

Neil Barnes
Ofgem
9 Millbank
London
SW1P 3GE

2 December 2008

Dear Neil,

ENERGY SUPPLY PROBE – INITIAL FINDINGS REPORT

ScottishPower is grateful for the opportunity to respond to the Initial Findings Report of Ofgem's Energy Supply Probe. ScottishPower and its parent Iberdrola champion competitive energy markets in the EU and beyond. We strongly favour the continued development of the GB energy system within a competitive market framework.

We welcome the principal findings of the Probe, which concludes after thorough investigation that:

- The level of consumer participation in GB energy markets is among the highest of any retail energy market throughout the world;
- Switching rates compare well with other retail services in the UK such as fixed and mobile telecommunications, insurance products, mortgages and personal current accounts;
- There are high levels of awareness, confidence and satisfaction with the switching process;
- There is no evidence of prices increasing by more than can be justified by wholesale costs, or of the lag between wholesale price movements and tariff changes being longer when prices are falling than when they are rising; and
- After careful examination of the issue, Ofgem is satisfied that there is no cartel operating.

Beyond these key conclusions, the Report makes a series of 20 recommendations for further improvements to the market. This is a valuable agenda to consider – there is always room for improvement in any system.

In broad terms, we think we can accept 15 of the recommendations in whole or in part, in some cases subject to clarification. That clarification could usefully involve market research to pin down what is needed for some of the customer facing and communication ideas, as well as cost benefit analysis. It would be good regulatory

practice to review existing communication requirements to assess whether any can be reduced or removed to help ameliorate the cost or complexity of adding more.

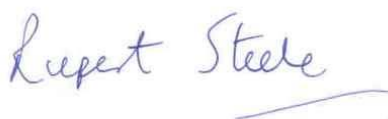
Of the remaining 5 recommendations:

- We are supportive of the ideas behind the two recommendations on price differentials and agree that it would be timely for the industry to review its cost reflectivity between tariffs – and, in the case of some companies, between gas and electricity – with a view to making improvements where appropriate. However, considerable care will be needed in preparing an approach to this which does not obstruct the running of the competitive market and which allows innovation to flourish. We have given some initial thought as to how this might be approached;
- On the question of separate accounts, we are concerned about the compliance cost compared to the value of the information that will be provided, and whether the additional visibility between companies could harm competition. It would be helpful to understand more clearly what are Ofgem's information needs and how they can most effectively be met, since full regulatory accounts seem to us unlikely to be compatible with the principles of better regulation;
- We believe that the current rules allowing suppliers to object to transfers for reasons of debt are in the interests of consumers because the cost and availability of credit terms would be seriously and adversely affected if a significant loophole in the enforcement of payment were allowed to develop. While we are happy to look again at the details of the way the system works, we would not support radical change;
- We do not believe that the case has been made for general provisions on market abuse that go beyond competition law. In a commodity only market for generation, prices are likely to be below new entry cost for much of the time, and investment cases will need to rely on the ability to make strong profits in times of shortfall. The risk that these gains might be subject to regulatory review under a market abuse condition would inevitably have a chilling effect on investment, just at the time that that investment is needed. For this reason, we do not support this proposal.

I attach a note which discusses each of the recommendations in more detail.

We look forward to further discussions with Ofgem on the Probe Report; please get in touch with me if you have any questions on the matters raised in this response.

Yours sincerely,



Rupert Steele
Director of Regulation

ENERGY SUPPLY PROBE – INITIAL FINDINGS REPORT

SCOTTISHPOWER INITIAL RESPONSE TO RECOMMENDATIONS

| Recommendation 1 | Accept, subject to clarification |
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| <i>A requirement for clearer information on customer bills (for example, detailing the customer's existing tariff and consumption level) to make it easier to compare current arrangements with alternative offers.</i> | |

Clarity on customer bills is something we at ScottishPower constantly strive for; we spend a lot of time and effort finding out what our customers want from the bill and then using that to improve our bills – which are a key communication with our customers. In principle, we believe that our bills already state the level of consumption and the tariff, because this information is used to work out the sum due.

