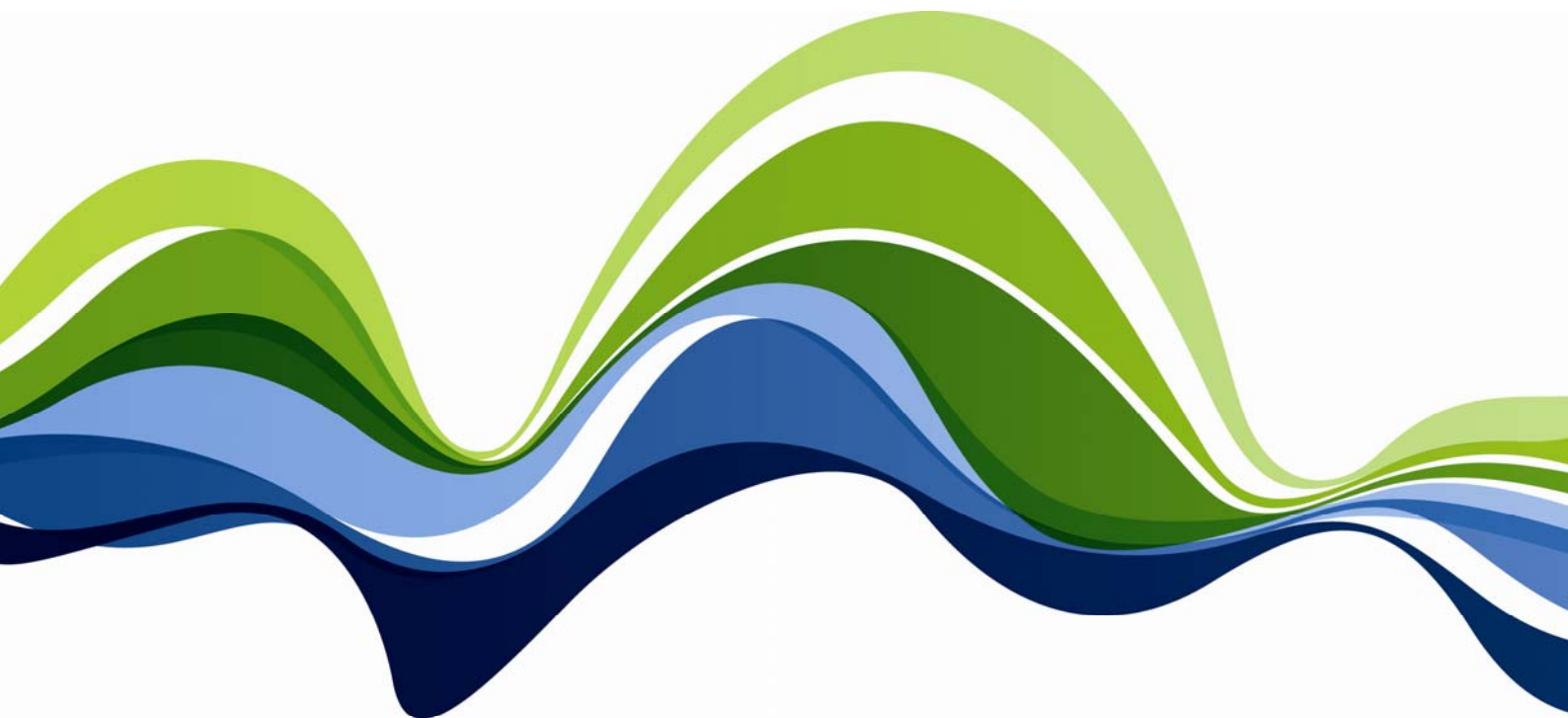




SSE's response to consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain

This document sets out SSE's response to Ofgem's consultation on its proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain. SSE supports the need for a competitive energy market in which customers have confidence and in which investors are willing to invest. In such a market SSE will be able to fulfil its core purpose, which is to provide the energy people need in a reliable, affordable and sustainable way.



1. Executive Summary

- 1.1 SSE believes that the energy market in Great Britain is competitive and has brought significant benefits for customers. In addition much has been done in recent years to make it more transparent and easier to understand, ranging from greater liquidity in the wholesale electricity market to simplification of tariffs in the retail markets. In parallel with this, there has been significant investment in wholesale and retail businesses in Great Britain - SSE alone has invested around £4bn in the last five years. Throughout this time, SSE has consistently demonstrated its appetite for reform to the competitive market that is in the interests of customers.
- 1.2 Nevertheless, SSE recognises that many of the key features of the competitive energy market have become contentious and been subject to significant change designed to achieve a mixture of objectives while maintaining the equilibrium of the energy trilemma – balancing energy security of supply, affordability and reducing energy emissions.
- 1.3 Ofgem has said that it believes a referral offers the opportunity 'once and for all' to clear the air and restore public trust. Should there be a referral, we will engage in a positive and constructive way as we believe that a market reference can provide a platform for achieving greater political and regulatory stability for a competitive GB energy market, for the benefit of customers and the investment in the country's energy system that is needed. In this regard it is critical that the terms of reference which underpin it are sufficiently wide to cover all the main issues where there is public concern over the operation of the competitive energy market.

