SCOTTISHPOWER

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Dear Jemma,

WORKING PAPER #5: COMPETITIVE REFERENCE PRICE

Thank you for the opportunity to respond to the fifth working paper on the updated approach to the competitive reference price under the default tariff cap. Whilst we remain of the view that the default tariff cap will not be in consumers' interests, we are committed to working with Ofgem on its implementation, aiming to preserve effective competition so far as possible.

Our comments on the working paper in are in Annex 1 attached. In particular:

- We agree that it may be appropriate to use the level of customer engagement as a criterion, but we think it would be wrong to simply focus on fixed price tariffs. Once a supplier has been selected, Ofgem should calculate the average price charged to all its customers, whether on fixed or variable tariffs.

- We strongly disagree with the proposal to further select the supplier or the suppliers with the lowest prices. This is very likely to result in a competitive price below the long term sustainable level and would be contrary to Ofgem's duty to set the cap at a level which ensures the financeability of efficient suppliers and their ability to compete effectively.

- We think Ofgem has identified the main factors which might justify adjusting or excluding a supplier's prices. However, we would note that, in the case of ECO and WHD, there are cost advantages to growing suppliers which persist after they have reached the obligation threshold. Any corrections in respect of ECO/WHD costs should also include an adjustment for this issue.

We will be providing a report which we have commissioned from Baringa on the subject of level playing fields in retail. The report provides further detail on the ECO/WHD adjustments referred to above and also on the cost advantages enjoyed by smaller suppliers by virtue of their customer mix.

Should you have any questions on this response, please do not hesitate to contact me.

Yours sincerely,

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Annex 1

WORKING PAPER #5: COMPETITIVE REFERENCE PRICE – SCOTTISHPOWER RESPONSE

1. Introduction

We welcome the opportunity to comment on Ofgem's final working paper on possible approaches to calculating a competitive reference price for the purpose of the default tariff Our comments are offered under the following headings:

- pricing competitively;
- relevance as a market-wide comparator (after feasible adjustments);
- other considerations.

2. Pricing competitively

Ofgem suggests that the first high-level criterion for selecting suppliers for the competitive reference price would be *pricing competitively*, and that suppliers could be selected for this on the basis of

a) level of customer engagement; and
b) low prices

Level of customer engagement

We can see the logic for screening out suppliers with a low level of customer engagement, since the prices they charge will be subject to weaker competitive constraints. Ofgem suggests three options for implementing this:

a) only include fixed-term tariffs in the updated benchmark;
b) only include suppliers with a high proportion of fixed term tariffs;
c) only include suppliers with a low proportion of customers on SVT for more than 3 years

We do not agree with option (a) for the reasons that Ofgem alludes to. In the case of many suppliers it is likely these fixed term tariffs would not be sustainable in isolation and it would be erroneous to base the benchmark on these tariffs alone.[1]

In our view, the only viable approach, as recognised by the CMA, is to look at the *average* price charged by the selected suppliers, ie averaged across all their customers, and preferably averaged over more than one point in time. This averaging process would need to control for factors such as payment method, electricity meter type and region. It seems to us that options (b) and (c) are likely to yield similar results (depending on the definitions of 'high' and 'low'), but on balance we would suggest (c) is preferable, since (b) would unnecessarily exclude smaller suppliers who choose to offer competitively priced variable tariffs.

[1] Indeed, Ofgem's 2017 State of the Market Report estimated that in the case of the six largest suppliers, if SVT prices were reduced so that they provided the same gross profit margin as fixed tariffs, they would have made a 6% loss. See https://www.ofgem.gov.uk/system/files/docs/2017/10/state_of_the_market_report_2017_web_1.pdf, page 31

Low prices

We think Ofgem's second criterion of 'low prices' is misguided and potentially contrary to the Ofgem's obligations under the Bill.

Ofgem explains that after selecting suppliers on other criteria (such as level of customer engagement) it would '*select the remaining supplier or suppliers with the lowest average prices. This would help ensure that the benchmark was as close as possible to the efficient level of costs'*.

