Household Retail Project
Ofwat
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By email: household.review@ofwat.gsi.gov.uk

Non-confidential version

Dear sir/madam

Costs and benefits of introducing competition to residential customers in England – emerging findings

I am writing in response to the various papers published by Ofwat on 18 July 2016 and to the workshop on 20 July 2016.

This letter provides background on First Utility, a brief summary of our entry into the GB energy market, and our growth to date. We include details of [✂] in the Annex to this letter. We are not currently active in the water sector. On that basis, we have focused in this response on our experiences in the GB energy market, which may be useful for Ofwat's ongoing work on costs and benefits. We also briefly consider the Competition and Markets Authority (**CMA**) GB energy market investigation, as this has featured in several of the papers published by Ofwat as part of its costs and benefits review.

We have a few observations based on the emerging findings:

- It appears from the retail non-household market opening process that substantial investment is needed from new market entrants in order to participate in that process before any customers are won;

- We recognise that this market opening model may not pertain should the Government decide to open the retail household market but it would appear to be a reasonable assumption that it would, as would the assumption that significant consumer protection, in particular for vulnerable customers, would be appropriate and would apply in any retail household market;

- The regulatory framework is a key component of both cost, and ability to compete, as seen in the CMA findings and remedies (although participant views vary as to the balance of cost, risk and impact, adverse or otherwise, on competition);

- The likely savings from switching for customers are, as Ofwat notes on all models, low, noting the above points about costs of early participation: it remains to be seen how customers would behave and in particular, how they would value choice of supplier;

- We are not in a position to critique the assumption that cost and efficiency savings can be derived from new entrants striking deals with wholesale providers given we are not active in the water market. However, experience from other markets indicates that early entry, absent scale, inhibits the deals that can be struck (based on our experience of trying to purchase energy, even where this is traded), as do standardised terms (drawing on the "reference offer" model in telecommunications); and

- That said, Ofwat's perception that a multi-utility model may be workable is very interesting (although issues could exist on matching national customer bases and regions given geographical scope and different industry histories), as is the potential "hard exit" framework in the retail non-household market alongside the recognition of other scale means of entry, e.g. outsourcing, etc.

Background

First Utility is the largest independent energy supplier in Great Britain, with around 950, 000 customers.

Following a period of research into the GB energy market, the company founders, who had substantial experience in the technology and telecommunications sector, identified a compelling market opportunity in energy. This concerned where data available via the introduction of smart meters would deliver two vital benefits the energy industry had previously lacked:

- Accurate billing (a major challenge for the industry from a customer satisfaction perspective); and

- The capability for a supplier to present back to customers an analysis of their consumption based on real usage, thereby presenting an opportunity to optimise (reduce) their consumption and lower their bills.

Thereupon, the company decided to enter the market itself, rather than through a white label or other business model. First Utility was licensed to supply, and to ship, gas and electricity in 2006.

Entry into the GB energy market

To this corporate background, and the identification of this market opportunity, was added the aim of being a pioneering, customer-focused, low-cost energy company. The company would meet this aim using a technology-enabled low cost business model, in order to generate substantial operating leverage and sustainable competitive advantage.

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The company effectively started trading in 2008 by addressing the SME sector. It quickly became apparent with the emergence of online price comparison websites (**PCWs**) that there was a retail opportunity in the consumer mass market for a 'challenger' energy supplier. Channels were opened up not only via PCWs, but also in the 'new build' sector of housing development where smart meters could be easily introduced to customers and their benefits more readily marketed. These opportunities were however subject to a number of challenges: new build developments for example cost us money to secure supply, before customers could be obtained, creating cash flow and debt risks. Further, the industry-wide Smart programme effectively rendered investment in smart meter technologies outside the developing programme "standards" more risky than usual for technology-driven investment as the regulatory framework for advanced meters and Smart meters was worked up and then rolled out.

The most material barrier to entry and growth for independent energy suppliers was the onerous working capital requirements associated with the posting of collateral needed to trade in the wholesale energy market, which led to the need to adopt a robust and disciplined forward risk management, or hedging, strategy. Our initial experience was that obtaining energy was particularly challenging: absence of scale created a disincentive for generators to trade with us, and the regulatory regime offered few straightforward avenues to challenge this situation. This led First Utility ultimately to negotiate a 'counterparty' agreement with Morgan Stanley's commodities arm, allowing us the flexibility to address the market with significantly greater freedom and lower risk.

These challenges were in counterbalance to the benefits derived by incumbent energy suppliers vertically integrated (**VI**) with generation capacity. We believe that VI supply businesses benefit from greater security in their ability to procure bespoke wholesale product at competitive prices. Further, VI suppliers are, we infer, inherently more secure as compared to independent energy suppliers as they have access to capacity *per se*, whether trading forward or to avoid being in imbalance, and this is likely to be on known terms set internally through a trading function or otherwise.

