Executive Summary – ScottishPower response to RMR

We continue to believe that competition is the most effective way to meet the needs of consumers, drive innovation into the market and secure the appropriate returns needed for efficient investment. That investment is much needed throughout the GB energy chain – whether in smart meters and the green deal at the retail end; new renewable and other low carbon generation upstream; or in the networks needed to enable the market to function. In this context, it is crucial that the Review should build investor confidence in the market by establishing a stable platform for the future.

Looking at the overall operation of the market, Britain has an impressive story to tell. There is a high level of competitive activity with around 100,000 customers switching energy supplier every week. This has driven considerable efficiency and innovation, with benefits to customers in terms of lower prices - relative to many EU countries - and significant product and service innovation such as fixed and capped price offers, green energy, social tariffs, energy service offerings, online billing and remote energy monitoring and control devices. Smart metering will result in a step change in the amount of information available to consumers and their suppliers on electricity and gas usage and will enable the development of new products and services which should be embraced by consumers and enhanced by the pressure of competition.

However, while the results of competition at a macro level have been remarkable, we agree that there is evidence that individual outcomes for some consumers have not always been as effective. Some consumers may have switched to higher priced deals or not fully understood the products on offer. While it is not possible in a competitive market to eliminate the possibility of consumers making bad choices, we agree that there is more that can and should be done to clarify the options available and reduce confusion.

We also welcome the presence of a wide variety of suppliers in the market, and the stimulus for innovation that they provide. For this reason we have already taken action through our "Six Commitments" to facilitate their entry into the market. While we have limited ability to influence some of the barriers to entry, such as low and/or inconsistent financial returns and the complexity of regulation, we are supportive of reasonable steps that will remove other barriers.

We consider that the next step is for the industry and Ofgem to work together both to explore the areas of potential consumer detriment so that they are fully understood, and to devise appropriate remedies that address the issue without the risk of unintended consequences either now or in the future, when consumer confidence will be crucial to the successful creation of a low carbon economy. It is essential to understand, before implementation, which remedy is likely to be most effective at addressing any potential consumer detriment; how such a remedy could impact upon consumer behaviour; and how remedies can be fine tuned in order to maximise their effectiveness. Robust "road-testing" will be required of any proposed remedy to ensure that the desired outcome will be achieved.

Our summary views on each of Ofgem's proposed measures are set out below.

Proposal 1- Improve Tariff Comparability

As set out above, we accept that there is room for improvement in the way tariff choices are explained to consumers in order to clarify the options available and reduce confusion. We set out below a number of suggestions that would help in this process. However, we do not believe that the suggestion of a single evergreen tariff, with an element set by

Ofgem, is likely to be a helpful way forward for consumers or for energy policy. The reasons for this doubt have been expressed not only by us but by a number of other market participants and Consumer Focus. They include:

- *Upheaval* – a huge number of customers would need to be migrated onto a tariff that differed from the choice that they made, with a large number of winners and losers as well as significant transition costs which would need to be recovered;

- *Customer choice* – it is contrary to normally understood competition policy to prevent companies from offering products (other than on unfair terms) which customers want to buy;

- *Competition intensity* – some commentators have questioned how keenly the evergreen tariff would be priced, noting the risk that it could drift to a relatively unattractive level like mortgage Standard Variable Rates, which could disadvantage inactive consumers

- *Specialist products* – it is unclear what would happen for products such as heating tariffs, green energy, smart meter based products, social products etc. If these had to be opted in to annually, many consumers would at best be inconvenienced and at worst could be defaulted to an inappropriate product

- *Investment signals* – the fact that an element of the tariff would be set by Ofgem would inevitably raise questions in investors' minds about whether the UK might be moving towards a re-introduction of price controls.

We doubt that these difficulties can be overcome and accordingly focus below on alternative measures to address the issues of complexity and customer confusion. We do so starting from the principle that Ofgem should not be banning particular transactions (provided that they are fair), but should be setting down standards of disclosure and clarity so that consumers can, to the greatest extent practicable, make informed choices.

