SCOTTISHPOWER

Rupert Steele OBE
Director of Regulation

Maxine Frerk
Partner, Retail Markets
Ofgem
9 Millbank
London
SW1P 3GE

23 May 2014

Dear Maxine,

**Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain**

ScottishPower is pleased to respond to Ofgem's consultation on its proposal to make a market investigation (MI) reference in respect of the supply and acquisition of energy in Great Britain.

The energy sector is of huge importance to UK economic activity, to investment and employment and to the welfare of consumers throughout the country. It is vital that competition works – and is seen to work – well, and has the confidence of end users and investors alike.

We believe a thorough, rigorous and authoritative review of the state of competition is required to restore confidence in the energy market and we therefore welcome Ofgem's proposed reference. This is particularly important as low levels of consumer trust and increasingly negative political and media debate have diminished the attractiveness of the UK to energy investors. Since autumn 2013, the UK has moved from being perceived as one of the least politically risky countries in Europe to one of the riskiest.[1] The same political and media factors that Ofgem found to deter market entry[2] are also a deterrent to continued investment by established players – investment which will bring long term benefits to consumers.

A CMA market investigation would be an opportunity to determine once and for all the health of competition and address any problems which may exist. This investigation must help to draw a line under the political debate, make any changes that are necessary, reassure consumers that their interests are being served by the market, and restore investors' confidence that they face a stable and predictable regulatory regime.

Our response to the detailed issues and proposals in the consultation is in Annex 1 attached. We are broadly comfortable with the proposed scope of the MI subject to the following points:

[1] Exane BNP Paribas concluded in their European Utilities Q2 2014 study that the "the UK now tops the political risk table and now ranks above Spain for the first time". It was previously seen as the least politically risky country in Europe for utilities after Finland.
[2] SoTM report para 1.35.

ScottishPower London Office, 4th Floor, 1 Tudor Street, London EC4Y 0AH
Telephone +44 (0)141 614 2000, Fax +44 (0)141 614 2001, Direct +44 (0)141 614 2012
rupert.steele@scottishpower.com www.scottishpower.com

- **Generation**: Ofgem's draft terms of reference for the MI define the scope as 'the supply and acquisition of energy in Great Britain'. We think it is important that the CMA considers the health of competition across the whole electricity value chain from generation through to supply. Ofgem says that it is 'unable to place any more than limited weight' on its finding that the generation sector is 'covering its cost of capital but no more'. Given the level of investment needed in the UK generation sector over the coming decade, a much clearer conclusion from the CMA on the health of the generation market (and any necessary remedies) will be required in order to provide a sound basis for investors.

- **Gas**: As well as investigating the health of competition across the whole electricity value chain, we think the same is required for gas. In particular, more transparency is needed in the linkages between upstream and downstream (retail) gas markets. Given that gas accounts for approximately 65% of consumers' energy bills and generally entails higher average profit margins than electricity, we think the MI should scrutinise intra-group transaction prices for gas, including purchases by a supply business from upstream assets such as gas storage and production operated within the same parent group.

- **Impact of regulation**: Academic economists have been critical of past regulatory interventions which have sought to constrain suppliers' pricing flexibility. For example, there is analysis that suggests that the now-lapsed undue discrimination licence condition (SLC25A) may have led to reduced competition and increased prices. Similar concerns have been expressed about the Retail Market Review tariff rules. By limiting consumer choice and enforcing high levels of supplier-to-supplier transparency on costs and prices, regulation may have increased the risk of co-ordinated behaviours emerging. Badly designed threshold arrangements for Government environmental and social obligations may inefficiently subsidise some suppliers while acting as a barrier to growth of others. The MI should consider explicitly whether any problems that are identified with the market may have been caused or exacerbated by regulation.

We think the State of the Market Assessment correctly identifies a list of issues that the CMA should look into, though we would not agree with Ofgem's preliminary conclusions in a number of areas. We believe that in many respects energy consumers are well served by current levels of competition.

