By email to: rmr@ofgem.gov.uk

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27th May 2011

Dear Sirs

Re: Retail Market Review Consultation

SmartestEnergy welcomes the opportunity to respond to Ofgem's Retail Market Review.

Introduction

SmartestEnergy is a licensed gas and electricity supplier operating primarily in the half hourly electricity market. We consolidate small generation and supply electricity to corporate and group customers. We also trade on the wholesale market on the exchanges and with the Big 6 on GTMA arrangements and provide access to market for smaller participants through more bespoke trading agreements.

Overview

SmartestEnergy is supportive of the review's aims to improve liquidity and increase competition in the market but we have a number of concerns over specific proposals.

As a general principle and starting point we believe that any reforms should be consistent with commonly accepted free market principles and that the market should operate as a level playing field for all participants.

We are concerned that disproportionate action by Ofgem could destabilise the market and that some of the proposals may not be entirely consistent with a free market.

There is also a risk that moves towards standardisation and centralisation will deter, rather than encourage, new entrants.

We are against further markets/exchanges and any obligations which affect all suppliers as the purpose of this review is to tackle the dominant position of larger players.

We are of the view that liquidity would be best improved with commitments to market making activity from the Big 6. We note that liquidity has probably worsened slightly since the merger of EdF and BE. We believe in the freedom to trade and hence the right to integrate vertically. However, if the government is serious about liquidity, they should consider limiting the size of vertically integrated companies (this could be achieved through self supply restrictions) or at the very least preventing further mergers.

There is no linkage between liquidity and supply competition; the gas market is liquid but has a similar level of competition to the electricity market. The real "barrier" to entry is credit, but it is not unreasonable to expect counterparties to be credit-worthy, especially in the light of companies which have failed.

Reform Proposals

Proposal 1: Improve tariff comparability - To make it simpler for domestic consumers to compare prices and get a better deal, Ofgem is proposing supply companies can offer only one standard or 'evergreen' contract per payment type.

> As SmartestEnergy is not a domestic supplier this issue does not impact us directly but we feel it is important that consumers should have as much choice as possible. To allow only one 'evergreen' style contract would appear to restrict innovation in the market. Given there is more than one price comparison website, consumers already have ready access to information to help find the right supplier for their usage/payment preferences.

Proposal 2: Enhance liquidity - To address continued concerns on low electricity wholesale market liquidity and new entry, Ofgem proposes improving market access through the introduction of a Mandatory Auction and Mandatory Market Making arrangements.

> We would welcome more liquidity in the market but the introduction of further auctions would not be an efficient solution. An increase in the number of auctions would merely spread liquidity more thinly and increase costs which ultimately get passed on to customers.

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We support more formalised market making arrangements. However, we are not in favour of market making on a new platform. Ways should be devised to monitor market making activity on existing arrangements ie on APX, N2EX and through brokers.

The N2EX has the backing of many trading organisations other than the 'big-6' UK producers (29 and counting) including financial players (Barclays, Citigroup, Deutsche Bank, JP Morgan, Koch, Merrill Lynch & Morgan Stanley). This platform and the market coupling innovations by APX have the potential to significantly improve UK liquidity and should be given time to become established. We believe that constant initiatives and consultations will only serve to hamper development of liquidity.

We believe that it is credit arrangements rather than liquidity which represent the main hurdle small suppliers face and that is an issue outside of Ofgem's control; the nature of trading arrangements in a competitive market demands that participants have sufficient financial protection. SmartestEnergy and other suppliers and banks already provide services which lessen this problem for smaller participants.

Proposal 3: Strengthen Probe remedies in domestic market - To address the continued "patchy and poor" response by companies to its Probe reforms, Ofgem proposes to strengthen licence conditions to ensure consumers receive clear and transparent information.

Some suppliers in the domestic market already provide sufficient information for customers to switch easily. What is required is consistency and for Ofgem to ensure that such arrangements are implemented simultaneously across all suppliers so that none gain an unfair advantage by delaying. Given the way that guidance can be interpreted differently this almost certainly means Ofgem providing specific wording or agreeing this collectively with suppliers.

Proposal 4: Strengthen Probe remedies in non-domestic market - To address continued concerns Ofgem have found in the non-domestic sector they propose to take further action to prevent unfair contracting practices in the non-domestic sector with regard to micro-business protection, objections and TPIs.

We are surprised by Ofgem's proposal to write to suppliers to seek explanations for objections given they have been aware of this issue since 2003 when it was the subject of an MRA appeal. The problem is the weakness of MEC.

In regard to TPIs, we believe the proposals are the wrong approach. In line with best practice in other industries such as financial services it is important that advice given to consumers is regulated and that customers have full visibility of

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the charges/commissions involved. Brokers should also be able to demonstrate that they have access to the full market and that comparisons between suppliers are being made on a level playing field. No obligation on suppliers would be able to bring this about. Brokers should be able to demonstrate that they are independent of suppliers; agreements between suppliers and brokers would mean that brokers cannot claim to be independent.