Accordingly, we do not believe that the issue here is that there are too many products in the market, but rather that there is a clear need to improve customers' understanding of them. We are keen to ensure that our products are as transparent as possible while still allowing a high degree of innovation and differentiation to meet particular needs. We believe that the elements of a package aimed at addressing these issues would include:

- **Common Language -** Simple, consistent and consumer friendly language is essential to ensuring understanding. Existing energy terminology and nomenclature can be intimidating, misunderstood and mean different things to different stakeholders. An agreed common language for describing the tariffs, types of contract and other key characteristics of interest to consumers would undoubtedly be a valuable step forward in improving basic levels of comprehension in the energy market.

- **Energy Jargon-Buster –** A glossary of customer friendly terms should be developed to define the agreed common language. This "Jargon-Buster" should be accepted, utilised and publicised by all key stakeholder including suppliers, Ofgem, Consumer Focus, price comparison sites and the media. While similar tools can already be found, there is a clear lack of consistency and clarity that could easily be eliminated if concerted industry action was taken on this matter.

- **Key Facts Documents –** The financial services sector has developed "Key Facts" documents to assist consumers when buying investment products. We believe that

Ofgem should specify the format, content and use of such documents so that energy consumers receive clear, straightforward and comparable information to help them understand the services and products being offered and make informed decisions when switching supplier. Key Facts documents could be prominently displayed on supplier websites and switching sites and provided to customers at the point of sale to ensure that switching decisions were being made in the full knowledge of the fundamental factors likely to influence the decision process.

- **Simple Price Metric –** A simple price metric similar to the Annual Percentage Rate ("APR") should be developed to enable consumers to easily compare different products on a like-for-like basis. We think that this metric needs to be composed of two parts:

    - First, there needs to be a clear description of the actual price. While the specific terms will need to be disclosed, we think that this needs also to be expressed, as closely as possible (for the typical range of consumers), as a standing charge (possibly in pounds per month) plus a unit rate;

    - Second, there needs to be a calculation of the total bill in pounds (either per month or per year) at low, medium and high consumption levels. Those consumption levels should be approved or set by Ofgem.

  It would be valuable to use consumer research to fine tune this metric. If sufficiently consumer-friendly, it could be reflected in annual statements, displayed in Key Facts documents and used in price comparisons. A simple, effective metric has the potential to provide greater clarity for customers, while still allowing innovation and product development within the market.

- **Clear disclosure of special terms –** To include both benefits and restrictions such as termination fees.

- **Standard format –** To be used to the extent practicable for the presentation of the information described above.

Within this framework, suppliers would be expected to strive hard to achieve a step change in the transparency and clarity of presentation of tariffs, but there would not be restrictions on what is on offer. In the light of this approach, we would suggest the following approach on two tier tariffs and roll-overs.

It is clear that many customers prefer to buy energy on a two tier tariff rather than with a standing charge. This is particularly an issue for gas customers, who may resent summer bills which can mainly comprise a standing charge. Since a two tier tariff is not unfair to consumers and reflects the preference of many of them, it would be wrong to ban it. However, it is also wrong for suppliers to use this approach to hide that there is a *de facto* standing charge being levied. Our proposed price metric would require suppliers to identify the standing charge equivalence of a two tier tariff for a typical customer.

Similarly, it is not appropriate to require standing charges, or two tier products, to be standardised. Suppliers should be free to structure tariffs as they see fit, providing that there is absolutely clear disclosure of the deal on offer. It is likely that Smart Meters will further increase the options around the shaping of tariffs, which again suggests that a disclosure based remedy is better than limiting choice and innovation.

On roll-overs, we think that the following minimum conditions could apply before a customer could be rolled over to a new product with a termination fee on an opt-out basis:

- Neither the termination fee can be higher nor the period for which it applies can be longer than applicable for the expiring product;

- An indication of the possible roll-over process should be given when the product is marketed;

- The customer must be given at least two opportunities, at least 21 days apart and close to the renewal date, to opt out of the roll-over; and

- Those opportunities should include a description of a standard alternative tariff without a termination fee, reflecting the supplier's view of a reasonable alternative choice for the consumer, together with an easy method to switch to that tariff. Additional options could also be offered.

