

27 March 2015

## CMA Energy Market Investigation

### Response to the Updated Issues Statement and Working Papers

#### A Overview

- 1 This is the response of First Utility Limited (**First Utility**) to the Updated Issues Statement published by the Competition and Markets Authority (**CMA**) on 18 February 2015 (the **Updated Issues Statement**). Rather than producing separate responses to each of the Working Papers issued by the CMA, First Utility's comments on the various Working Papers which inform the Updated Issues Statement are incorporated within this response and, where more appropriate, in the Annexes to this response.
- 2 First Utility is the largest independent energy supplier in Great Britain (**GB**) with over 770,000 households in March 2015. First Utility's growth in recent years has been in large part due to its differentiated and competitively-priced customer offering. First Utility believes that its success in growing its business reflects customer dissatisfaction with the six largest incumbent suppliers (the **Big Six**).<sup>1</sup> Notwithstanding that there are six leading energy suppliers, competition in GB energy markets is evidently not delivering good outcomes for consumers.
- 3 In spite of our recent growth, and the entry into the market of a number of smaller suppliers, we remain convinced that independent energy suppliers continue to face significant barriers to expansion in the GB energy market and that these barriers constitute market features leading to adverse effects on competition (**AECs**). In this context we note:
  - The retail energy market has been open to competition since liberalisation in 1999 and yet independent and smaller suppliers, and new entrants, have only reached some 7 per cent for electricity and 8 per cent for gas market share overall in July 2014, with most growth occurring since 2011;<sup>2</sup>
  - As Ofgem states in the Assessment of the Market,<sup>3</sup> it will take the independent and smaller suppliers, and new entrants, some years to make more significant inroads into the market share of the Big Six energy providers; and
  - Our recent growth and the increase in the number of entrants has occurred against a background of benign wholesale energy market conditions since the last significant period of volatility around 2008/9, which may mask key risks to more effective competition in less benign conditions.

---

<sup>1</sup> The Big Six are referred to by the CMA as the "Six Large Energy Firms": Centrica, EDF Energy (**EDF**), E.ON, RWE npower, Scottish and Southern Energy (**SSE**) and Scottish Power.

<sup>2</sup> Updated Issues Statement, paragraph 116.

<sup>3</sup> Ofgem State of the Market Assessment, section 5 – chapter summary.

27 March 2015

- 4 These barriers to expansion are acting to the overall detriment of GB energy consumers by restricting innovative firms, such as First Utility, who are seeking to improve the energy offerings available to GB consumers, from increasing their customer base. In particular, as addressed further below, the absence of a meaningfully liquid wholesale market which provides independent suppliers with the access to the shaped product they need to hedge their positions and manage their risk effectively gives the vertically integrated Big Six an ongoing structural market advantage.<sup>4</sup>
- 5 The barriers to expansion at the wholesale level of the market reinforce the cosy position of the Big Six with regard to many consumers in retail markets. As the CMA notes, customers could save an average of between £158 and £234 per year by switching supplier.<sup>5</sup> However, for reasons not yet fully understood by the CMA, the vast majority of customers on the Big Six's Standard Variable Tariffs (**SVTs**) are not switching.
- 6 As a result, there are effectively two markets for GB energy: (i) a contested market made up of those customers who actively switch, engaging in the market through price comparison websites (**PCWs**) or other channels, and who realise savings in so doing ("engaged customers"); and (ii) the vast majority of customers who are disengaged and do not consider switching. This position is exacerbated by the ability of the Big Six to cross-subsidise attractive entry tariffs with SVTs, a strategy which allows them to win engaged customers on price, who then fail to maintain their levels of engagement and revert back to SVT tariffs.<sup>6</sup>
- 7 Given that the CMA's analysis shows SVT customers achieve 12-13 per cent higher revenues as compared to customers on other tariffs,<sup>7</sup> the Big Six have a rational economic interest in seeking to discourage consumer engagement and switching. It therefore makes sense for the Big Six to adopt retail strategies designed to make engagement with retail choices unattractive to consumers. The Big Six stand to gain far more from the *status quo* than they would from unfettered competition. In this context, the CMA acknowledges that there is "*some support for the view that these suppliers can segment the market and price discriminate.*"<sup>8</sup>
- 8 These two key concerns: (i) illiquid wholesale markets; and (ii) disengaged SVT consumers (and the strategies that seek to exacerbate that position) remain the market features of most concern to First Utility, and which – in our view – lead to AECs. Remedy of these two key

---

<sup>4</sup> These advantages have been evident in the recent relatively benign market conditions, and would be materially exacerbated in times of higher or more volatile energy wholesale prices.

<sup>5</sup> Updated Issues Statement, paragraph 17.

<sup>6</sup> Indeed, the most recent switching statistics for February 2015 show that the share accounted for by small suppliers has fallen from a high of 44.68 per cent in May 2014 to 25.86 per cent. Of further concern is that the level of switching has also fallen: whilst there were a 100,000 additional switches in February 2015 as compared to January 2015, which may in part be due to the recent Government campaign to improve switching rates, the overall figure of 317,000 households is still half of what it was in November 2013 when 615,000 households switched. See <http://www.energy-uk.org.uk/publication.html?task=file.download&id=5062>.

<sup>7</sup> Updated Issues Statement, paragraph 15 and 122.

<sup>8</sup> Updated Issues Statement, paragraph 146.

27 March 2015

concerns would represent a significant step towards more competitive GB energy markets, and the accompanying improvements in consumer welfare.

- 9 In counterpoint, failure to recognise the challenges faced by independent suppliers such as First Utility in wholesale markets (as is the case in the CMA's working papers, in particular the working paper on liquidity),<sup>9</sup> or to go beyond the fact of customer disengagement, and recognise the incentives for the Big Six to maintain that disengagement with SVTs as the default tariff, would be a major missed opportunity for an investigation with the profile and powers of this CMA review.
- 10 First Utility has recently launched a campaign for the abolition of SVTs to be replaced by an "out of contract" tariff that could better reflect near-term wholesale costs. This campaign forms part of our ongoing drive to promote customer engagement with energy consumption through: low pricing, transparent billing and tariff offerings, frequent communications, and encouragement of the use of smart meters. We would encourage the CMA to consider closely a remedy which forces suppliers to offer more competitive tariffs than the SVTs which are currently their "standard" tariff offering.
- 11 First Utility welcomes the opportunity to comment on the Updated Issues Statement and relevant Working Papers. We look forward to continuing to engage with the CMA on these important and challenging issues.

## **B The CMA's Theories of Harm**

- 12 The Statement of Issues published by the CMA on 24 July 2014 (**Issues Statement**) set out four Theories of Harm, which included various hypotheses in respect of Theories of Harm 1 and 4. In its Initial Submission and Response to the Issues Statement, (**Initial Submission**) dated 14 August 2014, First Utility agreed with the concerns identified by the CMA and also that there are overlapping elements in these various theories.
- 13 We recognise that the CMA has progressed its investigation during the intervening period and further developed its thinking on the market features which may be indicative of possible AECs. In the following section, we provide First Utility's comments on each of the updated theories of harm.

---

<sup>9</sup> "Liquidity", CMA working paper published on 13 March 2015 (**Liquidity WP**).

27 March 2015

## 1. Updated Theory of Harm 1: The market rules and regulatory framework distort competition and lead to inefficiencies in wholesale electricity markets

- 1.1. We agree with the CMA that *“it is important to consider whether competition operates well in the wholesale market.”*<sup>10</sup> We also agree with the inclusion of an additional Theory of Harm concerning the market rules and regulatory framework, providing a means to consider wholesale issues beyond low liquidity. However, the initial conclusion that there is sufficient liquidity<sup>11</sup> in our view causes the CMA to view a number of key regulatory interventions in the wholesale market more positively. We consider lack of meaningful liquidity in more detail below in the context of Theory of Harm 3.

### **Market rules**

- 1.2. Our response on the market rules aspect of CMA’s updated Theory of Harm 1 focuses on the second sub-theory relating to the reforms to the system of imbalance prices (**cashout**) that Ofgem and the industry are currently considering as part of the Electricity Balancing Significant Code Review (**EBSCR**), although we do address self-dispatch and locational signals briefly in this section.

### **Self-dispatch**

- 1.3. The CMA believes that there are two trends which reduce the link between self-dispatch and vertical integration, namely that: (i) within day markets are much more liquid than they were, reducing the value in “contracting with oneself”; and (ii) the proposed cashout reforms will reduce the punitive element of being out of balance.<sup>12</sup>
- 1.4. First Utility agrees that a single cashout price is an important reform which will address the more punitive and distorting element that currently exists in the dual cashout regime. However, we disagree strongly with the suggestion that there is no longer value in “contracting with oneself”. We believe the CMA has fundamentally misunderstood the differing needs of vertically integrated and non-vertically integrated suppliers in terms of wholesale market liquidity, in particular in relation to managing wholesale market risk. Independent suppliers hold a significantly higher “shape risk profile” than vertically integrated utilities, who see a far lower net shaping risk across their overall generation and supply portfolios. The Big Six’s ability to self-supply means that they - unlike independent suppliers such as First Utility - have a natural hedge that they can use to shape to their requirements to manage financial risk relating to both shaped electricity and imbalance cost avoidance.

---

<sup>10</sup> Updated Issues Statement, paragraph 30.

<sup>11</sup> Updated Issues Statement, paragraph 100.

<sup>12</sup> Updated Issues Statement, paragraph 37.

27 March 2015

- 1.5. A vertically integrated energy supplier can therefore leave the purchase of its required bespoke products until much closer to delivery than an independent supplier might prefer, since it can largely purchase those bespoke products from its own generation arm without having regard to the higher prices charged closer to delivery. This is because any increase in costs for the supply business will be offset by a higher profit derived by the generation business. The Big Six therefore have more limited exposure to market price risk than independent suppliers and generators.

### **Cashout prices**

- 1.6. As mentioned above, First Utility agrees that the introduction of single cashout will be beneficial (and remove a market feature - dual cashout - that does and would otherwise continue to result in an AEC). However, we are concerned that other elements of the cashout reforms – notably the proposed reduction of the Price Average Reference or PAR to 1 MWh in 2018 as set out in the P305 proposed modification - has the potential to significantly distort competition in a future of scarcity. This does reflect a staged reduction from 50 MWh in 2015 to 1 MWh in 2018, but nonetheless renders the end point as fixed at 1 MWh.<sup>13</sup> Not only are the balancing actions over the course of a half hourly delivery period not reflected in a PAR 1 scenario (as covered by George Yarrow in his submission),<sup>14</sup> the potential impacts on participants at times of significant scarcity, particularly on smaller suppliers who are exposed to settlement risk on a half-hourly basis, could be significantly damaging and as a consequence adversely affect retail competition. Such suppliers have little or no ability to manage this risk.
- 1.7. The percentage imbalance faced by independent suppliers is, as the CMA's research shows, far higher (typically by an order of magnitude) than the integrated suppliers.<sup>15</sup> PAR 1 MWh would increase the volatility of the cashout price that this order of magnitude higher volume imbalance is exposed to. Further, we believe that PAR 1 MWh would result in changes to the bidding behaviour in cashout, which could adversely change the wholesale price distribution in cashout, spot and forward markets. In contrast to Ofgem's view that a sharper PAR value could increase liquidity, we believe there are good reasons why this could decrease liquidity as market participants focus more on managing their own internal cashout risks than on offering products externally into the wider wholesale market to other participants to manage that same risk.
- 1.8. Instead, we consider that further modelling, based on actual market data, is needed, reflecting those market conditions that the modification is actually intended for. We consider a staged approach to be more appropriate, providing for a check on the actual behavioural impacts of the

<sup>13</sup> The BSC Panel has recommended the approval of an alternative modification P316, which reduces PAR to 100MWh and then stops (to allow the industry time to assess if unintended consequences have materialised). Both modification proposals P305 and P316 are with Ofgem awaiting a decision.

<sup>14</sup> "Wholesale electricity market rules", CMA working paper published 27 February 2015 (**Wholesale Electricity Market Rules WP**), paragraph 57.

<sup>15</sup> "Descriptive statistics: generation and trading", CMA working paper published 6 March 2015 (**Descriptive Statistics: Generation and Trading WP**), Figure 25.

27 March 2015

changes before such a sharp reduction is considered.<sup>16</sup> A phased introduction allows industry time to adapt to the new commercial environment, potentially minimising unintended consequences on participants. This will allow the market time (assuming sufficient liquidity) to provide participants with the tools needed to address imbalance risk.

- 1.9. In this context, we agree with Stephen Littlechild that, whilst there is a case for some move towards sharper prices at cashout, *“such as might be embodied in a move from PAR 500 to PAR 250 or PAR 100...it would be premature to move immediately to PAR 1”*.<sup>17</sup> Such a phased introduction would allow an assessment to take place of whether and how supplier behaviours have changed, and what the impacts of any further reduction on PAR may be - prior to any decision to further reduce PAR, being taken. Any reduction in PAR from its current level must also coincide with single price cashout.
- 1.10. The CMA notes that *“imbalances tend to be low for many large and vertically integrated generators and suppliers”*<sup>18</sup> and that *“[w]hat we do know is that reductions in PAR have a greater impact on independent suppliers compared to vertically integrated parties as a result of their exposure to imbalance.”*<sup>19</sup> The risks of change are therefore somewhat greater for independent suppliers, and this would be an effect amplified by the redistribution mechanism whereby net imbalance costs would be redistributed to “better balancers” (i.e. vertically integrated suppliers).<sup>20</sup>
- 1.11. First Utility therefore suggests that the CMA also considers how low liquidity compounds the size of imbalance risk faced by independent suppliers, particularly if the price ratio of Peakload-plus-Baseload-to-Shape starts to increase materially in less benign market conditions (that would impact the forward market, the spot market and cashout).

#### ***Locational pricing for transmission losses and constraints***

- 1.12. The CMA has considered that the absence of locational pricing of constraints and losses may distort competition in the siting of new generation. However, First Utility believes that the CMA must also take into account the renewables policy objectives of both the UK Government and the devolved Parliament in Scotland, as well as other incentives<sup>21</sup> to encourage generation to sit close to centres of demand.

<sup>16</sup> This also formed the basis of First Utility's alternative mod to P304 - P314, which sought a more phased introduction to early reductions in PAR.

<sup>17</sup> Stephen Littlechild “Reflections on cashout arrangements” 13 February 2015.

<sup>18</sup> Descriptive Statistics: Generation and Trading WP, paragraph 31

<sup>19</sup> Ibid.

<sup>20</sup> Energy Spectrum, Issue 464, 9 March.

<sup>21</sup> Generator Distribution Use of System (GDUoS) charges: Negative charges (credits) are applied when the additional exported power has a positive effect on the distribution of electricity via the local grid (i.e. close to the point of demand).

27 March 2015

- 1.13. Furthermore, the CMA must recognise that the debates to date around the Balancing and Settlement Code (**BSC**) modification proposal P229<sup>22</sup> and Project Transmit highlight the significantly different commercial interests at stake between each of the vertically integrated companies and renewable developers/investors. Their respective positions depend on whether or not their existing generation portfolio is largely southern-based (and therefore would commercially benefit from a change to locational pricing for transmission losses). Changing the economics of existing plants could have significant unintended consequences on security of supply and investor confidence.
- 1.14. Instead of focussing on the charging arrangements for transmission losses to create an additional signal for siting new generation and penalising existing capacity which is northern-based, we believe there is greater benefit in the CMA exploring how the regulatory environment may be inhibiting the reduction in overall system losses. Overall, around 8 per cent<sup>23</sup> of generated electricity is lost on delivery to customers, but losses differ significantly for customers connected at different voltages, as indicated by the CMA's calculation for transmission losses which make up about 2 per cent of total spending on electricity, i.e. just 25 per cent of total system losses.<sup>24</sup> For illustration purposes, the Sohn Associates report to Ofgem in 2009 on Electricity Distribution System Losses shows the amount of electricity lost if the supply is taken at the indicated voltage as shown in the table below.<sup>25</sup> The report also notes that average losses are in the order of 5 per cent of energy put into the distribution network - so over and above losses resulting from transmission.

<b>Voltage</b>	<b>Indicative Distribution Loss Levels</b> (as a cumulative total at the indicated voltage level)
132kV	0.50%
33kV	1.50%
11kV	3%
400/230V	7%

- 1.15. As we discuss in Annex 1, the roll-out of smart meters and industry moves to introduce demand side response (**DSR**) and time-of-use (**ToU**) tariffs, will be key tools to reduce losses and constraints on distribution networks. However to fully unlock the potential of these important tools, distribution network operators must be enabled to participate in industry processes such as the balancing mechanism.

<sup>22</sup> <https://www.elexon.co.uk/mod-proposal/p229-introduction-of-a-seasonal-zonal-transmission-losses-scheme/>  
Modification proposal to the BSC raised by npower on 28 November 2008 on introducing seasonal zonal transmission losses.

<sup>23</sup> 2012 DUKES Table 5.1.2 Electricity Supply, Availability & Consumption.

<sup>24</sup> "Locational pricing in the electricity market in Great Britain", CMA working paper (**Locational Pricing WP**), paragraph 9.

<sup>25</sup> Sohn Associates, "Electricity Distribution System Losses - Non Technical Overview", dated 31 March 2009, page 10.

***The Capacity Market and Contracts for Difference***

- 1.16. We agree with the CMA that the EMR programme will lead to fundamental changes to the remuneration of both thermal and low carbon generators.<sup>26</sup> However, there is significant transfer of risk from generators to suppliers in the design of the CfD FiT Supplier Obligation, which will significantly impact the prices that retail customers pay.<sup>27</sup> We are concerned that the CMA's focus on how this programme works for generators has entirely avoided the implications of the supplier obligation design on supplier tariff setting and consequently consumer bills.
- 1.17. In addition to those areas around capacity that the CMA would like to investigate,<sup>28</sup> we encourage the CMA to consider that whilst the focus of policy makers to date has been on *"reducing generators' financing costs and risks, in turn reducing the support they require and therefore the cost to consumers"*,<sup>29</sup> these risks will instead pass to suppliers. The challenge for suppliers is that the CfD FiT payments will be for a variable volume of generation and the payment per unit volume is also a function of variable wholesale market prices. As the scheme grows in size over the coming decade, the very volatile cost this results in will become a large and hard to manage cost component in retail tariffs. Thus an unhedgeable variable cost (changing every quarter in an unpredictable way) conflicts with a retail market that sells up to three year fixed price tariffs. We recommend that, in order to remove this future threat to competition in supply, steps are taken to reduce the volatility and uncertainty in the supplier obligation as the scheme grows. In contrast, the RO changes annually in a more predictable way for suppliers.
- 1.18. Supplier tariffs and consumer bills will now have to include a significant risk premium to manage the payment volatility, given that only three months visibility on expected costs is provided to suppliers, and most tariffs now are of a fixed nature between one and three years. As in other areas, the vertically integrated Big Six are substantially protected from these risks and costs given that between 50 per cent and 90 per cent<sup>30</sup> of their customers are on SVTs, whereas for independent suppliers, such as First Utility, this can be less than 15 per cent. First Utility therefore believes that the operation of CfDs may also be a market feature contributing to an AEC.
- 1.19. Given the new risks in cash and gross margin volatility the scheme design engenders, we are concerned this could lead to increased risks faced by suppliers. In Annex 1, we cover in more detail the concerns we have around the design of the Supplier Obligation.

