

## Energy Market Investigation: Response to the CMA's Updated Issues Statement

This document sets out Centrica's views on the updated theories of harm set out in the Updated Issues Statement (UIS) and related issues. Our views on the more detailed Working Papers ("WPs") published by the CMA in parallel to the UIS are provided in separate submissions and referenced, where relevant, in this response<sup>1</sup>.

### EXECUTIVE SUMMARY

#### *Wholesale Markets*

1. Centrica supports the CMA's initial views that the wholesale markets in electricity and gas are working well. While we observe extensive political and regulatory interventions in electricity market design, which have sometimes reduced the role of competition and market forces and led to inefficiencies, we find that the wholesale market is generally effective and we see no evidence of any detrimental impact to the functioning of competition.
2. We agree with the CMA's initial view that it is unlikely that firms have the ability or incentive to increase profits by withdrawing capacity in generation through the exercise of any form of market power. Competition in the generation market is strong, with a diversity of ownership of generation assets and many independent participants. Important operational and regulatory constraints also help to ensure that there is no material scope to exercise unilateral or coordinated market power in this market.
3. We also agree that there are no significant competition problems regarding transparency or current levels of liquidity. Liquidity in the wholesale gas market is very good, and in the electricity market is sufficient to allow us to manage our demand requirements and optimise our power station output. Wholesale electricity prices are transparent, and driven by market fundamentals.
4. Consistent with the CMA's emerging views, we do not believe that vertical integration is detrimental to the functioning of competition. Centrica chooses to invest in upstream assets to provide diversity and financial robustness but we operate our businesses as standalone units, relying on functioning competitive markets, with only a small amount of self supply. As a result we gain no competitive advantage from the ability to trade internally and have no ability or incentive to engage in customer or input foreclosure.
5. Our experience regarding updated theories of harm 1, 2, 3a and 3b are set out in further detail in paragraphs 17-33 below.

#### *Domestic Retail Markets*

6. The theory of harm to which the UIS – and therefore this response – devotes most attention is updated theory of harm 4. Our experience does not support the CMA's initial views, and we note the following in particular:
  - The GB retail markets are very competitive, characterised by significant new supplier entry and third party activity including in particular the influence of price comparison websites (PCWs). The extent of competitive pressure we experience for our customers

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<sup>1</sup> In Annex A at the end of this document we have provided a list of our Working Paper responses and also noted the four for which we have not provided a dedicated response as our views are provided elsewhere.

on Standard Variable Tariffs (SVTs) is understated in the UIS. The differential between fixed term contracts (FTCs) and SVTs seen today is a result of the pattern of wholesale prices and how they flow through into the distinctly different risk offerings of the products. This differential has been significantly amplified by the fall in wholesale prices over the last year. As the forward curve stabilises (as is happening to some degree) this differential will diminish.

- We do not accept the CMA's analysis that large suppliers' margins have increased over time, inferring a weakening of competition for SVT customers - using our own actual costs, our margins are relatively stable from 2009 to now. Indeed, our average profit on a dual fuel bill has actually fallen from £54 (2009) to £42 (2014) in this period. Moreover, retail industry supply margins were very low (or even negative) pre-2009 and so the CMA's analysis describes a normal return to sustainable competitive profit margins rather than a weakening of overall competition.
- We do not see evidence of unengaged or dissatisfied customers - the CMA's own survey confirms that 89% of customers know they can switch supplier and nearly half of all customers have either switched or considered switching in the past three years. Moreover, 73% of customers are satisfied with their current supplier and of those who know it is possible to switch supplier or change payment method, 70% are confident that they are on the right deal for them.
- Only 18% of customers said they would switch for a saving of £99 or less, which is consistent with our view of the engagement of customers and the value they place on non price factors as well as price. The CMA's analysis of "gains from switching" contains methodological flaws, identifying gains that in reality are likely to reflect customer preferences between different product characteristics. If we apply reasonable adjustments to the CMA's approach, the amount that customers can save falls below that required by most customers to switch.
- The small number of customers who are dissatisfied and yet not confident to switch is not unusual or particularly high, and neither do these customers fall predominantly into "vulnerable" categories. Further, different levels of customer engagement are a common feature of many markets and we note that energy supply has some atypical features (such as ongoing supply) which will likely affect engagement.
- We support the CMA's initial view that public price announcement behaviour is likely to be consistent with unilateral incentives and not tacit coordination and we have explained to the CMA the unilateral factors that drive our price announcements.

### *Microbusinesses*

7. We note that the CMA proposes to further investigate the supply of energy to microbusinesses. There are several important features of supply to microbusinesses that differ from the domestic market. Microbusiness customers involve much higher levels of bad debt and business failure, so the risks for suppliers in serving microbusiness customers is typically much higher compared with domestic customers, justifying higher overall margins.

8. Further, the microbusiness market is currently going through a period of significant transformation, resulting in increasingly high levels of customer engagement and switching and significant reductions to margins (60% of microbusinesses reported switching supplier in the last five years in 2014 vs. 40% in 2013).<sup>2</sup>
9. Brokers are becoming ever more active in this market<sup>3</sup> and as the market evolves further to move from high levels of negotiated pricing to more transparent and standardised pricing, we anticipate the further involvement of Price Comparison Websites (PCWs).
10. We set out our views on updated theory of harm 4 in detail in paragraphs 34-134 below.

### *Regulatory Intervention*

11. We share the CMA's view that the general regulatory environment plays a crucial role in explaining the dynamics of competition in the energy market (both in upstream but particularly in downstream markets). We consider that the pace and breadth of regulatory change, and the lack of thorough evaluation of the impact of interventions before new change is introduced, are creating risk and instability in the markets, and preventing the full force of competition taking effect.
12. We also welcome the introduction of updated theory of harm 5 and agree that the nature and operation of Industry Codes warrants specific scrutiny. While we do not see evidence that smaller suppliers are excluded from influencing industry change as a result of Code governance processes, we do agree that there are opportunities for simplification to make the market work better and, in doing so, facilitate increased innovation and participation.
13. We set out our views on updated theory of harm 5 in detail in paragraphs 134-140.
14. In summary, Centrica considers that the evidence demonstrates that the operation of the GB energy markets is not consistent with a finding of any adverse effects on competition. We do recognise that there are ways in which the market could be improved, some of which are the responsibility of suppliers, including consistently higher levels of customer service and improved transparency, all of which would improve customer satisfaction.
15. Further improvements to the working of this market are emerging with the roll out of smart meters and increasing innovation to support customers' increased focus on consumption management. However, some other improvements need external support, in particular the need to ensure clarity and consistency of regulatory policy and intervention, and we welcome the CMA's focus on addressing this. Competitive markets are the most effective way of delivering optimal outcomes for consumers and the competitiveness of GB energy markets (both upstream and downstream) is of critical importance to Centrica in order that we can run our businesses efficiently.

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<sup>2</sup> Ofgem report: <https://www.ofgem.gov.uk/publications-and-updates/micro-and-small-business-engagement-energy-market-2015-quantitative-research-report>

<sup>3</sup> The same Ofgem report shows that 85% of small and micro businesses say that they have been approached by a TPI in the last 12 months and 38% report more than 10 contacts.

## RESPONSE

16. In the rest of this document, we set out our more detailed views on each of the Theories of Harm and related issues set out in the UIS.

### COMPETITION IN WHOLESALE ENERGY MARKETS (Theories of Harm 1-3)

17. Centrica supports the CMA's initial views that the wholesale markets in electricity and gas are working well. In our experience:

- Liquidity in the wholesale gas market is very good, and in the electricity market is sufficient to allow us to manage our demand requirements and optimise our power station output. Liquidity levels would not prevent independent market participants from replicating the hedging strategies of larger firms with generation businesses, should they choose to do so;
- Wholesale electricity prices are driven by market fundamentals, and wholesale prices are transparent;
- Competition in the generation market is strong, with a diversity of ownership of generation assets (especially among price setting plant) and many independent participants. Important operational and regulatory constraints also help to ensure that there is no material scope to exercise unilateral or coordinated market power;
- Our business model is rational for an energy retailer at scale, as our investment in upstream assets gives us important diversity and financial robustness that supports an investment grade credit rating. But we operate each of our businesses as a standalone unit and our structure does not restrict or distort competition; and
- Whilst the market rules and regulatory framework are complex, (because they have to balance the potentially conflicting policy goals of affordability, decarbonisation and security of supply), within this framework the markets are working effectively.

18. We therefore largely support the initial views on wholesale markets set out in the UIS, regarding updated theories of harm 1, 2, 3a and 3b (except as noted herein) and set out our views on each of them and related topics in the following sections, which follow the structure of pages 8-24 of the UIS.

### Market rules and regulatory framework

19. The wholesale electricity markets are underpinned by rules and regulations that are complex. This is not only because of the physical constraints of electricity supply, but also because they have been overlaid with specific policy objectives around decarbonisation and security of supply. The resulting market is transitioning from an "energy only" market to an "energy plus capacity" market, and by 2018 all new generation will be supported by either a low carbon or a capacity supplement. In future the wholesale electricity market might capture an ever smaller part of the value of electricity.

20. Within this framework, we are confident that the wholesale electricity market is working effectively, but it is the case that some of the interventions may have rendered the market less efficient at dealing with the additional policy goals in the most cost effective way, as well as adding further complexity to industry rules.

