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Ofgem's Retail Market Review – Findings and initial proposals

RWE npower's response to consultation

1 Introductory remarks

We are somewhat puzzled by the timing of the review. The existing Probe remedies cannot reasonably be said to have had time to bed in. And rapid developments in wholesale market arrangements and liquidity are in train. Given this background, there is a strong case for allowing these developments time to bear fruit, or at least working with the grain of existing initiatives. We believe Ofgem should consider these options as serious alternatives to its consultation proposals which are unique in the extent to which they apply radical and intrusive regulatory interventions to an already workably competitive market.

At this stage, many of the proposals remain high level and rather poorly specified. Many of our remarks which follow raise issues which we believe need to be addressed in order that we can effectively appraise the proposals.

2 Tariff standardization proposals

2.1 Competition and consumer welfare implications

As with the recent non-discrimination licence condition, our concern is that these proposals will restrict the competitive avenues open to suppliers. The proposals have the potential effect of instituting cross subsidy between high and low consumption consumers and also between consumers in different regions. To the extent that they undermine suppliers' ability to reflect costs in tariff structures, they increase supplier risk with a consequent effect on customer prices. The net effect on consumer welfare compared to the status quo or to developments of existing comparative information is far from clear-cut.

Our view is that the cost/benefit of restricting the nature of competition in the non-domestic sector is clearly against further regulatory intervention. The great majority of our micro-business customers are on fixed term contracts and so, are already subject to the protections of SLC7A for renewals.

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2.2 Standard Evergreen Tariff (SET) eligibility

Ofgem's aspiration is for one SET per payment method per region. However, a number of characteristics of the energy market present challenges to this aspiration. For example:

Existing Economy 7 customers;
Customers on Independent Gas Transporter networks;
Customers on embedded electricity distribution networks;
The potential richness of tariff structures afforded by smart metering with the consequent benefits for energy efficiency and reducing carbon emissions;
Whether any differential will be permitted between regional unit charges to reflect underlying differences in regional costs;
Whether any additional product features will be permitted at all and if so which ones (e.g. discounts for online billing, dual fuel, Nectar or Clubcard points, high street vouchers, "green" features).
Non-standard aged electricity tariffs including SuperTariff, Preserved Off Peak tariffs. These are designed to facilitate continued use of the space & water heating systems installed for many years. Many such systems would not provide acceptable performance on a modern tariff such as Economy 7 as they require a daytime charging boost to maintain heat output. Circa 3% of UK electricity customers are believed to retain such tariffs**.**

A failure to recognize these characteristics in SETs has the potential to increase the gap between supplier revenues and costs with adverse effects noted in 2.1 and/or to deny customers legitimate benefits.

2.3 Fixed Term Product (FTP) eligibility

Ofgem has suggested that adverse unilateral variations – "will not be permitted". This would appear to preclude a number of products:

2.3.1 Smart meter tariffs

It seems reasonable to assume that the innovative tariffs made possible by smart meters, e.g. a 4 rate Time-of-Day tariff, would be offered through Fixed Term Contracts.

Costs invariably change over time and prices on such tariffs will rise/fall as a result. As such, it is inappropriate to preclude adverse unilateral contract variations (i.e. price rises) from such Fixed Term Contract offers. Suppliers would be obliged to adhere to SLC23 in the normal way when they introduced such a price rise.

2.3.2 Price capped products

A price-capped product that sets a price level above which rates will never go but permits rates to fall below that maximum level. Such a product also allows rates to rise following an earlier fall providing that the original price ceiling is not breached.

2.3.3 Fixed discount to standard products

A Sign-on-Line (SOL) offer with a guaranteed price advantage to Standard rates for a stated period. The Standard rates can vary in price, at present we believe that SOL rates can also vary providing the guaranteed price advantage is maintained.

2.3.4 Tracker products

A Tracker product, which, by it nature, can go up or down as it tracks its given cost index.

Is the prohibition of such products envisaged by section 3.16 of the proposals?

To sum up, the proposals regarding Fixed Term Products may restrict unreasonably the types of products which suppliers can offer to the detriment of competition and to consumer welfare.

2.4 Cost Reflectivity, risk and customer prices

We have outlined above some of the factors which bear on cost reflectivity, supplier risk and customer prices.

