February 23rd, 2012

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RMR Domestic Consultation

Dear Louise,

First Utility believes that the only way to drive enduring best practice in energy retail markets is to create conditions for vigorous retail market competition. Retail market competition will naturally develop if key barriers to entry are removed. We believe the key barriers to entry are vertical integration and punitive dual priced cashout. These barriers are strongly interrelated and drive the low liquidity currently observed in the wholesale market, illustrating our view that the root causes of retail market stagnation are in fact a result of current market conditions at the wholesale level. Therefore independents will enter, compete and innovate at the retail level only when these wholesale market barriers are removed.

First Utility supports Ofgem's aim of increasing information clarity and tariff comparability for consumers. However, we have a number of concerns with the proposals in the Domestic RMR consultation. We believe if domestic RMR is implemented as envisaged, it may act to further reduce the already minimal level of competition in that sector and thus reduce consumer choice. We support improved tariff comparability and improved clarity of information for customers, but not if this is accompanied by the stifling of innovation and greater costs to consumers, which we believe may be an unintended outcome of the proposals.

RMR Standard Tariff Reduces Cost Reflectivity of Tariffing, Increasing Costs for Consumers
While we appreciate that customers may prefer to only need to compare one number in order to compare tariffs, a single regulator-prescribed standing charge in the "standard tariff" will create more issues than it solves. Supply companies operate their businesses with different fixed and variable costs. The concept of a tariff with a fixed element and a variable element allows a supplier to allocate its fixed costs into the fixed element of the tariff, and its variable costs into the variable element of the tariff, in a fully cost-reflective way. If in the future the supplier can only charge the regulator-approved standing charge as a fixed element, this will push all the other fixed costs into the variable element of the tariff. In order to collect the correct amount of fixed costs in the variable element of the tariff, the supplier must make assumptions about the consumption profile of that customer, which may or may not be accurate at the time an offer of supply is made to that customer. In summary, this increases uncertainty in the collection of the fixed costs that have been smeared into the variable tariff element, which means suppliers must hold an additional risk premium to cover the risk of under collection. In this way (all else being equal) a regulator-prescribed standing charge will result in higher costs for consumers on that tariff.

Annual Review of Standing Charge
Ofgem proposes to review the fixed element of the standard tariff annually. However, there are many industry costs that are updated twice yearly or more frequently, and they do not all change at

the same point in the year. This means that intra-year suppliers would be forced to collect some of these fixed industry costs via the variable element of the tariff. This is another example of the lack of cost reflectivity this tariffing proposal will create as, ultimately, these extra risks that will be forced onto suppliers via the restriction on the fixed element in the standard tariff will be borne by end users. The extra risks could incentivise suppliers to offer a range of fixed price tariffs on more competitive terms, in order to migrate customers away from the more risky standard tariff, as the supplier will be able to incorporate fixed costs into the standing charge on a fully cost-reflective basis.

Increased Confusion in Comparing Tariffs
While it will be possible to compare standard tariffs between suppliers by a simple comparison of the unit rates, it will not be possible to make the following comparisons based on unit rate alone:

- The standard tariff of Supplier A and the fixed tariff of Supplier A
- The standard tariff of Supplier A with the fixed tariff of Supplier B
- The fixed tariff of Supplier A with the fixed tariff of supplier B

Looking at these three examples illustrates how it could be argued that tariff 'simplification' could increase complexity by creating even more confusion; a simple comparison of the two unit charges is only sufficient for a comparison between two standard tariffs. In all other tariff comparisons one needs to use the standing charge, the estimated annual consumption and the unit rate to calculate the annual cost of each tariff in order to make a like for like comparison between the annual costs of the two tariffs. There is a risk that some consumers may become confused as to when comparison of the unit rates is sufficient and when it is not. Calculation of the annual cost of the tariff is the only robust method to compare tariffs in all cases. We argue that there is a real risk of consumers making the wrong choices due to confusion about how to compare tariffs in each case, and have serious concerns that this could increase the risk of customers inadvertently switching to more expensive tariffs, which was not Ofgem's intention.

Stifles Tariff Innovation
There are a range of new tariffs that First Utility intended to develop for customers that would provide extra benefit to them, but would be forbidden under the proposed RMR rules. We have provided Ofgem with examples of some of these tariffs in a separate confidential document. We believe it is an unintended consequence of RMR to stifle tariff innovation when such tariffs would be clearly beneficial to customers, particularly if innovation by smaller players results in increased levels of switching away from incumbent suppliers.

Creation of Perverse Incentives for Incumbent Suppliers to Offer Fixed Tariffs
There is a real risk that RMR tariff proposals will disadvantage independent suppliers relative to integrated utilities. Given the previously discussed risks in the new proposed standard tariff, it is likely that this will drive co-ordinated launches of fixed rate tariffs by incumbents that could 'lock-in' a large proportion of their retail bases for a fixed term of up to 3 years or longer. This would make it impossible for independents to compete for such customers. In the current market environment, co-ordinated activity of this nature might lead to a competition investigation. However, under the RMR proposals, such activity would have regulatory consent.

Summary
We support Ofgem's aim to improve clarity and drive simplification to the extent that it doesn't adversely affect the ability to innovate and compete. However we believe there is a real risk that

RMR tariffing proposals as currently structured could increase tariffing confusion, further disadvantage independent suppliers and damage innovation and competition.

We propose Ofgem instead require suppliers to clearly state on every customer bill the annual energy costs for that customer at their estimated annual consumption for their current tariff, thus replicating the information provided on the annual statement but ensuring that all customers are able to benefit from this irrespective of the length of time that they have been with their supplier. This would enable a quick and easy comparison with other tariffs in a robust way that avoids confusion.

Please do not hesitate to contact me if you have any questions or would like any further information.

Best regards,

Chris

Chris Hill

Regulation Manager

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