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27 September 2019

Dear Teams,

Flexible and responsive energy retail markets: putting consumers at the centre of a smart, low carbon energy system

We welcome the opportunity to respond to the above Consultation seeking views on BEIS and Ofgem's initial views from its joint programme to review the current regulatory framework for the energy retail market, in particular, assessing reforms to address potential challenges and opportunities that the future energy retail market may face.

We are broadly supportive of the initial views set out in the Consultation document and in particular would highlight the following points.

- We agree with the view that the Default Tariff Cap risks distorting incentives and innovation to the detriment of consumers in the long run. Accordingly, we are committed to working with BEIS and Ofgem on promoting a market environment that will facilitate an early move on from the Default Tariff Cap regime.
- We believe that after the Default Tariff Cap has been removed there is likely to be a continuing need for enduring price protections for vulnerable consumers and we have set out a proposal as to how this might be achieved (see Annex 2).
- We welcome the recognition that the uneven distribution of high cost to serve customers between suppliers – coupled with universal service and other regulatory obligations – distorts competition. We believe that an appropriately designed levelisation scheme could avoid this distortion, reduce the need for universal service obligations and incentivise the full range of suppliers to properly compete to serve high cost to serve customers.
- We agree that the remaining small supplier exemptions under the Energy Company Obligation (ECO) and Warm Home Discount (WHD) scheme are a significant cause of continuing market distortion, thereby undermining a competitive level playing field. We, therefore, welcome the intention to take further steps to address this, including through developing a new auctioning delivery model for ECO and the better use of data sharing powers under the Digital Economy Act 2016 for WHD.

We set out detailed answers to the specific questions in the Consultation document in the enclosed Annex 1. Should you wish to discuss further or have any questions please contact us or Rhona Peat (rhona.peat@scottishpower.com).

Yours sincerely,

A handwritten signature in blue ink that reads "Richard Sweet". The script is cursive and fluid.

Richard Sweet
Head of Regulatory Policy

A handwritten signature in blue ink that reads "Tom Restricks". The script is cursive and fluid.

Tom Restricks
Head of Public Policy

**FLEXIBLE AND RESPONSIVE ENERGY RETAIL MARKETS: PUTTING CONSUMERS
AT THE CENTRE OF A SMART, LOW CARBON ENERGY SYSTEM
- SCOTTISHPOWER RESPONSE**

Chapter 2: Overarching approach

1. Do you agree with our vision for the future of the energy retail market, the outcomes we are seeking to achieve and our characterisation of the key challenges we need to overcome?

Yes, we broadly agree with the vision as outlined in Chapter 2 of the consultation document. We comment in more detail on the related issues in subsequent questions but would make the following high level observations on the desired outcomes set out as comprising the vision:

- **Wide choice of energy services** - any changes to the regulatory framework to enable greater innovation and choice must ensure a level playing field is promoted in existing service areas within energy supply, to ensure there is no distortion of competition. New entrants who may be approved to operate in energy supply under an alternative licensing approach should not benefit from reduced energy supply regulations simply because they are supplying energy as part of a wider innovative service.
- **Consistent consumer protection** - we agree that consumers in the energy retail market should be entitled to the same level of protection regardless of the provider offering the service. Therefore third party intermediaries (TPIs) and other parties that fall outside the existing regulatory frameworks (auto switching services, price comparison websites (PCWs) etc) should at a minimum be subject to existing consumer protection regulations. This review should also take account of any harm resulting from TPI activities that is identified in Ofgem's current Strategic review of the Microbusiness Energy Market.
- **Minimal market distortions** - we agree that businesses should not face policy obligations and responsibilities that distort competition. Accordingly, current and future policies should be designed in a way that aims to create a level playing field for all participants, in a way that does not place disproportionate administrative burdens on smaller parties. We also agree with the suggestion in the consultation document that the distribution of certain higher cost to serve customers across the market effectively constitutes a current policy distortion.
- **Competitive prices for all** – we believe that after the Default Tariff Cap has been removed there is likely to be a need for enduring price protection for vulnerable consumers and we have set out a proposal to achieve this in Annex 2. Our proposal is structured to ensure that protections are introduced in a way that minimises any distortions resulting from an uneven distribution of vulnerable customers across suppliers, and also minimises the administrative burden on smaller parties. Separately we also agree that all consumers should be safeguarded from “excessive” pricing, though further work is required to articulate at what point loyalty penalties and/or price differentials should be regarded as excessive.
- **Ensuring consumers in vulnerable situations receive services they need** - we agree that the provision of services to vulnerable consumers should be consistent across the market regardless of energy supplier. The consultation document makes specific

reference to support for consumers in debt. A deficiency in the current framework in this respect is the fact that administrators of insolvent suppliers are not subject to supplier regulations on debt management, as highlighted in a recent Citizens Advice report.¹

We agree with the aims set out in the consultation document that the above outcomes must be achieved whilst taking account of the need for and benefits of regulatory simplicity and the requirement to be able to adapt to changes in the market environment. In particular, we would highlight the following points.

- **Regulatory simplicity** - we support initiatives such as Ofgem's move to principles-based regulation and the energy industry codes review that seek to simplify the regulatory framework and ensure energy suppliers are clear on the obligations they must meet. We agree that the regulatory simplicity resulting from such initiatives will benefit smaller parties and new entrants by ensuring they can understand their regulatory obligations. We also consider that parties entering the energy retail market, which is at heart an essential service, have a responsibility to energy consumers to be well prepared to comply with their regulatory obligations. In this respect, we would highlight the May 2019 amendments to the supply licence application process, which placed greater requirements on applicants to demonstrate their understanding and capability to ensure compliance. We believe it would be in consumers' interests to ensure commensurate requirements were in place on all future new entrants to the future energy retail market.
- **Reforming regulations in a rapidly changing world** – we think the proposed overall approach to the phasing of reforms is sensible. We note the intention to retain the supply licence in the medium term ahead of more radical regulatory reform. If this approach is adopted it will be important to ensure that in the interim period there are no unintended consequences that allow new entrants to engage in energy supply activities without a licence and gain an undue competitive advantage over existing licensed suppliers.

Chapter 3: The regulatory framework: facilitating consumer choice

2. Are there examples of new products, services and business models that would benefit current and future consumers, but are blocked by the current regulatory framework?

We are not currently aware of any products, services or business models that have been offered elsewhere but could not in principle be offered in the GB energy market. For example, electric vehicles (EVs) and peer-to-peer trading (P2P) are emerging in the market with no significant barriers, other than perhaps the requirement of a supply licence or affiliation with a licensed supplier. Other stakeholders external to the current market may be better placed to answer this question however.

