The GB Energy Market: Customers and Competition

A Summary of SSE's Response to the CMA's Statement of Issues

Purpose of Document

Following Ofgem's original announcement to refer the GB energy market to the Competition and Markets Authority (CMA), SSE proposed five principles to make sure that the market reference delivers for all stakeholders. These were as follows:

- Get the scope right - so it is broad enough to restore trust in the competitive markets.
- Focus on all energy customers - so what they pay for is defined and transparent.
- Create simple markets - which encourage new entrants and enable different business models to thrive.
- Establish clear measures of success in advance - so people can see objectively how the market is performing.
- Achieve lasting results - so there is a clear and enduring framework that gives customers confidence, allows regulators to regulate and encourages investors to invest in the GB energy market.

Throughout every stage of the investigation, SSE will be urging the CMA to bear these principles in mind. At this stage of the investigation, the CMA has published its Issues Statement and asked interested parties to respond. The Issues Statement sets out four high-level hypotheses for investigation which it refers to as 'Theories of Harm'. The CMA has stressed very clearly that "*a theory of harm does not imply any prejudgement of an adverse effect on competition; it is solely a hypothesis to be tested*".

SSE has formally responded to the Issues Statement with a detailed submission, addressing each 'Theory of Harm' in turn. Alongside its Response to the Issues Statement, SSE is publishing this overview to allow its stakeholders to see its approach and response at this stage of the investigation.

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Overview from Alistair Phillips-Davies

The GB energy market was originally designed to ensure secure energy supplies and deliver affordable energy. There has since been an introduction of policies designed to tackle climate change. At SSE, we have seen first-hand how the market arrangements designed to meet this new 'trilemma' have become increasingly contentious as the cost of the transition to a lower carbon economy has begun to be passed through to customers.

With public trust low and significant amounts of investment into energy infrastructure required in the coming years, at SSE we are fully committed to supporting the CMA in its independent market investigation. We very much see it as an opportunity to take an independent look, test the market structures and regulations and to establish once and for all a clear regulatory framework which benefits customers and gives industry participants certainty.

At SSE we have a history of proactively leading industry change. As the leading major energy supplier on customer service, the architect of efforts to improve liquidity in the wholesale electricity market and the company which implemented the longest retail price freeze that the energy market has ever seen, we have consistently demonstrated our appetite for reform.

The CMA's framework for the market investigation is both considered and appropriate. Our attention has now turned to looking at the four hypothetical 'theories of harm' on which the CMA is focusing. We have looked at each Theory of Harm in turn and, based on the facts, illustrated that the energy market is functioning well. However, SSE believes that there are certain issues which require further attention. Some of these will be tackled by current regulatory reforms and for the remainder, SSE has suggested realistic and feasible improvements.

In 'Ensuring liquidity and transparency in wholesale electricity markets – a response to CMA Theory of Harm 1', SSE highlights how its own initiatives, as well as those of the industry and the regulator, have already done much to improve the liquidity and transparency of wholesale electricity markets. Evidence shows that these measures are having an impact, with record volumes being traded in some products and a wide range of products available. However, while some of Ofgem's more recent initiatives need more time to take effect, this investigation is an opportunity to consider the impact of policies, and the uncertainty around these, on long-term liquidity. In particular, the Carbon Price Floor has had a negative impact on long-term liquidity due to uncertainty around future levels, which can be set at every budget. Furthermore, SSE sees no need to exclude the wholesale gas market from examination to the extent that it has an impact on the retail market, as the UK is now a net importer of gas and this is one of the main cost components of electricity. SSE welcomes the letter from Mr Roger Witcomb to Mr Tim Yeo MP confirming that the CMA would be mindful of the impact of the wholesale gas market on the retail market, maintaining an open mind as to whether further investigation into the wholesale gas market may be warranted.

