first:utility
there is a better way

Maxine Frerk,
Retail Markets
Ofgem / Ofgem E-Serve
9 Millbank
London, SW1P 3GE

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

Dear Maxine,

First Utility is a leading UK independent utilities supplier, offering electricity and gas services to a range of consumer and business customers. With over 450,000 dual fuel domestic customers and growing, we have gained substantial experience of issues affecting the energy sector today. Outdated billing practices, old technology and inefficient customer service not to mention poor price competition, are just some of the issues affecting UK consumers: these are areas where First Utility is offering a real alternative for consumers.

Promoting competition and engaging consumers is essential to providing choice and fair value to consumers, as well as contributing to government's energy efficiency targets and security of supply. With this in mind, we are also leading the sector in engaging consumers in reducing energy demand and lowering energy bills. For these reasons we welcome the opportunity to respond to Ofgem's consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain.

Overall Comments

First Utility supports an Ofgem market investigation reference to the Competition and Markets Authority (CMA) in order to address structural issues that currently distort competition in the market in favour of the Big 6, incumbent suppliers, which, by making it difficult for new entrants to enter the market, impact on retail prices and consumer confidence. Whilst there are a wide range of points that we hope will be highlighted during the course of this investigation, First Utility would like to draw attention at this point to the following three key areas which have a restrictive impact on the ability of smaller supply businesses in particular to compete:

- Wholesale market liquidity and the effects of vertical integration
- Electricity Market Reform and in particular the CfD Supplier Obligation structure
- Retail market behaviour

Below we expand on these issues in some detail in order to set out the key reasons why they cause market distortions.

Wholesale Market Liquidity and the effects of Vertical Integration

Currently, the Big 6 integrated suppliers are able to source shaped electricity and gas products[1] from their own generation portfolios. Whilst there is currently an obligation on integrated suppliers to transact internal transfers at prices which reflect the wholesale market price, we believe these prices have no market basis given the lack of liquidity.

First Utility has long been campaigning for a significant intervention in the wholesale market to drive the step change in liquidity which is needed to deliver vigorous wholesale competition. We continue to believe that a liquid wholesale market will create the conditions for entry both upstream and downstream, driving competition along the entire energy supply chain. It is only when the structural issues at a wholesale level are addressed that the benefits of vigorous competition (such as a reduction is the prices companies have to pay for their energy on the wholesale market, and therefore what price they must charge customers for it in the retail market) can become available for all retail consumers.

Low liquidity is the natural consequence of a market structure with the Big 6 integrated participants owning between them 70% of the generation assets and 90% of the retail supply base in the UK. Such participants understandably have more benefit to gain from defending their existing market share than from aggressively competing and innovating to win new market share.

Integrated market participants have a decreased need to trade with other market participants as they have a natural hedge within their business for a large proportion of generation volumes. While we recognise that the Big 6 cannot supply their entire retail demand from their generation volumes, their ability to supply the bulk of their demand – particularly at times when there are unexpected changes in demand – skews competition in downstream markets. Trading activity of such market

[1] Bespoke volume and time periods which reflect different consumer / industry demand levels both within day and within week

players is based more on the desire to trade than a need to hedge. Introducing conditions that encourage the formation of a market with a diverse range of vigorously competitive and innovative market participant types would be the best way to ensure new entrants have access to the range of hedging products they require.

We note that shaped products are particularly illiquid in the forward market, increasing hedging risks for new entrants and reducing transparency on retail costs for consumers. We believe that, overall, lack of liquidity in the wholesale market results in at least £30 of additional cost to each household bill per year.

Ofgem's recent reforms through the Secure & Promote (S&P) licence condition were intended to tackle some of these problems. However, First Utility does not believe that these reforms are themselves sufficient to drive the step-change in market liquidity the UK wholesale market requires; in fact the S&P licence conditions risk segmenting liquidity into smaller and more illiquid pools. This is because the reforms do not address the driver of illiquidity, namely the lack of <u>need</u> for vertically integrated players to trade. The current proposals will simply allow these companies to adjust the timing of their normal market activities in order to tag these activities as 'Market Making Obligation' (MMO) actions. Furthermore the creation of 'time windows' presents a serious risk to EMR implementation. If prices in these time windows were to be used to set the CfD FIT market reference price, this would result in a significant gaming risk being introduced to the scheme and higher costs in delivering the CfD FIT regime for consumers.