### *Self-dispatch*

21. Given the recent public concerns around the perception of opaque prices in the electricity market, we welcome the CMA's initial findings that prices in the current GB wholesale electricity market are accessible and not opaque.<sup>4</sup> The current GB system of self-dispatch is efficient, price formation is clear and reflects market fundamentals, anonymity exists and the market is accessible to all participants. We agree that the differences between the GB system of self-dispatch and systems of centralised dispatch are relatively minor.<sup>5</sup> Given this, we do not consider that moving to a system of centralised dispatch would be in the interests of consumers. Such a change would be very costly and risky (requiring the replacement of systems and processes, both centrally and across market participants) and it is unclear that a centralised system would demonstrate any significant advantages over the current system of self-dispatch to justify that cost and disruption.

### *Cashout prices*

22. We welcome Ofgem's reforms to the system of cashout prices and support the move to a single price for imbalances which is more 'marginal' than "PAR500". We are concerned that the "PAR1" methodology would produce very high, volatile cash out prices that would be difficult to predict and also implies a false degree of precision. We therefore favour a move to "PAR100" (at least as an initial stage). While we do not believe that the introduction of Reserve Scarcity Pricing (RSP) would lead to systematic overcompensation of generators,<sup>6</sup> we consider that it might be prudent to delay the introduction of RSP pricing until the effect of the Capacity Market and the other cashout changes are better understood.

### *Locational prices*

23. Cost reflective pricing can drive efficient use of the network, and locational pricing could help in this regard, but it has to be balanced with other objectives such as the ability of participants to respond to a new signal and its compatibility with other Government policy objectives. We believe that the implementation models that have previously been put forward for locational pricing have been flawed (in respect of ability to respond and compatibility with other policies), and we have been unable to support them, although we have been actively engaged with the debates around alternative solutions. See further our response on the relevant WP.

### *Capacity Market*

24. The absence of a properly functioning competitive market for setting the price of CO2 emissions has led to policies that subsidise renewable generation operating in the wholesale electricity market. We agree therefore, that there are now strong arguments for introducing a Capacity Market and we believe its design is competitive. See further our response to the relevant WP.

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<sup>4</sup> UIS, para 38.

<sup>5</sup> UIS, para 41.

<sup>6</sup> UIS, para 45 and 54.

### *Contracts for Difference*

25. Government objectives for promoting low carbon combine affordability with development support for emerging technologies, so we understand the rationale for having more than one auction pot. We do believe, however, that the allocation of technologies to the various pots needs careful management in order to allow the competitive process to minimise costs for consumers.

### **Market power in generation**

26. The CMA's assessment of the generation market (that it is unlikely that firms have the ability and incentive to withhold capacity<sup>7</sup>) is consistent with our own experience of the market, as is the CMA's initial view that profits in generation have not been excessive.<sup>8</sup> We observe wholesale power prices that are driven by the market fundamentals facing the sector – fuel costs, carbon costs and consumer demand. It is very important to model the practical constraints faced by generators operating in the GB market in order to reach robust conclusions, and we welcome the application of appropriate filters in the CMA's modelling process.

### **Wholesale gas**

27. We agree with the CMA's preliminary conclusion that the wholesale gas market is transparent and sufficiently liquid<sup>9</sup>, and we consider that the market is working well.

### **Vertical Integration**

28. We choose to invest in upstream assets as it gives us important diversity and financial robustness that supports an investment grade credit rating. This is an efficient business model for an energy supplier at scale. Our credit rating allows us to manage our risks efficiently. Other corporate models that support an investment grade rating would achieve the same aim.
29. We operate each of our businesses as a standalone unit. Each interacts extensively with the market in order to get a true measure of its performance. Importantly, despite our investments upstream, our self supply ratio is low (in 2013 it was 14% in power and 7% in gas). We do not believe that our structure is detrimental to liquidity, transparency or the functioning of competition, and so we welcome the initial views that the CMA has set out in the UIS.

### *Liquidity and Transparency of Prices*

30. We agree with the CMA's analysis that levels of liquidity are sufficient to allow market participants to trade and hedge, whether they are vertically integrated or not.<sup>10</sup> Power market liquidity could improve further, but we would caution against additional micro-level regulatory intervention which may have unintended consequences (such as mandating an extension to the product coverage of "Secure and Promote"). Instead, we concur with the CMA's initial view that a meaningful improvement in liquidity depends principally on

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<sup>7</sup> UIS, para 74.

<sup>8</sup> UIS, para 72.

<sup>9</sup> UIS, para 78.

<sup>10</sup> UIS, para 98.

attracting a broad range of market participants.<sup>11</sup> We therefore advocate market based measures that would attract additional participants to the market and increase the reasons to trade such as:

- reducing uncertainty around policy and regulation, including the UK Carbon Price Floor (CPF) and the impact of further EU financial legislation (such as MiFID II), as such risks are much greater than in the GB wholesale gas market;
- promoting exchange-based futures trading on the forward curve, in order to provide an alternative to broker markets; and
- supporting inter-connectivity between geographical markets, and continuing efforts to homogenise traded products across borders. We note, in particular, the likelihood of significant further investment in cross-border interconnectors and the benefits of harmonising DAH auction algorithms, as well as the GB market move to a standard Gregorian trading calendar as from October 2014.

31. We recognise the desire some participants may have for additional shaped products to be made available further along the curve. However we believe the market would provide those products if it was cost effective to do so taking account of risk. We reject the suggestion that we have the ability to shape differently from the market by virtue of our so-called vertical integration. In fact, the scale of our gas generation, CCGT running patterns and related hedging strategies fit poorly with the peak electricity supply requirements of British Gas. We do not use our generation fleet to internally provide additional shape for our retail business in the forward curve. We find the products available in the market adequate to manage the shape requirements to which we are exposed in a sizeable downstream portfolio.
32. We support the CMA's initial view that there are no significant problems with regard to transparency of wholesale electricity prices<sup>12</sup> – given the level of transparency offered via exchange-traded prices from APX and N2EX, ready access to Trayport prices for brokered OTC trades on payment of a modest fee, or the publications issued by price reporting agencies. We see no evidence to support a theory of harm that opaque wholesale prices are distorting competition.

#### *Market foreclosure*

33. We agree with the CMA's initial view that it is unlikely that a vertically integrated firm has the ability or incentive to foreclose generators or customers due to the anonymous nature of trading, and the commercial drivers that both generation and supply companies face.<sup>13</sup> In this context, we note the CMA observation that all the Six Large Energy firms are trading multiples of their electricity demand or generation output<sup>14</sup> and can confirm that this is the case for Centrica.

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<sup>11</sup> Liquidity Working Paper, 105.

<sup>12</sup> UIS, para 95.

<sup>13</sup> UIS, para 107.

<sup>14</sup> Liquidity Working Paper, para 27.

## COMPETITION IN RETAIL ENERGY MARKETS (Theory of Harm 4)

34. As we have previously noted, the theory of harm to which the UIS devotes most attention is updated theory of harm 4, that *energy suppliers face weak incentives to compete [...] due to inactive customers, supplier behaviour and/or regulatory interventions*. We have therefore focused a large part of our response to addressing that theory of harm, as summarised below.
35. The CMA suggests that large suppliers are insulated from competitive pressures for disengaged customers, pointing to evidence from the survey and analysis of gains from switching. However, the CMA's own survey suggests that many customers are confident in their current deal and/or in their ability to switch. While we accept that there may be a small number of customers who are not confident in their current deal and/or in their ability to switch, it is important to recognise that different levels of customer engagement are a common feature of many markets and we note that the energy supply has some atypical features (such as ongoing supply) which will likely affect engagement. Only 18% of customers said they would switch for a saving of £99 or less, which is consistent with our view of the engagement of customers and the value they place on non price factors. Moreover, when we consider the analysis of gains from switching we find that the CMA approach contains methodological flaws which overstate the gains available for comparable products. If we apply quite reasonable adjustments to the CMA's approach, the amount that customers can save falls below that required by most customers to switch according to the CMA's survey.
36. The CMA also suggests that the large energy suppliers may exert UMP over SVT customers through non competitive pricing. We have serious reservations about the characterisation of supplier behaviour and the drivers of it. In particular, we believe the CMA's analysis should recognise the impact of wholesale market volatility and price risk on the range of offers made to customers by suppliers.
37. Similarly, we consider that differential profitability across market segments can be better understood as a reflection of absolute and relative wholesale market risk.

### *Competition in the domestic retail energy market*

38. In paragraphs 39-134 we set out our views on:
- the **nature of competition** in the domestic retail energy market;
  - **supplier behaviour** in that market, including pricing and profitability;
  - the **engagement of customers**;
  - the CMA's review of **tacit co-ordination**
  - the **micro business** sector;
  - the **impact of regulatory interventions** on the market; and
  - the **broader regulatory framework**.

