Stefan Bojanowski
Retail Markets
Ofgem
9 Millbank
London
SW1P 3GE

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Dear Stefan,

<u>The Retail Market Review – Findings and initial proposals</u>

<u>Chapter: Two</u>
Question 1: Do stakeholders agree with our finding of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets?

While we agree with Ofgem's conclusions in this area, First Utility feels that barriers to entry in the energy retail markets *are* the main causes of persistent consumer harm. These barriers take the form of the almost exclusive concentration of domestic market share within the large vertically integrated incumbents' customer portfolios along with their ability to supply themselves from their own generation fleets. This has the effect of ensuring a separate revenue stream and some degree of hedge from wholesale market volatility, while at the same time decreasing liquidity in the wholesale market as a result of that generated output being withheld. This also constrains opportunities for other players in that market, particularly as this withholding of generated output then pushes up wholesale prices, allowing the incumbents to then claim the need for consumer price rises on the back of this.

Additionally, all of the incumbents have considerable numbers of "sticky customers" who have never exercised their right to switch. This provides the incumbents with a "pricing umbrella" in the sense that these customers do not appear to be price driven and can thus be used to subsidise further customer acquisition.

The extreme challenge for smaller suppliers to compete in this market is then further compounded by the unwillingness of the incumbents to engage with smaller players in order to provide access to shaped products in non standard clip sizes which meet those smaller players' requirements.

These factors reduce liquidity, increase risk for other players and generally make the UK energy retail market a less attractive prospect for new investment. This then reduces competition and harms consumers by requiring them to purchase energy supply and associated services in a market dominated by an oligopoly rather than a large number of firms competing on the basis of innovative products and excellence in customer service as was envisaged when the market was first liberalised in the 1990s.

At the same time, there has been a significant degree of unwillingness among the gas transporters to provide unsecured credit to smaller players on a reasonable basis. Instead, these smaller players are often given little other option than to post cash for security, often in sums which have the potential to significantly constrain both cash flow availability at those firms and their ability to grow their businesses.

first:utility

Chapter: Three

Question 2: Do stakeholders consider that Ofgem should take action to reduce the complexity consumers face and enhance engagement with the energy market?

First Utility believes that action is necessary in order to ensure a more liquid market and more competitive pricing which will ultimately benefit consumers.

Question 3: Do stakeholders agree with our initial proposal for intervention to reduce the complexity consumers face and enhance engagement in the energy market?

We welcome the steps that Ofgem is taking to ensure consumers are more able to easily compare tariffs and thus suppliers. A single price per payment method for standard evergreen domestic supply contracts should enable consumers to make faster price based decisions and make it easier for Ofgem to ensure that price differentials by payment method are cost reflective. However, we are keen to understand whether suppliers will be required to strip out the components that make up the tariff price (such as standing charges, distribution charges, wholesale costs etc.) as separate lines on the bill or whether all of the components can be contained in the one number. Smart metering charges for suppliers who currently offer this technology must be taken into consideration as well as the manner in which online evergreen deals will be treated.

We also have some concern over the possibility that the large incumbent suppliers may use this as an opportunity to "lock in" their customer base by means of a suite of "fixed" deals with high exit charges and would request that Ofgem consider this as part of its design process in order to ensure that this is not used as an opportunity to stifle the very innovation that these reforms are designed to foster.

Finally, we would suggest that Ofgem concentrate its monitoring following the introduction of these changes on those domestic and SME customers who have never switched supplier, as it would appear to us that the rationale behind this proposed change is primarily to provide those customers who have never exercised this right with a "trigger moment" which would then presumably impel them towards comparing their current tariff with others available.

Question 4: If not, then do stakeholders have alternative suggestions for proposals to reduce the complexity consumers face and enhance engagement in the energy market?

The proposals put forward by Ofgem seem appropriate, subject to the concerns we have raised above.

Question 5: We are proposing to standardise evergreen contracts across suppliers. Do stakeholders agree with the proposed contents of the standardised charge?

We agree that only allowing one price per payment method for standard evergreen products should make comparison of those products considerably more straightforward for consumers. However, we would appreciate further details as to how these proposals would be enacted in relation to multi rate (such as Economy 7) customers, as fulfilment of this aim could be complex with regards to these given the way in which contract standardisation is proposed to function.

Question 6: We are proposing to create a standardised metric to allow consumers to compare evergreen and fixed term contracts across suppliers. Do stakeholders agree with our proposal for a standardised metric?

We are interested to further understand exactly how this metric will be standardised. One particular issue for consideration is that of standing charges. Some suppliers have this as a separate line on bills whereas others incorporate it into the tariff. This may make direct comparison difficult unless Ofgem specifically rules as to whether this component should or should not be included in the unit price for all suppliers.