In the event that there is clear evidence of any products, services or business models being blocked by the current regulatory framework, then the next question is whether the supply licence is an unnecessary and unjustified barrier to such products, services or business models entering the market - and whether they can be regulated outside the supply licence without gaining undue competitive advantage. The answer to these questions will inform whether or not more radical reform of the regulatory framework is required to move beyond the current supply licence and provide a common framework for all current and future participants.

¹ https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/SoLR%20report%20FINAL_v2.pdf

3. Are there current or emerging harms to energy consumers which are currently out of scope of the regulatory framework? Do these differ for domestic and non-domestic consumers?

With regards to existing identified harms, those that might be out of scope of the current regulatory framework are those that could arise from greater connectivity and automation of the household and smart devices. For example, it is not clear whether additional protections would be required for automated (direct) load shifting and demand side response, both in terms of assuming control over consumers' houses or premises and in assuring a sufficient level of cyber security. Similar concerns would apply to both the domestic and non-domestic market.

In relation to known harms that exist under the current regulatory framework, we would highlight a risk that certain parties operating within the market but who are not directly subject to the existing supply licence could give rise to consumer detriment. In this respect there is a reasonable question around whether TPIs, for example auto switching sites and PCWs, should be regulated given their increasing prevalence in the domestic energy retail market and strong presence in the non-domestic market. We think there could be a strong case for regulating such third parties, and it will be important to consider the conclusions of Ofgem's Strategic Review of the Microbusiness energy retail market in this regard.

Another area of consideration might be the increasing potential for cross-sector service providers to offer services that include energy supply. For example, it may be possible for a party to gain accreditation in a sector outside the energy sector and by virtue of this provide services to energy consumers without entering the market directly. The European Electronic Communication Code Directive (EECC) would see Ofcom having regulatory oversight of energy supply (in addition to the oversight by Ofgem) where it is offered as part of a bundle with relevant communications products or services. Using the example of telecoms, potential harms could be mitigated by developing a common cross-sector framework such as that proposed for third party providers (TPPs) of digital services in the telecoms and energy markets, as proposed in the recent Smart Data Review.

4. Would it be beneficial to allow suppliers to specialise and provide products and services to targeted groups of customers? If so, how can this be delivered while balancing the need for universal service?

At this stage it is not obvious to us that under the existing Universal Service Obligation (USO), suppliers are precluded from targeting particular consumer segments or groups or indeed offering energy supply to consumers under an innovative business model efficiently. As energy is an essential service, we believe that the USO remains an integral part of the energy retail market in ensuring all consumers have access to energy supply. If reforms to the present USO arrangements are to be implemented these will need to be justified in terms of need and consumer impact and also demonstrate that there would be no competitive distortions created. Our proposed levelisation scheme (see Annex 2) would potentially allow the USO to be relaxed without creating such distortions.

In any such reform, structural changes to the market in other areas would be needed to ensure no detriment to consumers or significant competitive distortions to the market. If the USO were completely removed, this would necessitate an alternative option for customers unable to secure a supplier in the market, for example appointment of a designated supplier to offer terms to all customers. We think there would be significant risk of competitive distortion if the USO were to be removed from only a subset of suppliers in the market,

unless this is accompanied by a levelisation scheme such as the one that we have proposed.

5. Are incremental changes to regulation sufficient to support the energy transition and protect consumers? Or does this require a more fundamental reform, such as moving to modular regulation?

As noted in our response to Question 1 above, a key consideration in the question of incremental versus radical reform is the need to avoid a situation where future new entrants can gain an undue competitive advantage over existing market participants. In particular, we note the proposal to phase reforms to the retail market that might retain the supply licence in the medium term before any more radical reforms to the regulatory framework in the longer term, including moving beyond the current supplier licence model. Of course, it is important to ensure that such a phased approach does not give rise to an interim period which enables new entrants to engage in energy supply whilst being subject to fewer regulations than licensed suppliers with whom they would be competing. Such lack of a level playing field would obviously be unfair and counter to the interests of consumers.

We can conceive that it should be possible to implement incremental reforms to introduce certain classes of authorised activity that have no overlap with energy supply, for example the introduction of regulation of TPIs could coexist alongside the current supply licence for energy suppliers without creating any competitive distortions. However, as the Consultation document notes in this context, an important question to consider would be how to ensure the proper monitoring of those parties operating in these separately regulated areas in the event that Ofgem is not operating a licensing regime. Conversely, where new business models and/or services have some overlap with energy supply, there is a greater case for moving to a more radical form of modular regulation so as to ensure that all parties are competing on a level playing field.

Chapter 4: Tackling distortions and complexity in supplier obligations and responsibilities

6. Are there any other potential market distortions we should be considering as part of our review?

We very much agree that the use of a 'small supplier exemption' in supplier obligations such as the Energy Company Obligation (ECO) and the Warm Home Discount (WHD) scheme represents a significant distortion to the energy retail market that needs addressing so as to better deliver a competitive level playing field across the market.

In addition, we also consider that the uneven distribution of high cost-to-serve customers (as identified in the consultation document) is resulting in significant market distortions and, indeed, the negative impact of these on competition is currently being exacerbated by the Default Tariff Cap. We set out below further detail on the nature of these distortions, and possible ways to address them, in our responses to Questions 7-10 and, in the case of high cost-to-serve customers, in our response to Question 13.

7. Would removing the thresholds for the Energy Company Obligation and Warm Home Discount help remove imbalances in the retail market, and could this be done without significantly increasing barriers to supplier entry or expansion in the retail market?

We agree that the current small supplier exemption in ECO and the WHD scheme distorts competition by creating an uneven playing field between suppliers who fall above and below the threshold. Indeed, we consider that a robust evidence base has never been produced to set out a clear justification for the use of such exemptions.

ECO

As detailed in the consultation document, the difference in charges for suppliers above the ECO threshold and those below is material – the BEIS Impact Assessment for ECO3² estimates it to be around £25 - £27 per dual fuel customer per year in 2019 (based on annual overall costs of £640m). This difference is providing a competitive advantage to those suppliers who fall below the threshold, as they are able to offer reduced tariffs to their customers or can operate with higher costs or profits while matching obligated suppliers' pricing. This amounts to a significant distortion of competition resulting in sub-optimal outcomes for consumers.

WHD

Energy accounts held by suppliers who are not included in WHD, either on a statutory basis or a voluntary basis, currently represent over 5% of the total market. Moreover, as is detailed in the consultation document, the BEIS Impact Assessment estimates that the costs borne by obligated suppliers under the full WHD scheme amount to around £14 per dual fuel customer. Thus, removing the small supplier exemption for the WHD scheme would improve competition in the market by providing a more level playing field for all suppliers, whilst also making the discount more widely available to consumers of all suppliers.