2. A market reference needs to be based on strong principles

- 2.1 We believe that the following five Principles will be useful in the scoping, conduct and resolution of any reference:
 1. **Get the scope right** - so it is broad enough to restore trust in the competitive markets.
 2. **Focus on all energy customers** - so what they pay for is defined and transparent.
 3. **Create simple markets** - which encourage new entrants and enables different business models to thrive
 4. **Establish clear measures of success in advance** - so people can see objectively how the market is performing
 5. **Achieve lasting results** - so there is a clear and enduring framework that gives customers confidence, allows regulators to regulate and encourages investors to invest in the GB energy market.

We will expand on what these Principles mean in concrete terms below.

3. A market reference needs to have the right scope

- 3.1 Ultimately, regulators, politicians, customers and SSE all want the same thing: a competitive energy market that not only works for customers, but is also trusted and seen to do so. We welcome any efforts to clear the air. In the meantime SSE will continue with its positive agenda for customers including its energy price freeze for household customers until at least 2016.
- 3.2 The first three of our five Principles have a direct bearing on the terms of reference
 - **Get the scope right**
 - In order to assess the market properly, it is necessary to understand all of the areas of the supply chain that affect the competitive supply market. This should include interconnectors, gas storage, the role of switching sites, smart metering, on and off-shore trading arrangements, and generation and upstream gas investments.

- There also needs to be a recognition that the market is not static. The landscape is evolving and the CMA will no doubt be very mindful that there have been a number of positive initiatives from Ofgem and the industry which need sufficient time to bed in so that their beneficial effects on competition can be properly assessed.

- **Focus on all energy customers**

- We believe that **all** business and industrial customers should be included in the reference, not just 'small' industrial and commercial customers as currently proposed.
- We believe this will allow a fuller debate as to both *what* and also *how* customers should pay for their energy.

- **Create simple markets**

- Parts of the current market are complex and this does not help participants or customers. For example, the current supply licence contains a number of very detailed obligations, which are expensive to comply with and arguably are not always necessary in a vigorous competitive market.
- The current system also distorts competition because of the imposition by successive Governments of several policy initiatives on the industry which pose substantial and complex obligations on certain suppliers. In addition it has created an arbitrary 250,000 customer threshold below which smaller suppliers are exempt. Beyond this threshold there is a need for larger suppliers to recoup these common social and economic taxes via price adjustments and this creates an artificial barrier to expansion for smaller suppliers. For these reasons, we believe that customers should not pay for environmental and social taxes through their energy bills and that these amounts should be paid for via general taxation.

- 3.3 Whilst the role of suppliers is a critical component of the competitive energy market, it needs to be assessed in its proper context. Even though energy supply and other parts of energy production may be operating effectively, it is clear that many stakeholders, in particular, customers and consumer groups, have lost faith that they are. Restoring trust in one part of the competitive energy market is all well and good, but if doubts remain elsewhere, customers will not trust the competitive market as a whole and in such an environment companies will find it hard to raise the much-needed finance to invest in the generation capacity required to safeguard security of supply.
- 3.4 The scope of the reference should exclude networks as they are subject to economic price regulation by Ofgem. These natural monopolies are separate legal entities from the market-based retail and wholesale businesses and are already subject to robust and challenging economic price regulation. These price controls are underpinned by a lengthy, detailed and transparent review process, in which stakeholders are actively encouraged to participate, and followed by regular reporting and monitoring. A comprehensive review of the regulatory regime was undertaken from 2008-10, which resulted in substantial changes that put customers at the centre of network operations and pricing. This new regime is at a very early stage (and is yet to be implemented in electricity distribution), but nevertheless has been designed to allow financially disciplined, efficient, innovative and customer-focused network operators to attract the investment required for renewing and upgrading infrastructure while delivering value for money for the consumer.
- 3.5 The State of the Market Assessment (SMA) does not propose, nor give reasons, as to why the CMA should inquire further on particular features of the price-regulated distribution or transmission markets. Should the CMA consider that price regulated networks should be within the formal scope of its review, then we consider that it would require a further consultation on the revised terms of reference as well as the implications for the current electricity distribution price control review process and outcome.
- 3.6 Should a market investigation reference into the competitive energy markets be considered necessary, SSE would support terms of reference that are sufficiently wide to cover all the main issues where there is public concern. The terms of reference also need to bring all the key disputes about the health of the market to an unambiguous conclusion to allow a resetting of the political

consensus, renewed consumer confidence and a stable climate for long term investment in the GB energy market.