Question 7: Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to reduce the complexity consumers face and enhance engagement in the energy market?

We have nothing further to add in regard to this proposal.

Question 8: Do stakeholders consider that low electricity market liquidity constitutes a barrier to entry in the domestic retail supply market?

First Utility believes that the current lack of liquidity in the traded electricity and gas markets presents a very real barrier to entry as smaller players are not easily able to hedge their demand at a reasonable price and without paying a significant risk premium.

Larger players, due to the size of their domestic portfolios, are able to trade standard base and peak load products in standard clip sizes and then fine tune their shape requirements by means of netting demand off against their generation fleets or trading through exchanges. However, very few smaller players have access to generation and it is difficult for them to trade through exchanges due to the onerous credit requirements that these have. Although it is true that any exchange trading could potentially be sleeved through a third party, the third party will charge some level of risk fee for providing this service and this is likely to make exchange trading even less attractive.

We also believe that a more level playing field could be achieved in the electricity and gas traded markets by means of the introduction of a single cash out price for both buying from and selling to the system. This should more evenly apportion wholesale market risk between the large incumbents and other market players and provide a stronger incentive for additional energy supply to the market in tight network situations.

Question 9: Do stakeholders consider that our two proposed interventions (the MA and the MMM) could improve the ability of the wholesale electricity market to meet independent participants' needs, and will ultimately improve the likelihood of retail supply market entry?

First Utility has some questions and observations that it would like to make in relation to these proposals. Firstly, although we applaud Ofgem's intention to force vertically integrated incumbents to sell a percentage of their generated output into the wholesale market, we do not feel that the proposed level goes far enough. We also have some concerns about the manner in which this requirement will be implemented.

It would appear that Ofgem is suggesting a lower limit of ten percent and an upper limit of twenty percent for these auctions. First Utility does not believe that this goes far enough, and we would have favoured a requirement to sell all generated output into the wholesale market, with the large incumbents being prohibited from supplying themselves. This should have an immediate beneficial impact on wholesale liquidity as generated power will not be withheld from the market as at present. In addition, we would have preferred required sale into the market at a price derived from a forward index or exchange rather than an auction which smaller players might be effectively excluded from due to their inability to outbid larger players.

Question 10: Subject to the results of our further wholesale market assessment, do stakeholders consider that both interventions could be necessary to meet the objectives stated in questions 8 and 9?

We feel that both interventions could play an important role in meeting these objectives, however, please see our further recommendations made in our answers to Questions 8 and 9.

Question 11: Do stakeholders consider that there are other intervention options we should be developing?

First Utility feels that nothing less than Government led wide ranging structural reform to the UK wholesale market is required in order to provide reassurance to potential investors and remove the barriers to competition and consumer choice that currently exist.

Question 12: On the basis that we could decide to take forward these interventions, do stakeholders have comments on the indicative design choices we have made, as set out in Appendix 2. In particular, views are welcome regarding our initial position on each of the following:

- *Volume requirements*

  Mandatory Auction - Of the options available, we believe that 20 per cent is the most appropriate. However, we would have preferred the introduction of a restriction on self supply with large incumbents required to sell all generated output into the wholesale market.

  Mandatory Market Maker – We would prefer to see the volume requirement at the upper end of the proposed 20 – 50 MW band.

- *Product requirements*

  Mandatory Auction – We are pleased to note that product requirements will include small clip sizes and a number of shaped products. However, we would appreciate more clarity as to what volume of shaped products are likely to be available, as these are more appropriate to smaller suppliers' needs than baseload and peak products. Shaped products should include standard domestic consumption profiles.

  Mandatory Market Maker - The proposal for supply of only baseload and peak products is unlikely to be of great assistance to smaller domestic suppliers as their requirement is more for shaped products in order to reflect the consumption patterns of their customer base. This is illustrated in the appendix at the end of this response.

- *Frequency*

  The arrangements for both the Mandatory Auction and the Mandatory Market Maker seem appropriate in this respect.

- *Governance arrangements*

  The governance arrangements for the Mandatory Auction are appropriate but we note that there are no proposed governance arrangements listed for the Mandatory Market Maker. We would appreciate further clarification as to how Ofgem intends to monitor this.

- *Participation*

  Although we agree that it would be anti competitive to prevent the Big Six from participating on the buy side, it should be borne in mind that smaller players are less likely to be able to compete with the Big Six on a pay as bid basis due to the considerable differences in size and bidding power between these participants. It may also be that the auctions for power some distance along the forward curve have the effect of setting the price for these contracts as they are currently only very thinly traded.

