EXECUTIVE SUMMARY

The Retail Market Review: Domestic Proposals

Thank you for providing SSE with the opportunity to respond to Ofgem's Retail Market Review: Domestic Proposals. SSE believe that the GB energy supply market is competitive, and that this competition continues to be the most effective means of protecting consumers' interests. However, we recognise that there are challenges affecting the market, and we will fully support considered and proportionate measures that will address them. In October 2011 we announced our Building Trust initiative: a set of ten commitments that we believe will tackle the most pressing issue of all, namely the erosion of consumers' trust in their energy supplier. SSE was the first major supplier to publically commit to addressing this, but we recognise that the measures subsequently announced by British Gas, Eon and more recently EdF reflect the growing consensus that there is a need for suppliers to do better.

Ofgem is correct to seek to address obstacles that make it harder for consumers to engage with the market. However, since it is not possible to *force* consumers to engage, more thought needs to be given as to how best to promote increased engagement without adversely impacting on the choices or level of service available to all consumers in the market. Stipulating that all tariff innovation and all loyalty products or discounts should be relegated to the fixed-price market ignores the fact that 75% of customers are currently on evergreen, variable rate tariffs. Consumers are generally happier with the flexibility and convenience that this arrangement offers. Ofgem has not provided a rigorous cost benefit analysis to support the assertion that enhancing understanding justifies the level of harm that these proposals could have on both competition and customer choice. Meanwhile Ofgem's own consumer research does not support the measures in the proposed core tariff proposal.

Ofgem has presented data collected by Creative Research ("Tariff Comparability Models Volume 1 - Consumer Qualitative Research Findings") which show a clear preference from consumers for the style of tariff presentation that SSE advocates, whereby customers choose a tariff with clear visibility of selectable options that could provide a saving. This is slightly pejoratively labelled 'airline options' in the consultation document, evoking the threat of hidden costs – we would prefer to liken it to the immediately familiar process of selecting pizza toppings; removing unwanted toppings (for example quarterly credit) provides a saving, whereas more expensive toppings (such as paper bills) add a premium. As announced this week, we have gone live with the first stage of our simplified tariff presentment with planned enhancements later this year subject to Ofgem's implementation of the RMR proposals.

Ofgem's quantitative research found that nearly 67% of respondents (and a majority of respondents in all reported consumer sub groups) would prefer evergreen tariffs to include the same range of extra features as fixed and tracker tariffs (Ipsos MORI, "Consumer Reactions To Varying Tariff Comparability"). The quantitative research also highlights that consumers recognise that ease of comparison is not the whole story, putting a value on choices that increase tariff complexity:

> *The second part of the study showed that additional features such as internet access, dual fuel and green tariffs are popular among consumers. When asked about their preferences for additional features, a majority would choose internet access and dual fuel features themselves, and a majority would like to see green tariffs available to all. Interest is lower among vulnerable groups, but still significant. This is an interesting finding given the added complexity of making tariff comparisons when tariffs have additional features (p. 33).*

Our detailed concerns and objections to aspects of the proposals are outlined below and covered in detail in the attached Annex, which provides a response to all of the questions posed in the consultation.

This notwithstanding, we agree that the following measures will be instrumental in rebuilding consumer trust:

- a significant reduction in the range and complexity of available tariffs
- development of a standardised, simple and clear tariff comparison metric
- standardisation of terminology used by all suppliers

However, we believe that the proposals in their current form risk a number of unintended consequences, including:

- the rising number of customers on fixed-term contracts longer than one year in duration (with exit fees) could result in a reduction in switching rates
- the restriction of the evergreen tariff could result in an increase in the total number of tariffs offered in the market as simple discounts are replicated in the non-standard market
- the proposal for Ofgem to set the standing charge risks adversely impacting on low users, particularly if the charge is set at a low level

The combined impact of these proposals therefore risks long term damage to competition and consumer trust in the market. We elaborate the reasoning behind our concerns in the remainder of this document and throughout our detailed response to this consultation.

