Ms Faye Fullalove
Competition and Markets Authority
Victoria House
Southampton Row
London
WC1B 4AD

14 March 2018

Submission on SSE-Npower merger

From Stephen Littlechild[1]

1. The CMA is assessing whether the proposed merger between the domestic retail businesses of SSE and Npower would result in a substantial lessening of competition, and if so whether remedial action should be taken. Proponents of the merger will presumably argue that it does not lessen competition and may indeed increase it. Opponents will ask whether reducing the Big 6 to the Big 5 is really going to have no adverse effect on competition. Independent observers might ask: How can we know what the consequences will be?
2. This submission does not express a view on this central issue. Rather, it suggests a possible action that might be considered at one of two stages: either a) as a voluntary proposal by the two suppliers in question to help ensure that the merger would lead to an increase rather than substantial lessening of competition, or alternatively b) as a remedy that the CMA might impose as a means of remedying, mitigating or preventing any lessening of competition that it identifies.
3. The proposed action is that SSE and Npower agree to divest a proportion of their long-standing Standard Variable Tariff customer accounts to other existing or potential small or medium suppliers in the market. The terms should provide for these customers to be better off than they would be with the merged SSE/Npower company.
4. The following sections I) explain how a similar approach was previously used to increase competition in the generation sector, II) note the market and political context in which this merger and any remedies need to be considered, III) give ten indications of the various benefits to customers and competition that this remedy could have, IV) begin to explore the quantitative implications of this proposal, and V) conclude.

I Increasing competition in generation

5. During the mid-1990s, after privatisation, it became evident that National Power and PowerGen had market power and were using this to increase wholesale prices. Although Nuclear Electric had baseload plant and some new entrant generators were constructing such plant, only these two companies owned the existing mid-merit plant that mostly set

[1] Emeritus Professor, University of Birmingham; Fellow, Judge Business School, University of Cambridge; former Director General of Electricity Supply (DGES) and head of OFFER (1989-98).

prices in the market. As DGES I proposed to refer the two companies to the Monopolies and Mergers Commission unless they agreed to dispose of 10% of their generation capacity, in the form of mid-merit plant, to new entrants into the market. They agreed to do so, and sold the plant, at negotiated prices acceptable to the buyers and sellers.

6. I was conscious that I did not have power to require these companies to divest plant. In specifying 10% of the companies' generation capacity, I wanted a proportion that was big enough to make an improvement to competition in generation, but small enough that the companies could not object on the basis that it would compromise their businesses.
7. I was also conscious that this would set a precedent. It would establish that existing generation plant could be traded and that there were potential buyers in the market. It would also begin to establish a market price for existing mid-merit plant that would enable decisions to buy or sell such plant to be better evaluated in future.
8. As the retail market was opened further, the two large generators wanted to purchase Regional Electricity Companies (RECs) that would give them direct access to the retail market. I proposed that they sell further mid-merit generation plant in order to further increase competition in generation to offset any reduction in competition as a result of this move to vertical integration. The companies again agreed to do so.
9. Later, the two companies each decided to sell more mid-merit plant to potential entrants, without any prompting. They had now concluded that this was an attractive prospect in its own right. As a result of all these steps, mid-merit plant was distributed more evenly throughout the market, and generation competition significantly increased. In its recent investigation, the CMA identified no signficant problem in respect of generation competition.

II The present market and political context

10. The recent CMA energy market investigation concluded as follows:

> 160. Overall, our view is that the overarching feature of weak customer response gives suppliers a position of unilateral market power concerning their inactive customer base and that suppliers have the ability to exploit such a position through their pricing policies: through price discrimination by pricing their standard variable tariffs materially above a level that can be justified by cost differences from their non-standard tariffs; and/or by pricing above a level that is justified by the costs incurred in operating an efficient domestic retail supply business. (*Final Report* p. 39)

11. The CMA estimated the resulting customer detriment at an average of £1.4 billion per year, rising to £2 billion in 2015. It recommended measures to increase customer response but argued against a widespread price cap. In view of the level of detriment, one member recommended such a cap, on Standard Variable Tariffs (SVTs). The Government has decided to require Ofgem to implement such a cap, again citing the CMA's customer detriment calculation. There appears to be widespread support for the Bill presently before Parliament. In considering whether or when to remove the price cap, the Bill would require Ofgem to report on whether the conditions are in place for effective competition.