<sup>26</sup> Updated Issues Statement, paragraph 49.

<sup>27</sup> We refer to the last question in paragraph 18 of Appendix A of the CMA's "Capacity" working paper and paragraph 115 of the CMA's "Case Studies on barriers to entry and expansion in the retail supply of energy" working paper published on 18 February 2015 (**Case Studies WP**).

<sup>28</sup> "Capacity", CMA working paper published 3 March 2015 (**Capacity WP**), paragraph 106.

<sup>29</sup> Capacity WP, paragraph 39.

<sup>30</sup> Updated Issues Statement, paragraph 113.

## **2. Updated Theory of Harm 2: Market power in generation leads to higher prices**

- 2.1. The CMA's current thinking is that the Big Six have not earned excessive profits from their generation business or that wholesale market prices have been above the competitive level. The CMA also argues that the three conditions for showing coordinated market power are not satisfied with respect to generation.
- 2.2. First Utility's view is not that the Big Six have market power in relation to generation, but that by being vertically integrated, they have a competitive advantage with respect to an insufficiently liquid wholesale electricity market, as a result of internal trading coupled with the fact that they are less exposed to risk on the products that do not trade in a liquid market. This lack of liquidity in wholesale electricity supply is a risk to expansion for suppliers such as First Utility, which in turn works in the interests of the Big Six. Inability to source shaped products in wholesale forward markets has a material influence on possible hedging strategies and risk profiles for suppliers and so translates into an additional cost to consumers, as a higher risk premium has to be priced into those suppliers' consumer tariffs. Our assessment of the cost differential between vertically integrated and independent energy retailers as a result of this illiquid wholesale market, was in the order of £30 per customer accounting for the costs relating to shaping products and imbalance.<sup>31</sup> This is therefore a market feature which has a material impact on the independent suppliers' ability to deliver lower prices to GB consumers and may become substantially greater in periods of greater wholesale market volatility.
- 2.3. The profitability of the Big Six with regard to generation is not the salient point in this context, but rather whether the Big Six have any incentive to increase shaped liquidity in a manner which would make it easier for non-vertically integrated suppliers to hedge risk more effectively, and to grow their supply volumes. First Utility has attempted to enter into transactions for more shaped products in the wholesale markets, but we find that we cannot do so reliably, on acceptable terms or in a timely way. As discussed in the next section, for products not generally traded, we have no way of knowing, whether the price being offered (taking relevant terms and conditions into account) is competitive in these circumstances.

## **3. Updated Theory of Harm 3a: Opaque prices and low liquidity in wholesale electricity markets distorts competition in retail and generation**

- 3.1. The CMA is considering liquidity in the GB energy market, since it wants – as it states in its Working Paper on Liquidity<sup>32</sup> – to assess its possible effects on competition between respectively the vertically integrated and independent energy firms. The CMA's concerns are that if liquidity is poor:

---

<sup>31</sup> Information provided to the CMA on 24 September 2014 and submission of 20 October 2014 to the CMA's questions on liquidity; question 4.

<sup>32</sup> Liquidity WP, paragraphs 106 and 107.

27 March 2015

- 3.1.1. “Down the curve” (i.e. further ahead of the time of delivery) - independent suppliers/generators may be less able to hedge their demand or output, increasing their risk or causing them to pay a premium to reduce risk, which may in turn affect competition in the retail or generation markets; and/or
- 3.1.2. “Near-term” (i.e. closer to the time of delivery) – independent suppliers would be more exposed to cashout than vertically integrated firms, increasing their costs and again distorting competition.
- 3.2. First Utility fully agrees with the CMA’s concerns, but disagrees with the CMA’s initial view, as set out in its Updated Issues Statement,<sup>33</sup> that current levels of liquidity in the electricity wholesale market appear to be sufficient, because they allow independent suppliers and generators to trade and hedge “in the same way as the Six Large Energy Firms”. The CMA considers that, while there is some lack of liquidity in less widely traded products which may impose some degree of increased risk on market participants, there is no lack of liquidity in the overall market which seems to be distorting competition or acting as a barrier to entry or expansion.
- 3.3. First Utility is of the view that only wholesale market liquidity for a wide **variety of products** - including forward shaped products - will deliver the vigorous wholesale competition required to enable independent suppliers and generators to enter the market and expand their businesses, which in turn will drive competition along the entire energy supply chain:
  - 3.3.1. Liquidity along the forward curve is particularly important for non-vertically integrated energy firms to enable them to manage their wholesale market risks and reduce future cost uncertainty, so as to secure steady gross margins and be able to offer fair and stable prices to consumers.<sup>34</sup>

First Utility considers that there is currently little to no liquidity in the more bespoke products and that there is still a distinct lack of forward shaped products in the market.<sup>35</sup> This lack of liquidity in forward shaped products prevents non-vertically integrated electricity suppliers from competing effectively with the Big Six, as independent suppliers rely on products available in the wholesale market to manage shape risks since they have no natural hedge, i.e. the ability to purchase the required bespoke products from their own generation arms coupled with the offsetting risk reduction this provides.
  - 3.3.2. In the near term, the lack of liquidity can render independent suppliers more exposed to cashout than vertically integrated firms, which – as the CMA itself acknowledges –

<sup>33</sup> Paragraphs 98 and 100.

<sup>34</sup> Liquidity WP, paragraph 43.

<sup>35</sup> See First Utility’s response of 20 October 2014 to the CMA’s questions on liquidity (question 2) for a list of products we would like to see.

27 March 2015

increases their costs and ultimately leads to higher retail tariffs. As we note in paragraph 1.7 above, independent suppliers find themselves much worse off in terms of imbalance as compared to the vertically integrated suppliers.

- 3.4. First Utility is concerned that if such forward products have not been forthcoming in a wholesale market where: (i) prices have been relatively low and volatility has been benign in recent years; and (ii) it is reasonable to suppose that flexible energy generators would look to trade flexible shaped product, it follows that in a more volatile period, this lack of product liquidity would only increase. In these circumstances, First Utility, and other independent suppliers, would have even fewer options to manage their risk prudently.

***A different question regarding liquidity needs to be asked***

- 3.5. In First Utility's view, the CMA has asked itself the wrong question to establish whether there is sufficient liquidity in the electricity wholesale forward markets. The question regarding liquidity is not whether independent suppliers and generators are able to hedge and trade in the same way as the Big Six, but whether these non-vertically integrated market players can sell and buy electricity ***as they require*** in order to offer fair and stable prices to consumers.
- 3.6. First Utility and other independent suppliers (as well as the independent generators) do not and cannot trade and hedge in the same way as the Big Six, since they have: (i) different customer bases; (ii) a different market risk profile owing to them being "single-sided" players; and (iii) a greater risk of imbalance due to the lower forecastability of their portfolio and less options to mitigate this. In this context, it is notable that ESB stated in its Initial Submission to the CMA<sup>36</sup> that independent players, contrary to the vertically integrated energy companies, use the wholesale market both as a route to market and as a means of managing risk, while the CMA found that the Big Six's trading and hedging patterns differ from those of the independent firms.<sup>37</sup> In our view, it is erroneous to draw any conclusions on the adequacy of liquidity in wholesale markets based on a comparison of the behaviour of the Big Six and independent suppliers given that such behaviours are: (i) influenced by the limited products available in an illiquid market; and (ii) driven by different needs in terms of downstream customers and risk profile.

*Different customer bases*

- 3.7. Unlike the independent suppliers, the Big Six energy suppliers have a very slowly evolving customer base, which means that it is mainly the weather that drives electricity demand variations. We therefore consider that these suppliers should always know to a high degree of confidence what products they require to buy and sell in order to shape a very large proportion of their customer demands.

---

<sup>36</sup> Dated 14 August 2014.

<sup>37</sup> Liquidity WP, paragraph 157.

27 March 2015

- 3.8. As First Utility submitted in its Initial Submission to the CMA,<sup>38</sup> the Big Six vertically integrated suppliers are able to source such forward shaped products from their own generation portfolios with relative ease at their own choice of timing, because their risk profile for shaping internally is far less sensitive to both the timing and the price of the trade. First Utility considers that this explains why, in our experience, integrated suppliers almost never bid for forward shaped products on the wholesale markets and why integrated generators almost never offer forward shaped products on the market. Any trading for the vertically integrated firms is merely to balance their positions closer to delivery and to address any changes in demand as a result of changes in the weather.

*Different risk profile – hedging*

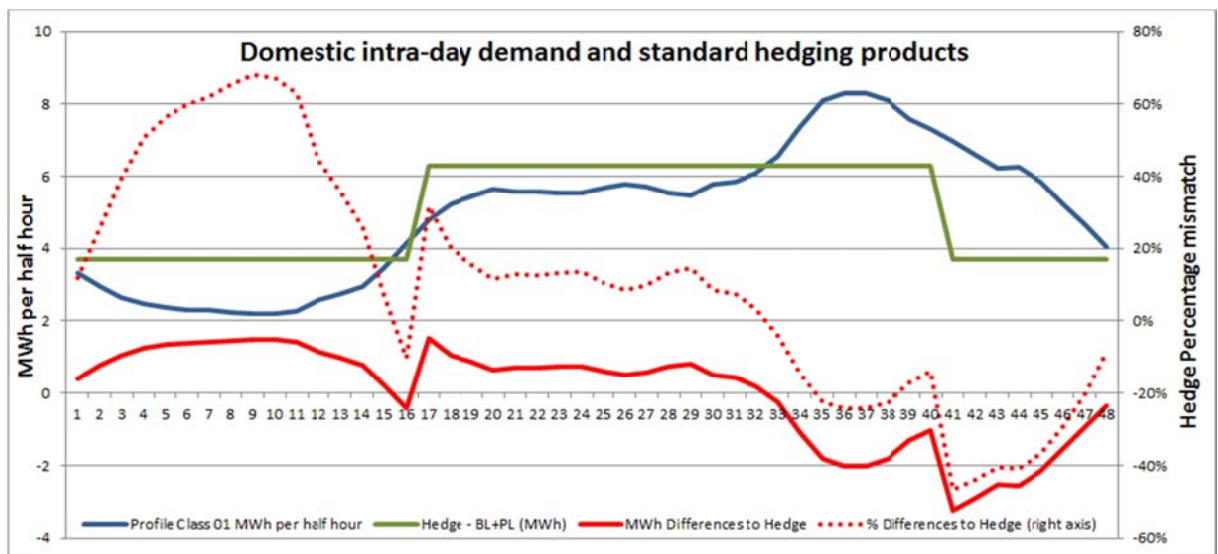
- 3.9. The ability of the Big Six to self-supply provides them with a natural hedge and minimises their exposure to traded markets. As Ofgem stated in its March 2014 proposal to make a market reference in respect of the GB energy market:<sup>39</sup> “*Vertical integration provides a financial hedge against volatile wholesale energy prices and a natural hedge against balancing risk.*” 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 as well as their ability to purchase bespoke products without having regard to price distorts competition in downstream retail markets. As set out above, such market players’ need to trade is limited to smaller adjustment trades around the edges of their generation and supply portfolios to balance their net positions with further trading based more on the desire to trade than a need to hedge their positions.
- 3.10. On the other hand, non-vertically integrated suppliers such as First Utility are dependent on the wholesale electricity market to ensure that they can source their electricity requirements; and must rely on the products available in the wholesale markets. This often leads to inefficiencies which could be avoided if there was a wider range of products available on the market. Our graph below illustrates clearly that there are significant mismatches in each half hour of the day between the shaped profile that a supplier must purchase for a typical domestic customer and the standard Baseload-plus-Peakload hedge that can be purchased in the forward market.

---

<sup>38</sup> Paragraphs 2.8.

<sup>39</sup> Dated 27 March 2014, paragraph 3.18.

27 March 2015



*The blue line shows the half-hourly volume requirements for a typical domestic customer in each half hour of the day, while the green line indicates the hedge possible using typical forward products available on the wholesale market. “Shaped” products (the red line and expressed as a percentage of demand in the dotted line) 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. It is clear that for some half hours the shape mismatch can be as much as 70 per cent.*

- 3.11. First Utility considers that a key feature of a competitive wholesale forward market for non-vertically integrated suppliers is availability of hedging products to enable them to prudently manage the risk in their supply portfolios for a minimum of one year forward, in line with the main retail products on offer. This would enable independent suppliers to choose when to hold or mitigate wholesale risks in order to secure steady gross margins and offer fair and stable prices to consumers. Currently some of those risks are held more by default than by choice, because there are no or only limited alternatives.
- 3.12. 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 in limiting expansion of independent suppliers notably to a scale where they might make more significant and enduring inroads into the Big Six market share.
- 3.13. In its response to the CMA’s questions on liquidity of 20 October 2014,<sup>40</sup> First Utility explained that it is unable to hedge shape risk forward in the current electricity wholesale market due to a lack of products being available. This means that First Utility has to factor a risk premium into its retail tariffs to cover a range of potential cost outcomes for purchasing wholesale shape close to delivery. Consequently, this risk premium increases First Utility’s tariff rates relative to

<sup>40</sup> Question 4.

27 March 2015

the price at which it might have been able to sell at (i.e. by our calculation of up to around £30 per year in dual fuel tariff costs for an average customer), which is likely to lead to:

- 3.13.1. a reduction in the number of customers who might switch to First Utility owing to First Utility's prices being higher than might have been the case if liquidity in products required by First Utility was better;
  - 3.13.2. an increase of First Utility's costs, thereby reducing its gross margin relative to the vertically integrated suppliers who benefit from access to such products via internal upstream businesses; and
  - 3.13.3. an increase in business uncertainty, since it leaves First Utility exposed to market risks that could adversely impact its profitability (particularly when the cost of shaping exceeds the risk premium) in volatile market conditions.
- 3.14. First Utility therefore considers that the lack of forward shaped products in the electricity wholesale market places it and other independent suppliers at a competitive disadvantage to the Big Six and/or acts as a significant barrier to expansion. Ofgem drew the same conclusion in its proposal to make a market investigation reference: “[...] we had consistently found that GB electricity market liquidity was poor, particularly for products traded ahead of when they will be supplied. We found that this was inhibiting the ability of market participants - particularly independent market participants - to compete effectively in the electricity generation and supply markets”.<sup>41</sup> The CMA's initial views seem inconsistent with the detailed work Ofgem has carried out in this area.

*Greater risk of imbalance*

- 3.15. Since any out-of-balance supplier will be exposed to the punitive cashout prices under the balancing mechanism, which can deviate significantly from wholesale prices immediately prior to trading ending for each half hour of delivery, suppliers will need to predict their customers' demand accurately at all times in order to minimise volumes of electricity purchased or sold via the balancing mechanism. This can be difficult for smaller suppliers.
- 3.16. The CMA has observed that “*imbalances tend to be low for many large and vertically integrated generators and suppliers.*”<sup>42</sup> We agree. Figure 25 in the CMA's Descriptive Statistics in Generation and Trading Working Paper shows that the imbalance percentage of the independent domestic suppliers in the period 2010 - 2012 was much higher than the imbalance

---

<sup>41</sup> Ofgem consultation on a proposal to make a market investigation reference in respect of the supply and acquisition of energy in Great Britain dated 27 March 2014; paragraph 1.8.

<sup>42</sup> Descriptive Statistics: Generation and Trading WP, paragraph 31.

27 March 2015

percentage of the Big Six<sup>43</sup> and First Utility understands that this situation has not changed for the period 2012-2014.

- 3.17. First Utility considers that the higher percentage of imbalance in independent suppliers is linked to both: (i) a lack of availability of wholesale forward shaped products; and (ii) the inability of independent suppliers to adjust their positions close to delivery, since they do not have a generation arm to contract with immediately prior to gate closure. Independent suppliers, such as First Utility, need these products, or at the very least visibility of potential products and likely prices, to manage and price their volume and imbalance risks. We infer from the lower imbalance percentage of integrated suppliers that there is an advantage in having a natural hedge in either providing “shape” along the forward curve or at delivery via internal trades and/or in enabling vertically integrated firms to avoid imbalance positions closer to delivery. These additional imbalance costs and risks impact independent suppliers’ ability to offer the most competitive retail tariffs downstream.

#### ***Other market participants’ views***

- 3.18. We think it is telling that the overall view put forward by the vertically integrated energy firms in their initial submissions to the CMA is that there are no liquidity concerns in relation to the GB electricity wholesale markets, but that many of the other market participants – both suppliers and generators - considered that liquidity in the wholesale markets was at a low level.<sup>44</sup> For instance, we understand that Haven Power found it difficult to source its power requirements before it was acquired by Drax in 2009 and therefore became vertically integrated,<sup>45</sup> while Ovo Energy considers the GB wholesale electricity market to be less liquid than countries like Germany and has decided to buy “*the most liquid product in the market*”<sup>46</sup> as a strategy to try and manage this relative illiquidity. The Co-operative Energy appear to have similar concerns to First Utility, since it stated in its Initial Submission to the CMA that “*liquidity is at a very low level*”<sup>47</sup> and that “*the lack of liquidity in the wholesale market makes it more difficult and expensive for smaller non-vertically integrated energy suppliers to trade in and out of physical positions*”.<sup>48</sup>
- 3.19. We note that some independent suppliers, such as Utility Warehouse, do not echo our views on the lack of liquidity in wholesale markets.<sup>49</sup> However, we consider that their views are based on the fact that these suppliers have chosen not to be exposed to any liquidity issues, since:

- 3.19.1. Utility Warehouse has a long term 20 year supply arrangement with RWE npower,<sup>50 51</sup> under which RWE npower supplies energy to Utility Warehouse on a “retail minus”

<sup>43</sup> Descriptive Statistics: Generation and Trading WP, table 25.

<sup>44</sup> Liquidity WP, paragraphs 37 – 40.

<sup>45</sup> Case Studies WP, paragraph 33.

<sup>46</sup> Case Studies WP, paragraphs 29-31.

<sup>47</sup> Initial submission by The Co-operative Energy dated 29 August 2014, paragraph 4, page 2.

<sup>48</sup> Initial submission by The Co-operative Energy dated 29 August 2014, paragraph 3, page 5.

<sup>49</sup> Case Studies WP, paragraphs 12 and 32.

27 March 2015

basis (that is, a discount to a benchmark transfer price based on the Big Six variable tariffs), so that the wholesale risk remains with RWE npower;<sup>52</sup> and

- 3.19.2. Certain “green” suppliers, such as Ecotricity and Good Energy, have a degree of vertical integration, since they own some renewable energy assets.
- 3.20. The views referred to by the CMA suggesting lack of concern at the low levels of liquidity may also be influenced by the relatively small current customer base of some of the independent suppliers, and the benign wholesale market conditions of recent years. Unlike First Utility, some of these independent suppliers may have not yet grown to a size and/or operated in more volatile market conditions so as to experience the full scale of the possible risks associated with a lack of liquidity. We believe it would be dangerous to assess wholesale liquidity threats to competition based on market conditions in recent years alone without also considering scenarios of increased wholesale market volatility that have occurred historically, and will doubtless be repeated.
- 3.21. Finally, the CMA suggested in its Working Paper on Foreclosure that independent suppliers are not reliant on the generation arms of the Big Six and that they can instead seek to source their electricity requirements from the independent generators, since “*the volume of independent generation significantly exceeds the demand from independent suppliers*”.<sup>53</sup> We do not think that this is a solution to the concerns we have.
- 3.22. First Utility contends that in practice this does not prove to be possible, since many independent generators have entered into long term tolling agreements in order to lock in revenues to secure funding<sup>54</sup> and/or cannot offer bespoke products along the forward curve. For instance, Drax informed the CMA that it does not engage in shape trading until close to delivery, since “*it is inconvenient for generators to trade non-standard products and because suppliers’ demand becomes more predictable closer to delivery*”.<sup>55</sup> Whilst it is true that suppliers’ demand becomes more predictable closer to delivery, we believe that a high percentage of demand is already predictable a long way in advance of delivery.
- 3.23. We believe lack of wholesale liquidity in electricity trading is a market feature which limits competition. While independent suppliers have increased their market share in recent years, this has been despite a lack of shaped products along the forward curve. (We consider in paragraphs 3.46 – 3.48 our concerns around foreclosure in the provision of shaped products.)

