ENERGY MARKET INVESTIGATION

Summary of hearing with First Utility on 19 March 2015

Introduction

1. First Utility was an independent energy supplier. It welcomed the investigation as one of the most important events in the industry in decades. It expressed its disappointment with the CMA's emerging conclusions under the theory of harm 3(a) as it believed that there remained issues around market liquidity.

Market rules and the regulatory framework

2. First Utility did not have strong views on whether central dispatch versus self-dispatch was the most efficient way of operating the generation portfolio in the UK. The important aspect was that it did not disadvantage different participant types in the market such as mid-sized suppliers.

Market liquidity

3. First Utility did not think that wholesale prices were sufficiently transparent and, by implication liquid. Despite Ofgem recently putting the Secure and Promote liquidity intervention in place it was not enough to alter liquidity as it focused on baseload and peakload. Baseload and peakload was only a proxy hedge for the demand profile and it left First Utility exposed to risk until the day before delivery, when more products were available to trade. These risks could seriously undermine the business model of a supply-only business in a way that a vertically integrated business would be able to offset.

4. First Utility said that a typical day of domestic energy demand would have lower demand overnight, higher demand in the morning and an evening peak. If First Utility could not buy that volume, it would be exposed to an imbalance. It also explained that base and peak load electricity traded in seasons – a few seasons forward and up to two to three years forward in some cases.

5. First Utility explained that it might be able to buy a block for a forward season, but it was rarely traded as the price transparency was very poor. This was because bid-offer spreads were large and products difficult to source.

6. First Utility also explained that suppliers would want to buy the back-to-back wholesale hedges that would lock in gross margins. These products were not always available, however, so this was not possible – and subsequently suppliers could be exposed to risk until delivery. The risks were that during periods where suppliers were short power, the price rose at delivery, and during the periods where they were long power, the price fell at delivery.

7. First Utility explained that the inability to hedge as it would like meant that it had to take this into account in the way it set out tariffs for its customers.

8. First Utility said that 90% of energy supply businesses that wanted electricity were part of vertically integrated businesses, and they did not appear to be going out to the market to source it.

9. First Utility clarified that the other independent suppliers were using different business models. Ecotricity and Good Energy were generators, and so they were mini vertically integrated businesses. Telecom Plus (Utility Warehouse) was not exposed to the risk because of their commercial relationship with RWE npower. It was difficult for First Utility to comment on Co-op as it did not perceive liquidity to be an issue. Ovo would eventually face similar challenges around liquidity.

10. First Utility stated that it had advocated the idea of a self-supply restriction. This would mean that all vertically integrated generators would have to put all of their output onto the wholesale market. It saw that as a less intrusive approach than full divestment to achieve liquidity.

11. First Utility suggested that its business model had a different appetite for risk from some other market participants. In its view, a lot of the new independents had grown in very benign market conditions and had not previously experienced volatile market conditions.

12. In 2008, wholesale markets were extremely volatile and prices doubled between January and August – and then they collapsed rapidly over the following couple of months. That volatility was very painful for most companies that existed in the market at that time. Since that point with demand destruction and higher capacity it was apparent that forward market, spot market and imbalance prices had been relatively benign. First Utility was careful not to be complacent just because the wholesale market had been benign; it would not stay like that, which is why it was concerned about its exposure to risk.

13. First Utility had not been advocates of the structural separation of vertically integrated energy suppliers.

Secure and Promote

14. First Utility thought Secure and Promote could have been a positive step forward. It had suggested to Ofgem that it should think about putting more granular products into the Secure and Promote programme. These would include block products such as monthly granularity base and peak and monthly granularity block. It also thought that there should be enforced price discovery on those products in Secure and Promote.

15. First Utility stated that liquidity had shifted to the trading windows and there had been no net improvement in overall liquidity. In addition, other products had become less liquid. There was concern that the existence of those trading windows had kept potential participants out of the market.

16. First Utility agreed that one of the intentions to improve liquidity was to bring in more market intermediaries so there would be more liquidity through secondary trading products. However, this was very hard to do if there were large parts of the day where there was little or no trading activity. First Utility suggested that Secure and Promote had done little to promote new entrant intermediaries into the market or to halt participants exiting the market.

Imbalance

17. First Utility believed the size of an energy supplier did matter in terms of managing imbalances as it had seen its own imbalances reduce as the size of its business had grown. First Utility said that the overall cost of imbalance was approximately £30 per customer.

Cash-out reforms

18. First Utility thought there should be a single cash-out process. It had been very concerned with the move to Price Average Reference (PAR) 1 and it had suggested to Ofgem that it should contemplate a phased reduction of PAR.

19. First Utility's concern with PAR 1 was that by making it that sharp in opposition to what Ofgem might want in terms of promoting trading in the market and increasing visibility, it thought there was a strong risk that it could actually do the opposite. It explained that when cash-out was a risk, people were more defensive and kept the optionality of generating their own portfolio as a mitigation for imbalance.

20. First Utility said that the new reforms would produce significant change that could impact on behaviour within the wholesale energy market.

Contracts for Difference

21. Regarding the replacement of Renewables Obligation Certificates (ROCs) with Contracts for Difference (CFDs), First Utility stated that at a strategic level the challenging issue for it was the prospect of choosing technologies and setting an appropriate price. First Utility was pleased the process had moved to an auction where more efficient technologies would be successful.

22. First Utility's concern was around the variability of the costs and the risk that was being passed on to the supplier. Consequently, it considered that this was likely to increase as the scheme progressed, although at this stage, it had noted a fairly narrow impact on its business.

23. First Utility said that while CFDs was a small scheme, there was not too much risk. However, as CFDs grew and moved to a 5 to 15% part of the overall cost of supplying electricity, there might be an increased level of risk.

