

## CMA Energy Market Investigation

### Initial Submission and Response to the Issues Statement

#### 1 Introduction

- 1.1 This is the combined response of First Utility Limited (**First Utility**) to the request for initial submissions and to the statement of issues published by the Competition and Markets Authority (**CMA**) on 24 July 2014 (the **Issues Statement**).
- 1.2 Established in 2008, First Utility supplies gas and electricity to domestic households. It is one of the fastest growing independent energy suppliers in the country. From installation of its first domestic meter in 2008, First Utility has grown to around 500,000 customers or just under 1 million accounts (gas and electricity) in August 2014. This growth is despite, as explained further below, the significant barriers to expansion faced by independent energy suppliers in markets in Great Britain (**GB**).
- 1.3 First Utility welcomes the current CMA investigation and feels that there are a number of concerns relating to the functioning of competition in wholesale and retail energy markets in GB which may benefit from this investigation, and that several of these concerns may constitute market features leading to adverse effects on competition (**AECs**). First Utility considers that features of the market, particularly around lack of liquidity in wholesale markets and vertical integration, are causing real harm to GB energy consumers. As it has previously outlined in submissions to Ofgem (notably in relation to the consultation leading to this investigation),<sup>1</sup> First Utility's concerns include:
- the lack of liquidity along the forward curve in the wholesale electricity market,<sup>2</sup> which leads to high and uncertain transaction and hedging costs for independent suppliers and acts as a barrier to entry and expansion. Lack of liquidity also discourages retail competition as the Big Six vertically-integrated suppliers<sup>3</sup> rely on their own generation for the majority of their retail supply and have little incentive to increase their exposure to trading in wholesale markets;
  - market conditions which have developed to a point where they may encourage tacit coordination at the retail level of the GB electricity market between the Big Six suppliers; and
  - the tendency for regulatory intervention in the energy markets (which in principle is recognised by First Utility as being necessary and is indeed supported where it is

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<sup>1</sup> See <https://www.ofgem.gov.uk/ofgem-publications/88412/first-utilityresponse.pdf>

<sup>2</sup> By "along the forward curve", First Utility is referring to electricity trades transacted in the wholesale market at an agreed price today but where the electricity is not delivered until a number of months or years into the future.

<sup>3</sup> When the electricity supply companies were privatised in 1990, customer accounts with the former publicly-owned suppliers were transferred to certain companies – the Regional Electricity Companies (RECs) – who as a result of merger and acquisition activity, became customers of Centrica, E.ON, EDF, RWE nPower, Scottish Power, and SSE – known as, and referred to in this response as the "Big Six".

appropriate and proportionate) to focus on specific concerns often without fully considering the potential effects on different types of market participant,<sup>4</sup> some of whom are disproportionately affected. First Utility considers that the opportunity to consider holistically and in terms of impact on consumers the current complex of overlapping, inconsistent and disproportionate policy and regulatory changes is important in order to assess the uncertainty and cost which currently forms a barrier to entry and expansion that would otherwise drive competition in GB energy markets.

- 1.4 First Utility also considers that there is a lack of innovation in technologies, in service offerings and in business models that is due in large part to the current market structure, including the lack of liquidity and the weight of numerous regulatory and market interventions that have had and continue to have a disproportionate effect on independent suppliers and more generally.
- 1.5 First Utility remains available to assist the CMA with its investigation.

## 2 The CMA's theories of harm

- 2.1 The Issues Statement sets out four theories of harm, which include various hypotheses in respect of theories of harm 1 and 4. First Utility recognises the concerns identified by the CMA and also that there are overlapping elements in these various theories – these are explained further below. First Utility is of the view that many of the market features identified in the theories of harm may constitute AECs, and welcomes the opportunity this investigation offers fully to explore these issues.<sup>5</sup>
- 2.2 In particular, the impact of vertical integration on wholesale and retail competition (notably in electricity supply) appears to be a common feature of the various theories of harm. Indeed, the joint findings published in the State of the Market Assessment Report by Ofgem, the OFT and the CMA on 27 March 2014 (the **State of the Market Assessment**) found that vertical integration was a feature that contributed to delivering poor market outcomes that “*has costs in terms of reduced competition in energy markets*” – “[l]ow levels of liquidity in the wholesale electricity markets, particularly for certain types of product at particular times, act as a barrier to entry for non-integrated suppliers. They also act as a barrier to expansion for those non-integrated suppliers already in the market.”<sup>6</sup> Further, the State of the Market Assessment’s conclusion on “*the costs to retail competition in terms of the barriers to entry and expansion resulting from vertical integration*” was that they may be “*significant – particularly in a market where competition is already weak*”.<sup>7</sup>

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<sup>4</sup> Such as vertically integrated incumbent energy providers, independent suppliers, independent generators and market intermediaries.

<sup>5</sup> See First Utility’s 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, dated 23 May 2014 (**First Utility’s MIR consultation response**).

<sup>6</sup> The State of the Market Assessment also goes on to conclude that “[a] lack of liquidity in the market for longer-term contracts may also inhibit the ability of independent generators to secure finance for new investment, or raise their cost of capital.” (State of the Market Assessment, paragraph 1.38).

<sup>7</sup> State of the Market Assessment, paragraph 1.39. First Utility also notes the letter to the CMA of 7 August 2014 from five former energy regulators, and the comment that the fact GB electricity B2B markets appear to function more effectively than B2C markets suggests there is no competition concern at the wholesale level of the market (paragraph 7). First Utility notes that B2B customers have more buyer power and have been more successful in engaging with

- 2.3 First Utility agrees with the CMA's view that the GB wholesale gas market can be differentiated from the wholesale electricity market and does not possess the same potentially harmful market features.<sup>8</sup> However, First Utility believes that reduced competition in electricity retail markets may lead to a dampening of competition in gas retail markets, in particular given the growth of dual-fuel tariffs with domestic consumers, and believes that the CMA should remain mindful of this. That said, this submission focuses primarily on GB electricity markets where First Utility believes the CMA should focus its attention.

***Theory of harm 1: Opaque prices and low levels of liquidity in wholesale electricity markets create barriers to entry in retail and generation, perverse incentives for generators and/or other inefficiencies in market functioning***

- 2.4 First Utility fully agrees with this theory of harm and very much welcomes the CMA's proposed in-depth investigation of the wholesale electricity market. In First Utility's view, the most fundamental barrier to competitiveness in electricity retail markets in Great Britain is the ability of the Big Six integrated energy companies to better control – and effectively limit - the level of longer-term liquidity in electricity wholesale markets. First Utility recognises that wholesale electricity markets are complex and attempts to explain the nature of its concerns further below.

