CMA
Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with First Utility on 2 October 2015

Introduction

1. First Utility offered its continued support to the CMA's investigation, stating that its own views were broadly aligned with that of the published provisional findings and notice of possible remedies, with the exception of some areas that it wished to address during the hearing.

2. Its concerns were focused on the proposed remedies rather than the provisional findings. It expressed concern that the proposed remedies represented a missed opportunity to take the action necessary to improve engagement in the retail market.

3. First Utility felt that the retail market was demonstrably dysfunctional, citing evidence that 70% of customers remained on the most expensive available products. It also said that the proposed remedies would leave the incumbent six large energy firms in a position to leverage their disengaged customer base to maintain their market position.

4. First Utility reiterated its support for putting forward new ideas to increase levels of engagement and promote wider access to the most competitive prices in the market.

Background

5. First Utility provided evidence demonstrating that the growth in market share by independent suppliers occurred after 2008, in a period of low market volatility, with stable average base load prices. It cautioned, however, that the period of stability should not be assumed to continue.

6. First Utility said that it was working-capital-positive. This meant that during normal weather conditions it collected payment from customers via direct debit in line or slightly ahead of paying out to creditors.

7. First Utility noted that many independent suppliers had grown significantly during benign market conditions and acquired customers on fixed-rate tariffs, thereby building in a lot of risk if they had not properly hedged for a potential rise in wholesale prices. [✂]

8. First Utility said there were challenges for small independent suppliers in scaling up operational processes once they exceeded 100,000 customers, such as the complexity of administering high volume transfers, change of tenancy, house moves, or losing a customer.

9. Operational stability tended to increase with size as volume growth revealed challenges that could then be addressed, eg around industry processes. In 2012 First Utility invested heavily in operating platforms and automation that enabled scalability and permitted sustainable growth.

Provisional findings

10. On the topic of wholesale market liquidity, First Utility disagreed with the CMA's findings and the absence of an adverse effect on competition.

11. First Utility recognised that there was no example of a vertically integrated energy company able to perfectly match its generation profile with its supply business, but stated that a high degree of symmetry and overlap existed. It questioned to what extent those companies were capable of maintaining their own shaped products in a higher risk environment, much unlike recently benign conditions.

12. For new suppliers, it was too risky to become vertically integrated as they did not have the scale to build a portfolio of generation assets that would be varied enough to simulate the UK stack and obtain an average price.

13. First Utility recommended that a remedy was developed that would mandate the supply of more granular products.

14. First Utility's trading agreement with Shell meant it [✄]. It felt that the challenge of acquiring more customers for independent suppliers was the level of its forward position and potential mark-to-market movement. New entrants had to use cash as collateral, which was expensive.

15. The trading agreement was an efficient solution that gave First Utility access to the wholesale market [✄], provided it demonstrated it was [✄].

16. If a generator needed to raise collateral then it might place a lien on its plant in return for uncollateralised trading. First Utility's agreement with Shell acted as a lien on its customer contracts. First Utility said there were two elements to the commercial side of the contract, the first allowing Shell [✄]. This protected Shell by [✄], in addition to providing a debenture. Secondly, arrangements ensured Shell's interest were aligned with First Utility's as it had an equity-like stake via a warrant [✄].

17. First Utility said the ten-year agreement with Shell was [✂].

18. The agreement with Shell [✂].

19. First Utility said that at a certain commodity price-point costs had a negative contribution to its profit and loss (P&L), and that historically this hadn't been an issue during the benign post-2008 market, but could be if there was greater market volatility. Furthermore, it said that although gas had a greater volume swing (and thus risk) due to weather, electricity (which was settled by the half hour) could lead to an extreme volatility of cost at imbalance or in spot markets. First Utility felt there was a different risk profile in this respect for vertically integrated firms when compared to independent suppliers.

20. First Utility said that a long warm winter posed just as much of a challenge to suppliers as a long cold winter because they were forced to sell their surplus energy at a loss during a time of volatile prices and demand changes.

21. First Utility said that direct debit customers had a lower cost to serve and that the price differential between its direct debit and non-direct debit customers was cost reflective. It noted that the six large energy firms had larger differentials.

Notice of possible remedies

Remedy 3 – Remove from domestic retail energy suppliers' licences the 'simpler choices' component of the RMR rules

22. First Utility said that it supported the four tariff rule and that there was no connection between a greater proliferation of tariffs and increased engagement. It reasoned that less than half of suppliers used their full allocation of tariffs, that customers were not demanding more tariffs, and due to derogations it meant many more tariffs could exist at any one time than suggested by the four-tariff rule.