Summary

If Ofgem is convinced that significant regulatory intervention in the market is still required, despite the recent strides made by a number of large suppliers, then we believe that the unintended consequential damage to competition could be minimised if:

- Ofgem allows suppliers to continue to set their own standing charge
- All tariffs comprise a standing charge and a single unit rate
- Ofgem introduces a simple EPR style of tariff comparator
- Ofgem loosens restrictions in the standard market to accommodate benefits such as paperless and prompt pay discounts and nil premium loyalty products
- Ofgem avoids imposing increased price risk onto suppliers by accelerating the move towards a fixed term/ fixed price market
- Suppliers should be free to choose whether discounts (including for MDD) are applied to the standing charge (defined benefit) or the unit rate (defined discount)

Online price differentials erode consumer trust

Whilst Ofgem has helped to waken the market up to the issue of consumer trust, the root cause has not been clearly articulated. In our view, the biggest factor that has led to the erosion of trust is the prevalence in the market of loss-leading online offers designed to attract the most proactive consumers. If Ofgem is able to identify and implement a remedy that satisfactorily resolves this issue, we are convinced that many of the concerns that consumers (and Ofgem) have expressed about the current operation of the market will go away. Having said that, we remain concerned that despite raising our concerns about these practices on a number of occasions no action has been taken, and we discuss these issues in more detail below.

Heavily discounted deals have led to extensive and persistent market commentary on the significant savings available to consumers who switch supplier. Considered in the context of historically high energy prices, it is not surprising that consumers have been left with the mistaken impression that all suppliers are overcharging their stickiest dual fuel customers to the tune of £200-£300 per annum. SSE agrees with customers' assertion that the best deals should not be reserved for those customers who are willing to switch on a regular basis. We operate a fair pricing policy; we maintain price differentials that are as reflective of cost savings between different payment and billing methods as possible.

Whilst no supplier offering heavily discounted (non-cost reflective) deals has sufficient market power for this behaviour to constitute ‘predatory pricing’, we believe that the outcome is similar: a market is created in which neither small suppliers who lack the customer base to absorb the impact of loss leading tariffs, nor large suppliers committed to fairer pricing, are able to compete for a large section of the market. This makes it almost impossible for new entrants to become established – an observation which reinforces consumer scepticism about the level of competition in the supply market.

We do not believe that the proposals contained in the RMR consultation, in their current form, will deliver the best outcome for consumers as they do not directly address such heavily discounted online deals. Indeed, the fundamental changes proposed are likely to do further harm to competition (and hence consumer trust) in that there is a risk of unintentionally reinforcing the benefits to suppliers of offering loss leading discounts. It is impossible to say with any degree of confidence exactly how the market will develop under the proposed tariff reforms, but it is useful to consider what might be described as ‘worst case’ and ‘best case’ outcomes.

The worst case would result in the development of a two-tier market, ultimately characterised by less switching between standard and non-standard products. There is an even greater incentive for suppliers to offer large discounts in the early stages of the evolution of this scenario. If switching levels initially rise in response to the introduction of the market reforms, there is the potential for suppliers to attract previously sticky customers. Behavioural economics and Ofgem’s own customer research have consistently pointed to a strong preference amongst a significant group of consumers to remain fairly passive in regards to tariff choice. In time it is therefore likely that these customers may become fed up with the requirement for constant engagement and instead choose to remain with the standard tariff they are moved on to by default. In the longer-term, a more polarised two-tier market will develop in which the customers who are currently the most engaged will remain regular switchers and will benefit from discounted prices that could continue to be offered (potentially subsidised in some cases by sticky customers on less competitive standard tariffs).

Under the best case outcome, the reforms will lead to increased intensity of competition in both standard and non-standard tariffs – initially suppliers could continue to offer clearly labelled ‘introductory discounts’ (either with a mid-term step change in prices that is clearly identified up-front, or a fixed price contract for 6-9 months with customers then being migrated to the standard tariff). Over time, heightened competition will lead to the level of discount being reduced (as suppliers are forced to recognise the unsustainable nature of such deals), ultimately resulting in a reduced signal to switch. At this stage, previously very active consumers may start to become stickier, and their latest supplier will have acquired a long-term customer.

At both extremes there is a benefit to the supplier serving a customer at the point where they become sticky – either as a result of the customer becoming disillusioned with the “market of hassle” in non-standard tariffs or as a result of the erosion of significant savings. It is hard to envisage an intermediate scenario that would provide an outcome where discounted deals do not continue to confer a benefit on suppliers who offer them. The conclusion that can be drawn is that the proposed reforms could actually reinforce the benefits of offering significantly discounted deals, in that suppliers making these offers can expect to increase their customer base in the medium term at the expense of suppliers who do not or cannot compete in this sector of the market.

