The co-operative energy

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Energy Market Investigation – Comments on the Statement of Issues

Dear Sir,

Cooperative Energy's mission is to provide consistently competitively priced energy for its customers. When we entered the market in 2011 we introduced a new ethos to customer service and ensured that tariffs and bills were simple and clear - with a focus on improving customer service and experience. Our clear and fair approach was recognized by 'Which' in 2011, and we continue to embed fairness, openness and transparency at the heart of Cooperative Energy.

We welcome the opportunity to respond to the Statement of Issues published by the Competition and Markets Authority (CMA) on June 26, 2014, we have provided comments on which we consider may assist the CMA in its work in respect of its investigation of the GB energy market. This response considers the four "theories of harm" listed by the CMA in its statement of issues as well as comments on other market areas which we think might benefit from its attention.

For the avoidance of doubt we fully support the CMA examination of the theories of harm and the structural market imbalance. We consider the structural market imbalance has stifled competition and led to consumers not engaging actively in the market. We also welcome the CMA's examination of the pace, scope and depth of regulatory change. We believe that excessive regulatory change has disproportionately affected smaller suppliers, and acts as a barrier to market entry and growth.

We have provided further reflections on how the structural imbalance in the market has developed. Also we raise a number of current regulatory concerns that merit examination as they could stifle competition, growth and innovation in the sector.

Theory of Harm 1: Opaque prices and/or 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

We agree that the CMA should investigate this theory of harm and offer the following comments. Our comments focus on:

- Liquidity
- Market structure

Liquidity

It is recognised generally within the industry that liquidity in the wholesale electricity market has diminished by some sixty percent in the last 10-15 years. In early 2001 electricity market liquidity, as measured in terms of "churn" or the amount of times physical electricity volume was traded between counterparties in the form of financial contracts, was estimated as roughly seven times financial to physical. Today, this has fallen to roughly two and a half times financial to physical.

Although there are a number of theories as to the causes of this, we believe that the most likely explanation is a combination of the results of the introduction of the New Electricity Trading Arrangements (NETA) and a greatly increased level of caution around trading credit required between market parties following the high profile bankruptcies of Enron and TXU UK in the early part of the last decade.

The consequence today is that liquidity is at a very low level. The majority of trades are bilateral trades conducted outside of the wider market. To a large extent the vertically integrated companies self-trade exploiting their structural competitive advantage.

Market structure

Prior to the introduction of NETA in March 2001, the electricity market traded under a system known as the "pool". The principles of the pool were relatively simple. Generators set the price paid for electricity in each half hour of any given day and determined which generators would run in each half hour in order to meet forecast demand. National Grid operated the pool and administered settlements on behalf of market participants. The majority of electricity was bought and sold through contracts for difference (CfDs) generally priced against the pool outturn.

While some criticisms were made of the pool in relation to the fact that generators set the price and this potentially created opportunities for gaming, it provided a highly visible reference price as opposed to the current BETTA (British Electricity Trading Transmission Arrangements, a slightly modified version of NETA incorporating the Scottish networks) system where the majority of trades are bilateral trades conducted away from the gaze of the wider market and thus depriving the market of the visible reference price given under the old pool arrangements.

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

We agree that the CMA should investigate this theory of harm and offer the following comments. Our comments focus on:

- Vertical integration
- Risk premium

Vertical integration

The evolution of the market has been characterized by the embedding of vertical integration as a key element of large suppliers business strategy. It is worth an examination of the development of the market to understand this feature and the consequences today.

The pool featured a single priced imbalance mechanism whereby market participants were charged for "short" (less electricity delivered in the relevant half hour period than required under contracted obligations) positions or paid for "long" (more electricity delivered in the relevant half hour period than required under contracted obligations) positions at the same price, which was the pool outturn price for that particular half hour period.

By contrast, NETA introduced a dual priced imbalance mechanism whereby market participants with a short position would almost always (there are some uncommon occasions when the prices are the same) face higher charges to buy electricity from National Grid through the balancing mechanism than they would be paid for their excess electricity resulting from a long position in the same half hour period. This created a situation where it made sense for market participants to have access to generation in order to use this to fine tune their positions within day in order to reduce their exposure to the asymmetric risk that the new dual priced imbalance mechanism created.

Although it would not be true to say that there was not at least some degree of vertical integration present among the large suppliers descended from the CEGB and the former state owned gas monopoly, the acquisition of generation assets by these parties seems to have significantly gathered momentum following the introduction of NETA.

In late 2001, a few months after the introduction of NETA, Enron, perhaps the biggest player in the England and Wales electricity wholesale market at the time, filed for bankruptcy. While this event was not linked to NETA, it created a climate of uncertainty amongst market participants in relation to willingness to extend credit to other counterparties which was compounded by the bankruptcy of TXU UK in October 2002.

