Response to CMA publications

August 2015

1. Introduction

1.1. SSE's objective in its engagement with the Competition and Markets Authority (***CMA***) has been, and continues to be, to strive to improve the GB energy market for the lasting benefit of customers. Of equal importance is the need for the market to inspire higher levels of trust. SSE considers the CMA's investigation offers a once in a lifetime opportunity to find a lasting settlement for the benefit of all customers throughout Great Britain, which builds trust in the market.

1.2. Since the start of the investigation a significant amount of work has been done, and evidence adduced, to focus the debate and narrow the issues, and to ensure a proper understanding of how this complex market works. As SSE has said from the outset, in order to deliver a lasting settlement it is important that we start with a complete and accurate assessment of the current state of the market to ensure any remedies are well-targeted and properly thought through, including identifying any unintended consequences. Therefore, SSE sets out below a brief synopsis of the Provisional Findings (***PFs***) to highlight where the debate has rightly moved on (particularly with regard to the wholesale market) and where SSE considers the evidence does not, in practice, support the CMA's provisional findings, primarily in the retail market.

2. State of the market – summary of SSE's PF response

2.1. In the round, the PFs provide a thorough and well-evidenced record of the overwhelmingly positive features of the GB energy markets. In particular the PFs set out that:

- The key elements of the wholesale market are working well and are highly competitive. The generation sector is competitive and diverse. Wholesale electricity markets are liquid[1], offer prices that are transparent[2], and operate efficiently[3]. The wholesale gas market is "*relatively unconcentrated*" and "*healthy*" on "*all measures of liquidity*."[4]
- There is "*no evidence*" that vertical integration (***VI***) is "*likely to have a detrimental impact on competition for independent suppliers and generators.*"[5] In particular, VI does not "*affect liquidity*" or raise barriers to entry[6]. The VI model offers significant potential for efficiencies and benefits to consumers.[7]
- A significant number of positive features are identified in the domestic supply markets. There has been a "*rapid expansion*" in the market shares of suppliers outside the six large energy firms, leading to "*falling levels of concentration in energy supply.*"[8] The PFs contain extensive examples of suppliers seeking to compete on price, innovative tariffs, or through a wide variety of different product offerings. The CMA also notes the various strategies of energy suppliers aimed at "*improving customer service, promoting trust and providing value-added products and services.*"[9] The PFs touch upon a number of supplier initiatives to support and engage vulnerable-type customers, and highlight that all of the six large energy firms have "*offered discounts to vulnerable domestic customers.*"[10]
- Market developments will have (and are already having) a positive impact on the market. For example, the roll-out of smart meters will "*increase competition within energy supply markets.*"[11] Other measures are in train to "*increase the reliability and speed of switching, as well as reducing its complexity and cost.*"[12] Furthermore, recent liquidity initiatives adopted by Ofgem have had positive effects in terms of "*increased transparency*" and have "*facilitated the engagement of (small) parties.*"[13]

1. PFs, Appendix 6.1, paras. 89 – 91 and 102.
2. PFs, para. 5.20.
3. PFs, paras. 5.17 – 5.18.
4. PFs, paras. 4.21, 4.38.
5. PFs, paras. 72 – 79.
6. PFs, para. 6.27.
7. PFs, para. 79.
8. PFs, para. 7.101 – 7.102.
9. PFs, Appendix 7.3, para. 11.
10. PFs, Appendix 7.3, para. 48.
11. PFs, Appendix 8.6, Annex C, para. 6.
12. PFs, para. 8.116.
13. PFs, para. 11.156.

2.2. Notwithstanding these positive features the CMA has identified, the PFs identify some potential indicators of competitive harm within the retail sector. The assessment is often at odds with SSE's experience of the market and is not supported by the evidence. In particular:

a. *Customers are engaged.* The CMA's survey underlines that the vast majority of customers are aware of their ability to switch tariff, payment method, and supplier, that switching rates are material (and increasing), and that there are high levels of customer satisfaction (with over 70% of customers being satisfied with their supplier).

SSE has on average, gained 1 million customers and lost 1.2 million customers every year since 2009. Switching levels compare favourably with those in other consumer markets, including those that the CMA might consider less "*homogenous*", and therefore on the CMA's analysis more likely to switch (such as mobile phones), or that typically account for a higher proportion of household expenditure. Customers also engage in a wide variety of other ways; for example, SSE had 1.4 million internal tariff switches in 2014 (up from 500,000 in 2013)[14].