With these safeguards, we do not think it is necessary to ban roll-overs with modest termination fees. In particular, where customers have expressed a preference for the security of a fixed price fixed term product, it is reasonable that the default if they do not reply to two communications is to provide a similar product. Because a fixed price product with a termination fee is more likely to be retained for its term by the customer even if prices fall, it can be offered on better terms than a fixed price product without such a fee. These considerations suggest that roll-over with a termination fee can be both fair and in the consumer's interest if the procedures set out above are followed. Our experience of the roll-over process, where we already operate a dual notification process, indicates a high degree of consumer satisfaction with the process. The reforms suggested above should improve this further.

Proposal 2 - Enhance Liquidity

We think that there are essentially two separate issues which lie behind Ofgem's proposals:

Overall liquidity and transparency of wholesale pricing

This is intended to be addressed by the Mandatory Auction proposal. At one level, there is considerable bulk liquidity in the wholesale electricity market, with total trades being several times generation volumes. That liquidity has been improving in recent years, but as a growing company at the smaller end of the "Big Six", we would like to see continued growth in liquidity and in the granularity of traded products.

In this context, we welcome the establishment of N2EX, and have recently changed our systems to allow us to make more extensive use of the platform. N2EX has the potential to enhance liquidity, product granularity (i.e. beyond baseload) for future dates and pricing transparency. It does not however comprise the entire solution, and we expect other trading routes to continue to have a major role.

One issue that has hampered liquidity further out along the curve has been the growing extent of basis risk. A major component of this has been the carbon price floor. Until the actual rate of CCL is set for the generating fuel, there is an uncertainty as to the costs of generation which cannot be hedged in the traditional way by buying or selling commodity futures. This is likely to inhibit trading beyond the period for which the CCL charge has been set. Similar issues may also arise with other proposed regulatory changes in the market

A further related issue is the likely need for there to be a firm, liquid and objective price reference for the purposes of the Government's Electricity Market Reform (EMR) proposals. It seems essential that any proposed mandatory auction acts to support those requirements rather than diverting liquidity away from them. It therefore seems sensible to us to start from the EMR requirements and establish the nature of the index price required. In the light of that, it can be decided whether an auction process is needed and what its characteristics should be.

We do have concerns, based on experience of our parent company in other jurisdictions, that a mandatory auction could lead to market distortions and unfair outcomes for sellers. This could arise if the rules are not fairly defined, for example if there were restrictions as to who could buy in the auctions; if there was an unfair approach to reserve prices; or if the product to be sold was one with insufficient demand or one which could not be properly priced because of basis risk.

Our view of the mandatory auction proposal will therefore depend greatly on both how the auction is intended to interact with EMR and on how the detailed rules are defined.

Contestability and entry of small players

At ScottishPower, we welcome the challenge and innovation brought by new players in the market. For this reason, we implemented our "Six Commitments" initiative to help make the market more contestable. We also welcome the availability of N2EX for new entrants, although the cost and collateral requirements inherent in exchange trading may continue to be a difficulty.

In this context, we are supportive in principle of the proposed Mandatory Market Making arrangements and look forward to working with Ofgem and other stakeholders to develop the finer points of what is proposed.

Proposal 3 - Strengthen Probe Remedies – domestic

Although a number of the Probe remedies have not had long to bed in, it is right that Ofgem continues to review the market and assess progress against the remedies that it introduced in 2008 Probe. In essence, Ofgem is looking at possible action in four areas:

- Requirements for more clear and transparent information, including standardised information on Annual Statements and/or bills
- Embedding one or more Standards of Conduct in the licence
- More active monitoring of suppliers and compliance
- Work to inform consumers better and improve switching sites.

