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Dear Neil

Energy Supply Probe – Initial Findings Report

Thank you for inviting us to comment on the consultation issues raised in the Retail Markets Probe initial findings report.

We welcome Ofgem's overall affirmation that the competitive market is working well and that its continued successful operation is in the best interests of customers. We agree that the current market provides suppliers with very strong incentives to innovate, provide good customer service and be competitive on price or risk losing customers.

We also welcome the thorough nature of Ofgem's analysis, much of which we have found helpful. It has caused us to reflect carefully on some of our pricing structures, such as the effect of basing direct debit discounts as a percentage of the bill in a rising price environment and, more generally, the cost-reflectivity of gas prepayment (PPM) prices.

There are, however, a number of parts of the initial findings report where we do not agree with the conclusions Ofgem has inferred from the data. For example, we would dispute the assertion that SSE's pricing policy has in some way adversely disadvantaged customers. Indeed, we find it odd that an attempt by suppliers such as SSE to protect customers from the full effect of high gas wholesale prices has been viewed negatively, when it has been beneficial to customers. Furthermore, the report has not reflected the fact that whilst gas customers have not seen the full increase in wholesale costs, neither have electricity customers who use electricity for heating when they are on Economy 7 tariffs. Storage heaters use low night rates on Economy 7 and other off-peak tariffs to charge up. Ofgem's analysis does not take this into account as far as we can see. In addition, the successful roll-out and uptake of energy efficiency measures has helped to reduce gas consumption in recent years so the comparison is not on a like-for-like basis. We therefore believe that it is misleading to suggest that electricity only customers are somehow being discriminated against.

Nevertheless, we are always happy to work constructively with Ofgem and other stakeholders to improve customers' perception of the functioning of the market. As a consequence, we plan to take a number of steps to address the points Ofgem make in the report about our current tariff rates, which we set out below.

In/out of area tariff differentials: In electricity, we, like the other ex-PES suppliers, have legacy issues arising from the price control which have affected cost-reflectivity between our traditional "in area" and "out of area" customers. When competition was introduced ten years ago, it was generally accepted that all fixed costs were recovered from the "in area" customers. As one would expect, as the competitive market has matured, this has gradually been eroded away over time. Furthermore, in recent years, when we have amended our prices, we have used this as an opportunity to narrow the gap between our former franchise areas and the “second tier” supply areas, whilst minimising price disturbances to customers.

As a result, SSE’s gross margins in each region are broadly comparable, although in one area of the country there is a small variation of a percentage point or two. We will therefore address this one remaining differential in full when we next change our prices in 2009. We note that other suppliers have a much larger differential between “in” and “out of area” prices across many more regions of the country. Clearly, we would expect them to similarly align “in” and “out of area” prices over the same timescales.

Gas/electricity tariffs: This situation has arisen due to the historical position that we found ourselves in relative to the incumbent gas supplier, British Gas. We have also sought to protect our customers from rising gas prices. In addition, the gas market has displayed significant volatility over the last few years, which has often resulted in a different outturn position on gas tariffs than was intended when they were set. We have also noted above that a similar position on margins has arisen (albeit to a lesser extent) on electricity heating load tariffs.

For these reasons, we would vigorously dispute any suggestion that the lower margins historically earned on gas versus electricity have distorted competition or disadvantaged certain classes of customer, particularly vulnerable customers. Nevertheless, in the interests of promoting the competitive market, we are willing to address different tariff gross margins and in particular to move towards a position where our headline gas and electricity tariffs have the same underlying gross margin. In doing so, Ofgem must recognise that this position has opened up over a number of years and we need to rebalance our tariffs in a way that does not significantly adversely affect some customers. Accordingly, we will make substantial progress towards equalising margins on gas and electricity tariffs when we next change our prices in the first half of 2009. If it is not possible to completely align the margins in one tariff iteration we will have done so by the end of the 2009/10 financial year. As noted above, we would expect Ofgem to insist that our competitors take similar action.

Payment method differentials: We firmly believe that our tariffs are broadly cost-reflective across the different payment methods, although we have recently taken a few steps to ensure that this remains the case. In particular, we reduced the level of the direct debit discount at the last price change, to recognise that there were impacts against payment differentials of basing the discount as a percentage of the bill in a rising fuel price environment. More recently, we have implemented a 3% reduction in the price paid by our gas customers who use PPMs, thus reducing the average differential between them and customers paying by standard credit terms by around £25 per annum.

Ofgem will be aware that our electricity PPM and quarterly charge is already aligned, which is not cost-reflective (a pure cost-reflective approach would imply a premium for electricity PPM), but we have adopted this approach for public policy reasons in response to lobbying from customer groups. This tariff has no standing charge and, as a consequence, we are taking steps to ensure that customers at the higher end of the consumption spectrum are not inappropriately and adversely affected by this. In particular, we intend to review the consumption of the PPM consumers with the highest bills to make sure that they are on the most appropriate arrangements. We are also reviewing whether a single unit rate remains appropriate and, depending on the outcome of this review, we will take any remedial steps the next time we change prices.

In summary therefore, we do not believe we have fundamental issues with tariff cost-reflectivity and will seek to address the remaining areas of concern identified by Ofgem the next time we change our prices, subject to the caveats noted above. In particular, we note that our competitors have many more issues in this regard and it will clearly be necessary for Ofgem to ensure that they also take remedial action over the same timescale.