12. My own view differs in some respects from the CMA's. It is mentioned here, not to press the case for it against the CMA's analysis, but to establish some common concerns that are relevant to the present merger and the action recommended here.
13. In my view, the CMA's calculation of customer detriment is best seen, not as an indication of present exploitation of customers, but as an indication of how far prices could be reduced in a competitive market if the existing Six Large Suppliers were more efficient and had lower costs. I am not convinced that the data and analysis establish that the Six Large Suppliers have made significant excess profits in aggregate – indeed, two of those suppliers have generally made losses - or that prices generally have been above what might be called the competitive level.
14. Certainly there have recently been high price differentials between SVTs and fixed tariffs, and these have been a source of concern. However, price differentials are used by about two thirds of the suppliers in the market, not just the Six Large Suppliers. This suggests that price differentials play a significant and indeed necessary role in the competitive market. It seems that, at a uniform high or even medium price, a typical supplier gradually loses customers and cannot attract new ones, whereas at a uniform low price a typical supplier can keep and attract customers but cannot make a profit. Hence the need for a combination of higher-priced and lower-priced tariffs.
15. Thus, it is not the case that the lowest (fixed) prices in the market are "the competitive price" and the higher (SVT) prices are exploiting market power. Rather, price differentials are an outcome that competition forces upon suppliers, including the Six Large Suppliers as well as many others. To understand the competitive market we therefore have to look at the whole picture.
16. Nevertheless, large price differentials offered by individual suppliers are evidently a cause of concern and widely seen as "unfair". It is said with some justification that the Six Large Suppliers have been able to maintain higher SVT prices because many of their customers have been willing to accept that. The Six Large Suppliers are therefore open to the accusation that they have exploited rather than rewarded their most loyal customers. They are also open to the accusation that the market itself is unfair, and biased in their favour, because these Six Large Suppliers inherited customers at privatisation, many of whom have proved willing to accept higher prices. In contrast, entrants into the market have had to attract new customers who are more active, less willing to accept high prices, and more likely to move on to other suppliers in due course.
17. This is of course a somewhat simplified picture. In reality, there are not only two types of customers: engaged and not engaged. There is a whole spectrum. Most customers on dual fuel tariffs have switched at least one fuel at some point. At the margin, some customers on SVTs with the Six Large Suppliers are always willing to consider switching to lower fixed prices. This has prevented the Six Large Suppliers from increasing SVT prices further, which in turn has meant that the combination of low fixed prices and high SVT prices has not, in aggregate, yielded significant excess profits to these suppliers.
18. Nonetheless, it is important to consider whether the price differentials need to be so high, and what could reduce them. At least half a dozen factors are relevant.