- *Platform*

  Presumably both of these aims will be facilitated by means of common online platforms. The operation of these could be awarded to independent third parties on a competitive tender basis.

Question 13: Do stakeholders have any comments on the costs and risks of our proposal, or any alternative suggestions that you have put forward, to take action to improve wholesale electricity market liquidity?

Please see our comments above.

Question 14: Do stakeholders consider that Ofgem should strengthen licence conditions around suppliers' communications and interactions with their customers, to give suppliers less freedom in how they interpret these obligations?

This would seem appropriate as it will ensure a more level playing field for all suppliers and provide better protection for consumers.

Question 15: Do stakeholders consider that Ofgem should increase its monitoring and enforcement activity to enhance suppliers' compliance with licence conditions?

We believe that Ofgem should devote more time and resource to this. In addition, we feel that greater transparency is required around the enforcement process and any ongoing investigations as this will provide a greater incentive to comply with licence conditions as well as a greater deterrent against questionable or non compliant practice.

Question 16: Would stakeholders welcome the extension of some elements of the Standards of Conduct into domestic supply licence conditions?

We believe that extensions of the Standards of Conduct into the domestic supply licence conditions will provide Ofgem with the necessary powers to take action in the case that these are not fully observed. It will also provide a level playing field in that all suppliers will be forced to comply with these requirements.

We feel that this action is required due to the fact that the market is clearly not working as Ofgem feels it should. However, we would like to make the point that greater regulation should be applied in an appropriate manner to fix an obvious problem as an increased level of regulation can itself become a barrier to competition given larger players' greater resource to engage with this.

Question 17: Do stakeholders agree that more needs to be done to improve consumer trust and use of switching sites?

Although switching sites have a strong role to play in terms of consumer engagement, we have been disappointed by the fact that we have been unable to offer some innovative products (such as time of use tariffs) by these means due to the inability of the sites' systems to deal with products of this nature.

Question 18: Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 3?

We have no further comments to add in regard to this proposal.

Question 19: Do stakeholders consider that Ofgem should strengthen licence conditions to prevent unfair contracting practices in the non-domestic sector?

We believe that there is an increasingly strong view within the industry that smaller non domestic customers (particularly micro businesses) should be accorded many of the same rights and protections as domestic customers. It would therefore seem logical that Ofgem should take steps to prevent unfair contracting practices within this sector by means of licence modification. However, we would appreciate a more clearly delineated definition of exactly what constitutes a micro business as there is likely to be a serious impact on competition if smaller suppliers are required to extend these protections under the current definition to the potentially large number of businesses which could be captured.

Question 20: In particular, would stakeholders welcome additional licence conditions surrounding the objections procedure?

We are sure that Ofgem is aware that there is a considerable body of anecdotal evidence relating to misuse of the objections in the non domestic sector going back some years. We would welcome the strengthening of the licence in relation to this to ensure both increased competition and customer choice in the non domestic market.

Question 21: Would stakeholders welcome the extension of some elements of the Standards of Conduct into non-domestic supply licence conditions?

Although Ofgem has stated that it will give consideration to individual licensees' observance of the Standards of Conduct in relation to any investigation these are obviously not binding in the way that supply licence conditions would be. Therefore, First Utility would support the extension of some elements of the Standards of Conduct into non domestic licence conditions in order to ensure a level playing field with all non domestic participants required to abide by the same standards.

Question 22: Do stakeholders agree with our position, at this stage, not to extend our proposals on tariff simplification into the non-domestic sector?

Given the way that tariffs are priced and agreed in the non domestic sector, we agree that it is not currently appropriate to extend these proposals into the majority of that sector. However, we feel that there may be a case for extension of these proposals to micro businesses as a large number of these have never switched supplier and we feel that there is the potential to benefit this sector in this manner. Please also see our comments in relation to the need for clearer definition of what constitutes a micro business in our answer to Question 19.

Question 23: Do stakeholders agree that Ofgem needs to look further at the role of third party intermediaries (TPIs) in the non-domestic market?

We believe that there is a strong requirement for TPIs to be regulated in some manner, although we are uncertain as to whether it should be the role of Ofgem or another regulator to perform this function. As it is not possible for this area of responsibility to be easily defined, we would support the imposition of a supply licence condition requiring suppliers to disclose to non domestic customers exactly how much commission is paid to a TPI, as the current situation whereby a TPI can make more margin from a non domestic contract than the supplier is a clear mismatch in terms of risk and reward.

Question 24: Do stakeholders have any comments on the costs and risks of any of our suggested policies under Proposal 4?