23. First Utility suggested that Ofgem's Retail Market Review (RMR) ushered in two major positive changes, more frequent communication due to the Fixed Tariff Expiry and improved information via reporting supplier's cheapest tariff to customers. First Utility prompted customers at least 12 times a year with the cheapest tariff available. It said that it may not have always have been in its immediate economic interest to prompt so frequently, but that frequent prompting supported it in offering a product and service customers trusted. First Utility felt that the fixed tariff expiry prompt should also apply to customers on standard-variable tariffs and that it would result in improved engagement.

24. Removing restrictions put in place by RMR would increase market complexity and decrease consumer understanding. It had been the intention of the six large energy firms to retain customers, with a proliferation of tariffs, 'confusion marketing', and dominating the first page of price comparison websites.

25. The restrictions put in place by RMR did not negatively impact competition between price comparison websites, whose switching percentages had risen since the introduction of RMR due to wider consumer usage.

26. First Utility did not support all the components of the RMR, notably the tariff comparison measures, which it said did not fulfil the potential envisaged by Ofgem, and the complexity of bills due to the requirement for prescriptive and complex information. First Utility advocated a principle-based approach to regulation that permitted enough flexibility for suppliers to provide an innovative service for their unique customer base.

27. First Utility felt that the RMR should have prohibited suppliers from withdrawing their cheapest tariff prior to billing runs. This practice was used to temporarily minimise the differentiation between customer's actual tariffs and the possible savings listed via cheapest market tariff, thereby undermining the reform.

Remedy 4a – Measures to address barriers to switching by domestic customers

28. First Utility said the incumbent energy suppliers had the technological and operational means by which to restore trust in the industry and raise switching rates through sophisticated prompting messages, but had chosen not to employ them to further entrench their market position.

29. First Utility advocated a remedy that in principle communicated on a monthly basis the approximated amount customers were overpaying compared to the market cheapest. First Utility said the removal of the four-tariff rule would mean the market cheapest tariff would have to be averaged across a longer length of time due to the logistical restrictions of tracking the average price across all tariffs.

30. Price increases acted as a trigger for switching, and First Utility experienced large growth during 2012 and 2013 when competitors' high price rises resulted in a doubling of switching in the market.

31. First Utility supported switching sites and third parties branching out and diversifying their acquisition channels, not just online, but said the industry was hindered by a lack of confidence and trust by consumers for face-to-face acquisitions.

32. First Utility said that having a large proportion of customers on a fixed-rate tariff prevented it from changing their prices on short notice, such as when there were changes to the Renewables Obligation, Contracts for Difference or Supplier Obligation. Many suppliers had a customer base made up largely of standard-variable tariffs in order to have short-term flexibility over pricing.

33. First Utility said that three categories of customer existed: the engaged who made up 30%; the active but unengaged who also made up 30%; and the disengaged, who made up the remaining 40%. First Utility said that its customer base was largely from the engaged and active 30%, but that it was increasingly acquiring new customers from the active but unengaged customers.

34. First Utility said digital routes to switching, such as switching sites, determined the make-up of its active customer base. Online acquisitions represented an efficient and low cost channel for small suppliers to grow, but it was more difficult to develop the right channels to acquire disengaged consumers.

35. First Utility said that active customers had a higher cost to serve than disengaged customers as they were more likely to change tariffs frequently and contact suppliers regarding billing.

36. First Utility said that the cost-to-serve differential between small suppliers and the six large energy firms was due to respective technological and operational constructs, rather than the profile of its customer base. A static customer base had lower costs to serve because of the inactive customers who infrequently change suppliers, tariffs or contact customer service.

Remedy 6 – Ofgem to provide an independent price comparison service for domestic (and microbusiness) customers

37. First Utility believed that the success of price comparison services reflected their investment, including in marketing and advertising. First Utility thought Ofgem should not operate a price comparison service. Such an arrangement might pose a conflict of interest between its regulatory responsibilities and acting as a switching channel. First Utility also thought that Ofgem could not make the same investment and that it lacked the commercial and marketing knowledge of commercial price comparison services, and it would require significant data input from suppliers.

38. As an alternative to Ofgem operating a price comparison website, Ofgem might instead collate market-wide data and make public the cheapest market tariff. First Utility said that this offered a more suitable function for Ofgem that could tie into its messaging on customer bills.

Remedy 7 – Measures to reduce actual and perceived barriers to accessing and assessing information in the SME retail energy markets

39. First Utility said that it did exit the microbusiness market, not because of its market features, but because it was focusing on where it could be most successful. It decided to focus its resources on the mass market.

Remedy 9 – Measures to provide either domestic and/or microbusiness customers with different or additional information to reduce actual or perceived barriers to accessing and assessing information

40. First Utility recommended that the standard-variable tariff should be renamed an 'out of contract' tariff in order to better reflect its actual function as a more costly alternative for consumers not on a fixed tariff.