19. SVTs and fixed tariffs are hedged over different periods. Expected and unexpected movements in wholesale prices are therefore significant factors in determining price differentials. Such wholesale price movements are not amenable to regulatory control.
20. The relatively high costs of some of the Six Large Suppliers are another factor. Clearly some of the highest-cost suppliers will need to significantly reduce their costs, as the CMA envisaged.
21. The CMA's suggested stimulants to customer engagement will have an impact. So too will the growth of services (like Flipper, Labrador and ismybillfair.com) to take the hassle out of monitoring the market and switching. Ofgem's recent controlled trials suggest that customer engagement could be increased by a few percentage points. However, it cannot be expected that all or even the majority of customers will become continually active in the market, or should be required to be so. And there is a question whether putting more customers on lower price tariffs would lead to an increase in the higher price tariffs (and hence in price differentials) in order to cover suppliers' total costs.
22. The present arrangements for recovering environmental and social costs, from which small suppliers are presently exempt, lead to higher tariff differentials. The CMA *Final Report* discussed this issue at paras 8.85 – 8.94. Although it noted the strong concerns about the exemptions, it did not believe they were likely to be market-distorting, "given the relative strength of firms above the exemption thresholds compared with new entrants, due for instance to the existence of an established customer base ….". It is true that the non-exempt suppliers have generally been able to compete with the exempt smaller suppliers. However, to do so they have had to price their SVTs higher than otherwise in order to cover these additional costs, while at the same time they have had to price their fixed acquisition tariffs lower than otherwise, sometimes even below cost. Thus, the small supplier exemptions have caused tariff differentials to be higher than they otherwise would have been. The obligations on the larger suppliers to operate Warm Home Discount arrangements probably have a similar effect.
23. Recent departures of some new entrants from the market raise the question whether some of the present business models are economically viable, and take adequate account of all costs and risks. Regulatory arrangements for protecting customers in the event of a supplier going out of business have made (or are intended to make) customers less questioning of low prices from unknown suppliers. And some of the local authority suppliers in the market seem to be operating on a basis that achieving breakeven can be deferred for several years. This suggests that some of the lowest prices in the market have actually been below a sustainable competitive level, which again increases the price differentials.
24. All the above are factors that would influence the level of price differentials in a competitive market. Of course, the proposed price cap will reduce the highest price levels and will therefore reduce price differentials while it is in effect, as indeed it has already done for Prepayment Meter tariffs.
25. However, the Bill requires Ofgem and the Secretary of State to look at the conditions for effective competition, and in doing so they will need to consider the nature of

competition that would apply in the absence of a price cap. In order to remove the cap it would seem necessary to demonstrate some tangible improvement compared to the present. This will be difficult because, as the CMA explained, a price cap can be expected to "undermine the competitive process … reducing the incentives of customers to engage, reducing the incentives of suppliers to compete". (*Final Report* p 656)

26. The challenge is to find tariffs and prices that are competitive and economically viable but also socially acceptable and seen as "fair". This suggests a need to encourage competition and innovation in tariff and product design. It is important to explore (inter alia) new ways of rewarding loyal customers and ensuring that the least engaged customers are adequately protected, without compromising suppliers' ability to compete for new customers. The present proposal seeks to address these needs.

III Benefits of the proposed divestment

27. The proposal, to recall, is that SSE and Npower should divest a proportion of their customer accounts to other existing or potential small or medium suppliers in the market. The customers in question should have been on that supplier's SVT for at least three years. If the data allow, a longer period should be considered, such as those that have been customers of that supplier since the retail market opened to competition in 1998, or even since Vesting in 1990.
28. The buyer(s) of the customer accounts should provide an assurance, acceptable to the CMA and/or Ofgem, that, for at least an initial period of time, these customers would be better off than with the acquiring supplier than they would have been with the merged SSE/Npower company.
29. At the CMA's discretion, provision could be made for individual customers to opt-out and stay with their existing company if they wished. At least some customers that may appear disengaged are not simply passive but consciously choose to stay with their existing supplier because of loyalty or concerns about other suppliers. All customers would also have the freedom that they have at present, to transfer to yet another supplier of their choice.
30. The terms of sale should be negotiated between the buyer(s) and sellers, possibly subject to considerations specified by the CMA and/or Ofgem. It is not an aim of the proposal to expropriate the assets of the merging companies.
31. What would be the benefits, to customers and to competition? Here are ten potential benefits.
32. First, since the transferred customers are required to be better off than they otherwise would have been, this provides an additional competitive challenge to the SSE/Npower successor company beyond what would otherwise exist. Indeed, it provides an additional challenge to all other suppliers in the market.
33. Second, this provides for innovation in the design of new tariffs. The new customers will either remain on SVTs or be put on non-default tariffs. In the former case they will presumably be subject to the price cap. So what additional protection can the new or prospective acquirer(s) offer? Possibly a price below the price cap, or a price indexed to wholesale and other costs in a different way? If the transferred customers are put on some

kind of non-default tariff, this might have a fixed price for a period of time or again could be indexed. Whether or not the new tariff is an SVT, it might be subject to some kind of guarantee. In either case there might be some monetary or non-monetary benefits for loyalty. Is it possible to develop a reputation for good value tariffs in the way that such reputations have developed in (for example) the grocery sector? Different potential acquirers would make different offers based on different marketing strategies, and over time experience would indicate which were more successful.

