

ENERGY MARKET INVESTIGATION

Summary of hearing with Utility Warehouse on 3 March 2015

Market rules and regulatory framework

1. Utility Warehouse was a retail supplier with no generation assets. It did not actively engage with the wholesale market as it had a long-term (20-year) agreement with npower under which npower supplied energy to Utility Warehouse, which still had 19 years to go. Utility Warehouse considered itself to be locked into its agreement with npower, although the contract could be amended if both parties agreed.
2. Utility Warehouse did not have strong views about theories of harm 1, 2, 3 and 5 (market rules and regulatory framework; market power in generation; pricing, liquidity and vertical integration in the wholesale market; and the broader regulatory framework, respectively). It was most concerned about theory of harm 4, which concerned the retail market, and in particular the role of the regulator, inactive customers and suppliers' behaviour, including their pricing policies. Utility Warehouse welcomed the focus of the updated issues statement on inactive sticky customers and noted that this was a problem for both the large and independent suppliers.
3. Utility Warehouse said the potential solution of centralised switching was dangerous, and reiterated its belief that a better solution would have been to impose a maximum delta between the standard variable tariff and the cheapest tariff a supplier can offer.
4. It was important for the regulatory framework to recognise innovation and customer service, and not simply be focused on price, as this led to suppliers engaging in a race to the bottom on prices.

Opaque prices and low liquidity in electricity markets

5. Utility Warehouse expressed concern that EDF Energy would receive windfall profits from the extended use of its legacy nuclear plant. The energy which EDF Energy generated at its nuclear plants could be available to it at a price significantly below that of the open market, which could enable EDF Energy to cut its own prices and distort the retail market. Utility Warehouse noted that EDF Energy had some of the lowest prices of any of the Six Large Energy

Firms. EDF Energy had the ability to cross-subsidise the retail part of its business with cheaper energy from its generation business. It could do this either by selling the electricity on the open market or by reducing its retail prices.

6. The decisions to extend the life of the legacy nuclear fleet, and the accompanying price advantage it gave to those companies with these assets, had been made for a number of reasons, including political ones, which had not taken account of their possible effects on the market. While downward pressure on consumer prices was normally a good thing, Utility Warehouse argued that since it was only EDF Energy and other generators with legacy nuclear plants, and not the wider market, which had benefited from the decision to extend the life of these plants, the decisions had created a distortion in the market by giving the nuclear generators, particularly EDF Energy, a competitive advantage.
7. Utility Warehouse felt that the wholesale gas market could act in the future in a similar way as it had done in 2005, when supply disruption caused a four-fold increase in wholesale gas prices that did not recede. This increase in the wholesale price had forced many independent companies out of the market at the time. Utility Warehouse said its relationship with npower mitigated its exposure to changes in wholesale prices.

Generators

8. Utility Warehouse had no view regarding the group's preliminary view that generators had not made returns that were excessive when compared to their cost of capital.

Liquidity

9. Utility Warehouse's arrangements with npower meant that there was no limit to the volume of gas it could obtain, and that any liquidity risks were absorbed by npower.

Incentives to compete

10. The increase in independent suppliers' market share was not due to improvements in customer service or the introduction of innovative products. It was due to the independent suppliers' ability to exploit benign market conditions and differentials between wholesale and retail market prices. The extent to which a small supplier could exploit these price differences depended on whether it hedged or not. While suppliers that did not hedge at

all would be able to respond more quickly to changes in wholesale price, they could also find themselves exposed if wholesale prices changed rapidly.