We believe that customers would be better protected if Ofgem's or the FSA's remit was extended to cover TPI activities. It would make sense for the focus to be on ensuring the integrity of the service being offered to customers by brokers not on the relationship between suppliers and brokers.

Proposal 5: Improve reporting transparency - To address concerns on suppliers' financial reporting, Ofgem will investigate how to improve reporting requirements for vertically-integrated utilities.

It has been difficult to assess profitability of retail businesses across the 'Big 6' because of differing hedging strategies and price transfer arrangements. Retail businesses often don't appear particularly profitable but this is primarily because trading functions tend to be more aligned with generation in the Big 6 because of the synergies between trading and flexible generation. The fundamental issue is market dominance and the government should consider limiting the size of vertically integrated companies; this could be achieved through self supply restrictions.

Remainder of this document

Our answers to the specific questions contained within the consultation document can be found in the Appendix to this letter.

Should you wish to discuss this further please do not hesitate to contact me.

Yours faithfully,

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APPENDIX: Answers to specific questions in the Consultation Document

Question 1: Do stakeholders agree with our findings of the Review in relation to causes of persistent consumer harm and barriers to entry in the energy retail markets?

As a half hourly only supplier we are largely disinterested in matters pertaining to the domestic market which is the main subject of the "consumer harm" analysis. There are a couple of assertions which relate to the wholesale and business markets which we do not agree with.

Firstly, it is stated that independent and small market participants find the wholesale market does not meet their needs to compete effectively. We agree that liquidity could be improved but as a small supplier which provides access to market services to other small suppliers we do not agree that this is a severely serious issue in the market place. SmartestEnergy provides access to market services and we know that there is competition in this area: there are other suppliers and banks who also provide access to market services.

Secondly, we do not believe that the failure of some TPIs to follow the spirit of the Standards of Conduct can be regarded as a failure, merely a lack of improvement. This does remain a major area of concern but, as we say elsewhere, it should be dealt with through regulation of the service brokers provide to customers and is not directly an issue for suppliers.

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

We are somewhat surprised at the suggestion that in a competitive market there is too much choice for customers. Websites such as YouSwitch provide a useful and easy-to-use comparator so that it is not necessary for customers to understand the complex calculations. All a customer requires is the previous year's consumption and we welcome the fact that this information is being provided by some suppliers already. It should, however, be mandatory for it to be on every bill.

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

Whilst on the face of it this seems like a sensible solution it bothers us that such an intervention is not in line with an open competitive market. This type of market intervention could possibly deter a potential innovative new entrant from entering the market.

We are also concerned at the concept of only allowing one evergreen tariff per payment type. We do not believe that Fixed term tariffs are really appropriate for domestic consumers; they should be free to move when the time is right for them. An increase in the number of roll-overs or defaults will only lead to greater confusion.

We agree with the proposal that customers coming to the end of a fixed contract would default to the standard evergreen.

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?

We do not believe the issue is that there are too many evergreen contracts, merely that it is difficult to compare a standard one. Perhaps the solution is to ensure that the one evergreen contract being proposed by Ofgem is given a standard name thus ensuring ease of comparison, but allowing suppliers to offer other evergreen products under different names.

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

We think that the standardised element is unnecessary and creates additional complexity on the bill.

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 do not understand how this would work in practice.

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?

No

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

No. Liquidity is not the real issue. Strong credit requirements are.

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The consultation document states: "We continue to observe little market entry and exit."

Becoming a supplier is a serious matter, involving big business decisions. It is little wonder that few participants enter the market. Is Ofgem suggesting it would be good for competition if more participants entered the market ill-prepared and subsequently left?

It is important that companies which participate in the market are credit worthy. Companies which have failed in the past have not been in a strong financial position. Their problem was not liquidity.

Further evidence that there is no linkage between liquidity and supply competition can be seen in the gas market; the NBP gas market is very liquid yet this does not lead to an increase in the number of players participating in the domestic or I&C gas supply markets. The gas market is largely dominated by the same organisations as the electricity market yet Ofgem do not seem to consider there to be the same problem with competition in gas.

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?

No. Additional complexity and the possibility of further unpredictable market intervention would probably reduce the likelihood of supply market entry.

A proliferation of auctions merely spreads liquidity more thinly and increases costs which ultimately get passed on to customers.

N2EX has already taken some liquidity away from the short term APX and an additional market such as that proposed by Ofgem will simply take liquidity away from APX's other products.

Having a monthly auction as opposed to an open market will increase prices by creating artificial demand.

We believe a simpler arrangement would be the 'Self Supply Restriction' option (previously suggested by Ofgem) which would improve liquidity without smaller suppliers having to enter into any additional markets.

Some market making in existing markets could be helpful especially on season blocks and quarters.

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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 consider market making obligations and smaller clip sizes through existing arrangements to be sufficient on their own as an intervention, but consideration could be given to Self Supply restrictions. We are against the idea of additional markets/auctions/exchanges.

