

Energy Market Investigation
SSE: Response to Updated Issues Statement

1. Introduction

- 1.1.1 This document provides the response (the *Response*) of SSE plc (*SSE*) to the Updated Statement of Issues (the *UIS*) issued on 18 February 2015 by the Competition and Markets Authority (*CMA*).
- 1.1.2 SSE considers that the GB energy market is well-functioning and competitive. There is no feature, or combination of features, of any relevant market within the scope of the current investigation that prevents, restricts or distorts competition. In other words, there is no adverse effect on competition (*AEC*) within the GB generation or supply markets.
- 1.1.3 SSE is encouraged that this position is reflected in much of the CMA's current thinking. In the retail sector, where the CMA's analysis appears to be less well-advanced, the UIS identifies certain market features that raise prima facie concerns. As explained in the remainder of this Response, the characterisation of the retail market set out in the UIS does not reflect SSE's experience or market realities. Once a more complete and accurate assessment of the retail sector can be made, SSE is convinced that the CMA will agree that the market is generally well-functioning and that there is no AEC. Notwithstanding this overall conclusion, there are certain aspects of the market that offer scope for improvement and, where relevant, SSE has suggested measures that might be taken to this end.
- 1.1.4 The remainder of this Response first sets out an overview and executive summary of SSE's views on the CMA's case (see Section 2), before in turn addressing each of the CMA's five updated theories of harm, as well as the CMA's stand-alone observations in relation to the wholesale gas sector, in more detail (see Sections 3-9 respectively).

2. Overview and Executive Summary

- 2.1.1 Overall, the GB energy markets are well-functioning. As explained in the responses to each of the individual theories of harm, there are no features of those markets (or combination of features) that give rise to an AEC.
- 2.2 Updated theory of harm 1: the market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets** (see Section 3).
- 2.2.1 **Market rules are generally working well.** SSE considers that the current market rules and regulatory framework (including the changes in progress) are generally fit-for-purpose and do not distort competition. SSE is keen to support a well-designed, well-executed, and above all stable set of market rules. Accordingly, SSE would support any improvements where cost-benefit analysis shows that the likely benefits would outweigh the potential negative

effects, including the detrimental impact that introducing additional uncertainty and change into the market can have on liquidity and investment.

2.2.2 The CMA has identified potential concerns around certain market rules and regulations affecting the wholesale market. In particular, the CMA suggests that there may be market benefits from moving to a centralised dispatch system (from the current system of self-dispatch) and introducing locational pricing for transmission losses and constraints. This is not the case. In both instances, the potential benefits cited by the CMA are over-stated and outweighed by the significant drawbacks to such changes. In particular, the introduction of locational pricing would have a significant detrimental impact on suppliers and generators. It would be very difficult for suppliers to forecast the regional variations in balancing services use of system (*BSUoS*) charges under a locational pricing regime, and this increased risk may be reflected in higher prices for consumers. Generators could face increased regional constraint costs as a result of an unforeseeable decision made by a rival to locate new capacity in an area. This represents an increased risk for generators and would be likely to increase the cost of capital. In a market environment where stability is key, the risks, uncertainty, and transitional costs that such changes would bring about, leaving aside the limited and uncertain nature of the purported benefits, would be extremely detrimental to the market.

2.3 **Updated theory of harm 2: market power in electricity generation leads to higher prices** (see [Section 4](#)).

2.3.1 **The upstream sector is competitive, diverse, and highly liquid.** SSE's experience is that the wholesale market is competitive and well-functioning. The generation sector is "*among the most diverse and competitive in Europe*" and highly liquid.¹ There are no concerns around market power in generation. It is not conceivable: "*that any generator has the ability or incentive to exploit UMP in the GB electricity wholesale market*".² Profits are reasonable with main technologies all making a return in line with or below the cost of capital.

2.4 **CMA's observations on the wholesale gas market** (see [Section 5](#)).

2.4.1 **Wholesale gas markets are well-functioning.** SSE agrees with the CMA's conclusions that the wholesale gas market has sufficient liquidity, that market prices are transparent and that there is an absence of unilateral market power.

¹ *RIS*, para 1.3.3.

² *Market Power in Generation Working Paper*, para. 5.

2.5 Updated theory of harm 3a: opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation (see Section 6).

2.5.1 Liquidity in the wholesale electricity market is good (and will continue to improve with market reforms) and, in general, “prices are transparent”.³ Independent generators and suppliers are able to trade effectively, stand-alone retailers are able to access sufficient products to build a cost-effective hedging strategy, churn rates are going up, bid-offer spreads are dropping, and the overall volumes being traded are rising. Liquidity issues are therefore clearly not distorting competition or raising barriers to entry. Nevertheless, liquidity could be improved further by measures such as the introduction of mandatory gross-bidding arrangements, stabilising the Carbon Price Floor, and addressing concerns around MiFID II.

2.6 Updated theory of harm 3b: vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of the consumer, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies (see Section 7).

2.6.1 Vertical integration has provided SSE “with an efficient way of operating over the last decade”.⁴ A number of alternative business models are also working well in the market demonstrating that vertical integration is not acting as a barrier to entry.⁵ Some market participants have stated that not being vertically integrated is an advantage to them, or that they have no interest in becoming vertically integrated.⁶

2.6.2 Furthermore, as the CMA finds, vertically integrated firms “do not have the ability”⁷ to foreclose rival suppliers or generators, nor do they have any incentive to do so.

2.7 Updated theory of harm 4: energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and/or regulatory interventions (see Section 8).

2.7.1 **SSE does not recognise the characterisation of the retail sector set out in the UIS.** In the GB energy market there are over 25 domestic suppliers competing hard to deliver some of the cheapest prices in Europe. SSE was

³ *Wholesale Electricity Market Rules Working Paper*, para. 20.

⁴ *RIS*, para. 1.3.1

⁵ *RIS*, para. 1.3.2.

⁶ *Case Studies on Barriers to Entry and Expansion in the Retail Supply of Energy in Great Britain Working Paper*, paras. 56 & 65.

⁷ *UIS*, para. 103.

therefore surprised by some of the characterisation of the retail market in the UIS, which does not reflect its experience. In particular:

- (a) *Customers are engaged.* There are significant levels of switching – that measure up well against those in comparable consumer industries – and high levels of other forms of engagement. Millions of customers are exercising their right to choose and are switching supplier. Since 2009, SSE alone has on average gained [X] customers but lost [X] customers every year. [X] per cent of SSE’s electricity customers have switched to SSE from another supplier in the last ten years. All of SSE’s 3.1 million gas customers have switched to SSE since liberalisation in 1999. Almost 90% of SSE’s current electricity customers have meaningfully engaged – by switching externally or internally, signing up to another SSE product, changing their payment method and/or changing their meters – in the last 10 years. Over half of SSE’s customers are outside its former PES areas. All of this underlines that levels of customer engagement are high, not low.
- (b) *Suppliers are competing hard in a tough and evolving marketplace.* All relevant indicators point to a dynamic retail market with aggressive competition. At present, SSE has a range of offers available to all customers and SSE is constantly devising new ways to engage with customers and to differentiate itself from its competitors. SSE initiatives include: the introduction and extension of an energy price freeze; award-winning customer service; investment in digital service offerings; partnerships with M&S and Ebico; the provision of energy services offerings (e.g., micro-renewables and solar installations); the provision of other service offerings (e.g., broadband, boiler maintenance and home services); developing broader and deeper customer engagement through innovative customer-focused initiatives such as the SSE Reward scheme, and a new advertising strategy intended to encourage consumers to think about energy differently.
- (c) *The CMA has fundamentally over-estimated the money “left on the table” by consumers.* The CMA presumes that customers are inactive, in part, because it considers that there are “considerable gains” from switching supplier and/or tariff that are being left unclaimed. This is simply not the case. The CMA’s estimates are inaccurate and misleading. In fact, the gains from external switching are somewhere closer to £39 to £130 (for median fuel customers) and the gains from changing both supplier and tariff type lie somewhere around £76 to £117 (for median dual fuel customers). When internal switching options, such as changing to direct debit payment, are also taken into account, these are levels of saving that are fully consistent with current switching rates. This overall level of activity indicates good levels of engagement when considered against other comparable markets.
- (d) *There are no material barriers to switching for any customer group.* The CMA’s survey indicates that 67% of customers who have

switched previously are likely to switch again, suggesting that switching is not onerous or off-putting. Market developments already in train – such as improvements in the switching process, the increasing penetration of Price Comparison Websites (*PCWs*), and the opportunities offered by smart meters – are making switching even easier.

- (e) *There are no identifiable groups of customers who are unable to switch.* There are few “hard and fast” trends within vulnerable-type customer groups. In any case, the engagement of these customers can also be expected to improve further in line with broader market developments (*e.g.*, improvements in the switching process, the increasing penetration of *PCWs*, and the roll-out of smart meters). SSE works hard to support all customers, in particular to reduce their energy bills. In 2013, SSE introduced a Customer Service Guarantee which included a commitment (against which customers can hold SSE to account) to help customers save money on their energy expenditure. SSE’s frontline general enquiry advisors have access to information that enables them to make the most appropriate money-saving offers to customers (*e.g.*, by ensuring that they have the best tariff to suit their circumstances, payment discounts or energy saving advice). Targeted government and industry programmes to improve the engagement of vulnerable consumers also exist, and are working well. That said, to the extent that certain customers may find it difficult to engage in the market (notwithstanding the further improvements in train) SSE would be keen to work on mechanisms that would improve engagement and ensure that all customers are able to capitalise on the benefits of supplier competition without distorting competition between suppliers.
- (f) *Developments already in train will increase customer engagement, facilitate switching, and offer new competitive opportunities.* *PCWs* are already a crucial route to market, stimulating switching and enabling smaller suppliers to attract customers rapidly. Smart meters have significant potential to improve customer engagement further and facilitate new and innovative product offerings. There are industry-wide efforts to put in place a faster and yet reliable switching process. All of these developments are already having a positive impact on competition in a continually-evolving market, and can be expected to continue to broaden and deepen competition in future.

2.7.2 In light of these observations, there is no AEC within the GB retail market (although, as with any competitive market, there are aspects of the market that offer scope for improvement). More specifically:

- (a) *SSE does not exercise market power over its standard variable tariff (SVT) customers.* The market is not divided between “sticky” SVT and “non-sticky” fixed tariff customers. Customers are fully engaged, with all relevant indicators underlining that the market is competitive, so suppliers are not somehow “insulated” from competitive pressures

for any group of customers. Customers are fluid and move between fixed tariffs and SVTs (indeed, over [X]% of the electricity and gas customers that SSE acquired between 2010 and 2013 joined on SVTs). Pricing differences between SVTs and fixed tariffs do not result from suppliers exercising market power. Because of RMR reforms, suppliers are effectively unable to offer discounted SVTs, so any investment in customer acquisition has to be made through fixed tariffs. In such circumstances, it is to be expected that revenues per unit of energy and margins for fixed tariffs should be lower than those for SVTs. There are often significant differences in costs – particularly wholesale energy costs – between SVTs and fixed tariffs. Finally, no other element of the evidence cited by the CMA suggests that suppliers exercise unilateral market power (*UMP*) over customers; a comparison of indirect costs across suppliers does not suggest weak price competition and SSE’s retail profits are not excessive by any relevant benchmark. The CMA’s analysis found that average margins on sales to domestic customers were only 3.3% between 2009 and 2013.

- (b) *There is no credible basis to suggest that suppliers are tacitly coordinating through price announcements.* The CMA recognises that there is no evidence to suggest tacit coordination. In particular, the retail energy market is highly competitive, and independent and new entrant suppliers are swiftly increasing their market shares and gaining all kinds of customers, including those on SVTs. There is no evidence of suppliers altering the timing or level of their intended announcements based on the actions of other suppliers.
- (c) *Regulatory interventions have not produced a “softening” of competition, but have restricted suppliers’ ability to innovate and undermined market trust.* It is, at least to some extent, difficult to isolate the impact of specific regulatory changes given the other market developments that have occurred in parallel and the fact that certain more recent changes (in the case of the RMR reforms) are still bedding down. Nevertheless, there are concerns that regulatory rules impose a regime that is overly restrictive and unduly onerous, and prevent SSE and other suppliers from giving customers what they want – an energy offer tailored to their personal circumstances. Whilst some of the RMR reforms have undoubtedly had a beneficial impact for customers, SSE considers that a number of changes should be made so that the current regulatory framework adopts a more “principles-based” approach, including:
 - (i) Reducing the prescriptive rules imposed on customer communications – thereby addressing the unnecessary complexity of bills, annual statements, Price Increase Notifications and end of fixed term letters;

- (ii) facilitating customer choice and supplier innovation in tariff design by permitting fixed discount tariffs and removing the restrictions associated with bundled offers;
 - (iii) removing the bureaucracy associated with customer requests to change their payment or billing method; and
 - (iv) reducing the number of energy-specific obligations associated with the sales process – on the basis that consumer protection arrangements and the Standards of Conduct should be sufficient to ensure that customers’ interests are safeguarded.
- (d) *Social and environmental obligations and policies can give smaller suppliers an unfair advantage, although the overall intensity of competition remains high.* Electricity customers are subject to a number of different, overly-complex social and environmental policies, which have a significant impact on bills. As many suppliers are exempt from the significant cost burdens of meeting these obligations, a fairer and more progressive way of funding these programmes would be through general taxation. At the very least, these charges should apply to all suppliers without exemption to avoid giving smaller suppliers an unfair cost advantage.
- (e) *Certain aspects of the gas settlement and reconciliation systems currently operate to the disadvantage of domestic customers.* Under current gas settlement arrangements, the means of recovering the cost of unallocated gas weighs disproportionately on domestic suppliers (with the costs ultimately borne by domestic customers), with I&C customers largely avoiding these costs. This situation will in part be addressed by the introduction of a revised settlement regime under Project Nexus, but SSE considers that further work may be necessary to address these issues in full.

2.7.3 No AEC in the microbusiness segment. The CMA also raises a small number of concerns in relation to the microbusiness segment, around barriers to engagement, a possible lack of transparency, and the role of brokers within the market. On the contrary, in SSE’s view, the microbusiness segment is well-functioning and there is no AEC. Competition in the non-domestic segment is fierce, with 33 active electricity suppliers and 35 active gas suppliers. SME and microbusiness customers face no material barriers to engaging in the market, as evidenced by the high rates of switching and high proportions of customers on “acquisition” fixed-term contracts. Switching rates are higher than in the domestic market and higher than the CMA has indicated when the number of eligible switchers (i.e. those who are not on fixed contracts) is taken into account. There is no other evidence suggesting that the segment is not competitive. SSE’s margins are not excessive by any relevant benchmark. SSE does not segment between “active” and “sticky” customers, but instead actively seeks to ensure that all customers are on fixed-term arrangements.

2.8 Updated theory of harm 5: the broader regulatory framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change (see [Section 9](#)).

