Competition & Markets Authority

ENERGY MARKET INVESTIGATION

Summary of hearing with Royal Dutch Shell plc on 10 December 2015

Background

1. Royal Dutch Shell plc ('Shell') through its affiliate Shell Energy Europe Limited ('SEEL') entered the UK energy market as an intermediary trading service provider to independent retail energy companies in early 2013 with a contract with Hudson Energy. Since that time it had been expanding these type of services it offered in both the UK and Europe.

Entry to UK market

2. Shell decided to pursue the UK market because it showed similar features to that of North America, where it was also active via Shell Energy North America. It said that its operating model was successful in North America and thus there was incentive to introduce it to the UK. Since 2013 it scaled up the model to an efficient size by acquiring new contracts.

3. Shell said that in North America, unlike the UK, the number of independent energy suppliers was high, but that the market share of small suppliers had increased in the UK since 2011. It was this change in market share of small suppliers that indicated to Shell that a degree of openness and opportunity was available for businesses in the UK, as it had been prior in North America.

4. Shell stated that a liquid market was facilitated by the activity level of wholesale counterparties offering commodities over-the-counter, and the existence of exchanges, and they were required for Shell to fulfil their role as an intermediary supplier. It said that liquidity in gas and electricity markets had evolved positively and that the UK was one of the most liquid markets in Europe.

5. Shell felt that the UK market also shared regulatory and legal similarities with North America that reduced the complexity of operation compared to operating in European markets.

Operating in the UK market

6. Shell said that the liquidity of gas volumes traded in the UK were at parity with the Netherlands and Germany, but that the liquidity of electricity volumes traded had decreased over the preceding three years. It felt that the electricity market liquidity was not currently as good as it had been.

7. Shell supplied three independent retailers under structured supply arrangements, with a fourth contract pending finalisation. It said that all the arrangements together represented a small portion of its total traded flow for both electricity and gas in the UK. It said that it did not segregate between customer subsets such as number of customers served, as it focused on total traded volume overall.

8. Shell cited evidence in North America that there was increasing competition to provide an asset-light non-collateralized supply arrangement with retail energy suppliers.

9. Shell thought that the service it provided was not the only model available to independent suppliers to facilitate growth. It said that alternatively a company could strengthen its balance sheet, seek equity investors, and call upon bank overdraft facilities.

10. Shell reasoned that the six large energy firms had in their current vertically integrated setup no use for intermediary services due to the strength of their asset-heavy balance sheets, which facilitated their access to the market to buy hedging products on an open credit line basis. Shell also offered an open line of credit with the six large energy firms.

11. Shell said that the fee it charges to suppliers as part of its intermediary service was an important component when suppliers assessed their financial options, alongside the alternative options of equity investors, private equity, angel investors, or bank funding. Shell reasoned that the fee would vary based on the risk of the supplier and that parties may wish to use its service because of their international reach and experience in differing markets.

12. Shell said there was no defined cap on the size of business it would provide intermediary services to. Shell did not believe that the service it offered was only suitable to small companies, as it said it had an appetite to provide a similar service to larger companies. It explained that agreeing the arrangements can take up to six months and required significant resources by both sides; the intermediary structure therefore suited parties who had an ambition to grow.

13. Shell said many factors played a role in determining the fee it charged parties: length of the hedging required, market volatility, the party's risk profile, and the complexity of the transaction.

14. Shell thought that the cost of contracting with a larger supplier that was experiencing stable growth would not necessarily be more than would be the case with smaller suppliers. Consequentially, additional contracting effort, if any, may be commercially justified. It also said that such a company might choose such a model, despite having other options, as a form of leverage to provide it with a higher return on equity. Shell said that if the risk profile of the counterparty and product offering was lower, then the expected fee would also be lower.

15. Shell said that even if it were to provide an intermediary service to a large public company, it was confident that it could still find a way of providing security.

16. Shell said that although the past was not an indication of the future, its presence and growth as an intermediary service was evidence that it could effectively manage the varying risk factors it faced.

17. Shell said that it was able to offer more sophisticated electricity trading products in the North American market compared to that of the UK due to its limited scope to hedge certain products themselves in the whole UK power market. It said that certain electricity products simply did not trade in sufficient liquidity in the UK.

18. Shell said that clients had the opportunity to call the trading desk to negotiate the purchase of products not initially part of their trading agreement. Shell explained that the margin charged to clients depended on the liquidity of the product, the complexity of the arrangements, the volume requested, the payment period and other factors.

19. Shell said that it required parties to have a hedging policy as a key risk they faced was that prices they agreed on the sale side mismatched those on the supply side. It said this was also a risk for suppliers with large numbers of standard variable customers, as it would be impractical for energy retailers to alter their customers' variable prices with the same volatility as wholesale prices. Shell noted that its approach to a supplier would depend on its customer portfolio and the way in which such a supplier planned to bridge the gap between wholesale and retail prices.

20. Shell confirmed that it undertook stress tests prior to entering structured supply arrangements with parties.

21. Shell believed that the important factors in managing risk as counterparties became larger was to promote good management, diversity of income, and a growing customer base.

22. Shell said that its approach to the riskiness of particular customer profiles was indirect, as it was of greater concern to suppliers themselves. Shell noted that the associated risks of working with the microbusiness sector must be well managed with a return that reflected the high turnover of ownership and its associated costs. Shell said that domestic customers, due to their dispersion, were from a credit point of view lower risk.

23. Shell stated that it did not consider warrants as a form of security because they would lose value should a party’s financial position worsen. Instead, warrants could act to align the interests of Shell and the counterparty and give Shell the potential to benefit from any growth in business equity. Shell said the value of warrants came down to how the business in question was run over time and whether it was growing in value.

24. Shell said the impact of smart meters and half-hourly billing would depend on the legal framework and the technology behind the incentive. It said that there was evidence from pilot programmes that some households would respond to price incentives, but its potential was limited.