<sup>50</sup> See Liquidity WP, paragraph 39, where the CMA appears to give equal weight to First Utility’s view of trading with that of Utility Warehouse on liquidity.

<sup>51</sup> <http://www.telegraph.co.uk/finance/newsbysector/energy/10461986/Utility-Warehouse-buys-770000-customer-accounts-from-npower-in-218m-deal.html>

<sup>52</sup> Telecom Plus shareholder circular and notice of general meeting.

<sup>53</sup> “Foreclosure”, CMA working paper published on 24 February 2015, paragraph 95.

<sup>54</sup> As stated by InterGen UK, Energy and Climate Change Committee Written evidence submitted by InterGen UK, June 2012

<sup>55</sup> “Liquidity”, CMA working paper published on 13 March 2015, paragraph 40.

27 March 2015

- 3.24. First Utility understands that such forward shaped products were available under the Pool.<sup>56</sup> However, we do not believe reversion to centralised dispatch and the Pool would be a practical or proportionate solution. We consider that requiring all supply to be procured through open traded markets would remove the advantages currently enjoyed by the vertically integrated Big Six and encourage availability of shaped product in the wholesale market to meet the needs of market participants who would then all be wholly reliant on traded markets.

***Opaque prices***

- 3.25. First Utility is of the view that a lack of reliable price signals in the forward market further reduces the ability of non-vertically integrated generators and suppliers to compete effectively.
- 3.26. Although we agree with the CMA that there is some transparency of prices in the wholesale market, e.g. the prices paid on exchanges and for over-the-counter (**OTC**) contracts, there is absolutely no transparency in relation to the longer term bespoke wholesale products which – as explained above – First Utility considers to be essential for independent suppliers. These products are largely subject to bilateral or indeed internal trades, which prevent their prices from being publicly known.
- 3.27. This lack of reliable price signals in the forward market further prevents non-vertically integrated generators and suppliers from competing effectively, since it hampers their ability to secure financing for new projects or expansion as projecting future earnings of the expanded businesses is correspondingly more difficult.
- 3.28. Requiring generators to make all generated electricity available for trade through broker platforms and exchanges would, in our view, increase market transparency and competition to the benefit of downstream market participants and consumers. Preventing integrated suppliers from taking advantage of their natural hedge in upstream generation via internal trades would significantly increase sales and purchases in the wholesale forward market leading to increased engagement with other players in the 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.

***Reduced activity by third party intermediaries is further evidence of a lack of liquidity***

- 3.29. First Utility considers that further evidence of a lack of liquidity in the wholesale electricity markets is evidenced by Figure 19 in the CMA's Descriptive Statistics in Generation and Trading Working Paper.<sup>57</sup> After the collapse of Enron in the US in November 2001 and despite new firms entering the market, the availability of medium-term supplies to energy retailers was significantly reduced, due to the perceived risk. Many of these new firms subsequently left the

---

<sup>56</sup> A number of products known as "shapes" were available, the most popular of which was "load shape 36".  
<sup>57</sup> Descriptive Statistics: Generation and Trading WP, page 19.

27 March 2015

market or went bankrupt (for example, TXU Europe), leaving traders, power companies and a handful of banks to try and improve transparency and liquidity.

- 3.30. Yet the improvements in liquidity have not transpired. Generally, in a liquid market with robust price discovery, First Utility would expect that market intermediaries provide smaller and new entrant independent suppliers and generators with innovative solutions for the warehousing of the various risks faced by such players e.g. market price, volume and credit risks. Instead, a number of counterparties have left the GB energy market recently. For example Barclays left the market last year<sup>58</sup> and Morgan Stanley also appears to be considering exiting the market.<sup>59</sup>
- 3.31. In its Liquidity Working Paper,<sup>60</sup> the CMA states that various parties have commented that liquidity is a “vicious (or virtuous) circle”. We are concerned that taken together with the exit of a number of counterparties and the low level of liquidity in shaped products, we are in a vicious circle, with increasingly illiquid markets for bespoke products (which may be available in a technical sense but the terms are uncommercial) and potentially increasingly illiquid “standard” products.
- 3.32. Moreover, the little liquidity in the current market may further be put at risk from the impending European legislation under the Markets in Financial Instruments Directive II (**MiFID 2**)<sup>61</sup> which could force energy traders to back their trading positions with more capital. This will increase costs and could drive out smaller players, as well as reducing the availability of innovative hedging products. A liquid market with market intermediaries will help create solutions to issues around credit and collateral, weather forecasting and fuel supply; yet if settled in cash rather than actual electricity, the availability of such products will reduce, and the costs will increase, under the new arrangements.<sup>62</sup> Historically there have only been a handful of counterparties with appetite to innovate around these problems so that smaller players can compete and grow market share. Therefore, First Utility considers that unless steps are taken to improve liquidity, this situation will only deteriorate further.

***Comparison with the gas wholesale markets is not useful***

- 3.33. We do not consider that the wholesale gas market is as useful a comparator for the wholesale electricity market as the CMA seems to suggest in paragraph 99 of the Updated Issues Statement. Gas and electricity are very different commodities – not least because gas can be stored (e.g. in long term storage such as Rough; in faster response salt cavern storage; and/or as linepack) while electricity cannot (limited amounts of pump storage and battery technology aside).

<sup>58</sup> Article in the FT.com April 20, 2014 Barclays to wind down commodities trading.

<sup>59</sup> [http://www.sparkspread.com/sparkspread.php?sparkspread\\_concept=topic&id=6](http://www.sparkspread.com/sparkspread.php?sparkspread_concept=topic&id=6).

<sup>60</sup> Liquidity WP, paragraph 73.5

<sup>61</sup> Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU.

<sup>62</sup> This reflects the point we made in our response of 31 October 2014 to S10 (j) of the Supply Questionnaire, which noted that competitive wholesale markets are able to find solutions for such problems and the lack of availability of such solutions is a reflection of an uncompetitive market.

27 March 2015

3.34. First Utility considers that the trading and shaping requirements for each product vary significantly, since each product has a different risk profile at settlement:

3.34.1. Electricity is settled half hourly, whereas gas is settled daily - there is therefore more shaping risk and imbalance risk in electricity than gas. We estimate that these differences mean that the cost and risk of gas shaping is estimated to be nearly two times smaller than the cost and risk of electricity shaping. This lower gas shaping risk explains why gas seasons might not break up into gas quarters and months as far forward as electricity seasons should (i.e. the risk in gas is smaller so there is less need to trade the higher granularity products). This is not to say that the gas market is perfect - we believe that at least some parties would benefit from the trading of some higher granularity products along the forward curve.

3.34.2. The electricity imbalance arrangements mean that prices can deviate materially from pre-gate closure prices. By contrast, gas imbalance prices tend to be more predictable by reference to the short term market prices, which reduces risk and cost of gas shaping at delivery.

3.35. These features mean that there is greater risk in trading electricity than gas. A range of different wholesale forward products should therefore be available so as to allow participants to manage this greater risk if the market is to serve the needs of all participant types.

3.36. The fact that the CMA found the electricity and gas forward markets to trade in a similar way when they are structurally very different (and with different risk profiles) confirms in our view that there is something wrong in the electricity forward market. Consequently, First Utility disagrees with the CMA's initial conclusion that, if there was indeed a lack of liquidity in the wholesale electricity market and vertically integrated electricity firms were hedging their trades internally, it would have expected to see more forward shaped products being traded and vertically integrated gas firms trading further forward in the wholesale gas market, which, according to the CMA, is characterised by a lower degree of vertical integration and better liquidity than the wholesale electricity market.

#### ***Secure & Promote licence condition***

3.37. As previously submitted to the CMA,<sup>63</sup> First Utility considers that the Secure and Promote licence condition has to date had very little impact on the overall liquidity in the electricity wholesale market. There are no new products for sale to mitigate shape risks (intra-day, intra-week and intra-season) along the forward curve and the two one-hour trading windows have reduced the number of opportunities in a day for independent suppliers to execute trades on the market. InterGen stated in its initial submission to the CMA that it was "*concerned that despite the introduction of Secure & Promote the volume of peak demand period sales transactions for*

---

<sup>63</sup> See First Utility's response of 20 October 2014 to the CMA's questions on liquidity; question 3.

27 March 2015

*forward seasons remains incredibly low despite tightening system margins. There is no simple single reason for this but in our view credit constraints, substantial regulatory uncertainty (e.g. carbon price support, introduction of cashout reform) and the hedging strategies adopted by the vertically integrated suppliers all play a role.”<sup>64</sup>*

- 3.38. First Utility understands that the main result of the Secure and Promote licence condition so far has been to move the days’ continuous trading into two one-hour windows. There is often a material increase in bids and offers inside the trading windows as compared to before or after the windows. However, there is a feeling in the market that the overall volume of trading per day is largely unchanged. The CMA acknowledges in its Liquidity Working Paper<sup>65</sup> that the Secure & Promote licence condition may have improved liquidity in the designated windows, since the products are now available in windows when they were not previously regularly available, or are available in greater depth, but that this improvement may have been at the expense of liquidity in other parts of the day. First Utility believes that, since risk positions evolve continuously throughout a trading day, a continuously liquid market is far more helpful for managing risk than one which is largely only open for trading during two one hour windows.
- 3.39. First Utility sees the Secure and Promote licence condition as a missed opportunity to encourage “product discovery” by stimulating participants to trade forward some of the shaped products which rarely or never trade forward. We consider that a successful liquidity intervention should increase the range of products sold in the forward market, particularly shaped products, and should require the vertically integrated companies to release more forward shaped products into the wholesale market.<sup>66</sup>
- 3.40. As discussed above, vertically integrated utilities benefit from a natural hedge which means they have a reduced need to source shape in the forward market since they can source these volumes internally at any time. All the internal price for shaped products in a vertically integrated utility then sets is a level of shaping income benefit for the generation arm and a level of shaping cost for the supply arm, with the price making little overall impact on profit across the entire vertically integrated entity. This means that a vertically integrated supplier does not need to hedge shape in the forward market to protect profits, which is likely to be the reason why it does not hedge shape in any meaningful volume in the forward wholesale market. In contrast, the cost of shaping for an independent supplier impacts fully on any profit as there is no offsetting benefit elsewhere.
- 3.41. This means that an independent supplier, who has every incentive to hedge shape in the forward market, is unable to do so, because the vertically integrated energy suppliers who account for the majority of the supply market are far less exposed to this profitability risk when

<sup>64</sup> Initial submission by InterGen dated 14 August 2014, page 1.

<sup>65</sup> Liquidity WP, paragraphs 97 and 98.

<sup>66</sup> See First Utility’s response of 20 October 2014 to the CMA’s questions on liquidity (question 2) for a list of products we would like to see.

27 March 2015

viewed across their entire business and are thus not incentivised to hedge shape in the forward market.

- 3.42. First Utility strongly believes that by requiring the vertically integrated companies to release more shaped products into the market, a more complete set of forward products will be fully available and a transparent forward price for shape will emerge. This would allow current and potential new suppliers to gain confidence in their ability to hedge; while allowing potential new generation entrants to gain confidence in their ability to value flexible generation more accurately as part of their investment decisions. It would therefore be beneficial to the entire electricity wholesale market.
- 3.43. As submitted previously to the CMA,<sup>67</sup> 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 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.

**Updated Theory of Harm 3b: Vertically integrated electricity companies act to harm the competitive position of non-integrated firms to the detriment of the consumer, either by increasing the costs of non-integrated energy suppliers or reducing the sales of non-integrated generating companies**

- 3.44. The CMA has been considering the possibility of “input foreclosure” in the wholesale electricity market and has set out its current thinking in its Foreclosure Working Paper.<sup>68</sup>
- 3.45. The CMA’s current view is that input foreclosure is unlikely to occur, since vertically integrated energy companies lack:
- 3.45.1. the incentive to try and foreclose rivals by withdrawing generation from the market;<sup>69</sup> and/or
  - 3.45.2. the ability to foreclose rivals by reducing liquidity on the market.<sup>70</sup>
- 3.46. We consider that the CMA’s analysis on this point fails to recognise the existing input foreclosure that occurs with regard to the lack of availability of the shaped products which would allow non-vertically integrated suppliers to better hedge their positions along the forward curve.

---

<sup>67</sup> First Utility’s initial submission to the CMA of 14 August 2014; paragraph 2.16.

<sup>68</sup> Dated 24 February 2015.

<sup>69</sup> Updated Issues Statement, paragraph 105.

<sup>70</sup> Updated Issues Statement, paragraph 106.

27 March 2015

This illiquidity is a form of input foreclosure which restricts the ability of non-vertically integrated firms to offer the most competitive tariffs in downstream supply markets.

- 3.47. This is essentially a different characterisation of the concern we have with regard to liquidity as described above, but it is apparent that the vertically integrated suppliers who account for a material proportion of GB generation have both the incentive and the ability to restrict access – or simply not offer – the shaped longer-term products which would create a truly liquid market (as was the case under the historic Pool arrangements). They also have the ability to contract with independent generators (given the scale of their retail demand) thereby foreclosing possible trading partners to independent firms.
- 3.48. The incentive arises as a consequence of the Big Six's ability to naturally hedge by self-supplying – thus limiting their exposure to trading markets, and their ability to limit availability of these shaped products (which are an important input for First Utility) is self-evident, as described in our responses of 20 October 2014 to the liquidity questions raised by the CMA.
- 3.49. Our point is not that the Big Six are systematically holding back wholesale product to prevent non-vertically integrated customers competing at all. The critical point is the ability of the Big Six to influence the availability of the type of shaped products – which we understand were more widely available under the Pool – that would make independent suppliers more competitive on the retail market. The increased risk on hedging costs faced by independent suppliers as a consequence of illiquid wholesale markets and increased imbalance costs are a market feature which distorts competition in downstream supply markets to the benefit of the Big Six – and therefore something that the CMA should consider remedying.

#### **4. Updated 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 behaviours and/or regulatory interventions**

- 4.1. As highlighted in paragraph A8 above, First Utility's second key concern, in addition to the problem of illiquid wholesale markets, is the way in which the retail market is currently functioning and the repercussions of this for GB consumers. In particular and as rightly identified by the CMA, a combination of the following problematic market features all contribute to an AEC:
- 4.1.1. inactive customers - efforts by the incumbent Big Six energy suppliers to keep SVT customers disengaged;
  - 4.1.2. supplier behaviour - the potential for tacit coordination between the Big Six; and
  - 4.1.3. the (unintended) consequences of certain regulatory interventions.

27 March 2015

- 4.2. In our view, there is a strong link between all the Theories of Harm identified by the CMA and First Utility considers that an increase in competition on the wholesale market through the release of more bespoke products (in particular, forward shaped products) would lead to more vigorous competition on the downstream retail market.
- 4.3. We note that the CMA's initial views on this Theory of Harm are at an earlier stage of development compared with those relating to wholesale electricity and vertical integration. In order to assist the CMA in its analysis, we have set out below our views on the detrimental nature of these features and explain why SVTs are having a negative impact on competition below together with the underlying evidence.

***SVTs are having a detrimental effect on competition in the retail energy market***

- 4.4. The CMA has found that, post-liberalisation, competition has focused on SVTs with the Big Six aiming to convert domestic customers in their home areas to dual fuel and to attract new customers in other areas by offering cheaper SVTs or cheaper fixed rates<sup>71</sup> which revert to SVTs after the introductory period has lapsed. First Utility agrees with this view and believes that this has enabled the Big Six to entrench their customer base.
- 4.5. Between 50 per cent to 90 per cent of customers supplied by the Big Six pay a SVT,<sup>72</sup> and that significant savings are available to customers who switch.<sup>73</sup> The table below (based on published tariff data and our own calculations) highlights the percentage differences between the average SVT and short term fixed tariff offered by each of the Big Six. In the case of British Gas, for example, the percentage difference is significantly increased when compared with the average short term fixed tariff offered by its white label provider, Sainsbury's Energy.

---

<sup>71</sup> Updated Issues Statement, paragraphs 114 and 118 and "The pricing strategies of the Six Large Energy Firms in the retail supply of electricity and gas to domestic customers". CMA working paper published on 2 March 2015 (**Pricing Strategies WP**), paragraph 9.

<sup>72</sup> Updated Issues Statement, paragraph 113.

<sup>73</sup> Updated Issues Statement, paragraph 134.

27 March 2015

**Average usage of 3,200kWh electricity and 13,500kWh gas**

£	Average standard rate	Average short term fixed	Difference	% Difference
British Gas	1,156	1,099	57	4.9%
EDF	1,155	964	191	16.5%
Eon	1,135	1,101	34	3.0%
Eon - Collective Switch		877	258	22.7%
nPower	1,169	954	215	18.4%
Scottish Power	1,166	949	217	18.6%
SSE	1,158	1,156	2	0.2%
Sainsbury's Energy	1,156	949	207	17.9%

All rates are for customers paying via DD and after the standard variable rate reductions announced to date (19/3/15)

There are no termination fees on the short term fixed deals offered by BG, EDF, nPower and SP. This means there are effectively variable tariffs and should be treated as such.

Sainsbury's Energy are a white label provider for BG and the discount shown is also the discount to the equivalent short term fix tariff offered by BG

- 4.6. The CMA notes the gains that can be made from switching, with an average saving of between £158 and £234.<sup>74</sup> Thus, the vast majority of consumers are overpaying considerably for their energy supply even if they simply accepted the best tariff from their existing supplier. As we note in the table above, four out of the six Big Six offer fixed tariffs with no exit fees, rendering any difference with SVTs moot.
- 4.7. Further, the CMA's initial analysis suggests that customers subscribed to SVTs offered by the Big Six could save between £183 and £278 by switching to any type of tariff (including SVTs) offered by independent suppliers.<sup>75</sup> If this level of saving was unimportant to consumers, then this would not be an issue per se. However, according to the CMA consumer survey, 50 per cent of consumers said they would switch for savings of less than £150/year, and an additional 18 per cent would switch for savings between £150-£250/year.<sup>76</sup> The fact is that less than 11 per cent of consumers switched providers in 2014,<sup>77</sup> and only 27 per cent switched supplier in

<sup>74</sup> Updated Issues Statement, paragraph 134. Our own calculations found that up to 70 per cent of customers of the Big Six are on SVTs.

<sup>75</sup> "Analysis of potential gains from switching", CMA working paper published on 24 February 2015 (**Switching WP**), paragraphs 36 and 37.

<sup>76</sup> A report for the Competition and Markets Authority by GfK NOP, published on 20 February 2015 (**GfK Survey**), figure 70.

<sup>77</sup> See <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics>.

27 March 2015

the past three years.<sup>78</sup> First Utility welcomes that CMA's intention to assess the relative difference in savings between customers subscribed to SVTs and non-standard tariffs in its proposed regression analysis.

