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Dear Jeff,

DISCUSSION PAPER ON NON-TRADITIONAL BUSINESS MODELS: SUPPORTING TRANSFORMATIVE CHANGE IN THE ENERGY MARKET

Thank you for the opportunity to comment on the above discussion paper dated 25 February 2015.

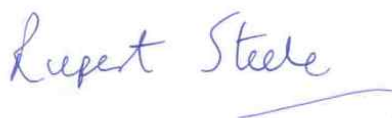
We broadly agree with Ofgem's definition of Non-Traditional Business Models (NTBMs) as business models offering new products or services, or delivering them in innovative ways, and we welcome the thrust of this review. However, it should be recognised that NTBMs do not have to be operated by new entrants – it is possible that 'traditional' energy businesses may develop NTBM offerings alongside their existing business, and this should equally be encouraged.

NTBMs have the potential to deliver significant consumer benefits and choice alongside traditional business models and we agree that it is important to consider whether current regulatory arrangements may place unnecessary barriers in their way. We think the outcome of the CMA market investigation may be helpful in this respect. If the CMA investigation results in changes to the regulatory arrangements designed to facilitate competition amongst traditional business models, these changes are also likely to benefit NTBMs.

Finally, although it may be helpful to suggest hypothetical examples of NTBMs by way of illustration, markets are the best way of discovering what actually works and Ofgem should be wary of picking winners. Any policy making or decision taking should be neutral as to technology and business model. Ofgem's focus should be on fostering a fully competitive market in which companies are driven to innovate and respond to consumer needs.

We have provided answers to the questions set out in your discussion paper in Annex 1 attached to this letter.

Yours sincerely,



Rupert Steele
Director of Regulation

**NON-TRADITIONAL BUSINESS MODELS: SUPPORTING TRANSFORMATIVE CHANGE
IN THE ENERGY MARKET - SCOTTISHPOWER CONSULTATION RESPONSE**

Chapter 1: Introduction

1. What is your view on our definition of non-traditional business models?

Ofgem is proposing to define non-traditional business models as follows:

“Business models offering new products or services, or new ways of delivering these, that are different to those traditionally provided in the existing energy market. Those offering such services have diverse motivations (technological, social and environmental as well as financial) and ownership arrangements, and operate at various scales. Over time, NTBMs have the potential to transform the existing energy system.”

We think that Ofgem’s proposed definition is a reasonable starting point, and we agree with the need to keep the definition broad in order to take in the variety of ways in which NTBMs may appear in the market. However, we believe the first sentence to be the most important part of the definition, and that issues around ownership and motivation should be subsidiary.

It should be recognised that NTBMs do not have to be operated by new entrants – it is possible that ‘traditional’ energy businesses may develop NTBM offerings alongside their existing business.

2. How can we engage with NTBMs more effectively in the future?

In the case of small businesses seeking to enter the energy market with a NTBM, Ofgem could potentially build on the DECC/Ofgem small supplier champion initiative.

In the case of larger businesses seeking to move sideways into energy with a NTBM, it is likely that the business will be sufficiently resourced to engage with Ofgem directly.

Chapter 2: Drivers for NTBMs

3. We would like to hear your views on the drivers for market entry. Do you think there are other important drivers?

We think the four drivers for market entry identified by Ofgem are all likely to play a part:

- a) low carbon energy transition
- b) rapid technological innovation
- c) lack of consumer engagement and trust
- d) a greater focus on affordability and supporting vulnerable consumers.

We think that technological innovation is likely to be the main driver (or enabler) for new and disruptive business models and should be the focus of Ofgem’s analysis. The low carbon energy transition could also be a significant driver for certain new business models, which seek to respond to Government incentives or to consumers’ desire to be ‘green’.

We are less persuaded that lack of consumer engagement and trust will be material drivers for market entry by NTBMs. There may well be an opportunity for third party intermediaries (TPIs) to improve engagement – notably with customers who would previously have been engaged through face-to-face selling – but the challenge here is to overcome the current regulatory barriers relating to SCL25¹ rather than a need for non-traditional business models *per se*. Likewise, lack of trust may make it easier for trusted brands or not-for-profit organisations to enter the market, but they will need some other selling point (such as low prices or innovative services) if they are to succeed. Although consumers may have a low level of trust in suppliers as a whole, survey evidence suggests they generally have a rather higher level of trust in their own supplier².