**Ability of suppliers to source electricity products**

- 2.5 Wholesale markets serve a critical function in allowing retail suppliers to purchase volumes of forward contracted electricity to serve the forecast demand of their retail customers into the future. This hedging activity works to reduce volume and price risks for suppliers. All suppliers face the challenge that they must at the point of delivery have matched their electricity purchases with the exact demand of their customers on a half-hourly basis. In order to do this, they purchase and trade (or self-supply) packages of electricity products that exactly replicate the "shaped" half hourly demand profile of their customers.<sup>9</sup> Suppliers must purchase various shaped supply products to achieve this.
- 2.6 There are essentially three stages to electricity trading:<sup>10</sup>
- (a) along the forward curve over-the-counter (**OTC**) trades, which occur on a bilateral basis between generators and electricity retailers (and/or market intermediaries);

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suppliers in order to secure competitive outcomes from the Big Six suppliers in particular. This does not mean that the wholesale market is functioning effectively – simply that those suppliers least damaged by the AECs of the wholesale market are more incentivised to compete in relation to supply in B2B contexts than in the B2C market.

<sup>8</sup> Issues Statement, paragraph 62.

<sup>9</sup> "Shaped" products are contracts which specify bespoke volume and time periods to reflect different consumer/industry demand levels both within day and within week. Thus, a bespoke "shaped product" with half-hour granularity could provide for different volumes in respect of different half-hour periods.

<sup>10</sup> Wholesale electricity can be bought short-term (day-ahead and intraday) and on a forward timeframe and this can be done either on power exchanges, or over-the-counter (**OTC**) from a counterparty (i.e. a generator or intermediary). In GB, the bulk of electricity, notably along the forward curve, is purchased on an OTC basis, including "prompt" trades (i.e. products of 4 weeks to 4 hours before delivery) and "spot" trades (i.e. products for 4 hours to half an hour before delivery). Power exchanges offer standardised blocks of electricity which are not ideally suited for the bespoke "shaping" that suppliers need to meet their customers' precise demand levels.

- (b) short-term “spot” market trades, allowing for smaller adjustments between forecast supply and demand nearer to the date of delivery. While some of these trades occur OTC, much day-ahead trading occurs on power exchanges;<sup>11</sup> and
  - (c) balancing, which is governed by the Balancing and Settlement Code (**BSC**)<sup>12</sup> (administered by Elexon), and which provides for the final adjustments of supply and demand after wholesale trading for each half-hourly settlement period has finished, at the point of delivery. Under the BSC, any “long” positions (contracted volumes in excess of metered demand) in balancing are deemed to have been sold back to the grid at the System Sell Price (**SSP**), while any “short” positions (shortfall between contracted volumes and metered demand) are deemed to have been bought from the grid at the System Buy Price (**SBP**). This dual-priced “cash-out” mechanism is very punitive, with the SBP being typically far higher than market prices and the SSP being typically far lower than market prices. This was intended to build an economic incentive into the system to encourage market participants to balance their positions; however, it works as a key structural design feature that drives vertical integration.
- 2.7 It is critical for suppliers to be able to source shaped electricity products broadly matching their forecast demand at delivery in order to minimise imbalance volumes exposed to the punitive “cash out” mechanism in the balancing phase of trading.
- 2.8 Currently, the Big Six integrated suppliers are able to source forward “shaped products” from their own generation portfolios with relative ease at their own choice of timing these internal purchases. Non-integrated suppliers are dependent upon the wholesale electricity market to ensure that they can source their electricity requirements. The ability of the Big Six to self-supply the bulk of their demand provides them with a natural hedge, and minimises their exposure to traded markets.<sup>13</sup> Moreover, independent retailers must rely on the products available in wholesale markets, which provides inefficiencies which can be avoided by vertically integrated suppliers as the indicative illustration below demonstrates.

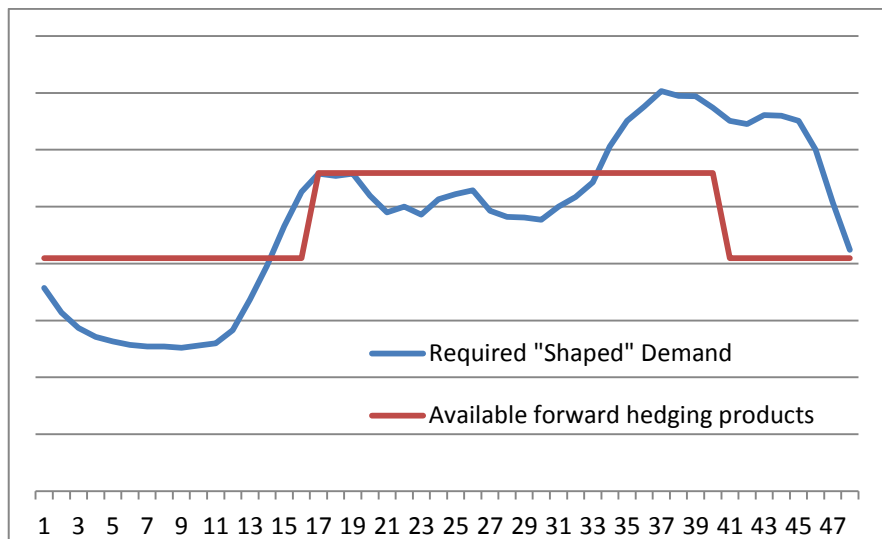
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<sup>11</sup> There are currently two power exchanges operating in the GB electricity market: APX (<http://www.apxgroup.com/>) and N2EX (<https://www.n2ex.com/>).

<sup>12</sup> See <https://www.ofgem.gov.uk/licences-codes-and-standards/codes/electricity-codes/balancing-and-settlement-code-bsc>.

<sup>13</sup> The ability to self-supply means Big Six can turn to their own generation portfolio to offset the impact of demand/price fluctuation in wholesale markets, while non-integrated suppliers must enter forward so-called hedging arrangements to protect themselves against the impact of such wholesale market volatility.

