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Dear Sir / Madam,

Response to CMA's Issues Statement for its Phase 2 consideration of the anticipated merger between SSE Retail and npower

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In advance of our oral evidence session on 18 June, we would like to provide an overview of our views on the Issues Statement relating to the anticipated merger of SSE Retail and npower.

In a nutshell, we think that the merger would likely result in a lessening of competition within the domestic retail gas and electricity markets, but think that dilution is likely to be limited and will probably fall short of meeting the substantial lessening of competition test. The scope for consumer harm should be mitigated in the short term by the planned introduction of a default tariffs cap, though the time-limited nature of that intervention will mean it falls away by or before 2023. We agree with the CMA's observation that policy cost exemptions for small suppliers distort the market, although we think the principal beneficiaries of this are exempt suppliers not large incumbents. We find the commercial arrangements between Utility Warehouse and npower puzzling, and recognise the concern that the merged entity could foreclose Utility Warehouse's market, however from the information provided it is not clear that this possibility does not already exist (i.e. that the risk exists regardless of whether the merger goes ahead). We agree that price movements by the Big 6 energy suppliers[1] do act as a trigger for engagement, and as a constraint on each others price movements, and a narrowing in the number of highly visible suppliers may therefore dull switching nudges. We note that while price appears to be the single biggest driver of switching decisions, that other

[1] British Gas, EDF, e.on, npower, Scottish Power and SSE.

factors like brand recognition are also relevant, and the merger would result in a reduction in the pool of recognised brands.

We explore all of those issues in the remainder of our submission. Where relevant, we have tried to frame the arguments against the theories of harm identified by the CMA. We also suggest some further relevant considerations that are not naturally framed by those theories of harm at the end of this letter.

CMA theory of harm: a loss of rivalry in the setting of default tariff prices

Under this theory of harm, you propose that changes in default tariff prices may prompt switching and that the Big 6 suppliers need to balance the effects of price changes with any loss of customers. You also suggest that the magnitude of price movements by these suppliers may bind each other, with the potential consequence that reducing the number of large incumbents might reduce the risk that one of them loses customers as a result of a price movement that is out of line with its peers.

We find this theory of harm plausible, and note that there is some evidence to suggest that price announcements by the Big 6 do stimulate consumer engagement.

For example, if you look at historic switching data there is some coincidence of high switching rates with public concern about Big 6 price hikes. The biggest single monthly switching spike since records began occurred in November 2013, when 609,000 households changed their electricity supplier.[2] This coincided with a round of Big 6 price hikes.[3] The first of these were announced in October, but it typically takes around four to five weeks for a change of supplier event to complete, so one would expect an equivalent lag time between a prompt to switch occurring and it being evident in switching statistics. On Friday 11 October 2013, the day after the first announcement (by SSE), at least seven different national newspapers led with energy prices on their front pages.[4] Energy prices featured on at least six front pages on the day after British Gas's price rise announcement, on at least three the day after npower's, at least one after Scottish Power's, and on at least three after

[2] 'Quarterly domestic energy switching statistics (QEP 2.7.1),' BEIS, https://tinyurl.com/o2ux9mb
[3] SSE announced increases in their standard variable tariffs on 10 October 2013 to take effect from 15 November 2013. British Gas announced price rises on 17 October to take effect from 23 November. Npower announced a price rise on 21 October to take effect on 1 December. Scottish Power announced a price rise on 24 October to take effect on 6 December. EDF announced a price rise on 12 November 2013 to take effect on 3 January 2014. E.on announced a price rise on 3 December to take effect on 18 January 2014.
[4] The Sun "Upped yours, Britain!", The Mirror "Fuel bills will kill", Daily Express "Millions face heat or eat dilemma", i "Fuel price hikes for winter", Daily Telegraph "Axe green tax, says energy chief", The Scotsman "Cameron feels heat as energy firm hikes prices", The Herald "Fears of more energy price rises as SSE raises bills".