We believe that it is necessary to go much further. A prohibition on self-supply would neutralise the competitive distortions caused by the Big 6's vertical integration and increase the volume of trading in the open market, thereby reducing the prices paid for energy by suppliers, which we believe could save UK energy consumers at least £1bn per year. Generation (in particular flexible plant) would see a transparent economic signal along the forward curve (driven by demand for forward shaped products from energy retailers) to offer shaped products into the wholesale market, providing all suppliers fair access to shaped electricity. This would enable smaller suppliers to hedge their energy volume requirements on a level playing field with the Big 6 incumbent utilities so that more meaningful competition can develop. It would therefore drive a step change in the ability of smaller companies and new entrants to compete in the market whilst also driving a much clearer investment signal for new flexible generation; this would result in customers benefitting from competitively priced energy and greater energy security.

Electricity Market Reform – CfD Supplier Obligation

The anticipated June announcement by DECC to opt for what is in effect a variable rate obligation for suppliers will have serious consequences on the ability of independent suppliers to compete in the retail electricity market. The lack of certainty of CfD FIT annual costs in a variable rate obligation is something that cannot be hedged. Customer bills will be impacted because independent suppliers will either have to price a much higher risk premium into their tariffs, which will result in reduced ability to compete in the retail market, or face being exposed to significant new margin risks (which may damage their longer-term viability).

We understand that a variable rate obligation would be the result of a combination of (i) a need to "gold plate" the generation credit arrangements to ensure the CfD FIT regime is attractive to generation investors and (ii) lack of ability of the central counterparty to raise finance in order to set "predictable" annual payment obligations under the scheme on behalf of suppliers.

However, we note that passing this variable annual cost risk downstream to suppliers has not removed the risk from the scheme: in a year with high volumes of generation (e.g. an especially windy year) it is also likely that wholesale prices will fall (due to the anti-correlation between generation volumes and price). If far larger than average payments fall due, there is a risk that suppliers will be unable to meet these payment obligations, with resulting systemic risk of supplier failure. We believe the only way to mitigate this risk is by allowing the central counterparty to raise finance to manage annual cost risks so that the supplier obligation may be set in a way that the annual costs of the scheme are predictable for suppliers and can be appropriately factored into tariffs and general business planning.

The best solution for both generators and suppliers to engender investor confidence and the ability of suppliers to recover costs, is to implement a fully fixed CfD supplier obligation with any required reconciliation to be repaid over the following obligation year. This coupled with a self-supply restriction on vertically integrated utilities (to minimise CfD FIT gaming risk in the illiquid wholesale market) is in the best interests of competition, security of supply and minimising costs to the consumer. We hope that a market investigation by the CMA will address these critical issues in order to avoid substantial damage to the industry and further increasing costs to consumers.

Retail Market Behaviour

<u>First Utility has three main concerns in relation to retail market behaviour, which are: (i) the speed of consumer switching; (ii) tariff innovation; and (iii) deep discounting by the Big 6.</u>

Speed of Switching

Whilst there have been some recent increases in consumer switching, the number of people switching energy provider is currently near half the level reported in 2010. This is despite a Which? Survey showing the average saving from switching supplier to be £217. On this basis, if a third of households were to switch, we estimate this would drive consumer savings of £1.5bn in the UK.

The obvious explanation for the lack of switching given the available savings is a lack of consumer engagement. Ofgem has recognised that the complexity of tariffs offered by the Big 6 suppliers in particular, combined with the "hassle factor" of switching and consumer distrust of these suppliers are all contributing to less than optimal competition. These low levels of consumer engagement must be addressed and a move to one-day switching, which we championed via our 'fix the switch' campaign, is a vital part of this. Faster switching may also increase consumer trust in the sector as the balance of power shifts to the consumer. More switching will likely drive improvements in service and innovation as suppliers increasingly compete to gain and retain consumers.