The mechanics of the price control arrangements are also relevant. Key questions are:

- How will the prescribed element be defined?
- How will the prescribed element be quantified?
- To what extent will these arrangements introduced distortions between the costs incurred by suppliers and the associated prices charged to customers?

Some specific questions arising out of discussions with Ofgem are attached at appendix 1.

There is the potential for enormous cost risks and significant levels of reporting/bureaucracy to be introduced by this proposal if inappropriate options are selected for the structure of charges. Different tariff and discount structures have been adopted by suppliers in order to manage those risks with each supplier determining its own competitive position. If Ofgem mandates radical change for such a large proportion of the UK residential customer base the cost risks may be increased and, as a result, upward pressure exerted on prices to cover those risks.

2.5 The proposed comparison metric

In addition to standardization of evergreen tariffs, Ofgem proposes that Fixed Term Products (FTPs) should be expressed in a similar format. This raises a number of issues:

i) Where these comparisons are presented in a hard copy table, they will need to be made at a specific consumption level which may not match that of the customer. This may potentially mislead the customer;
ii) A straight price comparison risks underplaying the importance of other key characteristics of a fixed period product e.g. the insurance value of a fixed price product.
iii) In order to avoid misleading customers, a table may need to be accompanied by significant text explaining different products in more detail including eligibility criteria. Our customer research tells us that "less is more" in terms of bill content. It would therefore be unhelpful to try to achieve this on customer bills

iv) The current metric is the annual fuel bill based on previous consumption, or average consumption if individual consumption is not known. If another metric is added then Ofgem would need to clarify which metric is the standard and to avoid confusion it may be necessary to drop the secondary metric. At the very least, dropping the current standard would require careful consideration and specific consultation.
v) Ofgem reports Ofcom's experience (para. 5.19 of the Behavioural Economics report) that customers found total bill costs more helpful than info on individual call prices. It appears that in conducting its customer research, Ofgem did not explain the potential of the existing Probe remedies and in particular the information about total bill costs which is now available to customers. Nor did it ask customers to rate this method of simplifying tariff decisions, possibly with refinements, against the newly proposed options. Had Ofgem done so, it seems likely that customers would have preferred the existing information. The observations on page 33 of Ofgem's opinion research report (Ofgem Consumer First Panel Year 3 Report from the second set of workshops March 2011) are telling. Although initially understanding and awareness of Annual Statements among panellists was low, by the end of the discussion, some of the panellists had come to appreciate the benefits in terms of making comparisons, predicting costs and reducing usage. This suggests that a more proportionate response would be to improve awareness and perhaps presentation of the existing information.

3 Wholesale market proposals

3.1 RWE's involvement in promoting liquidity

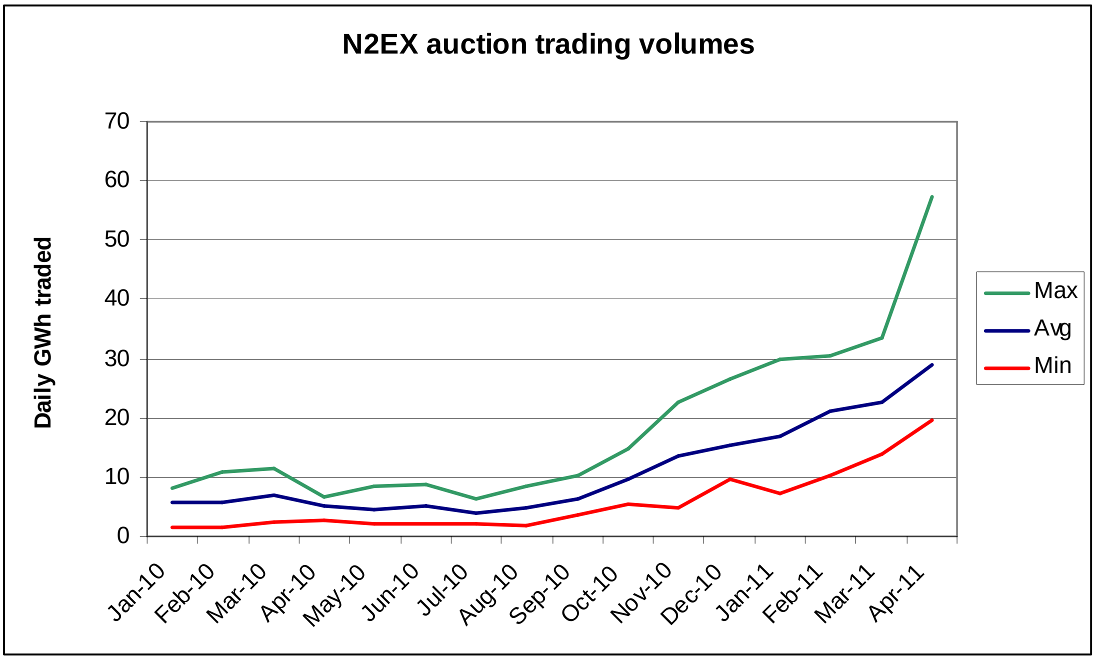
We support the objective of promoting wholesale market liquidity. RWE is already pro-actively pursuing many elements discussed in Ofgem's proposals as beneficial commercial and industry initiatives in their own right. Further regulatory intervention in the wholesale market is more likely to damage liquidity than enhance it.

