ANTICIPATED MERGER BETWEEN THE DOMESTIC RETAIL ENERGY BUSINESS OF SSE PLC AND NPOWER GROUP PLC

RESPONSE OF CENTRICA PLC TO THE CMA'S ISSUES STATEMENT DATED 29 MAY 2018

This is the non-confidential response of Centrica plc ("**Centrica**") to the CMA's Issues Statement in relation to the anticipated merger between the domestic retail energy business of SSE plc and Npower Group plc (the "**Parties**")[1].

We focus briefly on three areas of the Issues Statement – the counterfactual to be used by the CMA in assessing the merger between the Parties[2], the CMA's theory of harm, namely a loss of rivalry in the setting of default tariff prices[3], and the theories of harm which have been discounted by the CMA[4].

Before doing so, however, it is important for the CMA to consider the state of the residential energy market today (and, particularly, how it has developed since the CMA's energy market investigation).

Customer engagement has been increasing steadily. Customers are already engaged and, absent the impact of the proposed price cap on standard variable tariffs, this level of engagement can be expected to continue to increase. The degree of engagement seen by customers is heavily dependent on the degree of savings a customer can achieve. Engagement today therefore requires a significant degree of price dispersion in the market. There is of course a risk to increased customer engagement if a price cap on standard variable or default tariffs is introduced which does not allow for price dispersion and effective competition to be maintained.

The counterfactual

The CMA states that the Parties identified a number of recent or anticipated changes in the retail energy market, including the introduction of a price cap on standard variable or default tariffs. It is also our view that the CMA should include the introduction of a price cap on standard variable or default tariffs as part of a range of counterfactuals when assessing this merger.

However, to date the CMA has chosen not to include the implementation of the price cap in its counterfactual when assessing the merger[5]. Whilst the exact form and timing of the price cap remains unclear, there is in our view sufficient certainty over the introduction of a cap (Ministers have repeatedly called for a default tariff price cap to be in place prior to the end of 2018) for it to be included within a range of reasonable counterfactuals alongside no default price cap at all.

The Domestic Gas and Electricity (Tariff Cap) Bill, currently before the House of Lords, requires Ofgem to have regard to "*the need to set the cap at a level that enables holders of supply licences to compete effectively for domestic supply contracts*"[6]. Ofgem therefore should include sufficient headroom to allow suppliers to compete effectively for residential customers. For the purposes of the

[1] https://assets.publishing.service.gov.uk/media/5b081f7eed915d21e1d0f5f3/issues_statement_sse_npower.pdf

[2] At paragraphs 26 to 30 of the Issues Statement

[3] At paragraphs 33 to 39 of the Issues Statement

[4] At paragraph 48 of the Issues Statement

[5] See https://assets.publishing.service.gov.uk/media/5b0297e4e5274a4df17fd3a0/SSE_Npower_decision.pdf at paragraph 48

[6] See https://publications.parliament.uk/pa/bills/lbill/2017-2019/0100/18100.pdf, at section 1(6)(b)

counterfactual in the current merger, therefore, the CMA should assume (in keeping with Ofgem's legal obligations) that a cap on default tariffs is set at a level which does not impede competition.

Nevertheless, as the CMA notes[7], "*following the Energy Market Investigation, a temporary price cap on prepayment meter tariffs was introduced. Since then, prices have concentrated around the cap*". There is a significant risk that the introduction of a price cap on standard variable tariffs – despite the legal obligations placed on Ofgem by section 1(6)(b) of the draft Bill - leads to customer disengagement and a softening in competition. This risk is greater than the problems caused by the PPM price cap, because it would cover a far greater proportion of the residential energy market.

In this case, it will be extremely important for the CMA to distinguish between competitive effects arising from the merger between the Parties and the competitive effects which may arise as a result of the proposed cap on standard variable or default tariffs. Absent the effects of retail price regulation, there is an overall trend of innovation and improving consumer engagement and hence competitive pressure in the retail energy market which the proposed merger, in our view, will not significantly impede. The key risk is that the proposed cap on standard variable tariffs will reduce customer engagement and competitive pressures going forward, as well as potentially placing at risk supplier innovation and the delivery of the smart meter programme.