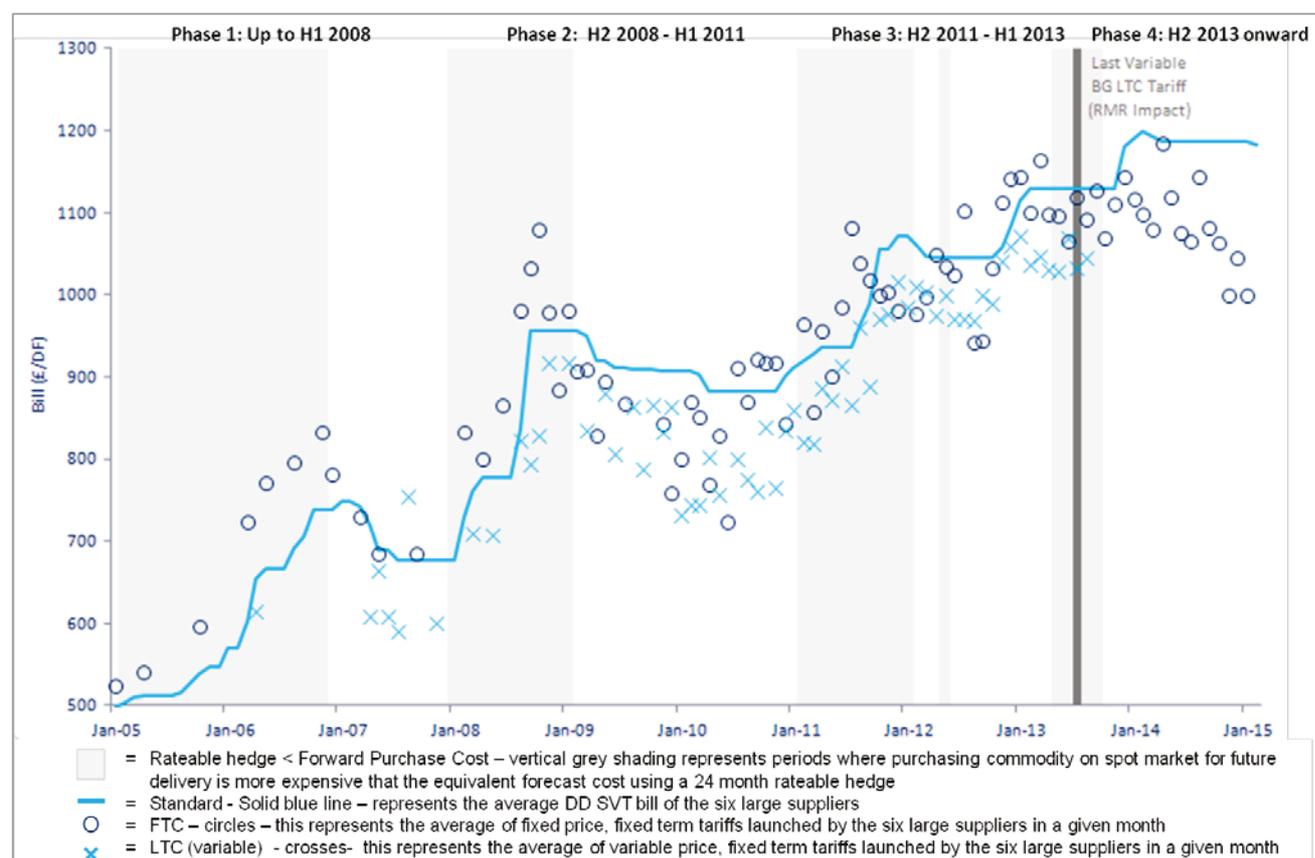
## Nature of competition

39. Our day to day experience of the retail market does not accord with the CMA’s hypothesis that there has been a “potential weakening of competition” for standard variable tariffs in recent years.<sup>15</sup> We work hard to win new customers from our competitors, and face strong competition for our current customers on a daily basis (whether on SVT or non-standard products). Our customer base is dynamic and engaged; we gain and lose around two million customer accounts each year. We invest in understanding our customers' needs and are constantly innovating to ensure that we are successfully meeting them (within the constraints of RMR).

### *The evolution of the market*

40. The evolution of the market since liberalisation, which is key to understanding the competitive dynamics observed today, can broadly be categorised into four phases, as outlined below.

**Figure A: Four phases of the energy market**



41. **Phase I – 1998 – H1 2008** - Following liberalisation (the gas supply market was fully open by May 1998 and electricity by May 1999), suppliers immediately saw the opportunity to convert their existing customers to ‘dual fuel’ and switching rates grew via field sales. Throughout the period, commodity costs rose steadily with suppliers either making losses

<sup>15</sup> UIS, para 126.

or very low margins. As competition became effective, retail price controls were removed (2002), switching continued to grow (for both single and dual fuel) and discounts to SVT became prevalent. By 2004, Ofgem concluded that most customers had now switched and that competition had “produced substantial benefits”. Products offered were still largely SVT, with discounts to that for different payment methods (e.g. Direct Debit, Advance Pay) but FTCs (with fixed prices) had been launched and were growing in popularity. The latter part of the period saw a boom economy.

42. **Phase 2 - H2 2008 - H1 2011** - Wholesale prices became extremely volatile, particularly in H2 2008 when they rose sharply (77%) and then fell back with retail prices having to rise and fall as a consequence. Wholesale prices then stabilised but the volatility led Centrica (and we believe, other suppliers) to a shift to longer hedging strategies. Some suppliers exited the market due to the volatility<sup>16</sup>. FTCs (usually longer term e.g. 2-5 years, fixed price and at **a premium to** SVT) became more popular. New products such as Fix and Fall (a capped offer) were introduced. The economic crash led to real incomes falling at the very point that energy bills were increasing through a combination of wholesale cost increases and environmental and social policies and customer concern about the affordability of energy became a key issue. Ofgem began to intervene in the market through the Energy Supply Probe in 2008, introducing SLC 25A to prevent “undue discrimination” between regional electricity prices, closely followed by the launch of the RMR. Part way through this period, the forward curve meant that FTCs were available at a discount to SVTs and new tariffs were created e.g. discounted online variable deals. Service improved, switching declined.
43. **Phase 3 - H2 2011 – H1 2013** - Wholesale prices increased, meaning FTCs became more expensive than SVT again. All major suppliers withdrew from field sales leading to a fall in switching rates - although over the period, switching was increasingly driven by pull channels (particularly PCWs), resulting in better quality switches (customers more likely to save money when they switch) and more positive engagement. Customers increasingly demanded simpler and fewer offerings: suppliers responded by improving market transparency, reducing the number of tariffs in market (including deep discounted tariffs) and introducing measures to meet customer demand for help in managing the cost of their energy.
44. **Phase 4 - H2 2013 – to date** - RMR concluded, introducing tariff restrictions, information remedies and new rules to ensure ‘fair’ treatment of customers. Suppliers withdrew niche products, cash discounts and other offers in response. Steeply falling wholesale prices enabled FTCs (post-RMR these are predominantly fixed price) at deep discount to SVT again. Switching to small suppliers reached record levels and increased their share of the market to its highest ever, driven in part by the rise of PCWs and collective switching.

#### *Standard variable and non-standard tariffs*

45. The market has evolved to provide different tariffs to reflect different customer attitudes to risk / volatility. SVTs smooth out the volatility in the underlying wholesale costs but create time lags between price and cost changes (which can attract negative media comment). FTCs, in contrast expose the customer more directly to the immediate wholesale price

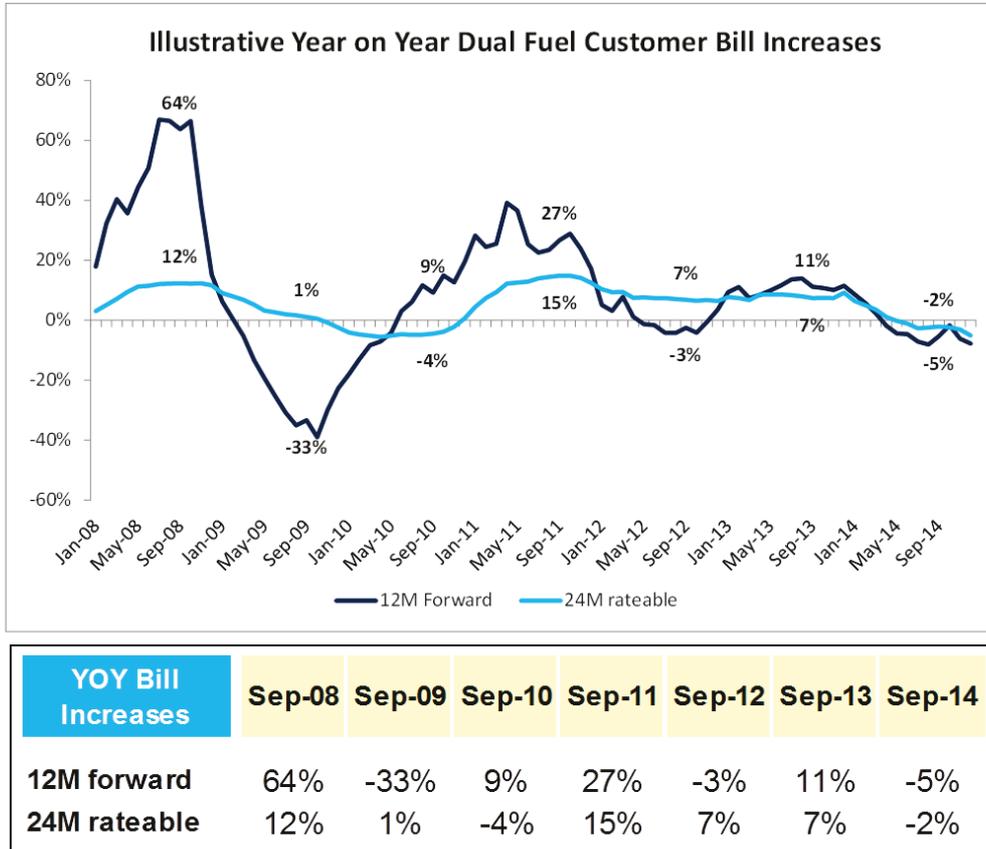
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<sup>16</sup> E.g. Bizz Energy and E4B (both non-domestic suppliers)

and potentially large price variations at the end of the fixed period. Some FTCs have been offered at a fixed price and others at a variable price (for example a fixed percentage discount to SVT) for the fixed term period.

