are levied on the basis of customer numbers/energy volumes supplied in the previous calendar year means that there is a time lag effect: the impact of such levies is lower for businesses that are growing their customer base.

CERT: CERT started in April 2008 and places legal obligations on large energy companies to deliver energy efficiency measures to domestic premises. CERT is composed of several obligations: an overall carbon emission reduction target, a carbon emission reduction target for a 'Priority Group' (consumers aged over 70 and on certain benefits), a carbon emission reduction target for a 'Super Priority Group' (vulnerable households on certain, more narrowly defined benefits) and an insulation installation target. Targets for each of these categories were set for each of the SLEFs. CERT ended in December 2012, but activities exceeding suppliers' obligations under CERT could be carried forward to meet obligations under CERT's successor scheme, ECO (discussed below).

CERT applied to energy companies with more than 50,000 customers at the end of 2008, 2009, and 2010, and to energy companies with more than 250,000 customers at the end of 2011. In effect, the SLEFs were the only energy suppliers subject to CERT obligations.

CESP: CESP was initiated in October 2009 and ran until the end of 2012, obligating large energy suppliers and generators to improve energy efficiency standards in deprived areas of Great Britain. The SLEFs as well as four independent energy generators were obligated to provide energy efficiency measures under this scheme.

CESP applied to energy suppliers with more than 50,000 customers at the end of 2009 and 2010, and to energy suppliers with more than 250,000 customers at the end of 2011. CESP also applied to electricity generators who produced more than 10 TWh of electricity per annum. As the SLEFs are vertically integrated supplier-generators, the bulk of this obligation was borne by the SLEFs, with a small proportion falling on independent generators.

ECO: ECO started in January 2013 and places legal obligations on large energy companies to deliver energy efficiency measures to domestic premises. ECO is composed of three obligations: Carbon Emissions Reduction Obligation (CERO), Carbon Saving Community Obligation (CSCO) and Home Heating Cost Reduction Obligation (HHCRO). Measures implemented under the scheme range from better insulation to boiler repair or replacement.

ECO applies to energy companies with more than 250,000 customers on the 31 December in the previous calendar year, and that supply more than a minimum amount of gas (2,000GWh) or electricity (400GWh). Suppliers are subject to the obligations from 1 January 2013 (if they met the conditions above on 31 December 2011), or from 1 April of the year following when they met the requirements. Ofgem sets obligations for obligated suppliers using a formula based on the supplier's share of total gas and electricity supply.

WHD: Since April 2011, obligated energy suppliers have to provide support to fuel-poor households under the WHD scheme. Suppliers provide direct financial support to the 'Core' and 'Broader' groups; and indirect support ('Industry Initiatives') to vulnerable households. The Core and Broader groups—defined as pensioners and other households who are fuel poor or at risk of fuel poverty—receive a £120-140 annual rebate off their energy payments. Industry Initiatives are supplier-funded programmes such as energy efficiency advice assisting vulnerable households.

All suppliers with more than 250,000 domestic customers as at 31 December of the year prior are obligated under the WHD scheme from 1 April. Additionally, smaller suppliers are allowed to participate to the scheme on a voluntary basis. Ofgem apportions the scheme spending target for each year depending on each supplier's market share for the different customer groups as of the 31 December of the previous year.

8. Oxera calculated the cost of environmental and social obligations over time for each supplier, using Ofgem data on WHD costs for each supplier;[1] and total CERT, CESP and ECO cost data.[2] Data on the delivery of CESP and ECO measures for each energy company[3] is used to apportion the total cost of ECO and CESP to each supplier over the time period. Data on customer numbers provided in the CMA Confidentiality Ring is used to apportion the total cost of CERT measures.[4]

9. Oxera also adjusted the ECO cost per consumer for the benchmark companies to reflect a situation in which obligations would be calculated based on present number of customers (and their energy consumption), in order to capture a steady-state value for obligations, rather than for a growing company.[5]

a. Oxera applied the customer and supply thresholds for scheme participation to quarterly firm data to determine when First Utility and Ovo would have entered the scheme if obligations were calculated using the prevailing customer base.[6]

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[1] Ofgem, Warm Home Discount reports and statistics, https://www.ofgem.gov.uk/environmental-programmes/social-programmes/warm-home-discount/warm-home-discount-reports-and-statistics , accessed on the 30 March 2016

[2] Competition & Markets Authority (2015) 'Energy market investigation. Provisional findings report', 7 July. Appendix 7.1: Social and environmental obligation thresholds.

[3] Ofgem (2015), 'Energy Companies Obligation Final Report', 30 September; Ofgem (2014), 'The final report of the Community Energy Saving Programme (CESP) 2009-2012', May.

[4] We are not aware of data on the number of measures implemented by supplier being available for CERT.

[5] Note: Obligations are currently calculated based on customer base and market share on the 31 December of the previous year, for entry in the scheme the following April.

[6] For a company that holds a gas and electricity licence:
'A licence-holder that […] holds both a gas supply licence and an electricity supply licence, is a supplier if it had more than 250,000 domestic gas customers and domestic electricity customers at 31 December of the relevant year, and it either supplied more than 400 gigawatt hours of electricity or supplied more than 2,000 gigawatt hours of gas to domestic customers during that year.'
Source: Ofgem (2014), 'Energy Companies Obligation (ECO): Guidance for Suppliers (Version 1.2)', 6 November

b. Market shares are recalculated based on the prevailing customer base on a quarterly basis, and include all firms that could be subject to ECO in its calculations.

c. First Utility and Ovo's obligations are uplifted to account for their new market shares, which are different due to earlier entry in the scheme and larger customer base.[7] The obligations for other suppliers are also recalculated based on prevailing market shares.

d. Total ECO costs are apportioned between energy companies proportionally to their revised obligations and entry dates as calculated in (c) and (a).

e. These timing adjusted ECO costs feed into total costs of environmental measures per consumer.