The theory of harm

The CMA's theory of harm for the merger focuses on "*a loss of rivalry in the setting of default tariff prices*". The CMA notes[8] that "*this theory of harm proposes that changes in default tariff prices may prompt switching and SLEFS need to balance the effects of price changes with any loss of customers*". We broadly agree with this statement based on our experience.

However, the CMA goes on to state that "*Default tariff customers will therefore tend to respond to price changes depending on what other suppliers have already announced regarding default tariff price changes*". We do not believe that this is a complete representation of the current market. Firstly, it should be noted that competition in residential energy is moving away from rivalry in standard variable tariffs. Centrica has unilaterally withdrawn its standard variable tariff from new customers and has asked Ofgem to consider prohibiting tariffs without an end date[9]. To this end our default tariff is now known as a Temporary Tariff, reflecting our expectation that customers will move from this tariff as soon as possible.

More specifically, most customers who decide to switch from a default tariff do not switch to another default tariff – they generally move to a fixed term tariff offered by the same or a competing supplier, either directly or using a price comparison tool. Ofgem regularly publishes data focussing on the differential between default tariffs and the cheapest deals in market (rather than other default tariff rates)[10]. Whether any given customer decides to switch will be based on a variety of factors including brand and service levels[11], but for many customers the primary consideration is price – and in

[7] At paragraph 48(c) of the Issues Statement
[8] At paragraph 37 of the Issues Statement
[9] See https://www.centrica.com/news/centrica-sets-out-proposals-deliver-fairer-and-sustainable-energy-deal-customers
[10] See https://www.ofgem.gov.uk/data-portal/average-tariff-prices-supplier-standard-variable-vs-cheapest-available-tariffs-gb
[11] See, for example, the CMA's domestic customer survey results at https://assets.publishing.service.gov.uk/media/559fb619ed915d1592000044/Appendix_8.1_Customer_survey.pdf, which notes (at paragraph 145) that "*good quality service*" was a driver of choice for 50% of respondents

particular, customer perception as to whether the savings they might make by switching tariffs / suppliers outweigh the perceived time investment required to make the switch.

That decision will differ by customer. Some customers will be very price-sensitive and will switch where there is a relatively small saving to be made. Others will place a greater value on their time, or the service levels and brand offered by their current supplier, and so will require a greater differential between their current deal and the cheapest deals in the market before being willing to switch. Others may decide not to switch because they are happy with the price and service provided by their current supplier, which outweighs the time cost of switching, potential savings to be made, and /or the actual or perceived potential reduction in service levels associated with changing supplier or tariff.

In setting default tariff levels and considering changes (either up or down) to the prices of default tariffs, therefore, it is in our view incorrect for the CMA to focus solely on the impact of default tariff price rises announced by other large energy firms. The differential between default tariff prices and the cheapest deals available in market, which are likely to be fixed term contracts and can be offered by any energy firm – large, medium sized or small – is also important (indeed, given the distortive effect of the policy costs threshold, the smallest suppliers will enjoy a smaller costs base and can offer cheaper fixed term deals). That differential influences both the decision as to where to set the prices for default tariffs, and the extent to which they should be changed if competition and cost / regulatory pressures require an amendment.

The lower the prices of default tariffs, the lower the potential cost savings for customers switching from a default tariff to a fixed term deal will be and, therefore, a lower number of customers are likely to be move from a default tariff to a fixed term deal (either from their current supplier or from a rival). In short, the competitive pressure applied by fixed term tariffs incentivises suppliers to keep default tariffs low in order to retain customers. Therefore, we do not believe that the CMA's theory of harm – that the merger between the Parties will lead to a loss of rivalry in the setting of default tariff prices – is a relevant consideration in assessing the merger.

The theories of harm discounted by the CMA

We agree that none of the theories of harm currently discounted by the CMA have a realistic prospect of demonstrating a substantial lessening of competition. We do believe, however, that the evidence of the impact on competition in the prepayment market cited by the CMA at paragraph 48(c) – in particular, the fact that prices have converged around the cap, which in our view demonstrates a detrimental impact of the cap on competition – is relevant to the consideration of the counterfactual for the proposed merger between the Parties as set out above.