46. As the Pricing Strategies Working Paper notes in Appendix A, over the period, we have offered a range of products to our customers (comprising a mixture of fixed, capped discounted, green and tracker products) in addition to our SVT.
47. Our different tariffs are designed to appeal to different consumer preferences to allow us to compete for as wide a range of customers as possible. A significant proportion of our customers buy products that fix or cap their price. Other customers have chosen tariffs or products explicitly by reference to account features – for example online account management, renewable electricity or a requirement to buy dual fuel.
48. Our SVT is hedged on a rateable basis to smooth potentially volatile prices, meaning that the customer experiences neither the extreme highs nor the extreme lows of the wholesale market in their retail prices. This relative price stability can represent a significant benefit to consumers. For example, if we calculate an implied customer bill increase at each point in time assuming that commodity is bought 12 months forward, or alternatively on a 24 month rateable hedging strategy, then we see that the 24 month rateable strategy generates substantially smoother prices than a 1 year forward product. Most strikingly, in 2008, during the period of steeply rising prices, a supplier with a 24 month rateable buying strategy may have increased prices by 12%, but a one year fixed price product renewed in September 2008 would have seen a 64% increase in price as illustrated in Figure B below. Significant benefits from price smoothing were also experienced by customers in the period from 2010 to 2012.

**Figure B: – Illustrative YOY Dual Fuel Price changes under 1 yr forward and 2 yr rateable hedging strategy<sup>17</sup>**



49. The relative prices of SVT and FTC products change materially over time, driven in particular by movements in wholesale energy markets. This is because there are different costs and risks associated with the ways we buy energy for the different products. In particular:
- Fixed priced products have typically had different weighted average cost of fuel ("WACOF") to our SVT because we have bought some, or all of the expected volume for the product back-to-back (ie we purchase forecast volumes at prevailing market prices at time of launch) and, on some occasions, different operating costs (e.g. limiting the pay types available on the FTC); and
  - For our SVT, and other tariffs without exit fees, our customers can leave us at any time. We bear significant volume risk here which we reflect in our price.
50. Our internal analysis indicates that, for the reasons stated above and excluding heavily discounted social tariffs, over the past five years we have earned broadly similar gross margins overall on our standard and non-standard products. For example, we have calculated what a hypothetical consumer (at average national consumption and prices) would have paid had they taken the British Gas SVT for the period 2007 to 2014,

<sup>17</sup> Graph illustrates the YOY bill increases that would have resulted from customers signing up to a YOY contract based on either a 2 yr hedging strategy or one year forward purchasing strategy. Analysis includes the impact of non-commodity cost increases at Ofgem's industry average consumption and with a constant indirect cost and net margin totalling £150.

compared to what they would have paid had they taken a series of the cheapest available British Gas fixed term, fixed price contracts (or SVT when no FTCs were available). Taking SVT would have been on average only £24 per annum more expensive over that period (approximately 2.5% of the SVT dual fuel direct debit bill).

### *Tariff pricing and bills*

51. In Figure 1 in the UIS, the CMA notes a widening gap between average SVT bills and expected direct costs from 2009. The CMA's initial view is that this appears to be consistent with a potential weakening of competition<sup>18</sup>. Figure 1 represents the six large suppliers, but the CMA's profitability paper (in Table 5) shows that margins for these suppliers have remained at between 3-4% from 2010 onwards. This reflects our own experience that bills for our SVT customers have fluctuated in line with costs over this period. We therefore contest any assertion that the gap between our costs and prices has increased materially.
52. Importantly, Figure 1 takes, as a starting point, a period when average retail profitability was unsustainably low. We note that, according to Ofgem's Consolidated Segmental Statement (CSS) reports, residential supply has been unprofitable for one or more of the major suppliers even since 2009,<sup>19</sup> and that prior to 2009, Ofgem's analysis suggested that a typical dual fuel customer would generate negative net margins.<sup>20</sup> Thus, the pre-2009 position cannot be regarded as sustainable and is not an appropriate starting point for the analysis (see further the section on Profitability below).
53. We believe there to be a number of significant differences between the assumptions used for the CMA's Figure 1 modelling and our experience in the market that explain why we have not, in reality, seen increased margins or profits since 2009. Specifically:
  - Commodity cost: Neither of the measures of commodity costs used by the CMA are a good proxy for the commodity costs we incur on our SVT. The one year forward view does not take into account the energy we have already bought for existing customers. There are also limitations in using Ofgem's SMI: for example, it does not reflect our hedge length over the period and assumes that any open volumes are valued at the same price as for those volumes purchased to date. This effectively ignores the fact that, at a pricing point, we would have purchased only a proportion of the commodity required and that the cost for the remaining volumes would be estimated using the forward curve. Finally, neither measure includes gas imbalance costs or the costs associated with electricity shaping and balancing activities;
  - Indirect costs: Neither metering nor opex costs have been included in the CMA's analysis. We believe these costs should be taken into account by the CMA in considering competitiveness, as many of them will (at least to some extent) vary with customer numbers, and even those that are fixed need to be covered over the medium to long term (against a background of falling consumption – see next point).

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<sup>18</sup> UIS, para 126

<sup>19</sup> See Ofgem's 2013 CSS summary: <https://www.ofgem.gov.uk/ofgem-publications/90701/css2013summarydocument.pdf>

<sup>20</sup> See Ofgem's SMI publications, e.g.: <https://www.ofgem.gov.uk/ofgem-publications/39779/january-smr-graphs.pdf> (each report contains 5 years historic data, so the January 2012 report is the most recent to show data from 2005/6): we do not agree with the SMI methodology, but unfortunately the CSS is not available prior to 2009.

Furthermore we note that these costs have been increasing over time and have become an increasingly large proportion of the bill; and

- Consumption: Actual consumption has varied significantly year on year, which impacts our ability to recover our non-energy costs. There is both a downward trend in consumption over time as well as significant weather variation in any given year. This makes standard consumption a poor reflection of customers' actual consumption. This is particularly seen in 2014, when the CMA's Figure 1 suggests margins were increasing, when in fact our profit was 26% down on the previous year.

54. As we discussed at our Oral Hearing, we have created our own versions of the CMA's Figure 1, based on our own data and assumptions we consider more appropriate.
55. Adjusting for actual commodity costs removes any widening in gross margin between 2009 and 2014. Aside from "pinch points" for gross margins at times of very fast rising commodity costs e.g. in 2008, the gap between direct costs (including commodity) and SVT price is otherwise broadly similar.
56. Overlaying the impact of indirect costs and actual consumption on both the costs and prices shows that SVT prices often do little more than cover total costs and that periods when SVT prices have returned a higher price than this are short-lived. It also shows the impact of ongoing consumption declines and differences in weather conditions from year to year (e.g. the warmer than usual weather in 2014) on the reducing gap between costs and prices since 2009.
57. While the CMA's analysis suggests industry margins have increased since 2009, our own analysis shows our margins are lower today than they were in 2009. Furthermore, while margins have increased from time-to-time, these have always subsequently narrowed. We have also faced regular periods of severe pressure on our margins. We consider that this further supports our argument that we face competitive pressure when deciding upon the pricing of our SVT.
58. We welcome the fact that the CMA plans to continue this analysis using company specific costs.<sup>21</sup> To this end, we are submitting updated evidence as part of our response to the Cost Pass-Through Working Paper.

#### *Competition for standard variable customers*

59. We strongly disagree with the hypothesis that we have unilateral market power over our SVT customers.<sup>22</sup> We experience significant competition for our customers, gaining and losing around two million customer accounts each year, a significant proportion of which are SVT customers. Our SVT prices reflect our competitive dual fuel positioning and our costs, with our gas and electricity prices are structured so that we can offer a competitive dual fuel price whilst maintaining a strong electricity price message to target both customers of other suppliers to switch to British Gas and to encourage our own gas customers to switch to dual fuel.
60. The SVT dual fuel tariff is an extremely high profile tariff and changes to it attract widespread media attention and close external scrutiny. We have invested significantly in

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<sup>21</sup> UIS, para 127.

<sup>22</sup> UIS, para 144.

above the line advertising (including TV) to support our “cheapest standard electricity” positioning, recognising the importance of, and competitive pressures on, the dual fuel SVT. Pressure on our dual fuel price position means we delay as long as possible before passing on increases to customers (in order to minimise customer losses) and have an incentive to cut prices as soon as we can when our costs fall (to win customers from our rivals and to retain our existing customers). We note that the CMA plans to carry out further analysis to test the so-called “rocket and feather” hypothesis – our own analysis of our SVT prices and our costs shows no picture of prices consistently leading costs up and following them down<sup>23</sup>.

61. An important part of our ability to remain price competitive is reducing our operating costs where possible and we are constantly reviewing them. Opex appears prominently in our widely available 'cost light bulbs' and we continually strive to deliver an improved service at a reduced cost. We have made savings of £350m per year from British Gas Residential (BGR) operational costs between 2007 and 2013.
62. We do not believe that a variance in energy suppliers' operating costs suggests weak competition or a lack of incentive for suppliers to reduce their cost base.<sup>24</sup> We note the submission of Professor Littlechild of 20 February 2015 (dated 24 March on the CMA's website) on this topic. We, along with many other suppliers, have invested in IT systems, e.g. we have just implemented a new customer relationship management system to drive more cost savings and improved service. These lumpy investments, in time, feed through to cost reductions that are passed on to consumers. However, in the short term they can lead to a supplier having higher indirect costs whilst systems are being implemented and bedding-in. We experienced this in 2005/06 (during the replacement of our billing system) and in 2013/14 (during the implementation of our new customer relationship management system).
63. In addition, customer mix affects opex and makes cost comparisons between suppliers problematic. For example we have higher than average amounts of prepayment customers – who cost more to serve - in contrast to smaller suppliers, which have focused on acquiring direct debit customers.