However, as one of the smallest integrated suppliers, we are ambitious to grow our business and this will depend on a strong competitive environment. It will be important that the CMA looks at the regulator's duties, as amended in the Energy Act 2010, to ensure that there is no bias toward *ex ante* intervention as an alternative to relying on the market. We are concerned that the benefits of such interventions are more apparent to regulators than their costs, and that the cumulative impact of such interventions may distort or slow competition.

We would be pleased to discuss the points raised in this letter and response.

Yours sincerely,

Rupert Steele

**Rupert Steele**
Director of Regulation

**Annex 1**

## CONSULTATION ON A PROPOSAL TO MAKE A MARKET INVESTIGATION REFERENCE IN RESPECT OF THE SUPPLY AND ACQUISITION OF ENERGY IN GB: SCOTTISHPOWER RESPONSE

### 1. Introduction

We think the State of the Market Assessment correctly identifies a list of issues that the CMA should look into, though we would not agree with Ofgem's tentative conclusions in a number of areas. Overall, we believe that energy consumers are generally well served by current levels of competition and that the trends are positive:

- New entrants are growing at a faster rate than ever before. The 5% plus shares of the household electricity, gas and dual fuel markets held by medium sized and smaller suppliers at 31 January 2014 are the highest they have ever been since competition started in the late 1990s.[3] In April 2014 a record 47% of people switching chose small suppliers.

- Although Ofgem highlights a decline in consumer trust, more recent research by Ipsos Mori for EnergyUK shows that the proportion of customers who do not trust their energy supplier to be open and transparent in their dealings with them fell from 43% in 2013 to 15% in 2014.

- By the time the Market Investigation is complete, suppliers will be well on their way with the rollout of domestic smart meters, which will bring further benefits for competition, not least a radical speeding up of the switching process.

We believe that in many respects energy consumers are well served by current levels of competition and that the market has delivered sustained benefits for consumers, low retail margins and some of the cheapest energy prices in Europe.

### 2. Scope of MI reference

We broadly agree with the proposed scope for the MI reference, but would welcome clarification from Ofgem that the scope includes the three areas outlined below, all of which we consider will be important to achieve an effective outcome.

<u>Generation</u>

Ofgem's draft terms of reference for the MI define the scope as 'the supply and acquisition of energy[4] in Great Britain'. We think it is important that the CMA considers the health of competition across the whole electricity value chain from generation through to supply (including supply to larger customers, to the extent necessary).

Ofgem says that it is 'unable to place any more than limited weight' on its finding that the generation sector is 'covering its cost of capital but no more'.[5] Given the level of investment

[3] http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1061-cornwall-energy-competition-in-british-household-energy-supply-markets-report-march-2014.html, page 5
[4] It may be more appropriate to refer to "electricity and gas" rather than energy
[5] SoTM report, paragraph 6.79

needed in the UK generation sector over the coming decade, a much clearer conclusion from the CMA on the health of the generation market (and any necessary remedies) will be required in order to provide a sound basis for investors.

We therefore think the MI should:

- establish measures of profitability for the generation segment with a greater level of reliability than Ofgem was able to achieve in its SoTM report;

- estimate benchmarks for generation businesses in order to assess whether there is any evidence of excess profit and whether there is sufficient incentive to build the new capacity that is needed;

- consider whether there are any barriers to entry or evidence of unilateral market power in the generation market.

We would caution against the MI investigating the detail of the Government's Electricity Market Reform (EMR) programme and other renewables support. The EMR programme is about to be put into operation following some four years of development and there is a need to proceed with it, so that companies have confidence to invest. If the MI were to extend the uncertainty, this could have a negative impact on investment and security of supply.

Gas

As well as investigating the health of competition across the whole electricity value chain, we think the same is required for gas. In particular, more transparency is needed in the linkages between the upstream and downstream (retail) gas markets. Our view is primarily motivated by the observation that gas accounts for approximately 65% of consumers' bills and generally entails higher average profit margins than electricity.