EDF's.[5] Aside from the price rises themselves, energy repeatedly hit the news during this period due to a dispute between suppliers and government on what was causing bill inflation, which ultimately resulted in the government changing the format of the Energy Company Obligation to try and cut its costs.

The second highest monthly switching spike for electricity was in August 2008, when 553,000 households changed their supplier.[6] Again, this manifested the month after a round of Big 6 hikes had started, suggesting possible causality. EDF had commenced that pricing round, announcing a 17% increase in electricity prices and a 22% increase in gas prices on 24 July 2008, shortly followed by British Gas announcing even larger gas price rises on 30 July.

We have not conducted a thorough statistical analysis of the linkages between price movements and engagement (switching) rates, but the examples above suggest there is at least anecdotal evidence that pricing rounds - particularly those associated with bad news (price hikes) - may prompt higher than normal levels of consumer engagement. We also note that while price movements by the Big 6 tend to get significant press attention, and can often prompt front pages and significant broadcast media attention, this is not true of smaller and medium size suppliers. It therefore appears plausible to us that a reduction in the number of large suppliers could reduce the public prominence of price rise rounds, with the potential for knock-on effects on engagement levels.

It is less clear to us however, how substantive any reduction in engagement a movement from six to five major players would be. It is our perception that while the first mover in a pricing round will receive significant publicity, that this tends to incrementally reduce as each of its rivals follow, perhaps because the media lacks a new angle to take when the substance of the story is the same. It is therefore possible that the overall switching prompt driven by five large suppliers moving prices may not be materially lesser than the prompt driven by six.

We note your observation that a reduction in the number of large suppliers may reduce a constraint on the level of default tariffs, as parties would be less at risk of announcing a price that is out of line with other suppliers (and by implication, be less at risk of being punished by consumers moving away if they announce a higher rise than their rivals). This is, again, plausible but hard to quantify. It does appear to us that Big 6 default tariff retail price movements are usually closely inclined in magnitude, although the companies would likely argue that this simply reflects that

[5] According to the archive of UK newspaper front pages at Paperboy (https://tinyurl.com/y8ltpvfz). Note that it does not appear to be exhaustive, hence our use of the 'at least' qualifier.
[6] 'Quarterly domestic energy switching statistics (QEP 2.7.1),' BEIS, https://tinyurl.com/o2ux9mb

they face similar underlying cost drivers. The first mover in any pricing round is likely to set a benchmark that others subsequent moves will be judged against. npower has rarely been the first mover in pricing rounds, but SSE has been on several occasions (for example in Autumn 2012, and then again in Autumn 2013). It is probably therefore more reasonable to regard SSE as a price setter than npower.

Consumer survey results tend to suggest that consumers biggest single motivation for switching is to save money.[7] The best buy tables are dominated by smaller suppliers, yet despite this a considerable fraction of switching remains between Big 6 suppliers, or from small suppliers back to Big 6 suppliers - over half in some months.[8] This may reflect a brand recognition dividend - a desire from many consumers to stick with a brand they know. It may also reflect concerns about the level of customer service that may be, or has been, provided by smaller suppliers. One of the largest consumer websites, moneysavingexpert, includes an option to filter price searches to only include the Big 6 and three of the best known medium suppliers in an explicit acknowledgement that some consumers are concerned about switching to a supplier they have not heard of.[9]

This constraint on switching is something the CMA may wish to be mindful of in its determinations. The energy retail market is often simply characterised as having two tiers, of sticky customers and the engaged. But in practice, there are sub-tiers within these tiers - and while some engaged consumers will consider moving to any supplier, there are clearly some who will consider switching but only to a recognised brand name. This may mean that the loss of a single big brand supplier has very little meaningful impact on the former, who would still have ~70 other ones to choose from, but a more meaningful impact on the latter, who may now have four.