34. Third, the proposal provides initial access to what has hitherto been an almost monopoly resource, namely, the longest-established customers of the Six Large Suppliers. As is well-known, small and medium suppliers have now taken about 20% of the domestic customers in the retail energy market. But as noted above, the small and medium suppliers have greater access to some kinds of customers than others. As of Q4 2017 they had 25% of all Prepayment Meter customers in the market, 22% of all customers on Fixed tariffs, and 16% of all customers that had been on SVTs for 3 or less years. But they had only 4% of the customers that had been on SVTs for more than 3 years.[2] And presumably they have zero per cent of those customers that stayed with the supplier they had when the market opened twenty years ago and did not move to a dual fuel tariff. So the proposal would for the first time enable other suppliers than the Six Large Energy suppliers to supply the most disengaged customers in the market, to show what additional benefits these new suppliers can offer these customers, and to test whether or not the customers themselves support this.
35. Fourth, the proposition will enable acquiring suppliers to grow faster. They will therefore be able to challenge the Six Large Suppliers more effectively than they otherwise could have done.
36. Fifth, the transactions costs of such growth and challenge should be lower than the present alternatives. At present, acquiring customers often necessitates costly advertising in the media, remunerating switching sites and transferring customers individually.
37. Sixth, if the CMA and/or Ofgem considered it appropriate, the proposal could be used to enable the smallest suppliers to move more quickly beyond the 250,000 customer level below which they are exempt from the cost of social and environmental obligations. At present, as noted above, this exemption distorts competition in the market and aggravates tariff differentials.
38. Seventh, the proposal will begin to establish a market price for less engaged customer accounts. This will better inform decisions by existing and potential suppliers as to whether to enter, expand in or leave the supply businesses. (To illustrate: in the late 1990s, before the retail market opened for domestic electricity customers, the CEO of one of the RECs told me, "I should like to sell our supply business and concentrate on the distribution business, which we are better at. But I don't know at what would be a reasonable price to sell, and if it turns out we've sold too low I'm in trouble. So we're not selling." Eventually, one or two REC supply businesses were bought and sold, a market price became established (I think at around £250 per customer), more such transfers of

[2] Calculated from Figure 1 in Robert Buckley, 'Call of the wild: at the retail frontier', Cornwall Insight, *Energy Spectrum*, 602 22/01/2018 p 4, which is in turn based on Cornwall Insight research and Ofgem data.

ownership took place, and the retail market became more competitive.) At present, a handful of transactions have provided some evidence of market prices per customer account for small distressed suppliers, and for one medium-sized more established supplier, but in all these cases the customer base comprises relatively engaged and mobile customers. It thus unclear what value the market would attach to very loyal customers in a regime where SVTs are to be price capped for several years.