Price positioning

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25. First Utility also had a three-year fixed tariff as some customers wanted to set a fixed price for a long period of time and not have to worry about changing tariff. It also had a variable tariff. Most of First Utility's customers were on a fixed price tariff. First Utility said that the variable tariff was not a common consumer choice.

26. First Utility communicated with customers 12 times a year via their monthly bill to tell them about a possible cheaper tariff. It also communicated with an annual statement, and if the annual fixed tariff expired it communicated again. Its data showed that by contacting customers on a monthly basis, a certain percentage would engage. First Utility tried to actively move its customers away from standard variable tariff and suggested that a requirement to ensure that suppliers informed customers of the cheapest tariff on the market would be an effective tool.

27. First Utility said it served a specific demographic who had already switched at least once. This meant that its customers were more open to switching again. It also said that 70% of customers of the Six Large Energy Firms were on a standard variable tariff and inactive in the market and hard to attract.

Economies of scale

28. First Utility thought there were some economies of scale in the retail supply business and it had achieved some of those economies. In terms of cost-to-serve, it had benefited because it had one set of information systems and interacted with its customers differently from other suppliers.

29. First Utility was starting to look at how it could improve industry processes and reduce its cost-to-serve ratio. It was advocating for smart data as a platform as this would allow more opportunities for tariff innovation and to optimise its cost-to-serve ratio.

Smart meters

30. First Utility considered that there were potential benefits for smart meters and time-of-use tariffs. The customer benefit was around reducing the chances of mistakes being made on bills through incorrect meter readings. There would also be a benefit for suppliers as they could buy shaped products having used smart data and could forecast better for the future. This benefit could then be used to lower a supplier's cost-to-serve ratio.

The impact of regulation

31. First Utility did not think that Standard Licence Condition 25A had a big impact on it, although it changed how incumbent energy companies were competing. Before, the regulation companies had competed using the standard variable tariff; however, since the regulation, companies competed through tariff proliferation and a discounted variable tariff. First Utility noted that the larger energy suppliers had said the four tariff rule limited innovation, but First Utility did not agree that four tariffs had been restrictive and supported the rule.

32. It had seen an impact from the government's recent switching advertising campaign. It saw an increase of approximately 50% in registrations. This sort of campaign grabbed the attention of the 30% of customers who had previously engaged in switching supplier, but it did not impact on 'sticky' consumers.

33. Collective switching campaigns were attracting 'stickier' customers. The campaigns were run by organisations such as The Big Deal, local councils or consumer champions such as Martin Lewis. The campaigns were an interesting concept, but were only reaching small numbers of consumers. In 2013, the combination of increased politicisation of the energy market and the subsequent media coverage also saw a significant percentage of those who had never switched supplier becoming engaged in the market.

34. First Utility believed that Price Comparison Websites (PCWs) had done more to bring the price differential between tariffs to the attention of consumers than anything else. It noted, however, that every channel to market had a cost associated with it, and a switching site was no different as it received a commission from a supplier for each tariff taken on by a consumer. First Utility wanted the PCWs to be transparent with regards to commission, and was aware that Ofgem was working on this issue.

Gas settlement

35. First Utility said that gas settlement had caused historic problems. It was an imperfect solution that was adopted at the time of deregulation and it was very important that it should change through the implementation of Project Nexus.

36. First Utility wanted to resolve any problems before the full implementation of gas smart meters in 2020. There were data-cleansing and process lessons to be learnt to make systems running on smart data easier.

37. First Utility welcomed a possible move to half hourly settlement for domestic use profiles. It said that the main issue was whether to move to this format through a ‘big bang’ approach on a certain date or to spread the migration over a longer period of time.

Micro-businesses

38. First Utility had withdrawn from the micro-business and SME market.
First Utility thought there was an opportunity for a fair contract for micro-businesses. Protection for micro-business consumers had been less than that in the domestic market. It felt that some SME and micro-business energy suppliers had found a niche in the market by supplying these types of consumers.

39. In First Utility’s view, the issue for micro-businesses was similar to the domestic market in that there were consumers who were not engaged. These consumers ended up on standard contracts that rolled over and were signed up for another year at a higher rate. First Utility did not think that the industry was doing enough to solve this issue and that businesses failed to engage because the market was confusing and energy might be a relatively small part of their businesses’ overall spend.

40. First Utility’s main concern with regards to the market for micro-businesses was around the role of brokers, transparency and commission. If a broker was working with suppliers, a quote should be prepared including their commission. This issue had been debated in the industry and it struggled to

understand why a solution had not been adopted that made the supplier disclose how much it was paying to a broker or intermediary.

41. Brokers had capitalised on the complexity of the market. For micro-businesses and SMEs it was possible to access hundreds of different tariffs, which meant a business customer sometimes did not understand whether the offer that was being presented was competitive or not. It was difficult for PCWs to have a role in the SME market because of the complexity associated with many different tariffs.

Industry codes

42. First Utility believed that codes were designed around the market structure. When the market was broken up there was a desire for competition in every area of the market. This resulted in complex codes that allowed different systems to work with each other. Code modification group members were mostly employees of the larger energy companies – so there was inevitably an element of bias in their work towards their own organisations.

43. First Utility had debated the cost benefit ratio of attending the various modification groups. Code modifications were very complicated, so they required significant resources to influence the months of negotiation and deliberation. For suppliers such as First Utility there was a question of prioritisation and the resource implications of having representation at each group. Independent suppliers also had different business plans, models and interests. One company could not represent all the interests of all independent suppliers.

44. First Utility supported the idea of an Ombudsman or arbiter appointed to deal with code modification and did not think one large code with harmonised governance would help with the complexity of the areas dealt with in the codes.