Nevertheless, we are always trying to improve our communication and therefore would like some clarification as to the kind of changes that Ofgem may believe are necessary. In seeking improvements – which could perhaps be encapsulated in the ERA Billing Code (rather than formal regulation), if a consensus formed – there are a few practical matters which would need to be considered:

- Designing the bill is a constant challenge of matching the information that is required, or would be helpful to include, with the need to keep the bill reasonably simple and able to fulfil its primary purpose – namely to request payment and provide information as to how that payment should be made. Although we offer special large print bills for those who request them, good practice – endorsed by the relevant age and sight charities – is to avoid excessively small print for all customers. Accordingly, if the improvements would lead to placing additional information on the bill, we would therefore like to see if other information could be removed or provided separately “with” rather than “on” the bill.
- There are complexities concerning the level of consumption – for example in cases where there is an estimated bill, or the bill corrects for one or more previous periods when the account has been estimated. There may also be changes of supplier or tenancy during the billing period, for which the relevant readings may have been estimated. It will be necessary to consider how these and similar cases will be treated.
- It would be necessary to test any proposed changes to bills with consumers for ease of understanding and use.
- Bills are an opportunity for suppliers to innovate and differentiate their offerings. It will be important that this is not lost in excessive standardisation.

We look forward to considering these issues with Ofgem as the proposals are developed. The detail of the proposals could also affect the implementation cost, given the likely need for IT changes, and therefore the cost/benefit analysis.

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| Recommendation 2 | Accept, subject to clarification |
| <i>An annual statement to each customer showing, for example, the customer's current tariff, the size of any premium they are paying (for example, relative to an average tariff or other payment method), their annual consumption level and alternative price packages available from that supplier.</i> | |

In principle, we agree that an annual statement would be helpful to consumers. It would, however, be important to clarify the cost benefit case for requiring the statement as well as its content and how it would be calculated. It would also be necessary to understand which elements of the statement and its delivery would be standardised and which elements would be left to suppliers to determine.

We have just completed at some cost the system modifications needed to deliver a graphical display of how consumption in a billing period compares with the same billing period in the previous year, as required by the Electricity and Gas (Billing) Regulations 2008¹. Further modifications to deliver annual statements would need analysis to determine the systems impact and cost. We would also need to consider how the annual statement and the information required under the Regulations would relate to each other and whether there would be customer confusion.

Other points which we would seek clarification on include:

- The extent to which the statement is proposed to be “bespoke” for individual customers. Clearly, the further we go along this line, the more development and maintenance cost could arise and the higher the risk of giving what is later perceived to have been poor advice.
- The timing of issuing the statements and the impact on call centre volumes.
- How to deal with exceptions. For example, the statement might be affected by any changes of pricing or product during the year as well as by estimated readings or a change of tenancy or supplier. Comparisons between fixed and variable priced products – or products where a premium is paid for the benefit of a price cap – would need to be prepared with special care.
- The proposed mode of delivery – within or in addition to the billing cycle.

We are happy to discuss practicable and realistic options for the improvement of the information we communicate to our customers.

General information sent annually with the bill on a non-bespoke basis covering pricing, the difference between the various tariffs, and the various deals on offer would not be problematic. However, it would be essential to validate any proposals for bespoke statements with customer research and it would be appropriate to undertake a cost benefit analysis through the regulatory impact assessment process to ensure that the costs, which would fall on consumers in the long term, are justified.

¹ These implement Article 13 of Directive 2006/32/EC on energy end-use efficiency and energy services

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| Recommendation 3 | Accept in part |
| <p><i>An annual prompt to all customers of how to switch supplier, the advantages and disadvantages of each payment method and the potential savings from changing payment method.</i></p> | |

We already run – and strongly promote – a programme known as the “ScottishPower Savings Challenge” which encourages consumers to ensure that they are on the tariff that best meets their needs, whether or not they are already with ScottishPower. Within this context and others, we already aim to communicate to our customers the advantages and disadvantages of each payment method and the potential savings from changing payment method.

Accordingly, we have no difficulty with a requirement to give our customers an annual prompt with this information – perhaps in conjunction with recommendation 2. Some consideration would however be needed as to whether it would be appropriate to provide people with details of payment methods for which they would be ineligible. For example, in the case of a customer who is on prepayment terms as a result of a large debt, we might be unwilling to allow a switch to direct debit in the absence of progress clearing the debt and/or some evidence that the direct debit could be maintained.