<u>Summary</u>

We do not believe that the proposals contained in the RMR consultation, in their current form, will deliver the best outcome for consumers as they do not directly address heavily discounted online deals.

A possible solution is to re-examine whether such large price differentials should be prohibited. Two options suggest themselves: either an outright ban on online-offline differentials, or an Ofgem specified maximum percentage discount that suppliers can offer for online deals (based on a reasonable assessment of genuine cost reflectivity).

Reform requires clear and measurable objectives

We have two concerns with the RMR proposals that are more fundamental. The first is that the genuine efforts now being made by some suppliers to rebuild customer trust will be completely undermined if Ofgem introduces a set of remedies that so clearly indicate that the regulator itself trusts neither suppliers nor the competitive market to deliver a better outcome for customers. If Ofgem truly wants to demonstrate the level of commitment to competition expressed in a recent article in the Independent ("Erosion of consumer trust in energy market", 17 February 2012) we would urge that the proposals be reconsidered, with close attention paid to the concerns of both large and small suppliers regarding the impact of the proposals on their ability to compete effectively.

The other fundamental issue is that Ofgem continues to advocate comprehensive and far reaching changes to the market without having first established what a successful outcome would be. It is impossible to sensibly compare different solutions to a problem if there is not a set of clearly defined and measurable goals against which they can be assessed. The rate of customer switching, taken in isolation, is a poor indicator of market health, and it becomes woefully inadequate if tariff or payment method switches with the same supplier are ignored. We would suggest that the following indicators would give a more balanced view of the supply market:

1. **Customer satisfaction** – based on a standardised cross industry measure, such as Net Promoter Score or the Customer Satisfaction Index – the target should be year on year improvement and attainment of an average (or better) cross industry score;
2. **Relative price** - this should be relative to peer group of EU states for electricity and gas – the target should be to always remain in the top quartile, perhaps with a medium term goal of being the cheapest;
3. **Average consumption levels** - this could be aligned to UK Government targets for reduction by 2020 – annual targets could be defined simply based on a straight line between where we are and where we aim to be in 2020;
4. **Market participation** - defined more broadly to capture changes of tariff or payment method with the same supplier as well as inter-supplier switching.

Monitoring a range of factors would provide a more coherent measure of market health. If customer satisfaction is improving whilst price and consumption levels are falling it would not be unexpected to note a fall in the rate of customers switching. Similarly, high switching rates coupled with rising prices and falling satisfaction would be more indicative of a market that is failing consumers (which highlights the risks inherent in relying too heavily on switching rates alone). Other factors such as margins earned by suppliers or standard measures of market concentration such as HHI could also be considered as elements in a set of measurable parameters which would provide a more balanced view of competition.

Summary

Ofgem should allow recent initiatives by suppliers to simplify their tariff propositions time to be delivered and tested against consumer sentiment, rather than immediately adopting the position that radical regulatory intervention is the better means of restoring trust.

Ofgem must provide a set of clearly defined and measurable goals against which proposed remedies can be assessed.

Tariff Proposals 1: Comparability

Ofgem has proposed radical reform and regulation of tariffs to enhance comparability. This is in the reasonable expectation that customer disengagement can be addressed by making it easier for consumers to spot the cheapest tariff for them. We agree that tariff simplification coupled with improved comparability could produce significant customer benefits. In particular, consumer confidence that they can correctly identify the most suitable tariff for their particular needs is a prerequisite in building trust. Such simplifying changes are at the heart of our own Trust initiative. We discuss our preferred route to deliver both of these elements in more detail in the appendix to this response.

To successfully affect consumer engagement, tariff comparisons must be simple, clear and comprehensive. The core tariff proposal involves Ofgem setting the standing charge to be applied to all standard tariffs. This intervention would make comparison of *standard tariffs* trivial (requiring nothing more than the unit rate) but it does not provide a suitable means for comparing *non-standard tariffs* (so it passes the simplicity and clarity tests, but fails to provide a comprehensive comparator). An unfortunate consequence is that consumers may be provided with a false sense of confidence through misunderstanding this fundamental limitation of the proposed unit rate comparison. There is a very real danger that this could lead to some consumers selecting a relatively less competitive tariff and firmly believing that it is actually the best priced deal for them in the whole market! This would be a significant unintended consequence of Ofgem's proposed reforms.