39. Eighth, and more concretely, the evolution of a market price for less engaged customers opens up the possibility that one or more of the Six Large Suppliers might calculate and voluntarily conclude that disposal of some or all of its customer accounts to various smaller suppliers would be a profitable policy. At least, they might consider it would be more attractive than continuing to stay in the market with an onerous price cap and the need to make significant cost reductions that might be hard to achieve. And it could be easier to find several buyers to each take part of the customer base than to find a single buyer willing to take on an existing and not necessarily efficient company organisation. From a competition perspective, transfer of some existing capacity to other smaller existing players in the market could be more efficient than a longer drawn-out process involving the creation of additional capacity and the steady wearing down of some larger incumbent suppliers. At least, the option would be more readily available for consideration.
40. Ninth, the proposal offers the prospect of improving competition policy and regulation policy. Depending on how far new, smaller and medium-size acquiring suppliers also use tariff differentials, competition policy makers and the public will be better able to see whether tariff differentials characterise a competitive market generally, or are an indication of exploitation of market power by the Six Large Suppliers. If, alternatively, some of the acquiring suppliers choose not to use tariff differentials, and continue with a uniform pricing policy as they grow in size, there will then be better empirical evidence as to whether uniform prices are a sustainable policy in a competitive market.
41. Tenth, if the proposal is successful in promoting competition, it would seem worth consideration by the CMA and/or Ofgem for further application, until such time as a more competitive market is deemed to be in place.

IV Numbers?

42. According to Ofgem’s data portal, in Q3 2017 SSE had 14% of domestic electricity customers and Npower 10%, total 24%. SSE had 11% of domestic gas customers and Npower 8%, total 19%. There are nearly 27 million domestic electricity customers and nearly 23 million domestic gas customers. This implies that the merged company would have a total of about 6.5 million electricity customers and 4.4 million gas customers, say a total of 10.9 million customer accounts.
43. Suppose that 10% of these accounts were to be disposed of to other suppliers. That would be a total of about 1.1 million customer accounts.
44. One possibility would be to transfer all 1.1 million customer accounts to a single buyer. There is recent evidence of the purchase of a business with over 1 million accounts, so such transactions are eminently feasible. Such a transfer would allow a medium-sized

business to provide more quickly a distinctive intermediate-sized competitor to the large and small suppliers. At the other extreme, packages of, say, 50,000 customer accounts could be made available to about 22 suppliers, thereby enabling nearly half the small suppliers to grow a little faster if they wished to do so.

45. Obviously, there is a much wider range of possibilities here. For example, five packages of 220,000 accounts or ten packages of 110,000 accounts. Or one package of 500,000 accounts, five packages of 100,000 accounts, and ten packages of 10,000 accounts.
46. Packages could be designed to provide accounts in particular cities or areas, that might appeal to local authorities interested in supplying local residents. Or packages could be constructed with particular types of customer, such as vulnerable or non-vulnerable, or by payment method, or even consumption level, which might enable different kinds of purchasing supplier to provide tariff terms better suited to each particular set of customers.
47. The above calculations assume 10% of the combined accounts are to be disposed of. The precise percentage would be a matter for the two suppliers to volunteer and/or for the CMA to decide, depending on the assessment of their impacts, and that of the merger, on competition. Perhaps 5% would suffice, or perhaps 25% would be more appropriate. That would be for consideration.
48. The possibilities are almost endless. It would be a matter for SSE and Npower, in discussion with the CMA and/or Ofgem, to agree on parameters within which the two companies would invite negotiations with potential buyers. At the same time, the CMA and/or Ofgem would need to give some indication of what sorts of terms to customers would be regarded as acceptable, perhaps after inviting the potential purchasers themselves to make initial proposals.

V Conclusion

49. SSE and Npower propose to merge to form the second largest supplier in the domestic market, and to reduce the Six Large Energy Suppliers to Five. The present proposal has no wish to prevent necessary and productive adaptation to changing circumstances, nor frustrate attempts to increase efficiency. But insofar as there is some uncertainty about the competition consequences of such a merger, it would be better if there were tangible reasons to believe there would be improvements in competition.
50. The proposal is that SSE and Npower be invited or required to dispose of some SVT customer accounts as a condition of the merger being allowed. In the view of the CMA's energy market investigation, these are the customers who have most suffered at the hands of the Six Large Energy Suppliers. Without endorsing that particular interpretation, this submission has given ten reasons why disposal of these customer accounts would benefit the customers themselves and would increase competition, or offset any substantial lessening of it. In present circumstances, it is particular important to demonstrate that tangible steps are being taken to increase competition in the domestic retail market.