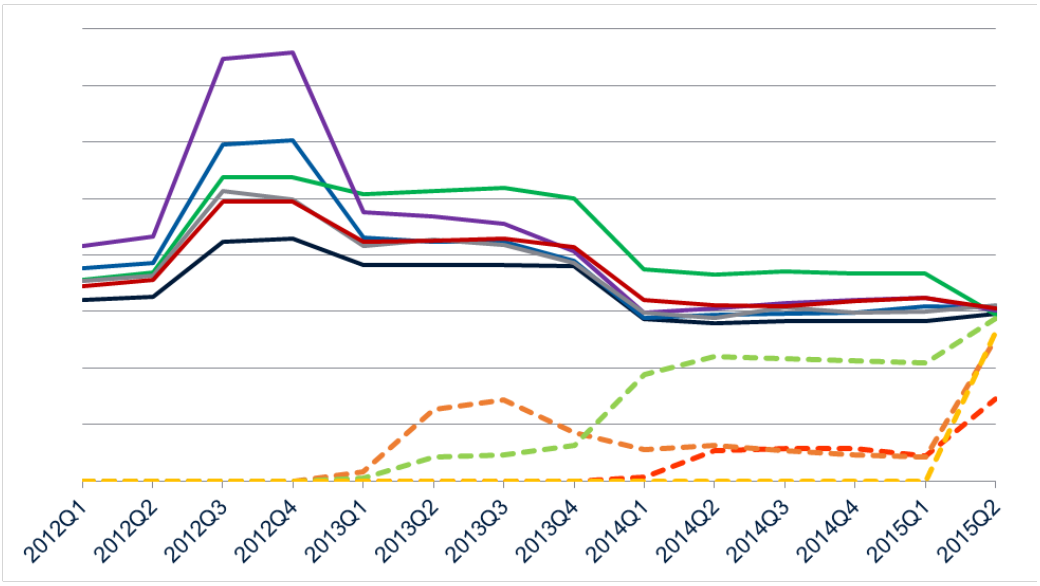
10. The first chart below shows Oxera's estimates of CERT, CESP, ECO and WHD obligations for each of the nine companies entered into the two schemes. As can be seen in Figure 2.1, there is a significant difference in the obligation of the SLEFs and the benchmark companies.[8]

11. Figure 2.2 shows Oxera's estimates of the timing adjustment, using prevailing market shares, as described above. The obligation for the SLEFs are lower to reflect their smaller market share using this method.

12. The differences between Figure 2.1 and Figure 2.2 reflect the time lag effects of basing obligations on historic rather than current customer numbers and energy consumption. For one supplier, despite a relatively early entry into the ECO scheme, the actual impact of the obligations as seen in Figure 2.1 is consistently and significantly lower than for the SLEFs until 2015 Q2 because of a combination of rapid growth in customer numbers and the obligation being based on historic customer numbers/consumption. For another supplier, very rapid growth in customer numbers during 2014 sees the impact of the obligations going from nothing in 2015 Q1 to near parity with the SLEFs in Q2 2015.

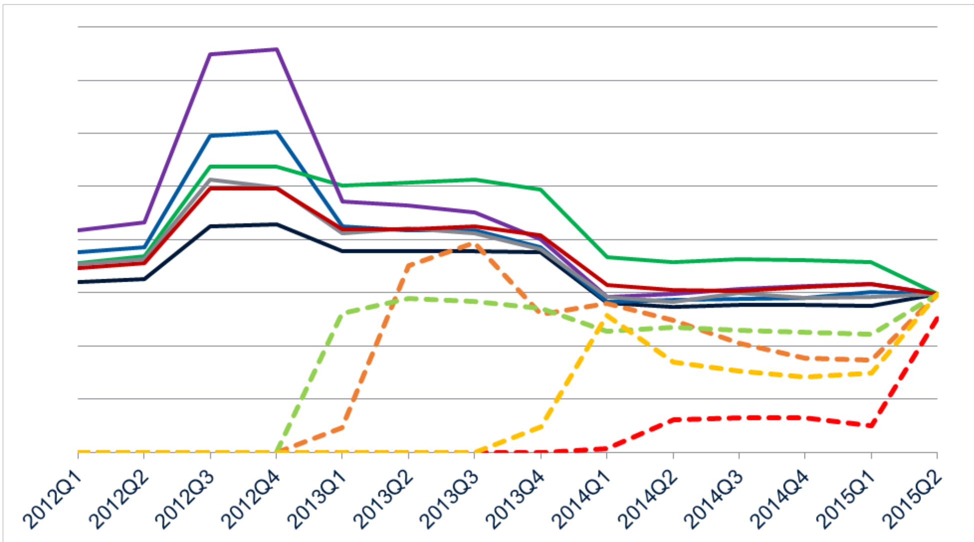
[7] These companies are growing so current customer numbers are larger than customer numbers on the 31 December of the previous year.
[8] This obligation applies to both gas and electricity customers, and therefore would apply twice to dual fuel customers.

Figure 2.1 Estimated environmental and social obligations



Source: Oxera.

Figure 2.2 Estimating environmental and social obligations: adjusted for prevailing market shares



Source: Oxera.

13. To ensure that the tariffs of Ovo and First Utility represent a fair benchmark that could be expected to prevail in a well-functioning market, they would need to be adjusted to ensure that their environmental costs reflect their current customer numbers. This follows since it is not theoretically possible for all suppliers to grow their market share simultaneously. A fair benchmark would need to assume a market equilibrium and be characterised by a steady-state value for environmental obligations per customer.