Please see our comments above.

Question 25: Do stakeholders agree with Ofgem's proposal to appoint a leading firm of accountants to review the transfer pricing and hedge accounting practices of the vertically integrated suppliers?

This seems appropriate and should provide a greater level of transparency relating to the vertically integrated incumbent suppliers' practices in these areas. Hopefully the greater liquidity at settlement granularity resulting from Ofgem and the government's proposed reforms will result in simpler transfer pricing. However, we note that our proposal to place a restriction on self supply by vertically integrated suppliers would remove this issue entirely.

Question 26: Do stakeholders have views on how Ofgem could improve segmental reporting in future years?

We have nothing to add to the proposals already made by Ofgem.

Question 27: Do stakeholders consider that our proposals will be sufficient to protect the interests of consumers, including vulnerable consumers, or are additional consumer protection measures necessary?

We believe that the simplification of tariffs and the incentive to innovate which should result from these measures should result in a better experience for the domestic consumer.

Question 28: Do stakeholders consider that our measures to simplify tariffs will reduce the ability for suppliers to price discriminate between regions and so reduce the need for a licence condition prohibiting undue discrimination?

It could be that this measure will make SLC 22 redundant. However, we believe that a period of observation will be required following the introduction of these new measures before this can be ascertained.

I hope this response has proved helpful, please do not hesitate to contact me should you have any questions or require any further information.

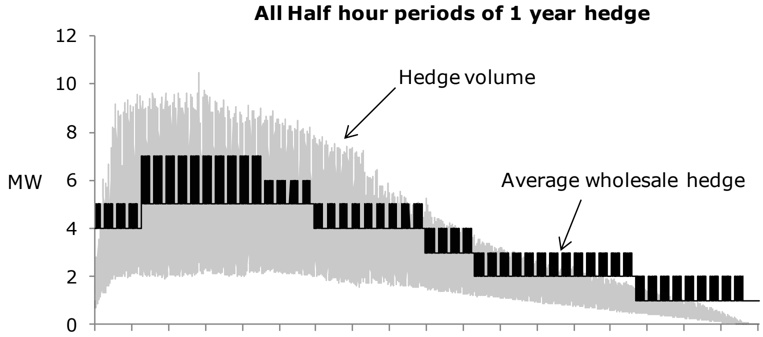
Best regards,

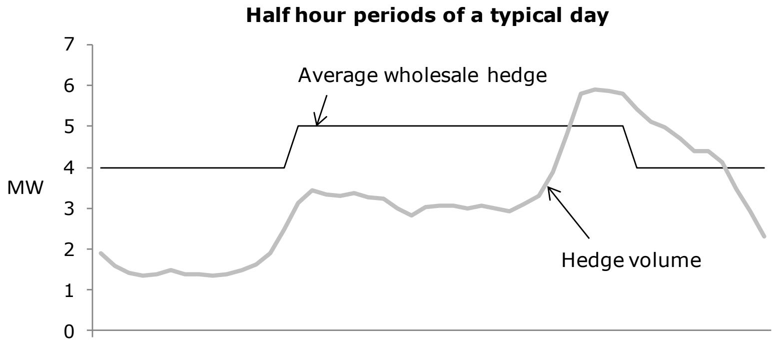
Chris

Chris Hill

Regulation

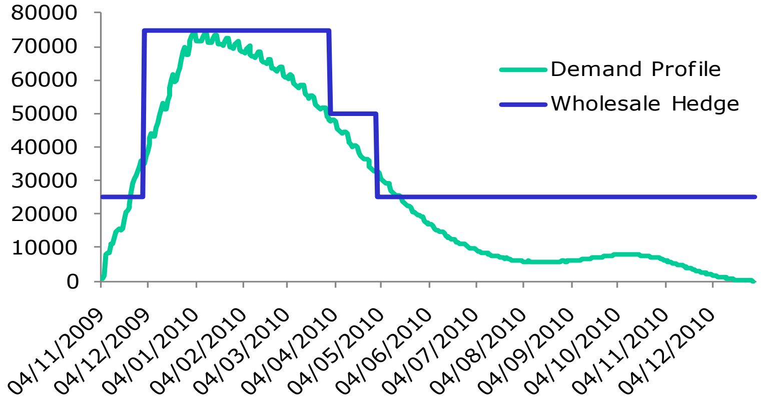
Appendix: Illustration of the impact of lack of market liquidity on smaller suppliers