Any intervention should therefore build on the industry efforts that are already in place, and should encourage all market participants to contribute to making the various platforms succeed.

3.2 Current state of wholesale market

RWE is investing both time, and money in terms of market making on NASDAQ and providing significant volumes to the market through the N2EX day-ahead auction.

N2EX has been developed by the industry to improve liquidity and access to products for all types of players. N2EX already offers cleared prompt trading, a day-ahead auction and from April intraday spot trading. Traded volumes on N2EX have increased progressively with around 100GWh being traded daily in the N2EX cleared prompt market and 20-30GWh every day in the auction. The auction markets already provide a reliable index for the UK market which will allow a futures market to develop. The graph below shows the evolution of auction trading volumes which in recent months have been increasing exponentially.



The NASDAQ futures market, based on the N2EX day-ahead auction reference price, began operations in March 2011. RWE is already acting as market maker on the NASDAQ market for financial futures products including both baseload and peakload products.

These innovations have reduced the costs of market entry significantly. Entrant credit costs have been reduced through centralization and the use of financial derivatives. Only a single agreement is now required to enter the market rather than the multiple bilateral agreements required previously. The evolution of day-ahead markets for the management of detailed shape risk, together with standard products for base and peakload products along the full tenor of the curve is a model that will provide the way forward for smaller players and this is the model we are proactively pursuing.

3.3 <u>Is liquidity a barrier to entry?</u>

The premise for Ofgem's wholesale market proposals is that poor liquidity has restricted new entry.

There are three elements to this premise:

i) That new entry is, in fact, low
ii) To the extent that entry is restricted, the cause is insufficient liquidity
iii) That liquidity is low

In our view, all three elements of this premise are fundamentally flawed.

Firstly, entry to the retail market is on an upward trend: many new potential suppliers have acquired licences over the last couple of years and the recent entry of the Cooperative into the market evidences the contestability of domestic retail supply in Great Britain;

Second, to the extent that barriers do exist, evidence provided by Ofgem suggests that low profitability is at least a more plausible explanation. Regulatory uncertainty, including the inexorable rise in the scale and scope of environmental and social obligations, is also likely to be a factor as energy retail businesses become increasingly distinguished from any other kinds of retail business, thereby reducing the transferability of retailing skills. All the evidence suggests that the UK market is one of the easier and cheaper markets to enter in Europe. Switching rates remain the highest in Europe across all customer classes. Indeed the evidence from the EU Commission's latest monitoring report[1] shows that four times as many customers switch annually in Great Britain (20%) than in Europe's most liquid wholesale market in Germany (5% annually). We agree that the credit, cash and collateral requirements sometimes make it difficult for small new entrants to establish and maintain a market position, but this is no more difficult than in other capital intensive, relatively high-risk industries or market segments (i.e. banking, telecoms etc.). Any proposal which involved subsidizing the creditworthiness of market participants would not be acceptable.

Third, whilst more liquidity is always welcome and RWE is working to enhance liquidity to reduce the costs of managing generation and retail risks, we also do not consider GB electricity market liquidity to be particularly "low". There is, in fact, reasonable volume and churn for many standard products. The main areas for improvement relate to peak products in general and for standard products further along the curve, but even here, there are readily identified drivers for the relative lack of liquidity, e.g. the limited availability of CO2 certificates for Phase Three. More recently, the introduction of the Carbon Floor legislation has reduced the tenor of power liquidity due to the uncertainty over the rate of tax feeding through into power prices more than a year hence.