11. Utility Warehouse felt that independent suppliers would eventually lose the price advantages that had enabled them to increase their market share. This would be due to either a rise in wholesale prices or because the hedging strategies of the Six Large Energy Firms began to reflect lower wholesale prices.
12. Independent suppliers' costs would grow as their businesses matured. Customer service and billing costs would increase as businesses which had initially only gained customers would need to develop processes for customers leaving them. Suppliers would also have to begin to address matters such as debt collection, the industry codes on balancing and settlement, and reconciliations. These issues only became larger as a business grew. The industry codes were not designed with smaller and growing suppliers in mind, and they favoured large, established suppliers.
13. Independent suppliers did have one advantage over the Six Large Energy Firms as they had not inherited the legacy systems or administrative burdens which the established suppliers had.
14. Switching energy suppliers had become much more common than when Utility Warehouse had entered the market 15 years ago. This was due to increased publicity from a number of sources, including media, politicians and government about switching and the amount customers could potentially save if they changed energy supplier. Current levels of switching might reduce if either the perceived amount of savings came down or if the amount of publicity around switching diminished. However, it might be the case that consumers get used to the idea of switching supplier, and that they continue to do so even if the achievable savings reduced.
15. Utility Warehouse considered that the number of customers who switched internally, from standard-variable to fixed-price tariffs with their current supplier, was as an important indicator of consumer engagement as external switching. The numbers of internal switches were not reported by Ofgem and were not in the public domain.
16. Utility Warehouse considered that if a supplier provided good customer service and treated its customers fairly and in a straightforward manner then it was possible to retain customers and reduce levels of switching.
17. Utility Warehouse considered the current advertising campaign by the Department of Energy & Climate Change (DECC) to encourage consumers to switch energy suppliers to be disingenuous. Large-scale switching by

consumers to small suppliers from the Six Large Energy Firms would undermine the funding of the Energy Companies Obligation (ECO) environmental programme, which was largely paid for by the Six Large Energy Firms. If the industry as a whole made approximately £1 billion profit (approximately £40 per household), then if every customer who could switched and saved £200 the industry would be losing £160 per customer on average and would not be sustainable.

18. Utility Warehouse considered its longevity in the market to have been the result of its unique relationship with npower. It said recent entrants to the market operated a business model that was only sustainable if they either managed to be the most efficient supplier in the market or by cross-subsidisation. As noted above, new entrants to the market faced a very different set of costs to established suppliers, and this difference was increased by smaller suppliers' exemption from ECO and other social and environmental costs.
19. Lower wholesale prices did not result in commensurately lower retail prices from the Six Large Energy Firms because low wholesale prices were considered to be short term whereas their hedging strategies were long term. The Six Large Energy Firms operated a strategy that ceded market share to small suppliers, which could offer lower prices, in favour of maintaining more stable retail prices. If the Six Large Energy Firms had reacted immediately to changes in wholesale prices they would have to stop hedging, leaving them at risk to sudden changes in prices.
20. Utility Warehouse thought there was no fundamental difference in cost to serve customers on a fixed tariff compared to a standard-variable tariff. Nor, owing to the infrequent use of exit tariffs, were fixed-tariff customers more predictable. Utility Warehouse offered one four-year fixed tariff, with a premium that reflected the certainty of stable pricing.
21. Utility Warehouse targeted the sticky customers of the Six Large Energy Firms by having a differentiated proposition based on service, value and providing varying utility-style services (electric, gas, landline, broadband and mobile). Few of its customers were tied into long-term contracts and none had exit fees.
22. Utility Warehouse felt its sticky customers chose not to go through the switching process because they would face inaccurate closing bills, inaccurate opening bills, and deal with poor customer service provided by other suppliers. Many customers had been willing to pay higher prices for improved service.

23. Utility Warehouse noted that customers were exploited when they transferred from bottom of the market tariffs to off-contract tariffs. Utility Warehouse enrolled customers onto the cheapest tariff they were eligible for.
24. Utility Warehouse said the reason explaining the widening gap between costs and the standard-variable tariff was due to new suppliers operating in a market of low wholesale prices. Larger incumbent suppliers also had higher prices due to ECO.
25. Utility Warehouse did operate a price differential between its standard-variable and introductory tariff, but its standard-variable tariff was cheaper than its competitors.

Smart meters

26. Utility Warehouse did not think that smart metering would solve all the problems it was supposed to. It would allow for more accurate billing, but it would not significantly change consumer behaviour and time-of-use tariffs were not likely to be widely adopted in the immediate future.
27. The additional costs that half hourly settlement would incur on suppliers had not been properly considered. Limited trials had only led to minor reductions in energy usage.
28. Utility Warehouse supported the application of new technology but not the manner with which it was being delivered. Decisions made at working groups, working parties, commissions and regulatory bodies were determined by the energy companies that had the resource capacity to influence decisions, namely the Six Large Energy Firms. This led to decisions in favour of expensive infrastructure and technology spending that might be unsuitable for smaller suppliers.
29. Utility Warehouse disagreed with the findings of the DECC cost-benefit analysis for rolling out the smart metering. It thought the project ought to be abandoned but that it would not be for political reasons.