Conclusion

As is noted in the consultation document, the existence of these distortions raises the question as to whether there are ways of moving beyond these respective small supplier exemptions without significantly increasing barriers to entry or expansion in the retail market. In this regard, we would start by noting the progress that BEIS has already made on setting a downwards pathway in the small supplier exemptions for ECO and WHD (due to reach 150,000 customers from April 2020) without any apparent signs of negative consequences to the energy retail market.

Moreover, we consider that further steps can be taken to move beyond the small supplier exemption regime as follows.

- First, as regards the WHD scheme, we agree that the better use of data matching under the Digital Economy Act 2016 will enable a straightforward move away from any kind of exemption threshold with the obligation applying to all suppliers. The availability of such data matching will have the effect of making any such threshold policy completely redundant.
- Second, in terms of ECO, we agree that a move towards an auctioning model at the end of ECO3 (as highlighted in the Consultation document) would facilitate a clear move

² BEIS, ECO3: 2018-2022 – final stage impact assessment, 2018

away from the small supplier exemption threshold. This is because the nature of any supplier obligation would be expressed in terms of a funding contribution towards such an auctioning mechanism with such an obligation being proportionate to size. (Of course, such a model need not preclude energy suppliers also choosing to continue to be delivery agents of energy efficiency improvements to households by virtue of bidding into the auctioning mechanism.)

8. How could the delivery burden on suppliers from the Energy Company Obligation be reduced, for example through the introduction of a buyout mechanism?

We welcome the focus set out in the Consultation document, highlighting the potential merits of moving to an auctioning model to support the delivery of energy efficiency improvements to households in need in the 2020s (ie after the end of ECO3 in March 2022). This kind of model would allow a broad range of participants to bid for funding to deliver energy efficiency measures to households, including energy suppliers who may have built up expertise in this area, as well as new providers who might wish to enter the market. It would also facilitate a move away from the use of a small supplier exemption threshold given that the nature of any continuing supplier obligation would be to make funding contributions towards this new delivery model in a way that is proportionate to their size.

As is illustrated by the Contracts for Difference (CfDs) auctioning mechanism for supporting renewable generation, well-designed auctions can be highly successful in promoting innovation and driving down costs over time.

A key additional benefit of any such model is that it would enable a shift away from consumer bill funding towards funding from general government spending in a way that would be less regressive. We recognise that this may be an area which the Government wishes to consider further as part of the planned Treasury review into the distributional impacts of meeting the new Net Zero target under the Climate Change Act 2008.

9. What effect does the range of Energy and Climate Change Policy Levies have on the retail market?

As set out in response to Questions 6 to 8 above, we consider that the use of so-called 'small supplier exemption thresholds' in respect of social and energy efficiency supplier obligations such as ECO and the WHD scheme have the effect of introducing significant distortions to the retail market that hinder competition based on a level playing field. In response to those questions above, we set out steps that might be taken to move beyond the use of such thresholds in a way that would not in any way hinder entry into the market or indeed supplier expansion.

More generally, we would note that the recovery of policy and system costs based on a cost pass-through approach should not in itself (ie apart from small supplier exemption thresholds) result in undue market distortions that undermine a competitive level playing field. That said, we would note that in the longer term, one possible effect of allocating a wide range of different types of policy costs onto electricity could be to distort competition between fuels (eg electric heat pumps versus hydrogen), as well as to create an inefficient 'hidden subsidy' for behind the meter generation. In this context, a sensible step would be to move to funding energy efficiency and social programmes, such as ECO and the WHD scheme (which are not related to the delivery of electricity), from consumer bills to general government spending. As noted above, there is a further policy rationale for this step given that the funding of such schemes by government spending would be less regressive and this would be consistent with their underlying policy focus on addressing fuel poverty challenges.

Lastly, there is one particular point that we would highlight in the context of the current Renewables Obligation (RO) and this relates to the need for BEIS to review the existing payment terms associated with the RO which are exceptionally generous (ie 5 months after the year-end). We consider that addressing this would be an important step in seeking to minimise the negative impacts of supplier insolvency in terms of cost impacts on other suppliers and, as such, would complement the important work that Ofgem is doing in this area.

10. What actions could government take to reduce any negative impact of Energy and Climate change Policy Levies?

Please see our responses to Questions 6-9 above.

11. Do you agree that now is not the time to make further changes on system and network cost recovery, metering and access to data as part of this retail market review?

Yes. These matters are being considered separately and do not need to be addressed as part of this retail market review.

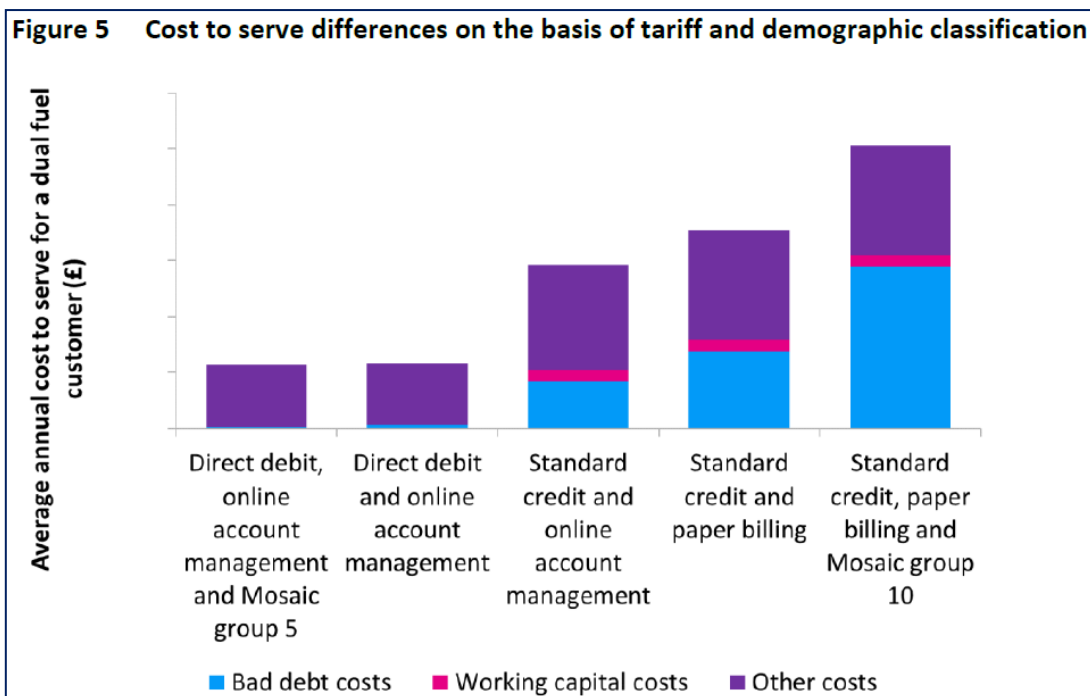
12. What total costs do suppliers face with regards to bad debt and supporting consumers who struggle to pay for their energy?