**Indicative differences in available products and domestic “shaped” demand**



*The blue line shows the half-hourly volume requirements for a typical domestic customer in each half hour of the day, while the red line indicates the hedge possible using forward products available on the wholesale market. “Shaped” products are only available close to delivery, leaving suppliers exposed to price risks on the volume mismatches unless they gain access to the bespoke products available to vertically integrated suppliers as a result of them owning flexible generation assets.*

2.9 While First Utility recognises that the Big Six energy suppliers cannot supply their entire retail demand from their generation assets, their ability to supply the bulk of their demand – particularly at times when there are unexpected changes in demand and price – skews competition in downstream markets. Such market players’ need to trade is limited to small adjustment trades around the edges of their portfolio with any further trading based more on the desire to trade than a need to hedge. This contrasts with non-integrated suppliers for whom hedging to reduce uncertainty about future wholesale costs in order to secure steady gross margins is vital.<sup>14</sup>

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<sup>14</sup> First Utility notes that shaped products are particularly illiquid in the forward market, which increases hedging risks and costs for new entrants, thereby: acting as a barrier to entry and expansion for new entrants; reducing transparency on retail costs for consumers; and preventing the establishment of price signals for potential investors in flexible generation.

## Measuring liquidity

- 2.10 As Ofgem recognised, liquidity is a “*key performance indicator for the wholesale electricity market*.”<sup>15</sup> Specifically, liquidity – i.e. the ability to buy and sell electricity at the wholesale level without major price fluctuations or transaction costs for purchasers – is particularly critical to the business model of non-vertically integrated electricity suppliers who cannot rely on self-supply from their own generation capacity as the Big Six suppliers do for much of their retail demand.<sup>16</sup> Liquidity relies on “*the presence of a large number of buyers and sellers willing to transact at all times*”,<sup>17</sup> and the relatively low levels of trade by the Big Six, who account for the vast majority of both generation supply and retail demand, stymies competition.<sup>18</sup> When considering liquidity, it is important that the CMA takes account of the longer-term, forward curve liquidity that is required to address competition concerns and not the higher volumes of short-term trading to delivery.
- 2.11 Liquidity of the energy market can be measured by reference to its “churn rate”.<sup>19</sup> Liquidity in the GB electricity market is much lower than in the GB gas market, which has a churn ratio typically in the range of 12-20<sup>20</sup> and is generally considered much more liquid. The GB gas market is a hub where around 60-70 per cent of all EU trading takes place<sup>21</sup> and as such has a large number of market participants who are regularly active on a daily basis.<sup>22</sup>
- 2.12 By contrast, liquidity in the GB electricity market is much lower and is also below its equivalent in a number of other European countries: for example, in 2013 the GB churn rate was 3, while Germany’s rate was 7.<sup>23</sup> First Utility believes that Germany’s higher churn rate is linked to the fact that retail businesses in Germany are far less vertically integrated than in GB. Markets with low liquidity are characterised by having poor “price discovery”,<sup>24</sup> high “bid-offer spreads”,<sup>25</sup> larger “clip size”,<sup>26</sup> high volatility and are at high risk of price manipulation by energy companies with large market shares. All these features exacerbate the problems for suppliers in meeting

<sup>15</sup> See <https://www.ofgem.gov.uk/electricity/wholesale-market/liquidity>

<sup>16</sup> See, for example, the Fourth Report of the Energy and Climate Change Committee of the UK Parliament on Electricity Market Reform, 16 May 2011, paragraphs 65 and 67, available at:

<http://www.publications.parliament.uk/pa/cm201012/cmselect/cmenergy/742/74207.htm#a14> (Parliamentary report).

<sup>17</sup> See <https://www.ofgem.gov.uk/electricity/wholesale-market/liquidity>.

<sup>18</sup> See, for example, Consumer Focus presentation on ‘*Liquidity in European Wholesale Electricity Markets*’, dated 5 March 2010, page 19, available at <http://www.consumerfocus.org.uk/files/2010/12/Liquidity-in-European-wholesale-electricity-markets-Cem-Suleyman-Consumer-Focus.pdf>.

<sup>19</sup> The “churn rate” represents the ratio between the total volume of trades and the physical volume of a commodity consumed.

<sup>20</sup> ICIS Heren, ICE, DUKES (as cited in the State of the Market Assessment, paragraph 5.27).

<sup>21</sup> European Commission Quarterly Report on European Gas Markets, Market Observatory for Energy, DG Energy, Volume 6, issue 2, Second quarter 2013, page 9.

<sup>22</sup> First Utility notes that nPower, in its Initial Submission (paragraph 3.7), suggests that “*wholesale gas markets do not exhibit potentially harmful features*” and then links this to liquidity in electricity markets, highlighting the “*high degree of interaction in hedging activity*” meaning the “*levels of liquidity are best considered for the two markets together*”. First Utility fundamentally disagrees with this approach. There are a number of critical differences between gas and electricity wholesale markets, most notably that gas can be stored and so there is no need to balance supply and demand as there is for electricity.

<sup>23</sup> State of the Market Assessment, paragraph 5.27.

<sup>24</sup> “Price discovery” is the process to determine spot prices. These prices are dependent upon market conditions affecting supply and demand.

<sup>25</sup> “Bid offer spreads” are the difference between the bid price and the offer price.

<sup>26</sup> “Clip size” is the minimum increment of volume of a particular product that can be traded on the wholesale market. Typically, seasonal baseload contracts trade in 10MW “clips” (so 10MWh of electricity are delivered in each hour of the entire seasonal contract). In the short term, markets such as the N2EX parties can trade each hour of the day ahead in 0.1 MWh “clips”.

forecast demand and mitigating the risk of finding themselves exposed to punitive imbalance positions. Reduced liquidity in GB is directly correlated to the ability of the Big Six to self-supply and minimise their exposure to trading markets, while at the same time depriving independent suppliers of the forward curve liquidity levels that they require to compete efficiently.

### Importance of hedging

- 2.13 As set out above, electricity cannot be stored and electricity supplied over the grid has to balance demand at all times. Any supplier that is out of balance will be exposed to the punitive dual cash-out prices, which can deviate significantly from wholesale prices immediately prior to trading ending for each half hour of delivery.<sup>27</sup> This means that suppliers need to accurately predict their customers' demand at all times in order to minimise volumes of electricity purchased or sold via cash-out, which can be difficult for smaller suppliers. Suppliers need access to a range of products over the near term and longer term in order to refine their supply position as each day moves closer to delivery to ensure it balances. This is more straightforward for vertically integrated suppliers who can rely on internal flexible generation to help them balance, but presents significant risks for non-integrated suppliers whose retail margin may be affected by any adverse movement in wholesale costs due to imbalance.
- 2.14 To manage this risk in order to offer fair and stable prices to consumers, suppliers hedge their position by buying electricity from counterparties on forward markets up to two or three years ahead.
- 2.15 Low liquidity of forward products can thus increase the exposure of small suppliers to adverse movements in wholesale prices and increase the costs of hedging. Taking on such risk exposure depends greatly on non-integrated suppliers' individual risk appetites but constitutes a real factor discouraging entry and expansion.<sup>28</sup>
- 2.16 First Utility has long been campaigning for a significant intervention in the wholesale market to drive the step change in liquidity which, First Utility believes, is needed to deliver vigorous wholesale competition.<sup>29</sup> First Utility believes that a liquid wholesale market will enable new entry and expansion both upstream and downstream, and will in turn drive competition along the entire energy supply chain. First Utility considers that it is only when the structural issues at a wholesale level are addressed that the benefits of vigorous competition can become available for all retail consumers. Indeed, any price reductions on the wholesale market resulting from

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<sup>27</sup> First Utility has experienced SBPs in excess of £1000/MWh, while the SSP rarely falls below £0/MWh for long participants. This incentivises market participants to hold a long position resulting in inefficient system imbalancing.