14. In addition, since lower obligation levels and exemptions represent a cross-subsidy to smaller and growing suppliers by larger suppliers, suppliers that benefit from such cross-subsidies cannot be considered to represent a fair

benchmark against which the performance of the SLEFs can be assessed. To adjust for this and the timing effects identified above, Oxera estimated adjusted tariffs for Ovo, First Utility and the SLEFs in the benchmark period by stripping out estimated costs to each business of complying with the relevant obligations as given in Figure 2.1. This is consistent with environmental obligations applying on an equal basis to all suppliers and with the obligations being proportional to suppliers' current customer numbers. Oxera then calculated the corresponding change to the CMA's direct benchmarking results and to the benchmark tariffs as of 30 June 2015.[9][10]

15. In Oxera's analysis, after adjusting for the costs of environmental and social obligations for each supplier as set out above, the estimated average annual overcharge is reduced to £362m for all customers and £117m for prepayment customers. The benchmark 2015 Q2 annual dual fuel direct debit bill level is correspondingly increased to £742. This illustrates that a large proportion of the CMA's overcharge estimates for prepayment and other customers is accounted for by the CMA's failure to correctly account for suppliers' costs related to social and environmental obligations. The corresponding effect on the benchmark annual bill, which is used as the basis for the proposed prepayment tariff cap, is also significant.

16. Oxera's adjustments in relation to the costs of environmental and social obligations assume that the actual impact of these obligations on suppliers' costs is passed-on to retail tariffs contemporaneously. This is a neutral assumption since pass-on can also be argued to be on the basis of historic or anticipated future costs. The basis for the obligations is relatively transparent and timing of entry would likely be anticipated by suppliers. Equally, suppliers' performance against the obligation is assessed at the end of the obligation period on a backward-looking basis, hence they have room to ramp up their performance over a number of quarters after entering a given scheme.[11]

17. The above points highlight that tariff levels on a particular day may not be a reliable basis for a price cap that would apply over a number of years. Pass-on of costs into tariffs can happen over an extended period. Finally, campaigns and other special offers may significantly distort average tariff levels for a given company on any particular day.

3 Choice of benchmark

18. In its direct benchmarking analysis, the CMA deemed that the tariffs of Ovo and First Utility represent a fair benchmark against which the performance of the SLEFs can be assessed. This approach is potentially problematic because the use of only two firms is a small sample and hence the results of

[9] Adjusted benchmark tariff is calculated by applying costs of social and environmental obligations that would have prevailed had they

[10] For 2015, the total ECO obligation for the market is taken as £0.8bn as per DECC impact assessment. The obligation is allocated to each supplier in line with the apportionment rule such that obligations from Q2 2015 are determined by market shares from Q4 2014. The market shares are adjusted for the taper, such as that suppliers with customer numbers between 250,000 and 500,000 face a reduced ECO obligation. The Warm Home Discount is calculated in a similar way. Oxera does not have information on any target for WHD for 2015/16, and therefore has assumed that the total spend on WHD across the industry remains the same as in 2014/15.

[11] The current ECO obligation period is set to end on 31 March 2017. Note that the drafting of this paragraph differs from the drafting of the corresponding Oxera non-confidential submission to the CMA. The drafting in the non-confidential submission mistakenly stated that performance against environmental obligations is assessed on an annual basis.

benchmarking analysis would be expected to be sensitive to the inclusion or omission of a single comparator.

19. In particular, the CMA has omitted Utility Warehouse and Co-op from its list of comparators. While Utility Warehouse operates a very different business model compared to the other large and mid-tier suppliers, the basis for excluding Co-op appears to be unconvincing. Para 3.172 of the PDR explains the reasons for excluding Co-op from the list of comparators as follows:

> *Although Co-op in principle uses multiple acquisition channels, including, at times, price comparison websites, a large number of its customers have been acquired from the members of the Midcounties Co-operative. Those who were not acquired in this way have also been given the option of becoming members, entitling them to a share in the profits it generates from all business streams, not just from the energy business. This would make it difficult to compare Co-operative Energy prices with that of the Six Large Energy Firms on a like for like basis. Another reason for not including Co-operative Energy in our benchmark is that it is a considerably smaller supplier than First Utility and Ovo Energy and may not yet be operating at an efficient scale. Further, unlike First Utility and Ovo Energy, Co-operative Energy is not yet fully subject to the costs of meeting environmental and social obligations.*

20. In particular, we note that First Utility and Ovo were not fully subject to relevant environmental obligations either for the duration of the benchmark period. Oxera's analysis adjusts for these differences to put the SLEFs on an equal footing with the benchmark companies.

21. In addition, the argument that Co-op is not comparable due to dividends being paid to members does not stand up to scrutiny since the amount of dividends payable is relatively small. For somebody paying £80 per month on their dual fuel bill, annual dividend payments would amount to £4.32, which is equivalent to a discount of less than 0.5%.[12]

22. Oxera's analysis incorporated the tariffs of Co-op into the benchmark using the CMA's existing methodology. First, the weighted average direct debit bill was calculated for each tariff type for each of the three suppliers using the number of accounts within each type as weights. Thereafter, the weights for each tariff type were calculated by computing the proportion of each of the three providers' customers on each of these tariff types. The benchmark estimation then uses these weights to calculate the weighted average bill of each tariff type across the three suppliers.

23. The adjustments for the choice of benchmark companies set out above were carried out cumulatively with adjustments for correct treatment of environmental costs. Oxera's analysis shows that including Co-op in the set of benchmark companies results in the estimated average annual overcharge being reduced to £220m for all customers and £98m for prepayment customers.