2.8.1 The existing system of codes is generally effective and does not distort competition between market participants, although aspects offer room for improvement. SSE considers that the existing system of codes (for both electricity and gas) is generally effective and does not distort competition between market participants. The current codes system therefore does not give rise to any AEC within the GB generation or supply markets. Notwithstanding this overall conclusion, there are aspects of the codes system that offer scope for improvement, so that the system of codes works well for all players in the market and for customers, and SSE suggests a number of incremental changes to this end. In addition, the codes system, unlike the licensing system, has never yet been reviewed as a whole. In keeping with Ofgem's recently announced review of industry codes, a more radical and whole-scale review of the codes system (aimed at a longer-term process of simplification) could also ultimately be of benefit to all market participants.

3. Updated theory of harm 1: The market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets

3.1 Introduction and overview

3.1.1 SSE is committed to a well-designed and well-executed set of market rules that allows it to compete effectively. The current market rules, including the changes in progress, are fit-for-purpose and do not distort competition between generators. However, stability and certainty remain key factors in the wholesale market and undue intervention, which destabilises the market, should be avoided.

3.1.2 The wholesale market has been exposed to a number of significant changes in recent years including global geopolitical shocks, constraints on capital, and the impact of EU regulations. Within the context of these changes, there is a real need to continue to invest in new generation plant in order to tackle the energy “trilemma” – balancing energy security of supply, affordability, and reducing carbon emissions. Ensuring the stability and certainty that provide a robust and attractive investment environment is thus critical for customers, as well as operators and investors. Consequently, the CMA’s assessment of updated theory of harm 1 needs to take these priorities and the recent regulatory changes – particularly from the Capacity Market – into account so as not to undermine the value of these recent improvements.

3.2 Market rules

Self-dispatch

3.2.1 Any suggestion that moving to a centralised dispatch system would be beneficial for the GB market is ill-judged. The current system of self-dispatch is “*the most economically efficient way to run the market*”, has worked well for many years and is governed by a mature and sophisticated set of licence conditions,⁸ underpinned by the industry codes. This is consistent with the views expressed to the CMA by both National Grid and Ofgem.⁹ The self-dispatch and cash-out mechanisms together provide a clear incentive for generators to trade and balance. Centralised dispatch would greatly increase the role of the system operator, eliminating the incentive on generators and suppliers to resolve imbalances and placing this burden fully on a central system operator.

⁸ [X]

⁹ See Summary of hearing with National Grid Gas plc trading as National Grid, CMA (14 October 2014), para. 8: “*National Grid considered that the current balancing and dispatch system, which relied on energy generators and suppliers to do the vast majority of the balancing and dispatch themselves, was efficient and was likely to be more efficient overall than a system where National Grid conducted all the balancing and dispatch itself*”. Ofgem also concludes on p.16, para. 3.8 of its submission, *Assessing the Wholesale Market*, 12 December 2014, that “*it is more efficient for the market to determine the most plant dispatch, with the role of the SO limited to technical activities and residual balancing*”.

- 3.2.2 There is no evidence of clear advantages in terms of offsetting benefits *e.g.*, impact on cost of constraint management, imbalance costs, wholesale costs. The Wholesale Electricity Market Rules Working Paper accepts that self-dispatch does not incentivise vertical integration,¹⁰ is not a barrier to price transparency,¹¹ and does not impose significantly higher transaction costs on any market participant compared to a centralised alternative.¹²
- 3.2.3 Self-dispatch, coupled with a robust imbalance cash-out regime, also has a positive effect on liquidity by incentivising companies to trade and balance their own position. SSE agrees with the principle of reducing reliance on the system operator and considers it appropriate for parties to balance their own position, as this reduces cost and complexity and creates strong incentives for the lowest-cost dispatch of generation. SSE considers that “*the best people able to mitigate their exposure to imbalances are actually the people who are exposed to it themselves rather than through a central dispatch mechanism.*”¹³
- 3.2.4 SSE notes that the CMA’s own modelling indicates that bilateral trading is leading to “technically efficient operation”.¹⁴ There is therefore no justifiable reason to move from a self-dispatch model to a centralised dispatch model, in particular where this might endanger the gains in terms of liquidity and access to market that have been made.¹⁵

Cash-out prices

- 3.2.5 SSE believes the move to PAR1 will result in a more efficient and cost-reflective market. Although EBSCR will lead to more extreme cash-out prices, this should more properly value dependability and flexibility (*i.e.*, the ability to ramp generation or demand up or down quickly in response to changing market conditions) in the market place. Ofgem has previously raised concerns that the existing rules do not sufficiently value the flexibility needed in a low carbon generation system.¹⁶
- 3.2.6 SSE considers that more marginal cash-out prices will also increase the incentive for market participants to balance their own position. This effect has the principal benefit of promoting forward and within day trading, which in turn makes it easier for all market participants to trade and to balance.
- 3.2.7 In terms of marginal cash-out price calculations, SSE agrees with Ofgem’s rationale that cash-out should be at a level that reflects the actual cost of the

¹⁰ *Wholesale Electricity Market Rules Working Paper*, para. 10.

¹¹ *Wholesale Electricity Market Rules Working Paper*, para. 20.

¹² *Wholesale Electricity Market Rules Working Paper*, para. 29.

¹³ *Transcript of SSE Issues Hearing*

¹⁴ *Wholesale Electricity Market Rules Working Paper*, para 12.

¹⁵ *Transcript of SSE Issues Hearing*

¹⁶ See, *e.g.*, Ofgem, Electricity Balancing Significant Code Review – Final Policy Decision, 15 May 2014, pp. 3-4.

marginal balancing action. The current use of a weighted average cost dilutes the incentive to balance, with the result that the energy market undervalues both scarcity and flexibility, producing an overall less efficient outcome. As a consequence, greater reliance may be placed on the system operator to balance, rather than it acting only as balancer of last resort. This move to marginal cash-out will more accurately reflect the costs of balancing and create the most appropriate incentives for generation.

- 3.2.8 At present, the cost of imbalance is relatively benign (compared to the cost of instructions placed on generators to resolve imbalances) and SSE does not consider it properly incentivises efficient balancing behaviour. The phased move to PAR1 by 2018 (via PAR50) will resolve this whilst at the same time avoiding excessive costs being incurred to avoid cash-out.¹⁷
- 3.2.9 Furthermore, there is no evidence that an individual participant would have the ability or incentive to manipulate the cash-out price. The CMA has found in its initial findings on UMP in generation that market participants do not have “*the ability or incentive to exploit UMP in the GB electricity wholesale market.*”¹⁸ It is similarly not credible to suggest that any one participant would have the ability to manipulate the cash-out price within the context of a competitive, transparent and well-functioning balancing mechanism, which is monitored by Ofgem.
- 3.2.10 Finally, cash-out reform, particularly reserve scarcity pricing (**RSP**), when viewed in tandem with the capacity market will not lead to “overcompensation” of generators. As noted in the Wholesale Electricity Market Rules Working Paper, Ofgem and DECC have both indicated that the capacity market and the EBSCR are intended to be generally complementary mechanisms.¹⁹ Key features of the capacity market assume that there will be scarcity value in the energy market which could be in part delivered by cash-out reform. [X]. Consequently, the magnitude of uncertainty from proposing further cash-out reform – in a market already suffering from uncertainty - far outweighs the resultant benefits and the current changes should be given the opportunity to bed in.

¹⁷ *Transcript of SSE Issues Hearing*

¹⁸ *Market Power in Generation Working Paper*, para. 5.

¹⁹ *Wholesale Electricity Market Rules Working Paper*, para. 96.

Absence of locational pricing for constraints and losses

- 3.2.11 The UIS suggests that there are “*clear arguments in principle for locational prices for constraints and losses.*”²⁰ Any benefits are, however, limited and uncertain, particularly within the current market context. In fact, as explained below, the purported benefits of a move to locational pricing for constraints and losses are heavily outweighed by the significant negative consequences that such a change would bring.
- 3.2.12 ***Additional locational signals would unnecessarily increase market complexity.*** The introduction of locational prices for constraints and losses would introduce additional complexity in the market, where the CMA has indicated that it already has concerns around the potential impact of market complexity on independent generators and smaller suppliers.
- 3.2.13 ***Confused policy landscape out of step with decarbonisation policy.*** Increased locational price signals would work in the opposite direction to Government policy on carbon reduction. Incentives for renewable generation and the Connect and Manage regime for transmission connections work to promote increased generation in precisely the areas of rich renewables resource (*e.g.*, Northern Scotland) in which higher costs would be incurred under the locational pricing of losses and constraints. The CMA suggests that any extra costs could be offset by increased targeted subsidies for affected renewables plant, but this would seem likely to increase the total cost of the renewables support.
- 3.2.14 ***Negative impact on liquidity.*** Depending on the exact details of any proposed new locational pricing mechanism, this policy could result in the development of multiple pricing zones. This would risk a significant deleterious effect on wholesale power liquidity, effectively undoing recent initiatives to improve access to the products required to hedge market exposure. Splitting the GB market into two (or more) smaller price zones would necessarily have this impact – each current product would be split into multiple sub-products (*e.g.*, regional or zonal baseload products). Such fractionated liquidity could also suffer from an exaggerated disparity between generation and demand for zonal products. This would risk undermining the currently good levels of liquidity in the market observed in the UIS. The additional complexities of having such regionalised price signals may also act as a deterrent to new entrants and independent generators wishing to enter the market.
- 3.2.15 ***Increased cost of capital for generators.*** A generator would self-evidently not be able to control the future locational decisions of competitors, whereas the locational choice of a rival generator in siting new capacity could increase the regional constraint costs for all generators in that region. The original generator could not have foreseen this, so there will be windfall losses and gains for generators based on factors entirely outside their control. This will

²⁰ UIS, para. 47.

make generation investment decisions riskier, consequently increasing the cost of capital for developers.

3.2.16 **Significant market uncertainty – threatening investment – would be created.**

The suggested transition to locational pricing is inconsistent with the CMA’s concerns about undue market complexity – in relation to the existing regulatory framework and market rules – and the importance of stability and certainty in the wholesale market. Locational pricing would create a new set of rules that market participants would need to comply with, absorbing resources that could be better used elsewhere and destabilising the investment environment.²¹ The prolonged uncertainty around energy policy generally, and the mechanism to reward capacity in particular, has resulted in a long hiatus in investment in new thermal generation. Introducing significant transitional costs and disruption to the market, at a time at which certainty and stability should be particularly important considerations, would not help the overall functioning of the market and could deter new entrants.

3.2.17 **Limited and uncertain benefits for competition.** There are significant doubts about the suggested potential benefits of a system of locational pricing for constraints and losses:

- (a) The CMA cites various academic papers that vary widely in their estimates of potential annual savings. The UIS places most emphasis on a previous estimate of efficiency gains in the order of £70 million per year for England and Wales (an estimate extended to £76 million GB-wide on a pro rata basis).²² This estimate is based on data from 1997 and therefore ignores eighteen years of market developments. More recent studies suggest much more modest benefits, although none of the available estimates amount to a meaningful percentage reduction in the total wholesale cost of meeting GB annual demand. This point is discussed in more detail in the response to the Locational Pricing Working Paper.
- (b) The CMA is not looking at the current state of the market. The UIS suggests that part of the rationale for locational pricing lies in the constraints faced in transporting electricity from one part of the country to another. However, recent network upgrades – including large infrastructure projects such as Beaulieu-Denny and the Western Boot Strap – have made, or will make, obsolete many of the constraints taken into account by the CMA.
- (c) Generators pay for grid access through Transmission Network Use of System (**TNUoS**) charges which are based on Transmission Entry

²¹ The new regulation would be particularly relevant for transmission losses which are dynamic and by their nature, highly variable both temporally and spatially. Calculating losses attributable to a particular generator for each settlement period is extremely complex and would need to be carefully considered before locational pricing could be introduced.

²² *Locational Pricing in the Electricity Market in Great Britain Working Paper*, para. 1.

Capacity (*TEC*). These charges can constitute a significant proportion of the total operating costs of generation assets. TNUoS charges already provide a strong locational signal for both generation and demand.

- (d) There should be significant doubt around whether locational pricing would provide an economic incentive for domestic and small business customers (which are the focus of the current investigation). The location of homes and businesses reflect wider social and economic drivers, and can be expected to be largely independent of locational differences in the price of energy. SSE would see greater benefit in tackling the customer confusion, especially in the domestic market, created by variations in network costs across the country. There may be simplification benefits for customers in reducing the impact of the regional variation in network charges through a move to national pricing for domestic customers.
- (e) Suppliers must forecast expected balancing services use of system (*BSUoS*) costs in order to set prices appropriately. Regional BSUoS is significantly more difficult to forecast than flat BSUoS (as currently applied based on the average cost of managing constraints). Greater uncertainty in BSUoS forecasts will either be reflected in increased prices for consumers or increased risk (and therefore higher cost of capital) for suppliers. This risk may also result in fewer suppliers being willing to offer fixed price deals in excess of one year duration – hence this is likely to have a particular impact in the non-domestic market.

3.2.18 **Conclusion.** The wholesale market is currently working well and there are no features of the market that give rise to an AEC. SSE does not see any convincing case for the introduction of locational pricing and considers that the current system of self-dispatch is effective and efficient. In fact, in light of the concerns outlined above, these changes would risk a hugely detrimental impact on certain generation assets and investor confidence.

3.2.19 Furthermore, with the delay in implementing EMR, and the lack of thermal plant built in the past decade, any further reforms are likely to continue to erode investor confidence, leading to further delays in new thermal generation being constructed. Consequently, any potential reforms must demonstrate clear, tangible benefits and not come at a cost to the market. SSE does not believe that the evidence compiled thus far establishes that these benefits outweigh the potential risks.

3.3 The Capacity Market and Contracts for Difference

The Capacity Market

3.3.1 SSE believes that in the long run, the Capacity Market will incentivise the cheapest forms of capacity, with sufficient capacity overall to provide effective competition. The introduction of the Capacity Market is therefore an

important change that should be given the opportunity to establish itself without additional regulatory uncertainty.

- 3.3.2 SSE’s experience to date (after only the first auction round it is perhaps too early to draw definitive conclusions) is that the Capacity Market mechanism is well-designed and working effectively, and providing a level playing-field for generators. There is no aspect of the Capacity Market mechanism that gives rise to an AEC in any relevant market. In particular:
- (a) SSE generally shares the CMA’s scepticism expressed around the stability of demand-side response (**DSR**) providers for longer-term capacity agreements.
 - (b) Limiting the total penalties a capacity provider faces over the course of a year to the revenue it receives from Capacity Market payments provides a sensible market signal.
- 3.3.3 SSE does not share the CMA’s initial concerns that the Capacity Market may result in “overcompensation” of generators due to the reforms under EBSCR. As noted above, the two policies were developed in tandem [8]. In fact, the opposite concern is more significant – the combination of the Capacity Market and the proposed cash-out reform may not resolve the under-remuneration of capacity.