Regulatory interventions

30. Ofgem's Standard Licence Condition 25(a) had contained small supplier exemptions that gave them an unfair advantage and promoted a price drive to the bottom of the market. Utility Warehouse said that Ofgem appeared intent on making the sector less profitable, with npower and Scottish Power having chosen to compete with the small suppliers while British Gas, SSE and E.ON had not.

31. Utility Warehouse felt that Ofgem was responsible for the state of the current retail market and that the Retail Market Review (RMR) had narrowly focused on concerns about the behaviour of the Six Large Energy Firms to the detriment of growing independent suppliers. Many of the regulations implemented by Ofgem on the retail market were prescriptive, difficult to interpret, and stifled innovation. Utility Warehouse welcomed Ofgem's move towards a principles-based approach to regulation.
32. Restrictions brought in by the RMR meant that Utility Warehouse was no longer able to offer flexibility in its multi-utility bundle (electric, gas, landline, broadband and mobile) service to customers. The effect was a restriction of customer choice without achieving the simplification of tariffs it intended to. Due to tariff simplification Utility Warehouse was not able to offer some of the kinds of tariffs that customers wanted, such as a green tariff.
33. The RMR did achieve some positive outcomes, namely the requirement for suppliers to inform their customers via their bill if a cheaper tariff existed. This was undermined, however, by the infrequency of billing. In addition, it provided additional information to many consumers who had been on legacy tariffs.
34. Utility Warehouse considered that increasing the smaller supplier threshold from 50,000 households to 250,000 had had a greater impact on the market than limitations on the Six Large Energy Firms competing vigorously out of their legacy areas. Utility Warehouse had grown to have one million customers, which was significantly over the threshold.
35. Utility Warehouse promoted and sold its products through 50,000 sales partners that would talk to friends, family, colleagues, and neighbours about the services it offered and receive a commission based on actual customer referrals. This method was not prohibited by regulation as it was not doorstep selling. Utility Warehouse had noted a decrease in customer churn as a result of the end of doorstep selling.
36. Utility Warehouse felt the Six Large Energy Firms welcomed the end of practices that promoted customer churn, like doorstep selling, and would like to see the end of price comparison websites for the same reason.
37. High rates of customer churn within the market resulted in greater costs for energy suppliers. Utility Warehouse felt that the emphasis placed on switching tariffs led to unforeseen consequences for customers. Consumers often did not save money in the long run from switching supplier because when their introductory tariff expired they were moved back to a standard-variable tariff with a high cost.

Price comparison websites

38. Price comparison websites did not solve the problems in the market as they drove customers from one loss-making tariff, or cross-subsidised tariff, to another. The commission received by those companies did not serve inactive consumers, whose overpayment paid for the aforementioned tariffs, and it increased the switching cost for energy suppliers. Utility Warehouse suggested that price comparison websites should charge consumers directly for using their sites.
39. The Ofgem confidence code for price comparison websites did not work for consumers on fixed-price tariffs as the formula used to calculate potential savings gave misleading and exaggerated results.
40. In the micro-business and small and medium-sized enterprises (SMEs) market it was typical to pay fees of 10 to 25% of the first year's savings to a broker.

Settlement

41. Utility Warehouse said more accurate settlement in the business market led to costs associated with theft, leakage and loss of energy being loaded onto the domestic market. These costs fell particularly heavily on independent gas suppliers. There was a significant difference between the quantities of gas that Utility Warehouse had to buy and the amount it was able to sell to its customers. It had to spread this cost across all of its customers.
42. Another disadvantage of the annual quantity system was that it did not make it worthwhile for suppliers to encourage their customers to use less energy. Project Nexus would help to solve these problems, despite attempts by the Six Large Energy Firms to delay its rollout.
43. Utility Warehouse did not have any concerns about the electricity settlement system. Due to its arrangements with npower, Utility Warehouse did not have to balance its supply and demand requirements on a daily basis and was more concerned with estimated annual consumption and settling with npower during the five resettlement cycles.

Microbusinesses and SMEs

44. Utility Warehouse felt that the practice of offering loss-leading introductory tariffs with brokerage fees, and the automatic enrolment to a high cost tariff once the tariff ended, led to SMEs paying higher premiums than they should. Utility Warehouse said it had concerns that the domestic market was

becoming increasingly similar to the SMEs market, where customers at the end of their fixed tariff had to be put onto the supplier's cheapest standard variable tariff, which might be significantly higher than their previous fixed tariff.