The points made in relation to recommendations 1 and 2 about testing, the merits or otherwise of bespoke, and the cost benefit of consumer communications would also need to be kept in mind.

We are less sure that the element of the recommendation about how to switch supplier is appropriate. As a matter of principle, we think that the message about switching is best given by the supplier making an offer of new terms to the customer, rather than the supplier from whom the customer is switching. The “winning” supplier has a definite proposition to offer, while the “losing” supplier has no such thing.

The Probe Initial Findings suggest that this process has already achieved 96% of customers knowing that they can switch supplier and 70% feel confident that they know how to. It is arguable that at these levels of understanding, a prompt from the “losing” supplier, which would always be out of context, would add little.

While we remain open to further discussion on this point, at present we do not think that the case has been made for the switching element of this recommendation. We do however accept in principle the other elements.

More generally, recommendations 1-3 and 8 form a package of measures broadly designed to increased comprehension, transparency and comparability of information to customers. We suggest there would be value in looking at the initiatives together to seek synergies. It might also be useful for Ofgem to review a variety of existing bill formats to assess the relevance and importance of the information currently provided. It may be that some of it could be provided on the reverse of the bill, or indeed on a separate enclosed leaflet. Suppliers are likely to choose based on a variety of criteria but typically they may favour bespoke customer information e.g. MPAN being retained on the bill (though possibly on the reverse side), while generic product information could be provided separately. Eliminating duplication and only requiring on the bill what needs to be there should lead to a better and clearer result for consumers.

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| Recommendation 4 | Accept |
| <p><i>A programme to promote confidence in price comparison and switching sites and to extend their scope, in particular to enable prepayment switching and switching among low income and vulnerable groups who do not have internet access.</i></p> | |

We would agree with this recommendation and like to see further progress in this area. Improving confidence in, and the scope of, the switching sites would be in the interests of consumers. We are already able to accept prepayment switches through the switching sites in the majority of cases.

We would also like to see this channel opened to a wider group of customers, including those low income and vulnerable groups who do not have their own internet access. We would support Ofgem and Consumer Focus in working with the switching sites to explore how this could be achieved.

It would be useful to document any improvements agreed with the switching sites in the energywatch / Consumer Focus Confidence Code.

It will be important that these improvements do not change the basis of the suppliers' relationship with the switching sites. It is for suppliers, in the light of their individual marketing strategies, to decide whether to advertise on switching sites (and therefore pay their commission and other charges for the services provided).

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| Recommendation 5 | Accept |
| <p><i>We will consider whether there is future scope to simplify the supplier switching process to identify any further possible simplifications to the customer switching experience.</i></p> | |

We would support looking at the options to improve the switching process. There are two classes of improvement we believe could be relevant:

- Improvements in industry switching processes which would reduce costs and complexity on the industry side. The benefits would be expected to feed through to consumers as a result of the competitive process.
- Enhancements to the process which would improve customers' switching experience. Although switching is relatively simple from customers' point of view, there is always room for improvement and we can see clear value to customers in any enhancements that can be realised.

Of course some improvements, such as reductions in the number of cases going wrong, can score in both categories above and are particularly valuable to consumers.

We have already looked at this as an industry through the Customer Transfer Programme (CTP), taken forward under the auspices of the ERA. Some useful improvements were made, although practice showed that realising improvements was not always as straightforward as first envisioned. We are happy to explore the scope for going further and consider that an industry working group may be the best way to take this forward.

It would also be sensible to take a wider look at the change of supplier process as part of the co-ordinated development of the smart metering programme.

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| Recommendation 6 | Do not accept |
| <p><i>We will look again at debt blocking with the aim of re-visiting the automatic right to block switching by customers who are in debt as it is currently being applied by suppliers.</i></p> | |

The process of objecting to transfers for reason of debt was introduced by the Government in the initial licence conditions for the opening of the gas market in 1996 and similar arrangements were put in place for the electricity market opening in 1998. It was introduced as a necessary mechanism to ensure that there was no loophole that could enable customers to avoid their debts by changing supplier. Closing that loophole was vital to ensure that energy could be sold on credit terms without the widespread requirement for substantial security deposits, and/or pricing which built in a very high risk of default.