Contracts for Difference

- 3.3.4 Contracts for Difference (**CfDs**) are well-designed and work effectively in practice. CfDs are an efficient mechanism for incentivising investment in a broad base of low-carbon generation and do not result in any material distortion of competition. Again, there is no aspect of the CfDs mechanism that gives rise to an AEC in any relevant market. In particular:
- (a) *The division of the CfD budget into three pots reflects government policy.* The division enables DECC to influence the GB generation mix by allowing less well-developed technologies to gain a foothold in the market. SSE supports the additional incentives for newer, more expensive technologies (which would otherwise likely be unable to compete with onshore wind plant) and considers that this split is necessary to secure the investment necessary to support a broad renewables generation base.²³
 - (b) *The continued eligibility for Renewable Obligation Certificates (ROC) until March 2017 is a necessary transitional arrangement.* Since the development time for a new onshore windfarm is several years (including obtaining the necessary consents) the ability of new projects to qualify for ROCs is rapidly coming to an end. Therefore the window to make the choice between ROCs and CfDs “*is narrowing*”

²³ [8]

very, very fast".²⁴ Although SSE did not participate in the recent CfD auctions, it has a number of projects that are "*ready and waiting*", including onshore wind farms, and SSE will be participating in the future.²⁵

- (c) *The Final Investment Decision enabling for Renewables (FIDeR) process is competitive.*²⁶ FIDeR was a one-off process intended to facilitate the transition to the CfD regime for projects at an advanced stage of development. Investment Contracts were awarded by means of a competitive process with the criteria for success set by DECC by reference to the viability and deliverability of the project. SSE's experience of the FIDeR process was that it was competitive, and only our Beatrice project was awarded an investment contract.²⁷

²⁴ *Transcript of SSE Issues Hearing*

²⁵ *Transcript of SSE Issues Hearing*

²⁶ UIS, para. 60.

²⁷ *Transcript of SSE Issues Hearing*

4. Updated theory of harm 2: Market power in generation leads to higher prices

- 4.1.1 In SSE's experience, the generation sector is competitive and diverse, and the market has been over-supplied for a number of years. Consequently, generators do not have the ability or incentive to increase profits by withdrawing capacity in generation through the exercise of either unilateral or co-ordinated market power. Furthermore, generators are not making excessive profits (with returns often not even covering the cost of capital) and wholesale prices are at competitive levels. There is no feature of the generation market that gives rise to an AEC. The CMA's thinking on updated theory of harm 2 – that there is no market power in generation – therefore reflects SSE's experience and market reality.

5. Response to the CMA's observations on the wholesale gas market

- 5.1.1 SSE agrees with the CMA's conclusions that the wholesale gas market has sufficient liquidity, that market prices are transparent and that there is an absence of unilateral market power. There is no feature of the wholesale gas market that gives rise to an AEC.

6. **Updated theory of harm 3a: Opaque prices and low liquidity in wholesale electricity markets distort competition in retail and generation**

- 6.1.1 In SSE's experience, there is already sufficient liquidity in the wholesale electricity market: independent generators and suppliers are able to trade effectively, stand-alone retailers are able to access sufficient products and liquidity to build a cost-effective hedging strategy, churn rates are going up, bid-offer spreads are dropping, and the overall volumes being traded are rising. Liquidity levels are not distorting competition or acting as a barrier to entry. Accordingly, there is no feature of the wholesale electricity market that gives rise to an AEC.
- 6.1.2 Nonetheless, liquidity could be improved further and SSE welcomes the CMA's suggestion that Ofgem should continue to monitor this area. SSE suggests that the following measures could be taken to help further improve liquidity:
- (a) *Gross-bidding.* The gross-bidding arrangements that SSE has entered into have had a considerable impact on trading volumes. The introduction of mandatory gross-bidding arrangements would likely improve liquidity even further by mandating companies to trade all their volume in the day ahead market.
 - (b) *Stabilising the Carbon Price Floor (CPF).* Some market participants (e.g., financial players) are not trading as much as they could. This under-participation is likely caused by the uncertainty stemming from the continual stream of political and regulatory intervention. The CPF, in particular, has had a negative impact on long-term liquidity due to uncertainty around future levels, which can be changed at every Budget. Setting out the future CPF trajectory in primary legislation would likely provide the kind of stability that would be helpful in increasing liquidity in the market.
 - (c) *Addressing concerns around MiFID II.* Uncertainty around the introduction of MiFID II has adversely affected the wholesale markets. The combination of the effects described below may well reduce liquidity and increase transaction costs, which would be a retrograde step for a market that has developed positively in recent years. In particular:
 - (i) The criteria to qualify for an exemption to MiFID are being altered so that many energy companies will be required to become MiFID-authorized. To avoid energy companies being subjected to onerous and unnecessary additional regulation, we have suggested that the proposed thresholds and criteria (to qualify for an exemption) are amended.
 - (ii) A new capability test is being proposed to distinguish between physical and financial trades. This test could lead to the energy market being split in two, with trades classified as financial

instruments being subject to significantly more onerous collateral requirements. Further clarity is required so that participants can assess for themselves whether they will meet the requirements of the capability test and avoid being caught by the financial instruments definition.

- (iii) Position limits are being proposed to restrict the level of exposure an entity can have when trading commodities. Exemptions are available for non-financial entities but there are issues around the timing of the exemption as it is not available far enough in advance of trading activity.

7. Updated theory of harm 3b: Vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of consumers, either by increasing the costs of non-integrated suppliers or reducing the sales of non-integrated generating companies

7.1.1 As SSE explained in its Response to the Issues Statement (*RIS*), vertical integration (*VI*) works well for SSE and provides a resilient business model benefitting customers and investors.²⁸ Vertically integrated firms “do not have the ability to foreclose generators (acting either unilaterally or through coordination)” and the CMA is also “doubtful that the incentive and effect conditions are met.”²⁹ The CMA’s initial thinking is therefore consistent with SSE’s experience that VI benefits do not represent a barrier to entry or expansion, and that it is “unlikely that vertical integration is a feature that, alone or in combination with other features, adversely affects competition”.³⁰ A number of independent suppliers support this view.³¹ It is therefore clear that vertical integration does not give rise to an AEC in any relevant market.

7.1.2 The CMA notes that certain of the larger six energy suppliers are taking steps to reduce their degree of vertical integration, citing Centrica and E.ON.³² This is also the case for SSE, which is currently moving from reporting its generation and supply activities as an integrated segment (as was the case prior to March 2012) to full business separation. The aim is to have separate companies for supply, trading, and generation with separately audited accounts from April 2015.

²⁸ *RIS*, para. 1.3.1.

²⁹ *Foreclosure Working Paper*, para. 5 (see also *UIS*, para 103).

³⁰ *Foreclosure Working Paper*, para. 6.

³¹ *Retail Barriers to Entry and Expansion Working Paper*, paras. 56-66.

³² *UIS*, para. 87.

8. Updated theory of harm 4: Energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and/or regulatory interventions

8.1 Introduction and overview

8.1.1 In the UIS, the CMA sets out a series of “observations” on the nature of competition in domestic energy retail markets before setting out its “initial thinking” on the competitive concerns that it considers are raised by these indications. In order to mirror the CMA’s approach, SSE first addresses the accuracy of these “observations” before proceeding to analyse the conclusions that can be drawn about competition in the domestic retail sector.

8.1.2 SSE does not recognise the characterisation of the retail sector set out in the UIS. Indeed, the “observations” on the nature of competition in the domestic retail market set out in the UIS – upon which a number of the concerns identified by the CMA are based – are inaccurate or incomplete. In particular:

- (a) Customers are engaged, including in former PES areas (see Section 8.2).
- (b) Suppliers are competing hard in a tough and evolving marketplace (see Section 8.3).
- (c) High quality customer service is important to customers and forms a key part of SSE’s competitive offering (see Section 8.4).
- (d) The CMA’s estimate of potential gains from switching is inaccurate and misleading (see Section 8.5).
- (e) There are no material barriers to switching for any customer group (see Section 8.6).
- (f) Developments already in train will increase customer engagement, facilitate switching, and offer new competitive opportunities (see Section 8.7).

8.1.3 On this basis, the following conclusions about competition in the domestic retail market can be drawn:

- (a) SSE does not exercise market power over its SVT customers (see Section 8.8).
- (b) There is no basis to suggest that suppliers are tacitly coordinating through price announcements (see Section 8.9).
- (c) Regulatory interventions have not produced a “softening” of competition, but have had the unintended consequence of restricting suppliers’ ability to innovate and have undermined market trust (see Section 8.10).

- (d) Social and environmental obligations and policies can give smaller suppliers an unfair advantage, although the overall intensity of competition remains high (see Section 8.11).
 - (e) Certain aspects of the gas settlement and reconciliation systems currently operate to the disadvantage of domestic customers (see Section 8.12).
- 8.1.4 The CMA also raises a small number of concerns in relation to the microbusiness segment, around barriers to engagement, a possible lack of transparency, and the role of brokers within the market. However, in SSE's view, the microbusiness segment is operating well and the theories of harm identified in the UIS do not raise material concerns (see Section 8.13).
- 8.1.5 Accordingly, for the reasons above, there are no features of the market that give rise to an AEC in the retail supply of energy.

The CMA's observations on the nature of competition in domestic retail markets

8.2 Customers are engaged across the UK

- 8.2.1 ***The market is characterised by significant levels of switching.*** Over [X]% of SSE's domestic electricity customers have switched externally to SSE from another supplier in the last ten years. The majority of SSE's customers are outside SSE's former PES areas. In addition, all of SSE's 3.1 million gas customers have switched to SSE since liberalisation in 1999. By way of illustration, SSE has on average gained [X] customers and lost [X] customers *every year* since 2009. (Moreover, as more than 70% of consumers switched their gas and/or electricity accounts between 2007 and 2012,³³ it is clear that this activity takes place across a broad base of customers rather than a sub-set that are particularly engaged.)
- 8.2.2 Switching levels are currently estimated at around 13%.³⁴ As the CMA's GfK customer survey dated February 2015 (the ***CMA customer survey***) highlights, switching levels in energy compare favourably with those in other consumer sectors: 27% of consumers had switched energy supplier in the last three years, higher than the proportion of consumers who had switched mobile phone provider (24%) or mortgage provider (12%) over the same period. With the possible savings from switching supplier estimated at around £39 to £130, and the savings from changing both supplier and tariff type at around £76-£117 (both for the median dual fuel customer), this kind of available saving is consistent with the level of switching observed in the market, particularly when allowance is made for the large volume of internal switching occurring. This element must be included for any meaningful assessment of the potential savings which include the benefit of such activity.

³³ YouGov SixthSense Utilities Survey (23-27 February 2012).

³⁴ CMA customer survey, p. 25, Figure 20.

- 8.2.3 Fundamentally, the energy market is one in which customers are highly engaged, particularly when suppliers are able to offer customers what they want and routes to market are operating well. External switching levels have been substantially higher in the recent past (e.g., at around 20% in 2008). This was at a time when it was easier for energy suppliers to innovate to meet customer needs (because there were fewer restrictions on tariff structures) and there was a greater variety of routes to market, including face to face sales and cold calling. The fact that customers have remained engaged throughout this period is highlighted by a significant increase in internal switching; [X] of SSE's customers switched internally last year, a [X] increase on internal switching levels in 2009.
- 8.2.4 SSE has worked hard to retain customers, but has lost more than [X]% of its customers in its former PES areas since privatisation. More than half of SSE's customers today are outside its traditional PES areas. The history of the market shows that customers will respond to attractive offerings in the marketplace.³⁵ There is therefore a far richer picture of the evolution of competition than has been painted in the UIS.
- 8.2.5 ***Customers actively engage with the energy market in a variety of ways.*** External switching is only one metric of customer engagement. There is strong evidence – including in the CMA's survey – that customers are engaging with energy markets in a variety of ways:
- (a) The CMA's customer survey indicates that 68% of customers take an active interest in their energy use and expenditure.³⁶ Similarly, 66% of respondents had actively engaged with the market either by considering their options, shopping around or switching.³⁷
 - (b) Almost 90% of SSE's existing 4.6 million electricity customers have switched internally, switched externally, or signed up to additional non-electricity services at least once in the last decade.³⁸ Some [X] customers switched internally within SSE last year.
 - (c) On average, SSE interacts with a customer [X] times a year, using up to [X] different touch points.³⁹
 - (d) SSE received a total of [X] inbound contacts from domestic energy customers last year (comprised of [X] telephone calls, [X] "self-serve" contacts, [X] letters, [X] emails, and [X] SMS messages).⁴⁰ In addition to this, SSE also

³⁵ In 2013, [X]% of SSE's total customer acquisitions were to its tracker and capped tariffs.

³⁶ *CMA customer survey*, p. 11.

³⁷ *CMA customer survey*, p. 18.

³⁸ This is consistent with RMR's baseline survey which found that 60% of customers had switched supplier at some point whilst 24% had switched tariff within a supplier.

³⁹ These touch points include: [X]

⁴⁰ *Transcript of SSE Issues Hearing*

reaches currently [redacted] customers through its brand advertising campaign via paid social media.

8.2.6 *Developments already in train will enhance customer engagement further.*

Customer engagement, while already high, is likely to continue to improve as a result of continuing market developments, including the roll-out of smart meters, improvements in the switching process, and the increased penetration of PCWs (all of which are described in further detail in Section 8.7 below). High-profile and well-funded government campaigns, such as the recently-launched “*Power to Switch*” campaign, should also have a positive impact on customer engagement.

8.2.7 SSE is working on a number of its own strategies intended to further improve its engagement with current and potential customers [redacted]. As explained in detail in Section 8.10 below, principles-based rules around customer communications would empower suppliers to communicate with customers more effectively in relation to all aspects of their energy supply, which would in turn have a positive impact on engagement. In 2013, SSE introduced a Customer Service Guarantee which included a commitment (against which customers can hold SSE to account) to help customers save money on their energy expenditure.⁴¹ SSE frontline general enquiry advisors have access to information that enables them to make the most appropriate money-saving offers to customers (*e.g.*, by ensuring that they have the best tariff to suit their circumstances, or access to payment discounts or energy-saving advice). This guarantee is promoted in SSE’s Customer Charter and across its branded websites.⁴²

8.3 Suppliers are competing hard in a tough and evolving marketplace

8.3.1 The high level of consumer engagement and pressure on energy prices in the market means that the 25 or more suppliers compete hard to attract and retain customers across a number of competitive parameters. These include: different types of tariff offerings (in particular in relation to price, term, and “greenness” *etc.*); customer service; the provision of “smart” services and complementary service offerings (home services, telecoms *etc.*); loyalty rewards and incentive schemes; and energy efficiency and micro-renewables offerings.

8.3.2 In a direct response to customer concerns around volatile energy prices, SSE introduced an unprecedented price freeze to its SVT tariff in March 2014, [redacted].

8.3.3 SSE also competes hard in a number of non-price specific ways including providing a sector-leading service, investing in its brand, offering vouchers,

⁴¹ See <http://www.sse.co.uk/uploadedFiles/CoreMarketingSites/Assets/Documents/CustomerServiceGuaranteeSSE.pdf>.

⁴² See www.hydro.co.uk/HelpAndAdvice/CustomerCharter/.

sponsoring world-class music venues, offering free broadband or using new digital ways to reach customers.

- 8.3.4 All relevant indicators point to a dynamic retail market in which there is aggressive competition between all suppliers. The market shares and relative positions of the six large energy firms continually evolve. Independent suppliers are entering the market and gaining significant share. The market is becoming less concentrated: between 2011 and 2014, the Herfindahl-Hirschman Indices (*HHI*) for domestic electricity services fell from around 1,800 to 1,600 (with similar reductions for dual-fuel services). The HHI for the UK electricity market is relatively low compared to the HHI of electricity retail markets in other EU countries. This is, in short, not a market that is “stuck” in any way.