### **Profitability**

64. We support the CMA's approach of using EBIT margins to consider retail supplier profitability, which is consistent with the approach which we use in assessing our own profitability and which UK city analysts and credit rating agencies also use when assessing energy suppliers. EBIT margins have also been used by Ofgem to assess sector profitability (e.g. RMR, March 2011).
65. The CMA analysis has highlighted that large suppliers' margins have increased over time. However we believe that this is to be expected, as retail industry supply margins were very low pre-2009 (as stated above). Such low (or even negative) retail margins are not sustainable indefinitely in a competitive market. We would therefore expect the CMA's

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<sup>23</sup> See the CRA report on cost pass-through and rocket and feather allegations through submitted with our responses to the Working Papers

<sup>24</sup> UIS, para 147.

analysis to describe a return to sustainable competitive profit margins rather than a weakening of overall competition.

66. We note that the CMA is also considering calculating ROCE for energy suppliers<sup>25</sup> and is continuing to investigate how it might reflect the value of contingent capital present in existing large energy firms. Having considered the estimated WACC values proposed for this analysis, we are concerned that the business risks faced by energy companies, and the consequent impact on the cost of capital, are being significantly under-estimated in the CMA's current modelling. In particular, we believe that a standalone retailer would face substantial risks, requiring a cost of capital of approximately 12-15% rather than the 9-11% suggested by the CMA. Our working paper response considers this in more detail.
67. We recognise that the CMA has found margins on gas to be higher than on electricity and margins in B2B to be higher than in B2C. We believe that this is to be expected and is an accurate reflection of the relative risks<sup>26</sup>:
- Volatility in gas, both in terms of volume/demand (primarily related to the weather) and wholesale prices, is far more significant than in electricity which increases the risk for gas suppliers. For example, the weather can drive 30% YOY swings in gas demand.
  - In B2B, suppliers face far higher bad debt risk (and potential for significant one-off loss) than in B2C as well as greater cost exposure and capital strain from the longer term fixed price contracts prevalent in B2B.
68. We also recognise that the CMA has observed that British Gas earns comparatively higher margins in gas than other suppliers in the market. This reflects the fact that our prices are structured to help acquire rivals' electricity customers and promote dual fuel acquisition and retention. As previously outlined, we believe that domestic retail supply predominantly operates on a dual fuel proposition basis, and we therefore seek to ensure that our dual fuel offering is as competitive as possible. However, historically we have sought to balance this with our desire to grow our dual fuel customer numbers through converting our gas only customers into dual fuel by targeting the acquisition of their electricity account by leading with lower electricity prices (we believe the converse is true of our competitors who will seek to acquire our gas only customers), as well as acquiring new to brand dual fuel customers.
69. As a consequence of this pricing strategy, our gas margins have generally been somewhat higher than our competitors (although there have been occasions when SSE and Scottish Power in particular have recorded higher gas margins than us). Conversely our electricity margins have been significantly lower than the market average. Our balance of gas and electricity margins remains under constant review, taking into account our experience of customer gains and losses, reflecting rival offers in the market.

### **Engagement of customers**

70. The UIS suggests that there are a significant number of domestic energy customers who are relatively inactive and that this is based on analysis showing that there are

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<sup>25</sup> UIS, para 149.

<sup>26</sup> See our response to the Microbusinesses Working Paper and Profitability of retail energy supply

considerable gains from switching tariff and/or supplier, which currently go unexploited, and in part on the CMA's survey results.<sup>27</sup>

71. We do not believe engagement with the energy industry is low and we believe our view is supported by the CMA's own survey. In particular, the evidence suggests that:
- **Customer engagement is relatively high**, as is confidence in the switching process and switching rates themselves;
  - **Customer engagement is broader than just switching**, and in particular that customers engage to reduce bills, rather than just the price they pay per unit;
  - **Gains from switching analysis is not indicative of a lack of engagement**, given the availability of a range of price points for the marginal customer is consistent with a competitive outcome, and that to the extent that “unrealised gains” exist, they are substantially lower than the CMA suggests once like-for-like products are compared; and
  - **We actively seek ways to reduce barriers to switching**, and consider it in our interests to do so given we compete hard to win new customers.

*Customer engagement is relatively high*

72. Data from the CMA's own customer survey is consistent with our experience of an engaged customer base. It shows that nearly half of all customers have either switched or considered switching in the past three years, and that awareness of switching is high with 89% of respondents stating that they know they can switch. In addition, 76% found no difficulty when shopping around, 70% are confident in making the correct decisions when switching and 89% of those that did switch found no difficulty in switching. This indicates that barriers to switching are low.
73. The CMA survey shows that the energy switching rate also compares favourably with the other sectors the survey considered<sup>28</sup> and our own review of evidence from other comparable markets suggest that customer engagement in energy markets is relatively high<sup>29</sup>.
74. Data room analysis also shows that of the customers surveyed who have *not* switched (externally or internally) in the past three years, the majority are satisfied with their current supplier. A significant proportion also intends to switch supplier within the next three years and are confident that they can find a good deal by doing so.
75. This leaves a relatively small set of around 5% of customers who have not switched and do not intend to consider switching (or who are not confident that they will be able to do so effectively), yet are not satisfied with their current energy supplier. We note that these customers are if anything *less* likely to be in vulnerable categories (e.g. elderly, low income, social housing) than across the wider sample, and are, if anything, *more* likely to have internet access. For further details, see the CRA data room summary document to be submitted.

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<sup>27</sup> UIS, para 133.

<sup>28</sup> GfK Survey, section 4.5.1.

<sup>29</sup> See our response to the Gains from Switching Working Paper which includes an annex summarising our review.

76. Any suggestion of a long term decline in switching rates needs to be assessed carefully. Over time, fluctuations in wholesale prices have led to changing differentials between SVT and FTCs, which in itself drives switching. Doorstep sales and poor service levels also drove a peak in switching in 2008 but some of it was not good quality. In 2008, Ofgem found<sup>30</sup> that many gas customers who switched as a result of their own enquiries saved between 2-6% compared to a loss of 0.5-2% for those who switched through field sales. In electricity those who switched following their own enquiry saved between 3-5%, with those switching as a result of a field sales visit saving 1-5%. Since then, service levels have improved and complaints have fallen by 50% between 2009-13 (although they have risen since, driven, we believe, by increased negative media coverage). And today, online pull channels / collective switching are increasing and replacing doorstep sales with better quality switching.
77. Price comparison websites have played a significant and increasing role in facilitating switching in recent years. They are proving effective in engaging consumers, and are good for competition amongst suppliers. Ofgem's RMR Baseline Survey (July 2014)<sup>31</sup> showed that 44% of customers who switched reported having done so through a PCW.
78. Just recently, we have seen the impact of the DECC "Power to Switch" campaign on increased levels of engagement - our own tracking shows that, as a result of seeing the campaign, 23% of our customers are likely to find out more about switching, with 7% claiming to have already switched.

*Engagement or activity is about more than switching*

79. As the CMA notes, switching is not the only measure of competition in the market.<sup>32</sup> Customers who understand and are satisfied with their supplier and tariff should not be considered "disengaged" just because they have not recently switched supplier.
80. We contact all of our customers regularly to offer them a choice of tariffs (and our Tariff Checker is available online or via our contact centres at any time for customers). All of our products are open to all of our customers and are designed to encourage both external and internal switching. We would offer more tariff choices if we had freedom to do so, but we are prevented from doing so because of RMR tariff limits.
81. We also believe that, as shown in the CMA's survey, a range of factors other than price are considered essential or very important to customers when considering an energy supplier. In particular, good customer service was noted as the most important factor to customers (83%) when asked.<sup>33</sup> We compete on service, with metrics improving significantly recently (e.g. contact NPS now +26 from -6 at the end of 2013) and invest in innovation to engage customers.
82. The CMA survey also showed that 73% of customers are satisfied with their current supplier<sup>34</sup> and 70% were confident that they are on the right deal.<sup>35</sup> As regards our customers, we believe positive feedback is reflective of the hard work we have

<sup>30</sup> <https://www.ofgem.gov.uk/ofgem-publications/38437/energy-supply-probe-initial-findings-report.pdf>

<sup>31</sup> <https://www.ofgem.gov.uk/ofgem-publications/89113/ofgemrmrbaselinefinalpdf.pdf>

<sup>32</sup> UIS, para 134.

<sup>33</sup> GfK Survey Report, para 90.

<sup>34</sup> UIS, figure 23.

<sup>35</sup> GfK Survey Report, para 120.

undertaken to improve customer satisfaction, investing significantly both to understand our customers' needs and to deliver better service to customers. As part of this, we track the satisfaction of our customers during their different interactions with us, including when they contact us and when they move home, and leave or join us as well as investing to understand the root cause of complaints.