In summary, whilst there are some challenges for entrants, it is not true to say that the present market arrangements do not meet the needs of independent players; there are a number of these that have successfully operated in the market for several years and there is significant evidence of entry.

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3.4 <u>The impact of Ofgem's proposals</u>

Liquidity is the outcome of a competitive process; it is not something that can be created by Governments or Regulators. It will develop most strongly where market participants have incentives to optimise and re-optimise their positions in the light of evolving information, including changes in prices and their physical portfolios.

Highly liquid markets are characterised by a large, diverse range of competing, credit-worthy participants including companies that are willing to take a view on exposure to the future direction of prices. The underlying demand and supply for products driven by fundamental business risks

[1] http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=SEC:2010:0251:FIN:EN:PDF

must be equally high. The design of the imbalance arrangements also has an impact on liquidity particularly for peak products

Not only are the Mandatory Auction (MA) and Mandatory Market Maker (MMM) interventions unnecessary and inappropriate given the voluntary initiatives already in place, they will also have negative implications for the future development of new products and services (e.g. in the futures market) that stem from these initiatives and the damage from intervening in one market segment (e.g. spot or future) will quickly cascade to all other time periods.

Our view remains that the greatest chance of increasing liquidity is to attract new entrants to the UK market who would not otherwise trade here. The market is doing this already, some six new entrants are on the N2EX membership list and actively trading, and the threat of regulatory intervention is more likely to repel than attract other potential entrants

Increased liquidity will support new retail market entrants in managing their risks, but we do not believe that this will be achieved by enforced Mandatory Market Making or Mandatory Auctions. Rather, enforced trading will impede liquidity and could add costs over more efficient trading options

3.5 <u>Specific comments on Ofgem's mandatory auction proposal</u>

RWE is opposed to the establishment of a Mandatory Auction. We have the following comments:

Volume requirements

- RWE already sells well in excess of 20% of its output into wholesale markets. Any mandated auction would simply displace these volumes in a less efficient exercise and may result in lower volumes traded.
- It would result in a sub-optimal trading strategy (for example companies may be forced to buy back sold capacity to meet the minimum volume requirement even if it costs money).

Product requirements

- We would like to see market participants trading more volumes on near term markets – particularly on platforms such as N2EX. This would strengthen the credibility of the reference price for forward financials;
- Shaped products can predominately be provided by generators other than the Big 6. We would regard the additional risk arising from a regulatory obligation along these lines as disproportionate. It would be expensive to unwind positions where we are forced to sell "shape" and buy it back in the wholesale market.

Frequency

- Monthly auctions would disrupt continuous trading and therefore liquidity would be skewed to the auctions. It is not clear that demand exists for products on a monthly basis. It would be better for any obligation to be around volumes traded on a continuous basis. In particular, forcing volume into a monthly market would mean that hedging would be focused at this time even though acquiring supply customers is a continuous business. In order to manage the price risk between customer acquisition and hedging, suppliers will have to introduce an additional risk premium - this is likely to increase overall costs which will have to be passed on to consumers.

Platform

- An auction process which competes with existing market platforms would increase collateral requirements by reducing the scope to net off positions

Reserve price

- There is no case for restrictions on reserve prices. Generators should be able to set a reserve price reflecting market conditions for the product being sold.

3.6 Ofgem's Mandatory Market Maker proposal

Although an obligation based around continuous trading would more likely be in tune with the needs of market participants than a mandatory auction, we have concerns about making this a mandatory requirement since – depending on the product - not all companies have the same capability to market make. We have the following comments on particular aspects of the proposal:

Volume requirements

- RWE already acts as market maker on the NASDAQ platform. From this perspective, the volumes suggested are not out of line with our expectations.

Product requirements

- The market already allow for small clip sizes down to 1MW. There is limited demand for smaller products. However we would consider offering smaller sizes.

Bid offer spread

- Regulation of bid-offer spread is undesirable as it will add to the cost of providing the service in terms of the risk carried by the market maker. Efforts to increase liquidity should not turn into being hidden subsidies for particular market participants.

Participation

- The proposal to limit the obligation to the 6 identified participants is clearly sub-optimal in terms of delivering its objective. There are a number of other participants who are at least as well placed.

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Platform

- As noted above, establishing arrangements independent of the existing platforms would increase collateral costs and raise transactions costs generally.

