Consumer Focus
Campaigning for a fair deal

19th January 2010

Dear Ed,

We welcome the opportunity to respond to the latest Quarterly Wholesale/Retail report from Ofgem. Some of the comments that follow have already been communicated to Ofgem informally after previous Wholesale/Retail reports; however we are pleased that other Consumer Focus comments (like the inclusion of dual fuel and net margins) have been incorporated into this latest version.

This response is non-confidential and we are happy for you to publish it on your website.

Questions

Have we used an appropriate level of aggregation for customer bills, i.e. wholesale energy cost, others costs and VAT? If not, what other splits would you suggest?

The splits used by Ofgem seem generally appropriate. We would hope that, given the NERA report released on the same day as this report, Ofgem was in communication with the ERA with regards to double-counting and attempting to understand the reports' starkly different costs and therefore conclusions. The Ofgem report seems the more credible of the two, however.
However we think the report would benefit from a consideration of whether or not some of the costs (such as that connected to hedging) are unduly borne by consumers rather than such risks being considered as a part of doing business. It could be argued that too high a proportion of the risk the big 6 face is passed onto consumers rather than other stakeholders.
Specifically, it would be useful if Ofgem were to unbundle operational costs into line items so that stakeholders can see assumptions for things like bad debt.

Do you think the 18 month hedging model provides a reasonable indication of suppliers' wholesale energy costs?

Consumer Focus thinks that the 18 month hedging model is one legitimate and widely-used hedging strategy but that it should not be relied upon solely as an indication of wholesale energy costs. We are aware of other hedging strategies (including ones that Ofgem have detailed in the past) and it is still unclear why Ofgem sees the 18 month approach as the dominant one; given the nature of hedging this seems slightly perverse.
Our main point here is that the extent of vertical integration in the energy market (especially in electricity) is such that the idea that that the forward curve is a fully appropriate marker of wholesale costs should be challenged by Ofgem. For example, at times of great volatility in traded

Artillery House
11-19 Artillery Row
London SW1P 1RT

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

prices (such as in the last two years), the difference between contracts and the forward curve is especially pronounced. Hence the observation of some commentators that the big 6 attempt to "beat" the forward curve, rather than follow it as Ofgem suggests.
In terms of hedging strategies it might also be, at the very least, reassuring for consumers if Ofgem were to make it clear whether or not they have more information or a new take on the Energy Probe line that the evidence of a disproportionate lag was inconclusive. The lack of such a line in the report could be seen as worrying given the central nature of this point to the entire wholesale-retail debate.
On a related note we wonder whether it would be useful to extend the analysis, at least in part, to non-big 6 energy suppliers. This might help to explain how some of these suppliers are able to undercut the big 6 in retail tariffs, as it is unclear whether this is a result of different hedging strategies or lower operational costs, or some other (short-term) input. This would also be useful in order to understand whether vertical integration is the only viable model in the British market or whether standalone suppliers could survive and flourish.

Do you have any comments on the assumptions and methodology outlined in appendix 4 of the document?

Consumer Focus is of the opinion that it is inconsistent to use different average user figures to that employed by ourselves, the Big 6, DECC and indeed Ofgem in other contemporary documents. Furthermore no advance notice or consultation was undertaken before their introduction (solely) in the quarterly reports; this is of some concern as the figures chosen affect the conclusions reached here and in other documents.
We also believe that the sole use of the medium/average user in consumption is not very useful. Low volume/income consumers face disproportionate charges from things like metering and CERT. It would thus be better to use the full range of Consumer Focus-approved user levels.
Ofgem appears to accept the big 6's transfer pricing methodology without comment or critique; we are conscious of an overreliance on the idea of "opportunity cost", which suggests a level of OTC energy trading that simply does not exist. This may have been Ofgem's CEO had in mind when he described the UK electricity market as "rubbish", adding that "we've got a structural problem in Great Britain"[1]. The report's approach would be better if it reflected the comparatively low-risk approach the big 6 take with their extensive use of bilateral contracts rather than going to the market and facing the market prices there.
It is not clear whether or not Ofgem has included elements like storage costs, interconnector flows and legacy contracts, despite their influence.
It is also not clear why certain dates have been used as start dates; in some cases such as chart 2.6 this choice (from January 2004) is pivotal to reaching a conclusion – clearly showing a substantial increase in retail margin from 2006 to date. At other points in the report 2000 is used as a starting point for comparison, adding to the confusion.

[1] http://www.bloomberg.com/apps/news?pid=20601109&sid=aHF.qX17tkUc

Artillery House
11-19 Artillery Row
London SW1P 1RT

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

Is the level of net margin presented in the value chain analysis reflective of actual industry margins?

The margins Ofgem presents seem consistent with what we have ascertained from meeting with other industry stakeholders. To us these increasingly large margins reflect suppliers' failure to pass on the falls in wholesale costs they have enjoyed over the last year.
We would prefer if Ofgem also included more discussion of wholesale margins given the vertically-integrated nature of the energy market, in particular for electricity.
For us the most interesting point about margins is that the big 6, according to this report, are making money across the whole value chain, rather than just at the retail level as one might expect at times of comparatively low wholesale costs. This contrasts with the recent past when suppliers' lower profits effectively moved upstream to their generating arms along with wholesale prices, and is of itself worthy of further investigation by Ofgem. It would also be interesting to ascertain the margins made by upstream gas producers as a further extension of analysing the supply chain.

Are there any other costs we should be including?

Whilst not a supply cost per se, it would be worthwhile for Ofgem to link the reports more formally to the work being undertaken on liquidity. In the absence of other factors low liquidity usually means higher retail prices regardless of the hedging strategies used; as noted above we do not believe suppliers necessarily face the cost Ofgem suggests as they fail to go to market and thus contribute to low liquidity, an approach which is not in consumers' best interests. We believe consumers lose out through paying for the unnecessarily high risk premia that result from thin trading of forward energy contracts by the big 6, amongst others.

Do you agree with the data presented in this chapter on choice in the market?

We have argued in the past that consumer choice is more limited than Ofgem suggests. In terms of managing risk consumers only have the option of fixed/capped tariffs, and these can leave consumers worse off. Indeed even this option is limited to those with security of tenure i.e. because of penalty clauses with early termination, those in private rented housing will probably not be able to benefit from such deals in the same way as owner-occupiers.
Those without access to the internet or a bank account are also poorly served by a market working on the assumption that online direct debit deals will ensure all have choice and low prices. We would prefer a market where most consumers do not have to take out fixed deals because all of the suppliers pass on wholesale costs fairly and in a transparent predictable fashion.
We also have some concerns that the choosing of a non-big 6 energy supplier by consumers has its own risks as they are considerably more exposed to the wholesale energy market and that an increase in wholesale prices could cause large retail price hikes.

Artillery House
11-19 Artillery Row
London SW1P 1RT

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk

Can you provide any extra information about choices available to consumers?

In addition to the above we are of the mind that Ofgem should remember that the Secretary of State, and others, have stressed repeatedly that falls in the wholesale cost of energy should be fully passed onto consumers via retail price cuts. It is not clear from the report whether or not this is happening; nor does it give any suggestion of where retail prices might go in the future.
We are concerned that Scottish Power appears to be charging penalty rates to those customers that cannot qualify for prompt pay deductions. We urge you to intervene to protect these customers.

Yours sincerely,

R. J. Hammond.

Robert Hammond

Head of Regulated Industries

Artillery House
11-19 Artillery Row
London SW1P 1RT

t 020 7799 7900
f 020 7799 7901
e contact@consumerfocus.org.uk
www.consumerfocus.org.uk