SSE RETAIL/NPOWER ANTICIPATED MERGER INQUIRY

Summary of hearing with Ofgem on 26 June 2018

Introduction

1. Ofgem stated that the merger should be considered in depth, given the market share of the merging parties post-merger and particularly in the context of energy being an essential service with inelastic demand, and so considerable consumer welfare was at issue.

Competition in the market

2. Ofgem said that 22 percent of the electricity and 23 percent of the gas residential markets were served by small and mid-tier suppliers (SAMs). There had been very rapid entry in the previous two to three years by new energy firms. Some of these new firms had grown quickly. However, there were concerns that SAMs lacked the capability to expand further. Ofgem explained that Ofgem had run two supplier of last resort process for SAMs over the previous 20 months and a review had been announced in respect of Ofgem's approach to licensing.

3. Ofgem explained that those customers who switched regularly are more comfortable switching to and between SAMs. Whereas, some of those who switched less regularly being wary of moving to a smaller unknown supplier is perceived as a barrier. Approximately 30 percent of all switching occurred between the six large energy firms (SLEFs).[1]

4. Ofgem said that in addition to price, competition based on quality of customer service is likely to become increasingly important.

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[1] Centrica, EDF Energy, E.ON, RWE, Scottish Power, and SSE.

Price cap on standard variable tariffs

5. Ofgem currently expected its price cap on standard variable tariffs (SVTs) to be in place before the end of the year.

6. Ofgem explained that the effect that the price cap would have on the prices of SVTs in the market would be dependent on how high or low the cap was set. [✂]

7. Ofgem noted that customer service might become a more important factor of competition under a price cap, and the Merger could affect this.

8. Ofgem recommended that the CMA consider in its analysis of the anticipated merger the potential scenarios that could take place beyond the minimum two-year and maximum five-year periods the price cap would be in place for.

9. Ofgem said that in deciding whether to recommend the removal of the price cap in two years' time it would develop specific criteria once it had a chance to observe how the price cap operated in practice. In doing so it was likely to consider factors including whether cost inefficiencies had been reduced by energy firms and whether the ease of switching had changed.

10. [✂]

Switching behaviour

11. Ofgem explained that many customers were reluctant to switch because they were not informed about alternative suppliers and they perceived switching as involving too much hassle and effort that would not culminate in savings. This sort of customer behaviour was reflected consistently in Ofgem's surveys over the past few years.

12. Ofgem had just ended consultation for the removal of the whole of market requirement for price comparison websites (PCWs). While removing the whole of market requirement had benefits in incentivising competition, it could make it harder for smaller suppliers to gain customers as they could not so easily compete just on price. Ofgem explained that customers who switched using PCWs were relatively more engaged.

13. Ofgem observed that customer engagement increased and spiked around the time price announcements were made. Ofgem said that it had observed a significant increase in external switching on the part of customers to other energy firms' tariffs.

Customer engagement trials

14. Ofgem said that its disengaged customers database and cheaper market offers trials had produced positive results in terms of customer engagement.

15. Ofgem said that it was in the process of trialling an alternative form of customer engagement – collective switching.

Effects of the anticipated merger

16. Ofgem explained that it was concerned with the merger in that normally where a merged entity has around 25 percent market share it is expected to incentivise price increases. Also, the market investigation had found that this was a market that was not working well. It was expected that prices for both SVTs and other tariffs such as fixed tariffs would increase, and some of its modelling work predicted a small price effect which concerned Ofgem given the essential nature of the service. However, it was unsure at this stage, and subject to efficiencies, whether the price increases identified would be sufficient for the conclusion that the merger gave rise to a significant lessening of competition (SLC).

17. Ofgem said that post-merger there would be fewer SVT price announcements potentially leading to a reduction in the number of prompts for customer engagement. However, it believed that broadly the anticipated merger would not have a striking effect on consumer engagement.

18. Ofgem said that it had general concerns about the anticipated merger in relation to vulnerable customers.

19. Ofgem said that it expected some upward pressure on prices in incumbency regions but not a dramatic effect It acknowledged that regions where one of the merging parties was incumbent, the other had very limited market share. It noted that SSE had a strong brand in Scotland. Hence the anticipated merger would only lead to a small increase in market share. It noted that currently regional SVT incumbency premiums had declined over recent years.

20. Ofgem said that SSE Retail and Npower were fairly close competitors, but not the closest (based on switching data). It expected British Gas to be the merged entity's closest competitor post-merger.

21. Ofgem said that most media coverage tends to be concentrated on British Gas at present. With the merged entity, it is possible the amount of media

coverage will reduce with two considerably larger suppliers compared to the current one large and five smaller suppliers. The larger two post-merger might drive pricing and media attention.

22. Ofgem said Npower had high SVT prices but lower fixed tariff prices. It was concerned as to whether the merger would lead to any reduction in Npower's costs being passed through to consumers.

Setting prices

23. Ofgem explained that competitor SVTs were not a strong constraint on SVT pricing, as customers tended to switch to fixed tariffs. Therefore they may look at the acquisition tariffs of competitors.

24. Ofgem said that another constraint was the way a change in price would be portrayed in the media. A SLEF would want to ensure that the media reaction does not lead to significant losses. SLEFs therefore tended to cluster their price rise announcements.

25. Ofgem explained that evidence showed that recently SAMs were offering much lower priced fixed tariff contracts compared to the SLEFs.

26. Ofgem said that evidence appeared to show that the SLEFs' prices for fixed term tariffs had been less competitive relative to the cheapest of all suppliers in the last year and a half. Ofgem said its analysis suggested fixed tariff pricing tracked variable costs more closely than did SVT pricing.

The move away from SVTs

27. Ofgem said that some of the SLEFs had stopped offering SVTs to customers, placing them on default fixed tariff contracts instead. Ofgem said that it was in the process of gathering data on this to understand its effects.

28. Ofgem explained that there was potential concern with increasingly placing customers on default fixed tariffs. This was because they attracted less media attention in comparison to SVTs, meaning that there would be fewer prompts for customer engagement.

29. Ofgem said that its previous expectation of a rapid and very substantial decrease in the number of SVT customers was not being realised.

Cross-subsidisation of fixed tariff from high SVT prices

30. Ofgem said that it did see some cross-subsidisation but it had not found evidence that cross-subsidisation was used by the SLEFs to attempt to foreclose competitors. Ofgem observed that some of the SLEFs’ fixed tariffs were higher than those offered by SAMs.