We believe that these reasons are as valid today as they were when debt objections were originally introduced. It would not be in the interests of consumers – especially those older consumers who like to pay on credit terms – for there to be an easy loophole to avoid payment, as this would require honest and/or prudent customers (some of whom may well be fuel poor) to subsidise consumers without those attributes.

At ScottishPower, we have a key focus on preventing debt build up and helping customers to manage this effectively when they do build up a debt, through promotion of secure payment methods. This focus will be particularly important as we move into challenging economic circumstances. However, despite our best efforts it occasionally becomes necessary to object to a customer leaving us with debt. We do this rarely – less than 7% of domestic transfer requests from ScottishPower are objected to for debt – but if the facility was not available, the impact on the prices we would need to charge for supplying energy on credit terms would be substantial.

Although we believe that the principles of the existing rules on debt objections are in the interests of consumers, we would not rule out looking at possible improvements. For example, for some prepayment and vulnerable customers it may be that there is scope to look at debt assignment. If a manageable, workable solution can be found for debt assignment, this would be of benefit to both customers and suppliers.

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| Recommendation 7 | Accept |
| <p><i>A sustained customer awareness programme will be launched to explain the switching process, promote the benefits of switching and, in particular, give vulnerable customers targeted information on the options open to them.</i></p> | |

We agree that this could be valuable for consumers and would recommend that the programme is carried out and supported by an independent third party – to create consistency and bring clarity and credibility for customers.

It would be useful for the programme’s success to be monitored by appropriate consumer research.

It would be helpful to understand more about how vulnerable customers would be targeted in this context.

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| Recommendation 8 | Accept, subject to clarification |
| <p><i>We will work with consumer groups and suppliers to explore the development of an easy-to-understand price metric to enable consumers to compare prices quickly and easily. This metric could be made available to all customers on their bills and proposed annual statements, and would be used by all suppliers in all price quotations.</i></p> | |

We fully support the concept of clearer product information for customers and agree that scope exists to improve the information that is currently available to customers. We think that a single price metric, if it can be devised in a way which is not misleading and does not prejudice the ability for suppliers to innovate and differentiate their products, could be a very helpful addition to this clarity.

In developing such a metric, which might perhaps be similar to AER / APR approach in financial services, it will be necessary to consider points including the following:

- How would pricing which varies with consumption be dealt with? There is a significant element of fixed costs from network use and billing, and suppliers differ in the way this is recovered – for example, some products use a standing charge while others use a graduated unit rate. It is important that suppliers have the option to charge out these fixed costs in a broadly cost reflective manner as otherwise significant market distortions could arise, with smaller customers becoming unprofitable to supply.
- How would any capped/fixed element in the pricing, or other incentives, be dealt with?
- As smart meters are rolled out with additional options for suppliers like time of day pricing, how would the metric take account of these ideas?
- Is there a risk that suppliers would design products to the metric rather than trying to ascertain and then meet customer requirements?

These issues are clearly complex. Despite this, we think it would be well worth giving further consideration as to how such a metric could work, and we would welcome the opportunity to participate in the process. It would be necessary for the metric to be tested in consumer research at an appropriate time in its development, to ensure that it is effective in conveying value information to customers.

If a metric is developed, we would agree that it should be used at the point of sale. We would suggest that further consideration be given in relation to any mandatory use on the bill for reasons similar to those in our responses to recommendations 1-3.

We understand that the proposed metric would not compel suppliers to list or analyse competitors' prices.

Recommendation 9**Accept in part**

Rules governing suppliers' sales and marketing activities will be strengthened, especially focused on enabling consumers to make well-informed decisions in response to a direct sales approach, and to prevent any misleading marketing or sales activity. This could, for example, include an obligation to provide consumers with a written quotation and comparison with the consumer's current price.

We would support appropriate strengthening of the rules governing suppliers' sales and marketing activities in order to assist consumers in making well-informed decisions and to curtail misleading marketing or sales activity. We would suggest that the AES Sales Code might be a good forum in which to take this forward.