41. First Utility suggested that the language used when addressing the amount customers could save by switching could be improved. It said there was research providing evidenced that consumers would react more proactively if communications suggested they were losing money by their inactivity, when compared to the thought of taking action to potentially save money.

42. First Utility provided evidence that its [✄]. It used the example to demonstrate the effectiveness that frequent prompting can have on customer behaviour.

Remedy 10 – Measures to prompt customers on default tariffs to engage in the market

43. First Utility said that many among the vulnerable segment of disengaged consumers would not respond to enhanced prompting or independent intervention due to their financial position, fear of debt, and mistrust of energy suppliers. It suggested that the CMA or Ofgem conduct the necessary anthropological and sociological research before implementing a tariff to protect vulnerable customers due to the complexity of the customer base.

Remedy 11 – A transitional 'safeguard regulated tariff' for disengaged domestic and microbusiness customers

44. First Utility felt that a safeguard tariff undermined the principle of improving engagement and that it would promote continued inaction amongst the disengaged. It recommended that an impartial intermediary is set up to identify and provide face-to-face or phone support to the disengaged to understand and change their position. It considered the role could be filled by a price comparison website, or local council, as a last resort should routine prompting fail to affect customer behaviour.

Remedy 12a – Requirement to implement Project Nexus in a timely manner

45. First Utility supported the timely delivery of Project Nexus and expressed concern that it was not delayed further or its scope altered.

Remedy 12b – Introduction of a new licence condition on gas shippers to make monthly submissions of Annual Quantity updates mandatory

46. First Utility welcomed moving to monthly submissions on gas shippers of annual quantity updates as a way to minimise the gap between what customers consume and what it paid Xoserve to settle. It said that it would ultimately lead to consumers paying more accurately for their consumption. It noted that any change prior to the introduction of Project Nexus must offer benefits that justify the resources required by suppliers to manage the temporary change.

Remedy 13 – Requirement that domestic and SME electricity suppliers and relevant network firms agree a binding plan for the introduction of a cost-effective option to use half-hourly consumption data in the settlement of domestic electricity meters

47. First Utility expressed concern that there was not a firm plan to move to half-hourly settlement. It noted that progressing such projects with the relevant parties had been slow historically. Similarly, it cast doubt on the ability to effect the prioritising of the delivery of smart meters to prepayment customers because it would not feature in the first iterations of Data Communication Company's software, and may therefore get pushed back.

Remedy 14 – Remedy to improve the current regulatory framework for financial reporting

48. First Utility said that historically suppliers' regulatory accounts and financial statements had been difficult to decipher and would support efforts to implement more transparent and useful regulatory accounts.

Remedy 16 – Revision of Ofgem's statutory objectives and duties in order to increase its ability to promote effective competition

Remedy 17 – Introduction of a formal mechanism through which disagreements between DECC and Ofgem over policy decision-making can be addressed transparently

49. First Utility said the frequency of changes to the laws determining Ofgem's statutory responsibilities made understanding them difficult and complex. It

thought Ofgem should adopt a pro-competition and pro-consumer ethos, consolidate its duties and be more accountable.

50. First Utility disagreed that the formation of a new body to assess the trade-offs between policy objectives would be helpful or bring clarity to the impact of policies. In addition, it expressed concern regarding establishing a formal mechanism for settling disagreements between DECC and Ofgem.

Remedy 18a – Recommendation to DECC to make code administration and/or implementation of code changes a licensable activity

Remedy 18b – Granting Ofgem more powers to project-manage and/or control timetable of the process of developing and/or implementing code changes

Remedy 18c – Appointment of an independent code adjudicator to determine which code changes should be adopted in the case of dispute

51. First Utility believed that within the code governance process incumbent suppliers had an advantage over small suppliers by being able to deploy greater resources to influence each code. It said that the code administrators themselves operated well, but that the working groups were largely composed of employees from the six large energy firms. First Utility suggested that a balancing mechanism should be developed to give independent suppliers more voting rights within working groups, but conceded that many independent suppliers simply could not resource participating enough to counterbalance the larger energy firms.

52. First Utility suggested a number of remedial possibilities to increase small supplier input into the code governance process: pooling resources, reactivating the Cross Code Forum, and making codes more easily enforced on a bilateral basis, including with incentive arrangements that suppliers could rely upon where failures had occurred that adversely affected them.

53. First Utility said that industry regulation must be carefully drafted to avoid loopholes that could be exploited by suppliers. It alleged such an example regularly occurred when suppliers manipulated the timing of tariff price changes to misrepresent the supplier cheapest tariff messaging shown on customer bills. It also cited the use by the large suppliers of white-label brands to circumvent the four-tariff rule as further evidence of undermining the principles behind regulation.