3.7 An alternative way forward

The greatest contribution that Ofgem could make to the development of the wholesale power market is to throw its full support behind the development of exchanges. Ofgem should continue to engage with industry through existing governance arrangements, such as the Market Council of N2EX. An effective dialogue via this route already exists and we would prefer Ofgem to influence companies to support and make best use of existing initiatives rather than devising further and competing interventions. A constructive approach would be for Ofgem to clarify *in specific detail* what minimum changes could be made to the proposed exchange development that would obviate the perceived need for further regulatory intervention. We would simply propose that generators be given a minimum level that they must offer through the wholesale market each year. Greater transparency from market participants about the amounts they buy and sell into different traded markets would complement such an obligation.

In this context, we note that the obligations as presently defined fall on the ‘Big 6’. While this term is generally used in association with the retail business, there are nine major generators (following the merger of GDF and IP) and it is two of those outside the “big 6” – Drax and GDF/IP – that are in by far the best position to provide shape to the market given the significant flexibility (shape) in their generation businesses. It should be noted that RWE is short shape, given the size of our retail business compared to our portfolio of predominantly high-efficiency CCGT generation plant. This kind of forced “intermediation” or “recycling” will do nothing to promote greater liquidity and can only result in unnecessary costs to the purchasers.

We see major scope for regulatory creep and overlapping regulatory jurisdictions between financial and energy regulators arising from these proposals. We predict that one or more regulator will feel obliged to interfere with the market again at some point in the future to correct a distortion created by the initial fix or to refine its operation. The increased regulatory uncertainty created could hamper the very issue that the regulator is trying to correct – trading companies do not like to participate in managed markets.

In addition, given the impact of imbalance arrangements on incentives to trade and hence on liquidity, Ofgem could make an important contribution by reviewing the current imbalance Cash Out Arrangements to:

- promote more cost reflective prices,
- remove the current asymmetry for some market participants which results from the use of the reverse price.

4 Strengthening licence conditions

4.1 Standards of conduct

There is substantial evidence that the competitive market is driving customer-focused behaviour on the part of suppliers. Indeed, Ofgem's standards of conduct are consistent with the criteria we seek to apply ourselves in our dealings with customers. However, we do not support their formal inclusion in licences, given the inevitable broad scope for interpretation and the legal uncertainty which would result. A better regulation approach is for Ofgem to focus on the provision and awareness of relevant information so customers make informed choices. Should specific issues arise which are not resolved satisfactorily by the competitive process, then it is these which should be translated into licence obligations.

4.2 Domestic Annual Statements and Bills

Ofgem's Proposal 3 is to make sure the Probe remedies are strengthened, and where necessary enforced, so that they achieve their original objectives. However, the only example quoted to cover concerns in the area of clarity and transparency of customer information is SSE's interpretation of the requirement to remind customers in a prominent position of their ability to switch supply.

In assessing the appropriate next steps, we note the following:

i) Annual Statements have only been issued since last July
ii) Ofgem's consumer first research indicated a lack of awareness of the existence and purpose of the statements
iii) Consumer Focus made a number of suggestions for improvements. In our own case, whilst fully compliant with the requirements of the licence, we responded positively to the CF suggestions.

These observations point to a conclusion that formal regulatory intervention is not necessary to improve the accessibility of, and engagement with, the Annual Statements. The evidence is that companies will respond positively to informal Ofgem proposals on formatting. At the same time, there is an important role for Ofgem in empowering consumers by promoting an awareness and understanding on the part of customers of the value of the information on bills and statements as tools to engage with the market. Indeed, there is evidence from Ofgem that building on the existing Annual Statements may be a more proportionate and effective intervention than Ofgem's tariff simplification proposals. At the least, adequate effort should be invested in the existing remedy and adequate time allowed for it to work before it is jettisoned in favour of a new approach.

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4.3 Extending regulation in the non-domestic sector

4.3.1 Unfair contracting

RWE npower supported the introduction of the new measures to protect micro business customers, which to a large extent reflected the processes we operated prior to the change. We consider that the new measures operate to the benefit of those customers.

Ofgem has not brought forward detailed evidence on the need for further unfair contracting regulations and has yet to report on its review of compliance. As indicated in the consultation, when the review is complete Ofgem intends to write to suppliers so that they may address any areas of concern and, if they do not, Ofgem has said it will take further action. It is too early to judge, therefore, whether the strengthening of licence conditions is necessary.