4. Recent reforms need time to bed in and may assist in developing appropriate remedies

4.1 Looking forward, there are a number of other important (recent or imminent) changes to the market which can be expected to bring further benefits to competition in the short-term. SSE believes that if there is a market investigation reference the CMA must take account of their impact when evaluating market conditions:

- A wide-ranging set of retail market remedies (RMR) have recently been implemented by suppliers. Their aim is to improve consumer engagement and trust in the market, through a number of measures including increased simplicity of tariffs, tariff comparison tools, simpler and clearer information for customers and principles-based (and enforceable) Standards of Conduct.
- The industry is moving towards quicker switching timescales, which will be fully implemented by the end of 2014. These will have a positive impact on the ease and speed of the switching process, and should further encourage customer engagement in the competitive market.
- On current plans, the domestic markets will see a comprehensive replacement of electricity and gas meters which is due to start apace during 2015 with the rollout of 'smart meters'. The economic case for this major investment relies on a number of important benefits to customers including an end to estimated bills, a reduction in switching times, innovative time of use tariffs and reduced costs to serve.
- A series of liquidity reform initiatives have been implemented by SSE and others which have improved liquidity in the electricity wholesale market and further facilitated new entry. These have been reinforced by the recent introduction of Ofgem's Secure and Promote Licence Condition (SPLC), which will oblige certain electricity generators to follow a set of "Supplier Market Access" rules when trading with small and independent suppliers. It is also designed to ensure that the market provides the products and price signals required for effective competition through a market making obligation on the six largest vertically integrated companies.

4.2 In SSE's opinion, all of these measures are broadly welcome and will help promote competition.

4.3 In the case of RMR, the CMA will no doubt wish to assess whether the limit on the number of tariffs to just four has reduced the scope for product differentiation that can be used to tailor products to customers' needs and persuade customers to switch. Furthermore, existing RMR changes require suppliers to switch customers automatically to certain tariffs, which may have the unintended effect of undermining the incentives to switch supplier. In addition, SSE considers that there may be some incremental improvements that can be made to the RMR package, for example, the treatment of white label and the promotion of innovation, which would further encourage more customer engagement in the competitive market. In particular, we consider that Ofgem's insistence on treating White Label as part of the Licensee's regular offer will limit competition and customer choice by deterring market entry.

4.4 Similarly, with regard to liquidity, SSE believes that further consideration needs to be given to which other companies should be obliged to provide market making services and whether the current arrangements can be improved upon.

4.5 The changes to the competitive market described above need to be carefully evaluated throughout any market investigation reference to make sure that the benefits which they bring are understood and taken into account. Equally, if it becomes apparent in the course of the CMA's work that any of the recent changes in the energy market are likely to produce consequences which would run counter to what is required to achieve a lasting settlement, they should be reversed or superseded.

5. Key issues raised in the State of the Market Assessment and Ofgem's consultation

5.1 SSE's view is that in contrast with the impression given in the State of the Market Assessment, overall the competitive market is working well and delivering benefits for customers. The sections below address some specific points identified in the SMA and the consultation:

a. 'Weak customer response'

5.2 While we believe it is right to continue developing initiatives to increase the level of customer engagement, the case for weak customer response in the SMA is overstated and relies too heavily on switching *between* suppliers as the almost exclusive measure of customer engagement.

5.3 Market commentary has tended to focus on switching rates but it is important that switching is not the sole metric for assessing engagement. Switching rates are a very imperfect indicator of competitive pressure in the market, as they fail to account of the steps taken by suppliers to reduce the risk that their customers switch supplier. In particular, an effective market in which all suppliers provide high quality service and competitive prices may have very low switching levels. In contrast, a market in which customers are highly dissatisfied with service and prices may be typified by very high switching rates. As such, switching provides an ambiguous measure of success and cannot be assessed in isolation.

5.4 In addition to switching rates, a fuller assessment would consider a wider range of factors including:

- Switching "within supplier";
- Customers' awareness of competition; and
- Ongoing initiatives to improve customer engagement and trust in the competitive market.

These issues are considered in more detail below.

Switching rates

5.5 Notwithstanding our point above regarding the over-reliance on switching rates as an indicator of the level of customer engagement, it is disappointing that the SMA dismisses the significance of changes in switching levels at the end of 2013.¹ The latest data suggests that switching rates in the first four months of 2014 have generally been higher than last year. There were 289,662 switches in April 2014 (a reduction on last year but up 8.9% from March), of which a record high of 47% were to smaller suppliers. April 2014 was the sixth consecutive month in which the small suppliers' share of overall switches has increased². This evidence indicates that there is effective competition between established suppliers and new entrants.