Ignoring for the moment the six large energy suppliers (which might in any case have been screened out before this stage, and can be adjusted for separately if necessary), the average prices charged by mid-tier and small suppliers may vary for a number of reasons:

a) the level of customer service offered (in the spectrum from 'no frills' to high quality);

b) their hedging strategy – different hedging strategies will perform better or worse at different points in the wholesale price cycle;

c) where they are on the growth and consolidation cycle – prices will be lower in the period after a big sales push driven by aggressive offers (this is distinct from the point covered in section 3 below, that new entrants may systematically price below cost in order to 'buy' market share);

d) where they are in the investment/innovation cycle – in competitive markets it is not uncommon for companies to leap-frog each other in terms of efficiency as successful innovations are copied and improved on;

e) differences in customer mix – as noted in section 4, there is a significant difference between large and small suppliers in terms of share of expensive-to-serve customers, and such differences may also arise between mid-tier and smaller suppliers.

The key point is that the ranking of companies in terms of their costs is not static, and will vary over time for a number of reasons, most of which have little to do with whether the company is 'efficient' or 'inefficient'.

Selecting the companies which happen to have the lowest prices (as a proxy for the most 'efficient') at a particular point in time is likely to result in a reference price which is not sustainable for the average competitive supplier, and which fails to have regard to ensuring the financeability of efficient suppliers and their ability to compete effectively.

Companies who are subject to competitive constraints will *on average* price at a competitive level, ie averaged across all their customers and over time. Rather than selecting on the basis of price, Ofgem should be seeking to average over a sufficiently large set of suppliers that variables such as those identified above can be averaged out.

3. Relevance as a market-wide comparator (after feasible adjustments)

Ofgem's second high-level criterion is *relevance as a market-wide comparator*. Ofgem identifies a number of reasons why suppliers may not be relevant and suggests that in each case it could either exclude 'outliers' from the reference or include them with appropriate adjustments. We comment on these reasons below.

Wholesale costs

We agree that it would be inappropriate to exclude companies based on their hedging strategy (not least because it would be difficult to do so on an objective basis) and that making adjustments would also be fraught with difficulty. However, it is important to recognise that wholesale costs can be a major factor in explaining differences in price between suppliers, particularly during periods of volatile prices, and the differences in price have more to do with timing of procurement (which is often linked to the timing of product launch) than efficiency. As an example, we estimated that for one of our recent fixed term tariffs, the margin would have been £[✂] lower if we had purchased the energy as little as two months earlier.

In our view, the most robust approach to deal with this issue is to average over a sufficiently large sample of suppliers and over a sufficient number of points in time (what constitutes 'sufficient' being a function of wholesale price volatility). If more than one point in time is used (which we would support) care would need to be taken in setting an appropriate baseline date for any subsequent wholesale price indexation scheme.

Network charges

We agree that it is appropriate to treat these in the same way as the prepayment price cap methodology, ie subtracting network charges from regional tariffs before averaging and comparing.

Environmental and social obligations

We agree that it is essential to take into account the differences in environmental and social obligations faced by different suppliers. Although it may be appropriate to exclude some suppliers on this basis, we think that the variations are sufficiently widespread that it would be preferable to adjust rather than exclude, to avoid having too small a sample.

In adjusting for social and environmental obligations costs, Ofgem needs to take into account the fact that companies who are above the threshold but growing may still be exposed lower average costs than larger companies with static (or falling) customer numbers. This is a consequence of the significant lag time between the measurement of market share for the purpose of the obligation and the point at which relevant costs are incurred, as shown in the table below.