CMA theory of harm: foreclosure of Utility Warehouse resulting from an increase in npower's wholesale price to Utility Warehouse

[7] For example, 'Consumer engagement in the energy market 2017,' GfK for Ofgem, found that 91% of those who had engaged in the market in the last 12 months priority for doing so was to save money. https://tinyurl.com/y74hu3yp
[8] Electralink data reported by Energy UK suggests that typically around a third to a half of all switches are either from small suppliers to large suppliers, or from large suppliers to other large suppliers. https://tinyurl.com/ycfbo2ro Please note that some caution should be used in comparing this data with the switching rates reported by BEIS cited elsewhere in this submission as there appear to be methodological differences between the two; Energy UK typically reports a higher level of switching than BEIS.
[9] '*We know many have reservations about switching to certain firms so let's address the main worries... Worried about switching to a firm you've never heard of? We know this is the biggest switching turn-off for many, so we've a special 'Big Name Supplier' filter where we remove all bar the Big 6 + Co-op, First Utility and Ovo. To see all suppliers, just unclick the filter.*' MSE weekly money saving email, 30 May 2018. https://tinyurl.com/y8w9l84y

Both the *Issues Statement* and the *Decision on relevant merger situation and substantial lessening of competition* appear to indicate that Utility Warehouse's wholesale price, subject to an exclusive Supply and Services Agreement (SSA) with npower, is explicitly linked to the retail SVT prices of the Big 6.

We find this linkage extremely strange. That an independent supplier would outsource their wholesale trading to a larger trader does not seem either unusual or inappropriate to us. It also does not appear to be unreasonable for those wholesale prices to be indexed. But we cannot understand why they are indexed to retail prices, and not to traded prices on the wholesale market. In general, the correlation between wholesale price and retail price movements is poor - making the latter an unusual proxy. Ofgem has previously found asymmetry in the extent to which retail prices respond to wholesale movements - that they are quicker to rise in response to wholesale price rises than they are to fall in response to falls.[10] The CMA similarly noted the lack of responsiveness of standard variable tariffs to wholesale price falls in its own 2014-16 market investigation.[11] It reached a broader conclusion that there was 'a combination of features of the markets for the domestic retail supply of gas and electricity in GB that give rise to an adverse effect on competition through an overarching feature of weak customer response, which, in turn, gives suppliers a position of unilateral market power concerning their inactive customer base.'

Based on your description of the Utility Warehouse agreement, this inactive customer base appears to be precisely what its deal with npower is indexed to. While the larger suppliers will also offer some more competitive acquisition deals, your description suggests these are not included in the reference basket - that the contract linkage is solely to standard variable tariff prices. Aside from the finding that these prices are formed in an area of the market where, in its own view, suppliers are in a position of unilateral market power, the CMA should also be mindful that retail prices will include a range of cost items that are not naturally correlated with wholesale price movements at all, such as network and policy costs and their own internal costs to supply.

Your description of the deal does strongly suggest that the parties to this merger, both individually or in combination, are capable of influencing the wholesale price of Utility Warehouse. It therefore follows that they could, in theory at least, foreclose its market. But it appears to us that this risk exists regardless of whether or not the two parties are allowed to merge - that it is also a feature of the status quo. The

[10] "Do energy bills respond faster to rising costs than falling costs?" Ofgem, March 2011. https //tinyurl com/y9tuvmsu
[11] See, eg, figure 8.25 on page 412 of the final report on its investigation, showing the more limited extent to which standard tariffs track underlying costs when compared to acquisition (fixed rate) tariffs. 'Energy market investigation: final report,' CMA, June 2016. https://tinyurl.com/j3ye89l

question for the CMA is therefore whether that risk is materially heightened by the proposed merger, eg whether it will result in inflation in the basket of SVT prices that the deal is indexed to.

If it considers that the risk is heightened, the CMA may wish to make a requirement that this Supply and Services Agreement be renegotiated or amended a condition of any merger clearance.

Other CMA theories of harm

We have no observations on the other five theories of harm mooted in your Issues Statement.

Other relevant considerations

<u>The forthcoming default tariffs cap</u>

The Domestic Gas and Electricity (Tariff Cap) Bill is expected to receive Royal Assent before the summer recess, and be implemented before the end of 2018. Its exact form remains under consultation, but should be finalised before this Phase 2 investigation completes.