8.4 High quality customer service is important to customers and forms a key part of SSE’s competitive offering to customers

- 8.4.1 SSE sees proactive customer engagement and high quality customer service as key ways for it to differentiate itself from its competitors, while simultaneously contributing to its wider commitment to improve consumer trust in the energy market.
- 8.4.2 SSE believes that high quality customer service is an important consideration for the majority of customers and a powerful driver of both customer acquisition and retention. This was confirmed by the CMA’s customer survey, which found that more than 80% of customers rate good customer service as essential or very important when considering their choice of supplier – more than any other factor.⁴³ This was true of both customers who had switched in recent years and customers who had chosen to remain with their existing supplier.
- 8.4.3 SSE’s commitment to customer service has been recognised externally, both within the energy market and across other sectors. For example, SSE has been voted Best for Customer Service every year since 2006 in the uSwitch Customer Satisfaction Reports and leads the six larger energy suppliers in terms of complaints handling.⁴⁴ SSE’s customer service is strong relative to other sectors too; when comparing transparency, honesty and dependability, SSE ranked higher than popular brands such as Tesco, Sky, BT and EasyJet.⁴⁵
- 8.4.4 Of the complaints SSE receives, [8<] % are resolved within the next working day (an increase of [8<] % from last year). To engender trust in its customer service proposition further, in February 2013 SSE introduced a Customer Service Guarantee, which sets out a number of commitments which SSE pledges to meet. If SSE fails to meet these pledges, SSE promises the affected

⁴³ *CMA customer survey*, p. 35.

⁴⁴ See *RIS*, para. 6.3.22.

⁴⁵ See *RIS*, para. 6.3.22.

customer a payment of £20.⁴⁶ SSE also holds regular independently-chaired consumer forums to allow customers to shape its customer service and tailor SSE’s offering, for example around bill design.⁴⁷ In the CMA’s summary of the Energy Ombudsman hearing, the Ombudsman praised SSE’s “*proactive approach to dealing with complaints*” and the consistently low number of complaints about SSE referred to the Ombudsman.⁴⁸

8.4.5 SSE’s proactive initiatives have had a positive impact on SSE’s customer satisfaction levels and corresponding number of complaints. In September 2014, an Ofgem report showed that SSE maintained its level of service and reduced the number of dissatisfied customers over the last two years. SSE’s activities have also increased customer trust. The CMA’s findings support this view with 62% of consumers trusting their own energy supplier as opposed to only 27% trusting other energy suppliers.⁴⁹

8.4.6 The CMA’s observations in relation to quality of service and complaints do not therefore reflect SSE’s track record of award-winning service. Direct complaints to SSE did increase in 2013, although this should be attributed to factors such as increased regulation, SSE’s widening of its internal definition of “complaint” (so as to improve customer service further),⁵⁰ intensifying negative media coverage and the November 2013 price increase, rather than a deterioration in SSE’s customer service.⁵¹ As the CMA recognises: “*negative publicity surrounding the sector may have had an effect on attitudes towards energy firms.*”⁵²

8.4.7 Finally, as explained in the RIS, brand perception also influences customers’ views on the quality of the service provided and their overall satisfaction levels.⁵³ The 2014 Which? Switch Energy Satisfaction Survey rated Ebico as one of the top four energy providers for customer satisfaction, even though it utilises exactly the same processes and staff as SSE and M&S Energy.⁵⁴ More recently, the 2015 Which? Energy Companies Satisfaction Survey⁵⁵ ranked Ebico 3rd, M&S Energy joint 8th, and SSE 12th, notwithstanding that customers

⁴⁶ As at 20 March 2015, 2794 Customer Service Guarantee payments have been made to customers, totalling £55,880.

⁴⁷ See SSE’s response to the Retail and Supply Financial and Market Questionnaire (*SQ*), S.78 for further details.

⁴⁸ *Summary of Hearing with Energy Ombudsman*, CMA (16 February 2015), p. 3.

⁴⁹ *CMA customer survey*, p. 2.

⁵⁰ This definition now includes all electronic written expressions of dissatisfaction (*i.e.*, social media, email). This also accounts for some of the increase in overall numbers of complaints.

⁵¹ See SSE’s response to *SQ*, S.73 for further details.

⁵² *UIS*, para. 25.

⁵³ *RIS*, para. 6.2.10

⁵⁴ *Which? 2014 Survey* as referenced in *RIS*, footnote 35.

⁵⁵ Available at <http://switch.which.co.uk/energy-suppliers/energy-companies-rated.html>

of all three businesses were accessing exactly the same SSE staff applying identical processes in each case.

8.5 The CMA’s estimate of potential gains from switching is inaccurate and misleading

- 8.5.1 The CMA’s initial view that “*there are a significant number of domestic energy customers who are relatively inactive*” rests, in part, on the basis that there are “*considerable gains*” from switching tariff and/or supplier that remain unexploited.⁵⁶ The assessment of the purported gains from switching provided in the UIS (and the relevant working paper) is, however, inaccurate and misleading, and the conclusions that the CMA seeks to draw from this assessment are unreliable.
- 8.5.2 The “headline” finding in the UIS suggests that over the period between the first quarter of 2012 and the second quarter of 2014, over 95% of dual-fuel domestic customers of the six large energy firms would have been able to save on average between £158 and £234 each year by switching tariff and/or supplier.⁵⁷ This is a gross mischaracterisation of the CMA’s own findings, which are simply that over 95% of customers could save something over £1 (as the CMA acknowledges in its Working Paper).⁵⁸
- 8.5.3 Leaving this misstatement to one side, the CMA’s presentation and assessment of the purported gains from switching are inaccurate and misleading for several other reasons.
- 8.5.4 ***The CMA’s “headline” savings are not based on a “like-for-like” comparison and unrealistically assume that all customers are completely indifferent to different payment methods, billing options, and contractual conditions.*** The CMA’s “headline” saving of £158 to £234 a year (*i.e.*, “Scenario 4” in the gains from switching analysis) includes savings that could be obtained by a customer without changing supplier (for example, by changing payment method or moving to paperless billing). This headline gain therefore appears to rest heavily on savings that are available to customers from engaging with their existing supplier (which the CMA indicates account for £69 to £144 of the stated savings).⁵⁹ The way in which these potential savings are presented and the strong emphasis placed on switching supplier are highly misleading. The “gains from switching” are instead most accurately represented by the CMA’s “Scenario 3b” analysis, which shows significantly more modest annual gains of between £46 and £153 a year (which would be lower still – between £39 and £130 – based on median consumption).

⁵⁶ UIS, para. 133.

⁵⁷ UIS, para. 134.

⁵⁸ *Gains from Switching Working Paper*, para. 33.

⁵⁹ *Gains from Switching Working Paper*, para. 35.

- 8.5.5 It is, in addition, unrealistic to assume that all customers are completely indifferent between different payment types, billing options, and contractual conditions, even though certain tariffs have features that those customers have not previously chosen (such as exit fees or payment by direct debit only).
- 8.5.6 ***The CMA's analysis suffers from material technical flaws.*** Even if it could be assumed that customers are freely willing to switch to different tariff types in this way, the CMA's analysis suffers from a number of significant flaws that result in the potential gains from switching on this basis being overstated. In particular:
- (a) *The analysis is based on mean consumption volumes, which means that it gives a poor representation of how potential gains from switching are spread.* As a result, the analysis in the UIS (and the Working Paper) systematically overstates the gains available to the majority of customers. In fact, because of the skewed distribution of consumption across the entire customer population, the range of savings stated in the UIS (even if calculated correctly) is only relevant to a minority of customers. Applying a median consumption provides a more representative view, but even this falls short of demonstrating the availability of savings across the customer base, as these will be driven by the specific consumption levels of different customer groups. The effect of consumption levels on the potential gains that can be attributed to customers is particularly relevant for customers in the lower consumption percentiles, which are more likely to include a higher proportion of low income and vulnerable customers. Indeed, projected savings for customers at the 25th percentile point would be around £40 lower compared to those at the median.
 - (b) *The estimated gains at a given time are often driven by a single tariff, often provided by a small independent supplier.* It is unrealistic to assume that even if all of these customers were able to find this tariff, that the supplier concerned offering it would be able to accommodate the surge in customer volumes (in excess of one million customers each quarter) assumed in the CMA's analysis.
- 8.5.7 Correcting the CMA's analysis to take account of such flaws materially reduces the estimated gains from switching, from £158-£234 to £76-£117 for the median dual fuel customer (even before other relevant factors that will influence customer engagement and switching levels, such as search costs, are taken into account).
- 8.5.8 ***The CMA's analysis ignores search costs.*** The CMA's customer survey suggests that the minimum amount of savings required to encourage a customer to switch suppliers is £158 per year.⁶⁰ Indeed, the survey also suggests that, as a minimum, the search costs of changing supplier are likely to

⁶⁰ CMA customer survey, p. 74. The mean saving required per annum was £158 whilst the median was £114 per annum.

be in the region of £75, and potentially higher still.⁶¹ It would be entirely rational for customers to take account of these search costs when considering whether to switch, which therefore significantly reduces the gains that are actually available from switching. As explained in SSE's response to the Analysis of the Potential Gains from Switching Working Paper, taking account of customer search costs further reduces the proportion of customers who would stand to gain anything from switching by about a third.

- 8.5.9 ***The CMA's analysis takes no account of the dynamics of competition and customer behaviour in the energy market.*** In any competitive market, it is typical for there to be “offers” available to customers, with material gains from switching available to the majority of customers. These price differentials exist to prompt high levels of external switching and other forms of customer engagement. The existence of potential gains from switching therefore does not mean that customers are not engaged. In the energy market, where new offers are continually launched to attract customers, taking a snapshot of relative prices at any one time will always suggest that there are gains to be had from switching, even though these customers are engaged in the market and switching supplier on a regular basis. This suggests that the results presented by the CMA relating to the proportion of customers who could save by switching at any one time are consistent with a high level of customer engagement, and do not provide any meaningful evidence of customer inertia. A more robust approach to the analysis of engagement would be to compare available savings and switching levels in the energy market against other consumer markets (on which basis – as described below – the energy market appears to be functioning effectively).
- 8.5.10 ***Gains from switching in the energy market are fully consistent with a high level of customer engagement.*** The discounts available and switching rates in the energy market appear in line with other sectors such as mobile phones (e.g., the CMA's customer survey shows that more customers had switched energy supplier (27%) than mobile phone (24%) or mortgage (12%) provider in the last three years).⁶² SSE encourages the CMA to consider objectively what a relevant benchmark should look like for a well-functioning retail energy market. In this regard, Professor Littlechild notes that switching rates in other consumer industries appear to be broadly similar – or lower – than those for energy markets, even where the average savings available appear to be of a similar scale or greater.⁶³

⁶¹ The customer survey reports that customers who had shopped around in the last three years on average spent 189 minutes identifying their current energy usage and/or tariff, and 164 minutes researching other suppliers. See *CMA customer survey*, p. 65. Using the ONS median hourly wage in 2014 (£13) as a proxy, this suggests that the search costs of changing supplier amount to around £75.

⁶² *CMA customer survey*, p.15.

⁶³ Professor Littlechild concludes: “*In any competitive market only a fraction of customers change provider over a given period of time, even though there may be a significant variation in the prices on offer from different suppliers: for various reasons not all customers choose the lowest*

8.5.11 ***Obtaining the lowest possible price is not always the only factor behind choosing an energy tariff.*** As the CMA’s survey highlights, other factors are also important in choosing an energy supplier. For example, 83% of customers rate good customer service as being essential or very important.⁶⁴ Indeed, customers who had chosen not to switch recently cited good customer service as being more important than cost (suggesting that customers are willing to pay more than the lowest possible tariff to retain their current levels of customer service).⁶⁵ Consumers will also take other non-price factors (e.g., loyalty rewards, customer service or the “greenness” of a tariff) into account when choosing a supplier.

8.5.12 ***Conclusion.*** The suggested savings presented in the UIS are inaccurate and misleading for several reasons, and the conclusions that it seeks to draw from these are fundamentally unreliable. The “headline” saving (of £158 to £234) from “switching” rests heavily on savings available without switching supplier and also wholly ignores that customers may not be willing to change tariff type. Even if the CMA’s framework for analysis is correct, material flaws in its technical analysis mean that the estimated gains of switching do not reach the level of £158 to £234, but rather lie in the region of £76 to £117. The available gains based on median consumption would be lower – between £39 and £130 (with savings around £40 lower for customers at the 25th percentile point compared to those at the median. After search costs and all other relevant dynamics of competition and customer behaviour in the energy market are taken into account, the levels of switching observed in the market are fully consistent with the potential gains available (and consistent with trends seen in comparable consumer industries). In short, the CMA’s analysis does not support the suggestion made in the UIS that there are “considerable gains” from switching tariff and/or suppliers that are currently “unexploited”.

8.6 There are no material barriers to switching for any customer group

8.6.1 The CMA indicates that a large part of its focus in the next stage of the investigation will be on identifying any barriers to switching that customers might face and whether there are any “sorts of customer” who do not switch.⁶⁶

8.6.2 ***Barriers to switching are not significant.*** The CMA’s survey indicates that 67% of customers who have switched previously are likely to switch again, suggesting that the switching process is not onerous or off-putting.⁶⁷

cost supplier.” See Response to Updated Issues Statement, Littlechild et al (24 February 2015), paras. 17-21.

⁶⁴ *CMA customer survey*, p. 35.

⁶⁵ *CMA customer survey*, p. 36.

⁶⁶ *UIS*, para. 135.

⁶⁷ *CMA customer survey*, p. 27. Similarly, the CMA’s survey also indicates that 62% of customers who had shopped around had done so twice or more in the last three years, suggesting that this is reflected in practice (*CMA customer survey*, p. 23).

- 8.6.3 To the extent that there are any barriers to switching (at least in the view of a limited number of consumers), these are likely to be further eroded by market developments already in train, such as improvements in the switching process, the increasing penetration of PCWs, and the opportunities offered by smart meters (all of which are described in detail elsewhere in this response). The removal of certain of the overly onerous restrictions around internal switching introduced by the RMR reforms (as described in detail below) would also make the switching process easier.
- 8.6.4 ***There are no identifiable groups of customers who are unable to switch.*** The UIS suggests that customers in certain demographic groups (*i.e.*, those aged 65 and over, those in social accommodation, those with no qualifications, and those on lower incomes) are less likely to have switched or considered switching.⁶⁸
- 8.6.5 As a starting matter, the CMA’s survey doesn’t provide a sufficient basis to draw robust conclusions around vulnerable-type customers.⁶⁹ In SSE’s experience, there are few “hard and fast” trends within these customer groups, with significant differences in behaviour observed within each group. For example, SSE’s churn rate for prepayment meter (***PPM***) customers – who would typically be considered to be lower income – is higher than that for the SSE customer base as a whole (and nationally, PPM customers are less likely to be with the former PES supplier for their area than is the case for a standard credit customer).⁷⁰
- 8.6.6 Furthermore, SSE would make the observation that it is impossible to categorically define “vulnerable customer,” despite attempts to do so in recent years. It is widely accepted that customers move in and out of this category depending on their particular circumstances. This is why suppliers have adopted a much more flexible and risk-based approach to assessing and identifying vulnerability based on a range of criteria. This is consistent with what Ofgem has advocated in its Vulnerable Customer Strategy.⁷¹
- 8.6.7 Moreover, the CMA has significantly overstated the financial incentives for such customers to switch. In particular:

⁶⁸ UIS, para. 135; *CMA customer survey*, p. 25.