We believe that there are better, simpler and clearer ways to compare tariffs. Many stakeholders have suggested that the clearest comparisons are based on the whole bill. We proposed this type of solution ourselves in response to the RMR consultation in June 2011, and have now implemented our version of this Energy Price Rate (EPR) for all tariffs currently offered on our websites and where appropriate through our other direct sales channels.

Ofgem has argued that since not all customers know their annual consumption (even at the coarse resolution of low, average or high) it is inappropriate to rely on an EPR as a tariff comparison metric. This assertion possibly places a great deal of emphasis on consumers admitting that they do not know their consumption off the top of their heads. Yet Ofgem implicitly concedes that its own unit rate comparison, the Standard Equivalent Rate (SER), is not sufficient to inform consumer choices in the non-standard tariff market (fixed-term, fixed-price); instead, the proposed Tariff Information Label (TIL) includes indicative consumption based prices. The low, medium and high monthly costs provide exactly the same type of information that we advocate in our EPR. The TIL for a non-standard tariff therefore includes the unit rate applied to all consumption during the fixed term, plus the three Standard Equivalent Rates used for tariff comparison, corresponding to low, average and high consumption. It is not credible for Ofgem to suggest that quoting a total of four unit rates for each non-standard tariff will not lead to increased confusion amongst customers. In attempting to make its SER comparison appear comprehensive, Ofgem have made things less simple and less clear. It would be very unfortunate if one of the unintended consequences of these reforms is that a significant proportion of consumers utterly disregard the non-standard tariff sector, in which suppliers may offer their most competitive tariffs.

Under Ofgem's proposals, customers would still require the same knowledge of their consumption to make use of the SER as they do for whole-bill based comparisons. Given that it is therefore not possible to provide useful comparison information that does not compare the whole bill, we believe that it would be preferable for Ofgem to consider the best way to present an EPR type comparator that makes it absolutely clear that it is an estimate, rather than a fixed price quote, which consumer feedback has suggested some consumers may have mistaken it for. Principles could be agreed to define the types of discounts and reward schemes that could be factored into the EPR and which could not. This would provide a simple basis for tariff comparisons and could be applied consistently by all suppliers across the whole market.

Summary

It would be preferable to identify the best tool for the job and make it as useful as possible, rather than create an inappropriate tool and then try and redefine the parameters to make the tool appear less inadequate. The extreme nature of the proposed intervention in the market, driven largely by the desire to facilitate unit rate based comparison of tariffs, therefore provides an exemplar of disproportionate regulation.

Ofgem should relax the restrictions in the standard market to accommodate benefits such as paperless and prompt pay discounts and nil premium loyalty products.

Ofgem should introduce a simple EPR style of tariff comparator, based on a clearly defined methodology that all suppliers can implement.

Tariff Proposals 2: Setting the standing charge

It is inappropriate for Ofgem to suggest that suppliers should compete purely on the unit rate. We can understand that a regulated standing charge is an option that may appeal to consumers – indeed, it may appear intuitively sensible to many consumers – but we do not believe that it stands up to scrutiny when the range and complexity of the constituent costs are fully accounted for. The current variation in standing charges across the market represents the different appetites of suppliers for the risk of under recovery of fixed costs. Each supplier is able to take a view on this based on the cross section of their customers and the balance between low and high consumption. Whilst it is appropriate for each company to make this choice for themselves, it is surely not appropriate for Ofgem to impose a particular choice about risk on all suppliers.

Competition in standing charges is advantageous for consumers. Someone with lower than average consumption can save money by choosing a supplier with a relatively low standing charge and a slightly higher unit rate, whereas customers with above average consumption would benefit from a higher standing charge and a lower unit rate. The current market offers those choices by default.