In the event that the CMA concludes that one or several of its theories of harm are persuasive, it should consider whether the legislative tariff cap would provide a means of mitigating the risk that the merger could further reduce the already poor incentives to keep default tariff prices down. In so doing, it should be mindful that the legislative cap is explicitly time-limited and may fall away as early as 2020.

<u>Regulatory understanding and oversight of cost drivers</u>

The Big 6 suppliers, and only the Big 6, are obligated to produce annual Consolidated Segmental Statements ('CSS') breaking down their costs and profits. The CSS are a useful tool to regulators in understanding cost drivers and possible (in)efficiencies in the sector - the CMA made extensive reference to them its 2014-16 investigation, and Ofgem clearly does likewise in various areas of its market monitoring work. While, at the time of writing, it is not clear what form the impending legislative price cap will take, it remains possible that the CSS may be used by Ofgem as a key information source when setting the cap - both initially, and in any updates. More broadly, comparative information - benchmarking - is invariably useful to competition authorities in understanding, and making informed judgements in response to, developments in regulated markets.

We do not consider that a relatively small narrowing of available benchmarking information is likely to constitute a reasonable reason to prevent the merger going ahead, but the CMA may wish to be mindful that the dilution of benchmarking data may constrain future regulatory oversight of the market. The CMA may wish to consider whether Ofgem needs to make any changes to the regulatory reporting regime in response to the merger.

Policy costs

Suppliers incur a wide range of costs associated directly, or indirectly, with the delivery of government policy. These will be passed on to their consumers, through their bills.

While every supplier is exposed to most policy costs, there are three policies where small suppliers are subject to exemptions, shown in the table below.

Policy	What it does	Estimated cost of delivery per household per year [12]
The Energy Company Obligation ('ECO')	Pays for investments in household energy efficiency, with a particular focus on low income households.	£23
The Warm Home Discount ('WHD')	Gives eligible customers - low income households with defined vulnerability characteristics - an annual £140 discount on their bills.	£11
Feed-in Tariffs ('FITs')	Pays households with solar panels or other renewable generation for the electricity that they produce.	£17
Total		£51

For the WHD and ECO, a supplier is exempt if it has less than 250,000 customer accounts (a dual fuel customer would normally be classed as two accounts). For FITs, a supplier is exempt if it has less than 250,000 electricity customers.

[12] These figures are estimated costs for 2020, taken from the October 2016 National Audit Office report, 'Controlling the consumer funded costs of energy policies' https://tinyurl.com/y89jzbzx.

During the course of its 2014-16 energy market investigation, the CMA considered whether the existence of these exemptions distorted competition in the market, concluding that they 'are not significantly market distorting in the present market conditions.'[13]

In its 26 April 2018 *Decision on relevant merger situation and substantial lessening of competition* relating to this merger, the CMA appears to have modified its view, now regarding these policy cost exemptions as having a distortionary effect in favour of large suppliers. In particular, it noted that:

'notwithstanding the number of new suppliers which have entered the supply of energy to domestic customers in GB in recent years, customer disengagement and higher costs arising from regulatory obligations (above a certain size) are significant barriers to expansion. Moreover, the small number of customers on SVTs with the SAMS means that these suppliers are unlikely to affect significantly the SVT price setting behaviour of the SLEFs for a considerable time.'

The CMA's logic appears to be that the additional costs incurred by suppliers as they grow through the exemption threshold will reduce their ability to compete as they now incur significantly higher marginal costs. Because these companies are not former incumbents they will not have a significant sticky customer base who these costs can be readily passed through to without the risk of them leaving, and it will also become harder for them to win new custom. In turn, this may act as a handbrake on their growth that stops them becoming competitive rivals to the Big 6.