The additional costs faced by suppliers with regards to bad debt and supporting consumers who struggle to pay for their energy include:

- bad debt write-off
- working capital costs associated with debt balances
- costs of specialist customer service agents (some of our most experienced and highly trained agents are those who deal with customers in payment difficulties)
- costs of debt collection activities (including obtaining warrants for installation of prepayment meters).

The largest of the above is likely to be bad debt write-off. Based on Ofgem price cap data, we estimate total annual bad debt write-off costs at around £420m.³ A report commissioned from Baringa by ScottishPower has highlighted how bad debt write-off costs can be particularly high for particular demographic groups, as shown in the chart below.

³ Ofgem estimates the average bad debt cost per dual fuel customer paying by standard credit at £56. (Ofgem Default Tariff Cap: Decision, Appendix 8 – Payment Method Uplift. Table A8.3). Assuming a total of 51m single fuel supplies (28m electricity and 23m gas) of which 30% pay by standard credit, this implies a total bad debt cost of around £420m.



The chart shows that standard credit customers with paper billing in Mosaic Group 10 ('Transient Renters') have annual average cost to serve £152 higher than average for all standard credit customers with paper billing. The difference in cost between the highest cost to serve and lowest cost to serve customer groups, after taking into account the Mosaic demographic categorisation, is over £390 per year. The Transient Renter demographic includes a high proportion of financially vulnerable customers who move frequently between different rented accommodation, and whose identity the supplier may not be aware of, making it difficult to engage normal debt collection channels.

In extreme cases, bad debt costs arise because customers do not pay their bills and suppliers are obliged to provide energy for free (for example where it is not safe or reasonably practicable to fit a prepayment meter). (NB. In this context, we understand that Energy UK has submitted a document as part of its response to this consultation with a number of case studies illustrating the range of scenarios in which suppliers can find themselves unable to recover the costs of energy supplied.)

We would encourage BEIS or Ofgem to request information from suppliers on their customer mix, for example the distribution by post code. This could be combined with socio-demographic profiling data to obtain an initial objective view as to the extent to which customer mix varies between suppliers and the extent to which it may reasonably be expected to drive cost to serve differences.

13. How could any potential distortions related to high cost-to-serve customers be addressed, for example by the provision of additional support services for customers struggling to afford their energy?

Distortions relating to high cost-to-serve customers

Socialising the costs of high cost-to-serve customers has always been a feature of energy supply. Some customers simply cannot afford to pay their bills. Rather than disconnect them, suppliers absorb the resulting bad debt costs and recover those costs from the rest of their customer base (referred to as 'socialisation'). Distortions (and unfairness) arise when the

customers of new entrant suppliers (who can be more selective about which customers they take on) do not contribute the same amount towards socialisation as other customers. When the market share of new entrants was small, these distortions could be overlooked, but as we enter an era of more intense competition involving a significant proportion of new entrants, and such costs are socialised over a dwindling pool of customers, the issue can no longer be ignored. Indeed, this unequal socialisation is a key factor behind perceived 'loyalty penalties'.

Levelisation scheme

A potential solution to this unfairness is to formalise the cost socialisation through an industry levy, in much the same way as other social and environmental obligation costs are currently 'levelised' (eg (WHD payments or Feed in Tariff payments). Each month suppliers who incur less than their fair share of costs would pay into a levelisation fund and this is used to reimburse those who pay more than their share. All customers, regardless of their supplier, would then pay an equal share of the costs in their energy bill, addressing this second dimension of fairness. We provide more detail on how this might work in Annex 2. As set out in Annex 2, the advantages of a levelisation scheme go well beyond reducing the incidence of 'loyalty penalties', and could include for example:

- creating an energy market where there is no disincentive to offer to supply energy to the most financially vulnerable customers;
- incentivising suppliers to develop innovative ways to support this customer group and drive competition in the market;
- making it easier for Ofgem to introduce new obligations on suppliers to provide specific services in support of vulnerable customers;
- ensuring that all customers contribute fairly to the costs of providing this support;
- helping lay the foundations for more radical retail market reform where suppliers can enter the market with increasingly targeted offers without raising concerns about 'cherry picking'.

One possible objection to such an approach is that it could allow a supplier's inefficiencies to be funded or be open to gaming. Whilst it would be important to design the scheme to avoid this (and Ofgem would need to exercise careful judgement in determining the amount of costs to be levelised), we think that the dynamics of the competitive market should provide a natural safeguard. If, for example, the costs of expensive to serve customers were assessed at too high a level and levelisation set accordingly, this would provide an incentive for more efficient suppliers to target those customers for acquisition.

Additional support services

We think there will always be a role for additional support services for customers struggling to pay for their energy services, particularly if these help to reduce the amount of debt that is built up. However, we consider that these will complement, rather than substitute for, the levelisation approach described above.

14. Would addressing market distortions (for example size-based obligation thresholds for some policy schemes, supporting those who are struggling to afford their energy bills) help reduce incentives for suppliers to adopt pricing strategies that lead to excessive prices for loyal consumers? If so, to what extent (providing quantitative evidence, where possible)?

As noted in our responses to Questions 7 and 8 above, we consider that it is vital that BEIS further addresses the market distortions that result from the continuing size-based obligation thresholds in the ECO and WHD schemes. These thresholds distort competition and reduce overall efficiency and are detrimental to consumers in the long run.

It is also possible (as BEIS suggests) that these distortions contribute to pricing strategies that lead to 'excessive' prices for 'loyal' consumers (although we would not see this as the main reason for removing the thresholds). The way in which this might happen would presumably be as follows. Small suppliers which are below the threshold for the policy obligations pass on the cost savings arising from not having to meet these obligations via lower prices, in order to win customers and gain market share. In order to defend and grow their customer base, larger suppliers attempt to match these prices with new tariff offers, which they can only do if they recover the policy costs (arising from the policy obligations they - unlike the exempted small suppliers - have to meet) over the remainder of their customers, who pay a bit more than they would otherwise have done, thereby creating a perceived 'loyalty penalty' for these customers as compared with those who benefit from the cheaper tariff. Although this may be a contributory factor to perceived 'loyalty penalties', we think it would be difficult to quantify its impact in rigorous terms.