We are also doubtful that a growing focus on affordability and supporting vulnerable consumers will be a material driver of NTBMs. So long as society expects additional support to vulnerable customers to be provided ‘free’, with the costs socialised across non-vulnerable customers, there is little financial incentive for new entrants to focus on this segment of the market. Indeed, new entrants have typically taken the opposite approach, focusing on credit worthy customers who will have the lowest cost to serve, leaving the large suppliers to provide a disproportionate share of this safety net.

Finally, we would note that regulation itself could be a driver for NTBMs, if non-traditional models can avoid regulatory burdens that would otherwise apply to traditional business models. However, this would not be an optimum outcome and could be expected to be more expensive overall than a solution without regulatory discrimination.

Chapter 3: Our understanding of NTBMs

4. Have we accurately described the NTBM environment? Have we missed something?

Yes, we think the three broad themes identified by Ofgem (local services, bundled services and customer participation) are a reasonable way of categorising NTBMs.

5. We’d like to learn more about organisations using NTBMs. If you are prepared to discuss this, please contact us (see Appendix 1 for contact details).

Ofgem might be interested in the issues raised during a similar consultation by the Australian Energy Regulator in November 2014.³ This consultation mainly focused on solar power purchase agreements (SPPAs) and how the existing regulatory arrangements (under which SPPAs were licence exempt) should evolve to accommodate business models which integrated solar generation and small scale electricity storage.

¹ For example, ScottishPower has suggested a ‘safe harbour’ exemption from SCL25 where the supplier is exempt from enforcement action in respect of a contravention by a TPI as long as the TPI is accredited (eg under the Confidence Code or similar), and the contravention was not a result of any action or omission by the supplier.

² For example, GfK customer survey for the CMA investigation, paragraph 9: https://assets.digital.cabinet-office.gov.uk/media/54e75c53ed915d0cf700000d/CMA_customer_survey_-_energy_investigation_-_GfK_Report.pdf

³ <http://www.aer.gov.au/node/28403>

Chapter 4: NTBMs within current regulatory arrangements

6. Our main focus in this paper is on regulatory issues arising from future energy market transformation, but we recognise that there are relevant issues within current regulation. Please let us know if there are any other issues?

Ofgem identifies four regulatory issues affecting small-scale NTBMs: setup costs for suppliers, regulatory compliance costs, environmental and social obligation thresholds and code compliance. We would note that these issues potentially affect any new entrant, whether traditional or non-traditional, and that some NTBMs, if they do not involve electricity or gas supply, will be able to avoid these issues. Indeed, to the extent that traditional businesses are caught by regulations which do not apply to NTBMs, it is possible that regulation will put NTBMs at an undue competitive advantage.

The issues relating to market structure and design (vertical integration, liquidity, imbalance costs, code modification and network connections, lack of customer engagement) similarly have the potential to affect traditional and non-traditional businesses alike. We note that many of these issues are being considered by the CMA in its market investigation and its updated issues statement suggests that some of the issues, such as vertical integration and liquidity, may not be as significant as some parties have claimed. We note that the Consultation was published just a week after the CMA's Updated Issues Statement and we assume that there was not time to update this section in line with that new information, and accordingly that it does not reflect Ofgem's current views.

The focus of chapter 4 is on energy-specific regulation, which is where Ofgem has the greatest opportunity to effect change. However, it may also be worth considering two other aspects of regulation which could have an important bearing on NTBMs.

First, rules around privacy and data protection will have a major impact on the evolution of business models which seek to exploit the information that will be generated using smart meters. Currently, there are very significant restrictions in place regarding use of half-hourly metering data, which are likely to remain in place until at least 2018, when the review of DECC's Data Access and Privacy Framework is expected to take place.⁴ Although there are good reasons for having a strict regulation around use of data, it could also be a barrier to widespread adoption of half-hourly settlement, which in turn is the basis for many potential NTBMs.

Second, rules around state aid may also be important for NTBMs which involve ownership or participation by public bodies. Such business models will need to be able to demonstrate that they are not competing unfairly with private companies as a result of public support and this may place additional constraints on their design.