[12] Energy customers get 1 point for every £2 spent. In 2014/15, dividends were 0.9 pence point. The theoretical customer with an £80 monthly bill would therefore receive an annual dividend of 80*12/2*£0.009=£4.32. For sources of assumptions, see http://www.midcounties.coop/Membership/Share-of-the-Profits-FAQs/ and https://www.midcounties.coop/PageFiles/288/MEM00027%20Everything%20You%20Need%20To%20Know_MEMBERS_v1.pdf.

The benchmark 2015 Q2 annual dual fuel direct debit bill level is correspondingly increased to £751.

4 Profitability of benchmark companies

24. By benchmarking the tariffs of the SLEFs against the tariffs of Ovo and First Utility, the CMA implicitly assumes that every element underpinning the tariffs charged by Ovo and First Utility, including all of the cost items and the profit, represent a reasonable benchmark for that which would be expected to prevail in a well-functioning market. For much of the period covered by the CMA's direct benchmarking analysis, one or both of Ovo and First Utility are either making a loss or making a profit that is below the benchmark that is considered reasonable by the CMA in its indirect benchmarking analysis.

25. By using these companies to construct the benchmark, with no adjustments for profitability, the CMA is implicitly assuming that established firms will make losses or sub-par profits for a prolonged period without a corresponding period of super profits in other years. This is not a reasonable approach to proxy for prices in a well-functioning market. Oxera adjusted the benchmark tariffs in the CMA analysis in order to bring the benchmark tariffs to a level that is consistent with a 'reasonable' profit as estimated by the CMA in its Return on Capital Employed (ROCE) analysis.

26. In order to estimate the size of the adjustment, Oxera have used the information contained in the data room files and followed a number of steps:

- Calculate EBIT per customer for each energy supplier, based on cost and revenue figures and the number of accounts[13] used by the CMA in its analysis;
- Calculate the 'normal' level of EBIT per customer (as defined by the CMA) for each of the SLEFs[14], by multiplying capital employed per customer[15] by 10% WACC (pre-tax nominal);
- Average the resulting figures across the 2012–14 period for each energy supplier;
- Calculate the difference between the 'normal' level of EBIT as defined above and actual EBIT of mid-tier suppliers.

27. The results of this analysis can be seen in Table 4.1 of Oxera's submission to the CMA.

28. These results demonstrate that the level of profit established as 'normal' by the CMA's own analysis is considerably higher than that achieved by the mid-tier suppliers during the benchmark period. Specifically, the CMA's benchmark based on tariffs of First Utility & Ovo Energy understates the reasonable level of profitability by around £19 per customer.

29. Using data in the CMA Confidentiality Ring, Oxera adjusted the tariffs of First Utility, Ovo and Co-op to be consistent with a normal EBIT level as defined

[13] Dual fuel customers are deemed to represent two accounts.
[14] Note that it was not possible to carry out this calculation for the mid-tier suppliers directly due to lack of available balance sheet data.
[15] Oxera has used capital employed figures as calculated by the CMA, without making any adjustments.

by CMA's ROCE analysis and calculated the resulting adjusted estimates of overcharge during the benchmark period and the benchmark annual direct debit bill level. This was done cumulatively with adjustments for correct treatment of environmental and social obligation costs and including Co-op in the set of benchmark companies. The estimated average annual overcharge is reduced to -£504m for all customers and -£28m for prepayment customers. The benchmark 2015 Q2 annual direct debit bill level is correspondingly increased to £785.

5 Benchmarking of wholesale costs

30. We note that the CMA's updated indirect benchmarking approach does not seek to benchmark the wholesale costs of suppliers. This follows the criticisms of the CMA's previous attempts to benchmark wholesale costs of suppliers from a number of respondents to the Provisional Findings, including ScottishPower, which pointed out that the prices of wholesale hedging products are highly volatile and timing of purchase of such products can have a substantial effect on the wholesale hedging costs of a supplier.

31. The CMA's direct benchmarking approach compares weighted average tariff levels of two mid-tier suppliers and the SLEFs. In making this comparison, the CMA implicitly compares all of the cost items of these suppliers and deems the costs of Ovo and First Utility, including their wholesale costs, to be a reasonable benchmark for the costs of the SLEFs. Since wholesale costs are the single biggest cost item for energy suppliers, the results of the implicit wholesale cost benchmarking under the CMA's direct approach are likely to account for a large part of the overcharge estimates produced by the CMA under this approach.

32. It is inconsistent in principle to benchmark wholesale costs under the direct approach but not the indirect approach. The critique of wholesale cost benchmarking that was produced by a number of respondents to the CMA's Provisional Findings is still valid. As an example, if Ovo and First Utility relied on shorter-term hedging strategies than the SLEFs in a period in which wholesale energy costs were falling, they would have had lower wholesale costs. Assuming that other costs and profits are the same across the comparators, this difference in wholesale costs would show up as overcharge in the CMA's benchmarking analysis.

33. In order to illustrate this point, Oxera has constructed a simple example of the costs that a hypothetical energy supplier would have incurred in the 2012–15 period if it had adopted the following two hedging strategies:

- Strategy 1: acquire half of expected baseload electricity/gas customer demand via a forward contract for delivery in the next season and another half for delivery one season ahead;
- Strategy 2: acquire half of expected baseload electricity/gas customer demand via a forward contract for delivery one season ahead and another half for delivery two seasons ahead.

Strategy 2 is essentially an offset of strategy 1 back in time by six months. When energy is acquired for the next season, this can be done from the first until the last date of the current season. For the purpose of this exercise, we have assumed that a supplier would hedge for the next season at the average price payable during the current season. A similar principle was applied in cases where energy is bought one or two seasons ahead.

Table 5-1 below shows that, in an environment of falling energy prices, the second longer-term strategy would generally result in higher costs for the supplier.