We appreciate, however, that it would be very difficult to establish fair rules for spreads in a market making scenario. If spreads are not tight enough there is no point in market making. On the other hand, it would be unreasonable to expect narrow spreads at times of high volatility. *It should suffice to encourage the Big 6 to offer power through certain products (e.g. season blocks) over a certain period of time (at least one day per week).* We do, feel, however, that it seems inconsistent with a free market to impose market making on parties.

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

Smaller clip sizes (preferably minimum of 5MW rather than the current 10) offered through OTC brokers would be helpful.

Ofgem have previously mentioned self-supply restrictions on the large vertically integrated utilities, which would limit the extent to which they may supply their own retail business from their own generation output and would force a proportion of their requirements to be traded through the market. A Self Supply restriction would have the desired effect but would mean that smaller suppliers would not have to enter into any additional markets.

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 – a distinction needs to be made between volumes offered and volumes sold. Net volumes sold may not be much greater than the market share of non-big 6 suppliers, although we are interested to know what the likelihood of further churn is.

We would ask how it is intended that the reserve prices in the auctions will be set as they could have a huge effect on how much power is actually sold.

Product requirements – It would be unreasonable to expect half hourly shape to be traded more than two days out. If a standard domestic load profile is to be offered we feel that business equivalents should also be available such as the standard business shapes which traded in the days of the Pool. We would like to see all the EFA blocks available for coming seasons and months and also a weekday block 5 for coming seasons and months

Frequency – an auction which is not constantly open will lead to higher prices.ie. an artificial demand is created for short periods and this will push prices up.

It should be noted that products on N2ex started off more expensive than APX till things settled down. If an auction takes place monthly rather than being constantly open we believe that the settling down would never occur. Instead of a monthly auction we would prefer to see guaranteed market making through existing channels (APX/brokers) once a week. A monthly auction would also be a distraction from other markets.

Governance arrangements – proper rules, systems and governance could make this a very expensive proposal.

Participation – participation will presumably be determined by the ability to provide sufficient credit to support the traded position

Platform – we are concerned that a totally independent platform would be potentially prohibitively expensive for participants to set up.

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?

The proposals would impose costs on all trading parties and Ofgem's role would be minimised. It would be more efficient for the market as a whole if Ofgem implemented obligations through the current arrangements and enhanced their own monitoring through auditing i.e. checking internal transfers of power and bidding behaviour.

We are in favour of a market making obligation on the larger players but we are not in favour of market making on a new platform. Ways should be devised to monitor market making activity on existing arrangements i.e. on APX, N2EX and through brokers.

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?

Standardised wording and information would appear a sensible approach. We are less convinced of the need for other actions.

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

Constant requests for information would probably be unhelpful. Greater use of "mystery shopping" activity may help inform Ofgem more qualitatively.

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

No, we feel this would be inappropriate and not the stuff of licence conditions.

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

We are unclear as to what is being proposed here, or indeed, whether the real problem lies with suppliers, switching sites or customers.

What needs to be reviewed here is the realism of expectations for high levels of consumer engagement and also whether switching rates are a sufficient metric to judge the effectiveness of the market.

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

Ofgem should resist the temptation to place obligations on suppliers. As stated, more first hand monitoring by Ofgem would be more productive.

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

Yes possibly, where these relate to supplier activity and not TPI activity.

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

No, we believe additional licence conditions on objections are unnecessary and inappropriate. What is required is greater enforcement by MEC of provisions already in the MRA.

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

No

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

Yes

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

Yes. In line with best practice in other industries such as those involving the selling of financial services it is important that advice given to customers is regulated. Similarly, it is very important that customers should have full visibility of the charges/commissions they are paying. Also, brokers should be able to demonstrate that they have access to the full market and that comparisons between Suppliers are being made on a level playing field. No obligation on suppliers would be able to bring this about.

SmartestEnergy believes that customers would be better protected if Ofgem's remit is extended to cover TPIs' activities. Suppliers' activities are licensed and regulated and it makes sense that TPIs' should be, too. It is not so much the relationship between Suppliers and brokers which needs to be focused on but the integrity of the service being offered to customers by brokers.

SmartestEnergy also believes that arrangements should be worked up such that TPIs, not only have an obligation to provide a fully transparent service, but also to make customers fully aware of green products and products which encourage energy efficiency.

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

No

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?

Yes and no. We see little value in this exercise on it own. However, it would be important to do this in conjunction with a self-supply restriction.

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

We consider this holy grail of segmented reporting to be somewhat misguided. It has been difficult to track profitability of retail businesses in the big 6 because of differing hedging strategies and price transfer arrangements. What we do know is that retail businesses tend not to look particularly profitable. We do not consider this to be a conspiracy, it just so happens that the trading functions tend to be more aligned with generation in the big 6 because of the synergies between trading and flexible generation.

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

We believe that additional consumer protections are probably unnecessary.

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?

No

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