Switching "within supplier"

5.6 We also believe that better switching data is required such that Ofgem can judge fully levels of engagement, by *including* switching between tariffs offered by the same supplier, as well as reflecting consumers' searching on price comparison websites (even if those consumers decide not to act). SSE notes that to further measure competitive market activity, Ofgem has been undertaking a review of its retail market monitoring. By the end of this year, changes in reporting by suppliers will be implemented which should provide greater visibility of the operation of the competitive market and-

¹ Ofgem (2014) Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain (p17)

² Energy UK (2014) <http://www.energy-uk.org.uk/publication/finish/5-research-and-reports/1105-energy-switching-figures-april-2014.html>

will include within supplier activity. These changes should be taken into consideration during any reference.

Customers' awareness of competition

5.7 SSE believes that customers are engaged with the market and, as we explain in more detail below, competing suppliers continue to be incentivised to take action to improve customers' ability to do so. Recent research conducted for SSE by Populus and reported by Frontier Economics found that the vast majority of energy customers regarded themselves as knowledgeable and empowered, with 74% reporting that they could easily find out the amount they spend on energy; 74% saying they could easily check which tariff they were currently on; and 70% claiming that they could easily switch supplier³.

Ongoing initiatives to improve customer engagement and trust in the competitive market

5.8 Consumer engagement and trust in the energy industry, and hence the competitive market, is clearly determined significantly by the activities of suppliers. However, it is also informed by the interventions of others such as politicians, regulators and consumer groups.

5.9 Recognising this, SSE has undertaken substantial efforts to restore customer trust in the competitive market in recent years with the introduction of a number of initiatives. The measures have included:

- the simplification of tariffs;
- steps towards a more transparent market such as sending customers information on the breakdown of costs that make up a typical bill;
- the introduction of freephone customer service numbers;
- a Sales Guarantee to boost confidence in sales; and
- the cessation of doorstep sales and cold calling.

5.10 SSE has seen the benefits of this investment - SSE has maintained its number one position in an industry customer service performance report, receiving the lowest rate of complaints of the major energy suppliers⁴. The most recent report covers the period from October to December 2013 and rates SSE with the best performance of 31.5 complaints per 100,000 customers. SSE has consistently held the top spot since 2010.⁵

5.11 SSE will continue to respond to the needs of its customers by taking account of the issues identified in complaints received and feedback by employees from their engagement with customers. It was representations from its employees that encouraged SSE to introduce its Customer Service Guarantee in 2013 which gives money back to customers if SSE fails to keep its promises.

5.12 SSE notes that elements of Ofgem's RMR package⁶ may have a positive impact on customer engagement, in particular: the provision of improved and clearer information for domestic customers; and the Standards of Conduct, which ensure customers are treated fairly in all interactions with their supplier. As we have stated above, these measures are expected to bring further benefits to competition in the short-term and their effectiveness needs to be carefully considered during any market investigation reference.

³ Frontier (2014) Competition in the energy retail market (p25)

⁴ Citizens Advice and Citizens Advice Scotland (May 2014) The Energy Supplier Performance Report

⁵ The Energy Supplier Performance 2010-2012 Consumer Focus Five Star Rating and Consumer Futures (now Citizens Advice) Energy Performance Report October 2012-December 2013.

⁶ Ofgem (2013) The Retail Market Review – Implementation of Simpler Tariff Choices and Clearer Information

- 5.13 Finally, the industry has been working to move towards quicker switching timescales and measures to facilitate this will be fully implemented by the end of 2014⁷. This development will ensure that where customers do choose to switch supplier, they can be confident that it is a straightforward process.
- 5.14 In summary, SSE believes that there is much more to an effective market than switching rates. Furthermore, as outlined above, in many cases customers may already be engaging with their own supplier and making other choices, such as changing tariff or payment method, which demonstrate their awareness of competition. SSE therefore considers that, whilst it is right to continue to seek ways to encourage customers to participate in the market, the case for a weak customer response is overstated.

b. Vertical Integration

- 5.15 The SMA sets out a number of perceived benefits to vertical integration including *"lower collateral requirements; the ability to better source energy in an illiquid electricity wholesale market; (the "natural hedge" provided by the ability to offset within group generation and demand); and the potential for co-ordination of activities and economies of scope."*⁸
- 5.16 SSE's view is that vertical integration is an efficient structure in this market for delivering value to customers in the long term.
- 5.17 However, the SMA's concern is that, from the viewpoint of a new entrant or smaller supplier (neither of which is vertically integrated), vertical integration could represent a barrier to entry or expansion.⁹ There seems to be two specific areas of concern about vertical integration – liquidity and transparency – and we address both of these in turn below.