Ofgem has said it wishes to extend SLC 7A beyond micro businesses. However, we do not consider that large or medium size customers require such protections, or that they are indeed practical for them, given the range of contracts and their size. In any case, these customers have the resources to ensure that they pay sufficient attention to their energy needs and contracts; indeed, they tend to enter into negotiations with their energy companies well in advance of contract renewal date.

4.3.2 Objections

The objections procedure is an important provision for both customers and suppliers: it protects suppliers by ensuring that customers honour the contracts they have signed; and protects consumers by ensuring they only transfer when they wish to. Ofgem's continuing investigations into this area will indicate whether it has been operating as intended. Again, at this stage it is premature to say whether additional licence conditions would be appropriate.

4.3.3 Third Party Intermediaries (TPIs)

We agree that Ofgem should look further at the way Third Party Intermediaries (TPIs) operate at the smaller end of the market.

However, we are concerned at the statement that Ofgem is considering new licence conditions that regulate the relationship that suppliers have with third parties. To reiterate the comments npower made in response to Ofgem's most recent Corporate Strategy and Plan, if Ofgem decides that regulation is needed in this area of the market then it should be applied in an efficient and proportionate manner. We do not believe that applying measures vicariously through licence conditions on suppliers would pass these criteria.

Customers should be made aware by TPIs that they may be paying commission charges and there need to be measures in place to guard against mis-selling by TPIs and any sub-brokers. We have previously supported the development of a code of practice, including the requirement that accredited TPIs explain how they receive payment and that they identify which suppliers they deal with. It remains our view that the code must be governed by an independent body such as the OFT, which as you point out already has powers that it could use in this area.

5 Financial reporting

RWE has responded positively to Ofgem's financial reporting initiative. Our Consolidated Segmental Statement for 2009 shows a high degree of transparency. And we have agreed to and complied with all twelve of the proposals for improved consistency for 2010 on which Ofgem has already consulted. We note that the required treatment of BSUOS has changed from the consultation to the final guidance. We consider that the proposal in the consultation was more logical; BSUOS charges are a direct cost linked to energy transacted rather than an indirect cost. We would point out that Ofgem has issued its revised guidance close to the due date for publication of the 2010 financial reports.

We welcome Ofgem's statement that any further refinements will take into account that companies have different business models and are free to employ accounting conventions reflecting the way they operate as well as recognising that providing detailed public information on each company's cost structure could be unhelpful in promoting competition. It is important that these considerations are reflected in the terms of reference for any accountancy review commissioned by Ofgem.

6 Concluding remarks

The government has a one in/one out principle for regulation. Nonetheless, there is an inexorable pressure for regulatory creep. In particular, there has been a growing tendency for repeated revisiting of regulatory issues and regular tweaking of the rules in different areas. We see this as a significant risk for both Ofgem's key market review proposals: retail tariff control and wholesale market obligations. The likely prospects for a degree of stability would be a significant consideration in our assessment of Ofgem's worked up proposals in both these areas. We note that network monopolies at least have the assurance that price control arrangements are stable for several years (historically five) before major revisions are implemented.

We would also hope that Ofgem continues to subscribe to the touchstone of better regulation, namely competition where possible and regulation only where necessary. Where Ofgem makes proposals for additional obligations we would expect that Ofgem would first want to present a compelling evidence base. The argument for these principles to underpin regulatory interventions has never been more powerful, given the investment needs of the UK utility sectors and the influence of regulation on the cost of capital and ultimately consumers.

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Appendix 1 Specific questions relating to Ofgem's tariff simplification proposals

- Will the regulated fixed element be set at a level sufficient to cover all reasonable fixed costs?
- Will the regulated element be changed in a timely way to reflect changed fixed costs especially bearing in mind the advanced notice suppliers are required to give customers?
- Will there be any under/over recovery provisions in the setting of the regulated fixed cost?
- Will Ofgem expect the fixed element to cover some variable costs (e.g. the variable component of network charges) or vice versa?
- Will unit charges be allowed to vary by region to reflect different regional costs?
- Does Ofgem, in fact intend to prescribe a fixed charge, a primary block charge or some other combination?
- Does Ofgem envisage the potential for additional transaction charges to SET customers, e.g. for debt collection, disconnection, meter change, provision of replacement PPM keys and so on.

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