83. A crucial finding from the survey is that customer trust in the energy industry as a whole is much lower (at 27%) than their trust in their own energy supplier (62%) and the proportion of customers who are satisfied with their current energy supplier is even higher (70%). The disparity between the trust figures suggests that customers view their actual experience of engaging with their supplier more favourably than they perceive the industry as a whole. For British Gas, this is particularly acute as we regard our brand as an important aspect of our engagement with customers, offering trustworthiness, service quality and security of supply. Our customers expect us to strive to provide dependable service and to resolve issues quickly. We have to live up to these values and do so through the positioning of our products and services. Failure to live up to these values damages our brand and the commercial impact is magnified by the level of media and regulatory scrutiny on us.
84. We innovate continually (within regulatory constraints)<sup>36</sup> in order to differentiate our offering in response to customer demand and competitor offers. We have developed innovative tariffs, such as Fix & Fall, and Free Saturdays (on smart), which have been popular with our customers, launched our Tariff Checker, the predecessor to Cheapest Tariff Message, (which was subsequently mandated by Ofgem to be provided by all suppliers) and new products, such as Hive, which allows customers to manage their heating remotely. These products have proved effective in engaging customers: 40% of customers with Hive report using it twice a day and our Brand NPS score for Hive customers is +18. We are also already seeing the service benefits of smart meters to our customers such as the end to estimated billing (the largest source of complaints).
85. The UIS makes little reference to the other significant form of engagement we see from our customers: consumption reduction. Customers tend to be more concerned about the overall level of their bill than the price they pay per unit and, primarily due to weather, energy bills are difficult to predict. Therefore the engagement of customers in reducing their levels of energy consumption should be an important additional consideration. In recent years we have seen significant declines in our customers' actual consumption (15% in electricity and 25% in gas since 2005). These declines reflect greater awareness of energy efficiency measures promoted by energy suppliers to customers and this is a trend we expect to continue as smart meters are rolled out and further energy management and connected home technologies are enabled.
86. This is an important respect in which the energy sector differs from other sectors such as motor or home insurance. In these sectors, consumption, and hence annual cost, is fixed at the point of sale. However, in energy the choice of product can have less impact on the annual cost than consumption.

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<sup>36</sup> UIS, paras 154 – 174.

87. Suppliers have been encouraged to engage with customers on this topic by promoting energy efficiency products and services to meet their energy efficiency obligations (such as CERT and ECO). It is therefore rational for customers to seek greater engagement with their energy suppliers by demanding an enhanced service (e.g. clearer bills, online data access, mobile apps, energy saving advice, smart) or by remaining with a supplier they trust to provide this service. We see the importance of service to customers reflected in the CMA survey.<sup>37</sup> This is indeed what we have experienced in the market and is a clear reflection of customer engagement which is not captured by switching metrics.

#### *Gains from switching*

88. The UIS identifies material gains that can be achieved by consumers from switching suppliers.<sup>38</sup> While we have some concerns with the analysis of differentials presented by the CMA (set out below), we do believe that the existence of gains from switching is entirely consistent with competition. Indeed, our review of available evidence from comparable markets suggests that such gains are a common feature of many markets<sup>39</sup>.
89. In terms of comments on the CMA's analysis, we would firstly note that there appears to be an underlying assumption that energy products are homogenous (and therefore that it is reasonable for units of energy to be priced identically). Rather, we would suggest that there are different costs associated with different forms of supply, different levels of service and assurance inherent in the products (fixed, variable, etc) and the non-price components of the offers made by different suppliers.
90. Secondly, we do not believe that the CMA's measurement of "gains from switching" can be interpreted as a measurement of customer "disengagement". This is particularly the case for the CMA's Scenarios 1, 2 (internal) and 4 (external), which calculate the gains if customers were willing to change tariff and/or payment type. Customers cannot be considered to be "disengaged" on the basis that they prefer the characteristics of one product over another, and therefore do not want to switch to an alternative product with different features in return for a certain level of saving.
91. The CMA's analysis also does not appear to control for prompt payment discounts that were offered to many cash and cheque customers during the period examined by the CMA (and therefore will have reduced the potential gains from switching to direct debit terms for those customers, even if they were willing to make that switch), or the £140 Warm Homes Discount (WHD), which is deducted from the bill, but not reflected in lower unit prices. Small suppliers have not offered WHD, so the savings available to vulnerable customers switching to smaller suppliers may be overstated, which will again impact average savings.
92. Moreover, even in the CMA's Scenario 3 there are important product characteristics that are not controlled for. For example, this scenario still assumes that customers place no value on significant differences between products (e.g. whether the product is online only or requires payment in advance), or for the role of exit fees or the value customers may place on tariffs that give price-certainty (even if a short-term saving could be made by

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<sup>37</sup> See figure 32, for example, which shows that good customer service is on average the number one factor for customers when considering a supplier.

<sup>38</sup> UIS, para 134.

<sup>39</sup> For details of this review please refer to our response to the Gains from Switching Working Paper.

giving up some or all of that assurance). Further, the CMA does not state that its analysis controls for whether products were widely available or only in limited numbers, or for suppliers operating at very small scale with niche marketing strategies.

93. Our economic advisers, CRA, have used the gains from switching data disclosed in the data room to test what the impact on results would be if these controls were applied for online tariffs, advance payment tariffs, and including only tariffs offered by the Six Large Energy Suppliers and the four largest independents. This brings down both the proportion of customers who can save, and the amount they can save. Specifically, the CMA's Scenario 3b indicates that 80-94% of customers (90% on average) can make average savings of £111-153 (a weighted average of £134). By contrast, including only tariffs from the Six Large Energy Suppliers and the four largest independents and controlling for online only and advance payment tariffs reduces this to 39-72% of customers (63% on average) who can save £49-105 (a weighted average of £81): a level that is below that required by most customers to switch according to both an Ofgem survey<sup>40</sup> and the CMA's own survey: according to the GfK survey, only 18% of customers said they would switch for a saving of £99 or less.<sup>41</sup> CRA's analysis also shows that taking account of exit fees and value placed on fixed term contracts would also reduce the apparent gains available.
94. We strongly believe that the CMA should update its analysis to apply controls for these factors, and to take account of the other dynamic and practical considerations raised by the CRA analysis (a summary of which will be submitted to the CMA under separate cover), as well as the issues in Centrica's Gains from Switching Working Paper response, in order to get a more accurate picture of the extent to which customers are willing to switch.
95. We note the allegations from certain small suppliers that the large suppliers cross-subsidise short term protective tariffs through the exploitation of inert legacy customers.<sup>42</sup> We do not cross-subsidise any of our tariffs with revenues generated by other customers in the British Gas base and we do not exploit less engaged customers to adopt "loss-leader acquisition tariffs" as suggested.<sup>43</sup> We therefore strongly contest any allegation that cross-subsidisation acts as a barrier to expansion for small suppliers as can be seen from their increasing growth in recent years.

*We actively seek ways to reduce barriers to switching*

96. We note the CMA's focus on perceived consumer barriers to switching. British Gas was among the first companies in the industry to implement faster switching (and, as we note below, we led the industry Code change needed to implement it), and we seek to offer as good a service to customers who switch away from us as we do to those joining. Moreover, the industry as a whole is now moving towards faster switching. We observe (from the CMA's own survey) that many of the customers who have negative perceptions

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<sup>40</sup> Ofgem's RMR baseline survey 2014 found that approximately 80% of customers require greater than £100 saving to switch (and around half of them require greater than £200).

<sup>41</sup> GfK Survey Report, Figure 70 page 75, based on Question F5.

<sup>42</sup> See for example the comments from Ovo and Utility Warehouse at para 117 and 123 of the Retail Barriers to Entry and Expansion Working Paper.

<sup>43</sup> Para 123, Retail Barriers to Entry and Expansion Working Paper.

of switching have not recently switched themselves,<sup>44</sup> and that those who have, found it easy.<sup>45</sup> In addition, the survey evidence suggests that those customers who have switched for cost reasons have confidence they have saved money.<sup>46</sup> The roll-out of smart meters will serve to further improve the switching experience for customers.

97. We also see an increasing importance of “pull channels” such as Price Comparison Websites (PCWs) in the switching process. We are seeing a larger proportion of switches happen online and expect this to be sustained as internet penetration is now high (Ofcom report 84% of households now have internet access<sup>47</sup>), and continues to grow across all demographics.
98. We consider that, as a default, PCWs should show all tariffs available to consumers. Where PCWs show a more limited subset of tariffs, consumers should understand what tariffs they are seeing and whether the site will earn commission for a switch to that tariff. However we also believe that the requirements on PCWs should not become so burdensome that they become unattractive to consumers or threaten PCWs’ ability to operate in the market.
99. Local authorities, PCWs and other groups are increasingly organising collective switches, in which we have been successful participants<sup>48</sup>. Although not all will have switched as a result, since 2012, 1.66m customers have registered for a collective switch.
100. Finally, we believe the full roll-out of smart meters, recently confirmed again by the Government, will help improve the switching experience further – ending estimated bills, giving customers even easier access to their data, improving industry processes and further engaging with their energy use. As the CMA notes, this will bring benefits by reducing barriers to switching and increasing customer engagement more broadly<sup>49</sup>.

#### *Historical Incumbency and the effect on customer behaviour*

101. The UIS refers to 40% of Centrica’s gas customers who have been served by Centrica for more than ten years. We consider that this overstates the level of and impact on customer behaviour of incumbency.
102. Of our original gas base of 19m customers (which we started with at market liberalisation), only 0.5m have remained in the same state since. This means that 18.5m gas customers have bought electricity from us, switched supplier and come back, moved home, changed tariff and/or changed payment type. We have previously discussed with CMA that there are some customers who are difficult to engage (including off gas grid electricity customers who are not eligible for a dual fuel proposition, or those customers who have actively opted out of our marketing communications).

#### **Tacit Coordination**

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<sup>44</sup> See e.g. figure 37.

<sup>45</sup> For instance, 64% of respondents who had switched in the last three years found the overall task of shopping around had been easy or very easy. GfK Survey Report, para 108.

<sup>46</sup> 93% of those who said they had switched for cost reasons were confident that they would actually save money. This contrasts with reports from Ofgem’s Supply Probe, where customers sold to on their doorsteps did not report savings

<sup>47</sup> ONS: Internet Access – Households and Individuals 2014

<sup>48</sup> British Gas has won three collective switches in the last six months, two for pre-pay customers and one for direct debit customers

<sup>49</sup> UIS, para 143.