Ofgem also suggests that further regulatory action is required in a number of areas to further stimulate competition. In recent years, SSE has more than doubled its customer base by offering competitive prices and best-in-class service to its customers. In light of this, we are very supportive of any measures that further enhance competitive pressures. We are therefore willing to consider any sensible and practical suggestions which deliver that objective.

We do, however, have some concerns that a number of the remedies proposed by Ofgem would have the opposite effect than intended. Indeed, in some cases, there are considerable risks associated with the proposals in that they could stifle competition by limiting the scope for differentiation, growth and innovation. For example, we are concerned that some of the new obligations in relation to marketing could make direct selling uneconomic and/or impractical. We are also concerned that excessive intervention by Ofgem in tariff setting could result in the regulator becoming the de facto price setter, with attendant adverse effects for innovation and competition. There are also concerns that some of the well-intentioned new obligations could make certain segments of the market (by payment method for example) unattractive.

Against this background, we have set out our detailed comments on Ofgem's suggested further regulatory actions in the attached paper, with a brief summary below of our overall reaction to the specific proposals.

Information with customers' bills: We are willing to listen to reasonable and proportionate suggestions for improvement, but would welcome greater clarity from Ofgem regarding what specifically it is trying to address. We are happy to work constructively with Ofgem to improve the level of information available to customers, but this must not cut across the normal functioning of the competitive market or the range of other initiatives presently underway and it must be proportionate. We would therefore expect any proposals to be subject to a rigorous cost-benefit analysis and to be "road-tested" with customers beforehand. Finally, we would want any new obligations in this area to avoid being overly prescriptive, to enable suppliers to implement new measures in a way that reflects their current bill format, etc.

Annual Prompt for how to switch supplier: We have no objection to this provided it is in the form of a short, generic note reminding customers of the right to switch and how the process works.

Work to promote confidence in switching sites: We support this initiative.

Work to simplify the transfer process: This was looked at in depth during the Customer Transfer Programme, as a result of which changes were made to improve the process where cost-effective. We note that the switching process itself is not cited by many as a barrier to choosing an alternative supplier. For these reasons, we would be opposed to a wholesale and expensive re-write of the transfer process. However, improvement is always possible and we believe that the next step in this regard should be to focus on gas to align the transfer timescales with electricity. We consider that this can and should be taken forward through the usual industry governance process. We would also note that there is currently a considerable variation in the performance of suppliers to operate the change of supplier process efficiently and would suggest that a focus on this difference this might yield more improvement overall.

Ofgem funded customer awareness programme: We support this.

Debt objections: This has been examined many times since the market opened, more recently as part of the supply licence review. We continue to believe that there is a trade-off between removing objections (and hence more customers switching) and greater industry bad debts (which we believe would be substantial and would be reflected in higher prices for the generality of customers). Our concern is that more security deposits, PPMs, disconnections and aggressive debt management would be the outcome if debt objections were abolished. That is why on each occasion when this has been looked at, the practice has been retained.

Simple price comparison metric: We are open to sensible and deliverable ideas in this area, but we note that previous attempts to derive such a metric have proved to be unpopular with customers, impractical for suppliers and misleading for the majority of customers. We have therefore suggested an alternative approach which would achieve the same objective based on improving industry-wide post-sales verification. This is discussed in more detail in the attached paper.

Further marketing obligations: We need to be careful that any future obligations in relation to marketing do not, in effect, make direct selling impractical. We therefore consider that our proposals in relation to post-sales verification will also address the issues Ofgem has raised about selling.

Regulatory accounts: We do not believe that this will reveal any interesting or useful information since we do not run our business in this way. Nevertheless, we are willing to produce such accounts, should Ofgem find it helpful, provided the amount of information requested is not onerous and that all suppliers are treated equitably, including the gas market.

Wholesale market liquidity: SSE is a major provider of liquidity in the wholesale market, particularly the electricity market, and we have been able to transact most product periods to manage our position. We are, however, willing to work with Ofgem to consider further measures in relation to liquidity. For example, SSE is a member of the Power Trading Forum who are looking to introduce improved trading platforms to encourage greater liquidity.

Market abuse licence condition: We believe that there is no evidence to suggest that Ofgem needs its existing powers to be augmented by the introduction of a licence condition to address "adverse" market behaviour. We believe that the substantial increase in regulatory risk and market uncertainty arising from such intrusive regulation would undermine confidence in the wholesale market and have a detrimental effect on competition. We would also note that the introduction of new market abuse powers for Ofgem could have an extremely adverse impact on liquidity. This proposal was previously looked at by the Competition Commission and rejected and we do not believe anything fundamental has changed since then.

Helping small business customers: We are very willing to contribute to initiatives which support and promote competition.

Non-discrimination licence condition: We are not opposed to the re-introduction of the previous obligation. We could however, not accept a more restrictive form of words based on tariffs always being cost-reflective, which would not take account of the practicalities of tariff setting and would risk undermining competitive pressures and distorting the market.

We would be very pleased to discuss these points and those raised in the attached paper in greater detail with Ofgem.

Yours sincerely

Rob McDonald
Director of Regulation