As noted in response to Question 13 above, a more effective intervention to remove one potential cause of perceived 'loyalty penalties' would be to introduce a cost-levelisation scheme which addressed the wide variation in costs faced by suppliers resulting from their customer mix, in particular, higher costs related to the proportion of expensive to serve customers who struggle to pay their bills.

15. What are your views on the measures being considered to address loyalty penalties in different markets? What approach or – combination of approaches – would be most effective in the energy retail market?

The consultation lists four measures considered by the CMA for preventing excessive loyalty penalties in other sectors:

- targeted interventions to certain sections of the market either to limit price differences or cap prices where there is clear harm, for example to consumers in vulnerable situations;
- regulators applying principles (rather than prescriptive formulae) which describe unfair pricing approaches – with compliance demonstrated through ex post monitoring and reporting;
- actively helping people move to a better deal through the use of smart data, intermediaries and collective switching (which can be on an opt-in or opt-out basis);
- bolder enforcement of consumer law and sector specific rules to tackle harmful and exploitative supplier practices.

We comment on the applicability of these to the energy retail sector below. However, we would also note that any benefits in terms of the protections from the price cap intervention could result in some enduring benefit beyond the removal of the cap. This has been recognised by Martin Cave in his dissenting opinion on the CMA Energy Market Investigation where he argued that the cap would have an influence on energy prices in the market even after it has been removed. We agree that this is likely to be correct.

Vulnerable price cap

Loyalty premiums are a feature of nearly every competitive market and provide an incentive for customers to shop around. They are only problematic when they are too high or fall on those who can least afford them. For that reason, we think there is likely to be a continuing need for a price capped tariff in the energy retail market to protect the most financially vulnerable who do not shop around, complementing the financial support provided by the existing Warm Home Discount (WHD) scheme.

Pricing principles

Coming up with a definitive definition of what constitutes excessive pricing is challenging. It will vary from market to market, it may vary from one group of consumers to another, and will likely have to exclude any pricing differences for which there is objective justification. For that reason, we agree that a more promising approach may be to come up with pricing principles rather than prescriptive formulae.

Such principles might, for example, focus on situations where identical products or services are offered for a sustained period of time in the market at widely varying prices, and without objective justification. (If a supplier can demonstrate that its higher prices were due to a more expensive to serve customer basis, that would potentially be justification).

Indeed, the new duties imposed on Ofgem under Section 9 of the Domestic Gas and Electricity (Tariff Cap) Act 2018 may prompt some further thinking along these lines. Section 9 requires Ofgem to continue monitoring supplier pricing practices after the cap has been lifted, to consider whether there are categories of customer who still need protection from excessive default tariff prices (including vulnerable customers and those coming to the end of a fixed term tariff) and if so possible intervention.

Even if some suppliers were tempted to explore and test the possible use of excessive 'loyalty penalties' once the price cap is removed, we think Ofgem's new monitoring duty mentioned above (with or without fully developed pricing principles) should provide a strong disincentive, particularly if combined with the transparency of a cost levelisation scheme.

Facilitating switching

Improving customer engagement (e.g. by smart data, intermediaries) is a pro-competitive solution which should form part of any strategy to address the risk of 'loyalty penalties'. We think these means will have a role to play in energy – together with the major industry programme currently underway to deliver faster and more reliable switching.

Bolder enforcement of consumer law

Bolder enforcement of consumer law may have a place in the energy retail sector, but we do not see it as a solution to the risk of some suppliers introducing excessive 'loyalty penalties'. There has never been any suggestion (so far as we are aware) that the prices in the energy sector have been in breach of consumer law. If there is a concern that suppliers could adopt

'excessive' prices once the cap is removed, this will best be addressed via pricing principles discussed above.

16. What other approaches could be adopted to ensure loyalty penalties do not re-emerge?

We think the three approaches mentioned above (vulnerable consumer price cap, pricing principles and facilitated switching) will go a long way to mitigating the risk of excessive 'loyalty penalties emerging.

A fourth area, mentioned in response to Question 13 above, is the introduction of a levelisation scheme to ensure that the costs of expensive to serve customers are borne more equally between the customers of different suppliers. As set out in Annex 2, a levelisation scheme will have a range of positive benefits for the market, including:

- removing the need for some suppliers to charge a higher price than others to recover costs of serving more expensive customers – which might otherwise be perceived as being part of an excessive 'loyalty penalty'
- increasing the transparency and comparability of supplier pricing; differences in pricing will be driven by differences in efficiency, service level or profit (assuming that any other significant distortions such as the small supplier exemptions under ECO and WHD are removed), and suppliers will not be able to justify higher prices based on customer mix.

17. What protections or support may be required to engage consumers in vulnerable situations in the future market?

There are already a number of obligations on energy suppliers to protect and support those customers in vulnerable circumstances with the majority of these obligations being principles-based rather than rules-based which ensures that suppliers are offering appropriate protections and support even where the market is evolving. As such, we consider that the appropriate protections and support are adapting and evolving over time in an effective way.

In addition, as we set out in response to Question 13 above, we believe that the introduction of a levelisation scheme for the higher financial costs of supporting vulnerable customers will help to create an energy retail market where there is no disincentive to offer to supply energy to the most financially vulnerable customers. This will also incentivise suppliers to develop innovative ways to support this customer group including through alternative ways to engage with and support customers.

Lastly, as is noted in our response to Question 1 above, a deficiency in the current framework for supporting consumers in debt is the fact that administrators of insolvent suppliers are not subject to supply licence obligations on debt management, as is highlighted in a recent Citizens Advice report.⁴

⁴ https://www.citizensadvice.org.uk/Global/CitizensAdvice/Energy/SoLR%20report%20FINAL_v2.pdf

**FLEXIBLE AND RESPONSIVE ENERGY RETAIL MARKETS: PUTTING CONSUMERS
AT THE CENTRE OF A SMART, LOW CARBON ENERGY SYSTEM -
SCOTTISHPOWER PROPOSAL TO CREATE A FAIRER ENERGY MARKET**

1. Introduction

The default tariff price cap is a temporary regulatory intervention designed to protect disengaged customers from higher energy prices while we transition to a more competitive and fairer energy market. With Ofgem due to consider in 2020 whether the cap can be removed, and Ofgem and BEIS recently launching a review of future retail market design, it's timely to look beyond the cap and consider what changes are necessary to achieve a more competitive and fairer energy market which protects our most vulnerable consumers.