<sup>28</sup> Specifically in First Utility's case, its recent growth was supported by a new strategic partnership with Shell, announced in December 2013. First Utility now purchases all its electricity and gas through Shell – this arrangement provides First Utility with access to wholesale market forward traded products to support the vitally important hedging activity that manages volume and price risks to gross margin in order to build a sustainable business that can compete with the incumbents in the retail market.

<sup>29</sup> See, for example, First Utility's MIR consultation response and see <http://www.first-utility.com/the-utility-room/campaigning-for-change/energy-market-investigation>.

increased competition at that level should lead to price reductions on the retail market as downstream competition provides the incentive for cost savings to be passed to consumers.<sup>30</sup>

### Opacity of prices

- 2.17 The majority of wholesale electricity is purchased OTC on a bilateral basis with sellers and purchasers reaching the terms of arrangements for trading of electricity through negotiation.<sup>31</sup> While power exchanges and wholesale market indices serve as reference prices for off-exchange bilateral negotiations, they do not provide transparency as to longer-term bespoke wholesale product pricing which is essential to an effective wholesale market. The Big Six benefit from this opacity given their position as generators gives them insights into forward curve pricing.
- 2.18 If generators were required to make all generated electricity available for trade through broker platforms and exchanges, this would increase market transparency and competition to the benefit of downstream market participants and consumers. Preventing integrated suppliers from taking advantage of their natural upstream generation via “internal trades” would significantly increase their sales, and purchases, on the wholesale market and force them to engage with other players in the forward market in order to hedge their generation and retail businesses. Moreover, this would remove the opacity concerning the prices that vertically integrated suppliers are able to pay for their own upstream generation and lead to the forward trading of a broader range of shaped products to the benefit of all market participants.
- 2.19 The lack of reliable price “signals” in the opaque forward wholesale market currently reduces the ability of independent suppliers and generators to secure financing for new projects and expansion, as projecting future earnings of new/expanded businesses is correspondingly more challenging.
- 2.20 The opacity of wholesale prices has an adverse impact on consumers and the confidence they have as to the fairness – or otherwise – of their domestic tariffs. The need to address potential volatility and the other risks and costs of trading and balancing when designing new tariffs could add to the perception that retail prices are not cost reflective or at least, not sufficiently responsive to changes in wholesale market price changes and in particular, reductions in those prices. More generally, detailed regulatory rule changes at wholesale or code level may have significant impacts on the ability of suppliers to offer fair and stable retail pricing, increasing any risk premium that needs to be included in such pricing. This speaks to the need for a holistic assessment of proposed regulatory rule changes, fully taking into account at all times the impact on consumers.

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<sup>30</sup> 66 per cent of the increases in retail gas bills, and 54 per cent of the increases in retail electricity bills, between February 2004 and January 2011, were attributable to increases in wholesale prices: see Paul Bolton, UK House of Commons Standard Note SN/SG/4153, 31 January 2014, available at <http://www.parliament.uk/business/publications/research/briefing-papers/SN04153/energy-prices>.

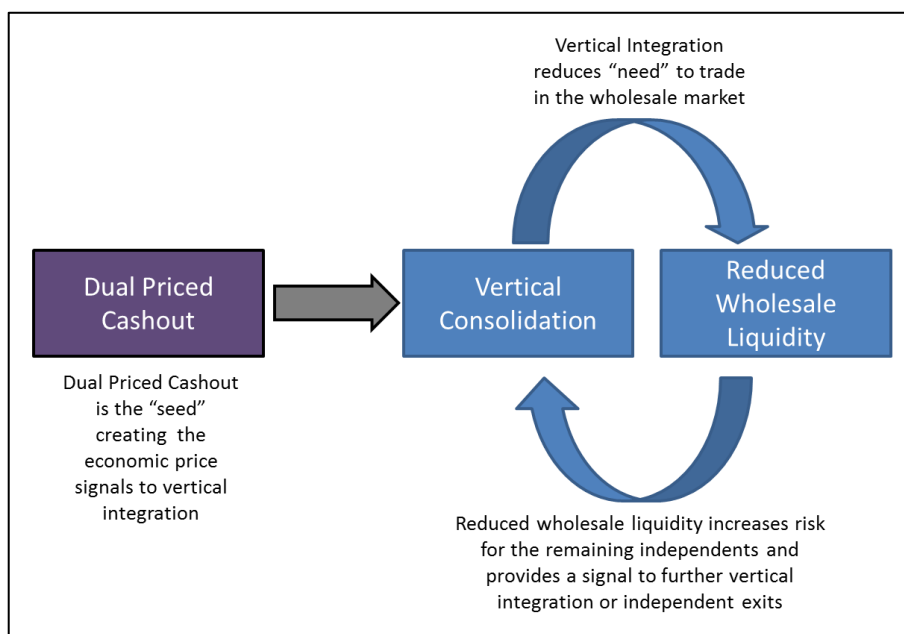
<sup>31</sup> As explained in Ofgem’s Initial Submission to the Competition and Markets Authority, 21 July 2014 (**Ofgem’s Initial Submission**).



**Vertical integration and low liquidity**

2.21 The CMA proposes two hypotheses in relation to theory of harm 1 – either that opaque prices and lack of market liquidity at the wholesale level are driven by market rules, or by vertical integration in itself. First Utility believes that low liquidity is a result primarily of vertical integration, which was a reaction to and is now reinforced by market rules such that now, market rules intended to address this concern may in fact have exacerbated it – and that therefore both hypotheses may reflect AECs in the form of a “vicious circle”, whereby low liquidity and vertical integration are reinforced by one another, as suppliers are incentivised to avoid as far as possible the need for balancing under the current dual priced cash out mechanism.