- 4.8. In our view, a major barrier to expansion is the Big Six's ability to segment and exploit their customer base, which is confirmed by the CMA's initial finding that the Big Six's gross margins over the last three years are 12 per cent to 13 per cent higher for customers on the SVT than those on non-standard tariffs.<sup>79</sup> This suggests that huge gains are made by the Big Six on inert, non-price-sensitive customers who do not switch, despite the obvious benefit for them in doing so. This enables the Big Six to cross-subsidise short-term attractive acquisition tariffs offered to new customers who then often revert to the higher SVT once the initial term expires.<sup>80</sup>
- 4.9. First Utility notes that the ability of the Big Six to cross-subsidise short-term protective tariffs has been raised by a number of other independent suppliers as a significant barrier to expansion.<sup>81</sup> For example, Utility Warehouse believes that the majority of the Big Six engage in the cross-subsidisation of *"loss-leader acquisition tariffs through the exploitation of their less-engaged legacy customers, many of whom are stranded on inflated standard variable tariffs."*<sup>82</sup>
- 4.10. Furthermore, we have concerns that some of the Big Six are using these higher margins to compete in the acquisition market via their white label – and without the requirement to communicate these better tariffs to their brand customers (although we note that Ofgem is addressing this for the future).<sup>83</sup> Recent evidence shows that rather than White Labels offering an independent product mix and greater choice to the consumer, Big Six suppliers may instead be using them as an additional acquisition route.<sup>84</sup>
- 4.11. First Utility therefore holds some concern that the current White Label tariffs may provide a convenient and anti-competitive workaround of the RMR four tariff rules. This further undermines the principles behind the regulations, aimed at rebuilding trust in the market, and also is in contrast to claims by the Big Six suppliers that their White Labels providing greater choice to consumers.

---

<sup>78</sup> GfK Survey, figure 10.

<sup>79</sup> Updated Issues Statement, paragraphs 15 and 122.

<sup>80</sup> First Utility notes that in its Case Studies WP, the CMA acknowledges that Ovo Energy also raises such practices as a barrier to expansion. For example, "[Ovo Energy] believed that the Six Large Energy Firms charged "sticky" customers, many of whom are vulnerable, the maximum they could, and then attracted active switching customers through discounted deals that expired after a short period of time when the customer ended up on a more expensive tariff". Further, in the context of "White Label" agreements between certain members of the Big Six and their "White Label" partners, "The Customers got a very competitive price for the same product if they were to buy it directly from one of the Six Large Energy Firms, and then over time the incumbent would transfer those customers onto higher-cost tariffs." See paragraphs 117 and 118 of the Case Studies WP.

<sup>81</sup> Case Studies WP, paragraphs 117-120 and 123.

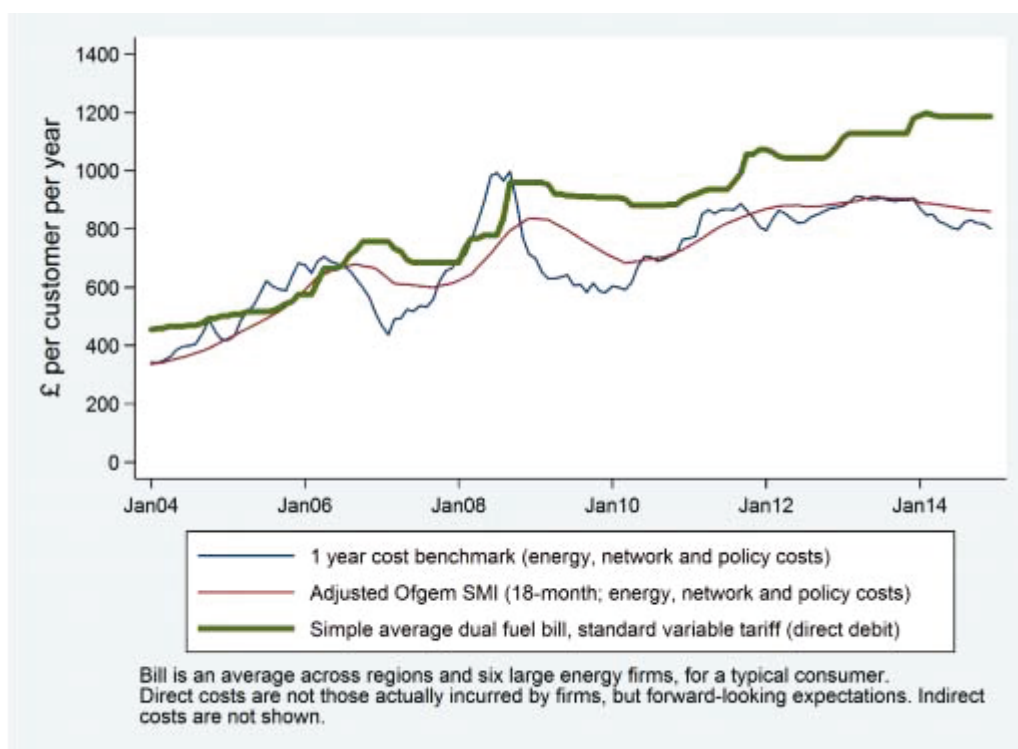
<sup>82</sup> Case Studies WP, paragraph 123.

<sup>83</sup> See <https://www.ofgem.gov.uk/publications-and-updates/final-proposals-treatment-white-label-providers-domestic-retail-market>

<sup>84</sup> As set out in greater detail in Annex 2 on Tacit Coordination.

27 March 2015

- 4.12. Further reinforcing the negative impact on GB customers, energy prices do not appear to come down during periods where direct costs decreased significantly. First Utility believes this is a market feature indicative of an AEC. In particular, and as demonstrated in the Cost Pass-through Working Paper,<sup>85</sup> there is a marked difference between the average SVT bill and underlying direct costs. Indeed, First Utility agrees with the CMA's initial view, as confirmed in the diagram below, that this is indicative of a weakening of competition in SVTs.<sup>86</sup>



Source: CMA analysis of data collected from Ofgem and ICIS.

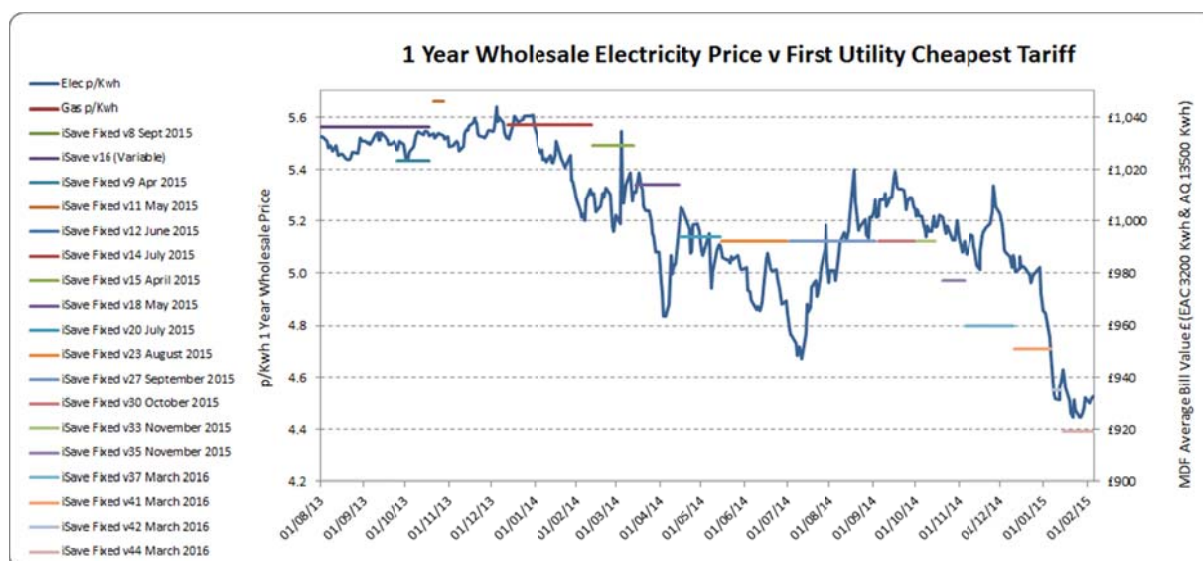
- 4.13. While the gap between the price index and cost benchmarks need not necessarily represent profits, this is strong evidence illustrating the detrimental impact of SVTs: there have been two periods of steep reductions in costs where prices did not accordingly reduce to the same degree.<sup>87</sup> First Utility is supportive of the CMA's intention to further develop its analysis of the relationship between wholesale costs and retail prices. In particular, First Utility looks forward to the CMA's assessment of the applicability of the so-called "rockets and feathers hypothesis", which we believe will further demonstrate evidence of the anti-competitive nature of the Big Six's current SVT practices.
- 4.14. As a contrast, First Utility's most competitive one year fixed price tariff has fallen in direct correlation to the change in the one year wholesale market price as shown in the table below:

<sup>85</sup> Dated 23 February 2015.

<sup>86</sup> Updated Issues Statement, paragraph 126.

<sup>87</sup> See Updated Issues Statement, paragraph 126 and "Cost pass through". CMA working paper published on 23 February 2015 (**Cost Pass-through WP**), slide 12.

27 March 2015



- 4.15. First Utility strongly believes that the industry needs to re-think how it can work to help those SVT customers who are now overpaying by an average of £235 per year when compared to the cheapest fixed tariffs on the market – meaning the UK is overpaying on its energy bills by a massive £3.4 billion a year.<sup>88</sup>
- 4.16. First Utility believes the way to engage those customers with little awareness about their energy spend, or the options available to them, is to scrap the SVT and to provide information to customers about the cheapest tariffs on the entire market on a monthly basis. Currently Ofgem's regulations mandate that suppliers must include details of only their own cheapest tariff on all customer bills. However, many customers, particularly those with the Big Six, only receive bills quarterly or half yearly to advise them of these. This aids the level of disengagement amongst the majority of energy customers and fails to tell the full story about possible savings. By contrast, First Utility bills all customers monthly, shows its cheapest tariffs on a monthly basis and was one of the first in the market to launch similar homes comparison - these efforts are aimed to give our customers more tools to understand and control their energy spend and eliminate wastage. We know that more frequent prompts are effective in persuading consumers to change tariff or change supplier, and we believe the industry needs to do more to ensure consumers are getting a fair deal.
- 4.17. Scrapping the SVT would provide a clear statement to consumers that the industry is serious about change. We recognise that there always needs to be provision of a default tariff for those customers who choose not to take a fixed-price contract (as indeed there is within Ofgem's current regulations). However, the existing approach penalises those who are disengaged and does little to proactively engage them subsequently. Instead, an "out of contract" tariff that operates as a three-month rolling fixed-price tariff with no exit fees should drive a higher level of

<sup>88</sup>

First Utility press release from 9 March 2015 <http://www.first-utility.com/scrap-the-variable>

27 March 2015

engagement: each new fixed term would be communicated in the same way as a traditional fixed-contract expiry – something which is known to drive a higher level of engagement.

- 4.18. During the consultation around RMR, Ofgem proposed development of a scheme for requiring suppliers to inform their customers of the “Market Cheapest Deal” in an attempt to engage so-called “sticky” customers. We think this idea should be reconsidered. There would need to be a mechanism for centralising the data and sharing it with all suppliers but First Utility does not believe this should provide a significant barrier, particularly given the potential benefits to customer engagement. Given what we believe to be the differential in price between the SVTs and the cheapest tariffs on the market, it is only through communicating the market’s cheapest deals in an appropriate way that customers can be fully informed about the potential savings on offer.

### ***Inactive customers***

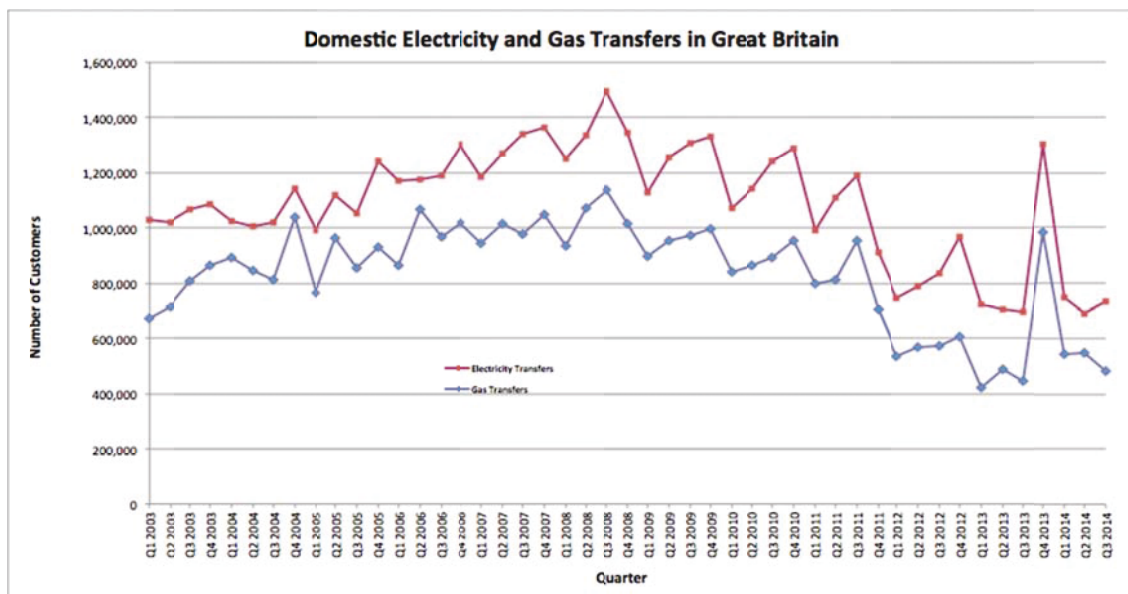
- 4.19. The CMA has reached the initial view that there are a significant number of domestic energy customers who are relatively inactive. This is particularly illustrated by the fact that there are considerable gains to be made from switching which currently go unexploited.<sup>89</sup> As mentioned in paragraph A6 above, First Utility believes<sup>90</sup> there are two different retail markets: (i) one very small well-functioning market for those customers that are “engaged”; and (ii) a much larger but poorly functioning market for inactive customers which are “disengaged”.
- 4.20. Given the numerous available options and the fact that there are demonstrable gains from switching supplier, the expectation would be that there would be far greater movement in the market. However, since the overwhelming majority of customers are inactive, we consider that competition is not working well overall.
- 4.21. Each year, fewer consumers vote with their feet by changing providers as shown below.<sup>91</sup> Indeed, supplier switching rates have decreased from 20 per cent in 2007 to 12 per cent in 2014, the lowest year on record since 2003.

---

<sup>89</sup> Update Issues Statement, paragraph 133.

<sup>90</sup> Case Studies WP, paragraph 120 (Ovo Energy) and paragraph 123 (Utility Warehouse).

<sup>91</sup> See <https://www.gov.uk/government/statistical-data-sets/quarterly-domestic-energy-switching-statistics>



- 4.22. Approximately 93 per cent of households continue to be supplied by the Big Six,<sup>92</sup> 16 years after liberalisation. This in and of itself would not suggest a lack of competition, but when combined with independent suppliers consistently topping the “best buy” and customer service league tables relative to the Big Six, there is a strong suggestion that there is an inherent problem in the market.
- 4.23. The domestic energy market differs from other typical consumer markets in one key way: consumers need never actively make a purchase decision. Thus, with energy, should a customer not want to think about energy (and indeed many do not) there is no need to consider and compare the options available. The evidence demonstrates that around 40 per cent of households<sup>93</sup> have never switched energy providers, which means that many do not consider whether or not they are receiving value for money, if indeed they think about their provider at all. In addition the CMA has identified that 40 per cent of Centrica’s domestic gas customers and 40 to 70 per cent of incumbent supplier electricity customers have been with their incumbent supplier for more than 10 years. Whilst independent suppliers have grown to 7 per cent market share,<sup>94</sup> their growth in the future will be significantly curtailed as a result of the 70 per cent of the market that is disengaged unless these households can be encouraged to participate in the market. However, the incumbent Big Six suppliers have no incentive to engage and encourage these households to engage and participate, in fact their incentive is exactly the opposite, they have every incentive to leave these customers disengaged.

<sup>92</sup> Updated Issues Statement, paragraph 116.

<sup>93</sup> Ofgem State of the Market Assessment, 27 March 2014, paragraph 1.13.

<sup>94</sup> Updated Issues Statement, paragraph 116.

27 March 2015

- 4.24. By virtue of the lack of engagement by the majority of customers and the fact that these customers do not change suppliers or tariffs frequently or ever,<sup>95</sup> the competitive pressure on the Big Six is low, since there is no serious threat that the ability to switch supplier will have a significant impact on their customer base.<sup>96</sup> Indeed, as recognised by the CMA, this leaves great potential for the Big Six to leverage this disengagement to earn much higher profits than on fixed tariff customers as we noted in paragraph A7 above. In addition, it is instructive and informative that according to the CMA Customer Survey, more customers are aware that they can change supplier than aware they can change tariff and payment method with their current supplier.<sup>97</sup>
- 4.25. We do not believe that the majority of Big Six customers are on their SVT through exercise of choice. Our experience shows that less than 15 per cent of customers on our SVT choose to be on our SVT, whereas 85 per cent ended up there as a result of not making a choice - at time of Fixed Tariff expiry or Change of Tenancy. We believe the position will be even starker with Big Six customers who, as a whole, are less likely to consider their options than First Utility customers (who by definition have already made the decision to switch supplier at least once). First Utility believes that this lack of customer engagement is having a negative impact overall in terms higher prices, lower quality of customer service and decreased incentives among the Big Six to compete.
- 4.26. Moreover, First Utility's view is that the Big Six actively incentivise disengagement.<sup>98</sup> The naming convention of the tariffs only serves to support disengagement. Five of the Big Six have a "Standard" tariff with only E.ON naming it differently – "E.ON EnergyPlan". However, what this tariff really represents is a default: out of contract rates for customers that have not opted-in to a better value tariff. Therefore, to call the tariff "Standard Variable" or "Standard" misleads customers into believing that it is a general tariff which applies to all customers, i.e. that it is 'standard'. First Utility considers it to be suppliers' responsibility to ensure understanding of the competitive offerings available – beneficial for both customers and for driving healthy competition in the market – and not to encourage inertia and customers to fall back on the default rates.
- 4.27. Further, First Utility considers supplier communications as being hugely important in driving customer engagement and thus improving competition in the market. The majority of Big Six

<sup>95</sup> Indeed, the most recent switching statistics for February 2015 show that small supplier share has fallen from a high of 44.68 per cent in May 2014 to 25.86 per cent in February 2015. Of further concern is that the level of switching has also fallen: whilst there were a 100,000 additional switches in February 2015 as compared to January 2015, the overall figure of 317,000 households is still half of what it was in November 2013 when 615,000 households switched. See <http://www.energy-uk.org.uk/publication.html?task=file.download&id=5062>

<sup>96</sup> Just under a half (48 per cent) of all households had ever considered changing tariff with the same supplier, with just over a quarter (28 per cent) have made an active decision to do so at the same time. See "A report for the Competition and Market Authority by GfK NOP", published 20 February 2015, paragraph 98.

<sup>97</sup> GfK Survey, figure 35, page 39.