Costs arising from metering, billing, collections, acquisition and customer service are all subject to competitive forces and it is therefore correct that suppliers should be free to set the standing charge component of all of their tariffs. For Ofgem to set the charge would distort the market. In particular, a narrow definition would lead to setting the charge too low – this would result in low users becoming unprofitable, as costs could not be recovered fully. Similarly, the 13% drop in domestic gas demand year on year (referred to in the Authority minutes from 24 Nov 2011) represents another source of risk. Where fixed costs are recovered through the unit rate, lower than expected demand can result in significant under recovery. This risk will have a disproportionate impact on smaller suppliers. This highlights the importance of allowing suppliers to manage risk for themselves by retaining the freedom to set both elements of the tariff. Removing this freedom may result in a tendency for suppliers to charge slightly higher unit rates than they otherwise would, to the disadvantage of consumers. The harmful consequences of this proposal on both competition and customers are discussed in detail in the Annex. SSE intends to respond in full to the consultation "The Standardised Element of Standard Tariffs under the Retail Market Review", published on 6 February 2012.

The provision for suppliers to offer unlimited non-standard tariffs also ensures that the tariff reform does not guarantee to deliver the fundamental requirements of tariff simplification, namely a reduction in the range and complexity of tariffs. We believe that far greater benefits for consumers could be delivered quicker and more simply by stipulating that all tariffs should consist of a standing charge and a unit rate.

In particular, by removing paperless and prompt pay discounts from the standard tariff market, the proposals are almost guaranteed to lead to an *increase* in the number of tariffs as suppliers seek to find ways to offer these benefits in the fixed term market. Our greatest concern is that many customers do not choose to sign up for fixed term deals but have come to expect and benefit from these types of discount on their existing tariff. To remove the facility to pass cost reflective savings on to customers in the 'evergreen' market is to introduce a form of price discrimination. Up to 50% of our quarterly credit customers benefit from the prompt payment discount in each billing cycle. The removal of this benefit alone is therefore likely to lead to a significant increase in complaints and have an adverse impact on customers' perception of the market. We also see the removal of nil premium loyalty schemes from the standard market as detrimental to consumers. Whilst there is a simplicity benefit in ensuring that suppliers all have at least one tariff that conforms to certain structures and rules of presentation for comparison purposes, the removal of all other variants from the standard market is arbitrary, harmful to competition and not in the interests of customers.

Ofgem refers to "competitive benefits that should arise from homogeneous products" (Impact Assessment, 1.176) but contradicts this notion by stating that "[price] convergence could be the result of price competition among homogeneous products… the erosion of price differentials could result in lower levels of engagement, lower levels of switching and so to a less competitive market" (Impact Assessment, 1,122). We would agree with the second statement and would urge Ofgem to consider allowing sufficient scope for suppliers to engage in meaningful competition based on real differentiation in the standard tariff market. To do otherwise risks doing serious long term harm by conveying to consumers who prefer variable or evergreen rates the impression that suppliers place no value at all in their loyalty and long term custom.

Summary

We believe that far greater benefits for consumers could be delivered quicker and more simply by stipulating that all tariffs should consist of a standing charge and a single unit rate.

Ofgem should allow suppliers to continue to set their own standing charge.

Accelerating the move towards a fixed-term/ fixed-price market will increase the market price risk imposed on suppliers. We do not believe that forcing the pace of this change is in the best interests of customers.

If Ofgem were willing to reconsider the restrictions in the standard market, then it would be possible to achieve significant tariff simplification through a licence condition which restricts the total number of tariffs which each supplier can offer. The effectiveness of such a licence condition is dependent upon Ofgem recognising that a single tariff with different service options or loyalty schemes offered around it (which impact on price) is more easily understood by customers than presenting the same options as numerous distinct tariffs.

Information provision to customers

The standardisation of terminology used on all bills, statements and price change notifications would help to reduce customer confusion and will help to restore trust in the industry. We are very supportive of this measure.

There are increasing pressures on bill layout and design, reflecting both the information requirements that followed the implementation of the Probe remedies and now the new requirements arising from the Green Deal. Customers are bound to find the increasing array of information they are confronted with on reading their bill confusing or bewildering. We do not believe that standardising formats of bills and statements is the correct approach. It would be far better to conduct a fundamental review of information on bills, with the goal of simplifying and clarifying as far as possible the information that is actually required.

There is merit in this review going right back to basics and considering whether gas prices should be quoted per unit of volume, rather than per unit of energy – this would allow suppliers to get rid of conversion factors and formulae that confuse customers. There may be issues around the variation of calorific value (CV) between different distribution zones but it is likely that the errors introduced by standardising the CV across the country would be no more significant than the errors in the temperature and pressure adjustments currently incorporated into the conversion factor.