Liquidity

- 5.18 What the SMA does not explain fully, is that Ofgem has, for the last three years, been looking at ways to directly address potential barriers by measures designed to boost liquidity. These measures are intended to benefit in particular suppliers who are not vertically integrated. Should there be any reference, the CMA will want to consider first whether these Ofgem liquidity measures could, if given sufficient time, address any actual or perceived liquidity shortfalls in the market.
- 5.19 It is necessary for these perceptions to be addressed and SSE has been and continues to be very supportive of liquidity measures, such as encouraging market participants to trade a greater percentage of generation and demand in the 'day ahead' market. It is important to recognise that Ofgem's Secure and Promote licence condition already guarantees that not only will price discovery be improved as a result of the market making obligation, but that small suppliers will be able to trade the products and clip sizes they need at market prices. Furthermore, the SMA indicates that large companies are generally buying and selling multiples of their generation output consistent with an overall churn ratio of three in GB.
- 5.20 SSE has a strong track record on taking action in recent years to improve liquidity in the wholesale market:
- For each of the last five years SSE has traded more than five times its generated volume in the market, exceeding the level of the average market churn;
 - It was the first company to start 'gross bidding' in October 2011 and it is the only company that commits to entering 100% of Supply and Generation into the day ahead auction whenever possible;
 - Ofgem decided that no intervention was required in the short term market due to the improvements that came as a result of SSE's gross bidding initiative; and
 - SSE is one of the most active market participants in the power market and in effect pre-empted the market making licence condition before it came into force.

⁷ www.gov.uk/government/news/energy-switching-times-to-halve-by-end-of-year

⁸ Ofgem (2014) State of the Market Assessment, paragraph 5.63

⁹ Ofgem (2014) State of the Market Assessment paragraphs 5.91 and 5.92

5.21 An area which requires further consideration is which companies should be obligated to provide market making services, and whether the current arrangements can be improved upon. SSE disagrees with Ofgem's view that only the largest vertically integrated companies have sufficiently sophisticated trading operations to meet the market making obligation. SSE continues to believe that excluding other vertically integrated players such as Drax and GdF Suez from this licence condition does not benefit the market and this needs to be addressed.

Transparency

5.22 SSE is also open to additional transparency initiatives as evidenced by its involvement in the CSS amendments and is already in the process of reorganising its companies (announced on 26 March 2014) so that there are separate legal entities for its energy supply (Retail) and electricity generation and energy portfolio management (Wholesale) activities. These initiatives will further improve transparency, while retaining the benefits of common ownership that allow SSE to operate efficiently to the benefit of its customers.

5.23 We are open-minded about further reform that is in the clear interests of customers and believe there needs to be transparency around the terms on which energy is charged between the businesses in vertically integrated companies. It is also important that it can be clearly seen that there is a liquid market for wholesale energy accessible to all legitimate market participants.

5.24 In summary, SSE's view is that vertical integration is an efficient structure in this market and delivers significant long-term value to customers. Notwithstanding this however, SSE notes that there have been a number of extremely successful new entrants to the market, who operate a different business model and are continuing to grow their market share. This indicates that new entrants are able to mount a credible competitive challenge on the basis of their particular business model.

5.25 As explained above, SSE believes that the liquidity and transparency issues identified with the vertical integration model are already being tackled via current initiatives. We consider that these should be allowed to bed in, before further substantive reform is contemplated. SSE has also been considering whether these can be further developed to the benefit of the market.

c. Barriers to entry and expansion

5.26 SSE believes that the following issues should be considered in the context of assessing whether there are barriers to entry and expansion in the energy market:

- New entrants and smaller suppliers are competing effectively;
- The unique features of the energy market means that there are costs and risks associated with entry – but these are needed to protect the interests of customers and all market participants; and
- The effect of the small supplier exemption.

We discuss these points in further detail below.

New entrants and smaller suppliers are competing effectively

5.27 Over the last two to three years there has been increased entry and expansion in the competitive market.

5.28 Retail customers can now choose from a total of 24 suppliers in the UK¹⁰. This has included direct entry to the market by fully licensed suppliers. In addition, Telecom Plus has demonstrated the value of White Label arrangements by entering the market at scale through the purchase of the 700,000 customers supplied on its Utility Warehouse brand (previously a partnership with nPower) in 2013¹¹.

¹⁰ <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)

¹¹ 19 November 2013: www.npowermediacentre.com/Press-releases/RWE-npower-announces-sale-of-subsidiaries-to-Utility-Warehouse-owner-Telecom-Plus-Plc-for-218m-12dd.aspx

- 5.29 Several suppliers which entered the market around the time of the Energy Market Probe in 2008, including Ovo and First Utility, have subsequently grown market share to more than 250,000 customers (i.e. they exceed the upper limit for the small supplier exemptions). Ofgem's own analysis shows that the rate of growth of new entrants has increased in recent years¹².
- 5.30 This sustained and accelerating growth demonstrates that small suppliers are able to compete with established suppliers. Whilst some market participants and wider stakeholders continue to argue for further reform of wholesale markets to promote competition, SSE views the growing market share of new entrants and small suppliers as clear evidence that the competitive wholesale markets are able to meet their needs.