**Vicious circle of illiquid wholesale electricity market**



2.22 As shown in the diagram above, low liquidity is the natural consequence of a market structure with the Big Six integrated participants owning between them around 70 per cent of generation capacity<sup>32</sup> and around 95% of the GB domestic market<sup>33</sup> – this market structure largely protects the Big Six from the need to participate as active traders at the wholesale level,<sup>34</sup> and at the same time distorts the pricing and availability of a variety of electricity products at the wholesale level for other market participants.<sup>35</sup>

2.23 First Utility considers that current and forthcoming energy market rules do not fully address the issues arising from the low levels of market liquidity in wholesale markets. For instance, integrated energy suppliers must transact any internal transfers at prices which reflect the

<sup>32</sup> State of the Market Assessment, paragraph 5.58  
<sup>33</sup> <https://www.gov.uk/government/speeches/competition-in-the-energy-markets>  
<sup>34</sup> State of the Market Assessment, paragraphs 5.70 and 5.80-5.86  
<sup>35</sup> State of the Market Assessment, paragraphs 5.75-5.79

wholesale market price. First Utility believes that these internal transfer prices do not appropriately reflect underlying costs and actual supply and demand conditions facing the GB energy market. These opaque internal transfer prices, therefore, do not provide reliable guidance for non-integrated suppliers with regard to setting their fixed-price tariffs and locking in margins; they are merely at a level that chooses how the overall margin is shared across the generation, trading and retail arms of the integrated energy companies. These poor quality price signals, as the CMA recognises in its Issues Statement,<sup>36</sup> are likely to create barriers to entry and expansion for independent suppliers by increasing this risk and therefore costs.

2.24 There are several other current and proposed regulatory interventions in wholesale and in retail, markets which First Utility believes should also be examined by the CMA to ascertain whether they give rise to AECs, including:

- (a) Ofgem's recent Secure & Promote (**S&P**) licence obligations, which are intended to drive liquidity in wholesale markets, but First Utility does not believe are far-reaching enough to achieve this aim.
- (b) A consequential impact of these changes is that wholesale market price information, in a market that has been adjusted insufficiently to achieve liquidity, will be used to set the reference price for the Contracts for Difference Feed in Tariffs (**CFD FITs**) under Electricity Market Reform (**EMR**), and which could allow gaming by integrated companies to the detriment of smaller suppliers and ultimately retail consumers.<sup>37</sup>
- (c) In addition, a number of retail reforms could usefully be considered as part of a holistic assessment of the current regulatory regime and the inter-dependent impact of such changes across the supply chain. The current Retail Market Reforms (**RMR**), which are leading to the sale of predominantly fixed-price fixed-term tariffs, while wholesale costs and other significant industry costs are variable. This may prejudice those providers who cannot provide certainty over those costs, in particular network costs which vary over fixed retail tariff periods and constitute approximately 20 per cent of total input costs, and CFD FITs costs which will grow over the next few years to become a very significant percentage of overall costs.
- (d) Various social and environmental interventions, for example those measures intended to support renewable generation may also act to distort competition by imposing additional costs on suppliers, which are then of necessity passed on to customers. This would also cover the set-up and implementation costs of the complex delivery programmes for the various generation support schemes and for other extensive programmes, such as smart metering. We note that the CMA does not propose to consider all these measures comprehensively, focusing on those measures considered to have a direct impact on

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<sup>36</sup> See paragraph 32.

<sup>37</sup> The new costs of fully variable CfD FIT Supplier Obligations will also be both significant and unpredictable over coming years, with smaller suppliers more exposed in terms of the adjustments they will need to make to protect themselves against volatility in this respect.

competition.<sup>38</sup> First Utility considers that this may require considering all such interventions in the first instance, taking account of the downstream impact on consumers.

***Theory of harm 2: Vertically integrated electricity companies harm the competitive position of non-integrated firms to the detriment of customers, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies***

- 2.25 First Utility considers that there is a strong link between theory of harm 2 and theory of harm 1. The existence of six large vertically integrated energy companies owning between them about 70 per cent of the generation assets<sup>39</sup> and 95 per cent of the domestic supply base<sup>40</sup> leads to low levels of market liquidity in wholesale markets, which in turn increases the costs of non-integrated energy suppliers in wholesale markets (both in terms of the actual prices paid, but also the availability of “shaped” products as they seek to hedge their exposure to future market volatility). Non-integrated suppliers consequently have to absorb these higher costs in their retail pricing to the detriment of consumers.
- 2.26 In contrast, vertically integrated suppliers benefit from their positions by reducing their exposure to trading and wholesale market volatility. While this would be expected to lead to efficiencies for these operators, and lower pricing in retail markets, in reality their retail pricing is generally not competitive with that of non-integrated suppliers.<sup>41</sup> For example, First Utility, along with other independent suppliers, has been consistently offering lower priced fixed price tariffs during 2014, with little sign of the integrated suppliers seeking to compete. It is First Utility’s view that, to the extent any efficiencies arise from the vertical integration of the Big Six, these efficiencies are not being passed on to GB consumers. The reasons for this are two-fold: (i) the “vicious circle” of illiquid wholesale markets and vertical integration mean the Big Six have reduced incentives to try and grow market share in retail markets as this will correspondingly increase their exposure to wholesale trading markets; and (ii) as considered below in relation to theory of harm 4, market conditions may have consequently evolved to a point which encourages tacit collusion at the retail level.

***Theory of harm 3: Market power in electricity generation leads to higher prices***

- 2.27 First Utility sees a strong link between theory of harm 3 and theory of harm 2, in so far as it is the vertical integration of generators which is likely to lead to the most pronounced AEC in respect of electricity generation. The relative concentration in GB generation *absent* vertical

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<sup>38</sup> Issues Statement, paragraph 59.

<sup>39</sup> State of the Market Assessment, paragraph 5.58,

<sup>40</sup> <https://www.gov.uk/government/speeches/competition-in-the-energy-markets>

<sup>41</sup> For example, according to uswitch.com, the top five best buy plans paying by monthly direct debit as at 23 July 2014 were offered by Cooperative Energy, First Utility, Extra Energy, Green Star Energy and Flow Energy (see, Amy Andrew, ‘Energy bills: Could you cut your bills by switching and where are the best deals?’, 23 July 2014, 1127, <http://www.thisismoney.co.uk/money/bills/article-1607475/Energy-bills-As-prices-rise-winter-really-worth-switching-best-fixed-rate-deals.html>). Similarly, a recent Which? survey of customer satisfaction (of which value for money was key component) for 17 energy companies ranked the Big Six at the bottom (see ‘Energy companies rated - Which? satisfaction survey 2014 results’, <http://www.which.co.uk/switch/energy-suppliers/energy-companies-rated>).

integration would be far less likely to lead to any AEC given that this would force generators to participate more actively in trading markets where supply and demand would ensure competition remained vibrant.