Tariff Innovation

Innovation is key to growing and maintaining consumer engagement. In the wider context of tariff innovation, whilst we are very supportive of RMR, we believe that the CMA should consider the adverse effects on competition of limiting the number of allowable tariffs. This will limit consumer choice and differentiation between competitors, as RMR is likely to lead to tariff alignment, with suppliers offering broadly the same tariff range.

Whilst it is possible for suppliers to request a derogation for an additional tariff, this is not a practical and/or efficient solution given the length of time required to process such applications, the cost of doing so and the uncertainty in gaining approval, which are likely to undermine any competitive advantage the supplier may have gained. We would encourage the CMA to consider the unintended consequences of this legislation, particularly in relation to disadvantaged groups, given the withdrawal of social tariffs for certain market segments following RMR implementation.

Time-of-Use (ToU) tariffs will result in consumers taking a keener interest in the energy market as they seek to lower bills by avoiding consumption at times of peak pricing. This can only lead to benefits: it will reduce consumer bills, carbon intensity, and network capacity requirements, whilst increasing security of supply. To facilitate widespread ToU tariffing, we advocate a quick move to Half Hourly (HH) settlement of residential customers since only a number of tariffs can currently be supported in the existing non-half hourly processes and systems. Only a HH settlement regime, coupled with a time of use signal in all other network and transmission costs can enable the economic benefits of ToU tariffs to be realised. Single priced cashout is also crucial – as without this there are risks that the cost at imbalance due to the SBP-SSP price spread will undermine the demand response price signal in wholesale energy and network costs.

Overall, we would welcome a CMA market investigation in the current policy framework to ensure that innovation in tariff setting is maintained and that any proposed reform measures do not run counter to overall policy objective of reducing consumer bills.

More generally, it is possible that consideration of any structural or other changes would also require a re-consideration of certain of the remedies implemented to deal with issues arising from the current market structures. Ofgem notes this in its recognition of the need to be proportionate and take account of the interplay of potential remedies with current plans and proposals.

Deep Discounting

The risk associated with deep discounting by the Big 6 has also increased. Given that standard tariffs rarely change in price more than once per year, a one year fixed deal is very similar to a standard (variable) tariff, and is thus the product against which a deep discounting analysis should be undertaken. The latest analysis we have conducted shows an average 7% discount between Big 6 standard and short term fixed tariffs.

HostSupplier	Standard Tariff		Cheapest Fixed		% discount to standard	£ discount to standard	
British Gas	£	1,192.97	£	1,076.05	9.80%	£	116.92
EDF	£	1,163.60	£	1,048.77	9.87%	£	114.83
EON	£	1,169.50	£	1,134.18	3.02%	£	35.32
Npower	£	1,204.91	£	1,156.94	3.98%	£	47.98
Scottish Power	£	1,199.12	£	1,075.87	10.28%	£	123.25
SSE	£	1,186.27	£	1,114.64	6.04%	£	71.64
Average	**£**	**1,186.06**	**£**	**1,101.07**	**7.17%**	**£**	**84.99**

calculations made at ofgem average consumption figures of 3200kWh elec and 13500 kWh gas
calculations made on 19th May 2014

A common feature of uncompetitive markets is an increased focus by incumbents on the defence of their existing market share rather than on vigorous competition for new market share. Deep discounting demonstrates how a supplier with a large sticky base of customers on standard tariffs can provide a gross margin cross-subsidy for their lowest cost tariffs. This leads to a 'gross margin discount' requirement for new suppliers in the wholesale market, acting as a barrier to vigorous competition, which is clearly not in consumers' best interests. This is one of a number of features that work to restrict or prevent "major disruptive" new entry.

Summary

On the basis of the concerns highlighted above, First Utility considers that there are market features which prevent, restrict or distort competition in connection with the supply of energy in Great Britain and that it would be in the interests of existing and future consumers for Ofgem to make a market investigation reference to the CMA.

We look forward to working with all stakeholders and industry colleagues in the proposed market investigation, assessing the impacts of existing market reforms and considering where further changes such as self-supply restrictions and "one day switching" are required. Looking ahead, engaging consumers, building trust and greater levels of competition will be the key markers for success.

Please do contact me if you have any questions, and likewise I would be very happy to meet with you to discuss any of the issues covered in my letter.

Yours sincerely,

Darren Braham
Chief Financial Officer
Email: Darren.braham@first-utility.com