

**Corporate Response Form 'Raising Customer Threshold' Consultation
URN 10D/1022 Open: 21/12/2010 Close: 24/01/2010**

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Consultation Questions

1 Do you agree that the threshold should be increased to 100,000? If not, what level do you think it should be set at and why (please provide supporting evidence)?

We completely agree with the objective of this consultation exercise in that we are keen to maximise the benefits of competition by removing government regulation where it is counterproductive while ensuring that inefficient market entry (via non cost related subsidy) is not promoted. As such we agree that the threshold should be raised to 100,000 customer accounts. We also agree that a 250,000 customer threshold is not justified at this time. Below we provide the reasoning underpinning our response.

Perhaps most importantly, the overall targeted benefits of the different government policies (be it carbon abatement or price support for vulnerable people) will be unaffected by a change to the customer account threshold. Any reduction in targeted benefits would require a much more detailed impact assessment to justify a change to the threshold. However, with the overall targets of the Government's programme unchanged, the primary cost effect is likely to be distributional rather than absolute. As a consequence we believe support for this proposal can be more easily justified.

There is clear evidence that the requirements imposed by the Carbon Emissions Reduction Target (CERT) entail a significant cost barrier to smaller energy suppliers (approximately a 50 per cent premium in comparison with larger suppliers according to the impact assessment). The impact assessment points to lower industry costs (and thus lower costs for end users) of £6.7 million (net present value or NPV) over five years. This is because CERT obligations, which would be undertaken by smaller suppliers in the absence of an increased threshold, will instead be undertaken by the largest suppliers (who enjoy a cost advantage over their smaller rivals). As a consequence of the income transfer of £13.4 million (NPV) over five years from large to small suppliers (following the implementation of a new 100,000 customer account threshold) the costs to the big six subsequently increase by approximately 13–14p per dual fuel customer account. We agree with the impact assessment; that any negative consequences of this distributional impact are outweighed by the benefits of total industry savings and improvements to competitive conditions. As such a clear cost disadvantage for small suppliers relative to the largest suppliers has been demonstrated (assuming the data provided in the impact assessment is accurate). We

also agree with the impact assessment that there will not be a significant cost disadvantage imposed on the larger suppliers. This, in our view, justifies an increase in the threshold on cost grounds.

We understand that there are currently no suppliers in the 50,000 to 100,000 customer bracket. For as long as this remains the case the distributional impact of the proposal will be zero. This zero distributional cost is likely to nonetheless be accompanied by tangible benefits in the form of a more attractive investment environment for current and prospective small suppliers (because they can see fewer obstacles to growth) and improved cashflow for any small suppliers close to the existing threshold (because they may be able to defer compliance investment).

It is clear that the pricing behaviour of some small suppliers had an effect in lowering the energy prices paid by a significant minority of consumers (see figure 2.5 of the Impact Assessment). We would note that recently this effect seems to have significantly reduced in the online Direct Debit market presumably due to an increase in wholesale energy costs. We would suggest that this is because the pricing policies of smaller energy suppliers are more greatly affected by wholesale pricing movements due to a lack of wholesale forward market liquidity ie smaller suppliers have to procure proportionally larger energy volumes from nearer term wholesale energy markets. Nevertheless, the benefits of competition have been clearly demonstrated. We are optimistic that a change to the threshold will allow these benefits to continue or even be extended.

While we do not necessarily believe that the 100,000 customer account threshold should apply to all supplier obligations (see question 3 for more details) we believe that in this case the threshold should be raised for all four programmes – CERT, the Community Energy Savings Programme (CESP), Feed in Tariffs (FITs) and the Warm Home Discount. While there is not the same level of costing evidence provided for the CESP, FITs and Warm Home Discount (as there has been with CERT) we are of the view that these schemes are likely to pose some cost disadvantage to smaller suppliers relative to larger suppliers. This represents a significant barrier to entry and organic growth.

In addition there are likely to be some benefits in reducing the complexity of the regulation by having a uniform threshold for all four government programmes, although we do not consider this effect to be crucial in justifying an increase. Other areas of these instruments may also merit reform; in general we favour applying environmental levies on a per unit basis, rather than a per household basis, both because it is more socially equitable (the poorer tending to use less energy) and because it is more compatible with 'polluter pays' principles – that those with a higher carbon footprint should pay more towards tackling decarbonisation. CERT scores badly in this regard.

Furthermore, in light of the other significant barriers to entry and expansion that suppliers face (poor wholesale power liquidity and high collateral requirements, electricity cash out, competitors with very large, relatively stable customer bases etc) it is highly unlikely that there will be significant competitor growth in the near future in the absence of other regulatory reforms. As such we are of the view that the benefits of encouraging competitive entry and growth in comparison with the costs of making these relatively minor changes is justified when the number of different market

obstacles are considered overall.

It is also important to mention here that some of the benefits enjoyed by former incumbent suppliers can be represented as inherited from the post liberalisation/privatisation period. We believe that providing new entrants with appropriate access and protection is justified in that the competitive advantage enjoyed by the larger former incumbent suppliers (particularly those related to economies of scale) has not been fully related to their own efforts. If these companies' market standing and performance is significantly related to the investments made in the pre liberalisation/privatisation era with the risk borne not entirely by their own shareholders but also by taxpayers. Therefore raising the customer account threshold should not necessarily be regarded as promoting 'unfair' competition. The important point to note is that the larger energy suppliers will still be in a position to actively compete with their smaller rivals and, we contend, still compete holding many important advantages.