- 2.28 First Utility therefore believes that the CMA should explore the conditions in GB generation markets further – notably with regard to vertically integrated generators (who collectively account for the vast majority of GB supply).<sup>42</sup>
- 2.29 In particular, the extent to which the efficiencies offered from vertical integration do not lead to more competitive downstream behaviour by the Big Six may be consistent with the CMA’s suggestion of possible coordinated behaviour by the Big Six at the retail level. This is particularly pertinent in the context of transparency of wholesale costs and the ability to ensure competitive prices in the downstream retail market. Thus, First Utility very much welcomes the CMA’s decision to investigate this further.

***Theory of harm 4: Energy suppliers face weak incentives to compete on price and non-price factors in retail markets, due in particular to inactive customers, supplier behaviour and regulatory interventions.***

- 2.30 First Utility supports this theory of harm and would not only encourage the CMA to investigate the current state of the energy retail markets, but would also welcome a review of the impact of the retail market regulatory reforms<sup>43</sup> to ensure that innovation in tariff setting is maintained and that any proposed reform measures do not run counter to the overall policy objective of reducing consumer bills.
- 2.31 Fundamentally, First Utility believes that, whilst reforms of the energy retail markets were needed to deal with the most pressing concerns promptly, the root cause of the lack of vigorous competition in the retail electricity markets is a lack of vigorous competition in the wholesale electricity market as set out above. Addressing the lack of liquidity in the wholesale electricity market is therefore, in First Utility’s view, the most enduring way of addressing the concerns in relation to the retail markets.<sup>44</sup>
- 2.32 As First Utility has previously submitted to Ofgem,<sup>45</sup> it has three main concerns in relation to the energy retail market: (i) consumers who have never engaged in the market; (ii) deep discounting by the Big Six integrated energy suppliers; and (iii) tariff innovation. These three

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<sup>42</sup> Indeed, the UK Department of Energy and Climate Change has recently commented on the concentration within the wholesale market in the context of the potential for criminal behaviour: “[t]here is a strong case for considering criminal sanctions to support the enforcement of [the EU regulation on wholesale energy market integrity and transparency]. The wholesale energy markets are opaque at times as they are operated by small numbers of highly skilled organisations and individuals using sometimes very technical financial instruments and agreements.” See Department of Energy and Climate Change Consultation Document (URN 14D/277), “Strengthening the regulation of wholesale energy markets through new criminal offences”, 6 August 2014, paragraph 2.1:

[https://www.gov.uk/government/uploads/system/uploads/attachment\\_data/file/341293/remit\\_criminal\\_sanctions\\_consultation\\_final.pdf](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/341293/remit_criminal_sanctions_consultation_final.pdf)

<sup>43</sup> See <https://www.ofgem.gov.uk/gas/retail-market/market-review-and-reform/retail-market-review>.

<sup>44</sup> As above, First Utility does not have the same concerns in relation to gas wholesale markets, but is mindful that reduced competition in electricity retail markets may lead to a dampening of competition in gas retail markets given the growth of dual-fuel packages which now account for the majority of consumer accounts.

<sup>45</sup> See First Utility’s MIR consultation response, page 4.

concerns can be seen to align broadly with the three hypotheses proposed by the CMA in relation to this theory of harm, as set out further below.

*Hypothesis 4a: Inactive consumers reduce the incentives of energy suppliers to compete*

- 2.33 Whilst there have been some recent increases in consumer switching, the number of people switching energy provider over the last 12 months is still over 27 per cent less than for the average for 2010.<sup>46</sup> This is despite a Which? survey showing the average annual saving from switching supplier to be £204.<sup>47</sup> On this basis, if a third of GB households were to switch, First Utility estimates that this would result in consumer savings of approximately £1.5 billion.
- 2.34 Ofgem considered that the complexity of tariffs offered by the Big Six energy suppliers in particular, combined with the “hassle factor” of switching and consumer distrust of energy suppliers were all contributing to less than optimal competition.<sup>48</sup> Moreover, the lack of consumer engagement may serve the interests of incumbent suppliers, with passive “sticky” customers likely to pay the highest margin tariffs.
- 2.35 First Utility considers that it is vital to address these low levels of consumer engagement and a move from 5 weeks switching to “one-day switching”, which First Utility championed via its “Fix the Switch” campaign,<sup>49</sup> is an essential part of this. Faster switching times may also increase consumer trust in the sector, as the balance of power can start to shift to the consumer. Increased consumer switching is likely to drive the necessary improvements in service and innovation as energy suppliers will increasingly need to compete to gain and, indeed, retain customers.
- 2.36 First Utility welcomes the CMA’s proposals to explore whether different consumer groups are particularly vulnerable in this respect, and also believes (as suggested by Ofgem) that there is a link between consumer disengagement and the complexity of the options available to consumers, as well as a sense in some consumers (contrary to the evidence) that switching will not make a lasting difference to their energy bills.<sup>50</sup> These two factors are linked to the second and third hypotheses proposed by the CMA.

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<sup>46</sup> See <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics> this compares the period April 2013 to March 2014 and that for the whole of 2010.

<sup>47</sup> See <http://www.which.co.uk/switch/faqs> which states the estimated £204 annual saving “is the average estimated annual saving for customers who applied to switch suppliers through Which? Switch between 1 January 2014 and 31 March 2014.”

<sup>48</sup> State of the Market Assessment, paragraphs 3.25-3.26.

<sup>49</sup> First Utility has been an active campaigner for change within the energy industry to achieve overall customer benefits. In September 2013, the company launched its ‘Fix the Switch’ campaign which called for the industry to look at how the switching process could be sped up to make it easier for consumers to switch. Ofgem has since approved plans that will see the switch time reduce from five weeks to 3 days (after two week’s cooling off). First Utility looks to always pass on cost savings to its customers. See <http://www.fightthepower.uk.com/>. This campaign contributed to a mandated reduction of switching time to three days. See <http://www.first-utility.com/fix-the-switch-success>.

<sup>50</sup> As identified in the State of the Market Assessment (paragraph 3.26).