ScottishPower has made a point of ensuring that sales agents are equipped with a ready reckoner which indicates the savings a customer could make from switching to us from various suppliers' standard products and, importantly, the cases where no saving could be made. In such cases, our sales agent would be expected to advise the customer accordingly and, if appropriate, explore the consumer's interest in fixed price or other special products.

We believe that this approach is a core element of responsible sales activity and we would be inclined to accept appropriate additional requirements aimed at bringing all suppliers up to this level. We have experience of losing substantial numbers of customers to higher priced suppliers' standard products, especially in the prepayment market.

We have some concerns that the specific example quoted – an obligation to provide customers with a written quotation and comparison with the consumer's current price could be ineffective or even counter-productive. In particular:

- It would be extremely difficult for our sales agents to have a sufficient understanding of competitor products, including the various fixed/capped price deals and any termination fees, to be able to characterise them accurately in any written statement.
- Some consumers will not know the precise details of their current supplier's package and some do not routinely retain their bills to enable them to look this information up.

In some cases, consumers may move to a product with a higher headline price because they value other features, such as capping, fixed price, discounts for early payment or other incentives. This is not a failure of switching and it would be advisable to address this point more fully in establishing the most effective options for improvement and their cost effectiveness.

Another part of the package that could potentially be useful would be to encourage greater transparency in pricing and to signpost customers to third parties than can more readily perform comparison services or independently discuss the pros and cons of different products with consumers.

We would recommend that suppliers have the opportunity to pilot test any proposals made in relation to this recommendation, to ensure that the anticipated benefits to consumers are gained and unintended consequences avoided.

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| Recommendation 10 | Accept |
| <i>We will actively engage with government, suppliers and others in order to facilitate an efficient roll-out of smart meters.</i> | |

We fully support the delivery of smart meters on an organised basis across the industry and endorse the Government's indicative timetable of a two year preparation phase followed by a ten year roll-out. We believe that the provisions in the Energy Act 2008 are well designed to facilitate the process.

ScottishPower will continue to engage actively with Ofgem and the Government to facilitate the introduction of smart metering.

An early priority will be to set up the mechanics for the project management of this work, including putting in place a central delivery programme involving the industry, Ofgem and Government.

It will be important to continue to work on options for the market model and on how best to handle the stranding costs related to functional but outdated meters.

As mentioned in our response to recommendation 5, there could be a valuable opportunity to look at the switching process in the context of the smart meter roll-out.

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| Recommendation 11 | Accept |
| <i>We will review regulatory obligations that could act as an undue deterrent to new entry or obstacle to small supplier growth and, wherever possible, remove them or make them less onerous.</i> | |

We are supportive of the removal of unnecessary regulatory obligations and agree that such obligations could act disproportionately as a disincentive to smaller suppliers.

Obviously, some care will be needed where the obligation comprises an important safeguard for consumers. Conversely, where the obligation is unnecessary, it should normally be lifted for the large suppliers too, so that all consumers are able to benefit from the reduced compliance cost.

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| Recommendation 12 | Explore alternative solutions |
| <p><i>We will require the Big 6 suppliers to publish separate regulatory accounts for their supply and generation businesses, in order to improve transparency and make it easier for potential entrants to assess market opportunities at each point along the value chain.</i></p> | |

We have no difficulty with transparency in our accounting information or in explaining how our business works. We think that it is useful for the system to be open so that potential entrants can assess market opportunities at each point along the value chain.

GB energy markets already have a high degree of transparency with volumetric information on gas and electricity flows being available more widely than in many other markets. This has been highly positive for consumers and we see the benefit in an open approach, both to encourage new entrants and to enable Ofgem to monitor the issues on structure of tariffs described in recommendations 19 and 20.