Lags in determination of size of WHD and ECO obligations

	WHD SY7	**ECO2t**
Reference date	31 December 2016 – determined by customer numbers at the end of previous calendar year	1 July 2016 – since the size of the ECO obligation is determined by total supply volume for the previous calendar year
Scheme start date	1 June 2017	1 April 2017
Scheme duration	10 months	18 months
Lag between reference date and mid-point of the scheme	10 months	18 months

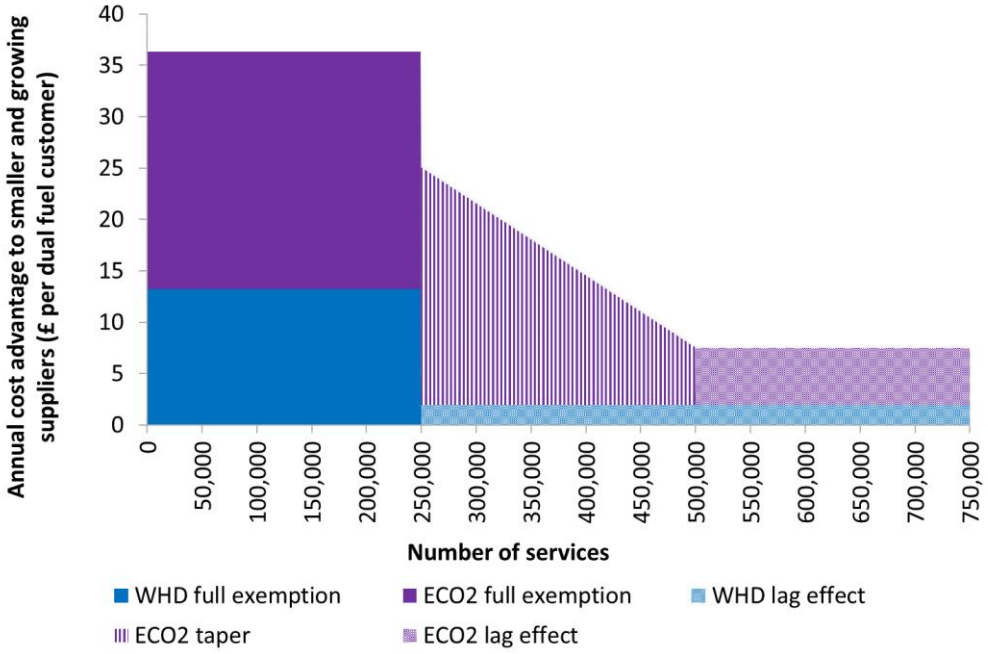
Source: Baringa[2]

[2] Baringa, May 2018, 'Creating a level playing field in the GB retail energy market'

These time lags mean that a company which is fully obligated but growing at 20% per annum would face 17% lower WHD costs and 30% lower ECO2t costs (expressed as cost per customer) than a supplier with static market share.

The magnitude of the cost advantage for current WHD/ECO schemes was recently estimated in a report by Baringa (which we will provide in support of this response) and summarised in the figure below.

Cost advantage under the ECO and WHD obligations to smaller and growing suppliers (at 20% growth pa)



Source: Baringa

Operational costs and/or business model

We agree in principle that it will be appropriate to exclude suppliers whose business model makes their costs or prices unrepresentative. For example, a supplier whose energy products are bundled with other utility services may not be representative (eg if there is a possibility of cross-subsidy) and a supplier which focuses on a particular niche segment of the market (eg customers with prepayment meters) may also be unrepresentative.

Size and profitability

It is a feature of many competitive markets that new entrant and small suppliers may need to price below cost in order to 'buy' customers and gain market share. Indeed, the majority of small suppliers are loss making. The CMA recognised this and adjusted its benchmark companies' prices to a level which it considered would yield an appropriate level of profitability. We think it will be essential for Ofgem to make similar adjustments if it adopts this approach and we would encourage Ofgem to do so in a more transparent manner than the CMA.

Ofgem raises the converse issue that small suppliers' costs may be inefficiently high because they have not achieved economies of scale. We do not think this is a problem in practice because in order to maintain the desired level of growth, a small supplier will need to price in relation to the market rather than its own costs. It is also possible that a small supplier may deploy below the efficient and sustainable level of resources (possibly because

of recruitment timescales) during a period of fast growth, potentially leading to a backlog of customer service or other issues.