In 'Demonstrating the benefits of vertical integration for customers – a response to CMA Theory of Harm 2', SSE highlights the advantages to consumers and the benefits of the 'natural hedge' in providing a more stable investment environment for companies owning both supply and either generation or having long-term generation agreements in place. It also highlights that the vertically integrated model is only one of many models that are thriving in the GB energy market, with each business model providing different benefits to customers and generators. Importantly, the vertically integrated model does not enable these firms to harm the competitive position of non-integrated suppliers or generators and there are already regulatory safeguards in place. Prices to end customers have been cost reflective and are low compared with many international markets. SSE is open to further reform that provides transparency for the benefit of market participants and customers. SSE is already in the process of reorganising its companies to allow separately auditable accounts for its businesses and supports Ofgem's ongoing work on transfer pricing and financial reporting.

In 'A competitive and evolving generation market – a response to CMA Theory of Harm 3', SSE shows how the GB generation market is one of the most diverse and competitive markets in Europe. It has been designed with specific features to prevent the conditions necessary for undue market power and all the indicators point towards the current market conditions working well. It is extremely important that any design interventions in this area are carefully considered in order to ensure there are no unintended consequences.

In 'Engaging customers in the energy market – a response to CMA Theory of Harm 4', SSE strongly disagrees with Ofgem's allegations of possible tacit collusion in the GB energy market—SSE has competed hard against larger and smaller suppliers alike to grow from the fifth to second largest GB retail supplier and it does not believe market conditions or suppliers' behaviour support this academic theory of market behaviour. Rather, SSE demonstrates that the GB energy market is dynamic, evolving and functioning well with evidence of movements in market share, relatively low measures of market concentration and engaged customers. This will improve further as reforms, including those on switching, progress. However, SSE understands the need to continually improve the market for the customer and suggests lowering and simplifying customer bills by paying for Government policy through taxation, reviewing regulations that complicate bills and tariffs and examining whether the different regional costs of transporting electricity could be passed on to suppliers as one national charge to make price comparisons easier.

Over the coming few months, SSE will keep looking for improvements which will benefit customers and competition.

I hope you find this interesting and helpful.

Alistair Phillips-Davies, CEO, SSE Plc

Ensuring liquidity and transparency in wholesale electricity markets

CMA Theory of Harm 1

"Opaque prices and low levels of liquidity in wholesale electricity markets create barriers to entry in retail and generation, perverse incentives for generators and/or other inefficiencies in market functioning"

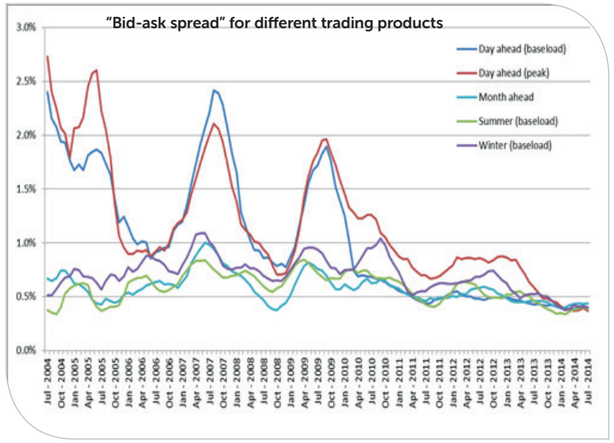
SSE's assessment

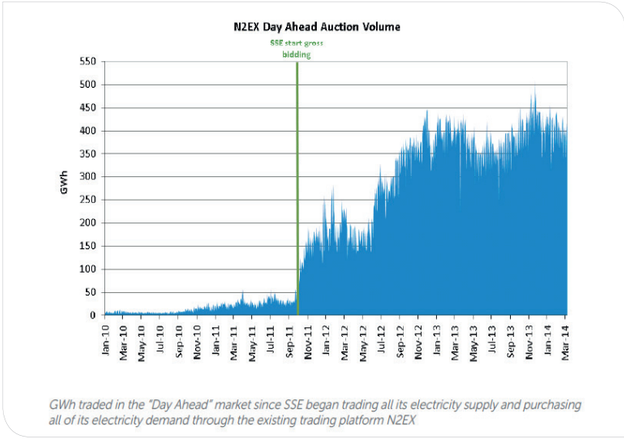
SSE plays an active role in the competitive GB wholesale markets – it operates over 10,000 megawatts of capacity for generating electricity (including investing in the largest portfolio of capacity for generating electricity from renewable sources). Nevertheless, SSE recognises that, in the past, the GB market may have had lower levels of liquidity than was desirable for retailers and generators. However, in recent years much work has gone into promoting liquidity in GB electricity markets with the result that liquidity for many products now matches the levels achieved in markets, such as in Germany, which are widely recognised as highly liquid.