However, there are a number of points which we believe merit further examination before finalising any decisions in this area:

- A number of energy companies, including ScottishPower, do not utilise separate accounts for the supply and generation businesses for the purposes of running the business, as the two businesses are run, along with the wholesale trading function, as a single profit centre, to enable optimisation across the entire value chain.
- The biggest variable factor in seeking to separate the supply and generation businesses for accounting purposes will be the transfer price used:
 - It is difficult to see how this could be related to the actual costs of the generation business and arising under any long term gas contracts, as this information would be affected by trading (ScottishPower's total trading volume is around 3 times its generation volume). Some of our competitors have centralised their trading function on an EU-wide basis, which further complicates the picture. And the accounts might provide competitors with rather a detailed insight into the cost structure of each supplier, which could be detrimental to competition;
 - If the transfer is to be at market prices, then it is necessary to decide whether the prompt market price is used (probably too volatile) or some combination of longer term prices along the forward curve. If the choice of this is not standardised, then any comparative information is likely to be significantly distorted by market movements. If a standardised metric is used, there is a risk that this becomes a "recommended" hedging strategy, discouraging suppliers from experimenting with other approaches and limiting competition and innovation in this area. Similar issues arise with making the necessary adjustments to the wholesale market price to deal with shape and risk issues;

- It is unclear what treatment of transfer pricing would provide the assistance to potential new entrants to identify opportunities along the value chain. New entrants would be able to understand the market related opportunities from data which is already available. And information relating to actual costs is unlikely to be an accurate predictor of companies' economic behaviour;
- As well as the transfer price, there would be a need to allocate costs and revenues, such as those arising from the trading operations, to generation or supply. Such allocations are by their nature arbitrary and are unlikely to represent the position that would apply to an independent upstream or downstream company;
- The production of full regulatory accounts would be likely to have significant compliance costs.

In the light of these issues, we believe that a requirement for full regulatory accounts would not achieve significant benefits for the consumer, nor meet the principles of better regulation. Accordingly, would like to understand more from Ofgem about what they are seeking to achieve and whether there are any better ways to meet their needs.

Possible approaches that might be considered would be a more targeted provision of information necessary for assisting Ofgem in monitoring cost reflectivity of charges (see recommendations 19 and 20) or else developing a set of standard operational and financial key performance indicators for companies to publish in or alongside their parent companies' statutory accounts.

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| Recommendation 13 | Accept |
| <p><i>We will begin, urgently, a programme of work to identify the underlying causes of low wholesale market liquidity, and explore with the Big 6 suppliers how best to achieve a significant increase in liquidity.</i></p> | |

We would welcome seeing a higher level of liquidity in the market, especially for power. For this reason, we have commented on certain aspects of the proposed merger between EDF Energy and British Energy which might lead to a reduction in liquidity and suggested remedies which would avoid this risk.

ScottishPower is keen to participate in the traded market and has historically had total trades (buys and sells) at around three times generation levels. We believe that we punch above our weight in terms of our participation. We do not think that the economic hedge provided by vertical integration has a negative impact on liquidity – indeed by ensuring that there are strong companies in the market, it may have the opposite effect by promoting confidence.

We are also willing (subject to appropriate credit terms) to offer energy to small suppliers in increments which suit their operations and at prices which take into account shape and risk considerations.

We would not however support a regulatory requirement on generators to trade a certain proportion of their output. We suspect that it would be difficult to set this at a level in excess of 100% of generation and therefore it could end up signalling a lower level of liquidity than is achieved by the existing free market. We also think that there would be scope for parties to increase volumes through swaps etc without actually increasing those trades which are based on an underlying commercial logic.

In order to take Recommendation 13 forward, we would suggest that Ofgem convenes an industry work group, building on the Power Trading Forum, to review options for improvement. It might be useful as a first step to review how liquidity should be defined and measured.

Any new proposals to improve liquidity should be fully tested prior to implementation.

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| Recommendation 14 | Do not accept |
| <i>We are also seeking views on whether Ofgem needs new or additional powers to guard against potential market abuses, notably in wholesale electricity markets.</i> | |

We do not believe that the case has been made for general provisions on market abuse that go beyond competition law. We believe that such general provisions would inevitably have a chilling effect on the market as participants would be unclear as to the way in which the provisions would apply. High prices are not necessarily a signal of abuse – the BETTA market was designed to produce these as a signal to investment.

If problems have been identified in the way in which BETTA is operating, we would suggest that these need to be set out and debated with the industry, so allowing specific changes to the rules to be made to resolve the issues. Such an approach would preserve the basic approach to governance in the energy utilities, whereby changes are generally only made by Ofgem with widespread consent from the industry or the authority (in advance or by appeal) of the Competition Commission.