Although Ofgem concluded that vertical integration is not such a strong feature of the gas market[6], it is notable that at least one gas supplier has substantially grown its upstream gas production business and its presence in LNG imports over the last few years. While this may help to bring gas to the UK on a flexible and competitively-priced basis, it would be important to determine whether there is sufficient transparency in the transfer of revenues and costs through the gas value chain to verify that this aspect of the market is working to the benefit of consumers.

We therefore think the MI should scrutinise intra-group transaction prices for gas, including purchases by a supply business from upstream assets such as gas storage and production operated within the same parent group, and consider, in the light of the Competition Commission's 2011 review of gas storage[7] whether any further investigation of this market is warranted.

Impact of regulation

Academic economists have been critical of past regulatory interventions which have sought to constrain suppliers' pricing flexibility. For example, analysis suggests that that the now-lapsed undue discrimination licence condition (SLC25A) may have led to reduced

[6] Ofgem consultation para 3.17
[7] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/media-centre/110112_centrica_review_of_undertakings_news_release.pdf

competition and increased prices[8], and similar concerns have been expressed about the Retail Market Review tariff rules[9]. By limiting consumer choice and enforcing high levels of supplier-to-supplier transparency on costs and prices, regulation may have increased the risk of co-ordinated behaviours emerging.

Similarly, badly designed threshold arrangements for Government environmental and social obligations may inefficiently subsidise some suppliers while acting as a barrier to growth of others. The "threshold and taper" mechanism for ECO is of particular concern to a variety of stakeholders and should be considered carefully.

The CMA should therefore consider explicitly whether any of the problems identified with the market may have been caused or exacerbated by existing regulation.

It may also be useful for the CMA to consider whether it has any general views on how regulatory structures in the UK could be adapted to better create and maintain a competitive market for energy, and the extent to which economics and competition experts (as well as persons well equipped to comment on network and infrastructure issues) should be represented among the non-executives of the Authority

In this context, it will also be important that the CMA looks at the regulator's duties, as amended in the Energy Act 2010, to ensure that there is no bias toward *ex ante* intervention as an alternative to promoting a strong competitive environment. We are concerned that the benefits of such interventions are more apparent to regulators than their costs, and that the cumulative impact of such interventions may distort or slow competition.

In the light of the provisions in the Enterprise and Regulatory Reform Act 2013 which confirm that competition action should be the first port of call for regulatory enforcement, we think that it would be timely to consider repeal of the provisions in the Energy Act 2010 requiring Ofgem to look at options other than competition first. Indeed, the regulator's duties as a whole are now very complex as a result of successive modification and could usefully be re-drawn to be simpler, more focussed on competition and more comprehensible.

Networks

We believe that there is no need for the MI to extend to networks. These are outside the competitive market and held in ring fenced separate companies. They are governed by price controls set by Ofgem in a thorough process that has recently been under review. Both network operators and network users have the opportunity to appeal any price control determination to the CMA for review.

[8] 'Pricing in the UK retail energy market, 2005 – 2013' Catherine Waddams Price & Minyan Zhu, December 2013, http://competitionpolicy.ac.uk/documents/107435/107587/13-12+Waddams+and+Zhu+(Final).pdf/6d49a6ed-b489-4603-a19e-890f6a098acc

[9] 'Sorry Ofgem: Why simpler energy tariffs are not in consumers' interests', Stephen Littlechild, 3 April 2014, http://www.cityam.com/article/1396543007/sorry-ofgem-why-simpler-energy-tariffs-are-not-consumers-interests

## 3. Features of market identified by Ofgem

There are four features of the market which Ofgem says it has reasonable grounds to suspect may be preventing, restricting or distorting competition[10].

- weak customer response;
- vertical integration and wider barriers to entry and expansion;
- continuing incumbency advantage and market segmentation;
- further evidence of possible tacit coordination.