We are supportive of universal wording on Annual Statements. Ofgem should prescribe wording that suppliers would use to inform customers of key information such as the switching reminder on bills and statements. Prescription of this nature would improve the consistency of the information given to customers and eliminate issues of interpretation when providing customers with information designed to assist a well functioning market.

Subject to any IT issues, we think that the Annual Statement in particular should aim to have a standard "look and feel" and possibly a standard Logo so that consumers can easily identify what it is. There is less scope for standardising bills because of the need to reflect the particular requirements of the relevant product and the role of the bill in innovation and supplier differentiation.

Our own customer research indicates that many customers only engage with the market when they need to, and customers are only now starting to get the additional information that will prompt them to take action. We think that, with the improvements set out above, this will drive developments year on year.

In terms of the Standards of Conduct, we do not think they are currently drafted in a form suitable for the licences. Moreover, the current enforcement process (which allows for very limited appeal where Ofgem finds breach) is not well adapted to principles-based obligations as opposed to rules-based approaches.

However, we do see the merits of a principles-based approach in this area because of the risk that a rules-based approach may create an incentive to comply with the letter but not the spirit of the rules. We think that a principles-based regulatory approach may be better than a "name and shame" approach because the latter can be corrosive to long term trust in the market and therefore the crucial smart metering and Green Deal programmes. We would therefore be happy to explore further with Ofgem and other stakeholders whether, instead of detailed rules, it would be practicable to create a general obligation on suppliers to describe their products fairly, transparently and clearly. Such an obligation would be subject to a two-stage enforcement process and supplemented by guidance, in the manner of the cost reflectivity condition.

We agree that it is right for Ofgem to monitor the industry with the intensity that they consider to be cost effective, taking account of both Ofgem and industry costs incurred. It is also important to give competitive forces sufficient space to operate. As a longer term objective, as confidence in the market is restored, so Ofgem should aim to progressively scale back detailed monitoring of outcomes.

We support work to enhance consumer education and improve confidence in switching sites, including through the Confidence Code currently administered by Consumer Focus.

Proposal 4 – Strengthen Probe Remedies – non-domestic

We support measures to improve protection and transparency for small business customers and are keen to ensure that our communications to small business customers meet high standards of transparency and clarity.

We believe that it is appropriate that greater controls are placed around Third Party Intermediaries (TPIs). However, there is some complexity about how this might be achieved, because TPIs are outside the existing licence framework. It may be possible to look at some accreditation system or OFT code to achieve this and we would support such an initiative.

We do not think it would be appropriate to seek to regulate TPIs via obligations on suppliers in the supply licence. Apart from the general difficulties of such indirect regulation, not all TPIs will be in a contractual relationship with a supplier and therefore such an approach would not provide an adequate level of protection for all potential customers.

Proposal 5 - Improving financial transparency

Our accounting systems properly assign transactions to the appropriate entity within the ScottishPower group and our segmental accounts are based on the published subsidiary accounts that arise from that process. Ofgem have made a number of incremental improvements to the guidelines for the existing segmental statements and we are in the process of preparing our 2010 statements for publication in accordance with these revised guidelines. During this process, we believe Ofgem have been mindful of the balance between transparency and not revealing too much confidential information between competitors, so as to damage the competitive process. This is an important balance to maintain and we support Ofgem's continued awareness of the issue.

We note that Ofgem wish to engage the assistance of a leading accounting firm to assist in reviewing this area and devising further information requirements, possibly in the form of additional confidential submissions to Ofgem. We would like the opportunity to work with Ofgem on the terms of Reference for this study and would of course wish to assist in such a review, subject to appropriate confidentiality arrangements for any unpublished data that the accountants wished to look at. However, we would urge caution in creating too much of an ongoing process of requiring detailed financial information in a competitive market sector. Obviously, the question of what if any continuing processes might emerge following the accountants' review is one which would need to be assessed at the time. The long term objective should be to resolve any competition concerns, such that detailed monitoring is not necessary.

ScottishPower

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