The main drivers of the increased liquidity have been industry and SSE-specific initiatives, reflecting the interests that all participants in a market have in establishing liquid trading to manage risks. This applies equally to vertically integrated businesses and stand alone generators and retailers. The principle drivers have been:

- Industry initiatives: The 'N2EX' trading platform was set up by industry participants in January 2010 aiming to establish a liquid and transparent UK power market providing a robust index price for electricity trading. Since 2010 volumes traded have grown rapidly with record volumes recorded.
- SSE initiatives: SSE has a strong need for and interest in developing and maintaining liquid markets. In August 2012, SSE began to place routinely 100% of its available generation and 100% of its demand requirement in the N2EX 'day ahead' auction. This benefits both the day ahead and forward markets. For each of the last five years SSE has traded more than four times its customer demand volume in the market. In 2013/14 this ratio was 6.7. This has helped all participants, by allowing them to buy electricity easily. SSE also introduced its own small supplier commitment in 2012, which has proved very successful. In general, SSE is one of the most active players in the power market and was effectively 'market-making' in advance of Ofgem's reforms.
- Regulatory measures: In March 2014, Ofgem introduced the "Supplier Market Access" and "Market Making" licence conditions on the largest electricity generating companies. These conditions require the companies to follow a set of rules when trading with small independent suppliers to ensure fair access and to develop liquidity by playing a 'market maker' role (where suppliers must post the prices at which they will buy and sell 15 forward products on power trading platforms and are restricted in the bid ask spreads they can offer). It is too early to judge the effect of these measures, but SSE's experience is that take up of these products has been low, supporting SSE's view that there is limited unmet demand for liquidity as a result of the initiatives described above.

The impact that these initiatives have had in transforming the market can be seen starkly in the two charts. The 'bid-ask spread' (the price gap between buying and selling a product) on core electricity products has fallen markedly since 2009 and is now low and consistent with what is being achieved in other global electricity markets commonly acknowledged as being highly liquid (see below left which shows the convergence of the 'bid ask spread'). Record volumes are now being traded on the N2EX platform (graph on the right shows volumes of electricity increasing in the day ahead market).





GWh traded in the "Day Ahead" market since SSE began trading all its electricity supply and purchasing all of its electricity demand through the existing trading platform N2EX

SSE believes that liquidity is now sufficient for independent retailers to manage risks and does not represent a material barrier to entry or expansion. Ultimately, there are a wide range of products available for different participants' needs. While there are some products, for example further forward peak products, for which liquidity is lower, the CMA should look to the role played by policy uncertainty in contributing to this rather than vertical integration. Political and regulatory interventions and policies have an impact on market operations and this investigation is an opportunity to consider the impact and the uncertainty around these on long-term liquidity. In particular, the Carbon Price Floor has had a negative impact on long-term liquidity due to uncertainty around future levels, which can be changed at every Budget.

Consistent with this, SSE presents evidence to show that small suppliers do not face material additional costs resulting from any lack of liquidity and that smaller non-vertically integrated retailers do not face disproportionately higher costs than vertically integrated suppliers. Indeed, this would be inconsistent with the success of entrants in recent years.

Looking ahead

SSE benefits from liquid markets and has shown over the years its commitment to improving wholesale market liquidity. The evidence points to reasonable levels of liquidity across most parts of the market and we can expect liquidity to improve further as a result of the Secure and Promote Licence Condition (SPLC) which only came into force on 31 March 2014.