The ability of suppliers to voluntarily undertake schemes, such as the Warm Home Discount and FITs, will allow them to make a commercial judgement which meets the financial requirements of their business. As such the potential detrimental effects to competition of making suppliers undertake economically disadvantageous (in comparison with their larger rivals) obligations can be minimised, while at the same time allowing those suppliers with the ability to undertake obligations economically the ability to do so to the benefit of consumers.

We note that there could be the potential to make available non-cost related subsidy to suppliers if the customer account threshold for FITs was to be extended to 100,000 accounts. This is because those suppliers with a customer base above 50,000 but below 100,000 (assuming the new threshold is implemented) would be entitled to an additional 'cost reflective' payment from the 'levelisation' fund to compensate for the additional administration costs for FITs. We would want to ensure that any additional payments available to suppliers who choose to voluntarily offer FITs are related to the additional costs of provision. The analysis of these additional costs should form part of the next review of the levels of administrative payments for FITs. We also add that the potential additional costs identifying in the impact assessment from obligation exempt suppliers offering FITs is small in comparison with the potential competition benefits.

Therefore, overall we believe that the benefits for consumers of helping to better facilitate competition are likely to outweigh any potential costs of permitting inefficient entry and expansion in this case.

The commitment to review the threshold in 2013–14 should ensure that the effects of the proposed threshold increase can be evaluated and thus determine whether an increase or decrease to the threshold is warranted. We consider that evaluation of the effects of the threshold on competition could continue post 2013–14 to ensure that efficient entry and expansion is encouraged in the energy supply market.

2

What factors should DECC take into account in determining the threshold?

We believe that all the relevant factors have been taken in to account by DECC in the impact assessment. These are:

- The target benefits the Government schemes intend to deliver. The Government programmes evaluated in the impact assessment state there should be no change to the overall target, be it carbon abatement or price support for vulnerable people
- Fixed costs and economies of scale. The impact assessment identifies that the CERT obligations are likely to entail a 50 per cent cost premium for small suppliers to ensure compliance in comparison with larger suppliers. This might entail a minimum 3 per cent price increase for small suppliers which we believe small suppliers would find difficult to absorb or pass through considering underlying market conditions.
- Competition benefits. The impact assessment shows that online discounts offered by small suppliers have placed downward price pressure on a significant market segment in the past. We also recognise the strong theoretical and empirical benefits of competition for ensuring consumers pay prices reflective of efficient costs. It is perhaps no coincidence that the trend of higher prices in the last few years has coincided with a visible lack of new scale entrants
- Other barriers to entry and organic growth. We note that the impact assessment lists the following:
 - Large competitors have inherited a large and relatively stable customer base
 - A lack of wholesale market liquidity especially in the wholesale power market
 - Greater exposure to imbalance prices in the electricity balancing mechanism in comparison with large energy suppliers
 - The fixed costs of regulatory requirements

We would add to this list the collateral requirements imposed on smaller suppliers as part of their wholesale trading activities as an additional and significant barrier to entry and expansion.

We believe that these factors should be assessed when DECC comes to review the threshold again in 2013–14.

3

Do you agree there should be a single threshold for all supplier programmes?

Not necessarily. We believe that the threshold levels for different government regulations should ideally be made on a case-by-case basis with reference to factors (although not limited to these) listed in answer to question two. However, thought should also be given to cost of regulatory compliance and whether uniform thresholds reduce industry costs.

For this particular consultation we believe that the four programmes the new threshold would apply to should be equal to 100,000 customer accounts. This is because we believe the analysis contained within the impact assessment suggests that threshold should be 100,000 accounts not just because the threshold should be the same (although we have given some weight to the benefits of simpler regulatory requirements).

We have one area of potential concern with raising the threshold to ensure that all compliance thresholds are equalised. We would not support an attempt to raise the exemption threshold for suppliers having to comply with Payment Method regulations. While we understand that the threshold is the responsibility of Ofgem we would not want a precedent set by the decision of this consultation exercise. We want to ensure that these

customers are served by as much of the market as possible to reduce the potential disadvantage they might face.

We also note that while it is acceptable for this consultation exercise to inform decisions on government thresholds for future programmes (Energy Company Obligation, the Green Deal etc) this consultation exercise must not fetter future decisions on threshold levels. These decisions are best made on a case-by-case basis with reference to the factors listed in question 2.

4

What options for design of future DECC programmes should the Government consider in order to reduce the burdens they place on small and large suppliers?

Below we outline an alternative way of designing DECC programmes which we believe can meet the Government's objectives while at the same time reducing the impact on the functioning of the competitive market.

We are of the view that a Energy Company Obligation (ECO) should be set up as a central pot to which different Green Deal providers can bid into (including energy companies). We believe that competitive tenders for area-based programmes using the central pot will deliver transparency, economies of scale, fair coverage of the UK, and will open the energy services market to new entrants. By placing delivery in the hands of focused organisations, this approach should also minimise the costs to smaller energy suppliers who do not have the necessary skills or economies of scale to deliver energy efficiency measures.

In general, scheme designs that offer small suppliers the opportunity to 'buy out' or transfer their obligations may provide them with a means to dilute their exposure to the capital costs of establishing a compliance regime without the risks of perceived cross-subsidy that may arise if they are simply excluded from the obligation. By creating secondary markets in delivering these services, they may also increase the overall value for money consumers receive from such schemes.