2. Achieving fairness for all consumers

A number of initiatives are under way to make the market more competitive, but how can we make it fairer? Fairness has a procedural aspect – making sure that customers are given clear and complete information about their options and not bamboozled into deals – but also a distributional aspect. Two key features of distributional fairness are (i) making sure that those in fuel poverty or other financial difficulty do not pay a 'loyalty premium' if they fail to shop around and (ii), where costs are 'socialised' across customers who can afford to pay, all such customers bear a fair share.

Loyalty premiums are a feature of nearly every competitive market and provide an incentive for customers to shop around. They are only problematic when they are too high or fall on those who can least afford them. Indeed, the Competition and Markets Authority (CMA) recently investigated the loyalty penalty in markets other than energy, and found that vulnerable people may be more at risk of paying higher prices due to a loyalty premium.⁵ For that reason, we think there is likely to be a continuing need for a price capped tariff to protect the most financially vulnerable who do not shop around, complementing the financial support provided by the existing Warm Home Discount (WHD) scheme. Of course price is not everything: a well-functioning market should ensure that such customers benefit from good service as well as good prices.

We also need to address the second dimension of distributional fairness, making sure the rest of the customer population bear a fair share of socialised costs. Socialisation of costs has always been a feature of energy supply. Some customers simply cannot afford to pay their bills. Rather than disconnect them, suppliers absorb the resulting bad debt costs and recover those costs from the rest of their customer base (referred to as 'socialisation'). The unfairness arises when the customers of new entrant suppliers (who can be more selective about which customers they take on) do not contribute the same amount towards socialisation as other customers. When the market share of new entrants was small, this unfairness could be overlooked, but as we enter an era of more intense competition and costs are socialised over a dwindling pool of customers (see Figures 1 and 2 overleaf), it can no longer be ignored. Indeed, this unequal socialisation is a factor behind the perceived 'loyalty taxes' that have drawn so much criticism from consumer advocates.

⁵ 'Tackling the loyalty penalty, Response to a super-complaint made by Citizens Advice', CMA, 19 December 2018

A potential solution to this unfairness is to formalise the cost socialisation through an industry levy, in much the same way as other social and environmental obligation costs are currently 'levelised' (eg (WHD payments or Feed in Tariff payments). Each month suppliers who incur less than their fair share of costs pay into a levelisation fund and this is used to reimburse those who pay more than their share. All customers, regardless of their supplier, would then pay an equal share of the costs in their energy bill, addressing this second dimension of fairness. We provide more detail on how this might work in the following sections.

Figure 1 – Supplier Domestic Market Shares 2013 to 2018

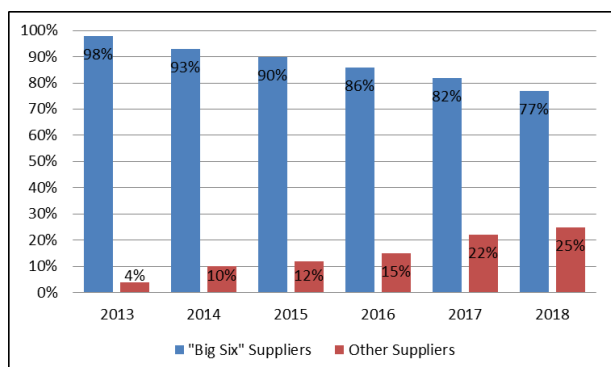
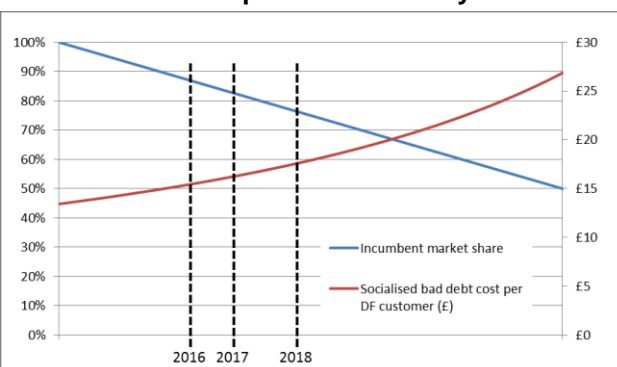


Figure 2 – Stylised illustration of how socialised cost per customer may increase⁶



Our proposed solution has two significant additional advantages that will help deliver the fair and competitive market we are aiming for. First, with the introduction of a levelisation mechanism, suppliers no longer have a disincentive to supply financially vulnerable customers. Indeed, instead of avoiding such customers, suppliers will be incentivised to target or retain them, and develop innovative ways of serving them more effectively and efficiently. (Instead of developing smartphone apps for Tesla drivers, suppliers may develop apps to help customers on benefits with their budgeting.) Such benefits could extend to other areas of vulnerability, such as mental or physical health, where there is often a correlation with financial hardship.

Second, introduction of levelisation will increase transparency of supplier pricing once the default tariff cap has been lifted. Differences in pricing will then be down to differences in efficiency, service level or profit, but not differences in customer mix. This will make it easier for customers to see if their supplier is pricing fairly, and easier for Ofgem to discharge its obligation under the Domestic Gas and Electricity (Tariff Cap) Act 2018 to monitor the pricing practices of suppliers (including the pricing of default tariffs). In turn, this greater transparency will help reduce the risk that the market reverts post default tariff cap to a situation where disengaged customers pay an excessive "loyalty penalty" with some suppliers.

3. Proposed approach - rebate and social tariff

Our proposal is that those in most need of financial support would be protected by a combination of a revised WHD scheme and an enduring price cap. The revised WHD scheme would provide a fixed rebate off energy bills regardless of consumption and tariff, as at present. The price cap would provide a form of social tariff at a level less than the average cost to serve, giving additional financial protection to those with the highest energy bills. As

⁶ Chart assumes circa £420m total bad debt costs (consistent with Ofgem tariff cap methodology) socialised across customers of incumbent suppliers only.

with the default tariff cap, customers who wished to engage in the market would be free to select uncapped non-default tariffs.

Eligible customers would be identified through data held and shared by the Department for Work and Pensions (DWP) in a similar way to the current WHD data matching process and potentially using the new powers in the Digital Economy Act. The eligibility criteria would be set by the Government and Ofgem, ensuring consistency regardless of which supplier a customer chooses. The criteria for the social tariff might for example be based on the mandatory criteria for the Core and Broader Groups in the current WHD scheme (which we understand would cover around 10% of domestic customers— compared to c.8% receiving rebates under WHD Scheme Year 7).⁷ The criteria for the revised WHD scheme could be the same, or potentially a subset of this group who are likely to be particularly financially vulnerable by virtue of their characteristics or circumstances.