Over the coming months SSE will be developing its thinking around the following areas as there may be the potential for positive reforms linked to this Theory of Harm:

- monitor the impact of the most recent Ofgem 'Secure and Promote' changes to liquidity;
- monitor the impact from recent reforms in Europe (MiFid, EMIR, REMIT) and those resulting from the Electricity Market Reform process;
- seek to reform the Carbon Price Floor which has an impact on longer term liquidity. There may be merit in exploring how to ensure its bankability, such as by legislating for its future trajectory in Primary Legislation;
- SSE would support additional requirements for companies to buy and sell 100% of their power via open exchanges as SSE does or additional market making incentives on companies; and
- all market participants should be obliged to treat small suppliers fairly and small suppliers themselves and independent generators should participate with the new Ofgem rules.

Demonstrating the benefits of vertical integration for customers

CMA Theory of Harm 2

"Vertically integrated electricity companies harm the competitive position of non-integrated firms to the detriment of customers, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies"

SSE's assessment

SSE's view is that vertical integration has provided it with an efficient way of operating over the last decade. Both Ofgem and the CMA have highlighted particular benefits that vertical integration may bring. SSE believes that the benefits include:

- having "a natural hedge" which, in the past, has been most beneficial to generators seeking to manage the risks of operating in a volatile market. This supports long-term investment, and reduces the extent to which retailers need to pass volatility in wholesale costs through to consumers, and
- assisting in trading as it lowers the amount of collateral that SSE must post. However, a part of this benefit is related to the fact that it is a large, financially-prudent company which is replicable under many other business models.

SSE does not believe that the extent of these benefits is such that they represent a barrier to entry. There are a variety of business models in the energy market. Not all energy players are vertically integrated with both supply and generation assets – there are some large generators who have no retail operations, a few companies with no generation and, of the vertically integrated companies, there are significant differences in the scale of their supply and generation arms.

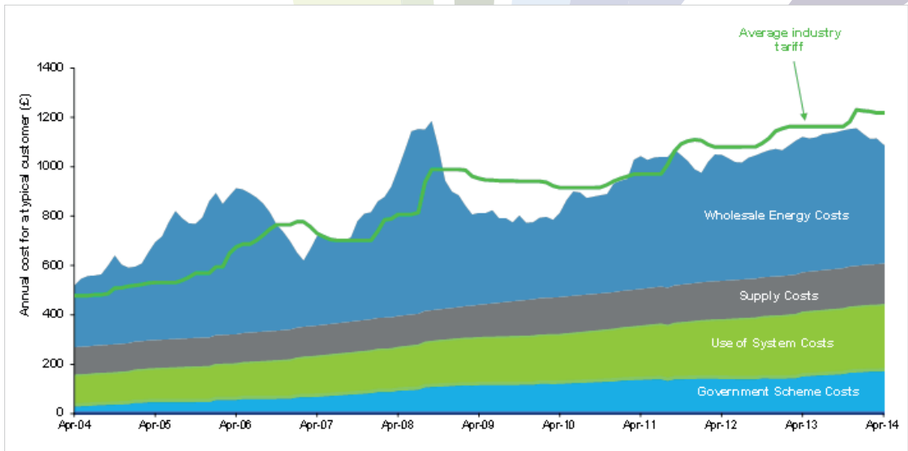
Indeed, both the generation and retail markets for electricity in GB are among the most diverse and competitive in Europe. This lack of concentration, and a lack of market power or "must-trade" status of any individual generator or retailer, means that foreclosure in either the generation or retail market would not be feasible.

It is not possible for vertically integrated companies to harm the competitive position of competitors for the following reasons:

- A combination of a lack of market power in the generation market, plus existing liquidity and regulatory constraints show that the vertically integrated energy companies have no ability to harm downstream rivals in supply. Independent retailers have multiple alternative generators from which they can purchase. Moreover, SSE and other vertically integrated generators have clear incentives to be active participants in trading wholesale products as this activity offers the opportunity to reduce costs and risks.
- Equally, a lack of market power in the retail market, plus existing liquidity and regulatory constraints, mean that the vertically integrated energy companies have no ability to harm upstream rivals in generation. Independent generators have multiple alternative suppliers to whom they can sell. In addition, many independent generators serve industrial and commercial customers directly.