103. We do not believe that conditions exist in the market which would allow tacit coordination to occur:
- While general energy costs will move in a similar manner for different suppliers, the magnitude and speed of change will vary as a result of varying hedging strategies. The combination of the different cost bases and different commercial strategies means that suppliers' incentives will not be consistently aligned over time – creating incentives to capitalise on periods of cost advantage to cut price and win customers.
  - We recognise that transparency in the market has increased since the publication of Consolidated Segmental Statements (CSS), but, given the historical nature of the CSS, and variability of hedging strategies over time, we do not believe transparency is sufficiently high to significantly improve the feasibility of coordination.
  - As regards external sustainability, the CMA is right to identify the growth of independent suppliers in recent years as mitigating any risk of coordination.<sup>50</sup>
104. We note the CMA's initial view that public price announcement behaviour is likely to be consistent with unilateral incentives.<sup>51</sup> Suppliers face similar, but independent incentives to change price which can result in price changes happening broadly around the same time, driven by (i) the fact that a large proportion of the bill is regulated, which means that a significant proportion of suppliers' cost base changes by a similar magnitude at a similar time and (ii) the additional risk of large customer losses for the first supplier to increase prices. We note the CMA's finding that supplier pricing intentions have not changed post announcement in response to other suppliers' announcements.<sup>52</sup> The existence of significant lead times in preparing for price increases is such that once we have decided to effect a change this cannot be varied in response to other suppliers' price announcements.

### **Micro business customers**

105. There are features of supply to microbusinesses that differ from the domestic market and which are key to any market review. In particular, microbusiness customers are much more likely to buy on a single fuel rather than a dual fuel basis and sign longer term fixed contracts than domestic customers. Customer attributes can also be very different – most notably in terms of higher levels of debt and business failure, so the risk to suppliers of serving microbusiness customers is typically much higher compared with domestic customers.
106. This market has evolved rapidly in recent years and we are currently operating in an intensely competitive environment. Ten new entrants in 2014 alone mean there are now 35 suppliers active in the business market, 29 supplying SME customers. There are high levels of engagement and ever increasing levels of switching. As a result, we are losing market share and face rapidly and dramatically reducing margins. We have responded to this increased competitive pressure and a major transformation is under way as seen by the ending of the practice of auto-rollovers, and increased focus on cost reduction and improving customer service.

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<sup>50</sup> Tacit coordination Working Paper, para 33.

<sup>51</sup> UIS, para 153.

<sup>52</sup> UIS, para 152.

107. Whilst PCWs are increasingly the key driver of switching of domestic customers, in B2B it is brokers that play a very active role, driving around 50% of switching activity. 85% of micro and small business respondents to Ofgem's 2014 survey<sup>53</sup> said they had been approached by a TPI in the last 12 months and 38% reported more than 10 contacts.

### *Customer Engagement*

108. Our experience of the SME market does not suggest there is generally low customer engagement. We have seen the proportion of SME customers who switch or renegotiate at renewal increase from 2009 to 2014, showing high and increasing levels of engagement. Findings from a survey commissioned by Ofgem in 2014<sup>54</sup>, shows that 60% of small and microbusiness reported switching supplier in the last 5 years vs. 40% in 2013 and just under half (47%) have looked into other supplier or tariff options in the last 12 months. In addition, this survey shows that 84% of fixed-term contract customers know when their contracts ends and 73% know when they are able to start negotiating or give notice of termination, higher figures than in 2013. The survey quoted by the CMA also shows that for 77% of the microbusinesses surveyed, their existing contract is either the first one with the current supplier (36%) or a negotiated renewal (41%).<sup>55</sup> We have seen a continuing increase in engagement of customers at the point of contract renewal since we ended the practice of auto-rollover contracts in 2014.

109. We agree with the CMA's initial assessment<sup>56</sup> of the benefit of providing negotiable quotes to non-domestic customers. Non-domestic customers have different characteristics to domestic consumers and pricing in this way allows suppliers to offer prices tailored to a customer's specific pricing variables.

110. We make significant efforts to remind customers of the benefits of engaging – contacting them at least three times in the renewal process – and providing contract end date and renewal options visible on every bill.<sup>57</sup> The same Ofgem commissioned survey referred to above found that 71% of microbusiness customers were satisfied with the information provided on available tariffs and options.<sup>58</sup>

### *Role of brokers*

111. Many microbusinesses will be contacted by brokers as well as their own suppliers to change supplier or renegotiate contracts. 85% of small / micro business respondents to Ofgem's 2014 survey had been approached by a TPI in the last 12 months and 38% reported more than 10 contacts. This indicates that smaller businesses represent an attractive commercial opportunity for brokers. Smaller suppliers have grown by using brokers because this allows them to compete without the need for a large, internal sales force or marketing presence.

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<sup>53</sup> <https://www.ofgem.gov.uk/publications-and-updates/micro-and-small-business-engagement-energy-market-2015-quantitative-research-report>

<sup>54</sup> <https://www.ofgem.gov.uk/publications-and-updates/micro-and-small-business-engagement-energy-market-2015-quantitative-research-report>, page 3.

<sup>55</sup> Quantitative Research into Non-Domestic Consumer Engagement in, and Experience of, the Energy Market, Report for Ofgem by The Research Perspective Ltd and Element Energy Ltd, December 2013, page 30.

<sup>56</sup> Paragraph 78 of the Microbusiness Working Paper

<sup>57</sup> <https://www.ofgem.gov.uk/ofgem-publications/85187/non-domquantfinalforpublication181213.pdf>, page 6.

<sup>58</sup> Ibid, page 15.

112. We believe that brokers who act in the best interest of consumers have the potential to play a beneficial role in the market today. We recognise that there are some concerns about transparency of broker commissions and we have supported Ofgem's work on developing a Code of Practice for brokers.
113. Broker usage tends to be more common with larger businesses as they benefit more from some of the added value activity that some brokers offer (e.g. invoice validation for multi-site customers). However, our experience is that microbusiness customers often use brokers to compare prices across the market but then engage with their chosen supplier directly, resulting in an understatement of the impact of brokers in this segment.
114. We agree with the CMA's view that PCWs can reduce search costs for customers<sup>59</sup> and believe that the development of this service in the non-domestic sector would benefit customers. Until recently, many business customers were automatically rolled onto renewal contracts after short renewal windows (periods in which they were able to switch freely). This limited the opportunity for switching sites to develop and encouraged push sales by brokers in the short periods in which customers could move to a new supplier. As auto-rollovers are now becoming less common in the industry we believe that the conditions will be right for PCWs to grow and we support this.
115. We already supply full price books to third party intermediaries (TPIs), including online TPIs, e.g. [makeitcheaper.co.uk](http://makeitcheaper.co.uk), and would welcome the opportunity to do the same for PCWs.

#### *Price Transparency*

116. We believe that microbusiness customers have good access to suppliers' prices. Customers and prospective customers can get a firm quote from our website within two minutes and we supply price books to all TPIs we work with. Pricing is more complex than for non-domestic customers, as there are many more pricing variables, such as meter types and configurations, and significant variations in energy usage amongst customers. However we have invested heavily in our pricing systems in order to manage this complexity on behalf of our customers. Non-domestic customers are now able to receive a quote if they provide us with the same data as a domestic customer.

#### *Margins by product and tariff*

117. As noted by the CMA,<sup>60</sup> suppliers incur additional costs in relation to deemed and out of contract customers. Our deemed tariff is a temporary price for customers who have moved into premises that we supply. It is generally higher than our negotiated prices as a result of two primary factors:
- The higher debt risk that these customers represent; and
  - The higher price and volume risks to which we are exposed because these customers do not have fixed term contracts and can switch at any time. We contact our deemed customers regularly to encourage them to upgrade to a fixed term contract. The messaging included on every invoice also prompts them to contact us and agree a new fixed term deal.

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<sup>59</sup> Microbusiness working paper, para 80.

<sup>60</sup> UIS, para 189.

118. In 2014, we replaced auto-rollover with a Variable Price Plan (VPP) product. Customers who choose not to renew their contracts move onto this product and are able to switch with 30 days' notice or negotiate a fixed term contract at any time.

### **The impact of regulation on the retail sector**

119. We share the CMA's view that the regulatory environment (and frequency of regulatory change) plays a crucial role in explaining the dynamics of competition in the energy market. Our concerns with regulation have been the pace and breadth of regulatory change, particularly in recent years, and the lack of thorough evaluation of the impact of interventions before new change is introduced. This creates uncertainty, and adds risk to energy supply. It also fails to allow the forces of competition to play out.

120. Additionally, the scale and breadth of retail regulation today is such that it shapes many of the key interactions we have with our customers: the type and number of offers we can make to them, the discounts we can offer, the content of our written communications (including bills) and our conversations. This has reduced the scope for suppliers to competitively differentiate themselves. And initiatives from Government, such as the criteria for the Warm Home Discount (where we have previously based payment on wider criteria than our competitors) further compound this.

121. Clarity over the way "fairness" should be reflected in Ofgem's decisions is particularly important, given the potential tension between decisions that deliver "fair" and "competitive" outcomes. While we recognise the special provisions required for vulnerable customers, we do not believe that fairness should equate to standardisation of outcomes, given the detrimental impact this may have on competition.

122. The CMA's continued focus on regulation is understandable given the way that the regulatory framework has shaped competition since liberalisation. We also agree that the nature and operation of Industry Codes ("Codes") warrants specific scrutiny (see further below).