Some features of the energy market means there are risks associated with entry – but these are needed to protect customers and all market participants

- 5.31 We recognise that there are some features of the energy market - such as the need to meet credit and collateral requirements, the need to be a party to industry codes and the complex body of regulatory obligations - which could make new entry more difficult. However these features are faced by all suppliers, are justified and are not insurmountable (as demonstrated by the existence of many small suppliers).
- 5.32 Such features are better characterised as a necessary 'cost of entry or expansion' rather than as a barrier. For instance, credit and collateral costs may differ according to the size and nature of the company in question. These measures simply represent prudent risk management measures: the risk of systemic failure would be increased by any move to reduce this level of protection. The customer upheaval and wider market consequences of the supplier of last resort provisions are significant and costly.
- 5.33 For that reason SSE believes that the existing credit and collateral requirements should be recognised as an important feature of the market which acts to protect customers. These costs naturally should be borne by the individual supplier in question as it is within their gift to control their own credit and liquidity profile, rather than the market as a whole being required to bear costs beyond its control.
- 5.34 Notwithstanding that there has been sustained new entry and expansion in recent years, SSE suggests that further consideration needs to be given as to whether steps can be taken to simplify parts of the market and reduce the complex regulatory burden, which would aid all suppliers and their customers. The current supply licence is substantial, with many detailed obligations, which arguably should not be necessary in a competitive market. SSE believes therefore that there is merit in exploring the streamlining of the supply licence and the development of 'licence lite' arrangements.

The effect of the small supplier exemptions and the regulatory burden

- 5.35 SSE believes, however, that a more serious barrier to expansion for financially sound entrants arises through the operation of obligations placed on large suppliers by Government. There have been a growing number of these in recent years, most notably in the form of environmental and social schemes such as ECO, Feed In Tariffs and the Warm Homes Discount. These schemes have grown in terms of complexity, placing a significant administrative burden on scheme deliverers and therefore the associated cost on the customer's bill. They have reached a point where shifts in the arrangements of schemes impact on the timing of tariff changes as has been seen with ECO in the first quarter of this year.
- 5.36 The exemptions given to small suppliers cause a serious distortion to the competitive market and customers' perceptions of price differentials between obligated and non-obligated suppliers. This is exacerbated as small suppliers enter a tapering system as they cross the 250,000 customer threshold. While some suppliers have grown beyond this threshold, it is likely that it may act as a disincentive to grow, because of the marginal cost of the 250,001st customer. Cumulatively, these obligations have-

¹² Ofgem (2014) State of the Market Assessment, Figure 38, paragraph 5.7

become a significant source of distortion in the market and SSE will continue to advocate that these policy costs should be taken out of bills and supported through the tax and benefits system.

- 5.37 In summary, SSE considers that there is compelling evidence that new entrants and small suppliers are competing effectively, although it must be recognised the small supplier exemptions result in some unfortunate distortions in the competitive market. SSE acknowledges that some aspects of the current market framework are complex. SSE therefore believes that consideration should be given to the current regulatory burden and whether steps can be taken to roll-back some of the existing requirements without removing any of the necessary protections for customers and market participants.

d. Continuing incumbency advantage

- 5.38 The SMA gives a misleadingly static impression of the energy market over the last ten years. As we have explained above, the GB energy market does not lack competitors and it is evident that the energy market is constantly evolving to the smaller suppliers' advantage.
- 5.39 Indeed, the SMA highlights that there has been a 'recent growth of smaller suppliers' with 'high levels of entry' and that 'new entry can be a particularly effective form of competition'. For instance, the market shares of the six main suppliers in the domestic electricity market are being eroded at an increasing rate by the eighteen smaller suppliers¹³. Four of these smaller suppliers now have over 250,000 customers with Ovo and Utility Warehouse showing particular growth.
- 5.40 Such growth illustrates that, contrary to the SMA's findings, it is 'possible to enter the market and compete with the six largest suppliers'. With the increased liquidity and the introduction of SPLC, the number of new entrants and their market share is likely to continue to grow. Energy UK has reported recently that the smaller independent suppliers have gained 47% of all switching UK energy customers in April 2014¹⁴. This demonstrates that the GB has a competitive retail market.
- 5.41 A recent report by Cornwall Energy assessed the UK energy market according to various technical indicators, including the Herfindahl-Hirschman Index (HHI), finding that the UK market is becoming less concentrated, with an HHI that dropped from around 1,800 in 2011 to 1,600 in 2014. The research also noted that nearly a third of all the gas and electricity licence applications since 2011 occurred in the six months to 31 October 2013¹⁵. Research conducted for DECC by London Economics in 2013 found that the HHI of the UK electricity retail market is also relatively low¹⁶.
- 5.42 While the SMA plays down the impact of this competitive pressure, SSE's own history demonstrates the ability for a company to increase its market share over a relatively short period. There was a dramatic change in SSE's market position between 2004 and 2008 in both the electricity and gas retail markets as can be observed in Ofgem's own figures¹⁷.
- 5.43 We therefore disagree with the suggestion that there is a continuing incumbency advantage.