Government and Ofgem would be responsible for determining the optimum balance between the support provided through the two measures (WHD and social tariff). Ofgem would be responsible for defining the methodology to be used in setting the level of the price capped social tariff and for updating it on a biannual basis, as per the default tariff cap.

The aim should be to ensure that the vast majority of financially vulnerable customers can afford to pay for their energy alongside other essential costs, but without placing a disproportionate burden on the wider customer base.

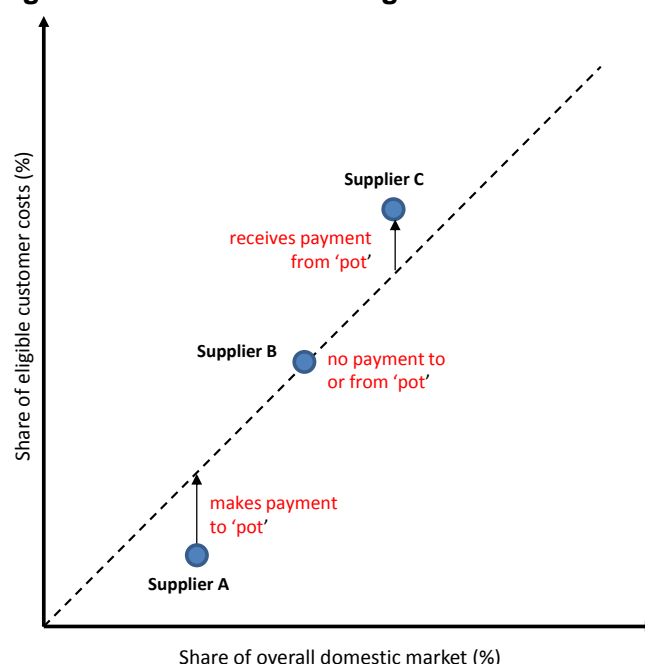
4. Proposed approach - levelisation

A key feature of our proposed approach is to achieve a fairer sharing of the costs of supporting vulnerable customers, so that all customers contribute the same, regardless of which supplier they are with. This would be achieved through a levelisation process, similar to that used at present for the WHD and Feed-in Tariff schemes.

The levelisation process would assess (on, say, a quarterly basis) each supplier's share of the cost of supporting eligible customers through each scheme and how this compared with their overall market share. Each supplier would either pay into a central pot, or receive a payment from the central pot depending on whether their share of eligible customer costs was lower or higher than their overall share of the market (Figure 3). This would ensure that all suppliers (and hence all suppliers' customers) share equally in the cost of supporting financially vulnerable customers.

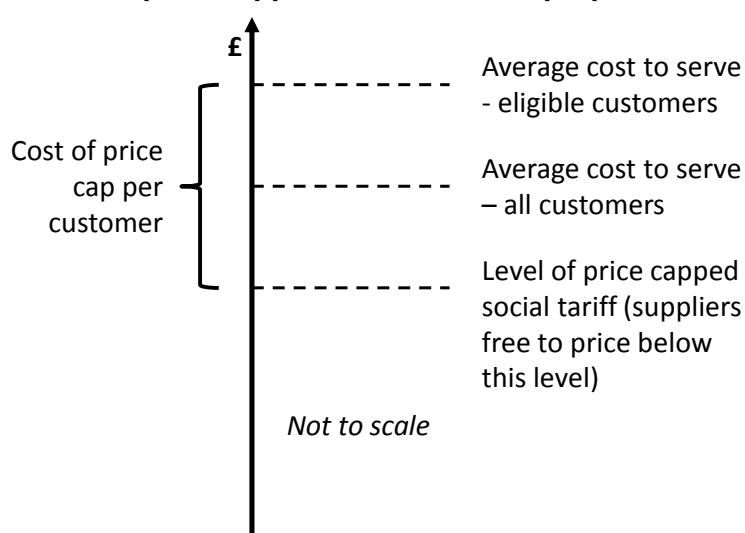
⁷ 2.2 million customers were provided with a WHD rebate out of 28 million electricity meter points in GB. Sources: https://www.ofgem.gov.uk/system/files/docs/2018/12/whd_sy7_annual_report.pdf and https://www.ofgem.gov.uk/system/files/docs/2018/10/state_of_the_energy_market_report_2018.pdf

Figure 3 –Levelisation of eligible customer costs



For the purpose of levelisation, the cost of the price capped social tariff would be the difference between the average cost to serve of eligible customers (determined by Ofgem through requests for information as part of its price cap setting process) and the level of the cap, as shown in Figure 4.

Figure 4 – Cost of price capped social tariff for purpose of levelisation



As noted above, it will be for Government and Ofgem to determine the level of the rebate and the price cap, but as a rough indication of possible magnitudes, the overall spending target for WHD scheme year 7 was £329m and based on Ofgem price cap data we estimate total bad debt costs at around £420m⁸. (Bad debt will not be the only additional cost

⁸ Ofgem estimates the average bad debt cost per dual fuel customer paying by standard credit at £56. (Ofgem Default Tariff Cap: Decision, Appendix 8 – Payment Method Uplift. Table A8.3). Assuming a total of 51m single fuel supplies (28m electricity and 23m gas) of which 30% pay by standard credit, this implies a total bad debt cost of around £420m.

associated with serving eligible customers but it is likely to be the main component⁹; equally, not all the £420m will relate to eligible customers.) The value of the price cap discount (relative to average cost to serve for all customers) will be additional to this.

We do not believe that these proposals will add a significant administrative burden to any supplier. All suppliers currently offer price capped tariffs and when Ofgem previously considered the feasibility of a price cap targeted at vulnerable customers it found no evidence that DWP data matching would be disproportionately onerous for smaller suppliers. The data matching process is not onerous for new suppliers offering the WHD, and indeed a recent Government paper suggested that WHD Scheme costs are very low.¹⁰

There may however be a need for a phased implementation to mitigate the impact of levelisation costs on suppliers who may have large numbers of existing customers on fixed term tariffs which cannot be increased to recover additional levelisation costs.

5. Wider protection for vulnerable customers

Ofgem's role in this fairer approach to supporting vulnerable customers is wider than simply facilitating the process of identifying eligible customers and setting the level of protection. With vulnerable customers potentially more likely to switch to new suppliers as more innovative services are offered, it will be important that Ofgem continues to monitor supplier practices to ensure any situations where customers are not being treated fairly are identified and acted on quickly. Ofgem's recently implemented revised new entrant criteria and proposals for ongoing monitoring as part of its supplier licensing review will facilitate this.