Table 5-1 Average unit cost under the two hedging strategies

Year	Strategy 1	Strategy 2
Average unit cost for electricity, £/MWh		
2012	51.74	52.76
2013	50.57	52.06
2014	51.17	52.67
2015	48.90	52.32
Average unit cost for gas, £/Therm		
2012	65.05	63.41
2013	65.51	66.17
2014	65.65	67.22
2015	55.12	61.64

Source: Oxera analysis based on data from Bloomberg.

Given the implicit benchmarking of wholesale costs in the CMA's analysis, Oxera has attempted to estimate how much of the headline overcharge figure of £1.7bn could be due to differences in wholesale costs between the SLEFs and the two mid-tier suppliers that the CMA uses as its benchmark.

34. First, the average unit wholesale costs were calculated separately for two groups of suppliers: the SLEFs and the CMA benchmark firms. This was done for the 2012–14 period using data in the CMA's Confidentiality Ring. The average figures took into account the companies' individual costs, weighted by their supply volumes.

35. Second, the difference between the costs of the SLEFs and the benchmark was calculated and then multiplied by total SLEFs' supply volumes for electricity and gas. This approximates the 'detriment' arising from differences in wholesale costs that is included in the CMA's overcharge estimates.

36. Table 5-2 below shows the results of this exercise, with a detailed breakdown available in the corresponding table of Oxera's confidential submission.

Table 5-2 Estimated 'detriment' due to differences in wholesale costs

Total detriment, £m	FY12	FY13	FY14
Total domestic	130	372	199
Average (2012-14 period)		234	
Total domestic (PPM only)[16]	21	66	36
Average (2012-14 period)		41	

Source: Oxera analysis based on the CMA Confidentiality Ring data.

37. The above analysis indicates that, on average, the SLEFs had higher wholesale costs than First Utility and Ovo Energy which the CMA used as the benchmark. Over the period, the results of analysis undertaken by Oxera indicate that £234m of the CMA's annual average overcharge estimate of £1.7bn is accounted for by differences in wholesale costs between the SLEFs and the two benchmark firms. In addition, £41m of the CMA's annual average overcharge estimate for PPM customers is accounted for by differences in wholesale costs between the SLEFs and the two benchmark firms.

38. Adjusting the CMA's detriment calculations to exclude differences in wholesale costs cumulatively with adjustments for correct treatment of costs of environmental and social obligations, profitability of benchmark firms, as well as the composition of the set of benchmark firms, results in average annual overcharge being reduced to -£738m for all customers and -£69m for prepayment customers.

39. Since, under the PPM price cap proposed by the CMA, suppliers will be able to minimise profit risk by copying the hedging strategy specified in the calculation of the price cap, the only differences in wholesale costs that are likely to persist after a PPM price cap is imposed relate to energy already purchased but not yet delivered to final customers at the start of the price control. Hence, to ensure that Oxera's adjustments remain conservative, there is no corresponding adjustment to benchmark direct debit bills that would form the basis of CMA's proposed PPM price control.

6 Growth path and share of SVT customers

40. A supplier that is growing rapidly by acquiring customers on its acquisition (fixed) tariffs, some of whom end up defaulting onto its SVT tariff, is likely to have a lower share of SVT customers than a supplier that acquires new customers in the same way but does not increase its customer numbers overall because it only just manages to replace those that it loses to other suppliers. Hence, assuming that acquisition (fixed) tariffs are cheaper than SVT tariffs, a business that is growing will have a lower weighted average tariff level than a business that is not growing, even if their corresponding SVT and acquisition (fixed) tariff rates are exactly the same.

41. It is generally the case across different sectors that breaking into a market and increasing market share requires investment. A lower weighted

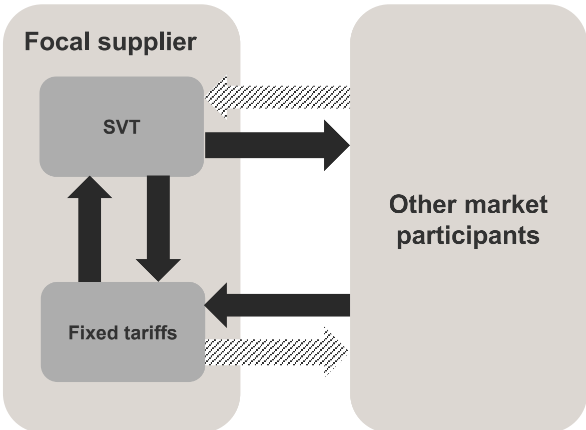
[16] PPM customer share of detriment that relates to wholesale costs is calculated on the basis of the proportion of PPM customer numbers in the total customer mix. The calculation therefore assumes that consumption levels of PPM customers are proportional to the overall customer base and the wholesale hedging undertaken by suppliers to meet the demand of PPM customers is not different to that undertaken to meet the demand of customers using other payment methods.

average tariff level, which would likely be associated with low profitability levels, would be consistent with such an investment strategy. However, behind every such investment strategy is a plan to recoup the investment in the form of higher profits when a certain target market share has been achieved. This would be consistent with an energy supplier reaching a stable number of customers and would imply a lower share of customers being on the supplier's acquisition tariffs.

42. Ovo and First Utility have grown their customer numbers rapidly during the benchmark period and their average weighted tariff levels can be expected to be subject to the effect identified above. To ensure that the tariffs of Ovo, First Utility and Co-op represent a fair benchmark that could be expected to prevail in a well-functioning market, since it is not possible for every supplier to be growing their market share, Oxera have modelled of the share of SVT customers in the customer mix of Ovo, First Utility and Co-op that would be consistent with a stable overall customer base. The results of this analysis were then used to estimate an adjusted weighted average tariff level for Ovo, First Utility and Co-op on the basis of this customer mix, and also the corresponding direct benchmarking results.