Several years later, the market had changed to a great extent as the largely American wholesale trading companies who had provided most of the liquidity closed down their UK operations. Whereas in 2000 the market had been characterised by a wide range of participants of different sizes and high levels of liquidity, today it is now dominated by the large vertically integrated suppliers who control a significant majority of the GB generation fleet and supply the vast majority of GB domestic customers.

Risk premium

As recognised by Ofgem's recently introduced "Secure and Promote" programme, larger energy suppliers have been generally unwilling to trade with smaller market participants without charging significant risk premiums that these smaller participants often struggled to meet, particularly for anything other than relatively short term trades. This has significantly affected the ability of smaller participants to efficiently hedge their market risk on a long term basis and left them exposed to market volatility. This has acted as a disincentive for new market entry as potential entrants concluded that, without access to generation or the ability to cover their long term market risk at a reasonable cost, the opportunity was an unattractive one.

It also seems reasonable to assume that the generation held by the large vertically integrated suppliers is also used to some extent to supply themselves, thus reducing their need to trade in the wholesale market and further negatively affecting liquidity.

We consider that there is merit in the CMA examining a self-supply restriction requiring vertically integrated suppliers who also own generation to sell all of their generated output into the wholesale market. Any reforms in this respect should facilitate the renewable generation and promote innovation in renewable energy. This should increase liquidity as more electricity becomes available for trading between counterparties.

We would also request that the CMA consider the reintroduction of a single priced imbalance mechanism at the earliest possible opportunity. This would mean that all market participants would be less exposed to the current asymmetric cash-out risk described above, which is likely to be exacerbated by the current changes to electricity imbalance price calculation proposed by Ofgem. It would also potentially reduce the incentive for vertical integration.

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

We agree that the CMA should investigate this theory of harm and offer the following comments. Our comments focus on electricity generation.

As outlined above the evolution of the electricity market particularly vertical integration has had a distorting effect. For independent generators operating in this segment of the market, the preferred model is to sell their output

contractually as far forward as possible, preferably to one or two large purchasers. This arrangement offers easier management of the contractual relationships for a smaller independent generator than dealing with a large number of counterparties.

For smaller suppliers entering into these contracts the credit requirements that are needed to cover the purchase of a large amount of generated electricity for an extended time period are onerous. If suitable credit is not an option, a cash payment schedule may be agreed. This negatively effects a purchasers cashflow position the cost of which is reflected in the commercial offering made to consumers.

The credit requirements in the current market not only affects liquidity but also pushes up prices for end consumers as risk premia are charged to smaller suppliers at every stage of the value chain. This is a direct result of the lack of liquidity in the traded electricity market which makes it harder and thus more expensive for smaller parties to trade in and out of physical positions. If liquidity were to improve participants would feel they could adjust physical positions more easily and at lower cost. A likely consequence is that credit requirements between market participants would be less onerous. This would encourage competition growth and innovation in the sector.

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/or regulatory interventions

We agree that the CMA should investigate this theory of harm and offer the following comments. Our comments focus on:

- Customer engagement
- Economies of scale and scope

Customer engagement

With reference to CMA's view that there are weak incentives for suppliers to compete on price factors in retail markets, we believe that this is true to some extent in the domestic market although there is strong price competition in the non-domestic market, particularly in relation to larger industrial customers. In the domestic market however, the large vertically integrated suppliers have large numbers of "sticky" customers who were either inherited when those companies were created or purchased when the former PESs (Public Electricity Suppliers, e.g. MANWEB, Midlands Electricity, Southern Electric etc) were privatised. These "sticky" customers are generally on the relevant supplier's standard variable tariff, which is usually significantly more expensive than other tariff offerings available in the market.

By contrast, smaller new entrant suppliers have a strong incentive to compete on price as all the customers they supply have demonstrated their engagement with

the market by exercising their right to switch supplier and will switch elsewhere if they feel they are not paying the best price for their energy. This incentive is evidenced by the fact that over the past several years smaller suppliers have consistently offered the cheapest deals in the market, yet the share of the domestic market occupied by smaller suppliers is just over 5%.[1]

This base of "sticky" customers supplied by the large vertically integrated suppliers provides higher margins to those companies than the more competitively priced offerings which smaller suppliers have no choice but to make and further affect the ability of these newer entrants to compete on a level playing field. Furthermore, it would appear that where the large suppliers do offer tariffs which are more competitively priced than their standard variable tariff, these seem designed to target the minority of their customers who appear inclined to switch away in order to deter them from doing so. These tariffs could then be regarded as "protective" products rather than products designed to provide the best deal for those suppliers' customer bases as a whole in the manner in which smaller suppliers are forced to compete.

We consider that commercially focused switching sites are not in the best interest of consumers and therefore the CMA should give consideration to the creation of truly independent switching / price comparison arrangements.

Economies of scale and scope

The social and environmental exemptions afforded to small suppliers is a recognition of the dominant position of the large suppliers. It can be argued that the 250 thousand customer exemption is a blunt tool. However we would argue that this should be extended in a tapered form as the scale of regulatory obligations coupled with the imbalance of market power limits the potential for growth in the current market framework.