45. Utility Warehouse did not consider there to be a conceptual difference between the microbusiness customer and the domestic customer, so it treated them in the same way. Utility Warehouse had around 30,000 microbusiness customers, which was a small proportion of its around one million total customers. Most of its microbusiness customers were sole traders.
46. There was a brokerage market for SMEs that filled a similar function to price comparison websites, except that the brokers derived their profits from uplifted tariff rates. Price comparison websites would be difficult to operate in the business market because of the lack of live tariff data, the need to take account of customers' varying degrees of credit risk, and bad debt. The brokerage model lacked transparency, so it was difficult for customers to know whether brokers were really acting in their interest.
47. Utility Warehouse felt the SMEs market offered opportunities to independent suppliers with an appetite for risk and with a strategy adapted to the brokerage model. The most exploited microbusiness customers were those that were time-poor and willing to commit to long and expensive contracts, especially new businesses and those moving premises.

Industry codes

48. It was difficult for new suppliers to obtain a place on, or have the resources to attend, the working groups that influenced industry codes. Utility Warehouse felt the support it had received from Energy UK to keep abreast of changes to the industry was invaluable. Nevertheless, it noted that even if Utility Warehouse had dedicated the resource required to attend every working group, the Six Large Energy Firms played so dominant a role on these groups that the influence of independent suppliers was limited.
49. Utility Warehouse did not think the industry panels and the working groups that oversaw the energy codes operated efficiently enough to handle and enable innovation in the industry.
50. Changes at Ofgem and DECC, such as a website targeting independent suppliers, suggested attempts had been made to improve information sharing outside of the Six Large Energy Firms.

Profitability

51. Utility Warehouse's target level of compound annual growth was 25 to 30%. It had focused on stable growth, scalable IT, recruitment and training, whilst maintaining its service and core brand.
52. Rapid growth placed independent suppliers under massive pressure that resulted in poor customer service, higher costs from customer churn, and difficulties in scaling IT infrastructure and processes.
53. The relationship between Utility Warehouse and npower had reduced its wholesale market risks considerably, but when wholesale prices were low it also placed Utility Warehouse in an adverse position compared to other independent suppliers. Utility Warehouse expected to regain its competitiveness when wholesale prices rose.
54. Utility Warehouse felt it was difficult to use its profit margin as a benchmark because it was an integrated multi-utility business, with efficiencies being gained by providing a number of services. It was this model that enabled Utility Warehouse to be profitable, which other independent suppliers, which only supplied energy, were not.
55. Large differences between suppliers' indirect costs could be accounted for by differences in their information technology systems, the processes they used, and their varying rates of growth. Utility Warehouse expected that companies such as Ovo Energy and First Utility would operate more efficient systems and administrative processes than the Six Large Energy Firms. Efficiency could be compared by dividing a supplier's total administrative costs by the number of customers it served or services it offered.
56. Utility Warehouse felt that customer service was costly in this industry because of the degree of scrutiny by the media, politicians, and the general public. Complaint levels often rose during periods of heightened publicity. Conversely, Utility Warehouse noted that it had experienced fewer referrals to the Energy Ombudsman.
57. Utility Warehouse did not think that smart metering would lead to improved consumer engagement. The positive contribution of smart metering would be that it would provide accurate readings of customers' energy use, the end of estimated bills, and the reductions it might have on the cost of providing customer service and the improvements in the overall perception of the industry. Utility Warehouse emphasised the correlating link between switching levels, customer service call volumes and complaints.

58. Utility Warehouse did not think mandatory switching was a viable solution to protect disengaged consumers because the available profit to be made was not sufficiently large. At £1 billion of industry profit, or £40 per household, increasing the size of the switching market and its associated costs might render the industry unprofitable. Utility Warehouse suggested that one possible way of better protecting consumers would be for customers at the end of their fixed tariff to be automatically enrolled onto the supplier's cheapest fixed tariff, rather than its cheapest standard-variable one.
59. Utility Warehouse noted that there were two categories of inactive customers; those who were completely disengaged from their supplier and the market, and those who were satisfied with the service they received from their supplier because the supplier had invested in their customer service provision and looked after its customers.