As noted above, our proposed levelisation scheme may have wider benefits for financially vulnerable customers since suppliers would no longer have a disincentive to supply them. Indeed, instead of avoiding such customers, they would be incentivised to target or retain them, and develop innovative ways of serving them more effectively and efficiently. Such benefits could extend to other areas of vulnerability, such as mental or physical health, where there is often a correlation with financial hardship.

The levelisation scheme could also make it easier for Ofgem to introduce new licence requirements on suppliers to offer additional services to customers in vulnerable circumstances. At present, any new requirement with material cost implications will disadvantage incumbent suppliers compared to new entrants and is likely to be resisted accordingly. Providing that the new requirement is reflected in Ofgem's levelisation calculations these objections would be removed.

6. Protecting Disengaged or Loyal Customers

Looking beyond the default tariff cap we need to be confident that the market will not move to a situation where disengaged customers may pay an excessive "loyalty penalty" with some suppliers.

Our proposals for levelising the cost of supporting vulnerable customers will help in this regard as they will increase transparency and comparability of supplier pricing. Differences

⁹ Others will potentially include the provision of additional services relating to vulnerability, and increased transaction costs relating to higher than average use of contact centres.

¹⁰ BEIS March 2018 consultation on the extension of the Warm Home Discount Scheme, para 9, page 9 (https://beis.gov.uk/citizenspace.com/home-local-energy/warm-home-discount-2018/supporting_documents/WHD%20extension%20consultation.pdf)

in pricing will solely be due to differences in efficiency, service level or profit, and suppliers will not be able to justify higher prices based on customer mix.

However, the key safeguard will come from the new duties imposed on Ofgem under Section 9 of the Domestic Gas and Electricity (Tariff Cap) Act 2018. This requires Ofgem to continue monitoring supplier pricing practices after the cap has been lifted, to consider whether there are categories of customer who still need protection from excessive default tariff prices (including vulnerable customers and those coming to the end of a fixed term tariff) and if so to intervene.

In his dissenting opinion on the CMA Energy Market Investigation, Martin Cave argued that the price cap will offer some protection on pricing of tariffs after the price cap¹¹ is removed. We think this is likely to be correct. However, even if some suppliers are tempted to introduce excessive 'loyalty penalties', Ofgem's monitoring duty will provide a strong disincentive, particularly with the increased transparency resulting from cost levelisation.

7. Conclusion

We believe it is important that the energy market transitions to ensure that customers in vulnerable circumstances are protected once the default tariff price cap has been removed, and that the costs of this protection are shared more fairly across the wider market.

The reforms we are proposing would protect the most vulnerable consumers through a combination of an enduring price capped social tariff and a targeted rebate similar to the existing Warm Home Discount scheme. The identification of eligible customers would be facilitated by data sharing from the Department of Work and Pensions to ensure customers are automatically protected rather than having to apply, and we believe the protections should apply to the circa 10% of most vulnerable consumers in the GB market.

To ensure that the costs are shared more equitably across all suppliers and their customers, we propose a levelisation process whereby suppliers with a lower proportion of vulnerable customers compared to their general market share make payments to a central pot which is redistributed to those suppliers with a higher proportion of vulnerable customers.

We believe the proposed reforms will:

- create an energy market where there is no disincentive to offer to supply energy to the most financially vulnerable customers;
- incentivise suppliers to develop innovative ways to support this customer group and drive competition in the market;
- make it easier for Ofgem to introduce new obligations on suppliers to provide specific services in support of vulnerable customers;
- ensure that all customers contribute fairly to the costs of providing this support;

¹¹ 'Energy market investigation Final report', CMA, 24 June 2016, page 1417, <https://assets.publishing.service.gov.uk/media/5773de34e5274a0da3000113/final-report-energy-market-investigation.pdf>

- help lay the foundations for more radical retail market reform where suppliers can enter the market with increasingly targeted offers without raising concerns about ‘cherry picking’.

Appendix 1 – Areas for further consideration

If these proposals are to be taken forward many detailed aspects of the design will require further consideration. We set out below our thoughts on some of the issues that will need to be considered.

Which DWP benefits categories would be eligible?

Ofgem’s May 2018 Statutory consultation on Price Protection Data Matching suggested the following benefit categories for the proposed vulnerable customer price cap, and we think this would be a reasonable starting point for consideration, both for the revised WHD scheme and the price cap – though there may be a case for targeting one more narrowly than the other.

Benefits	
Attendance Allowance	Jobseeker's Allowance
Bereavement Benefit	Pension Credit
Carer's Allowance	Personal Independence Payment
Disability Living Allowance	Severe Disablement Allowance
Employment and Support Allowance	Universal Credit
Housing Benefit	Widow's Benefit
Incapacity Benefit	Income Support
Working and Child Tax Credits	

How will data matching work?

Ofgem explored options for data matching in 2018 in the context of a proposed vulnerable price cap, including initial discussions with DWP and smaller suppliers. This work would need to be resumed.

Would benefits apply to electricity and gas?

The WHD applies only to electricity customers and we see no reason to change this. We suggest the price cap should apply to both electricity and gas, since for some vulnerable customers heating will comprise a large proportion of their energy demand.

How would the price cap be set?

Ofgem’s existing default tariff cap methodology could form a suitable starting point for the proposed vulnerable price cap, with separate caps for the standing charge and unit rate elements.

The cap could be the same for all payment methods (which would simplify levelisation and might be considered fairer) or the cap could include an uplift for payment methods such as standard credit which are more expensive for suppliers to administer (which would send an efficient price signal to consumers).

Ofgem would need to undertake some additional data gathering to determine the difference in average cost to serve between eligible customers and customers as a whole. Ofgem (or Government) would also need to decide how much lower than the average cost to serve to set the cap.

How frequently would costs be levelised?

The levelisation frequency needs to strike a balance between administrative costs and efficiency. We suggest a quarterly cycle would reduce the risk of default from supplier insolvencies, and ensure that market share data for fast growing (or shrinking) suppliers is reasonably up to date, without incurring excessive cost.

How would eligible customer costs be determined for purpose of levelisation?

The WHD cost is the same for all eligible customers so it simply scales with the number of the supplier's customers who qualify.

For the tariff cap, the simplest approach would be to assume a uniform cost per customer based on industry average consumption. However, if some suppliers' eligible customers consume significantly more or less than the average it may be appropriate to take this into account.

Depending on the design of the cap, it may also be necessary to take into account the mix of payment methods used by each supplier's eligible customers.

How would the measures be policed?

Ofgem's current processes for policing the WHD and default tariff caps would form a suitable starting point.

ScottishPower
September 2019