<sup>98</sup> In this context, First Utility notes the views of Ovo Energy as cited at paragraph 119 of the CMA's Case Studies WP. "Ovo believed that energy companies could, deliberately or inadvertently, confuse consumers to their advantage, and that they got away with it because there was no regulation that said, 'the price that suppliers charge any customer has to reflect the cost of delivering energy to that customer.'"

27 March 2015

customer communications are neutral or negative – such as bills, tariff migrations, price increases, direct debit changes, or a payment related communications. Moreover, the Big Six appear to minimise and combine their communications in order to communicate as little as necessary to their customers, e.g. billing on a quarterly, semi-annually or, in at least one case, a yearly basis. Such little interaction only serves to perpetuate disengagement. Furthermore, the Big Six very often combine two sets of negative communications (e.g. fixed direct debit increases are communicated via the bill rather than a bespoke communication), which makes it less probable that customers will take notice and indeed take action from what should be a prompt to the consumer to see if they are on the best deal.

- 4.28. First Utility is concerned that this manner of communicating information intended to incentivise engagement is (deliberately) ineffective. There are strong indications that customers find energy bills impenetrable and confusing post-RMR.<sup>99</sup>
- 4.29. Thus, it appears that the Big Six's billing behaviour may be perpetuating the disengagement of their customers in order to prompt customers as infrequently as possible and even then, only with negative and confusing communications. This only serves to exacerbate the issue of the high levels of distrust of energy providers which has been identified.<sup>100</sup>
- 4.30. As First Utility has previously argued, and as recognised by Ofgem, the “hassle factor” of switching constitutes a deterrent for customers to go through the process of acting on information they have received.<sup>101</sup> First Utility considers that it is vital to address low levels of consumer engagement and we see a move from five weeks switching to “one-day switching”, which First Utility championed via its “Fix the Switch” campaign,<sup>102</sup> as 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 customer. The rollout out of smart metering will be a key enabler of this, and alongside an expected improvement to industry data, increased 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.
- 4.31. First Utility notes that those on SVTs are more likely to mention concerns about searching for an alternative supplier when compared with those on fixed tariffs.<sup>103</sup> Further, it appears that this

<sup>99</sup> <http://www.thisismoney.co.uk/money/bills/article-2589735/Five-million-people-never-open-energy-bills-baffling.html>

<sup>100</sup> GfK Survey, paragraph 51. See also “CMA Strategic Assessment”, November 2014, paragraph 3.9.

<sup>101</sup> See First Utility's “Initial Submission and Response to the Issues Statement”, dated 14 August 2014, paragraph 2.34 and Ofgem's State of the Market Assessment, paragraphs 3.25-3.26.

<sup>102</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 three days (after two weeks 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>103</sup> GfK Survey, paragraph 106.

27 March 2015

apprehension is well founded, with over a quarter of SVT customers finding the overall task of shopping around difficult.<sup>104</sup>

### ***Price Comparison Websites***

- 4.32. First Utility agrees with the CMA's conclusions on the value of comparison websites to both suppliers and consumers. They are an important tool for engaged consumers as evidenced by the CMA's customer survey which noted that nearly three-quarters of those who had shopped around used PCWs, and that PCW usage was highest amongst 18-64 year olds, those with qualifications, owners and private renters and those with dual fuel supplier and those who earn £18,000 or more.<sup>105</sup> Furthermore they represent a cost effective acquisition strategy especially for independent suppliers as opposed undertaking separate marketing activities to achieve the same results.
- 4.33. We appreciate the concern that the amendment to the Confidence Code, preventing PCWs from displaying by default "fulfillable" tariffs only, has the potential to impact the commercial negotiations between PCWs and suppliers - however insufficient time has passed to enable industry participants to see what effect this change will have. As the CMA notes,<sup>106</sup> this is a step advocated by many consumer groups including the Energy and Climate Change Committee<sup>107</sup> to improve consumer trust in the use of PCWs, so Ofgem needs to monitor this area closely.
- 4.34. We support Ofgem's other policy decisions to ensure that language used by PCWs is both clear and simple for consumers, and efforts to improve transparency around PCWs' commission arrangements, through the provision of a list of suppliers with whom the PCW has commercial agreements with. As Ofgem also notes, the level of commission is irrelevant, as the cost of the tariffs is the same regardless of the consumer acquisition channel (PCW, supplier website, telephone etc). However, First Utility is keen to ensure regulatory interventions with regard to PCWs do not undermine or threaten the viability of these businesses which have had a powerful positive effect in empowering consumers to make switching decisions.

### ***Supplier behaviour and potential for tacit coordination***

- 4.35. The Big Six have highlighted in their 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 in the GB energy market are relatively low. First Utility does not agree with this and while it notes the CMA's statement in the Updated Issues Statement that it is yet to form an overall

---

<sup>104</sup> GfK Survey, paragraph 108.

<sup>105</sup> GfK Survey, paragraph 16.

<sup>106</sup> "Price comparison websites" CMA working paper published on 26 February 2015 (**PCWs WP**), paragraph 92

<sup>107</sup> <http://www.parliament.uk/business/committees/committees-a-z/commons-select/energy-and-climate-change-committee/inquiries/parliament-2010/energy-price-comparison-websites/>

27 March 2015

conclusion on whether the conditions for coordination are met in relation to the SVT price announcement behaviour, First Utility believes that the CMA is not applying the test correctly.

- 4.36. Specifically, and as set out in paragraph 151 of the Updated Issues Statement, the CMA needs to consider carefully whether the features of GB electricity retail markets are conducive to coordinated behaviour – and therefore explain why competition concerns appear to arise notwithstanding the number of leading retail suppliers – by reference to the following three-fold test:

4.36.1. *Can the Big Six reach an understanding and monitor each other's behaviour?* First Utility disagrees with the CMA's initial view that differences in the business models and short to medium-term differences in energy costs make it difficult to align and maintain incentives among the Big Six. We consider that this point relates to the second limb of the test (i.e. internal sustainability – see below) and not whether or not the Big Six have the ability to reach an understanding. The Big Six do have the ability to monitor each other's retail pricing behaviour (since this is publicly available on their websites) and to monitor their respective customer volumes (and locations). Furthermore, the CMA's own initial view is that there is evidence suggesting "*a high level of transparency in relation to prices, market shares and cost and margin information and relatively stable market shares for SVT customers*".<sup>108</sup> Moreover, Ofgem has suggested a pattern of the Big Six following each other's price announcements, which would be consistent with coordinated behaviour.<sup>109</sup>

4.36.2. *Is the coordination "internally sustainable" – i.e. is it in the Big Six's interest to adhere to a coordinated strategy?* First Utility believes that there is an incentive for the Big Six to adhere to a coordinated strategy, and that they are able to react to, or discipline, any deviation from such strategy – benefitting from the transparency of retail pricing which may facilitate sustained coordinated behaviour. Their established legacy customer bases add to this incentive, with each firm wanting to protect its existing customer base, rather than competing aggressively for new (i.e. each other's) customers by driving down tariffs through competition.

According to the CMA's Guidelines for Market Investigations,<sup>110</sup> the coordination does not need to be perfect or continuous to have an anti-competitive effect. The CMA's role in applying this test is not to ascertain whether the parties have been acting unlawfully (i.e. in breach of Article 101 TFEU or the Chapter I prohibition under the Competition Act 1998), but merely to establish whether the coordination has an effect on the competition in the market. Any form of coordination has the potential to reduce strategic uncertainty among competitors to the detriment of customers, and –

<sup>108</sup> Updated Issues Statement, paragraph 151.

<sup>109</sup> State of the Market Assessment, paragraphs 1.26 to 1.28.

<sup>110</sup> Guidelines for market investigations: Their role, procedures, assessment and remedies; paragraph 250.

27 March 2015

depending on the degree – this is a market feature which results in an AEC. In First Utility's view, it is in the Big Six's individual interests to adhere to a coordinated outcome and the CMA should consider this evidence further.

- 4.36.3. Is there “external sustainability” – i.e. is the coordination unlikely to be undermined by competition from independent suppliers? As mentioned above, there are barriers to expansion which insulate the Big Six from challenger suppliers at the retail level. Customer disengagement and the lack of liquidity on the wholesale market, in particular, constitute real barriers to expansion for independent suppliers and prevent them from undermining any coordination by the Big Six. A further barrier to expansion is “deep discounting” – that is, offering far lower “acquisition” prices to potential new customers than those offered to their legacy customers on standard tariffs. The ability of the Big Six to use targeted deep-discounting as a barrier to expansion by challenger firms, and a “retaliatory” mechanism to discourage competition from rival Big Six firms is an aspect of retail competition which – in our view - is consistent with tacit coordination. There is evidence to suggest that whilst RMR initially dampened certain deep discounting practices, recent figures indicate that this is reasserting itself.<sup>111</sup> For completeness, we include in Annex 1 comparison tables for SVTs and online tariffs pre-dating the implementation of RMR. The CMA acknowledges that there are barriers to expansion in the Updated Issues Statement and states that in spite of the gains made by independent suppliers in market share, *“there is a segment of the retail energy markets that is relatively disengaged and that the level of disengagement may be sufficient for coordination over this segment to be sustainable.”* This is exactly where a strategy of tacit coordination would be sustainable.
- 4.37. Although the CMA goes on to say that its initial view is that the behaviour observed could be explained by unilateral incentives, First Utility considers that such a finding would be inconsistent with the evidence. The key question is whether the unilateral incentives, based on an assessment of market conditions (a large, disengaged customer base, a high cost supply model and the higher revenues achievable through SVTs) make a strategy of dampened competition and tacit coordination the economically-rational choice. The market outcomes which the CMA is required to consider – such as, pricing behaviour, high levels of profitability and high and stable incumbent market shares – suggest that the CMA must further assess whether the evidence is consistent with the existence of tacit coordination as a feature in this market. We consider tacit coordination in more detail in Annex 2.

<sup>111</sup> See our response to Ofgem's consultation on white labels, regarding price differentials: <https://www.ofgem.gov.uk/ofgem-publications/93494/firstutilityconsultationresponse-pdf>

***Regulatory interventions***

- 4.38. First Utility agrees with the CMA that the energy industry is heavily regulated, with the form of regulation having a profound effect on the shape of competition in the retail energy markets. We do not however consider that regulatory interventions have of themselves adversely impacted on competition.
- 4.39. As the CMA says, there have been strong criticisms of the prohibition on price discrimination (SLC 25A) adduced in various submissions.<sup>112</sup> We do not have similarly strong views on the adverse impact on competition of this prohibition. We think that there are a number of factors that could correlate to what appears to be a softening of competition up to and around the time the prohibition was introduced.

***Retail Market Review tariff rules***

- 4.40. First Utility notes that the CMA has not yet formed a view on the impact of RMR reforms. First Utility is supportive of the aims of RMR and considers that overall, the package of measures resulted in a much-needed resetting of the market, clearing away dead tariffs and focusing on the means to engage so-called sticky customers. The reforms were based on substantial customer survey data and behavioural research, and drew upon industry knowledge and expertise in formulating specific aspects of the reforms (including around billing, tariff information). We also observe that there was substantial pressure for retail market reform, with statutory back-stop powers being taken to enable the Secretary of State to act.<sup>113</sup>
- 4.41. That said, we have a number of specific observations. In general, we encourage the CMA to consider the Standards of Conduct (**SoC**) alongside the RMR rules and to consider the RMR package of measures as well as the tariff rules. More specifically, the type and extent of the information required may not be facilitating active engagement. It is possible that the more artificial measures, such as the Tariff Comparison Rate (**TCR**) and Tariff Information Label (**TIL**), created to better support workable usage-based price comparisons, may not be working in the way anticipated. This may be compounded by infrequent communication as discussed above.
- 4.42. Whilst First Utility considers that the four-tariff limitation is workable, we also think that this could lead eventually to “tariff convergence”, with suppliers offering a broadly similar tariff range, which in turn will restrict consumer choice and differentiation between competitors. This may increase the scope for tacit coordination (as discussed above). As we have not applied for a derogation from the four-tariff limit, we cannot comment on whether the process could be improved in terms of time and cost. We would observe that too onerous a process will increase costs, reduce competitive advantage and limit innovation. Now that a number of derogations have been granted, Ofgem could usefully look to updating its guidance, and reviewing the

<sup>112</sup> Updated Issues Statement, paragraph 157.

<sup>113</sup> See sections 139-140, Energy Act 2013: <http://www.legislation.gov.uk/ukpga/2013/32/contents/enacted/data.htm>

27 March 2015

process and ensuring that as few barriers as possible are placed before suppliers seeking a derogation.

- 4.43. Furthermore under RMR, we have concerns that the “cheapest is best” Fixed Term Expiry (FTE) communication doesn't allow us to describe the full range of tariffs available to customers and instead focuses heavily on describing the cheapest tariff to the customer. This means customers are not necessarily seeing or being encouraged to consider the benefits of longer price security of other tariff types, whereas these may suit their needs better. Whilst First Utility describes all products available to customers who visit our website and view all the tariffs we have on offer, the customer is often already in the mindset of cheapest is best as a result of the communication. We would suggest that the CMA could usefully examine the impact of the FTE process on switching patterns and supplier behaviour as this feature particularly prevalent post-RMR.
- 4.44. There is also industry confusion as to what the most appropriate methodology is for estimating energy bills for the purpose of calculating savings when comparing tariffs. Whilst many use the Ofgem formula, this assumes that post expiry of a fixed tariff, a consumer's bill is based on the cheapest standard variable. As recently highlighted by the Energy Shop submission to the CMA, there are complaints this is misleading consumers by inflating bill savings.<sup>114</sup> The sooner Ofgem confirms a solution to this issue the better: further delay is not supporting growth in customer trust in suppliers or price comparison websites, or the industry as a whole.

#### ***Social and environmental obligations and policies***

- 4.45. First Utility and the other mid-tier suppliers also participate in the Energy Companies Obligation (ECO) and Warm Home Discount (WHD) schemes alongside the Big Six, with the costs applied across our customer base in the same way as for the bills of Big Six customers.
- 4.46. A concern that we, and other suppliers have around cost recovery is that smaller suppliers are not contributing to the scheme, thereby gaining a cost advantage to the mid-tier and larger suppliers. Furthermore, customers of smaller suppliers are also not eligible for to apply for the WHD benefit as their suppliers do not participate. Whilst there has been a case for supplier exemptions from certain environmental and social schemes, in the discussions for ECO post 2017, alternative mechanisms are possible whereby smaller non obligated suppliers can make their financial contribution, yet enable a third party e.g. another supplier, to ensure delivery.
- 4.47. We believe that all suppliers should be required to contribute to the schemes to ensure a level playing field between all suppliers and likewise to ensure that all consumers are able to access the social and environmental schemes, irrespective of what supplier they are with. This is especially important for disengaged and vulnerable consumers: the value of switching from one of the Big Six suppliers to smaller competitor, should not be undermined as a result of switching

---

<sup>114</sup> [https://assets.digital.cabinet-office.gov.uk/media/54da24ebcd915d514400000b/The\\_Energy\\_Shop\\_Submission.pdf](https://assets.digital.cabinet-office.gov.uk/media/54da24ebcd915d514400000b/The_Energy_Shop_Submission.pdf)

27 March 2015

customers subsequently discovering that they are ineligible to apply for the WHD because their new supplier does not participate in the scheme.

## **5. Updated Theory of Harm 5: The broader regulatory framework including the current system of code governance, acts as a barrier to pro-competitive innovation and change**

- 5.1. We note the CMA has added a further Theory of Harm in relation to the breadth of regulation in itself acting as a barrier to pro-competitive innovation and change. In our view the extent and nature of regulation of GB energy markets is necessarily complex, and it is not meaningful to characterise the broader regulatory framework as a market feature which leads to an AEC in itself, if that is indeed the basis for this additional Theory of Harm. Even if such a characterisation were to be made out, any such AEC would require, by way of remedy, complex reform of the regulatory landscape which is – in First Utility’s view – beyond the scope of this investigation.
- 5.2. That said, First Utility believes there are a number of general concerns regarding the broader regulatory framework that may have the effect of dampening competition, and we set some of these out below.
- 5.3. First, there is a significant resource asymmetry between the Big Six and independent market participants. This plays out in consultations for licence condition modifications, code modifications and policy development more generally. The lack of significant internal resources and often the means to obtain a broad range of external resources means that independents are limited in the range and scope of arguments that they can develop and pursue and the evidence that they can adduce to support those arguments. We consider in Annex 1 some of the background to the development of key aspects of the CfD FiTs element of EMR, where in our view, the concerns of independent and smaller suppliers in seeking to better mitigate the risks for suppliers and their customers under the proposed regime could not gain any real or effective traction with policy makers.
- 5.4. Second, there are information asymmetries that exist between the Big Six, with their long history of active regulatory and policy engagement, and independent and smaller market participants. Many independents do not set up their systems to provide, and simply many not have, the types of information that Ofgem may seek from market participants, either under formal powers or informally. This has been recognized by both DECC and Ofgem as part of their Challenger Business initiative and consideration is being given to a tailored impact assessment. In our view, it remains the case that many of the assumptions underpinning regulatory and policy options are based on views and assumptions derived from years of history in engaging with and being informed about incumbent systems, processes and approaches.

27 March 2015

- 5.5. Third, information itself is not neutral and value-free. It is filtered through internal processes and corporate views, internally assured and checked, and provided to policy-makers addressed to or in support of specific purposes or processes. The Big Six are able to call upon substantially greater resources to manage preparation and provision of information, as well as being able to utilise a wider range of external assistance. Thus in the type and amount of information, as well as the ability to draw upon their longevity to adduce precedents, previous examples and war stories, the Big Six have an informational and knowledge advantage that is difficult, if not impossible, for independent and smaller market participants to match.
- 5.6. Fourth, it is problematic when policy makers adopt “supplier-led” programmes (or general programmes in other elements of the market) of material legal, regulatory and technical complexity, which assumes the ability of all suppliers to participate in the development of: (i) the licence conditions setting out the framework and obligations; (ii) the various subordinate documents contemplated; (iii) the workgroups, expert groups and other means of participation. In reality, it must surely be known or at least recognised that such commitments can only be continuously met by the Big Six, and that the majority of individual participants will be provided by them.
- 5.7. In our view, this approach builds in an inherent advantage for the Big Six in structuring the implementation. This is not to deny the significant resources expended by them in so doing, just to note that in particular in light of the number of such scale programmes (e.g. Project Nexus, which covers the upgrade of UKLink and a large number of process-specific code modifications as well as substantial internal delivery projects and Smart, which established two new external bodies, a cross-code impacting new code in the Smart Energy Code, several different workgroups and higher level groups), this advantage really tells.
- 5.8. Taking these factors into account and in light of the wider policy and regulatory environment, the amount and sheer weight of change, occurring in parallel, makes tracking, understanding and prioritising proposed changes challenging for smaller market participants. This is also seen in the lack of sustained, cross-code active participation by such market participants.
- 5.9. We would also observe that the current focus on security of supply and generation has meant that some recent market interventions have worked to increase the risks borne by suppliers and their customers. In the case of CfD FiTs, DECC had options available which would have addressed supplier concerns and would have been at lower overall cost to customers. Our perception was that regulatory policy concerns, accepted in principle by DECC, were effectively overruled by HM Treasury. For example in one mitigating proposal, the possible benefits of the Low Carbon Contracts Company (**LCCC**) being able to raise finance were assessed by Treasury. However their analysis only considered costs of capital and not wider implications around suppliers managing cash and margin volatility risk, and so Treasury concluded that the benefits were not sufficient to allow the LCCC to raise finance.