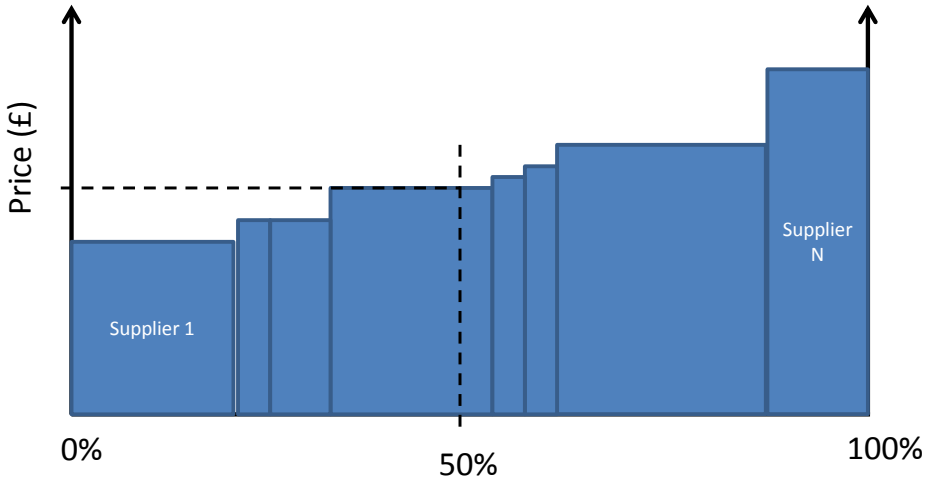
4. Other considerations

Approach to averaging

Ofgem raises the question of whether the average price for the selected suppliers should be weighted by customer numbers or a simple average.

The downside of a weighted average is that (depending on the set of suppliers selected) one supplier's prices could dominate the average. The downside of a simple average is that small suppliers' prices will in general be less representative for the reasons identified in section 3 above (and even if they have been adjusted for, there will be a degree of uncertainty in the adjustment), so they could be given undue weight in a simple average.

On balance we consider that a weighted average is likely to be more robust, particularly if the sample is chosen in a way that it is not dominated by a single company. The risk that the results are distorted by outliers could be reduced by taking the median rather than the mean. The sizes of the suppliers could be taken into account by calculating the median of the distribution as illustrated schematically below.



Payment methods and meter types

We assume that Ofgem will base the competitive reference on prices for customers paying by direct debit and with standard or E7[3] electricity meters (but not other multi-rate meters), and then apply uplifts for other payment methods and meter types, as was done by the CMA. Although there are potential pitfalls in this approach, we are not aware of any approach which is obviously better.

Customer mix

We have highlighted in previous submissions to Ofgem the fact that larger suppliers (by virtue of their incumbent status) have a higher proportion of expensive-to-serve customers

[3] Or equivalent. (In some areas, a slightly different standard two rate meter is deployed.)

than mid-tier and smaller suppliers. In particular, they have a higher proportion of customers who are more likely to fall into debt and incur bad debt costs.

Indeed, analysis carried out by Baringa showed that certain categories of ScottishPower customer (identified by payment method and socio-demographic group) have exceptionally high level of bad debt cost such that they are significantly loss-making even before any price cap is imposed. Small suppliers will have a disproportionately small share of such customers because those customers typically have very low levels of engagement and because they are unlikely to be targeted by small suppliers' sales and marketing.

These additional costs faced by large suppliers are akin to a social obligation in the sense that suppliers need to cross-subsidise them from other customers[4], including those paying by direct debit. They are not a sign of inefficiency – suppliers cannot refuse to supply a new customer if they become that customer's supplier by default. Whilst it may not be possible to adjust for these customer-mix related issues in the design of the competitive reference price (since they mainly affect larger suppliers who Ofgem exclude on other grounds) it is essential that Ofgem takes account of them at some point in the tariff cap setting process.

ScottishPower
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[4] An alternative policy, followed in some other jurisdictions, would be to cover these costs by some kind of external fund or levy. However this does not apply in the GB market at present