43. Oxera's approach was to simulate the customer flows for SVTs and fixed-term tariffs for each of these suppliers as shown in Figure 6.1 while calibrating the key parameters to actual data pertaining to the three mid-tier suppliers. The analysis assumes that there are two 'phases' for an entrant energy supplier – a growth phase, where suppliers aggressively attract customers onto their fixed tariffs, and a maturity phase, where suppliers' customer numbers stabilise, but customers churn externally between suppliers and internally between a supplier's tariffs.

Figure 6.1 Customer flows between tariffs



Note: Arrows indicate flows of customers. The analysis includes flows from fixed tariffs directly to other market participants in the overall net growth rate for fixed tariff customers. Flows from other market participants directly to SVTs of the focal supplier are not modelled since survey data provided by the CMA indicates that there are few direct flows in this direction.

Source: Oxera

44. The analysis calculates the flows from other market participants to the focal supplier in the growth phase based on the implied quarterly growth rates in net customer numbers observed for each supplier in Q1 2012-Q2 2015 for First Utility and OVO and in Q3 2012-Q2 2015 for Co-op. In the maturity phase, it is assumed that the flows from other market participants to the focal supplier are perfectly offset by flows from the focal supplier to other market participants,

resulting in a stable number of fixed tariff customers. Other input parameters remain constant between the two phases.

45. Since many fixed-term tariffs in the market currently have terms of one year, the analysis assumes that within a year, all fixed-term tariffs end, and those customers are rolled over to the focal supplier's SVT. Some of these customers choose a new fixed tariff from the same supplier, others switch supplier, and still others remain on the SVT. Flows from a focal supplier's fixed tariffs to the focal supplier's SVT (i.e. customers who mature from a fixed tariff onto an SVT, but do not then chose a new fixed tariff) are calculated based on the proportion of SVT customers for each supplier who have never switched tariff with an existing supplier.[17] The flow from the focal supplier's SVT to other market participants is calculated as the ratio of the number of customers who leave the focal supplier within a year to the number of SVT customers the focal supplier has. These flows are calculated separately for each of the three mid-tier suppliers based on survey responses to the GfK customer survey provided by the CMA in the Confidentiality Ring.

46. The metric of interest from this analysis is the change in each mid-tier supplier's proportion of SVT customers between the growth phase and the maturity phase. This reflects the expected effect of stabilising customer growth rates on the proportion of SVT customers in the overall customer mix of each supplier. Oxera used the ratio of the percentage of customers on the SVT in the maturity phase to the percentage of customers on the SVT in the growth phase to uplift the weighting of SVTs in the benchmark created by the CMA.[18] Results from Oxera's modelling, including the uplifts used to adjust the weight of SVT observations in the benchmark calculation, are available in Table 6.1 of Oxera's confidential submission to the CMA. Note that the above analysis only assumes a different tariff mix at unchanged tariff rates due to stabilisation of customer numbers and does not account for the possibility that Ovo, First Utility and Co-op raise their tariffs in order to bring about that stabilisation when they reach maturity. Hence, the adjustment to the benchmarking results calculated above can be seen as being conservative.

47. The effect of adjusting the CMA's estimates for the effect described in this section is to reduce the estimated average annual overcharge by £153m for all customers and £24m for prepayment customers. The benchmark 2015 Q2 annual dual fuel direct debit bill level is correspondingly increased by £14.

48. There is likely to be overlap between the adjustment described in this section and the adjustment for 'normal' profitability of benchmark companies. To ensure that Oxera's estimated adjustments to the CMA's benchmarking analysis remain conservative, adjustments relating to the share of SVT and fixed tariff customers in the customer mix of benchmark companies are excluded from the summary of adjustments in Table 7.1.

7 Conclusion

49. In summary, the benchmarking analysis undertaken by the CMA does not assess the performance of the SLEFs on a fair and reasonable basis. Oxera's analysis in the CMA's Confidentiality Ring identified the following

[17] Data taken from the GfK consumer survey commissioned by the CMA.
[18] We preserve the relative weighting of each supplier, and only re-weight the SVT and non-SVT tariffs relative to other tariffs offered by the same supplier in the same quarter.

features of the CMA's analysis that distort the results and create artificially high overcharge estimates. In particular, the CMA's analysis:

- Incorrectly assesses the impact of environmental and social obligations on benchmark companies;
- Omits a valid comparator from the list of benchmark companies – thus biasing the overcharge estimates upwards;
- Assumes that low or negative profitability of benchmark companies can be sustainably replicated by the entire market;
- Relies on benchmarking of wholesale costs of different suppliers despite such costs being subject to volatility of wholesale market prices and thus largely uncontrollable; and
- Fails to account for the effect of growth in customer numbers on the tariff mix of different suppliers.

50. The distortions created by these features of CMA's analysis affect the benchmarking results for the market as a whole as well as the prepayment segment of the market. In addition, they affect the benchmark that is to be used as the basis for the proposed price cap remedy for prepayment customers.

Impact on CMA's detriment calculation

51. Table 7.1 sets outs the results of analysis conducted by Oxera in the CMA Confidentiality Ring to correct for some of the issues with CMA's benchmarking analysis identified above. The adjustments are additive and hence the effect of each individual adjustment on the CMA's overcharge estimates can be shown separately. Oxera's results show that, once corrections for key issues have been made, there is no evidence of an overcharge over this period as the CMA's annual average detriment estimate is significantly negative, at -£738m for the entire market and -£69m for the prepayment segment of the market for the period 2012-2015(Q2).