End prices are cost reflective of the inputs that have gone into them. Although suppliers hedge and buy in advance, trends in customers' prices have reflected underlying costs resulting from government policies, network charges and wholesale energy prices. This can be seen from the simplified chart below, which provides a high-level generalised indication of how industry costs and average tariffs across the six largest suppliers have evolved over the last ten years (but which does not capture short run cost or tariff impacts or factors such as short-term wholesale energy costs that are influenced by supplier-specific hedging strategies on the energy futures market. As the chart illustrates:

- the long-run trend in average industry tariffs closely tracks the long-run trend in the costs faced by suppliers; and
- suppliers' cost increases—and hence price increases—reflect external factors over which suppliers can exert little control—namely growing cost pressures resulting from: (i) government schemes and interventions in the market; (ii) increases in network charges; and (iii) long-run increases in wholesale energy prices.



Notes: calculated from public data sources for a representative domestic dual fuel customer with an annual level of gas and electricity consumption in line with Ofgem's standard industry assumptions. Please refer to Annex 4.1 for a description and explanation of the data sources and methodology used to construct each of the components of this chart.

Finally, SSE believes that electricity market reform (EMR) measures will bring further changes which need to be considered when looking at vertical integration. Regardless of the firms' business model, the impact of EMR is to make generation income more dependent on centrally administered capacity payments or contracts for difference (CfDs) reducing the generators' risk to wholesale markets. Recovering these costs in this way, via a Supplier Levy, will reduce the benefits of the 'natural hedge' for vertically integrated firms described above.

Looking ahead

SSE believes that vertical integration provides an efficient way of organising generation and retail activities in GB energy supply given the inherent risks and uncertainties involved. Its existence does not prevent other models and clearly has benefits to customers.

Over the coming months, SSE will be developing its thinking around the following areas as there may be the potential for positive reforms linked to this theory of harm and in relation to improving transparency more generally:

- mandating the process SSE has already begun of reorganising its companies to allow separately auditable accounts for its energy supply (retail), electricity generation and energy portfolio management (wholesale) activities; and
- continuing to develop Ofgem's work around the Consolidated Segmental Statements (CSSs) and additional transparency measures.

A competitive and evolving generation market

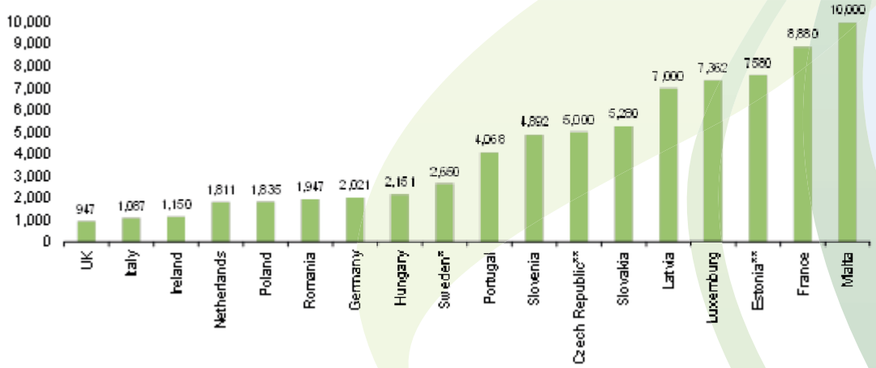
CMA Theory of Harm 3

"Market power in generation leads to higher market prices"

SSE's assessment

The GB generation market is one of the most diverse and competitive markets in Europe. Ofgem's 2014 assessment found that there were seven companies with market shares exceeding 5% and the largest three companies generated around half of all electricity consumed in GB. Following a Europe-wide review by the European Commission, looking at the standard economic measure of concentration (HHI), the UK came out as the least concentrated market (see table below).