⁶⁹ In particular, the CMA customer survey cannot be taken to suggest that all customers who are not engaged are vulnerable (as <1000 out of 7000 (c. 12%) of sample is vulnerable, and 42% of the sample were allegedly not engaged, then no more than about a third of the total “disengaged” population in the CMA customer survey could be vulnerable). The CMA survey acknowledges that the number of respondents displaying certain vulnerability characteristics was low (<1,000), so it is not possible to draw strong conclusions from the results.

⁷⁰ *DECC quarterly energy prices* (September 2014), Tables 2.4.1 and 2.5.1.

⁷¹ There are, of course, also some risks in conflating “vulnerable” customers with less engaged customers, as was recently identified by Professor Littlechild in his hearing with the CMA. See *Summary of hearing with Professor Stephen Littlechild*, (11 December 2014), para. 12.

- (a) The financial incentive to switch may be more limited for some of these customers, given the general link between income and energy usage.⁷² The skewed distribution of consumption means that the average saving implied by the CMA’s analysis would be considerably lower for a dual fuel customer towards the lower end of the consumption distribution. With the possible savings from switching supplier and/or tariff estimated at around £76-£117 for the median dual fuel customers after correcting for anomalies in the CMA estimates, we would expect the potential gain from switching at the 25th percentile point to be around £40 lower.
- (b) It can be more difficult to engage vulnerable-type customers with standard tariff offerings. For example, RMR reforms prohibited two-tier tariffs (commonly previously referred to as “no standing charge” tariffs).⁷³ This type of variable tariff was typically cheaper for both low or zero usage customers and, depending on tariff design, could also be cheaper for higher than average usage customers. These tariffs were therefore popular with all customer groups, including vulnerable customers.
- (c) Furthermore, as explained in the RIS,⁷⁴ other elements of the RMR reforms have prevented SSE and other suppliers from offering fixed discount tariffs and prompt payment discounts which were popular with customers who might not wish to commit to a fixed term deal or pay by direct debit.⁷⁵
- (d) In addition, the prescriptive RMR tied bundling rules limit suppliers’ ability to tailor offers to specific customer groups.⁷⁶
- (e) Whilst there is the opportunity to apply to Ofgem for derogations to address some of these issues, SSE’s experience is that such restrictions nevertheless stifle innovation in the market and limit the ability of SSE and its competitors to respond to customers’ requirements in a flexible way.

8.6.8 The engagement of these types of customer can, of course, be expected to continue to develop as part of broader market trends and developments described elsewhere in this Response, such as competitive pressure, increasing internet penetration, the continued growth of PCWs, improvements in the

⁷² See, e.g., *Beyond average consumption, Development of a framework for assessing impacts of policy proposals on different consumer groups, Final report to Ofgem*, Centre for Sustainable Energy (August 2012), p. 8, Table 3.2.

⁷³ See *SLC22A: Unit Rate and Standing Charge Requirements*. Although it should be noted that nil standing charge tariffs do exist and are permitted under RMR.

⁷⁴ See *RIS*, paras. 6.5.7-6.5.10 and Annex 6.2.

⁷⁵ See *SLC22B: Restriction on Tariff numbers and Tariff simplification*.

⁷⁶ See *SLC22B: Restriction on Tariff numbers and Tariff simplification*.

switching process, the roll-out of smart meters, and government and industry initiatives intended to improve consumer engagement.

- 8.6.9 SSE takes the responsibility of identifying and supporting vulnerable customers seriously, recognising the importance of providing appropriate and adequate safeguards and support.⁷⁷ SSE staff are specifically trained and encouraged to recognise where a customer may be vulnerable, and to discuss the ways in which those customers' energy bills might be reduced.
- 8.6.10 In addition to contributing to the industry-wide initiatives described in SSE's previous submissions to the CMA,⁷⁸ SSE operates its own specifically-targeted initiatives, such as its Winter Campaign,⁷⁹ to ensure that vulnerable customers are assisted over and above statutory requirements. SSE previously offered the "energyplus Care" tariff, a deeply-discounted tariff for fuel-poor customers (effectively funded by the remainder of the SSE customer base), which was particularly popular with customers and was of greater value to them than the Warm Home Discount (*WHD*) payment. SSE was required to phase out offering this product when the WHD scheme was introduced. SSE continues to participate in the WHD, which supports over 350,000 of its customers each year. SSE also operates a Hardship Scheme, which provides assistance to low income, vulnerable customers who have been struggling to pay outstanding debt. A total of £3.5 million was set aside for this purpose during the last financial year. SSE also has a solid relationship with and provides funding for key organisations, such as Citizens Advice Bureau, National Energy Action, and Energy Action Scotland, in the work that they do to help consumers reduce their bills. SSE uses its links with these organisations to ensure that its staff are able to benefit from training so that they are better able to identify, empathise with and assist customers who are vulnerable or likely to be fuel poor.⁸⁰ As described above, vulnerable-type customers also benefit (like all SSE customers), under SSE's Customer Service Guarantee, from advice from SSE's frontline general enquiry advisers to ensure that they have the best tariff to suit their circumstances (as well as access to payment discounts and energy saving advice). [X<]
- 8.6.11 To the extent that certain customers may find it difficult to engage with the market (notwithstanding the further improvements in train), SSE would be keen to work on mechanisms that would improve engagement and ensure that all customers are able to capitalise on the benefits of supplier competition. It is, of course, imperative that any mechanism intended to pursue this objective should be cost-effective (*e.g.*, SSE's experience shows that the costs of identifying and verifying vulnerable-type customers can be significant). Similarly, it should not impose disproportionate burdens on different suppliers

⁷⁷ See *RIS*, Annex 6.1 and SSE's response to *SQ*, S105 (paras. 105.2 and 105.4).

⁷⁸ See SSE's response to *SQ*, S105 (paras. 105.12 – 105.15).

⁷⁹ See *RIS*, Annex 6.1 and SSE's response to *SQ*, S105 (para. 105.5).

⁸⁰ See SSE's response to *SQ*, S105 (paras. 105.15 and 105.22).

(as is the case, for example, with respect to the costs of certain government social and environmental policies from which smaller suppliers are exempt). Within this context, SSE would welcome the opportunity to discuss these issues further with the CMA.

8.7 Developments already in train will increase customer engagement, facilitate switching, and offer new competitive opportunities

8.7.1 **Price Comparison Websites.** As stated in SSE’s RIS and further submissions to the CMA,⁸¹ SSE believes that PCWs have played an increasingly important role in driving customer engagement in recent years. PCWs enable customers to compare a wider range of tariffs easily and quickly; this increased engagement has stimulated switching and has enabled smaller suppliers to attract customers rapidly. As the CMA’s customer survey shows, particularly following the demise of doorstep selling, PCWs have become a crucial route to market for all suppliers.

8.7.2 However, as discussed further in SSE’s response to the Price Comparison Website Working Paper, there are features of PCWs that are curtailing competition. In particular, PCWs are restrictive about the types of tariff they show and type of comparison they provide. For instance, Economy 10, available throughout the country, does not appear within PCW searches, while non-price product features (such as customer service levels and vouchers) are not reflected in the featured products. Furthermore, it is also important that a standardised methodology, such as the use of Ofgem’s Personal Projection methodology is used to work out how much a customer stands to save by switching to a new supplier and/or a different tariff. If PCWs have applied different seasonality assumptions this should be clearly displayed so that it is clear to customers. Otherwise, this approach could result in consumers not getting an accurate picture of the savings available.

8.7.3 SSE welcomes proportionate and timely changes to the regulation governing PCWs; changes which improve the PCW sector without overregulating it. For example, SSE is supportive of Ofgem’s amendments to the PCW Confidence Code. However, SSE considers that the amendments – particularly the amendment requiring accredited PCWs to explain clearly that they earn commission on tariffs that customers can switch to directly through the site – must be implemented effectively and reviewed periodically. Without appropriate implementation and enforcement, the amendments are unlikely to have the desired effect of restoring consumer trust in the market.⁸²

8.7.4 In this regard, SSE considers that more could be done to improve PCWs as a route to market and ensure consumers are able to make as informed a decision as possible. For example:

⁸¹ See SSE’s responses (dated 26 August 2014 and 17 October 2014) to the Price Comparison Website Questionnaire and follow up questions and *RIS*, paras. 6.3.34 – 6.3.38.

⁸² This view is also supported by Professor Stephen Littlechild. See Summary of hearing with Professor Stephen Littlechild, CMA (11 December 2014), para. 36.

- (a) Ofgem should provide clarification about how PCWs should be treated under supply licence conditions. Clarifying the potential liability of suppliers for the conduct of PCWs will be critical in optimising the use of PCWs as a route to market;⁸³
- (b) information previously omitted by PCWs should be included so that consumers are better able to tailor their desired product(s); and
- (c) the Confidence Code should represent the industry minimum standard and all PCWs should be Confidence Code accredited. (All PCWs with which SSE currently has commercial arrangements in place are Confidence Code accredited.)

8.7.5 **Smart meters.** As the CMA notes, smart meters offer significant scope for improving customer engagement further and facilitate new and innovative product offerings. Smart meters have considerable potential to build energy “literacy” (by giving consumers more knowledge and control over their energy supply and consumption), facilitate quicker and smoother switching, and support new service offerings (opening up new competitive parameters for suppliers). SSE’s experience to date is that customers with smart meters have a greater understanding of their energy usage and play a more active role in shaping how their energy is supplied.

8.7.6 In order to ensure that the significant benefits offered by smart meters become available as quickly and effectively as possible, there are certain aspects of the proposed arrangements that the CMA may wish to address before the mass roll-out proceeds:

- (a) The restrictive rules on product bundling and tariff types that were introduced by the RMR reduce the scope for innovation. These elements of the RMR reforms would need to be removed or adapted in order for the benefits of smart meters to be fully realised. Currently, if suppliers wish to develop innovative tariffs for smart meters, they may have to apply for derogations.⁸⁴ It is therefore detrimental to the ongoing development of the market and for competition if suppliers continue to be required to apply for derogations for tariffs offered via smart meters.⁸⁵

⁸³ PCWs are potentially captured as “representatives” in the supply licence conditions. If PCWs are counted as “representatives,” a PCW breach of the supply licence conditions would constitute a breach by the relevant supplier, with significant repercussions for that supplier.

⁸⁴ Time of Use tariffs could have many permutations to achieve the full benefit envisaged under smart meter roll-out – four tariffs is too restrictive especially when some existing arrangements (e.g., Economy 7 or Economy 10) might already have used up the four available.

⁸⁵ At the end of December 2014, there were 671,200 domestic smart meters (400,600 electricity and 270,600 gas) operating in smart mode, which represents 1.5 per cent of all domestic meters operated by the larger suppliers. Source: *DECC Smart Meters Quarterly Statistics Report Q4/2014*.

- (b) Interoperability is key. All meters installed by suppliers should offer customers the same opportunity to switch suppliers (with “smart” functionality intact).
- (c) The costs of this programme – which will, of course, ultimately be met by consumers – should not be excessive. Technology choices should focus on the most cost-effective solutions and interoperability, rather than offering customers meters with “gold-plated” functionality that is not necessary for the benefits of smart meters to be realised. For instance, SSE considers that the mandatory requirement for all domestic customers to be offered an In-Home Display (*IHD*) should be removed and suppliers given the flexibility to provide the same information via other (less costly) means, for example, via a smart phone app.
- (d) A move to half-hourly settlement will ultimately be the best way of ensuring that the benefits of smart metering are fully realised for consumers. SSE is committed to continuing to work with Ofgem and other industry players on this through its *Smarter Markets Programme*.

8.7.7 **Better and quicker switching.** SSE continues to support industry-wide efforts to put in place a fast and reliable switching process (such as the recent introduction of three-day switching, following a two week cooling off period). SSE will continue to work with Ofgem and other industry players towards this end, in particular in light of the significant potential that smart meters offer to further support consumer switching. However, whilst SSE is supportive of faster switching, it is important that the reliability of switching and the overall customer experience are considered. The proposal, as part of the drive towards next-day switching, to switch customers within the cooling off period presents a risk to the customer experience. Indeed, a key theme in consumer research carried out for Ofgem was that customers wanted reliability over speed.⁸⁶ SSE considers that it is of more benefit to customers to switch them correctly and smoothly than to switch them within 24 hours.

8.7.8 **Targeted engagement initiatives.** A series of government or industry initiatives intended to improve consumer engagement are already underway and working well. Several government-funded initiatives, such as the Big Energy Saving Network,⁸⁷ Cheaper Energy Together,⁸⁸ and the current “Power

⁸⁶ See <https://www.ofgem.gov.uk/ofgem-publications/84905/finalcospanel.pdf>: *Ensuring reliability and accuracy during the CoS transfer was the most important issue for many*, (Ipsos Mori Social Research Institute (2013).

⁸⁷ A DECC-sponsored programme to support eligible third sector organisations and community groups in delivering help and advice to vulnerable consumers. The programme has already reached over 90,000 consumers.

⁸⁸ A £5 million fund supported by DECC that is designed to promote collective switching schemes. Since the start of 2013, collective switching schemes have saved households over £19 million.

to Switch” campaign,⁸⁹ are all aimed at raising customer awareness of the right to switch energy supplier. The *Energy Best Deal* and *Big Energy Saving Week* campaigns run by the Citizens Advice Bureau, and funded by SSE and other energy suppliers, are intended to make customers aware of the savings that can be made by switching fuel providers or negotiating with existing providers. Some aspects of Ofgem’s Retail Market Review reforms (while they remain at an early stage in their impact) are also intended to have a positive effect on the engagement of all customers in the energy market, including vulnerable customers (e.g., by mandating that customers are treated fairly and are provided with communications that help them to make an informed choice about their energy supply).⁹⁰

Analysis of competition in the domestic retail market

In light of the observations made above, there is no AEC within the GB retail market (although, as with any competitive market, there are aspects of the market that offer scope for improvement).

8.8 SSE does not exercise market power over its SVT customers

8.8.1 The UIS suggests that “*elements*” of the evidence that it has reviewed to date are consistent with the hypothesis that the six large energy firms have UMP over their SVT customers.⁹¹ The CMA’s current thinking appears to rest on a broad and misleading distinction between customers for SVTs and fixed tariffs. The UIS suggests, in particular, that SVT customers are “*more likely to be disengaged*” than those on non-standard tariffs,⁹² and that revenues per kWh and gross margins for SVTs are higher than those for non-standard tariffs.⁹³

8.8.2 The CMA’s initial thinking is, however, deeply mistaken. As explained below, the market is not divided between “sticky” SVT and “non-sticky” fixed tariff customers, pricing differences between SVTs and fixed tariffs do not

⁸⁹ A high-profile UK government campaign – launched in February 2015 – to promote switching. The campaign includes extensive national, regional and online advertising, as well as a targeted website intended to facilitate switching. See www.BeAnEnergyShopper.com.