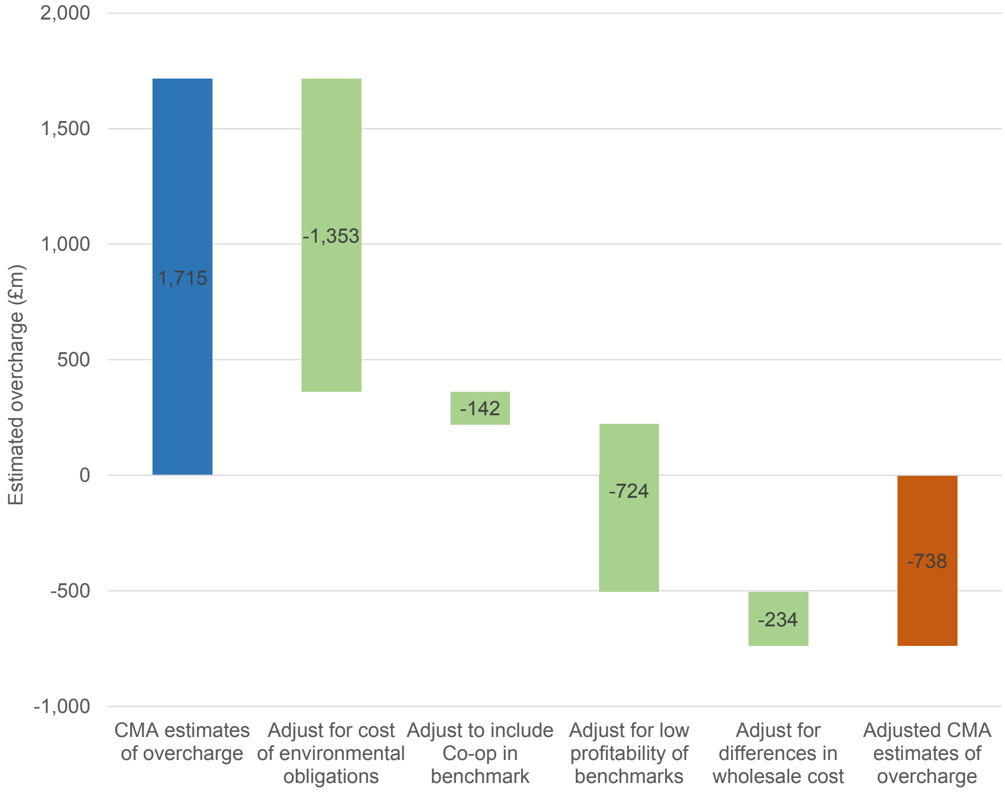
Table 7.1 Oxera adjustments to CMA's overcharge estimates

	Annual average (£m) - All	Annual average (£m) - PPM
CMA estimates of overcharge	1,715	345
Adjust for cost of environmental obligations (I)	*-1,353*	*-228*
Adjusted CMA estimates of overcharge (I)	362	117
Adjust to include Co-op in benchmark (II)	*-142*	*-19*
Adjusted CMA estimates of overcharge (I & II)	220	98
Adjust for low profitability of benchmarks (III)	*-724*	*-126*
Adjusted CMA estimates of overcharge (I, II & III)	-504	-28
Adjust for differences in wholesale cost (IV)	*-234*	*-41*
Adjusted CMA estimates of overcharge (I, II, III & IV)	-738	-69

Source: Oxera

52. Figure 7.1 charts the changes to the CMA's annual average overcharge estimates for the market as a whole as a result of the adjustments made by Oxera in the CMA Confidentiality Ring. This maps onto the figures shown in Table 7.1 above.

Figure 7.1 Oxera adjustments to CMA's overcharge estimates



Source: Oxera

53. The CMA found the average detriment to be £1.7bn for the years 2012-2015(Q2), and in its Table 3.10, also presents detriment calculated for each year, which shows the underlying annual detriment calculations increasing over this period. We have not reported detriment on an annual basis because the adjustments based on differences in wholesale costs, shortfalls in profitability of benchmark companies and the costs of social and environmental obligations show a lot of year-on-year volatility in line with volatility of corresponding costs and profits. In addition, the timing of pass-on of changes in suppliers' costs, such as the costs of social and environmental obligations, is highly uncertain. If annual numbers had been presented, they would likely show an overall increasing trend in the level of detriment through the period with a significant amount of year-on-year volatility. Given the variations that can occur from year to year in company performance, it is preferable to assess performance over a number of years to ensure that conclusions are not driven by results from one particular year. The fact that the average detriment disappears (and in fact becomes negative) once these reasonable adjustments have been made over this period indicates that, against the CMA's chosen benchmark for price in a well-functioning competitive market, the SLEFs have performed well over the recent past. Once the major issues with the CMA's benchmarking analysis are addressed, the adjusted detriment results provide no justification for a highly interventionist remedy such as the proposed prepayment tariff price cap.

54. Negative overcharge estimates show that the benchmark suppliers would have had to charge significantly higher average tariff rates than the SLEFs in the benchmark period if they were to make a ‘normal’ level of profit according to the CMA’s definition without the help of a partial or total exemption from social and environmental obligations. This indicates that they were likely operating below the minimum efficient scale, particularly in the early part of the benchmark period when they had a smaller customer base, and their costs per customer were higher than for the SLEFs on a like-for-like basis.

55. The large effect of the adjustments shows that direct benchmarking is not an appropriate method for concluding the extent of any detriment to all domestic customers or PPM customers in particular. The CMA cannot rely on evidence of detriment from a much shorter recent period or on an acknowledgement that these mid-tier suppliers are not good benchmarks for a well-functioning competitive market as they stand without undermining the rationale for its direct benchmarking approach. Indeed, the CMA itself has acknowledged a number of these criticisms, but has concluded the effect on its conclusions would not be substantial. This evidence indicates that the effect of these corrections is material and therefore the CMA has no coherent basis for its finding of a significant and persistent detriment.