Electricity generation HHI ratio in 2011



Source: European Commission, Energy Markets 2011.

*Notes: * Approximation.** Conservative estimate – actual HHIs are likely to be higher.*

There are also some other very important features of the market worth noting:

- No generation company has the ability to exercise material market power at specific points in time. If a generator were to raise its price above the level at which the next plant could profitably supply the market, the generator's plant will not run as it would be out-bid. In contrast, a situation where any individual generator is "pivotal" to meeting total demand in the market is rare. Even, when such conditions arise, only a small fraction of the pivotal generator's capacity might be needed to meet demand, giving no incentive to exploit that position given the revenue that would need to be forgone. Furthermore, it would also be difficult for a firm to predict when it would be "pivotal".
- There is also no ability to exercise local market power in the balancing market and there are specific regulations to prevent this. The 'Transmission Constraint Licence Condition' (TCLC) was introduced in July 2012 to regulate behaviour by electricity generators during periods of local grid constraints. The licence condition specifically prohibits generators from obtaining any excessive benefit from electricity generation in relation to a period of transmission constraint.

- The market would not support coordinated outcomes between generators. There is a lack of market concentration; a volatility of prices; a diversity of different trading and business models; and an asymmetry of incentives, market shares, cost structures and technologies, such that successful coordination could neither be reached nor be sustained. Strong sanctions exist and there is no history or evidence of such practices in this industry. There are already civil and pending criminal sanctions to prevent energy market manipulation.

Looking Ahead

There is no evidence of any adverse behaviour and all the indicators point towards current market conditions working well. An assessment of market rules and plant operations will allow the CMA to see that there are already sufficient regulatory safeguards in place. The conditions simply do not exist for market power and no additional action is necessary. It is extremely important that any design interventions in this area are carefully considered in order to ensure there are no unintended consequences to this well-functioning market.

Engaging customers in the energy market

CMA 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"

SSE's assessment

SSE does not believe the CMA's Theory of Harm 4 accurately reflects the situation in the GB energy market:

(a) Customer inactivity (4(a)): the methods employed by Ofgem in the SMA to measure customer activity are imperfect.

(b) Tacit coordination (4(b)): there are neither the conditions required nor any observed behaviour between the largest suppliers, which would allow tacit coordination to either occur or to be sustained.

(c) Regulatory intervention (4(c)): some of the recent regulations implemented have had, and will continue to have, positive effects, but others have been less effective for customers and competition.

SSE is operating in a very competitive and well-functioning energy retail market evidenced by

- fluctuating market shares - SSE has grown from the fifth to the second largest GB energy supplier over the last ten years, serving around 4.8 million domestic customers;
- the entry and growth of new suppliers has led to SSE's market share declining and the shares of the eighteen smaller suppliers growing steadily. Four of the suppliers outside the six largest now have over 250,000 customers and in April 2014, 47% of switching was to companies other than the six largest suppliers;
- relatively low measures of market concentration seen in the market - the UK retail supply market is becoming less concentrated and has amongst the lowest concentration of any supply market in the EU;
- the fact that prices within the GB energy market are low compared with many international comparators. The European Commission reported earlier this year that UK domestic gas and electricity end prices were the cheapest and fifth cheapest respectively in the EU15 in 2012; and
- retail margins are low. SSE's retail margin between 2009/10 and 2013/14 has varied between 2.7% and 5.0%, with an average margin of 3.7%. Industry retail margins have varied between 1.8% and 3.8%, with an average of 3.1%. A review of relevant benchmarks for energy retail margins, conducted by Frontier Economics on SSE's behalf, suggests that a reasonable margin should lie between 3.0% and 8.9%.

Within this highly competitive framework, SSE has in fact observed substantial engagement from its customers. If we look at switching (which is not the only metric for measuring customer engagement), 70% of our customers have switched to SSE from another supplier over the last ten years (including many customers who switched away from SSE and then switched back). Of the remaining 30%, the majority have proactively engaged in the market by switching their tariff or engaging with us in other ways.