*Hypothesis 4b: Tacit coordination between energy suppliers reduces their incentives to compete*

- 2.37 A critical theme of this investigation will be exploring why, despite the existence of six leading retail suppliers, competition is not meeting the best interests of consumers. The Issues Statement seeks to explore whether market conditions have developed such that the leading firms may have identified that strategies of less vigorous competition will benefit them in the longer term and thus forgoing the possibility of higher individual profits in the short term. First Utility welcomes the CMA's decision to investigate this.<sup>51</sup>
- 2.38 The Big Six have highlighted in submissions that the existence of six leading suppliers is evidence in itself that there cannot be competition concerns in these markets, and that by comparison with many other markets considered by competition authorities, concentration levels are relatively low.<sup>52</sup> First Utility does not agree with this.
- 2.39 In First Utility's view, the CMA needs to consider carefully whether the features of GB electricity retail markets are in fact conducive to coordinated behaviour which would explain why competition concerns appear to arise notwithstanding the number of leading retail suppliers. In this context:<sup>53</sup>
- (a) The Big Six have the ability to monitor each other's retail pricing behaviour (which is publicly available on their websites) and to monitor their respective customer volumes (and locations). Moreover, Ofgem has suggested a pattern of the Big Six following each other's price announcements, which should be explored further, but would be consistent with coordinated behaviour.<sup>54</sup> These factors suggest there is an ability for the Big Six to formulate and monitor a coordinated strategy.<sup>55</sup>
  - (b) First Utility believes that there is an incentive for the Big Six to adhere to a coordinated strategy, and an ability for these firms to react to, or discipline, any deviation from such strategy – benefitting from the transparency of retail pricing which may facilitate sustained coordinated behaviour. The established legacy customer bases of the Big Six add to this incentive, with each firm having the incentive to protect its existing "sticky" customer base, rather than competing aggressively for each other's customers by driving down tariffs through competition.<sup>56</sup>

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<sup>51</sup> As noted above, similar concerns have not been identified in relation to retail electricity supply to businesses, suggesting the buyer power of businesses is sufficient to destabilise any tacit coordination.

<sup>52</sup> For example, nPower notes in its Initial Submission (paragraph 3.5) that the CMA's Merger Assessment Guidelines provide that the CMA is not typically concerned where the number of firms in the market reduces from five to four (or above).

<sup>53</sup> See *CMA Guidelines for market investigations*, paragraph 250. While First Utility believes the CMA may not find evidence of "perfect coordination" (as referred to in the *Guidelines*), the consistency of behaviour of the Big Six and the incentives for them to tacitly coordinate, rather than compete, need to fully explored.

<sup>54</sup> State of the Market Assessment, paragraphs 1.26 to 1.28.

<sup>55</sup> State of the Market Assessment, paragraphs 4.64-4.74.

<sup>56</sup> As identified in the State of the Market Assessment (paragraphs 4.52-4.58) which concluded that switching rates for the Big Six were converging and dropping, as were their retail profit margins, and that "[o]ne interpretation of this is that, unlike small suppliers, the six largest suppliers are not competing as hard as they did in the past to win customers from each other."

(c) It is clear that there are barriers to entry and expansion which insulate the Big Six from challenger suppliers at the retail level.<sup>57</sup> Such challenger firms, including First Utility, are less able to compete at the wholesale level due to the vicious circle of vertical integration and illiquid wholesale markets described above, and do not have the legacy customer bases<sup>58</sup> which support the Big Six's retail positions. The relative lack of buyer power of individual retail consumers, and the lack of consumer engagement with large scale switching which would force a change in retailer behaviour, further renders coordinated behaviour externally sustainable.

2.40 First Utility believes the CMA will need to focus on the existence of market conditions supporting tacit coordination during the investigation. A common feature of uncompetitive markets is an increased focus by incumbent market players on defending their existing market share rather than on competing vigorously for new market share – something which, as above, is also consistent with tacit coordination. First Utility has historically observed targeted “deep discounting” by the Big Six – that is, offering far lower prices to potential new customers than those offered to their legacy customers on standard tariffs. Indeed, Ofgem has previously intervened to prevent such practices occurring<sup>59</sup> with mixed results. Programmes like RMR have addressed a number of entrenched historic behaviours, such as “dead tariffs”. Other measures may be helpful in order to increase price transparency for consumers. The ability of the Big Six to use targeted deep-discounting as a barrier to entry and expansion by challenger firms, and a “retaliatory” mechanism to discourage competition from rival Big Six firms is an aspect of retail competition which would be consistent with tacit coordination.<sup>60</sup>

*Hypothesis 4c: Regulatory interventions reduce the incentives for energy suppliers to compete*

2.41 The CMA rightly notes the “*prevalence of regulation*” in this market and that suppliers can be exposed to “*a significant degree of regulatory risk, particularly those that undertake large, long-term investments, the costs of which need to be recouped through future revenues*”.<sup>61</sup> First Utility believes that innovation is key to growing and maintaining consumer engagement. However, the balance between the need for regulatory intervention to encourage consumer engagement and transparent behaviour and such interventions stifling innovation and competition has proven challenging in the GB retail market.

2.42 While First Utility is on the whole very supportive of the reforms of the GB retail market, it would encourage the CMA to consider the possible adverse effects on competition in the round, for

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<sup>57</sup> State of the Market Assessment, page 76.

<sup>58</sup> State of the Market Assessment, paragraph 5.41.

<sup>59</sup> For instance, Ofgem's 2008 Energy Supply Probe found that the incumbent energy providers were charging higher prices for their home regions when compared to regions in which they were newly entering the market. In response to this Ofgem introduced Standard License Condition 25A which prevented price discrimination without objective justification. (See Ofgem Consultation on the Undue Discrimination Prohibition Standard Licence Condition, dated 24 February 2012, available at <https://www.ofgem.gov.uk/ofgem-publications/39642/unduediscriminationconsultation.pdf> ).

<sup>60</sup> The latest analysis First Utility has conducted shows an average 7 per cent discount between the standard and short term fixed tariffs of the Big Six energy suppliers. The question for the CMA is whether these form part of a strategy to deter new entrants and protect the incumbent energy supplier's existing customer base from competition. See First Utility's MIR consultation response, page 6.

<sup>61</sup> Issues Statement, paragraph 16.

example, of limiting the number of allowable tariffs suppliers may offer retail customers.<sup>62</sup> First Utility considers that the RMR reforms, which require that each supplier may only offer four distinct tariffs to customers,<sup>63</sup> are likely to lead eventually to “tariff convergence”, with suppliers offering a broadly similar tariff range, which in turn will restrict consumer choice and differentiation between competitors.<sup>64</sup> This may increase the scope for tacit coordination (as discussed above).