However, our biggest concern from these proposals is their likely impact on security of supply. In a commodity-only market for generation, prices are likely to be below new entry cost for much of the time, and investment cases will need to rely on the ability to make strong profits in times of shortfall. If a market abuse condition is to mean anything, it must mean that some conduct, which would be permissible under competition law, is to be restricted under the new condition.

Investors would accordingly perceive that a market abuse condition would increase the risk of a regulatory response to the high income periods of any new investment. What is more, there would be considerable uncertainty and discretion as to what might or might not be contrary to the new condition. This would inevitably lead to a marking down of return projections, which might well imply to a delay in projects, especially in current financial conditions. Given that considerable new investment is required in order to secure supplies around 2015 – or perhaps earlier when the coal opt-out plants close – we question whether now would be a good time in the interests of consumers for Ofgem to consider such an initiative.

We also note that the current procedures under Competition Law provide for appropriate due process and scope for appeals to the Competition Appeals Tribunal. It is not clear that a licence condition would be able to provide appropriately for these essential safeguards.

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| Recommendation 15 | Accept |
| <i>A requirement to inform small business customers clearly in writing of the key terms and conditions in their contracts, especially those related to switching and contract roll-over.</i> | |

We fully support the provision of clear contract information to customers. We have participated in the non-domestic working group and have made various improvements voluntarily, including highlighting the key Terms and Conditions in bold print.

We think that there could be advantage in requiring all suppliers to the small business market to include a clear “principal terms” section in the same way as retail financial products do. This would include provisions relating to switching and contract roll-over. Clearly stated principal terms would provide greater transparency and ensure that SME business customers are not misled by small print that they are too busy to read.

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| Recommendation 16 | Accept, subject to clarification |
| <i>A requirement to institute a code of practice to govern the objections and switching process, in order to ensure much greater uniformity in the arrangements for changing supplier and contract extension.</i> | |

As mentioned in our response to recommendation 15, we think that the principal terms relating to changing supplier and contract extension for SMEs should be clearly stated.

Beyond that, there could be scope for a customer-facing code of practice that explains certain aspects of the principal terms for SME customers. Where supplier practices exist that appear to be unfair or harmful to customers, that code could also play a valuable role in limiting unreasonable contract terms related to changing supplier and contract extension. However, excessive standardisation of supplier approaches is not desirable as it could limit innovation. Bearing this in mind, we would be happy to discuss possible options with Ofgem.

A clear governance framework has been developed through the supply licences, MRA and SPAA to manage the objections and switching process. We believe that this framework is currently working and accordingly we do not see any need to change the existing rules which refer the scope of the switching and objections processes to the contractual relationship between supplier and customer.

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| Recommendation 17 | Accept |
| <i>An extension of the accreditation scheme for switching sites to cover those dealing with small business consumers, in order to reduce confusion and ensure tariff information is presented in an easily understandable format.</i> | |

We believe that it would be beneficial for Consumer Focus to extend the existing energywatch Confidence Code for switching sites, to cover services provided to the SME market as well as to the domestic market.

Some care will need to be taken in the extension process to ensure that a reasonably light touch is applied and account is taken of the specific characteristics of the SME market.

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| Recommendation 18 | Accept |
| <i>A strengthening of the existing industry code of practice for Third Party Intermediaries (TPIs) with new provisions requiring TPIs to tell consumers how they are remunerated and whether they provide information on all or only some suppliers.</i> | |

We would support this recommendation in the interests of maximising consumer protection and ensuring transparency and clarity of information.

It may be useful to reflect on other aspects of the service offered by TPIs – for example, to ensure that the code of practice requires that TPIs properly advise the customer of the principal terms of any deal they are providing information on.

We have agreed 9 key questions with Ofgem that small business customers should ask before entering into a supply contract. We publish these and would suggest that answering them could also be considered for inclusion in this code.