In addition to this, there are further issues overlooked in the Issues Statement, including:

- customers choosing not to switch - SSE's experience is that customers who choose not to switch are not necessarily disengaged with the market – according to recent survey evidence, 55% of those who have never switched supplier are happy with their current supplier;
- customer engagement other than external switching – these forms include browsing (but not buying) on internet comparison sites and meter change requests; and
- the loss of traditional routes to market – the decrease in external switching rates is related to the cessation of doorstep selling and Ofgem's regulatory reforms.

Throughout this investigation, SSE hopes that the CMA will dispel some myths surrounding the GB energy market, for example around regional variations in prices. SSE does not charge less competitive tariffs to its 'in area' customers and regional differences in SSE prices simply reflect the differences in network costs.

This is particularly important in relation to 'tacit coordination'. SSE is not involved in 'coordination' or 'collusion', tacit or otherwise, between energy companies. Ofgem's assertion of 'tacit co-ordination' in the GB energy market is neither valid nor well-evidenced. The GB energy market is not characterised by conditions conducive to tacit coordination: concentration levels are low; new market entrants are disruptive; products are differentiated by value added services and broader products metrics; and cost structures differ from supplier to supplier, meaning that cost shocks would have a highly disruptive impact on any coordination. The recent activities of suppliers further demonstrate an absence of tacit coordination. For instance, SSE is the only supplier to have announced a price freeze until January 2016. If there was tacit coordination in the energy market, it is unlikely that SSE would be alone in the market following this strategy several months after the announcement.

In recent years there have been many Ofgem reforms which have delivered better outcomes for customers and stimulated further competition in the retail market. Reforms such as Personal Projection (an estimate of what a customer will spend per year, based on their own usage) and the concept of the Tariff Information Label (a standardised way of presenting key information about each tariff) have a direct, practical benefit for customers. However, certain aspects of these interventions have had unintended adverse effects:

- Ofgem's drive for tariff simplicity and non-discrimination is curtailing suppliers' ability to innovate and tailor products to customers' personal needs and circumstances while leading to a prohibition of previously popular choices such as fixed discount tariffs and prompt payment discounts.
- One of the key touch points for our customers is their bill. The current regulatory requirements make the bills lengthy and complex (3-4 pages on average), which can confuse customers.
- The customer journey through the sales process and the process for switching tariff within a supplier is also lengthy and involves the provision of a considerable amount of information. There is a balance to be struck between providing strong consumer protection and five star customer service, and the current regulations which frustrate customers.

In addition, whilst SSE remains supportive of the principles behind the mandatory social and environmental schemes that are paid for through energy bills, SSE has called for a clear commitment to reduce the costs of supplying electricity and gas in order to achieve sustainable reductions in the trajectory of prices. Building on the announcement of changes to the ECO and the Carbon Price Floor, a solution to reduce energy prices still further and ensure government policies are funded in the fairest possible way is to take more of these policy costs off energy bill payers and fund them in a fairer and more progressive way, such as taxation.

Looking Ahead

Whilst the market is well-functioning, over the coming months SSE will be developing its thinking around the following areas as there may be the potential for positive reforms linked to this theory of harm. These include:

- a wider and more inclusive view or benchmark of customer engagement, including switching rates not only between but also within suppliers, and other measures of engagement such as surveys of customers' views and customers' engagement with price comparison websites;
- working with and listening to customers' views about the access, design and delivery for their bills and other parts of the customer experience;
- a review of the appropriateness of interventions around restricting certain tariffs, whilst ensuring that tariff proliferation does not occur;
- a review of the role that price comparison sites can and could play in the market, including the information that these sites provide to customers and whether suppliers could provide better information to these sites to facilitate better informed decisions;
- lowering and simplifying customer bills by paying for government policy through taxation; and
- examining whether the different regional costs of transporting electricity could be passed on to suppliers as one national charge, allowing for fewer tariffs, a simpler understanding of regional differences and ultimately making price comparisons easier.

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