- 2.43 Many other significant new policy changes are being introduced to interact with an existing wholesale market, which is itself not as efficient as it could be. This is a particular risk where market mechanisms rely on reference pricing or other proxies to incentivise and sustain market entry.<sup>65</sup>
- 2.44 One potential regulatory intervention which the CMA could include in its assessment of the market is the potential impact on competition of the introduction of a price freeze. First Utility believes that a blanket freeze on prices would have a huge impact on suppliers’ cost recovery, potentially leading to losses of around £50 per customer over the price freeze period.
- 2.45 It is also highly likely that a price freeze would lead to less competition among suppliers during the freeze period (and possibly in the lead-up) and result in pre-emptive price increases to the detriment of consumers, while stalling switching during the period of the price freeze. Suppliers would need to incorporate a larger risk premium into their prices ahead of the price freeze (taking into account e.g. other regulatory changes and volatility of wholesale costs), as a form of “insurance” against the risk that costs go up more than they expect during the price freeze period given that there would be a regulated maximum return and some costs that are fully variable and hard to forecast.
- 2.46 Such a price freeze would have a disproportionate impact on independent suppliers and new entrants, potentially leading to systemic market failure among independent suppliers from their inability to absorb market volatility without being able to adjust prices at all - a problem which large, incumbent suppliers would be better able to withstand.
- 2.47 First Utility also agrees with the CMA<sup>66</sup> that the incentives arising from the transmission pricing regime should be considered. First Utility would urge the CMA to consider transmission and distribution costs more widely in the same context. Transmission and distribution costs

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<sup>62</sup> Ofgem *Retail Market Review – Implementation of Simpler Tariff Choices and Clearer Information*, 27 August 2013; see paragraph 2.8, available at [https://www.ofgem.gov.uk/sites/default/files/docs/decisions/the\\_retail\\_market\\_review\\_-\\_implementation\\_of\\_simpler\\_tariff\\_choices\\_and\\_clearer\\_information.pdf](https://www.ofgem.gov.uk/sites/default/files/docs/decisions/the_retail_market_review_-_implementation_of_simpler_tariff_choices_and_clearer_information.pdf).

<sup>63</sup> First Utility notes here that applications can be made for additional tariffs to be approved.

<sup>64</sup> Whilst it is technically possible for energy suppliers to request a derogation from Ofgem for an additional tariff, this is not, in First Utility’s view, a practical and/or efficient solution, given the length of time, cost and uncertainty involved in processing such applications. These factors are all likely to undermine any competitive advantage the supplier may have gained through offering an innovate tariff to start with. First Utility would encourage the CMA to consider the unintended consequences of these reforms, particularly in relation to disadvantaged groups, given the withdrawal of social tariffs for certain market segments following the implementation of the Retail Market Reforms.

<sup>65</sup> For example, First Utility believes that the current Energy Market Reforms establishing the Contracts for Difference regime and the Capacity Mechanism, are likely to reduce the importance of the wholesale market price signal for an increasing proportion of electricity generators in GB, as generators will become more focused on achieving the index price under the Contract for Difference rather than achieving the optimum market price when hedging generation plant, while those in receipt of capacity payments will be less exposed to wholesale market price volatility.

<sup>66</sup> Issues Statement, paragraph 65



constitute a key element of domestic consumers' bills as they make up around twenty per cent of the annual dual fuel household bill – and are the second biggest element of electricity bills (after wholesale electricity costs).<sup>67</sup> The variability of network costs, often at very short notice, feeds directly through to increased risks for electricity suppliers which must be factored into pricing, with a consequent adverse impact on consumer tariffs. We feel that the high variability of supplier network costs contrasts the nature of the network assets themselves - which are long term, low volatility, steady income investments.<sup>68</sup>

- 2.48 Other wholesale costs over which suppliers have no control and no ability to hedge should also be considered. These costs include the regulatory overheads (over and above internal and business implementation costs) of specific regulatory delivery projects, such as smart metering, CFD FITs Supplier Obligation and small-scale Feed in Tariffs. The CFD FITs Supplier Obligation for example is to be based on a fixed unit, payable on daily supply volumes, leading to volatility in payment requirements, together with a quarterly reconciliation requirement. This makes managing wholesale costs, requiring in this instance in-year variations in payments challenging in terms of cost recovery in an environment of retail fixed term, fixed tariffs. This will impact all suppliers but First Utility considers the impact to fall disproportionately on independent suppliers.
- 2.49 First Utility considers that these, and other industry costs, could distort competition and that the risk faced by suppliers as a result of industry charging volatility is significant, and falls disproportionately on smaller suppliers who are less able to forecast these costs, or absorb them into their retail offerings.<sup>69</sup>
- 2.50 Inevitably, such unpredictability for suppliers puts an upward pressure on consumer bills.<sup>70</sup> First Utility considers that these and other obligations highlight the regulatory tendency to place all delivery risk or potential risk of failure onto suppliers, with the inevitable consequence of pass through into available tariffs and onto customer bills.
- 2.51 First Utility looks forward to participating in the CMA investigation, which in our view provides an important opportunity to consider all such issues on a holistic basis, taking account of potential impacts at a wholesale and a retail level, and on the different types of supplier business model and their different customer bases.

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<sup>67</sup> According to DECC paper, "*Estimated impacts of energy and climate change policies on energy prices and bills 2012*" network costs are as follows: Gas bill - £124 (18%); Electricity bill - £133 (23%); Energy bill - £257 (20%).

<sup>68</sup> First Utility provided written and oral evidence at the recent Energy and Climate Change Committee (ECCC) hearing on network charging: <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/energy-and-climate-change-committee/network-costs/written/10550.html> and <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/energy-and-climate-change-committee/network-costs/oral/11166.pdf>

<sup>69</sup> This issue is compounded by the fact that, in a predominantly dual fuel market, the regional areas between gas and electricity do not overlap. As a national supplier, First Utility bears 28 network company charge changes (excluding the thousands of independent gas transporters and handful of electricity distribution network owners) each year.

<sup>70</sup> For example, the changes to the Transmission Network Use of System charges (TNUoS) – i.e. the charges paid by companies to transmit power from generating stations across the country – varied hugely between 2011-12 and 2012-13. Non half-hourly (NHH) metered customers pay a p/kWh charge based on usage, depending on which of 14 geographical areas they reside in, i.e. "a NHH zonal tariff". Between 2011-12 and 2012-13 the NHH charges changed between 9 and 66 per cent. Additionally, Distribution Use of System charges – i.e. the charges paid by companies to transmit power from the national transmission network to consumers - varied between 1 and 33 per cent.

14 August 2014