⁹⁰ More specifically, the enforceable Standards of Conduct are intended to give customers greater confidence that suppliers treat customers fairly in all interactions. This principles-based, outcome-driven approach must be embedded into the operating culture of suppliers, and at all levels in the organisation, including up to decisions made at Board level. The Standards of Conduct include a requirement to provide customers with clear communications; develop targeted products and services appropriate to the customer; and make it easy for customers to contact their supplier. (See *SLC25C Customer Objective and Standards of Conduct for supply activities*.) The consistent use by suppliers of information such as the Tariff Information Label (*TIL*) and the requirement to provide customers with a Personal Projection (*PP*) of costs as part of customer communications will/have enhanced customers’ understanding of the information required to help them make an informed choice about their energy supply. (See *RIS* para. 1.5.7.)

⁹¹ *UIS*, para. 144.

⁹² *UIS*, para. 145.

⁹³ *UIS*, paras. 122-133.

result from suppliers exercising market power, and none of the other elements of evidence cited by the CMA suggests that suppliers exercise UMP over customers.

The market is not divided between “sticky” SVT and “non-sticky” fixed tariff customers

- 8.8.3 ***Customers are engaged and suppliers are competing hard on a number of fronts.*** SSE’s experience – as described above – is that there are high levels of switching and that customers are engaging in a number of different ways. Energy suppliers are competing hard across a wide range of fronts and all relevant indicators confirm that the market is competitive. In short, the evidence does not support the position that a “substantial proportion” of customers are disengaged or that SSE is “insulated” from competitive pressures for its SVT customers (or any other customer group).
- 8.8.4 ***Contrary to the CMA’s contention, SSE does not attempt to keep its SVT customers disengaged.*** [X] % of SSE’s customers are on SVTs, and the large majority of these customers have demonstrated that they are actively engaged in the market.⁹⁴ A large proportion of customers actively prefer SVT products that do not lock them into fixed-term contracts with exit fees. In any event, competitive pressures mean that it is commercially imperative for SSE to engage both its existing SVT customers and customers on SVTs offered by rival suppliers wherever possible, through offering a competitive suite of SVT products alongside a consistently higher quality of customer service than that offered by its rivals. This is why SSE advocates a relaxation of the regulatory rules (as described below) to allow it to compete and innovate in its offers to customers. Furthermore, SSE received a total of [X] inbound contacts from domestic energy customers last year and made a total of [X] outbound contacts (excluding bills).⁹⁵ None of this is consistent with a supplier that is trying to keep a proportion of its customer base “disengaged” (and the CMA will not have observed any evidence of such a strategy in the extensive documents that SSE has submitted).
- 8.8.5 ***Customers are fluid and move between different tariffs.*** The market is not divided between separate groups of customers for fixed term tariffs and SVTs. Rather, attractive fixed tariffs are one of several offers that suppliers use to encourage the SVT customers (indeed all customers) of rivals to switch. Over [X] % of the electricity and gas customers that SSE acquired between 2010 and 2013 joined on the SVT. Customers move from fixed tariffs to SVTs and *vice versa*, and between SVTs. Accordingly, no group of customers are “stuck” on SVTs or fixed tariffs.

⁹⁴ Please refer to Section 6.3 of SSE’s response to the CMA’s original *Issues Statement* for a full breakdown of this customer engagement activity.

⁹⁵ These outbound contacts consisted of calls ([X]), letters ([X]), emails ([X]), and SMS messages ([X]). In addition, SSE also made [X] contacts through bills ([X] of which consisted of e-bills).

Pricing differences between SVTs and fixed tariffs do not result from suppliers exercising market power

8.8.6 *Previous differences in the pricing of SSE’s fixed and SVT tariffs were driven by regulatory or cost considerations.* There is currently no material difference between the level of prices paid by SSE’s customers on SVTs and fixed tariffs. To the extent that there has been any difference between the pricing of SSE’s SVTs and fixed tariffs in the past, these were driven by certain regulatory or cost considerations. To be clear, none of these factors imply that there is less competition for SVT customers than for customers taking up fixed term products.

- (a) *SLC25A and subsequent RMR requirements focus discounting activity on fixed term tariffs.*⁹⁶ In some cases, fixed tariffs are offered by smaller suppliers that benefit from cost advantages that SSE does not currently enjoy. For example, smaller suppliers may be able – subject to their choice of energy purchasing strategy – to buy energy at the current low wholesale prices (as they tend not to be hedged to the same extent as larger suppliers who face greater risks because of larger customer volumes) and they are exempt from the significant costs of government obligations, such as ECO. In other cases, fixed tariff offerings are often provided at close to or under cost and are intended as “introductory” offers to attract new customers. These discounts are not sustainable in the longer-term, and the viability of the tariff rests on expected revenues over the expected duration of the customer’s contract and their anticipated lifetime value. As a result of the RMR reforms,⁹⁷ suppliers are effectively unable to offer discounted SVTs. In practice, therefore, any investment in customer acquisition has to be made through fixed tariffs and the cheapest tariffs in the market will typically be fixed tariffs. As suppliers are often making an investment in customer acquisition when offering fixed tariffs, it is to be expected that the revenues per kWh and gross margins for fixed tariffs should be lower than those for SVTs.
- (b) *There can be significant differences in wholesale energy costs between SVTs and fixed tariffs.* The CMA’s analysis (in particular Figures 1

⁹⁶ SLC25A led to supplier offers being predominantly fixed term tracker type tariffs. RMR reforms do not accommodate a customer-friendly tracker tariff (see *SLC22A Unit Rate and Standing Charge requirements* and therefore offers are now predominantly fixed price or capped price.

⁹⁷ The RMR reforms introduced a general prohibition on creating new “dead” tariffs (see *Prohibition of Dead Tariffs SLC 22D.1*). Once an evergreen (or SVT) tariff has been removed from sale, all customers on that tariff must be migrated to the cheapest evergreen tariff for them. This means that if a discounted tariff were offered on an evergreen basis, as soon as that tariff was withdrawn from sale, all existing customers on that tariff would have to be migrated onto another (potentially higher-priced) tariff. This would, of course, risk a supplier suffering considerable reputational damage, and is therefore not a feasible commercial offering.

and 2 in the UIS) appears to presume that direct costs for SVTs and fixed tariffs should be the same. This is, however, not the case. [X]

- (c) *Other cost differences also impact the prices of SVTs and fixed tariffs.* There are also material differences in the risks of serving customers on SVTs versus fixed rate tariffs. This is the case, in particular, because of differences in certainty around customer numbers (SVT customer numbers are, by their nature, far more uncertain) and the volumes of energy purchased in advance for each customer group.⁹⁸ This uncertainty also results in suppliers typically facing higher imbalance costs for SVT customers.

None of the other element of evidence cited by the CMA suggest that suppliers exercise UMP over customers

8.8.7 *A comparison of indirect costs across suppliers does not suggest weak price competition.* The CMA should be cautious about making these comparisons across suppliers in order to inform the degree of competitiveness in the supply market. In particular, differences between suppliers might be because of:

- (a) *Suppliers being at different stages of their investment cycles.* [X].
- (b) *Differences in the customer base that suppliers serve.* For example, as customers on pre-payment meters generate higher costs to serve, suppliers that have a higher proportion of pre-payment customers will have higher overheads.
- (c) *Different approaches to sales and marketing, which reflect different business strategies.* Different levels of expenditure on sales and marketing would be expected in any competitive market. SSE has, for example, historically spent very little on advertising and marketing, although there has been increased investment in these activities more recently.

8.8.8 In short, the analysis that the CMA has put forward does not take into account all relevant factors and therefore does not allow robust conclusions to be drawn. The CMA must expect these factors to be material. [X].

8.8.9 Any dispersion of indirect costs would only be indicative of weak competition if less efficient suppliers were able to pass these inefficiencies down to end customers in the form of higher prices. This is not the case in the energy retail market. On the contrary, competitive pressure is preventing these suppliers from charging higher prices. As a result, it can be seen that high overhead costs damage profits; the suppliers with the highest indirect

⁹⁸ For example, SSE's price freeze commitment offers customers certain more attractive features than a fixed-term contract (the possibility of a price cut and no exit fees, in addition to protection against price increases for more than a year). However, it exposes SSE to considerably more risk in the short-term than a fixed-term contract – as recent experience has shown.

costs according to the latest CSS numbers – EDF and RWE – have incurred losses in recent years. In any event, we note Professor Littlechild’s recent observations on indirect cost comparisons.⁹⁹

- 8.8.10 ***SSE’s retail profits are not excessive by any relevant benchmark.*** This is a low margin sector. By the CMA’s own assessment, industry retail margins are 3.3%. SSE made a profit of only £48 last year on a dual fuel customer. This is clearly not excessive by any reasonable metric.
- 8.8.11 In the UIS, the CMA suggests that there is evidence that the gap between average SVT bills and direct costs has widened over time, particularly since 2009.¹⁰⁰ While it is true that this gap was generally lower in the years before 2009, this reflects the fact that retail profits were unsustainably low in this period. A series of significant unanticipated wholesale cost shocks resulted in a number of suppliers – including SSE – sustaining losses during these years, since tariffs could only be adjusted periodically to reflect these pressures. Such losses are clearly not sustainable in the longer term, meaning that the period before 2009 does not provide a good benchmark against which to measure margins in more recent years.
- 8.8.12 The CMA also contends that the gap between average SVT bills and direct costs has been increasing over the period since 2009 and suggests that this may indicate a softening of competition for SVTs over the period.¹⁰¹ SSE strongly disagrees with this suggestion for a number of reasons:
- (a) The CMA has based its estimates of direct costs on an inaccurate set of wholesale cost benchmarks and the CMA’s analysis has excluded a number of material indirect costs that vary with customer numbers and have increased in recent years. For SSE, minimising indirect costs has also been an important contribution to its profitability relative to its competitors. Correcting the CMA’s analysis to take account of these factors shows that tariffs closely tracked direct costs between 2009 and 2013.
 - (b) This means that any claim that the gap between tariffs and direct costs has increased since 2009 would rely entirely on the observation that the gap increased in 2014. However, the CMA does not consider the highly specific circumstances that influenced suppliers’ pricing decisions in that year, with suppliers departing from their standard hedging strategies in response to competitive pressures and macroeconomic and geopolitical developments. For example, SSE’s price freeze commitment meant that it had to purchase its energy considerably further ahead than it would normally have done, but this

⁹⁹ See Professor Littlechild’s letter to Roger Witcomb *Operating Cost Variations in a Competitive Market* (20 February 2015, published on CMA website 24 March 2015)

¹⁰⁰ *UIS*, para. 126.

¹⁰¹ *UIS*, para. 158.

is not captured in the standard hedging assumptions that the CMA has used in its cost pass-through analysis.

- (c) In addition to this, there has been no meaningful difference in the trend in the gap between direct costs and average bills for non-standard tariffs and SVTs. The UIS appears to use non-standard tariffs – such as fixed tariffs – as a competitive benchmark against which to measure the performance of SVTs. However, statistical analysis of the CMA’s cost pass-through results provides no evidence to suggest that the gap between average bills and direct costs has been larger or growing more rapidly for SVTs than for non-standard tariffs since 2009.

8.8.13 Full details of the evidence and analysis underpinning the above points can be found in SSE’s response to the Cost Pass-through Working Paper. This includes a version of Figure 1 of the UIS, reproduced based on data previously submitted to the CMA that includes all relevant costs. This clearly illustrates that once the concerns identified above (and described in more detail in the SSE’s response to the Cost Pass-through Working Paper) are addressed, the CMA’s suggestion that the gap between costs and tariffs has widened over the period since 2009 is not supported. By contrast, bills have tracked costs and there has been no trend of systematic margin increase.

8.8.14 SSE also disagrees with the CMA’s proposal to adopt the profit margins of mid-tier suppliers as the benchmark. The mid-tier suppliers are in a different business cycle to the six large energy firms. The negative or negligible margins of the mid-tier suppliers are due to discounting to attract customers and charging the costs of building up the customer base in full to the profit and loss account. SSE was in the same position as many of the mid-sized suppliers in the “noughties” when it grew its gas supply business, reporting significant losses at EBIT level. As stated above, this is clearly not sustainable over the long term and should not be used as benchmark for the whole industry.

8.8.15 SSE notes that the CMA is still considering its approach to ROCE and has not drawn any preliminary conclusions from it. SSE has grave concerns about the CMA’s proposal to use ROCE as the measure of supply profitability, which have been well documented throughout this investigation. These concerns relate to the measurement of the capital base, particularly surrounding collateral and risk capital requirements and the problems surrounding estimating an appropriate Weighted Average Cost of Capital (*WACC*). SSE will respond separately regarding its concerns regarding the CMA’s approach to estimating a WACC for an energy retailing business. However, the fact that the CMA has not attempted to estimate a relevant WACC for energy retailing is a clear signal of the magnitude of the difficulties involved. In the light of these difficult and fundamental problems, SSE has urged the CMA to reject ROCE for the measurement of profitability for supply, and instead to use profit margins – specifically, EBIT margins – as a more informative and robust measure.

8.8.16 However, in focusing on EBIT margins the CMA must recognise the considerable volatility in margins from year to year, reflecting the inherent volatility in input prices and consumption. It is therefore not appropriate to conclude that margins have increased by comparing a point estimate in the first year of the relevant period with a point estimate for the final year (as the CMA has done in its working paper on retail profitability). Both numbers could be highly skewed by particular circumstances that year, providing no information about the trend in margins. This point applies in particular to electricity. For gas, margins have increased over the relevant time but from an unsustainably low base. SSE urges the CMA to focus instead on the level of margin, which, at 3.3% for the industry cannot be considered excessive.

8.9 There is no basis to suggest that suppliers are tacitly coordinating through price announcements

8.9.1 The CMA recognises in the UIS and Coordination in the retail market facilitated by price announcements working paper that there is little evidence to suggest tacit coordination. The retail energy market is highly competitive: customers are engaged and suppliers are competing hard for business in a number of different ways across a number of fronts. Smaller suppliers are swiftly increasing their market shares and gaining all kinds of customers, including those on SVTs.

8.9.2 As the CMA recognises, price announcements are not reactive – suppliers do not alter the timing or level of their intended announcements based on the actions of other suppliers.¹⁰² Instead, suppliers take a variety of other factors into account when considering the timing and level of price changes.

8.10 Regulatory interventions have not produced a “softening” of competition but have restricted suppliers’ ability to compete and undermined market trust

8.10.1 There has been a significant amount of regulatory intervention in the retail energy market in recent years. Certain of these regulatory interventions have constrained suppliers’ ability to innovate. Accommodating persistent regulatory changes also occupies time and resource that would be better used on working on ways to compete. Persistent regulatory intervention also appears to have had a negative impact on customer trust (which, in turn, is essential to maintain switching rates).

Prohibition of Price Discrimination (SLC 25A)

8.10.2 The CMA suggests that it observes (particularly in Figure 1 of the UIS) an “apparent softening in competition” in SVTs from 2009 onwards and that this “broadly coincides” with the introduction of SLC 25A.¹⁰³

¹⁰² *Transcript of SSE Issues Hearing*

¹⁰³ *UIS*, para. 158.