e. Market segmentation

- 5.44 The SMA is particularly concerned about weak competition for customers who remain with their incumbent supplier. For the reasons outlined above, SSE considers this not to be the case, and that the market is competitive – namely increased switching rates between and within suppliers; initiatives to improve customer engagement and overall customer awareness of the market and their right to choose one of a large number of suppliers. When analysing different market segments, careful account needs to be taken of the extent to which online and direct debit discounts need to be cost-reflective and the impact of the small supplier exemption from delivering environmental and social policy obligations.

¹³ Figure 3, SMA

¹⁴ Energy UK (2014) <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>

¹⁵ Cornwall Energy (2014) Competition in British household energy supply markets (p5)

¹⁶ London Economics (2013) Energy Retail Markets Comparability Study (p120)

¹⁷ Ofgem (2014) State of the Market Assessment Figures 3 and 4 (pp8-9)

f. Tacit co-ordination

- 5.45 At SSE we consider that transparency for customers is a pro-competitive feature of the market. We were therefore extremely disappointed to see this feature and other regulatory protections for consumers being distorted into a concern about potential tacit coordination.
- 5.46 One of the most frequent criticisms of the energy industry is that it has been insufficiently “transparent” particularly with regard to revenues, costs and profits. There has been an increasing requirement to break down financial figures, display pie charts, disaggregate customer bills into their component inputs and explain cost forecasts underpinning tariff levels. In addition, Ofgem has ensured that suppliers must provide customers with more advance notice of price increases and their impact, thus providing customers with the opportunity to switch supplier in response¹⁸. These measures are identified as being of concern, yet were designed as solutions to help customers and give them confidence in the energy market.
- 5.47 SSE has embraced this agenda and was an early adopter of presenting more information publically particularly from the time of our “Building Trust” campaign over three years ago.
- 5.48 There is a policy choice to be made here and SSE believes that it should be the interests of customers that are paramount. This means more and better information for customers. We would be particularly concerned if suggestions of tacit co-ordination overshadow what is a real opportunity to improve transparency, and other measures designed to act in the customer’s interest, following any Referral.
- 5.49 It was particularly surprising to see adverse inferences seemingly being drawn in the SMA regarding the longer lag between price announcements and the price change becoming effective, given this is a direct result of regulation imposed by Ofgem to require proper communication of the changes in advance¹⁹.
- 5.50 SSE welcomes the SMA conclusions that there is a complete absence of evidence of any form of collusion or anti-competitive practices by suppliers. Indeed, SSE considers there is little evidence that there is the potential for tacit coordination to arise in a market comprising six large players and a significant and active tail of eighteen other suppliers (each able to disrupt any coordination arrived at tacitly). Ofgem has dismissed on a number of occasions concerns around tacit coordination and SSE therefore believes that tacit coordination theories are unfounded.

g. Profits/profitability

- 5.51 There has also been a significant focus on whether customers’ energy prices are reflective of costs and whether profits in energy supply are reasonable. These issues are considered below.

Energy prices are reflective of costs

- 5.52 Upward pressure on customers’ bills in recent years has been a consequence of the rise in the cost of generating capacity and wholesale energy costs, as well as the implementation of environmental and social schemes to meet important Government policy objectives. All of this has occurred during a period of constrained customer incomes following the 2008 recession and therefore affordability remains a key issue.
- 5.53 While GB domestic energy prices have risen in recent years, this is from a relatively low base. Although it may come as a surprise for customers whose bills have risen in recent years, the UK still has some of the cheapest prices in Europe as evidenced by recent statistics from the Department of Energy & Climate Change (DECC)²⁰.

¹⁸ Ofgem (April 2011) Standard Licence Condition 23.4 a

¹⁹ Ofgem (April 2011) Standard Licence Condition 23.4 a

²⁰ London Economics (2013) Energy Retail Markets Comparability Study (p70-79)

- 5.54 To help improve transparency, and as described in the sections above, steps have been taken to improve customers' and other stakeholders' awareness of the costs that make up energy bills and to give them confidence in the competitive market.
- 5.55 As a result it must be concluded that energy prices are reflective of costs.