27 March 2015

- 5.10. Whilst this is a very specific example, it does illustrate a concern we have about the sometimes competing interests of Government departments and other decision-making bodies. Another example of this is in regards to incentivising energy efficiency in the home and the interests from the Department of Communities and Local Government in respect of reducing costs for housebuilders,<sup>115</sup> and those of DECC to reduce energy bills in the home.
- 5.11. The CMA also raises two separate issues for further investigation: (i) the number of codes in electricity, which adds to the complexity and (ii) whether the current system of governance is acting as a barrier to pro-competitive innovation and change.<sup>116</sup>
- 5.12. The industry codes go to the heart of how wholesale gas and electricity operates, setting out as they do the process for change of supply, metering and read management, safety and theft handling, amongst other things. Inefficiencies in the codes, and their underlying processes, lead to higher costs for suppliers that are ultimately passed onto customers: they might also lead to poor customer experience.
- 5.13. All participants would no doubt acknowledge the myriad process and data failures that result in bad switching experiences for customers, from dilatory provision between participants of final meter reads, to the wrong address information, or meter issues requiring a site visit and correction by the new supplier. Fit for purpose code-based processes and accurate data are needed and whilst smart meters, and the underlying communications systems being installed, may offer the chance to address many of these issues, much remains to be done in the meantime to put the industry on the best possible footing going forward. In our view, some of these challenges are compounded by a lack of clear accountability in the relevant codes between the affected and causing participants. Such is the complexity of the codes that we recognise that dealing with this element alone may not fully meet the challenges.
- 5.14. We do not consider that the number of codes in electricity *per se* adds to the complexity of rules and requirements, but that the make-up of the individual codes is complex. As well as being voluminous in nature (as the CMA notes)<sup>117</sup>, there are: (i) the underlying process documents;<sup>118</sup> and (ii) the volume of modification documentation. As we note in Annex 3, these are not just technical requirements and cover legal, commercial and operational matters. These documents are clearly challenging in that respect and take up considerable resource internally, regardless of any wider participation in code governance and modifications.
- 5.15. Whilst available via websites, the codes themselves can lack transparency for participants, let alone for a wider audience. A consumer seeking to understand the basis for errors in a recent

<sup>115</sup> Energy efficiency for new buildings is regulated under building regulations managed by DCLG.

<sup>116</sup> Updated Issues Statement, paragraph 194.

<sup>117</sup> "Codes", CMA working paper published on 4 March 2015 (**Codes WP**), paragraph 13.

<sup>118</sup> For example, the Master Registration Agreement, itself over 300 pages, must be read along with the data transfer catalogue, the 18 MRA Agreed Procedures and the Working Practice Product Set. The MRA also interacts with a number of other specific agreements, including the Data Transfer Service Agreement and the Green Deal Arrangements Agreement, as well as the myriad system and meter-related interactions required.

27 March 2015

switch is likely to struggle to work through the provisions of the Master Registration Agreement (**MRA**) and its related documentation, for example. We would make the same point in relation to the various RMR licence conditions.

- 5.16. Our initial view therefore is that the complexity in the codes would not necessarily be decreased or otherwise addressed whether the issues were set out in fewer consolidated codes or retained in the separate codes. First Utility believes that it would not be appropriate to consolidate the current seven codes into one electricity as not all market participants are required to accede to all codes.
- 5.17. First Utility notes that industry initiatives already exist to restructure the industry code. A key example of this is the move to 24 hour switching, which Ofgem has proposed as something that the DCC might operate for both fuels. Considering that the Smart Energy Code (**SEC**) governs how the DCC (and others) operate from a Smart perspective, it seems likely that the MRA and Supply Point Administration Agreement (**SPAA**) will be incorporated either into the SEC or another consolidated switching code. First Utility would welcome either option and sees this as an important opportunity to resolve many of the issues highlighted above.
- 5.18. First Utility does have some initial thoughts on possible means to manage this complexity and assist all market participants in general and smaller participants in particular, as follows:
  - 5.18.1. reconstituting the Cross-Codes Forum,<sup>119</sup> with wider and more active marketing of it to encourage greater participation (whether in person, by phone, etc.). Whilst there are issues and sensitivities around scope of work for each code body, it would be possible to establish a joint code bodies working arrangement, building on current cooperation, to support this forum. The forum could have as one of its stated aims to facilitate smaller participant engagement in all codes. This could manifest in the provision of information, teach-ins and specific assistance, pushing information to such participants in an appropriate form, and also pulling information from them for inclusion in ongoing modification processes. This could include, for example, for workgroups without any smaller participant representation, putting a questionnaire or giving homework to such participants so their perspective can be obtained. Whilst the various consultation stages do allow this, the aim here would be to inject such input earlier in the process;
  - 5.18.2. cross-code change pipeline management, which could be done through the Cross Code Forum or through a specifically constituted Change Body. The aim would be to canvass industry and policy-maker views on possible matters for change; change suggestions could be categorised into non-material, cross-code impacting, material, major or other appropriate categories, and the amount of change in each category

---

<sup>119</sup> This was managed by Elexon but there have been no meetings since October 2013 - <https://www.elexon.co.uk/group/cross-codes-electricity-forum-ccef/>

27 March 2015

assessed and grouped. The aim would be to pro-actively manage cross-code changes to best achieve timely resolution whilst managing the potential clash of major changes at the same time (or otherwise managing this). This could also help to feed in smaller participant views earlier in the process. For example, SPAA modifications, the consultation process, whilst a valuable check-point for gathering wider views, can raise significant matters that cause the modification to be reworked. This can lead to delay and inefficiencies in the process;

- 5.18.3. use of smaller market participant representatives in workgroups and adjusted voting - if representing other smaller suppliers, a representative can vote on their behalf in addition to their own or, where relevant, have any votes weighted or representation otherwise pro-rated by total market share of those being represented (which approach is more suited to governance, where a similar approach could be adopted for constituent representatives); and
  - 5.18.4. a review of code governance bodies and the process, terms and conditions and frequency for contracting for them. The aim here would be to consider this contracting process as a means of encouraging other companies into the market with different experiences and viewpoints. There is always a trade-off between longevity and familiarity (where there is little or no cost to learning after a certain point) and promoting different approaches and widening the number of companies, and individuals, with experience of and familiarity with the codes, albeit with a potential initial cost uplift.
- 5.19. First Utility recognises that all the above initial thoughts would themselves have resource and time implications against which any benefits would need to be weighed. First Utility would welcome the chance to engage further with the CMA on these initial views and more generally on the codes.

## ANNEX 1

### First Utility's additional comments on the CMA's Working Papers

#### 1. Locational pricing in the electricity market in Great Britain (Working Paper 7)

- 1.1. First Utility considers that rather than focusing on the charging arrangements for transmission losses, it would be better to focus on reducing the overall system losses and constraint issues on the distribution networks instead. Overall, around 8 per cent<sup>120</sup> of generated electricity is lost on delivery to consumers, but losses differ significantly for customers connected at different voltages: at high voltage (transmission), losses are around 2 per cent; around 6 per cent at medium voltage; but around 12 per cent at low voltage. With the growth in distributed generation and the anticipated growth in the use of heat pumps and electric vehicles over the coming years, distribution network constraint issues will also increase.

##### *Charging for Losses*

- 1.2. The most significant period for losses is at times of peak demand when most current is flowing and losses are thus the greatest in winter when demand is at its highest point of the year. The only customers which have cost reflective charging (incorporating that greater losses are incurred during peak periods) are the Half Hourly (HH) metered and settled customers. Remaining charges are billed to suppliers and recouped through charges for all other customers.
- 1.3. HH settlement is therefore key to more cost reflective charging on losses. The progressive rollout of smart meters will trigger the move to shortening the current settlement timescale (currently out to 587 working days), with a subsequent trigger to adopt HH settlement once an agreed percentage of settlement takes place using actual energy. According to Elexon's Profiling and Settlement's Review Group,<sup>121</sup> this could be as early as 2017/18.

##### *Ofgem & Loss Reduction Incentives*

- 1.4. In the new RIIO price control mechanism (Revenue = Incentives + Innovation + Outputs), Ofgem has clear expectations of Distribution Network Operators' (DNOs) strategies on reducing losses - these should be accompanied by a robust cost benefit analysis and supported by well-justified assumptions. However, given that DNOs must satisfy themselves that they are compliant (Ofgem does not approve the strategies) there are no licence requirements which show how this is to be done.
- 1.5. To encourage the consideration of investments to reduce losses (and associated costs), First Utility would therefore advocate the following steps:

<sup>120</sup>

<sup>121</sup>

2012 DUKES Table 5.1.2 Electricity Supply, Availability & Consumption  
Elexon: "Profiling & Settlements Review: Reducing Settlement Timescales - Final Report" dated 27 October 2014.

27 March 2015

- Licence conditions on DNOs to publish (publically) granular (locational) information real time losses across all key nodes and equipment on their networks
- Licence conditions to compare losses with theoretical limits of their current equipment and potential new kit
- A ranking of these from largest to smallest potential loss savings; and
- A ranking of these by Net Present Value (**NPV**) of each investments (and subject to an independent audit), with positive NPV projects made public in order to further their implementation.

### ***Demand Side Response***

- 1.6. We consider that the roll-out of smart meters and industry moves to introduce demand side response and Time-of-Use (**ToU**) tariffs will be key to addressing overall system losses and constraint issues. However a significant stumbling block to unlocking the potential of these, lies within the regulatory framework which currently does not allow DNOs to participate in industry processes such as the balancing mechanism.
- 1.7. Likewise there are also opportunities under National Grid's Demand Side Balancing Reserve (**DSR**) and the forthcoming EMR Capacity Market. However given the separation of distribution and generation businesses in the UK as a result of the EU unbundling requirements, dispensations for DNO participation may be required given that they are not allowed to own generation capacity.
- 1.8. As noted above, DNOs are also not permitted to engage with the balancing mechanism in regards to offering additional options to reduce / increase electricity demand at peak periods of demand / supply. Since distribution networks (and costs) are a main beneficiary of demand response technologies, restrictions on DNO engagement in the value chain, may limit the technology rollout and benefits. Promotion of demand side response, will not only reduce losses, but also reduce the need for network investments and generation capacity, thereby reducing costs to the consumer.

### ***Smart Meters & Half Hourly Settlement***

- 1.9. The rollout of smart meters to all 29 million end customers and the introduction of HH settlement (we anticipate from 2019 at the earliest) will help make tariffs and charges more cost reflective and will in turn support the development of ToU tariffs by providing a stronger economic signal. The more ToU and locational signals are incorporated into tariffs, the greater the ability for DNOs to signal network "hotspots" where customer demand side actions (load shifting or reduction) could support network cost efficiency (through reducing losses and avoiding the need for additional investment). It must be recognised that locational deployment

27 March 2015

of DSR would require regional price discrimination and as a consequence, such ToU tariffs may only be available in some areas.

## **2. Capacity (Working Paper 8)**

- 2.1. As discussed in our main submission above, the EMR programme will lead to fundamental changes to the remuneration of both thermal and low carbon generators.<sup>122</sup> However, with the transfer of risk to suppliers regarding wholesale price fluctuation, this will adversely impact the prices that retail customers pay.<sup>123</sup> Whilst at the moment there is little impact as no payments are yet due under CfDs, as CfDs gradually replace the Renewables Obligation (RO), the payments and volatility risk will become ever greater.
- 2.2. For this reason we consider that the transfer of market risk to suppliers in the form of the current supplier obligation design, is a key part of any conclusions around the efficacy of the current CfD programme, given the implications it has for retail competition and consumer bills.
- 2.3. Whilst the focus of policy makers to date has been on “reducing generators” financing costs, in turn reducing the support they require and therefore the cost to consumers’,<sup>124</sup> Government departments have ignored the risk and cost implications of the current supplier obligation design: looking ahead, supplier tariffs and consumer bills will have to include a significant risk premium to manage the payment volatility, given that only three months visibility on expected costs is provided to suppliers, yet tariffs are set to over three years ahead. This cost impact is evidenced in part by DECC’s impact assessment from October 2013 which showed the best estimate NPV on a fully fixed unit rate supplier obligation was -£473m, yet DECC implemented a version of a fully variable rate obligation which had a best estimate NPV of -£545m.

### ***Impacts on Independent Suppliers***

- 2.4. We note that the current CfD FiT Supplier Obligation looks riskier for independent suppliers than vertically integrated businesses who are both payees and payers. For independent suppliers, as payers into the scheme and reconciled on a quarterly basis, it means a highly variable obligation commitment and it is highly likely that independent suppliers will need to factor in a higher risk premium than the integrated suppliers, who have a natural hedge and a lower cost of capital.
- 2.5. The current Supplier Obligation design will therefore skew the competitive landscape in the favour of the vertically integrated suppliers who have a level of SVT customers of around 50 per cent to 90 per cent<sup>125</sup> from which changes to CfD costs can be much more easily recovered. Consequently as the vertically integrated Big Six are substantially protected from these CfD cost recovery risks, this leads to a further AEC.

<sup>122</sup> Updated Issues Statement, paragraph 49.

<sup>123</sup> We refer to the question in the last bullet point at paragraph 18 of the Capacity WP and the Case Studies WP, paragraph 115.

<sup>124</sup> Capacity WP, paragraph 39.

<sup>125</sup> Updated Issues Statement, paragraph 113.

***Maintaining the level playing field***

- 2.6. For all suppliers to properly manage payments to the CfD mechanism at the least cost to their actual and potential customers, First Utility considers that the following points should have been taken into consideration:
- “Forecastability” is crucial to suppliers if they are able to set tariffs for consumers
  - Under the current Supplier Obligation design, there will be significant cash flow and gross margin risk which would destabilise the existing playing field in favour of vertically integrated companies, as well as those who are long in generation relative to their supply base;
  - RMR is pushing suppliers towards offering fixed tariffs, which exacerbates the risks with CfD FIT Supplier Obligation volatility; and
  - Any increase in risk which cannot be properly managed may lead to a destabilising effect amongst suppliers and damage competition - and with any exiting suppliers financial commitments under CfDs to be “mutualised” amongst the remaining suppliers.
- 2.7. Our proposal for the CfD FiT Supplier Obligation had been to create a fully fixed rate option with no end of year reconciliation. Any over- or under-collection from suppliers within year, relative to payments to generators in that year, would be factored into the fully fixed rate set for the subsequent year. This is the only way to remove the cash and margin volatility risk from suppliers that would otherwise materially disadvantage independent suppliers relative to integrated suppliers.<sup>126</sup>
- 2.8. This proposal could have been achieved through the LCCC having finance raising capacity to manage any fluctuations of payments to generators, at a lower cost of capital to that of suppliers. The study by the Treasury into this option showed this to be a cheaper option, yet it was not followed through, and the consequences of leaving a variable rate obligation on suppliers (in the context of their requirements to anticipate potential cash flow calls and the associated risk premiums to then be included in tariffs) were also not taken into account.
- 2.9. Although the Capacity working paper recognises that competition for support in renewable technologies is necessary to drive down costs which are passed through to consumer bills,<sup>127</sup> the CMA’s analysis, does not consider the impacts of DECC’s decision to opt for what is akin to a variable rate obligation<sup>128</sup> on suppliers, and consequently the impacts on consumer bills. Whilst this has little effect now as the scheme is in its infancy, as CfD payments increase in the years ahead, so will the impacts on consumer bills and the ability of independent suppliers to compete in the market.

<sup>126</sup> This proposal was supported by a number of suppliers including some of the Big 6. On behalf of 9 other independent suppliers we submitted a letter on 18 December 2013 to Jonathan Mills at DECC outlining the principles of the proposal. Capacity WP, page 10, paragraph 39

<sup>127</sup> This is a fixed unit rate levy set on a quarterly basis with overall scheme reconciliation also taking place on a quarterly basis

27 March 2015

In addition to those areas around capacity that the CMA would like to investigate,<sup>129</sup> we encourage the CMA to also assess the decision making process DECC took on the Supplier Obligation design, and the role of interested parties.

### **3. Microbusinesses (Working Paper 15)**

- 3.1. As noted in our responses to the Retail Supply Questionnaire and in response to questions at our hearing on 19 March 2015, First Utility is exiting the SME market in order to focus on the domestic market. For completeness, we summarise in this section the points we made at the hearing.
- 3.2. We had a number of concerns around serving this market segment, including around the transparency of the sales process, especially regarding broker commission payments. We supported a number of initiatives to address the presenting of broker commissions on quotations, but this did not happen. One suggestion to address some of these concerns is to require suppliers to disclose broker/Third Party Intermediaries (**TPI**) commissions.
- 3.3. We think that there is potential for PCW's to offer a microbusiness / SME service. However, SME metering and billing is significantly more complicated and therefore more costly for suppliers to implement. We believe that this is the reason why (i) brokers are needed; and (ii) PCW's do not appear to have been very successful in this area. Energy brokers seem to hold a high level of influence in this market and for some suppliers it may disincentivise them to enter it.
- 3.4. In general, our gross margins were relatively low for this type of business, due in large part to broker commissions. The cost to serve SME customers, although higher per customer than domestic customers, was actually lower as a percentage of margin because the average spend was approximately ten times that of a domestic customer.
- 3.5. There was a greater level of bad debt with these customers, although more tools are available to enable cost effective debt collection, e.g. including the ability to disconnect supply, which offset this higher propensity for bad debt.

### **4. Coordination in the retail energy market facilitated by price announcements (Working Paper 21)**

- 4.1. On looking at the recent price reduction announcements to standard tariffs, we noticed that the rates were exactly the same between brand and white label as shown below for SSE and British Gas:

---

<sup>129</sup> Capacity WP, paragraph 106

**Table 1: Standard tariff comparison**

M&S ENERGY	Standard Energy	N	Monthly Direct Debit	£1,186.27	4.53p	14.21p	32.88p
	Standard	N	Monthly Direct Debit	£1,186.27	4.53p	14.21p	32.88p
	Standard	N	Monthly Direct Debit	£1,192.97	4.52p	12.77p	47.91p
	Standard	N	Monthly Direct Debit	£1,192.97	4.52p	12.77p	47.91p

If White Labels were to operate separately and distinctly, we believe that SVTs would never be the same. On this basis, we are concerned that the Big Six may be using their White Labels as a tool to simply switch on and off aggressive acquisition tariffs, whilst leaving disengaged consumers of the licence holder (SSE and British Gas) on a high-priced standard tariff. An example of this is in the tables below where for SSE, the Fix & Shop Nov 16 and Fixed Price March 17 tariffs are the same as the M&S Energy Fix & More May 16 Paper Billing tariff.