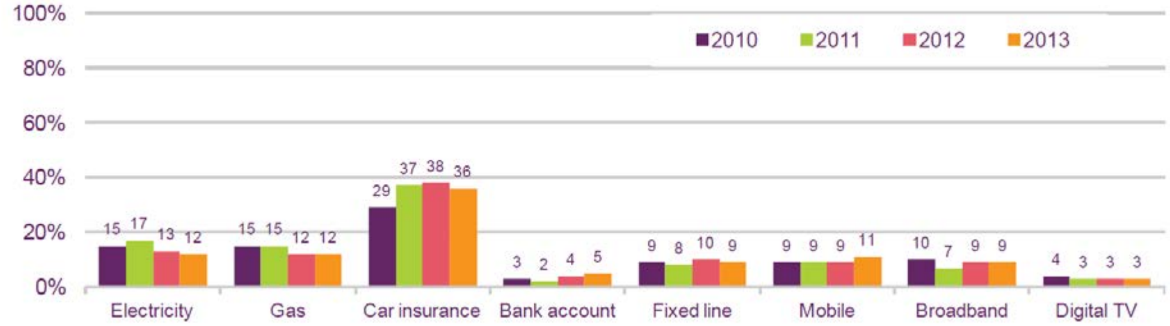
We offer below our initial thoughts on Ofgem's analysis.

<u>Weak customer response</u>

In identifying weak customer response as a feature of the market which is restricting competition, Ofgem highlights the fact that switching rates have been falling year on year since 2008 (with the exception of a spike at the end of 2013) and the large proportion of consumers who don't switch (or very rarely switch). Ofgem believes this lack of engagement has been caused by consumer confusion over the number and complexity of tariffs, consumer mistrust of energy companies, and time and hassle associated with the switching process.

Whilst we agree that more needs to be done to restore consumer trust and make it easier for consumers to switch, we think that current levels of switching and consumer engagement are sufficient to maintain competitive pressure on prices and are higher than for many other consumer services. Research published by Ofcom in January 2014 indicates that, despite the downward trend, annual switching rates for electricity and gas were still higher in 2013 than for mobile telephony providers, fixed lines and broadband.[11]

**Figure 145 Proportion of consumers who have switched communications and utilities supplier in the past 12 months**




We agree with Ofgem that energy companies' withdrawal from doorstep selling (and similarly motivated restriction of outbound telesales) will have contributed to the observed decline in switching rates. We think another important factor may also be the gradual convergence over time of prices[12], reducing the amount that consumers can potentially save by switching. Consumers will only switch if they expect to achieve sufficiently lower prices to justify the

[10] Condoc para 3.3
[11] Ofcom, "The Consumer Experience of 2013", January 2014, Figure 145 on p141. http://stakeholders.ofcom.org.uk/binaries/research/consumer-experience/tce-13/TCE_Research_final.pdf
[12] See for example the trend in SoTM figure 21

effort of switching. For this reason, we find it difficult to conclude that the RMR restrictions on tariffs will necessarily have a positive impact on switching.

Although switching rates fell in January 2014 from the spike of late 2013, figures for April 2014 show that the number of people changing electricity supplier is still increasing. April was the third month in a row when the total number of switches increased, with a record 47% of switchers choosing small suppliers[13].

It is important to note that in a well-functioning market, a proportion of customers will be inactive. This may reflect some customers simply being busy or not wishing to try something new. There is a clear trade-off between the incentive to switch and the disadvantage to those who do not switch. It would be useful for the CMA to consider how that trade-off is best established, bearing in mind that a competitive outcome is likely to involve some losers.

Over the last 12 months, considerable efforts have been made by suppliers to promote and facilitate customer engagement and rebuild trust. Research commissioned by EnergyUK in Feb-March 2014 showed that only 15% of customers did not trust their energy supplier to be open and transparent in their dealings with them[14]. This is a huge improvement on the 43% in research commissioned by Ofgem a year previously.[15]

<u>Vertical integration and wider barriers to entry and expansion</u>

Ofgem recognises that vertical integration (VI) of electricity supply and generation brings benefits such as reduced costs and risks, which can benefit customers through lower prices and improved security of supply; but notes that these benefits must be weighed against possible adverse effects of vertical integration in creating barriers to entry and expansion, and potentially weaker incentives to compete.