The CMA's assessment of engagement relies mainly on its customer survey and gains from switching analysis. However, the evidence has not been properly assessed in the round against a reasonable counterfactual of a well-functioning market.

b. *High quality customer service is a key part of SSE's competitive offering.* The CMA's survey underlines that high quality customer service is an important consideration for the majority of customers (more than 80% of customers rate good customer service as essential or very important when considering their choice of supplier). SSE has consistently been voted best for customer service since 2006 in the uSwitch Customer Satisfaction Reports and leads the six larger energy suppliers in terms of complaints handling. The Energy Ombudsman has praised SSE's complaints handling before the CMA.

c. *Prices are not excessive.* The CMA's analysis of *"competitive"* prices is not grounded in a realistic assessment of a well-functioning market. In order to be *"efficient,"* on the approach in the PFs, a supplier is assumed to have perfect foresight in its energy purchasing decisions, despite the fact that this is an impossibility over time given the inherent uncertainties around fluctuating demand and wholesale costs. Once these assumptions are corrected, it is clear that average retail prices are fully competitive.

d. *Profits are not excessive.* By the CMA's own assessment, industry retail margins are 3.3%. In the 2014/15 financial year, SSE made a profit of only £69 per dual fuel customer. At an average of 5.9%, SSE's SME margins are considerably lower than the industry average of 7.9%. The CMA's return on capital employed (ROCE) analysis is not a robust measure of retail supply profitability in principle and in practice the CMA's ROCE figure translates into a margin of just 1%, or £8 per customer account, which is very close to the CMA's WACC. In addition to being at odds with the CMA's own observed margin of over 3%, this level of return would clearly be unsustainable and would adversely impact competition by deterring new entrants. The CMA's analysis of profits is therefore internally inconsistent and produces wholly implausible outcomes. These errors need to be corrected and a more robust assessment of industry profitability factored into other elements of the PFs including the assessment of customer detriment.

14. This figure does not include customers changing payment method or billing type.

3. The CMA's proposed remedies

3.1. SSE welcomes those remedies which address issues in the market which SSE has previously highlighted to the CMA. Whilst SSE recognises that much depends on the detail of how the remedies would be implemented, and on the overall impact of the remedies combined, SSE supports the CMA's principles-based approach to the retail remedies; providing the framework for effective competition, facilitating widespread customer engagement and providing appropriate safeguards to help disengaged or vulnerable customers.

a. *Framework for effective competition*

SSE considers the retail market is generally well-functioning (and do not recognise some of the features the CMA has identified in its PFs) but nevertheless continue to support measures which further improve engagement. In some instances, such measures require a re-assessment of previous regulatory interventions. For example, the proposed removal of the "*simpler choices*" component of the domestic Retail Market Review (***RMR***) rules (*Remedy 3*) is very welcome and addresses serious concerns raised by SSE and others. If properly implemented, the remedy would also be far more effective at addressing some of the other concerns the CMA has identified in its PFs and which it has proposed addressing with alternative remedies, which would likely have unwelcome side-effects. For example, the suggested early roll-out of smart meters for prepayment (***PPM***) customers would prevent these customers switching between suppliers (as the functionality does not exist with the current model) and would adversely impact the development of a Smart Metering Equipment Technical Specifications (***SMETS***) 2 solution.

A number of the other remedies proposed by the CMA also provide an opportunity to improve the current framework for competition including introducing steps to ensure effective and efficient switching (*proposed under Remedy 4a*), and clarifying and simplifying the role of the regulator (*Remedy 16*).

Over the coming months, SSE will work with the CMA to ensure any individual remedies deliver the expected customer benefits and that due consideration is given to the interaction with other remedies and potential unintended consequences.

In SSE's view, the efficacy of these remedies collectively would be significantly compromised by: the unintended consequences of the transitional safeguard tariff of *Remedy 11*; their interaction with measures to provide information and prompts to customers to engage with the market (*Remedies 9 and 10*).

b. *Engagement*

As SSE has set out in its response to the PFs, its experience in the retail market shows that customers in the GB energy market are far more engaged than the CMA suggests. Despite this, SSE is generally supportive of any steps that would further improve engagement.

SSE disagrees with the CMA's premise that all customers on "*default*" tariffs are disengaged. Nevertheless, in principle, SSE supports additional measures to prompt these customers to further engage in the market (*Remedy 10*). The detail of how this would work in practice would need to be carefully considered (including the use of trials where possible) to ensure there are no unintended adverse consequences stemming from the proposed remedies aimed at improving engagement, *e.g.*, excessive information requirements on bills (these actually make meaningful engagement harder).

c. *Safeguards for disengaged customers*

In tandem with the work of many consumer groups, SSE and the other suppliers participate in a number of initiatives aimed at protecting vulnerable customers – the Priority Services Register and Warm Home Discount being two examples in the domestic market. With regard to the non-domestic market, SSE (and some other suppliers) voluntarily stopped auto-rollovers of microbusiness customers in April 2014 and SSE would support the general prohibition of auto-rollovers under *Remedy 8*.

Whilst SSE entirely agrees with the principle of helping disengaged and vulnerable customers, SSE considers this is best done through existing initiatives or implementing some of the proposed remedies discussed above which are specifically designed to improve engagement and/or promote a framework that allows for effective competition.

SSE remains concerned that the principal proposed remedy aimed at providing transitional protection for disengaged customers would in practice do far more harm than good.

Remedy 11 – safeguard regulated tariff:

3.2. The proposed remedy is neither proportionate nor well-targeted. SSE considers that such an onerous remedy as the proposed reintroduction of price controls could only be justified if it is designed to fix a very real and serious adverse effect on competition (***AEC***). The CMA has not identified such an AEC. SSE has set out in detail in its response to the PFs its concerns around flaws in the CMA's profitability analysis which has led to an erroneous perception of the market.