Impact on CMA’s calculation of the benchmark bill

56. In the event the CMA does choose to proceed with its price cap for the pre-payment segment, the corrections set out above also affect the level of the benchmark tariff that should be the starting point for the price in a well-functioning competitive market. Table 7.2 sets outs the results of Oxera’s analysis to correct the CMA’s estimate of the benchmark dual fuel bill for the same issues as those identified above. The adjustments to the benchmark bill are different in magnitude to the adjustments to detriment estimates since the two calculations are based on different time periods. The adjustments are additive and hence the effect of each individual adjustment on the CMA’s estimate of the dual fuel benchmark bill can be shown separately. Oxera’s results show that, once corrections for key issues have been made, the annual benchmark dual fuel bill is increased to £785.

57. The adjustment for the cost of social and environmental obligations appears small at just under 1% of the tariff, but is material in the context of margins of 1.5%. The main adjustment is that which ensures the benchmark tariff includes a reasonable return. This assumes that the mid-tier companies’ performance in 2015 is at the average of their performance in 2012-2014. If the pricing of the benchmark firms as at 30 June 2015 is consistent with their average profitability for the 2012-2014 period, the profitability adjustment to the benchmark tariff uplifts it to be consistent with profitability that would be considered ‘normal’ under the CMA’s ROCE methodology.

Table 7.2 Oxera adjustments to CMA's estimate of the benchmark dual fuel bill

	Annual dual fuel benchmark bill (£) – 30 June 2015[19]
CMA estimate	735
Adjust for cost of environmental obligations (I)	*7*
Adjusted CMA estimate (I)	742
Adjust to include Co-op in benchmark (II)	*9*
Adjusted CMA estimate (I & II)	751
Adjust for low profitability of benchmarks (III)	*34*
Adjusted CMA estimate (I, II & III)	785
Adjust for differences in wholesale cost (IV)	*N/a*[20]
Adjusted CMA estimate (I, II, III & IV)	785

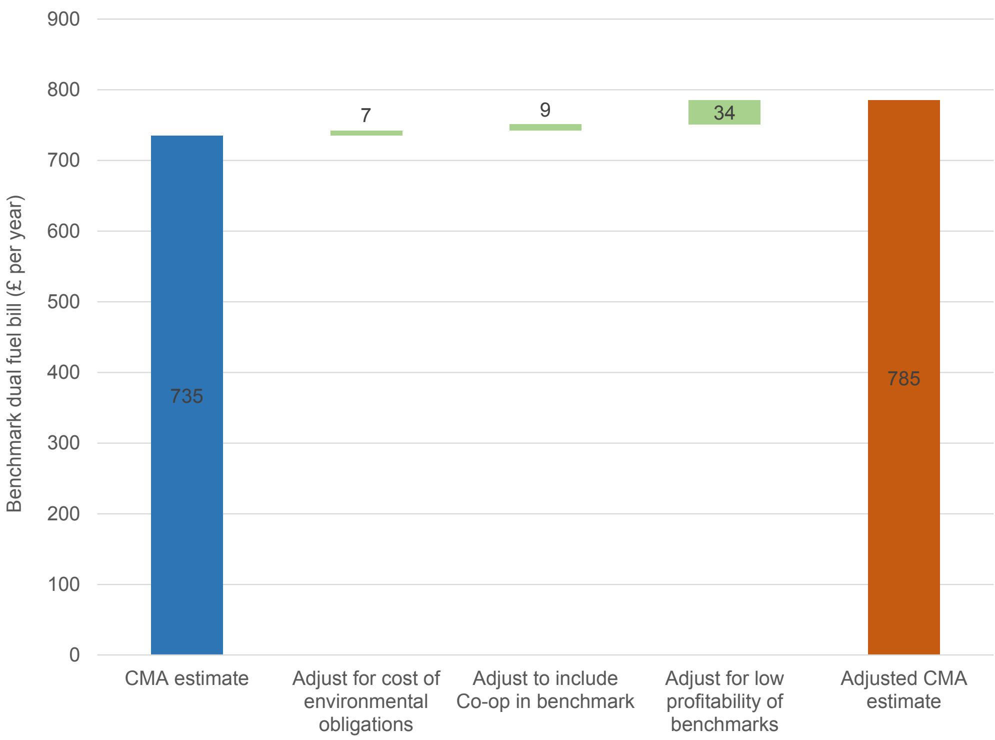
Source: Oxera

58. Figure 7.2 charts the changes to the CMA's estimate of the benchmark dual fuel bill as a result of the adjustments made by Oxera in the CMA Confidentiality Ring. This maps onto the figures shown in Table 7.2 above. It shows that the sum of adjustments to the benchmark annual dual fuel tariff is £50.

[19] The benchmark bills shown in this table exclude network costs.

[20] Since, under the PPM price cap proposed by the CMA, suppliers will be able to minimise profit risk by copying the hedging strategy specified in the calculation of the price cap, the only differences in wholesale costs that are likely to persist after a PPM price cap is imposed relate to energy already purchased but not yet delivered to final customers at the start of the price control. Hence, to ensure that Oxera's adjustments remain conservative, there is no corresponding adjustment to benchmark direct debit bills that would form the basis of CMA's proposed PPM price control.

Figure 7.2 Oxera adjustments to CMA's estimate of the benchmark dual fuel bill



Source: Oxera

59. Finally, the average tariff level for two particular suppliers on a specific date is unlikely to be a reliable basis for a price cap that would apply over a number of years, particularly if this date falls in a period when the cost base of the suppliers concerned is subject to significant change. This is due to the fact that pass-on of costs such as those associated with social and environmental obligations into tariffs can happen over an extended period, and customer acquisition campaigns may distort average tariff levels for a given company on a particular day.