We agree that the benefits must be weighed against possible adverse effects. The fact that companies in the UK (and many other countries) have gravitated naturally towards a vertically integrated model suggests that there are significant benefits. We think the main benefit is to provide a hedge against wholesale price volatility, but there are also benefits in terms of efficiency and economies of scope.

The main VI-related barrier to entry identified by Ofgem was the reduced liquidity that it identified as resulting from VI (and possibly a risk of foreclosure – though the evidence was inconclusive). To the extent that lower liquidity may be found to constitute a barrier to entry, this should be remedied by targeted interventions to improve liquidity which do not jeopardise the substantial consumer benefits of VI. Ofgem has recently introduced a number of such interventions under the "secure and promote" banner.

Among wider barriers to entry noted by Ofgem were the cost and complexity of compliance with regulatory obligations, the high level of (negative) political and media attention and the uncertain political environment. We agree with all of these. We also think the CMA should consider whether the design of 'small supplier exemptions' from government obligations such as ECO can be improved to reduce barriers to growth and consolidation among smaller suppliers.

[13] http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1105-energy-switching-figures-april-2014.html
[14] Published alongside the EnergyUK response to this consultation
[15] The difference may also be attributable to the fact that the Energy UK question asked about 'your supplier' whereas the Ofgem question asked about energy suppliers in general; if so, it suggests the low level of trust noted by Ofgem is less to do with companies' success in meeting their customers' needs and expectations and more to do with negative political and media comment.

Continuing incumbency advantage and market segmentation

Ofgem concludes that suppliers are able to charge their "sticky" customers higher prices, whilst making cheaper deals available to more active customers (who may be less likely to be vulnerable) and that therefore suppliers are 'exercising market power over their incumbent customers'. We think the behaviour Ofgem describes can best be understood as a form of behaviour-based price discrimination[16] which is a feature of many markets. Price discrimination does require the ability to differentiate between customers to be successful, including where customers differentiate themselves by differing willingness to shop around. Such differentiation is observed in many competitive markets and the existence of product and price differentiation does not necessarily mean customers are harmed or that competition is ineffective.

Theory does suggest that in competitive environments such price discrimination will normally lead to some consumers paying a higher price and some a lower price than they would in the absence of discrimination.[17] Such discrimination can have beneficial market effects, as it encourages competition for active customers and gives an incentive for firms to implement strategies to make the sticky customers of their rivals switch to them. It is also necessary for there to be an incentive for customers to shop around; if inert customers gained an equally good deal as active ones, engagement with the market would be likely to plummet. Price discrimination is not seen as generally harmful to consumers or competition, unless businesses are pricing services below cost or at an extremely high level.

Although we note Ofgem's concerns about the distributional implications, we believe that much more careful analysis is required before it can be concluded that such discrimination is having an adverse effect on consumers overall. For competition to function effectively, consumers need to have sufficient financial incentive to switch, and suppliers need the means to go after their rivals' customers.

Further evidence of possible tacit coordination

The European Court of First Instance, in its *Airtours* judgment[18], identified three conditions that need to be met for tacit coordination to be sustained, which can be broadly summarised as follows: (1) ability to monitor deviations from the common policy; (2) an incentive not to depart from the common policy (hence the existence of an effective and credible punishment mechanism is important); and (3) existing and potential competitors and consumers not undermining the common tacit 'understanding'. In addition, there are a number of market features that are generally examined because they assist in supporting coordination between market players.