Chapter 5: Market effects of NTBMs and future challenges for regulation

7. What are the benefits of different NTBMs to energy consumers?

We broadly agree with the categories of potential direct benefits listed in the discussion paper. Further work will be required to determine the likelihood of such benefits arising and their potential magnitude.

⁴https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/413712/Consultation_on_review_of_Data_Access_and_Privacy_framework_final.pdf

8. Are these benefits experienced by all energy consumers or only those directly receiving the NTBMs services?

Although the customers of NTBMs are likely to benefit first from innovative products and services, we would expect successful innovations to be adopted quickly by other market participants including those with traditional business models.

9. Are there additional wider benefits to the energy system and beyond it?

There are no additional wider benefits that we are aware of.

10. Which of these benefits should be taken account of in regulatory policy-making and decision-taking and why?

In general it is very difficult to 'pick winners' and predict how successful any given business model will be in delivering benefits (or avoiding costs). We therefore believe that any policy making or decision taking by Ofgem should be technology- and business model- neutral. Ofgem's focus should be on fostering a fully competitive market in which companies are driven to innovate and respond to consumer needs.

The great strength of markets is discovering what works. Policy should be designed to enable numerous different NTBMs to be launched – in the expectation that most will fail. Those NTBMs which achieve a resonance with consumers will succeed - and bring consumer benefits which outweigh any detriment caused by those that fail.

11. Are there energy system costs or risks from any of the NTBMs? How might these be addressed?

We think that the first two sections of Table 1 are a reasonable summary of the potential system costs and risks that could result from NTBMs. NTBMs providing demand side response services are particularly likely to have system impacts – as recognised in Ofgem's December 2013 consultation on DSR.⁵ We think that the third section, about wider indirect benefits, is incomplete because it does not consider the indirect benefits of serving customers through traditional business models, which also create jobs etc and social benefits.

The emergence of business models based on distributed generation and storage has raised concerns in a number of countries about the ability of electricity distribution networks to recover their fixed costs, when these costs are recovered from a decreasing volume of grid-supplied energy. It is important that the regulatory arrangements in GB maintain the ability of DNOs to recover their costs.

12. How will NTBMs help to drive innovation within the energy system?

This will depend on what kind of NTBMs emerge and succeed in the market, and how they are regulated. However, we believe that truly disruptive innovation is just as likely to come from existing large players and brands moving sideways into energy as from start-ups.

⁵ <https://www.ofgem.gov.uk/ofgem-publications/85129/creatingtherightenvironmentfordemandsideresponsetnextsteps.pdf>

13. How could NTBMs potentially transform the energy market and what fundamental challenges to regulatory arrangements could this entail?

To the extent that the definition of NTBMs is kept as broad as possible in order to take in all possible forms that these may take, it is difficult to envisage the direction that market transformation will take. The main challenge to regulatory arrangements will be to strike the right balance between being sufficiently inclusive as a regulator, so as to not put a brake on innovation, and at the same time ensure that all relevant activities in the energy market are indeed appropriately regulated (for example, in the field of data protection and privacy, as mentioned in our answer to question 6). In this respect, we welcome Ofgem's initiative with this discussion paper.

14. How could regulatory arrangements change to accommodate NTBMs?

We would expect any changes to the current regulatory arrangements that result from the CMA market investigation to benefit NTBMs as well as traditional business models.

We note that Ofgem is currently considering the potential to move away from prescriptive rules-based regulation to more principles-based regulation. One of the claimed advantages of principles based regulation is that it can better accommodate innovation and changing business models, so this may be helpful for NTBMs.

As noted above, we believe privacy and data protection regulations will have a particular bearing on NTBMs. Whilst the current rules on use of half hourly data are designed to allay consumer concerns during smart meter rollout, they will also act as an impediment to widespread adoption of half hourly settlement. DECC's planned review of the Data Access and Privacy Framework will be an opportunity to review the appropriateness of these rules.

15. What role do NTBMs and other parties have in managing energy market transformation and regulatory change?

Whilst Ofgem and Government have the main role in managing regulatory change, industry players also have an important role in managing the development of industry codes.

ScottishPower
June 2015