**Table 2: SSE & M&S Energy Tariffs**

M&S ENERGY	Fix & More May 16 Paperless Billing	Y	Monthly Direct Debit	£1,174.24	4.53p	14.21p	29.59p
M&S ENERGY	Fix & More May 16 Paper Billing	Y	Monthly Direct Debit	£1,186.27	4.53p	14.21p	32.88p
	Fix & Shop Nov 16	Y	Monthly Direct Debit	£1,186.27	4.53p	14.21p	32.88p
	Fixed Price Mar 17	Y	Monthly Direct Debit	£1,186.27	4.53p	14.21p	32.88p

In contrast, for British Gas, their Sainsbury's White Label Fixed Price February 2016 and Price Freeze February 2016 tariffs are currently offered at a discount of £177 and £115 respectively to the British Gas Price Promise February 2016 tariff and at a discount of £261 and £200 to the British Gas Fix & Reward February 2016 tariff (whilst the standard tariffs of both brand and White Label are the same as shown in Table 1 above):

**Table 3: February 2016 Tariffs: British Gas & Sainsbury's**

	fixed Price February 2016	Y	Monthly Direct Debit	£921.95	3.31p	9.38p	47.91p
	Price Freeze February 2016	Y	Monthly Direct Debit	£982.95	4.09p	11.56p	16.88p
	Price Promise February 2016	Y	Monthly Direct Debit	£1,098.94	4.00p	11.99p	47.91p
	fix & Reward April 2016	Y	Monthly Direct Debit	£1,103.86	4.12p	11.65p	47.91p
	fix & Reward February 2016	Y	Monthly Direct Debit	£1,183.20	4.47p	12.65p	47.91p
	fix & Fall June 2016	Y	Monthly Direct Debit	£1,192.97	4.52p	12.77p	47.91p

- 4.2. It appears that suppliers may also be using collective switches in the same manner, offering aggressive acquisition tariffs compared to their standard variable rate: Sainsbury's won the most recent collective switch (run by Moneysavingexpert) with a winning bid of £901 fixed until end of February 2016. This represents a discount of £198 to the British Gas Price Promise

27 March 2015

February 2016 tariff and at a discount of £282 to the British Gas Fix & Reward February 2016 tariff.

- 4.3. As mentioned in paragraph 4.36.3 in our main submission, we include below comparisons for SVTs and online tariffs pre-dating the implementation of RMR:

### **June 2012 - Comparison of standard v online rates**

#### **Average usage**

£	Average standard rate	Average Online rate	Difference	% Difference
British Gas	1,193	1,058	135	11%
Eon	1,160	1,113	46	4%
EDF	1,129	1,054	75	7%
nPower	1,149	1,061	88	8%
Scottish Power	1,169	1,055	114	10%
SSE	1,172	1,151	21	2%

### **July 2013 - Comparison of standard v online rates**

#### **Average usage**

£	Average standard rate	Average Online rate	Difference	% Difference
British Gas	1,270	1,219	52	4%
Eon	1,261	1,211	49	4%
EDF	1,251	1,192	60	5%
nPower	1,258	1,156	102	8%
Scottish Power	1,271	1,170	102	8%
SSE	1,274	1,146	128	10%

## **January 2011 - Comparison of standard v online**

### **Average usage**

<b>£</b>	<b>Average standard rate</b>	<b>Average Online rate</b>	<b>Difference</b>	<b>% Difference</b>
British Gas	1,162	1,034	128	11%
Eon	1,149	1,011	138	12%
EDF	1,097	987	110	10%
nPower	1,167	1,030	137	12%
Scottish Power	1,157	1,004	153	13%
SSE	1,163	1,133	30	3%

Standard rates are for customers paying by direct debit.

Based on average consumption of 3,300kw for electricity and 16,500kw for gas and averaged across all 14 regions.

## Annex 2

### The potential for tacit coordination among the Big Six

#### Market outcomes of the GB electricity retail market could point to coordinated behaviour

- 1.1 The Big Six have highlighted in their submissions that the existence of six leading suppliers is evidence in itself that there cannot be competition concerns in these markets.<sup>130</sup> First Utility does not agree with this and while it notes the CMA's statement in the Updated Issues Statement that it is yet to form an overall conclusion on whether the conditions for coordination are met in relation to the SVT price announcement behaviour, First Utility believes that the CMA is not applying the test for assessing whether tacit coordination may arise correctly.
- 1.2 As it stands, market outcomes are currently present which suggest the existence of coordinated behaviour – pricing practices, high levels of profitability, and high and stable incumbent market shares.<sup>131</sup> According to the CMA's own Market Investigation Guidelines (**MIR Guidelines**), in assessing whether such outcomes are the result of coordination (and, therefore, in determining whether this gives rise to an AEC), the CMA must:
  - (a) first, determine whether the market conditions are conducive to coordination, and
  - (b) thereafter, assess firms' behaviour,
- 1.3 In order to conclude whether the outcomes are best explained by coordinated or non-coordinated behaviour. As recognised by the CMA, coordinated behaviour by firms does not require any type of explicit collusion or any contact between them; nor does any decision to avoid mutually detrimental competitive behaviour necessarily have to be conscious, i.e. in the form of explicit analysis or consideration of interdependent strategies.<sup>132</sup> It could arise from a perception of interdependence between the Big Six, such that competitive behaviour that could worsen their respective profits is deterred and rivalry is reduced. It is First Utility's view that the CMA has not conducted a thorough enough assessment of the hypothesis that the Big Six coordinate by refraining from or avoiding direct competition with each other and adopting similar strategies so as to maintain their respective sizeable price-insensitive customer bases who are on SVTs.

<sup>130</sup> For example, in its Initial Submission E.ON states that, "There is *one* fundamental characteristic of the GB energy markets which means that the first two of these criteria (i) the ability of firms to reach an understanding and monitor terms of coordination, and (ii) coordination needs to be internally sustainable among the coordinating group cannot be satisfied in this instance: The fact that there are simply too many suppliers either for the larger suppliers to reach an understanding and monitor the terms of any coordination or for the coordination to be internally sustainable. The legal test for tacit coordination is therefore not met." See "Energy Market Investigation Statement of Issues Response of E.ON", published on 18.8.14, paragraph 120.

<sup>131</sup> First Utility notes that these are all outcomes that the CMA identifies as potentially consistent with tacit coordination. See "Coordination in the retail market facilitated by price announcements". CMA working paper published on 5 March 2015 (**Coordination WP**), paragraph 54.

<sup>132</sup> MIR Guidelines, paragraph 239.

**(a) The market conditions are conducive to coordination**

1.4 To determine whether features of GB electricity retail markets are conducive to coordinated behaviour – and therefore explain why competition concerns appear to arise notwithstanding the number of leading retail suppliers, the CMA must apply the following three-fold test:<sup>133</sup>

- Can the Big Six reach an understanding and monitor each other's behaviour?
- Is the coordination "internally sustainable" – i.e. is it in the Big Six's interest to adhere to a coordinated strategy?
- Is there "external sustainability" – i.e. is the coordination unlikely to be undermined by competition from independent suppliers?

***Condition 1: The Big Six are aware of each other's behaviour***

1.5 In First Utility's view, it is clear that this condition is met. The market is sufficiently concentrated for the Big Six to be aware of each other's behaviour. Indeed, as acknowledged by the CMA, there is a sufficient degree of transparency on the prices offered by suppliers and other terms and conditions.<sup>134</sup>

1.6 The MIR Guidelines indicate that considering this test requires analysis of the structural market characteristics that may help firms reach an understanding and monitor terms of coordination – however, it appears from the Working Paper on Coordination<sup>135</sup> that the CMA has applied this inconsistently. Firms that are relatively symmetric in terms of cost structures, market shares and business models may more easily respond to incentives to reach an understanding with one another.<sup>136</sup> However, although the CMA recognises that the market shares of the Big Six are fairly similar and stable,<sup>137</sup> that the cost structures and hedging behaviour of the Big Six were similar, and that the Big Six's product offerings<sup>138</sup> were also very similar (e.g. homogenous product, the majority of their customers are on SVTs, fixed-rated non-standard tariffs are typically one to two years in length), First Utility disagrees with the CMA's initial view that differences in the business models and short to medium-term differences in energy costs make it difficult to align and maintain incentives among the Big Six. Indeed, this relates to the second

<sup>133</sup> Updated Issues Statement, paragraph 151 and MIR Guidelines, paragraph 250.

<sup>134</sup> Coordination WP, paragraph 31.

<sup>135</sup> Coordination WP, paragraph 13.

<sup>136</sup> MIR Guidelines, paragraph 252(d).

<sup>137</sup> The CMA cites the "Descriptive statistics: retail". CMA Working Paper published on 11 March 2015 (**Descriptive Statistics: Retail WP**), as evidence; however, the entirety of this WP is redacted which makes it difficult for First Utility to comment. See also Coordination WP, paragraphs 15 and 16.

<sup>138</sup> Evidence of similar product offering: (i) "At the end of 2012 SSE note that the gap between the highest priced SVT (SSE) and the lowest (EDF) was £23 across both fuels on an annual basis, which is the smallest range seen for many years. This was considered by SSE at the time to demonstrate that no supplier was seeking to gain competitive advantage from deep discounting on their SVT but rather by offering varying levels of discount through other products in order to gain customers." Pricing Strategies WP, para. 40; (ii) "We found that the cheapest tariffs were all fixed-rate tariffs with terms of one to two years." Pricing Strategies WP, paragraph 30.

27 March 2015

condition of the test (i.e. internal sustainability) and not whether or not the Big Six have the ability to monitor each other's retail behaviour.

- 1.7 As far as the first condition for tacit coordination is concerned, this condition holds – the Big Six do have the ability to monitor each other's retail pricing behaviour (since this is publicly available on their websites)<sup>139</sup> and to monitor their respective customer volumes (and locations). Information is readily available on prices and terms of supply; the Big Six make public announcements in advance of implementation of SVT price changes; Cornwall Energy publishes quarterly market share information; the Big Six are required by Ofgem to produce annual consolidated statements showing their costs, revenues and profits for different parts of their generation and supply businesses; in addition, Ofgem's Supply Market Indicator provides information on trends.<sup>140</sup> Further, the switching process reveals to suppliers where their customers are switching, enabling the Big Six to monitor the switching behaviour of their customers.
- 1.8 According to the CMA's MIR Guidelines, the coordination does not need to be perfect or continuous to have an anti-competitive effect.<sup>141</sup> The CMA's role in applying this test is not to ascertain whether the parties have been acting unlawfully (i.e. in breach of Article 101 TFEU or the Chapter I prohibition under the Competition Act 1998), but merely to establish whether the coordination has an effect on the competition in the market.<sup>142</sup> Any form of coordination has the potential to reduce strategic uncertainty among competitors to the detriment of customers and depending on the degree this would result in an AEC. In First Utility's view, it is in the Big Six's individual interests to adhere to a coordinated outcome and the CMA should consider this evidence further. Thus, and as confirmed by the CMA's own initial view there is clear evidence that, among the Big Six, there is *"a high level of transparency in relation to prices, market shares and cost and margin information and relatively stable market shares for SVT customers"*. This awareness allows the Big Six to anticipate each other's reactions so as to identify mutually beneficial outcomes.

***Condition 2: It is in the Big Six's interests to adhere to coordinated behaviour***

- 1.9 First Utility believes that there is an incentive for the Big Six to adhere to a coordinated strategy, and that they are able to react to, or discipline, any deviation from such strategy – benefitting from the transparency of retail pricing which may facilitate sustained coordinated behaviour. Their established legacy customer bases add to this incentive, with each firm wanting to protect its existing customer base, rather than competing as aggressively as possible for new (i.e. each other's) customers by driving down tariffs through competition. Moreover, there is a material

<sup>139</sup> Coordination WP, paragraphs 25 and footnote 5.

<sup>140</sup> Coordination WP, paragraphs 24(a)-(e).

<sup>141</sup> MIR Guidelines, paragraph 239.

<sup>142</sup> MIR Guidelines, paragraph 240.

27 March 2015

proportion of the market which is not even aware of the possibility that it can switch,<sup>143</sup> which makes a strategy of tacit coordination entirely internally sustainable.

- 1.10 The MIR Guidelines point to the following among the market characteristics as helping to increase the internal sustainability of coordination: a concentrated market, and market transparency allowing coordinating firms to monitor deviations and to react. Both of these appear satisfied. Disengaged customers is another factor which makes tacit coordination more likely and more sustainable. It will be costly to the Big Six if a firm deviated from the prevailing behaviour – such as to cease current practices that maintain disengaged customer bases on SVTs – because although it might generate some new customers in the first instances, the likely response of the rival firms would be to do the same which would not allow the Big Six to continue being able to leverage disengagement to earn higher profits than is possible on fixed tariff customers. The cost of engaging customers and competing on price in order to build market share is likely outweighed by the benefit of customers remaining disengaged and SVTs gradually rising.

***Condition 3: The coordination cannot be undermined by competition from independent suppliers***

- 1.11 In First Utility's view, there are weak competitive restraints on the Big Six. Countervailing buyer power to undermine the stability of coordination by the Big Six is very low given the number of inactive customers. The CMA itself notes that there is evidence that a sizeable proportion of the Big Six's domestic customers have not switched (either internally or externally) to take advantage of cheaper tariffs.<sup>144</sup> For example, 40 – 70 per cent of customers of the Big Six have been with the same supplier for four years or more;<sup>145</sup> and just under a half (48 per cent) of all households have ever considered changing tariff with the same supplier, with just over a quarter (28 per cent) having made an active decision to do so at the same time.<sup>146</sup>
- 1.12 The CMA asserts that the growth of independent suppliers may be a constraint on the Big Six. However, the assertion that independent suppliers' domestic share of the market grew from 1 to 7 per cent between July 2011 and July 2014<sup>147</sup> is overstated as it does not take into account Utility Warehouse's acquisition of customers from npower, which First Utility believes accounts for approximately 2 per cent of the 7 per cent market share held by independent suppliers. Moreover, the independent suppliers have not successfully managed to engage a substantial proportion of the market.
- 1.13 Further, and as recognised by the CMA, barriers to entry and expansion do exist in this market. The MIR Guidelines set out that the degree to which fringe firms are able to compete is relevant

<sup>143</sup> GfK Survey WP, paragraph 98.

<sup>144</sup> Coordination WP, paragraph 28.

<sup>145</sup> Coordination WP, paragraph 28(a).

<sup>146</sup> GfK Survey, paragraph 98.

<sup>147</sup> Updated Issues Statement, paragraph 116.

27 March 2015

to whether they are able to constitute a constraint on coordinated behaviour. In First Utility's experience, there are real barriers to expansion which insulate the Big Six from challenger suppliers at the retail level. This is exacerbated by the lack of liquidity on the wholesale market which prevents them from undermining any coordination by the Big Six.

- 1.14 A further barrier to expansion is "deep discounting" – that is, offering far lower prices to potential new customers than those offered to their legacy customers on standard tariffs. The ability of the Big Six to use targeted deep-discounting as a barrier to expansion by challenger firms, and a "retaliatory" mechanism to discourage competition from rival Big Six firms is an aspect of retail competition which – in our view – is consistent with tacit coordination. Ofgem has previously intervened to prevent such practices from occurring, but evidence suggests that such practices have not completely disappeared. The CMA acknowledges that there are barriers to expansion in the Updated Issues Statement and states that in spite of the gains made by independent suppliers in market share, *"there is a segment of the retail energy markets that is relatively disengaged and that the level of disengagement may be sufficient for coordination over this segment to be sustainable."*<sup>148</sup>
- 1.15 Although the CMA goes on to say that its initial view is that the behaviour observed could be explained by unilateral incentives, First Utility considers that such a finding would be inconsistent with the evidence of the firms' behaviour.

**(b) The Big Six's behaviour may show signs of coordinated behaviour**

- 1.16 According to the MIR Guidelines, the CMA must examine whether actions (or "facilitating practices") have actually been taken to reach, sustain or enhance coordination. In First Utility's view the CMA has not considered the evidence to establish with sufficient certainty whether or not this is the case. Rather, the CMA has assessed whether the Big Six have been modifying their behaviour in relation to the scale or timing of their announcements to a higher standard - i.e. that akin to establishing whether or not there is cartel-like behaviour - and not, as First Utility believes, appropriately considered whether there are signs of coordinated behaviour among the Big Six.
- 1.17 In general terms, the two main types of evidence relevant in this context relate to the availability of information (i.e. the ease with which firms can obtain information about their competitors to facilitate coordination) and specific arrangements made by firms (e.g. pricing policies). As set out above, we strongly disagree with the Big Six's assertion that the existence of a number of suppliers is sufficient to counter any evidence regarding the availability of information. In First Utility's view, the Big Six's behaviour could be considered to demonstrate coordinated behaviour.

<sup>148</sup> Updated Issues Statement, paragraph 151.

27 March 2015

- 1.18 First, it is evident, as described above, that there is a strong incentive for the Big Six to push up prices, particularly in respect of SVTs, in order to increase revenues rather than to cut prices as this is unlikely to lead market share gains.
- 1.19 Second, the Big Six's prices do not appear to come down during periods where direct costs are significantly decreased – the evidence shows that there have been two periods of steep reductions in costs where prices did not accordingly reduce to the same degree. Thus, it is not clear why the Big Six price as they do and given that there is limited visibility for independent suppliers of this, First Utility is supportive of the CMA's intention to further develop its analysis of the relationship between wholesale costs and retail prices (i.e. the "rockets and feathers" hypothesis).
- 1.20 Further, we query the CMA's initial view that that the Big Six's behaviour would be the same unilaterally. Given that the market features are amenable to tacit coordination, as acknowledged by the CMA based on the evidence, we believe that the CMA has too quickly dismissed this evidence to suggest that the Big Six's actions are entirely unilateral.
- 1.21 In particular, the market outcomes in terms of the rockets and feathers hypothesis combined with the prevalence of high SVTs in relation to the Big Six are clear and given that these are to the detriment of GB consumers, this evidence should not be overlooked by the CMA.
- 1.22 While First Utility appreciates that the Big Six may not be modifying their individual behaviour to follow each other in relation to price announcements, this does not negate the potential for there to be tacit coordination. Indeed, evidence of modified behaviour post-announcements would be indicative of far more serious anti-competitive behaviour and so the CMA should rather be focused on whether that the three conditions set out above are satisfied and whether, as we believe, the evidence is consistent with the existence of tacit coordination.

## Annex 3

### Codes (Working Paper 23)

- 1.1 This Annex sets out First Utility's views on code governance in further detail.
- 1.2 Paragraph 7 of the Codes Working Paper describes in very general terms the governance structure of the codes, including the role of code administrator and the panel or executive committee.
- 1.3 First Utility cannot draw on much direct experience of code governance. As an independent supplier, we do not have the resources actively to participate across all codes in terms of governance. However, we have recently become involved in two aspects of code-related governance: (i) as a member of the SPAA Executive Committee (**EC**); and (ii) as provider of a member of the new Project Nexus Steering Group (which specifically according its Terms of Reference seeks to cover those areas not covered by the relevant industry code, generally the Uniform Network Code (**UNC**)). The CMA is focusing on electricity codes but we think that some useful points could be drawn from gas code governance given the similarities with certain of the electricity codes.
- 1.4 Membership of the SPAA EC requires appointment as a director of SPAA Limited, the corporate entity forming part of the SPAA governance structure. This entails appropriate due diligence of the company prior to assuming the duties of one of its directors. This is a significant commitment for a smaller company to support an employee or employees (as an Alternate is required) to assume such duties on an ongoing basis. A member must manage such duties alongside their ongoing role. This can have the effect of limiting their ability to perform that role or at least raise difficulties around information handling and management. An EC member could, for example, have sight of and be required to opine on various documents which are for members only. This could mean that for certain areas, the supplier may need to ensure different resource to address their interests. For independents and smaller suppliers and shippers, with substantially fewer resources than larger participants, this is challenging.
- 1.5 The governance of SPAA in theory enables a smaller shipper representative to participate. However, as highlighted above, and as noted by The Cooperative Energy and Ecotricity in the Case Studies Working Paper, the burden of participation falls disproportionately on independents and smaller market participants, who will have materially smaller teams by which to manage this.
- 1.6 In a different context, the Project Nexus Steering Group is not a part of code governance as such but is a means of addressing overarching programme assurance following diagnosis of

27 March 2015

such a gap by participants and Ofgem.<sup>149</sup> It has been set up as intentionally small in member numbers, with Terms of Reference covering detailed aspects of programme assurance. The overall aim is to arrive at recommendations around whether the industry is ready to meet the Project Nexus go-live date of 1 October 2015. This work is likely to require substantial commitment from all members. However, the smaller shipper representative must garner the views of his constituency and try and represent a larger, more diverse and potentially less code-experienced group. In the short period for which this Group is to be in existence, we will need to manage the constraints that participation in the Group will impose on our central codes team.