While Ofgem recognises that the requirements for a finding that tacit coordination is possible and sustainable are the three conditions set out above[19], it does not actually assess the market using the conditions articulated in the *Airtours* framework and, in particular, it does not identify any punishment mechanism that exists in the market. To conclude that there are

[16] That is, based on consumers' observed behaviour rather than their intrinsic characteristics (such as willingness to pay or elasticity of demand). A typical example of behaviour-based price discrimination is discrimination between 'old' versus 'new' customers.
[17] There are also special cases where all customers end up paying more than the uniform price or all customers pay less than the uniform price.
[18] Case T-342/99, Airtours v. Commission [2002] ECR II-2585, at para 62. Although the Airtours judgment was concerned with merger control, it has since become clear that the same conditions are applicable to the analysis of collective dominance. See e.g. Case T-193/02 Piau v. Commission [2005] ECR II-209 at para 111
[19] Paragraph 4.46 SoTM Assessment, 27 March 2014

market features supportive of tacit coordination, a more thorough and systematic assessment is warranted in line with the three conditions set out above.

It may also be noted that a number of the supportive features identified by Ofgem derive from regulatory requirements. Under regulatory pressure, there is significant supplier to supplier visibility of both costs and pricing, and notice is required to be given of price changes at least 30 days in advance. There have been increasing demands for the components making up tariff changes to be announced and debated. And the industry is under pressure to iron out differences in customer service standards. It would be useful for the CMA to consider whether these regulatory features do in fact increase risks that coordinated behaviours might emerge.

However, a review of other market features – level of concentration, market dynamics, and asymmetries – does not necessarily support the finding that the conditions for tacit coordination are being met:

- **Level of concentration –** With six large vertically integrated suppliers, and a fringe of smaller suppliers, the market is not overly concentrated. Economic theory and precedent from previous cases indicate that susceptibility to coordination decreases significantly with a larger number of firms, and that findings of tacit coordination have typically only been found in markets with four or fewer similar firms.

- **Barriers to entry in retail –** Small suppliers have successfully entered the retail energy market and continue to gain customers. There is plenty of evidence supporting this trend: 47% of recent switching customers have done so to small suppliers, and the joint market share of small suppliers has consistently and significantly increased over the past five years. Such disruptive entry undermines the sustainability of coordination.

- **Asymmetries –** the large vertically integrated firms themselves differ significantly in aggregate supply/demand balance, type of generation, customer types and locations, investment profiles and other relevant factors. It is not clear that there is sufficient alignment to sustain coordination.

Without more detailed analysis, assessment of the market features that may facilitate coordination is insufficient. Importantly, some of the same factors that may support tacit coordination – similarities in cost structure, price transparency and excess capacity – can also drive competitive behaviour. Given this, detailed assessment of the *Airtours* conditions and evidence on market outcomes (such as profitability analysis) are essential before concluding on the sustainability of coordinated outcomes.

Ofgem has presented some findings on the market outcomes it considers are consistent with coordinated behaviour, yet these analyses are not compelling:

- Price increases of similar magnitude can reflect similarities in input costs (or demand factors).

- The increase and convergence of domestic supply margins over the last four years can be a consequence of stable wholesale markets (with hedging strategies having less impact on profits) and can reflect a return to normal levels of supply margins. For any profitability or margin analysis to be relevant for assessing tacit coordination, it needs to be conducted for the whole market and for a reasonable period of time.

- ‘Rocket and feather’ pricing – even if it were to be shown to exist in this sector – is observed in a wide range of markets where competition is typically considered to be effective[20], and in many cases represents a rational response to market features. Following an initial review of Ofgem’s analysis, we are concerned about its robustness, in particular in relation to the choice of cost and price variables, and the need to control for relevant market features.

While we agree that it will be appropriate for the CMA to look carefully at the evidence on the feasibility and sustainability of tacit coordination, we do not believe this is a feature of GB energy markets. We believe that there are serious gaps in the analysis and arguments put forward by Ofgem so far.

ScottishPower
23 May 2014

[20] Pelzman, S., *Prices Rise Faster Than They Fall*, Journal of Political Economy, Vol. 108, No. 3, June 2000, pp 466-502.