A similar fundamental review of annual statements should be undertaken to identify the extra information that is actually needed by customers. Issuing the annual statement could be triggered either annually or by price changes. We present our work and thoughts on radical simplification of bills and statements in the confidential annex to this response.

Simplification and clarification of these documents could resolve the issue of confusion without resorting to standardised formats. Similarly we believe it would be preferable to ban specific formats on price change notifications that can be shown to confuse or mislead customers, rather than to impose on all suppliers the cost of implementing standardised formats.

Summary

It would be far better to conduct a fundamental review of information on bills, with the goal of simplifying and clarifying as far as possible the information that is actually required.

Standards of Conduct

Whilst we believe that the Standards of Conduct are a fair reflection of how we treat our customers, we do not think that Ofgem has established a sufficient case for these standards to be included as a condition of the Supply Licences. To do so would introduce a risk of double jeopardy when considered alongside the existing consumer protection regulations.

The fact that Ofgem has been unable to provide clear examples of the types of behaviour that SLC 1A would allow them to address - behaviour which is not already covered under existing powers - also brings into question the necessity for such a licence condition. Such examples, if they were provided, would be necessary but not sufficient to demonstrate the need for an over-arching principles based licence condition. If enforcement action really cannot be taken already as a consequence of poor drafting of existing regulations, it would be better to resolve the root problem rather than simply to treat the symptom.

As we noted in our response to the non-domestic consultation, despite discussion of this topic we are unclear regarding Ofgem's intended approach to enforcement of SLC 1A and whether it is really aligned with the requirements of principles based regulation: we would expect increased dialogue and co-operation between Ofgem and regulated companies under a principles based approach, and possibly even a two stage enforcement process. What we would not expect is a zero tolerance approach to compliance likely to result in a more adversarial relationship. Uncertainty on this point is also likely to result in the imposition of a greater than anticipated burden on suppliers and may have the unintended consequence of creating a barrier to entry or a disincentive to expansion.

There are also issues around the drafting of the licence condition in that the term "any representative" introduces significant enforcement risk that is hard to manage in the absence of clear guidance on exactly how this condition would be interpreted by Ofgem. The development of collective switching in the domestic energy market risks introducing the same set of issues that have been encountered with Third Party Intermediaries in the non-domestic market. We have already responded with our views on the inappropriateness of asking suppliers to monitor and control the behaviour of third parties in the non-domestic sector with whom they do not necessarily have a contractual relationship. This concern will be equally valid in interpreting the proposed licence condition in the domestic market.

Similarly we do not feel that the inclusion of the Standards of Conduct licence condition under the 'General arrangements' is appropriate as it ignores the fact that large non-domestic customers are fundamentally different to domestic customers. This difference is reflected in the differentiation that applies within existing consumer protection legislation.

Publically committing to uphold these standards - whether through the type of clear statement we have made in our Customer Charter or by reference to SoCs produced by Ofgem - is a far more appropriate way to incorporate these standards into suppliers' customer service standards. Such public statements are not empty gestures – the reputational risk of failing to meet these standards, or of not referring to the standards when handling complaints, are significant. Ofgem should not belittle this risk, nor the beneficial effects of such public commitments on supplier conduct.

Summary

Ofgem has not made a case sufficient to establish that there is a need for the SoCs to be incorporated into an enforceable licence condition.

Suppliers should make a public commitment to uphold relevant standards of conduct, preferably through a Customer Charter against which all customer complaints can be assessed.

Conclusion

We welcome Ofgem's desire to help suppliers rebuild trust amongst consumers. We believe that Ofgem has correctly identified many of the key issues that need to be addressed to remedy the current perceived levels of distrust and disengagement, but we would urge Ofgem to consider the concerns we have about the details of the proposed solutions.

SSE will continue to work with Ofgem and other stakeholders to develop proportionate and practical solutions that support competition in energy supply. Our concerns with the proposals put forward in this consultation primarily focus on the adverse impact on competition, the imposition of costs on suppliers without a detailed cost benefit analysis and the introduction of further barriers to entry.

We would be very willing to discuss any of the points made in our response in more detail with Ofgem and other stakeholders. We are keen to engage constructively in order to establish a route forward that delivers the best possible outcome for customers.