- 1.7 This active participation in the above groups is likely to effectively prevent us from considering active engagement in other new and ongoing code modification processes. The following factors, i.e. the number of modifications ongoing at any one time; deciding whether to participate actively in code governance or wider industry initiatives and the need internally to determine the operational and business impact of the proposed change and manage code modifications, as well as supporting internal project management for system changes and related matters all work to inhibit independent and smaller market participants from getting involved. Smaller market participants simply do not have the resources to do so on an equivalent or even nearly equivalent basis as the Big Six. Thus, the fact that code governance enables smaller market players to participate does not of itself mean that participation is practicable or even possible across all codes. In our view, this prevents innovative and disruptive thinking and new perspectives from being brought to bear on industry issues and processes, which may work to inhibit change and innovation overall.
- 1.8 Furthermore, there are simply too many changes across all codes at any one time for independent and smaller suppliers to consider the two key aspects of interest for them: (i) the impact of each change on their business and operations; and (ii) what changes they could propose to improve things.
- 1.9 As described in paragraphs 9 and 10 of the Codes Working Paper, Ofgem's Code Governance Review (**CGR**) was launched to address the impact on the codes of various changes to the regulatory and market regime. Importantly for current purposes, the CGR covered a number of areas, including complexity and ensuring input from smaller participants, new entrants and consumers.<sup>150</sup> Several years on, independents are still citing the inhibiting amount of resource needed to support active engagement with the codes.<sup>151</sup> Complexity and representation for independent and smaller suppliers are long-running concerns and remain so today: on this basis, the CGR was perhaps not entirely successful in its goals.<sup>152</sup>

---

<sup>149</sup> Codes WP, paragraphs 48-51 regarding Project Nexus, which is one of three case studies on modifications included by the CMA.

<sup>150</sup> <https://www.ofgem.gov.uk/publications-and-updates/industry-codes-governance-review-code-administrators-working-group-covering-letter>

<sup>151</sup> Case Studies WP, paragraphs 101 and 112.

<sup>152</sup> Codes WP, paragraph 56.

27 March 2015

- 1.10 It is interesting to note the comments made when Ofgem first proposed the CGR. Nigel Cornwall, for instance, commented that one of the key strands to NETA was governance. This was seemingly based on *“the merits of the approach adopted from the mid-1990s in the gas market.”* Here, there was a code required by regulation that *“embedded high level principles and requirements on a panel with varied membership to act objectively in assessing change proposals efficiently and effectively.”*<sup>153</sup> This is set against a perception of Pool governance being fractious, commercially motivated and frequently ending in impasse.
- 1.11 First Utility cannot comment on whether this is a fair representation of the Pool or of gas governance at the time but we would agree with varied panel membership acting objectively as a fundamental aim for good code governance. The preference, for BSC-style governance arrangements, reflected in Nigel Cornwall’s comments, is one we would echo today albeit based on our limited experience of active engagement with the code modification processes to date. At the time of the CGR, the industry had few new entrants and challenger businesses in the market. In 2015, with only around 9 per cent of the market in the hands of such players, the same point remains: *“in a context in which the industry – especially the scale players – will always have the upper hand because of the resources it has, some form of hybrid panel is essential.”*<sup>154</sup>
- 1.12 Our experience of the BSC Panel is that it is independent and capable of acting objectively.<sup>155</sup> We would also note that our experience of Ofgem, in its role as approver (or otherwise) of Panel recommendations, took into account independent and smaller supplier concerns when these were raised. We describe our engagement with the modification process in more detail in the Appendix to this Annex. Our concern with governance is not with the BSC Panel, but with the workgroup system. We also consider that as a result of this system seeming to favour the status quo, we had to engage more widely to be heard. In part this was due to being one of the few independents on the workgroup.
- 1.13 The CMA describes the industry codes as “detailed multilateral agreements”.<sup>156</sup> This is certainly correct. The codes are structured as agreements, with binding obligations on the parties and consequences for breach (including potentially a breach of licence condition). The codes are also extremely detailed, and they become more so each year. This “code bloat” is, while understandable, regrettable.
- 1.14 However, we think that to describe the codes as only covering “technical rules” for participation in the industry is underplaying the way in which the codes are constructed: they include

<sup>153</sup> See <https://www.ofgem.gov.uk/ofgem-publications/61514/nigel-cornwall-attachment.pdf>

<sup>154</sup> See <https://www.ofgem.gov.uk/ofgem-publications/61514/nigel-cornwall-attachment.pdf>.

<sup>155</sup> We note that there is an ongoing review of governance: <https://www.elexon.co.uk/news/ofgem-letter-elexons-governance/>. This is in addition to the recent announcement of a new Grid Code Development Forum to cover technical and operational issues and aspects of MRA governance are also being considered. We are able to note these developments but have not been able actively to participate in the MRA or the Grid Code to date. The Elexon review pre-dates the current central codes team.

<sup>156</sup> Updated Issues Statement, paragraph 193.

27 March 2015

charging rules (Connection and Use of System Code (**CUSC**) and Distribution Connection and Use of System Agreement (**DCUSA**)), detailed commercial arrangements (BSC and UNC) and have significant behavioural and financial consequences for participants. We noted above some of the concerns that arose under the Pool governance process being almost too commercial. We are concerned that in some areas, the codes may not be commercial enough.

- 1.15 Such is the interdependence of various key arrangements that failure by one party to perform its obligations (while not being material perhaps in a contractual sense) can cause significant adverse consequences for competitors. An important example of this is the Change of Supply process, where the consequences of a failure by the losing supplier to, for example, not maintain or arrange for the maintenance of correct data are felt by customers moving supplier and paid for by the gaining supplier. This is not a new concern. Indeed Ofgem encouraged an industry review of data quality, which was undertaken during 2014,<sup>157</sup> and resulted in two reports being made to Ofgem, each of which focused on the Change of Supply process.<sup>158</sup>
- 1.16 In the strict code sense, some of these issues may be an example of where the incentives to comply are misaligned. The gaining supplier has an incentive to ensure compliance but not necessarily the ability to do so. The losing supplier does not necessarily have the incentive to do so but can and should have done so, or ensured that any agent on its behalf has done so. Were the codes to be reviewed with a view to including more general behavioural incentives on parties, Ofgem may not have needed to prompt such a review.
- 1.17 In accepting the recommendation of the initial data quality, ownership and governance workgroup to set up a dual fuel workshop, Ofgem in its open letter to industry welcomed industry's commitment to resolve these issues.<sup>159</sup> We note that there is a feeling amongst the workgroup members that to prioritise the work based on facts will involve a large amount of work at a time when suppliers are already struggling to keep up with industry change.
- 1.18 The CMA sets out three case studies as part of its initial analysis of issues around the timeliness of modification processes.<sup>160</sup> We would note that some matters are of such significant commercial impact that the code modification may not be the best means of securing a balanced outcome. In these circumstances, it is not practicable to expect companies fully to take into account the interests of other participants where these run directly counter to their own. This may be the basis for the repeated impasses and challenges around locational prices with the CMA highlights in the Locational Pricing working paper and at paragraph 41 of the Codes Working Paper. It may also be the case that a Significant Code Review would not be able to encompass all the issues raised by this issue for market participants and others.

<sup>157</sup> <https://www.ofgem.gov.uk/publications-and-updates/industry-data-quality-ownership-and-governance>  
<sup>158</sup> <http://www.spaa.co.uk/meetings/detail?meetingid=222892> and  
[https://www.elexon.co.uk/wp-content/uploads/2013/12/231\\_07a\\_Electricity\\_Data\\_Quality\\_Working\\_Group\\_Report\\_v1.0.pdf](https://www.elexon.co.uk/wp-content/uploads/2013/12/231_07a_Electricity_Data_Quality_Working_Group_Report_v1.0.pdf)  
<sup>159</sup> <https://www.ofgem.gov.uk/ofgem-publications/94101/letterondataqualityfinalfinal-pdf>  
<sup>160</sup> Codes WP, paragraph 35 *et seq.*

27 March 2015

- 1.19 We include in the Appendix to this Annex a case study around the Electricity Balancing Significant Code Review. In general, we share the CMA's concerns with the timeliness of code modification processes. We do think that aspects of the code modification processes can, and have been, used to delay change.

## Appendix: Case Study of a BSC modification

### P304/P314 Case Study

#### Background

Cashout and the price average reference or PAR volume were issues significantly in advance of Ofgem's launch of the Electricity Balancing Significant Code Review (**EBSCR**) announced on 28 March 2012. As the EBSCR progressed, we consider some lessons could usefully have been learned from this background.

Some of this history starts with an earlier modification, and alternative, around tagging, P211 (raised by EDF Energy, with P212 raised by Bizz Energy<sup>161</sup> as an alternative) and P217 (raised by RWE npower). This modification has its own history, which we do not focus on in this case study. However, it is interesting to note that Ofgem, in deciding to delay the progress of P211 so that it could run in parallel with the mutually incompatible P217, said it was *"very disappointed to find itself in this position"*, noting that the issues the modification was intended to address had been raised *"through our various cashout review initiatives and in a number of previous modification decision letters."*<sup>162</sup> Ofgem considered that P217 should have been raised earlier and that as a consequence of the resultant delay, addressing the disproportionate adverse impact of the rules being changed on renewable generators, and small generators and suppliers was held up. This was to be an issue in the forthcoming review of industry governance.

#### Significant Code Reviews

In July 2010, Ofgem (via National Grid (**NG**)) laid the groundwork for addressing major policy issues by implementing the conclusions of its Code Governance Review in the main commercial codes (being the BSC, UNC and CUSC). It did this by directing the modification of the BSC to give Ofgem more power to initiate and drive through any BSC modifications required to implement the findings of a Significant Code Review (**SCR**). These new powers became effective on 31 December 2010.

However, Ofgem, on publishing potential areas for SCR, was persuaded to hold off on launching a review of balancing and related matters given the development of the Electricity Market Reform or EMR, which included proposals for a form of capacity market.

#### A renewed focus on cashout

In February 2010, Ofgem issued their Project Discovery Report<sup>163</sup> that highlighted a number of (ongoing) concerns regarding current electricity balancing arrangements. To resolve the issues

<sup>161</sup> It is worth noting that the representative of Bizz Energy, a relatively new entrant at this stage, although now no longer in existence, had previously worked in a Big Six company and was very familiar with trading and balancing and the code itself.

<sup>162</sup> <https://www.ofgem.gov.uk/ofgem-publications/40621/p211-delay-decision-letter-draft-final-2.pdf>

<sup>163</sup> <https://www.ofgem.gov.uk/ofgem-publications/40354/projectdiscoveryfebcondocfinal.pdf>

27 March 2015

highlighted in the Project Discovery Report, Ofgem launched the Electricity Balancing Significant Code Review (EBSCR) on 28 March 2012. Ofgem decided on “wide” terms of reference for the EBSCR, considering that this was merited given the range of views on the issues. Ofgem did in fact reduce the scope of the EBSCR, hiving off the wider issues into the Future Trading Arrangements project.<sup>164</sup> This was perhaps one of the lessons for managing complexity and what may prove to be contentious changes: a narrower focus.

On 15 May 2014 Ofgem published their EBSCR final policy decision.

Ofgem then directed National Grid (NG) to raise two modifications. P305 was the main modification and consisted of a complex package of changes that would require significant data analysis and industry consultation. Ofgem wanted to start implementing their policy for the winter of 2014, and so they unexpectedly directed NG to raise P304 as well. P304 was a simple change to implement that only proposed to change the value of the Price Average Reference (PAR) (used for calculating the imbalance price) from 500 to 250. The potential adverse distributional impacts of this modification prompted First Utility to get involved and support the industry in evaluating this modification.

In taking this decision, we accepted that we would need to obtain expert support in order to be able to contribute to the workgroup. We worked with Keith Munday, a veteran of the energy industry and Jeremy Guard, our Senior Codes Manager, also aimed to attend. In so doing, we determined that only one vote would be used, albeit the workgroup rules could have allowed us to call upon two votes. Given the impact of this separation of PAR from single cashout (which changes we agree with), we also worked with our Head of Trading and his team. We raised the issue with contacts in DECC as well, which involved our Chief Financial Officer. Across the company, our involvement took up the time of a number of Heads of Department (Trading, Policy), executive time through risk management and Board updates, and a substantial proportion of Jeremy’s working time.

A workgroup was formed and met three times to consider this modification, 17 people attended the workgroup over and above Elexon, Ofgem and National Grid (the proposer). First Utility was the only wholly independent supplier to attend the workgroup. Elexon had performed analysis and provided useful data that allowed participants to do their own research and come to their own conclusions. Unfortunately, the data analysis was performed over a period of time that was quite benign with no periods of scarcity, this resulted in the potential impacts of the modification being underestimated from the perspective of First Utility.

Reducing PAR from 500 to 250 would in our view increase the imbalance price and would have resulted in smaller suppliers paying higher imbalance charges especially during times of scarcity. We confirmed this in our own modelling. Conversely, due to a mechanism called Residual Cashflow Reallocation Cashflow (**RCRC**), vertically integrated suppliers would have significantly benefitted.

---

<sup>164</sup> <https://www.ofgem.gov.uk/electricity/wholesale-market/forums-seminars-and-working-groups/future-trading-arrangements-fta-process>

27 March 2015

The following timeline describes what happened:

Event	Date	Narrative
P304 Raised	30/05/14	National Grid at the request of Ofgem, raises P304.
P304 IA	05/06/14	Elexon publishes the Initial Assessment (IA) for the BSC Panel.
BSC Panel	12/06/14	The BSC Panel discusses the IA and agrees that the modification should proceed with the formation of a workgroup.
P304 WG1	20/06/14	The first workgroup meeting, mostly focussed on the reports needed from Elexon in order to assess the impact of the modification.
P304 WG2	17/07/14	The workgroup met again without the data being made available in advance. Normal practice would have been to delay the workgroup until the data was published and allow workgroup members to review the data for a week or so, then meet. Due to time constraints, it was decided that the meeting would proceed regardless.
P304 Data	21/07/14	Elexon make the data analysis publicly available.
P304 APC Opn	30/07/14	The Assessment Procedure Consultation (APC) opens even though the workgroup never had a chance to meet after the data analysis was provided.
P304 APC Cls.	20/08/14	P304 APC closes.
P304 WG3	21/08/14	<p>P304 workgroup discusses the APC responses (note this meeting was scheduled for the day after the consultation closed, leaving no time for work group members to discuss the responses internally before the workgroup meeting).</p> <p>The consultation highlighted that in terms of the modification better facilitating BSC objectives: 6 were in agreement and 8 were not in agreement.</p> <p>First Utility among others, expresses concern about reducing PAR to such a large extent and proposes a P304 alternative to reduce PAR to 350 instead of 250.</p> <p>Despite the above consultation response the workgroup voted</p>

27 March 2015

		against the PAR 350 alternative because the workgroup thought it was worse than the proposed PAR value of 250. It should be noted that in order to vote a workgroup member must have attended either in person or by phone 50 per cent or more of the workgroup meetings.
This was a significant blow to First Utility and some of the other participants at the P304 WG3. We wanted to give Ofgem another option so rather than having to choose between PAR 250 or nothing, they could compromise at PAR 350. We had concern that vertically integrated parties at the workgroup had voted against the alternative because they wanted PAR 250 as they would gain financially from it.		
EDF Announce	04/09/14	<i>"Nuclear reactors may stay offline until end of year"</i> , EDF says.
P314 Raised	05/09/14	First Utility raises modification P314 to provide Ofgem with an alternative PAR value of 350 and requests urgent status so it can be put forward to Ofgem alongside P304.
BSC Panel	08/09/14	Extraordinary Panel meeting called to discuss the appropriateness of the P314 urgency request - Panel recommends urgency.
Ofgem	10/09/14	Ofgem approves P314 as urgent.
BSC Panel	11/09/14	The panel agrees that a workgroup should be formed.
P314 WG1	15/09/14	The P314 workgroup consisting of the same people from the P304 workgroup discusses the modification and the questions for the RPC.
P314 RPC Opn		The P314 RPC Opens.
P314 Prices	22/09/14	Elxox publish more data relating to imbalance prices at times of scarcity.
P304 RPC Cls.	30/09/14	P304 Report Phase Consultation (RPC) closes.  The industry votes 12 to 9 in support of the BSC Panel recommendation to reject the modification. Despite this industry response the workgroup voted and by majority recommended that P304 should be approved.

27 March 2015

P314 RPC Cls.	30/09/14	P314 Report Phase Consultation (RPC) closes.  The alternative modification is recommended by the workgroup which was the same as requested by First Utility but with an implementation date the same as P304 - 31/10/14 instead if the proposed date - 02/01/15.
Ofgem / 1U	01/10/14	First Utility meets with Ofgem to formally explain its reasoning behind raising P314.  We understand that Ofgem may have met with other independent suppliers, along with Nigel Cornwall who coordinates the Independent Suppliers Group.
P304 P314 WG	02/10/14	The Draft Modification Reports are agreed for both P304 and P314.
BSC Panel	09/10/14	BSC Panel agreed by majority that both P304 and P314 should be rejected.
P304 Final P314 Final	10/10/14	The Final Modification Reports are updated with the Panel recommendations.
Ofgem	28/10/14	Ofgem decides to reject both P304 and P314.

## Conclusion

First Utility believes that the BSC workgroups are not structured to make decisions that are best for the industry. Our experience highlights that it is unrealistic to expect them to do so. On a number of occasions, the workgroups in this case study took decisions that directly contradicted industry sentiment received through the consultation process. BSC workgroups typically consist of employees from suppliers and in this case, generators, and it would be difficult to imagine them voting in favour of modifications that put their own companies at risk.

We therefore believe that a possible clash of interest exists at the BSC workgroup level that should be investigated and perhaps remedied.

Our experience of the BSC Panel is that it does not appear to have the same issues (based on their recommendations regarding P304 and P314). The BSC Panel has the benefit of a number of independent members that we believe might lead to a more balanced voting mechanism, even though

27 March 2015

there are still individuals on the BSC Panel making significant industry decisions who are employees of Big Six; there is still potential for a clash of interest.

We are sceptical that long time employees of the Big Six can easily put themselves in the position of independent and smaller industry participants. It is understandable that they perceive that all systems are run as they run their systems (which methods and approaches in our view is reflected in many of the operational elements of the codes) and that our processes are similar. However, the BSC and other codes are intended to enhance competition, for the overall benefit of customers. This makes it all the more important to ensure that workgroups take into account consultation responses, as independent and smaller participants may find it easier to resource responses than ongoing attendance at workgroups and ensure that appropriate options reflecting significant differences are put through to the next decision-making stage.