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| Recommendations 19 and 20 | Accept principle of broad cost reflectivity |
| <p><i>We will propose a new licence requirement on suppliers that differences in charges for different payment types must be cost-reflective.</i></p> <p><i>We are also considering placing a further new condition in the licences of the Big 6 suppliers that would either impose a prohibition on undue price discrimination or introduce a form of relative price control. Any such condition would seek to ensure that price differentials are objectively justified by cost differences.</i></p> | |

ScottishPower accepts the principle of broad cost reflectivity in the setting of tariffs. This ensures that all classes of customer carry broadly similar margins and therefore that suppliers have an incentive to give all customers good service and to proactively seek all types of customer in marketing activity.

We believe that ScottishPower is somewhat ahead of many of its competitors in this regard. Nevertheless, we intend to review the cost reflectivity of our tariffs with a view to making improvements at the next general price adjustment, which is likely to be in the Spring if the current falls in wholesale prices continue. Areas we have identified for consideration include:

- Charges for prepayment meters, where we think we are close to overall cost reflectivity for key meter users (token meter users do not pay their full costs), but wish to look at how the differential applies to customers of different sizes.
- Charges for credit customers, where much of the extra cost relates to debt risk and follow-up procedures.
- Differentials between electricity and gas pricing, which could have an adverse effect on consumers who are not able to benefit from gas. We believe that, unlike most of our competitors, our pricing is generally cost reflective between the fuels, but we will continue to look at this issue.

We would however emphasise that the objective should be “broad” cost reflectivity. Perfection is neither achievable nor in the customer interest. In particular:

- Rigid cost-reflectivity rules would reduce the incentive for suppliers to innovate to reduce cost to serve. If a supplier finds a way to cut costs for a particular group of customers, it should be able to benefit from increased profits until competitive pressure forces the savings to be passed on to consumers. This is a key mechanism through which the invisible hand of the market drives innovation for consumer benefit.
- It is difficult to be precise on the cost reflectivity of tariffs such as fixed price, capped or tracker deals when compared with standard prices. Similarly, cost differences between electricity and gas tariffs will move depending on market movements and actual or deemed hedging strategies. And there can be practical difficulties in segmenting the customer base for these purposes.
- Some tariffs, such as social tariffs, are not cost reflective, but are judged to be in the consumer interest. More generally, the ability of suppliers to make special offers and to innovate in pricing structures is an essential component

in the competitive process. It would not be in the interest of consumers for this flexibility to be frozen out by concerns of breaching cost reflectivity rules.

It is also important to recognise that in a competitive market, participants need some flexibility to respond to market pressures, whether expressed by customers or arising from competitor behaviour. It is also beneficial, in terms of ensuring that suppliers seek out all types of customers, to assign differential costs, such as debt and churn costs, to the groups to which they are attributable, rather than smearing them across the entire customer base.

As mentioned above, we believe that the current concerns will be met by the review we are planning to undertake. We would hope that other suppliers are taking, or could be persuaded to take, a similar view to us on the issue. If that is the case, it may be sufficient for Ofgem to obtain suitable undertakings from the companies that they will continue to keep tariff structures under review, aiming for broad cost reflectivity, and for Ofgem to prepare a report from time to time drawing attention to any areas of poor cost reflectivity it perceives as being potentially against the public interest.

If it is intended to go further and seek formal regulation, we believe that great care is needed. This is because the “chilling” effect of a directly effective licence condition (with the risk of fines in the case of breach) would in our view have a negative impact on competition and innovation. This would be a serious issue with a condition applying to price differentials by methods of payment – and an even more serious issue if applied to other kinds of differential. We would not support a directly effective condition.

We have given some thought as to the kind of licence condition that might work as an alternative to the “undertaking” approach we have recommended above. The structure which might be worth considering might be as follows:

- 1) No direct requirement for cost reflectivity, but a requirement to provide certain information annually on costs to Ofgem (this might perhaps supersede recommendation 12)
- 2) If Ofgem perceives a differential that it believes not to be broadly justified by cost and to act against the interests of consumers, it can issue a “notice of potential objection” setting out the concern
- 3) A requirement for the supplier to respond within a reasonable period to Ofgem either justifying the differential or proposing adjustments to it
- 4) If Ofgem is not satisfied, it can issue a “notice of objection” giving reasons and requiring the differential to be adjusted within [3 months] to the extent specified in the notice
- 5) Failure to comply with a notice of objection would be a licence breach.

2 December 2008