- 8.10.3 As a general matter, it is difficult to assess the impact that SLC25A has had on competition in retail supply in isolation given other significant developments in the retail supply market (e.g., the end of doorstep selling and general increase in costs) that occurred at around the same time. Similarly, it is difficult to isolate the longer-term impact of SLC25A from other, more recent developments, such as the growth of price comparison websites, the RMR reforms, and the entry and rapid expansion of new suppliers.
- 8.10.4 Nevertheless, so far as SSE is concerned, there was no “softening” in competition around the introduction of SLC 25A in 2009. In fact, SSE didn’t experience any change in competitive pressure at this time; suppliers continued to compete fiercely, even if certain tariff models were closed down.

Retail Market Review rules

- 8.10.5 The CMA indicates that it is keen to understand the likely impact of the RMR reforms on competition and consumer engagement.¹⁰⁴ The RMR reforms are, of course, still bedding down, and therefore the evidence of their impact is still evolving. SSE is nevertheless concerned that, as a package, the reforms are restrictive, unduly onerous, and prevent SSE giving customers what they want – an energy offer tailored to their personal circumstances. These concerns, and how they could be resolved, are explained in more detail below.
- 8.10.6 ***The current prescriptive rules create complicated customer communications.*** As explained in the RIS, there has been a substantial increase in the prescription regarding the content of customer communications such as bills and annual statements, price increase notification communications and end of fixed term letters.¹⁰⁵
- (a) **Bills and annual statements:**¹⁰⁶ SSE has long-argued that giving customers simple, comparable and necessary information is appropriate, however suppliers need to be able to respond to long-standing customer feedback that the bill is overly complex and cluttered with information that many customers do not want.¹⁰⁷ SSE continues to consider that RMR could have facilitated the move of some of the useful information from bills to the annual statement.
- (b) **Price increase notification (PIN):** RMR has introduced a substantial level of prescription in relation to the information content and precise

¹⁰⁴ *UIS*, para. 163.

¹⁰⁵ *RIS*, Annex 6.2.

¹⁰⁶ See *SLC31A: Bills, statement of account and Annual Statements and associated schedules*. See also *RIS*, 6.2.23 and *RIS*, Annex 6.2.

¹⁰⁷ Including more recently during SSE’s Issues Hearing [⌘]

layout of written communications relating to changes to customer contract terms and conditions.¹⁰⁸ This level of prescription is excessive and does not allow suppliers to respond to customer feedback on the clarity of the document. Furthermore, apart from the Cheapest Tariff Message, there is no ability for suppliers to offer customers additional advice such as energy efficiency advice or highlight other tariffs that might be suitable for their needs.

- (c) **End of fixed term letters:** Similarly, prescriptive requirements around these communications mean that the volume of information provided to customers risks obscuring the most important details which customers need to consider at the end of their fixed term contract.¹⁰⁹

8.10.7 Principles-based rules would:

- (a) establish the minimum information that is required and permit suppliers to innovate around the presentation of this information to customers;
- (b) allow suppliers to identify the best “nudges” to influence customer behaviour; and to respond to customer demands to simplify bills, annual statements and other communications; and
- (c) also be expected to reduce complaints.

8.10.8 ***The tariff restrictions and bundling rules introduced by RMR reduce customer choice.*** The primary difficulty with the RMR is not that there is an overall cap on the number of tariffs that a supplier might be permitted to offer, but the way in which tariffs have been defined.

- (a) Complex and restrictive rules govern how suppliers may attract, reward and retain customers and significantly limit the opportunities to innovate and create packages of services which differentiate themselves from their competitors. For instance, introductory offers for new customers taking up a tariff are no longer allowed as new and existing customers need to be able to take advantage of the same arrangements. As a consequence, it is not possible to offer any kind of sign-up reward directly targeted at new customers. Bundled offers (which customers are familiar with and value from their experience of other markets) are heavily restricted in the energy market. The bundling rules are extremely complex and prescribe not only how offers are to be presented to customers but also limit a supplier’s ability to offer a one-off reward. Relaxing the rules, specifically by removing all or most of SLC22B, would boost switching by allowing acquisition rewards for new customers and permit suppliers to offer loyalty rewards for existing customers.

¹⁰⁸ See SLC23: *Notification of Supply Contract terms and associated schedules.*

¹⁰⁹ See SL22C: *Fixed Term Supply Contracts.* See also SSE’s response to SQ, S103.

- (b) RMR has removed tariff characteristics such as prompt pay discounts and tracker tariffs which have previously proven very popular with customers. For instance, SSE had around [X] % of its credit payment customers benefiting from a discount that rewarded them for paying their bill promptly and [X] customers taking advantage of fixed discount tariffs which tracked the SVT. These tariff and discount options were valued by customers and should be reinstated. SSE therefore suggests rewriting SLC22B.3-7 to relax these requirements.
- (c) As described above, RMR has driven acquisition tariffs to fixed term, fixed price deals. It is now effectively impossible to introduce a commercially viable discounted evergreen tariff. Customers who opt for a fixed term tariff stay on that arrangement once it has been withdrawn from sale. However, RMR has placed restrictions on suppliers when withdrawing an evergreen offer from sale because there is a ban on creating new “dead tariffs”.¹¹⁰ Once an evergreen tariff is removed from sale, all customers who have opted for that tariff must be migrated to the relevant cheapest live evergreen tariff. These rules act as a constraint on competition for customers who prefer an SVT product. SSE therefore believes that this restriction should be removed so as to boost competition for customers who might prefer variable rates. This could be achieved by removing SLC 22D.1 and 1A. Provided customers continue to receive the Cheapest Tariff Message there is no risk that a supplier could “hide” better deals from its existing customers, as they would be informed on a regular basis of the cheapest offer available from their supplier.

8.10.9 ***Energy-specific sales regulation should be reduced.*** SSE observed in its RIS that there is a counter-productive impact associated with the onerous requirements placed on suppliers which acts to lengthen the energy sales process.¹¹¹ SSE considers that the reach of the rules, coupled with the understandably cautious view that suppliers will take because of Ofgem’s stated approach to enforcement, makes certain types of sales interaction with customers virtually impossible. For instance, because of the definition of “representative”, suppliers are reticent about using third parties to facilitate the sales process as has been suggested in the context of industry campaigns such as the “Big Switch”. Some customers prefer a face-to-face approach but this is not commercially feasible in the GB market under the current restrictions. SSE is concerned that the improvements that have been made in the switching process which should encourage customers that it is easy to switch have unfortunately been frustrated by the onerous requirements placed on suppliers. Fundamentally, SSE considers that consumer protection arrangements, coupled with the Standards of Conduct licence condition,

¹¹⁰ See *SLC22D: Dead Tariffs*.

¹¹¹ *RIS*, paras. 6.3.25-6.3.26

should be sufficient to ensure that customers are appropriately protected when they are signing up to an energy contract.

8.10.10 ***The current bureaucracy around trivial changes should be removed.*** In addition to the requirements imposed on suppliers associated with the sale of energy to domestic customers, RMR imposed the Mutual Variations Licence Condition (***SLC23A***). This means that simple changes and variations to customers' contracts are now subject to counterintuitive and non-customer friendly rules. For example, if a customer wishes to cease paying by direct debit, and revert to pay on demand (credit) arrangements, the customer might expect this to be done straight away. However the rules dictate that any change which results in a negative financial impact (in this instance losing the direct debit discount) cannot be made straight away, and before the change can be made, the customer must read and agree to a written notice of the negative impact that this change will have on the price paid. Whilst the intention of this process is to provide strong consumer protection, it has come at the expense of good customer service and customer satisfaction. These restrictions also apply to changes to billing method (*e.g.*, from paperless to paper). SSE does not believe that this level of regulation is necessary or appropriate given existing consumer protection regulations and, in the case of direct debit, the direct debit guarantee. This requirement could easily be reversed by removing the current SLC23A requirements and reviewing how these interact with other licence obligations.

8.10.11 In summary, therefore, SSE considers that regulatory interventions have had the effect of restricting suppliers' ability to compete and believes that implementation of the changes identified above and adopting a more principles-based approach would be to the benefit of competition and customers.

8.11 Social and environmental obligations can give smaller suppliers an unfair advantage, although the overall intensity of competition remains high

8.11.1 The CMA notes the increasing impact of social and environmental obligations and policies and indicates that it is keen to understand the potential implications for competition.¹¹² The CMA is right to be concerned about impact of social and environmental schemes – but the disparity of cost impact on gas and electricity is not the only way these impact on customers.

8.11.2 Electricity customers are subject to a number of different, overly-complex social and environmental policies. These policies have a significant impact on bills, amounting to over £100 per year on a typical bill. These costs are expected to increase in future, to over £200 per year on a typical bill by 2020.

8.11.3 As many suppliers are exempt from the significant cost burdens of meeting some of these obligations, a fairer and more progressive way of funding these

¹¹² *UIS*, para. 168.

programmes would be through general taxation. At the very least, these charges should apply to all suppliers without exemption to avoid providing smaller suppliers with an unfair cost advantage. This would also reduce the current distortion between electricity and gas, to the benefit of customers with electric heating systems.

8.12 Certain aspects of the settlement and reconciliation systems operate to the disadvantage of domestic customers

- 8.12.1 The UIS suggests some concerns that elements of the gas and electricity settlement systems may fail to provide the right incentives for suppliers to compete in retail markets.¹¹³
- 8.12.2 SSE has previously raised its concerns around the current gas settlement arrangements with the CMA (*e.g.*, as part of its response to S12). Domestic suppliers are unable to bill all of the gas allocated to them by national systems because of the allocation being greater than actual metered customer usage. This is due to the level of unidentified gas in the national systems, known as unallocated gas, the cost of which are currently predominantly met by domestic suppliers as a consequence of the industry process known as Reconciliation by Difference (*RbD*).
- 8.12.3 Larger supply points are settled individually based on actual metered consumption, but there is no individual settlement process for small supply points (predominantly serving domestic and small and medium enterprises (*SME*) customers) which means the unallocated gas referred to above is “smeared” across supplier portfolios by the RbD process according to aggregate annual quantities (*AQs*).
- 8.12.4 There is therefore a bias against domestic suppliers in the way RbD allocates imbalance, which results in domestic suppliers being overcharged by Xoserve (the company which independently maintains the national systems on behalf of the GDNs), compared to large gas customers (whose supply points are settled individually based on actual consumption). As RbD/unallocated gas represents a cost that suppliers must recover in their prices, these costs are ultimately borne (disproportionately) by domestic consumers.
- 8.12.5 The introduction of a revised settlement regime under project Nexus in October 2015 will address some of these concerns regarding the disproportionate level of unallocated gas costs currently borne by domestic suppliers. However, SSE continues to believe that there is further work to be done to address the underlying issue of unallocated gas in a robust way and would welcome the opportunity to discuss this further with the CMA.

¹¹³ UIS, para. 169.

Microbusinesses

8.13 The microbusiness segment is well-functioning with no material concerns

- 8.13.1 Competition in the non-domestic segment is fierce with 33 active electricity suppliers and 35 active gas suppliers.¹¹⁴ Indeed, competition is intensifying as existing players deepen and broaden their competitive offerings and new firms enter the segment. All relevant indicators underline that the market is competitive.¹¹⁵ For example, nearly 80% of the non-domestic gas market is held by energy firms excluding the six larger suppliers.¹¹⁶ In short: “*the [non-domestic] business electricity and gas markets are the most competitive they have ever been.*”¹¹⁷
- 8.13.2 SSE is in the process of repositioning itself to further improve its competitive offering for electricity and gas business customers, including MBCs.¹¹⁸ For example, SSE’s presence in the non-domestic gas market has historically been limited. However, SSE has recently increased its competitive emphasis on this segment and is pursuing business very actively, issuing [X] electricity quotations to non-half-hourly customers in 2013-2014 alone (and over [X] quotes to gas customers) and winning business from larger, more established rivals. [X]
- 8.13.3 In the UIS, the CMA raises three principal concerns in relation to the microbusiness segment, around barriers to engagement, a possible lack of transparency, and the role of brokers within the market. However, as explained below and in more detail in SSE’s response to the CMA’s Microbusinesses Working Paper, the microbusiness segment is well-functioning in SSE’s view, and there are no features of the market that give rise to an AEC.

Barriers to engagement

- 8.13.4 In SSE’s experience, microbusiness customers face no material barriers to engaging in the market. Switching levels are currently at 14%,¹¹⁹ slightly higher than in the domestic market. However, a better measure of engagement is provided by the number of microbusiness customers estimated

¹¹⁴ *Microbusinesses Working Paper*, para. 27.

¹¹⁵ Cornwall Energy, *Competition in the British business energy supply markets* (April 2014) (the *Cornwall Energy Report*), p. 4.

¹¹⁶ *The Cornwall Energy Report*, p. 13.

¹¹⁷ *The Cornwall Energy Report*, p. 4.

¹¹⁸ As explained in *SSE’s response to the Microbusinesses Working Paper*, whilst there is a regulatory definition of microbusiness customers there is no universal definition for SMEs. SSE does not differentiate operationally in its treatment of microbusiness customers and SME customers, therefore references to SME should be taken to include microbusiness customers.

¹¹⁹ *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market* (report for Ofgem), The Research Perspective and Element Energy (2013), p. 42.

to be on acquisition tariffs (because some acquisition products can have a term longer than one year and therefore some customers would be unable to switch again within a one-year period). The proportion of customers on acquisition tariffs – [X]% for electricity and [X]% for gas – underlines that customers are engaged, particularly where [X]% of customers who had chosen not to switch did so because they were satisfied with their current supplier.

- 8.13.5 ***SSE’s prices in the microbusiness sector are cost-reflective and its margins are not excessive.*** The CMA suggests that it observes significantly higher margins in the SME segment across the period 2009 to 2013, when compared to the domestic segment.¹²⁰ Firstly, SSE is concerned that the comparison between domestic and SME margins taken out of context is misleading because of the variability and volatility of margins across the period, coupled with the different characteristics of the business and domestic segments. Any differences between domestic and non-domestic margins primarily reflect the different risk profiles of these segments (*e.g.*, domestic demand is more sensitive to unexpected changes in seasonal weather conditions than non-domestic demand).
- 8.13.6 SSE is unable to comment on the veracity of the CMA’s SME margin figures because it does not have access to data on the margins of other suppliers. However, the UIS’s analysis does not represent SSE’s experience. Over the period in question, not only did SSE’s electricity SME margins fluctuate year on year but, at an average of [X]% they were also considerably lower than the industry average of 8.6% for the segment as quoted by the CMA. Furthermore, the difference over the period between SSE’s electricity SME and domestic margins was [X]%.
- 8.13.7 ***SSE does not segment between “active” and “sticky” customers.*** The CMA suggests that a further indicator of potential detriment is the use of “*automatic rollover contracts.*”¹²¹ Again, this is not the case for SSE, which abolished rollover contracts in April 2014.
- 8.13.8 Customers who previously would have been rollover customers instead move onto variable business rates (***VBRs***). The small minority of customers who have informed SSE that they are changing supplier move onto deemed contracts. A relatively small proportion of SSE’s customers are on VBRs or deemed contracts. More generally, it is anticipated that customers who move on to either VBRs or deemed rates will do so on a temporary basis, before they move to another supplier or onto a negotiated fixed term contract.
- 8.13.9 Price differentials between fixed and default contracts reflect the additional commercial risk of customers on default tariffs, including [X]. Risks also vary between customers on different types of default tariffs. The risks

¹²⁰ UIS, para. 185.