This is a plausible hypothesis, but it must be noted that at least one of these two disadvantages will be shared by the Big 6. They will differ in that they benefit from holding extremely large numbers of price-taking disengaged customers who these higher costs to serve can be more easily passed through to. But they will be in a similar position in finding it more difficult to offer attractive acquisition deals when in competition with a large number of exempt suppliers. When the policy cost exemptions were introduced in 2011, the Big 6 held around a 99% share of the domestic retail market. That figure is now below 80% and we have seen an explosion in the number of smaller suppliers. It is therefore relatively hard to make a case that the exemptions have commercially benefitted the large incumbents.

We do think it is reasonable to suggest that policy cost exemptions particularly disadvantage non-exempt suppliers who are outside the Big 6. Those suppliers face the simultaneous disadvantages of fewer price-taking customers than the Big 6, and a higher cost to serve than exempt suppliers. But we think the exemptions also

[13] 'Appendix 8.1: Social and environmental obligation thresholds,' CMA, 2016. https://tinyurl.com/ybq9ql6g

disadvantage the Big 6, because they make it much harder for them to acquire new customers than would be the case if all suppliers were exposed to all policy costs. The only clear winners from the exemptions are exempt suppliers.

Small suppliers who are not obligated to support these schemes get a competitive advantage from avoiding their delivery costs, and their customers escape the cost of paying towards these social and environmental policies. The CMA's own 2014-16 investigation found that poorer customers and those with vulnerability characteristics are less likely to switch than the average customer.[14] This results in a perverse outcome whereby affluent customers who are most able to pay are also most likely to not contribute towards these policies. Vulnerable customers may also find themselves shut out of the market as the best deals are often offered by suppliers who do not offer the Warm Home Discount, which they may be relying on. The exemptions distort competition, giving smaller suppliers an artificial leg up the best buy tables that is not necessarily driven by efficiency.

We recognise the CMA argument that the exemption thresholds themselves may create perverse incentives to slow growth beyond a certain point. Suppliers have told us that their growth strategies have been affected by a desire to time when they hit thresholds. Indeed, one supplier recently publicly commented that they had made a conscious decision to shrink back below the exemptions threshold in order to try and remain competitive.[15]

If, as its merger investigation continues, the CMA remains of the view that these exemptions are distorting competition in the energy retail market we encourage it to consider recommending to government that they be removed. We think that this would be a highly beneficial change to the regulatory landscape on both competition and social policy grounds.

<u>Quality of service</u>

You highlight[16] in the *Decision on relevant merger situation and substantial lessening of competition* that motivations for the merger include significantly reducing the combined cost base and decreasing the need for capital expenditure by using npower's newer IT systems.

[14] 'Appendix 9.1: CMA domestic customer survey results,' CMA, 2016. https://tinyurl.com/gr9vw5v. The CMA's investigation found that consumers with any of the following characteristics - household incomes under £18,000 a year, those in rented social housing, have no qualifications, are aged 65 and over, have a disability, or on the Priority Services Register (PSR) - were less likely to switch or to consider shopping around.
[15] See Utility Week's interview with Andrew Beasley, MD of Flow Energy, 22 March 2018. https://tinyurl.com/y7pvncfz
[16] Paragraph 25.

Our experience as the sector watchdog has been that initiatives by large suppliers to migrate between billing and customer service platforms have often been plagued with significant operational problems. Several of the large suppliers - including npower, as well as EDF Energy, Scottish Power and British Gas - have experienced significant complaints spikes as a result of these difficulties. In some cases these have been material enough to prompt major regulatory fines - £26m in the case of npower.[17]

In its consideration of the merger we would welcome the CMA, and indeed the two parties, providing assurance that the desire to cut costs from the merged entity can be achieved without reducing the quality of service that its customers receive. This is particularly important given the large number of disengaged customers that the two parties have, which may constrain the ability of competition to punish poor customer service.

We hope that this submission is clear and helpful, but would be happy to clarify or further discuss any issue that it raises if you would find that helpful. It is non-confidential and may be published on your website. We will also publish it on our own website.

Yours sincerely

[redacted]

Richard Hall
Chief Energy Economist

[17] 'npower to pay £26m for failing to treat customers fairly,' Ofgem, 18 December 2015.