While we understand that at least some of the large vertically integrated suppliers have explained this differential by pointing to the fact that smaller suppliers are exempt from certain social and environmental obligations while their customer base is below a certain size we do not share this view as at least three of the larger newer market entrants have acquired these obligations and continue to regularly offer the most competitively priced tariffs in the market.

While we accept that the overall cost of compliance with these obligations is higher for the larger suppliers this does not seem unreasonable as they have a much larger customer base over which to spread those costs. Indeed, it seems likely that costs of compliance on an individual customer basis are likely to be higher for smaller suppliers for this reason.

We consider that consumers would benefit if there was greater transparency and breakdown of suppliers' operating cost base to ensure that inefficiencies are not passed on to customers.

[1] Ofgem "State of the Market Assessment" based on meter points as of January 2014.

Other areas for possible CMA consideration

Other areas that we would like to highlight are the impact of:

- Credit and collateral requirements
- Smart metering costs
- Regulatory burden and information requests

Credit and Collateral requirements

One area of concern to us is the credit ratings required by the networks under the various industry codes (BSC / UNC etc.) for unsecured credit purposes in relation to transportation and balancing costs as an alternative to cash or letter of credit (which is essentially the same as cash).

With regard to unsecured credit requirements for gas transportation, it is true that credit ratings from independent ratings agencies such as Dun & Bradstreet, Experian and Graydons are accepted, with a top level rating from one of these being equivalent to a BBB+ rating from an "approved" ratings agency such as Moody's, Standard & Poor's or Fitch in terms of the amount of unsecured credit that it will allow access to. However, for unsecured credit for gas balancing purposes, nothing less than an A- rating from an approved ratings agency is acceptable with companies failing to meet this criterion having to tie up working capital in the form of cash which cannot then be used to grow the business.

Investment grade credit ratings (BBB- or better) from approved agencies are generally only provided to large companies with multi billion pound balance sheets and are beyond the reach of smaller market participants. To obtain a rating of this nature carries a cost of potentially millions of pounds. Similar requirements exist in relation to electricity transportation (unsecured credit) and gas legacy metering assets.

However, the large vertically integrated suppliers came into existence with large numbers of customers and physical (including generation) assets which made achieving ratings of this kind possible. This allowed them to avoid the difficult growth stage which smaller suppliers face where significant amounts of cash are tied up purely for credit purposes, making it even more difficult to compete with their larger competitors.

While we do not subscribe to the view that a third party such as the Government should underwrite credit costs for smaller players as this would be a clear distortion of the market, we think it might be worth considering the principal that credit and collateral requirements with regard to industry obligations such as balancing and transportation credit should be based on the likely effect of a market participant's insolvency on the wider market.

For example, if a smaller supplier were to become insolvent, the effect on the wider market would be negligible. By contrast, if this were the case with one of

the larger vertically integrated suppliers, the effect on the wider market would be potentially catastrophic.

We believe this has to some extent been recognised by the relatively recent legislative change allowing for a court-appointed administrator to run a "large supplier" on an interim basis should it become insolvent ("Energy Supply Company Administration Rules" resulting from the Energy Act 2011), but all this has done is provide an implicit guarantee to larger suppliers which smaller suppliers do not enjoy and which we believe has resulted in this being factored into credit requirements for smaller suppliers in the wholesale market.

Smart metering costs

Another point to which we would like to draw the CMA's attention is the general costs around the national smart meter rollout, particularly in relation to Data Communications Company (DCC, the company charged with overseeing the data exchange infrastructure for smart metering) charges.

Although DCC is not due to go live for at least another year, Co-Operative Energy is already incurring significant costs for a service which is yet to be delivered.

The DCC charging regime creates a misallocation of costs and a barrier to entry. These costs are predicted to increase sharply once DCC launches. In fact, analysis undertaken by Co-Operative Energy shows that, even if a supplier's customer base remains static, its DCC related charges will more than treble over the four year period between 2014 and 2018. This would appear to conflict with the premise that the introduction of smart metering will increase competition, we therefore request that CMA consider whether the current framework supports the wider objectives of increasing competition.

Regulatory burden and information requests

We believe it is right that the CMA examine the significant barriers to entry and growth caused by regulation. We would also welcome any recommendations the CMA may make with regard to information requests. The current situation is that regulatory authorities duplicate their efforts requesting similar information albeit tailored for slightly different purposes. Often separate meetings are requested by both DECC and Ofgem for updates on the same initiatives. We consider that there is more efficient ways for regulators to work together without impacting their independence.

I would like to close by stating Co-Operative Energy's support for the work undertaken by the CMA. GB consumers deserve a better deal than the one they have been given in recent years. Although the market share of independent suppliers has grown to levels considered impossible just a few years ago, much work remains to be encourage and facilitate competition.

I trust our response is helpful, please do not hesitate to contact Steve Rowe (steve.rowe@cooperativeenergy.coop) in the first instance should you have any questions or require any further information.

Yours sincerely,

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