Independent suppliers are dependent on the market and suffer from a lack of product discovery and price transparency given the lack of liquidity. Imbalance may not be avoided in certain market conditions given the lack of products available to the independent supplier to manage this risk. Punitive pricing signals intended to incentivise avoidance of imbalance can be seen but cannot be acted upon if there is insufficient liquidity in the products that would lessen their impact. The CMA found that VI did not lead to adverse impacts on competition, nor that there were (other than in specific circumstances) such effects on the wholesale side. We are not convinced that this is right.

By the end of 2011, First Utility had gained around 55,000 domestic customers (including 'new build' developments) and a few thousand SME customers. 68% of these domestic customers were gained via PCWs and this market was beginning to become more price sensitive, although historic tariff switching had occurred almost entirely within and between incumbents. The company determined that the strategic opportunity lay in mass-market switching and therefore undertook the following courses of action and identified new areas of focus:

- Withdrawal from the SME sector;
- Withdrawal from the 'new build' housing sector;
- Focus on being the 'low cost provider' of choice in the domestic energy sector through increasing the already material 'cost to serve' and overall efficiency advantage;
- Re-platforming of the business in terms of technology, processes and talent in order to be able to accept an order of magnitude increase in scale;
- Diversification of the company's acquisition channels;
- Focus on establishing the First Utility brand as a 'consumer champion'; and
- Establish the company as the leading voice of the independent energy sector from a policy and regulatory perspective through public campaigning for a fairer, more competitive and more transparent energy industry.

Company growth

During 2012 and 2013, First Utility grew materially. This was achieved by having the only business platform (in terms of pricing efficiency and platform scalability) in the independent sector able to take advantage of the massive 'spikes' of consumer switching activity. These 'spikes' were generated by the incumbents' consistent strategy of introducing large price increases just before winter (in order to maximise their margins during periods of the highest consumer demand).

By the middle of 2014, First Utility had become the largest independent energy provider in the UK with more than 1 million 'fuels' (electricity or gas account) being supplied to more than 500, 000 households (92% of customers taking both an electricity and gas supply). First Utility strengthened its position as the leading independent during 2014 serving some 700,000 households by the end of the year. Successful PR/marketing campaigns and campaigning on behalf of the consumer had positioned the brand much more prominently and structured work in the policy and regulatory arenas had placed the company in a strong position with both politicians and Ofgem.

In our view, a fairer regulatory environment (predominantly driven by Ofgem's Retail Market Review (**RMR**)) had also made growth more predictable, which therefore resulted in less operational stress. Part of this was the RMR "four tariff rule", which limited front-of-shelf tariffs - broadly per meter type – to four, as well as requiring all offers made to new customers to be made available to existing customers. Prior to RMR taking effect, First Utility effectively offered one front-of-shelf tariff type. The market itself was more complex, with customers on some 1440 tariffs.[1] RMR was intended to bring some order to a complex market, with a mandate to make that market "simpler, clearer, and fairer". First Utility itself changed its tariff types as a result, to reflect the RMR rules (which required a default tariff to be offered, which ended up being the cheapest variable – leaving only one "slot" for variable). The RMR aims however remain important in spite of the partial dismantling of RMR recommended by the CMA in its final report.

In the autumn of 2014, First Utility developed a new strategic plan which was effectively a coming together of what had been learned to date, an assessment of an evolving set of market dynamics coupled with a view of the possibilities afforded by technological developments and social trends. First Utility is in a position where it can profitably serve millions of households across multiple geographies, delivering a range of utility services, all of which are seen by its customers as delivering simple, accessible and engaging value.

First Utility has been for several years sufficiently large to have proportionately the same obligations as the Big Six in e.g. the Smart programme (as a "Relevant Supplier" based on market share), and fully to participate in the industry's social and environmental schemes. Along with the rest of the sector, we are conscious of the growing cost of regulatory programmes on us – and more importantly, our customers – including the implementation of the CMA remedies. The scale of industry change currently being managed and proposed in a short timescale as this effectively crowds out the ability of independent energy suppliers to innovate around products, services and prices: large-scale change is challenging for all participants, but falls disproportionately on those players who are growing their businesses and managing the scale changes needed to do so alongside material industry change programmes.

CMA energy market investigation

The regulatory and market conditions noted above led us to argue before the CMA that the RMR changes were not in themselves an adverse effect on competition. Indeed, the rules made it easier for customers to navigate around the retail market and to compare tariffs. It was certainly the case that incumbent providers made the most of a plethora of tariffs, and in our view, took advantage of the customer confusion that result.