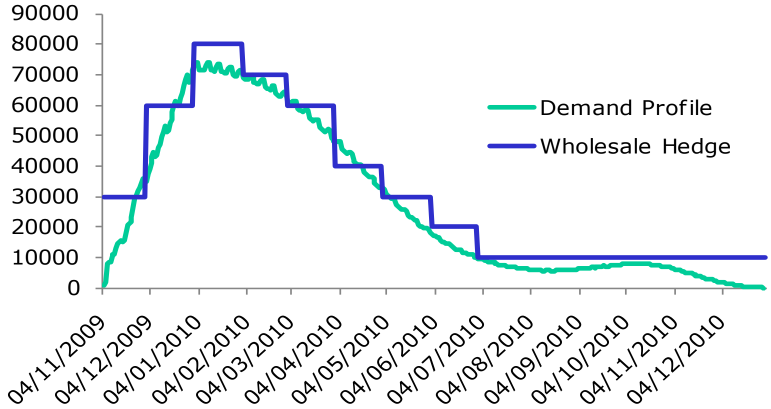




As illustrated above, standard power wholesale products do not provide a smaller supplier with an efficient hedge.

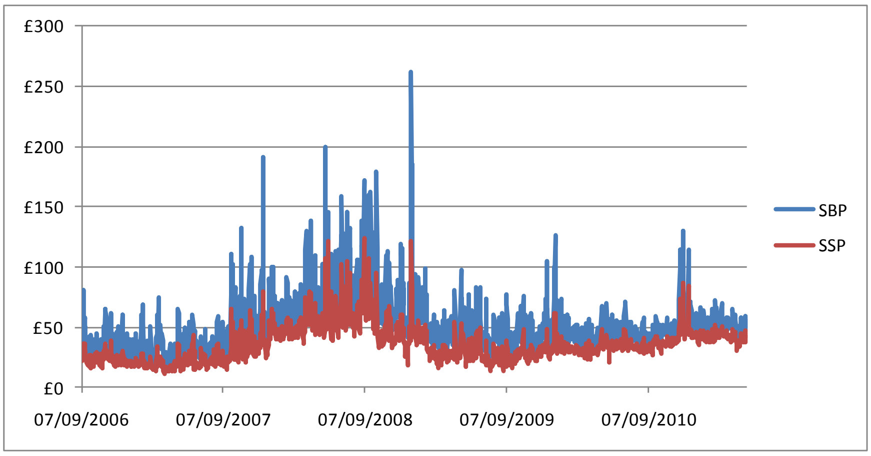
- Power wholesale products are only available in base and peak blocks in forward markets.
- Standard base and peaks clip size 10MW.
- Graphs show typical volume hedging profile for approx 45,000 residential electricity customers.
- Even at 1MW clip sizes and monthly products significant volume exposure remains.
- The only alternative is to negotiate structured shape deals at a premium price.

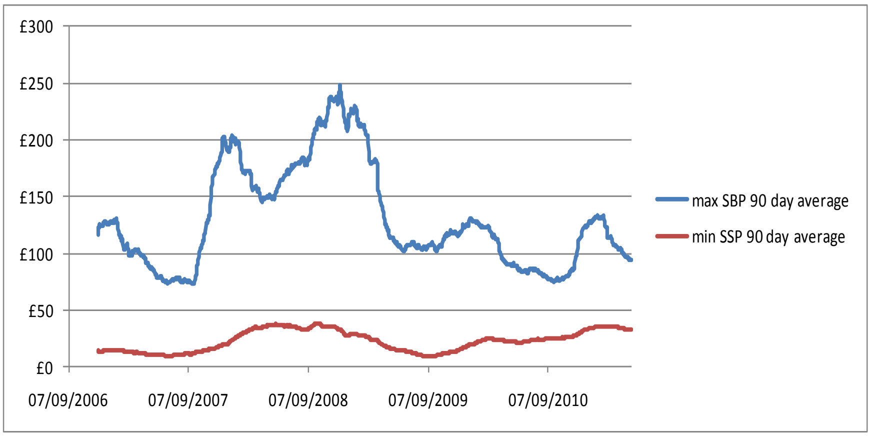




A similar picture for gas

- Standard clip size of 25,000 Therms.
- Graphs show typical volume hedging profile for approx 25,000 residential gas customers.
- Even at 10,000 Therms and monthly products significant volume exposure remains.





Any resulting imbalance is cashed out at system buy and sell prices. Electricity cash out prices are used as an example as these tend to be more volatile than gas cash out prices.

It can therefore be seen that low liquidity and lack of appropriate products in the traded electricity and gas markets leaves smaller players exposed to volatile cash out mechanisms, thus increasing risk at a crucial stage of growth. By contrast, the large incumbent players are insulated from this risk to some extent by the size of their customer portfolios and their access to generation as a hedge against cashout volatility.