### *The pace of regulatory change*

123. Our primary concern has been the rate and scale of change of regulation, particularly in recent years. In almost every month since March 2008<sup>61</sup> the retail market has been subject to either a major Ofgem investigation or employed in implementing remedies from the previous investigation. This has occurred on top of the 'day to day' regulatory change to Industry Codes, working practices and licence conditions, and in addition to reviews into topics such as vulnerability. For example, Ofgem completed the Energy Supply Probe in October 2009 and then mandated the implementation of a number of measures by July 2010 including SLC25A. Just four months later Ofgem announced another major review of the retail market: the Retail Market Review (RMR).

124. The constant cycle of review and change has created uncertainty over the future regulatory framework in an already complex retail market. It has also made evaluation of change and behaviours difficult because the rules tend to change even whilst the market is developing in response to the previous version.

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<sup>61</sup> The start of the Energy Supply Probe.

125. It is also our view that, if the market is left to work, it will come to the right answers. Consumer pressure had started to reduce the number of tariffs in the market when Ofgem's RMR proposed a cap. That cap is now stifling innovation, an example of the unintended consequences of excessive regulation. If allowed to continue, there is a risk that the retail market becomes less efficient (an outcome we highlight above in relation to the wholesale market).

#### *Regulatory changes – SLC 25A*

126. SLC 25A (the undue discrimination clause) was introduced following concerns that the use of regional price discrimination (between their in and out of area electricity prices) by incumbent electricity suppliers was excessive. Following the introduction of SLC 25A we focused our competitive efforts on leading with a national 'cheapest electricity' message in an effort to win customers from our competitors. In this respect whilst SLC 25A was in place, we continued to compete with competitive SVT prices to win customers.

127. SLC 25A contained a specific exemption from non-discrimination for offers targeted at customer acquisitions. This led to a proliferation of such offers in the market but, over time, and in response to customer feedback, suppliers started to reduce their number of offers. However, without allowing time for the market to self-correct, Ofgem introduced specific regulation through RMR to limit the number of tariffs suppliers were able to offer.

#### *Regulatory changes – Retail Market Review (RMR)*

128. Whilst we agree with the aims of the RMR (that energy should be simpler, clearer and fairer for customers), we believe that elements of these reforms have had a mixed impact, with some aspects potentially damaging competition. We were pleased to note that although Ofgem considered prohibiting dual fuel discounts, this part of the RMR proposals was dropped. Consumer Focus noted, at the time, that the removal of that discount would risk impacting customer engagement (because customers value a dual fuel relationship).

129. Some elements such as the Cheapest Tariff Messaging (CTM) are likely to have encouraged switching, however the benefits of other elements are less apparent, for example the removal of acquisition and prompt payment discounts. Although it is still early to assess the full impact of the RMR, we know that these discounts were valued by customers and enhanced suppliers' ability to compete effectively. We believe that their removal is likely to have reduced customer engagement and thus damaged competition. The fact that RMR allows PCWs to offer cash sign-up incentives to customers whilst prohibiting suppliers from doing so themselves is a continuing inconsistency in the current regulations.

130. We have also observed that the tariff cap, whilst making choice simpler for customers, has also resulted in a number of tariffs being withdrawn. Since its introduction, suppliers have faced strong commercial incentives to offer the four tariffs that have the widest appeal. This has led to niche offerings such as low carbon or low standing charge tariffs being withdrawn by some suppliers, as well as the removal of social tariffs. It has also limited innovation, with suppliers that already have four tariffs needing to apply to Ofgem for derogation to launch (or even trial) any potential new tariff. These limitations are likely to have had a negative impact on customer engagement, and also therefore on competition.

131. We also believe that the way the information remedies have been implemented has, in some places, created problems. For example, whilst the Personal Projection provides customers with valuable information designed to help them make an informed decision, the rules around how and when it is communicated to customers mean that it can contribute to long and heavily scripted conversations that customers find unengaging. The Tariff Comparison Rate we are obliged to give customers is calculated on average, rather than the customer's own consumption which we consider confusing to customers, and most of the bill format is now regulated by Ofgem, making it impossible for us to introduce more customer friendly bill formats.
132. Today's bill format is heavily determined by regulation and is highly prescriptive, removing any opportunity for suppliers to differentiate a key communication to customers (and one which drives most contact).

#### *Increasing drive for homogenisation*

133. We welcome Ofgem's move towards principle based regulation. However, we have significant concerns regarding the way in which Ofgem is implementing Standards of Conduct, and specifically its approach to the definition of fairness. We do not believe that a "fair" outcome is necessarily a "standardised" outcome. Instead, we consider it fair that customers who invest more time in trying to find a price or product that best suits their budget or needs should be able to choose products that suit those needs, even if that results in outcomes that differ from the average customer. The only customer grouping where we consider it may be reasonable for outcomes to be more standardised is vulnerable customers.
134. Finally, we are concerned by the recent intervention on service standardisation from both DECC and Ofgem. Prescriptive Codes around end of term Direct Debit treatment (immediate refunds over £5) and credit balances, as well as pre-payment meters, are limiting our scope to use high quality, customised service and choice as a source of competitive differentiation. Whilst these may have short term benefits for some customers, longer term they stifle innovation and reduce competition between suppliers.

#### **BROADER REGULATORY FRAMEWORK (Theory of Harm 5)**

135. We agree that the nature and operation of industry Codes warrants specific scrutiny. We also agree with Elexon's comments (referred to in the UIS) that there are too many retail electricity Codes and that rationalising them would reduce the time required to effect change.<sup>62</sup> It is also the case that these Codes are complex, having evolved organically over time in response to each new industry initiative, as opposed to by some centrally co-ordinated industry design. They are consequently a product of the complex industry structures and processes underpinning the energy markets.
136. To some extent, these industry Codes are 'a necessary evil'. For example, they set out in detail how common industry processes such as settlement and reconciliation will work with many different customer classes and meter types, in an industry reliant on estimated and periodic data. Without such technically detailed agreements, costs could not be

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<sup>62</sup> UIS, para 197.

allocated accurately between suppliers and customers, and competition could not operate effectively.

137. We do not believe that the number of Codes acts as a material barrier to entry or expansion, and note that support is already provided to help smaller parties navigate Codes, for example through Code Administrators acting as 'critical friends' or through the joint working group for smaller suppliers set up by Ofgem and DECC. Smaller suppliers are collaborating to share attendance at Code meetings and, increasingly, we are seeing more changes being proposed by smaller suppliers. It is also not the case that Centrica frustrates the proposals of others. All change (irrespective of who has raised it) needs to undergo an objective cost benefit analysis and where we have intervened in a process, it is because we do not believe the benefits justify the costs (as was the case for electricity half hour settlement). In addition, all Code modification proposals – whether accepted or rejected by the relevant Code Panel – can ultimately be determined by Ofgem (either through the usual operation of Code governance processes, or under appeal).
138. We do recognise that there are, however, opportunities for simplification to make the market work better and, in doing so, facilitate increased innovation and participation – particularly with regard to the 'downstream' part of the industry where underlying industry processes will significantly simplify as a result of smart metering (something we flagged as a possibility at the start of the smart meter programme). Other elements of Codes today, for example how to allocate costs between suppliers based on infrequent or estimated meter readings will become redundant post smart.
139. Upstream, we also agree that the Codes should be reviewed to see if simplification is possible. Many Codes have developed to encompass the changing characteristics of the generation and wholesale markets over the years. However, the nature of the Codes in this area often reflect the complex and technical nature of the upstream systems, and are needed to control significant risks inherent in connecting to and using the electricity network.
140. For a number of years, we have been actively seeking reform of Codes and a greater pace of change, particularly in the retail markets. We suggest the introduction of simpler governance, including imposing appropriate time limits for change processes. We believe the CMA's investigation will be helpful in this area.

## Annex A: List of Working Papers and Responses

<b>CMA Working Paper title</b>	<b>Centrica response document title (or comment)</b>
1. Descriptive statistics: generation and trading	<i>n/a - no specific response submitted</i>
2. Liquidity	WP Response – Liquidity
3. Wholesale electricity market rules	WP Response - Wholesale elec market rules
4. Market power in generation	WP Response - Market power in generation
5. Foreclosure	WP Response – Foreclosure
6. Wholesale gas market	WP Response – Gas wholesale market
7. Locational pricing in the electricity market in Great Britain	WP Response - Locational pricing
8. Capacity	WP Response – Capacity
9. Descriptive statistics: retail	<i>n/a - no specific response submitted</i>
10. Price comparison websites	<i>n/a - our views are covered within our UIS response</i>
11. The pricing strategies of the Six Large Energy Firms in the retail supply of electricity and gas to domestic customers	WP Response - Pricing strategies
12. Customer survey: GfK Report	WP Response - Customer survey
13. Analysis of the potential gains from switching	WP Response - Gains from switching
14. Cost pass-through	WP Response - Cost pass-through
15. Microbusinesses	WP Response - Microbusinesses
16. Gas and electricity settlement and metering	WP Response - Settlement and metering ( <i>to be submitted under separate cover by the later deadline</i> )
17. Case studies on barriers to entry and expansion in the retail supply of energy	<i>n/a - our views are covered within our UIS and Working Paper responses</i>
18. Analysis of generation profitability	WP Response - Generation profitability
19. Profitability of retail energy supply: profit margin analysis	WP Response - Retail Profitability
20. Legal and regulatory framework	WP Response - Legal and regulatory
21. Coordination in the retail energy market facilitated by price announcements	WP Response - Tacit Coordination
22. Analysis of the cost of capital of energy firms	WP Response - Cost of capital
23. Codes	WP Response – Codes