¹²¹ UIS, para. 187.

associated with VBR customers tend to be less acute than those associated with deemed tariffs, who are more likely to leave with minimal notice and are considered more likely to default on payment. This is reflected in lower rates for VBR customers when compared to deemed rates.

- 8.13.10 SSE makes significant efforts to engage with customers and encourage those on VBR and deemed arrangements to switch back to fixed contractual arrangements. SSE starts to contact customers with renewal terms around two to six months before contract expiry and continues to engage up to and beyond the expiry date. For example, SSE proactively contacts customers on its VBR and deemed rates two weeks after they have moved to these rates. SSE then continues to make contact with these customers (at least every six months) to advise them of the potential benefits of moving to a contract. In the meantime, VBRs and deemed rates are reviewed monthly (and updated as necessary) to ensure that they remain reasonable and cost-reflective.

Transparency

- 8.13.11 Improving trust in the energy market is one of SSE's core strategies. SSE recognises that transparency is a key element of this and it therefore aims to be as transparent as possible in its dealings with customers.
- 8.13.12 The CMA's concerns around transparency appear to rest, in part, on the fact that many suppliers' prices are not published and that many rates may remain subject to negotiation.¹²² SSE is not aware of customer concerns around the availability of price information, which is readily accessible on its website (in the case of VBRs and deemed rates), from SSE's customer service team, or through third party intermediaries (*TPIs*). [X]
- 8.13.13 The CMA also raises concerns around the search costs faced by microbusinesses, in particular because of the absence of online PCW services.¹²³ As a starting matter, this concern appears to be inconsistent with the Ofgem Survey cited in the Microbusinesses Working Paper, which suggests that, among non-domestic customers, microbusinesses are most likely (30%) to choose their tariff by comparing quotes on a switching site. The same survey also indicates that 75% of non-domestic customers stated that the process of choosing a new supplier was "easy".¹²⁴
- 8.13.14 To the extent that additional steps could be taken to improve transparency and customer engagement further in the microbusiness sector, for example by making additional information available on supplier websites or by incentivising the entry of dedicated PCWs into this segment, SSE would welcome the opportunity to discuss these issues with the CMA.

¹²² *UIS*, para. 181.

¹²³ *UIS*, para. 182.

¹²⁴ *Quantitative research into non-domestic consumer engagement in, and experience of, the energy market (report for Ofgem)*, The Research Perspective and Element Energy (December 2013), p. 32 and p. 50.

Role of brokers

8.13.15 The CMA raises concerns around poor microbusiness experience using TPIs and the negative impact that this might have on future engagement.¹²⁵ TPIs have an important role to play in facilitating engagement in the retail energy market and therefore ensuring trust in TPIs is critical. Poor TPI practices can have a negative impact on the energy market as customers lose trust in TPIs and suppliers, which can affect levels of engagement. SSE supports the work that Ofgem is carrying out on a draft code of practice (and associated licence conditions) for non-domestic TPIs, as well as the principles outlined in Ofgem's open letter dated 5 March 2015. As with PCWs, SSE considers that all non-domestic TPIs should be code of practice-accredited and would support other reasonable and proportionate measures necessary to improve SME customers' experience of TPIs.

¹²⁵ *UIS*, para. 184.

9. Updated theory of harm 5: the broader regulatory framework, including the current system of code governance, acts as a barrier to pro-competitive innovation and change

9.1 Introduction and Overview

9.1.1 The CMA has identified potential concerns around barriers to entry, relating to the scale and complexity of codes in the electricity market and how these codes are governed. SSE considers that the existing system of codes (for both electricity and gas) and code governance are generally effective and do not distort competition between market participants nor give rise to an AEC within the GB generation or supply markets. Nevertheless, SSE believes that there is scope to simplify, consolidate and/or otherwise streamline the codes, with improvements resulting in greater transparency, and a simpler set of operating rules for all players in the market, as well as efficiency savings. These improvements in relation to the energy market are described in detail below and in SSE's response to the Codes Working Paper.

9.1.2 In relation to code governance, SSE considers that the code panels are well balanced and represent a wide range of diverging views within the industry. However, the current code modification process, though fair, can be lengthy and inefficient. As with code consolidation, SSE would welcome reasonable, proportionate and timely adjustments which would improve the process without unintended adverse consequences.

9.2 Number and complexity of codes

9.2.1 The energy wholesale and retail markets are governed by numerous technical operational codes underpinning interactions between a wide variety of industry players. Although all suppliers and generators need to comply with the applicable codes,¹²⁶ there are sufficient affordable resources in the market to help those who do not have the technical expertise in-house.

9.2.2 Whilst recognising that the codes are technically detailed and precise, SSE would, however, encourage a comprehensive review with the aim of delivering further simplicity, efficiency and cost savings. Consolidating and/or streamlining the codes (as described in detail in SSE's response to the Codes Working Paper) could benefit all parties by: (i) minimising the resources required for compliance; and (ii) aiding players' understanding of their obligations through a more accessible codes system.

9.2.3 However, any assessment should be conducted on the basis that the regulatory framework is fast-evolving, rather than static. There are currently changes underway (described in detail in SSE's response to the Codes Working Paper) that are positive developments for the simplification agenda, for instance:

¹²⁶ In total, SSE believes that suppliers of both fuels must comply with 10 codes in total (including the Smart Energy Code) while generators must comply with 6. There are also a number of ancillary agreements and codes of practice which a supplier will have to engage with. SLC11 provides for suppliers to enter into Licence Lite arrangements to reduce the codes burden.

- (a) Project Nexus will impact the Uniform Network Code (*UNC*) and the Independent Gas Transporters' Uniform Network Code (*iGT UNC*);
- (b) the roll-out of smart metering will create a number of opportunities – elements of the Master Registration Agreement (*MRA*) and Supply Point Administration Agreement (*SPAA*) could potentially be subsumed into the Smart Energy Code (*SEC*) and there will be an evolution in the role of the DCC (the interoperability system);
- (c) DECC has indicated that collateral requirements under the codes will be reviewed as part of its work to support independent suppliers. Reducing the amounts of collateral required would be to the benefit of all suppliers, however SSE remains mindful that sufficient collateral needs to be provided to reduce systemic risk;
- (d) the European target model will have significant implications regarding locational prices in the Balance and Settlement Code (*BSC*) and Grid Code (*GC*);¹²⁷
- (e) the European Network Codes (*ENCs*) will have a substantial effect on existing codes, particularly the BSC, GC, Connection and Use of System Code (*CUSC*) and UNC, and so provide opportunities to simplify; and
- (f) the introduction of next day switching may potentially impact on what is covered by the MRA and SPAA.

European Network Codes

- 9.2.4 The implementation of the ENCs (part of the European Third Package legislation) in particular will have a significant impact on existing GB codes. The large-scale change required to implement the ENCs into the GB framework presents a timely opportunity to modify and streamline the GB industry codes arrangements.¹²⁸
- 9.2.5 SSE considers that, as a minimum, the ideal approach would place the existing GB industry codes which focus on upstream operations into the three groupings used for the ENCs, namely: (i) connections; (ii) markets; and (iii) system operation. Thus all of the existing GB upstream codes would, in the future, be consolidated into just three new GB codes, reducing any overlap or repetition. For retail operations, SSE proposes a cross-fuel market code covering the supplier to customer interactions. This code would sit alongside the DCC Service Provider arrangements in the SEC, giving a total of two retail dual-fuel codes.

¹²⁷ This is discussed further in paras. 21 and 22 of SSE's response to the Locational Pricing Working Paper.

¹²⁸ The ENCs will take precedence over anything in national GB legislation including the various industry licences as well as the industry codes.

9.3 System of industry code governance and modifications

- 9.3.1 In the CMA’s Case studies on barriers to entry and expansion in the retail supply of energy in Great Britain Working Paper, only two suppliers – the Co-operative Energy and Ecotricity – cited resource constraint as a reason for not engaging in the code modification process. The lack of wider concern is indicative that the codes do not act as a barrier to entry. National Grid supports this view stating that: “*small suppliers’ voices were heard in the various regulatory processes e.g. code modification*” and that “*in its experience, when changes were made to regulations it was the right arguments which won out rather than just those supported by the major participants in the industry*”.¹²⁹
- 9.3.2 National Grid’s experience is consistent with the principles in the Code Administration Code of Practice. Under that code, the Code Administrators are obliged to ensure that: unsubstantiated assumptions or assertions do not go unchallenged;¹³⁰ all arguments for and against a modification are adequately discussed; and previous discussions or decisions that may be relevant to a modification are highlighted.¹³¹ In addition, Code Administrators have a duty to raise modification issues that are relevant to small market participants who are not otherwise represented at appropriate industry meetings.¹³² The interests of smaller suppliers and independent generators are thus adequately safeguarded in the code modification process even in their absence.
- 9.3.3 In January 2014, as part of its Code Governance Review, Ofgem introduced a requirement for Code Administrators to act as a ‘critical friend’ for small market participants and under-represented parties.¹³³ Ofgem continuously monitors the performance of Code Administrators.

Panel composition

- 9.3.4 SSE does not agree that the modification panels largely consist of network operators and the six larger energy suppliers and consequently are biased against the smaller suppliers. While the panels do contain representatives of the larger energy firms and the DNOs, they are also made up of generators, other suppliers and independent experts with no affiliations to industry players.¹³⁴ Additionally, modification panels are generally attended by an

¹²⁹ *Summary of hearing with National Grid*, CMA (27 November 2014), para. 41.

¹³⁰ The administrators of the main industry codes are: Gemserv (MRA, iGT UNC, SEC and GDAA); Elexon (BSC); Electralink (DCUSA and SPAA); National Grid (CUSC and GC); Energy Networks Association (DC); and the Joint Office of Gas Transporters (UNC).

¹³¹ *Code Administration Code of Practice*, p. 4.

¹³² *Code Administration Code of Practice*, p. 5.

¹³³ *Government and Ofgem Action Plan: Challenger Businesses (Independent Energy Suppliers)*, p. 19.

¹³⁴ See *SSE’s Response to the Codes Working Paper*, Annex 1.

Ofgem representative and other industry representatives are entitled to attend panel meetings as an observer, by agreement with the panel chair.

- 9.3.5 Since panel membership is voted on, SSE believes that the members of the panel are representative of the best interests of the parties to the code. Codes require that panel members either undertake to act independently of their employer or fairly represent the constituency which has elected them and there are serious sanctions for breaches. A key factor in the consolidation would be ensuring that panels are representative of their constituents and able to review and assess all modification proposals affecting any consolidated codes properly and in a timely manner.

Code modification process

- 9.3.6 The code modification process must be “impartial, objective and balanced” when implementing changes and therefore it does not have a bias towards certain parties. The code modification process is transparent: in order for a proposed modification to proceed, the proposer must demonstrate clearly that it meets code objectives and the code must be approved by a working group and the panel.
- 9.3.7 SLC 11 of the electricity supply licence requires that suppliers do not take any unreasonable steps to prevent or delay a code modification, and that all reasonable steps must be taken to ensure that modifications are implemented. Finally, code panel decisions can be appealed to the Authority, which has the power to override a modification recommendation.
- 9.3.8 Despite these safeguards, SSE acknowledges that the code modification process can be lengthy and protracted. The code modification process can be fast-tracked if it is considered by Ofgem to be urgent, however this is subject to the proposal meeting certain criteria. However, as illustrated in SSE’s response to the Codes Working Paper, much of the delay in the delivery of routine code modifications arises once they have been passed to Ofgem for approval.¹³⁵
- 9.3.9 As well as code modifications requiring Ofgem’s approval, Ofgem can direct modifications it deems necessary via the significant code review (**SCR**) process. The SCR is a multi-stage process that is designed to gain a wider view of what the market wants through a series of consultations prior to the decision round; the process is not particularly efficiency focussed. SSE recognises that current delays in these processes can be frustrating for market participants and Ofgem alike. SSE therefore supports reasonable and proportionate changes that expedite the process provided always the process retains an appropriate level of scrutiny and rigorous review of proposed modifications.

¹³⁵ See SSE’s *Response to the Codes Working Paper*, Table 1.

Resources and expertise

9.3.10 Overall, while the resource and expertise required to attend stakeholder meetings or to review and respond to consultations is not insubstantial, SSE does not believe that smaller players and new entrants are excluded from the process. In addition to the code governance and representational arrangements described above, and in greater detail in the Codes Working Paper response, small suppliers and new entrants have opportunities to engage and to be represented through means such as Ofgem's small supplier forums and Ofgem's Action Plan for Challenger Businesses (Independent Energy Suppliers).¹³⁶ These programmes allow small suppliers to put their views forward without the need to attend all industry meetings, which can be a resource drain for smaller firms. Furthermore, Code Administrators can provide tailored guidance to help new entrants understand and comply with the codes. The success of these initiatives is reflected in the fact that code compliance is not identified as one of the barriers to entry/expansion raised by the smaller newer suppliers.¹³⁷

9.3.11 To an extent, industry code complexity is an unavoidable cost of doing business: they are technical operational documents which underpin the entire market. However, SSE recognises that additional complexity has been added due to the piecemeal way in which codes have evolved through the modification process. Simplifying the codes could help to reduce the expertise and resource needed to understand and comply with them to the benefit of all market participants.

9.4 Conclusion

9.4.1 As discussed above, SSE considers that the existing system of codes (for both electricity and gas) and code governance are generally effective and do not distort competition between market participants nor give rise to an AEC within the GB generation or supply markets. That said, SSE recognises that there is an opportunity to review the codes and re-draft to provide further clarity. Whilst it is inevitable that precise technical requirements will remain, there are areas where incremental improvements can be made. In particular, SSE believes that areas of overlap provide multiple opportunities for consolidation and simplification. SSE is in favour of reasonable and proportionate measures to ensure that processes for providing collateral are efficient; modifying the collateral arrangements with electricity DNOs would be an obvious means of lowering cost to the benefit of all parties. The other key change that should be made is to standardise the governance arrangements such that all codes are based on the open governance model.

¹³⁶ See <https://www.gov.uk/independent-energy-suppliers>.

¹³⁷ See the Case studies on barriers to entry and expansion in the retail supply of energy in Great Britain working paper dated 18 February 2015.

9.4.2 SSE is also mindful that, unlike licences, the codes system has never yet been reviewed as a whole. Ofgem recently confirmed an intention to review the industry codes,¹³⁸ which SSE welcomes. SSE believes that the current market investigation is an excellent opportunity for stakeholders to engage with a more radical and whole-scale review of the codes system which would be of significant longer-term benefit to all market participants. Ultimately, there is no reason why the industry should not target simplification to the point where, subject to taking due account of developing ENCs, there would be only one code for gas, one for electricity and perhaps one specifically for generation. SSE would therefore welcome this kind of longer-term process of simplification being set in train.

¹³⁸ See *Forward Work Programme*, Ofgem (March 2015).