SSE's profits are reasonable

- 5.56 SSE believes that its supply profits are reasonable, and is concerned by the statement in the consultation that "large suppliers appear to raise prices more quickly and fully when costs increase than they reduce them when they fall"²¹. There appear to be serious shortcomings in the models used to reach these conclusions and the calculations reported in the SMA which ignore the influence of non-energy costs are wholly inadequate for reaching such a firm conclusion.
- 5.57 Ofgem's published analysis at the time of the Retail Market Review must also be taken into account when considering suppliers' profits. This indicated a range of 3% to 9% as the profitability benchmark for energy supply depending on the extent of vertical integration²². Ofgem also showed that the margins in supply were modest by comparison with other retail activities. The SSE profit aspiration across its Energy Supply business over the medium term of 5% pre tax²³ (something SSE has not met over the last five years) lies at an appropriate point in this range given its mix between highly integrated electricity and minimally integrated gas, and its high efficiency rating reflected by its low customer cost to serve.
- 5.58 Ofgem itself concedes that determining what constitutes a fair margin, is very difficult to assess. However, we have been advised by Frontier Economics' extensive review of benchmark studies that there is no evidence to support the pre-tax nominal WACC for energy generation businesses of 7% assumed by Ofgem in the SMA²⁴. In contrast, this review of a wide range of evidence points to a pre-tax nominal WACC range of 8.7% - 20.7%.
- 5.59 Overall, SSE's profits in generation and supply combined have not shown an upward trend in recent years. Market participants need to make a reasonable profit as significant investment is required across the energy supply chain in order to invest in new generation, upgrade infrastructure, manage the fluctuating demand profile of a generation mix including more renewables and investments in 'smarter' energy (including grids, buildings, meters or electric vehicles). In recent years SSE has invested at a rate of between £0.7 and £1 billion a year in its wholesale and retail businesses in Great Britain. These investments are vital for meeting the country's security of supply standards and decarbonisation targets which are currently under pressure.
- 5.60 Protracted regulatory uncertainty is unhelpful in this context and we would expect any market investigation reference to have proper regard to the need to secure the long term investments in our energy supply chain and to conclude that there is a need for all market participants to be profitable.

²¹ Ofgem (2014) Consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain (p22)

²² Ofgem (2011) The Retail Market Review - Findings and initial proposals (Supplementary appendices) page 43

²³ http://sse.com/media/108594/SSEplcAnnualReport2013_optimised.pdf (page 19)

²⁴ Ofgem (2014) State of the Market Assessment, p119 paragraph 6.76

6. Conclusion

- 6.1 SSE's view is that overall, the competitive market has many positive features that operate well for customers and that it has shown its ability to adapt and change in response to customers' or other stakeholders' concerns. The recently implemented Ofgem-led RMR and liquidity reforms, coupled with the measures that will speed up customer switching times, should further bolster customer confidence and will increase participation in the evolving competitive market. In addition, the rapid growth and success of new entrants demonstrates that there is already competitive pressure on all market participants.
- 6.2 Nevertheless, it has to be acknowledged that the experience of individual customers can be poor. There remains a significant body of public concern with the energy market, particularly in the context of rising costs, and a perceived lack of transparency, which needs to be addressed. Rising prices are of concern and SSE has long-advocated for policy costs to be removed from energy bills to part-address the cost issue. SSE believes that with measures to improve transparency it is possible to address these issues within the current competitive market framework and without the need for fundamental structural interventions.
- 6.3 To underpin this, SSE considers it is very important that in addition to a successful set of remedies, consensus is reached on the measures against which the competitive market's performance can be assessed. Such measures should have customers' interests at their core. In a long-term sector like energy, which is overseen by an independent regulator with clear responsibilities, including promoting competition, it is vital that any remedies are underpinned by clear measures of success that do not become conflated with short-term political objectives. This will ensure that all stakeholders, and, in particular, customers, can see objectively how the competitive market is performing.
- 6.4 In this context, SSE believes its five Principles should underpin any market reference:
 1. **Get the scope right** - so it is broad enough to restore trust in the competitive markets.
 2. **Focus on all energy customers** - so what they pay for is defined and transparent.
 3. **Create simple markets** - which encourage new entrants and enables different business models to thrive
 4. **Establish clear measures of success in advance** - so people can see objectively how the market is performing
 5. **Achieve lasting results** - so there is a clear and enduring framework that gives customers confidence, allows regulators to regulate and encourages investors to invest in the GB energy market.
- 6.5 We look forward to working with the CMA on its work in relation to energy markets. With the right principles in place, a market investigation will help to ensure that the energy market remains competitive and one in which customers have confidence and in which investors are willing to invest.

20 May 2014