We therefore have a less sanguine view of certain of the outcomes of that investigation than other participants, considering that whilst on the retail side, the CMA correctly highlighted the problems, the remedies and their timing, make it unlikely that these problems will be successfully tackled. In our view, much of the package of retail remedies (not including those around prepayment in this regard) is focused on those parts of the market that are active and better served by developing competition, namely those customers who have already switched provider, and not adequately or as effectively as they could be on those customers whose lack of engagement is actively fostered by the Big Six – their default or "standard variable tariff" or SVT customers. The

[1] "Dealing with tariff complexity", BRIEFING PAPER Number CBP 007243, 1 February 2016 Competition in energy markets in Great Britain, p. 23.

direct remedies focussed on these customers risk being rather too little and too late to be effective.

Coupled with the proposed almost immediate effective removal of the RMR four-tariff limit and other "simpler" RMR measures, we remain concerned that there will be a massive proliferation of tariffs and offers, making it difficult for even active customers to navigate and adversely affecting that level of engagement, whilst not putting in place measures *at the same time* to effect or support engagement of the 70% Big Six SVT customers. The CMA did recommend a fairly radical solution, i.e. the database of SVT customers, to come into effect by 2018, but this risks becoming mired in implementation discussions around use of personal data and prevention of direct "junk" marketing by myriad energy suppliers. It is worth highlighting that one Panel member, Professor Martin Cave, diverged from the rest of the Panel, considering that more needed to be done to protect SVT customers.

On the wholesale side, as noted above, we are concerned that the CMA not finding that a lack of liquidity is an adverse effect on competition relies too heavily on the recent benign wholesale market conditions. Adverse changes in these conditions risk creating a situation where recent changes in wholesale market rules – around marginal energy imbalance prices – give signals to participants that those participants cannot successfully act on, putting them at greater risk than is warranted. This plays out in risk premia included in retail prices and limits the room to manoeuvre of companies. Added to this uplift are the likely increasing - and variable - costs incurred by suppliers to cover capacity market arrangements and CfDs and for industry programmes. There are certainly substantial lessons to be learned from the GB energy market.

Issues raised by stakeholders

In the paper, *The costs and benefits of introducing competition to residential customers in England, report on stakeholder views and issues*, a number of categories of concern were highlighted. We would make the following additional high level points to those already made previously:

Customer debt: this is a significant issue in the energy sector, and it has not been entirely in the gift of entrants to bring innovation to bear in managing this risk downwards. This issue needs to be considered alongside the concerns around credit and collateral, as depending upon how these material elements are structured, entrants will have little incentive to take on retail debt at all, notwithstanding the need to grow their business. We agree that treating legacy debt differently is important;

Customer support schemes: the various social and environmental schemes in the energy sector do technically co-exist with a competitive market. They perform legitimate and wider social functions, suffer from adverse distributional impacts, ideally should not be included on energy bills but via direct taxation to manage the adverse distributional impacts better, and as a result, they have the effect of keeping politics in energy (e.g. with public pressure to cut bills, provision was made politically for changes to schemes temporarily, which changes incurred costs for suppliers that had not necessarily been anticipated). Scheme thresholds have been contentious, with entrants arguing for high thresholds and incumbents for none. It is arguably more appropriate to provide for graduated thresholds, and for suppliers (and any intermediaries) to have to make it clear which providers offer them so customers have the information needed to exercise choice;

Customer engagement: this is a key aspect that the energy market is still grappling with – in our view, a "tale of two markets" has emerged and appears to be here to stay, where some 70% customers remain on the most costly default tariffs, with the more active customers able to take advantage of strong competition. This is less about cherry-picking (and we agree with Ofwat that these arguments on balance are not right) and more about the entrenched advantages that legacy suppliers have, which successive regulatory rules have not been able to counteract. Whilst we cannot draw upon knowledge of the GB water industry, we do think that retail markets traditionally have needed a substantial amount of time to take to competition. Independent energy suppliers have only just managed to achieve – taken together – more than 10% market share, following decades of competition and this in a market with higher perceived and actual savings from switching. Experience does show the need for significant investment from the regulator and new entrants in defining, tracking, challenging and pursuing, and actually addressing, inappropriate incumbent customer retention behaviour from the start.

Disruptive technologies: we agree that potentially, disruptive technologies offer the opportunity to reduce costs, increase customer benefit and make competition work. However, where the rules of the game are effectively set (and we assume here that the retail non-household model will form the basis for household competition although this may not be the case), there is a risk that this mutes incentives to innovate, something that has been seen in the GB energy sector (as highlighted by the CMA findings around industry code change processes and governance), although the scale of mandated change has contributed to this. Multi-utility billing may, for example, require more flexibility in the registration and settlement process in order to be workable. Experience from the energy sector also confirms that involvement from the start is needed in rule-setting – however, this has material implications for cost of entry and return on investment.

We would be happy to discuss any aspect of this response in more detail if that would be helpful or to provide further information or input on the issues raised, or those not covered, so far as we can in the time remaining to Ofwat.

Yours sincerely

Natasha Hobday
Group Policy and Regulation Director

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ANNEX

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