3.3. The reintroduction of any form of price control would be a significant intervention in the market with profound implications for competition (and for the role of the regulator and HM Government). There are also a number of significant practical issues with imposing a regulated tariff, particularly where it is aimed at a small, hard-to-define category of customers. It would be unfeasible to set a price control on a 1% margin with 70% uncontrollable costs. Errors would put suppliers into a loss-making pricing position and even the threat that it might occur would deter entry and expansion. There is also the risk of suppliers being deterred from competing for these customers leading to an adverse impact on the very customers the regulated tariff is designed to protect. The CMA has identified previous regulatory interventions as either constituting to an ongoing AEC, in the case of RMR tariff restrictions, or to have "*contributed to a softening of competition on the SVT*" in the case of SLC 25A.[15] The proposal to roll out a regulated tariff would similarly be a retrograde step and would cause more issues than it attempts to resolve.

3.4. By introducing a regulated tariff, the CMA seriously risks dis-incentivising customer engagement, further undermining customer trust in competition to deliver the best outcomes and severely impacting competition in the microbusiness market. The alleged harm it is designed to address could otherwise be achieved through the implementation of the other proposed remedies combined, such as the roll back of RMR for domestic customers, the

15. Summary of Provisional Findings, para. 150.

prohibition of auto-rollover contracts for microbusinesses and appropriately targeted information to support customers' choices of supplier and tariff. To the extent there are still issues for vulnerable customers after the implementation of these remedies, then it would be far more appropriate to address these issues via government intervention in the context of wider social policy.

3.5. In summary, the proposed reintroduction of price controls would be a significant intervention in the domestic and microbusiness market with profound implications for competition and is founded on flawed profitability analysis.

Remedy 5 – prioritisation of smart roll-out to prepayment meter customers:

3.6. SSE is supportive of measures that would lead to improved choices for prepayment customers. However, the proposed early roll-out of smart meters to prepayment meter (***PPM***) customers is unfeasible and risks alienating a significant group of customers by installing meters before the SMETS 2 technology has been properly developed. An accelerated SMETS 1 roll-out would be counter-productive and end up being a barrier rather than an enabler to switching and engagement, instead causing further customer confusion and distrust.

3.7. Furthermore, the proposed removal of the RMR tariff restrictions (*Remedy 3*) would present suppliers with alternative means of offering discounts and other tariff types to PPM customers. Coupled with the proposed remedies to improve information, simplify switching and to prompt customers to engage, these would be more effective, proportionate and timely ways to assist PPM customers.

3.8. The CMA's proposal to prioritise the roll-out of smart meters is therefore not required and would have a significant impact on the efficiency of the roll-out of programmes (with a high risk of higher costs for customers and delays to the programme as a consequence). Rather than alienating these customers through a premature (and inefficient) roll-out of smart meters, the CMA should focus on these alternative remedies as a more effective means of protecting PPM customers' needs.

3.9. As well as timing and cost issues around an early roll-out of smart meters, SSE is also concerned that caution is exercised around the roll-out of other remedies that SSE broadly supports, for example, the introduction of half-hourly settlement for domestic and SME (including microbusiness) customers before smart roll-out is sufficiently advanced (*Remedy 13*). SSE also remains concerned about any proposal to roll-out locational pricing for transmission losses (*Remedy 1*) as it would result in significant distributional impacts for minimum and uncertain gains in efficiency. This remedy would only provide a very weak despatch signal due to the diversity of generation technology on the system and would also need to take proper account of EU legislation. Even taking into consideration the modelling cited by the CMA (which is now out-of-date), this remedy would only equate to a reduction of around £0.10/MWh in the wholesale price of energy or an annual saving of less than 40p for the typical household or around £1 per year for a small microbusiness. [16]

3.10. SSE continues to believe that, overall, the GB energy markets are competitive and well-functioning and SSE has made a number of firm submissions to explain why many of the AECs suggested by the CMA do not (in practice) exist. Nevertheless, as the discussion turns to remedies, SSE looks forward to engaging with the CMA and other stakeholders on many of the potential remedies which, if appropriately targeted, are likely to bring about positive changes for the benefit of customers and competition.

3.11. When assessing the possible remedies the CMA must give due consideration to the likely speed of delivery and the potential to achieve the stated aim effectively and in a more timely, cost effective and proportionate manner. These questions are of paramount importance where a remedy would require a major IT system change affecting either the customer interface or market process, as the industry continues to be faced with a very challenging implementation timetable to deliver strategic change (with Project Nexus and smart roll-out being the most significant of these). In other areas SSE has raised real concerns with the principle of what is proposed, for example, the introduction of a price cap would be a retrograde step which could dramatically reduce the potential effectiveness of the other remedies under consideration. It also poses a threat to competition as it exists in the market now and is not justified.

16. Based on total GB generation of 300 TWh per year, typical annual consumption of 3,200 kWh and consumption of 10,000 kWh for small microbusinesses.