Endangered species?—independents' prospects in the event of a price freeze

At an event in London last Thursday, we launched our new report on *The Detrimental Impacts of a Price Freeze on Energy Supply Competition*. The event was attended by over 70 industry stakeholders and representatives, and staged an insightful debate on the current state of the energy retail markets, and the proposals being made to reform them.

In this week's *Perspective*, we summarise the key findings of our report, which had before our event received coverage both in the *Sunday Telegraph* and the *Financial Times*. We concluded that Labour's proposals for an energy price freeze risked seriously undermining the genuine progress that has recently been made in strengthening supply competition. Robert Buckley and Ed Reed presented our findings at the event.

Origins

While we agree with Labour that further measures are necessary to boost competition in the energy market, we strongly disagree that a price freeze will help the situation. Most importantly, there are several programmed cost changes that it is already known will occur during the proposed freeze period. We believe that limiting the ability of all competitors to adjust their prices in order to reflect these changes will severely distort the market to the ultimate disadvantage of customers. Moreover, it is likely to have disproportionate impacts on independents and new entrants. The measure will lead to suppliers competing less in the freeze period and possibly the run up to it, and in some cases will result in pre-emptive price increases. Both of these effects will harm consumers.

One of our principal concerns with the price freeze is that it flows from the proposition that the market is broken. While the market is by no means perfect we believe that this view disregards many healthy developments, in particular it ignores the growth of independents over recent years, which is already producing real consumer benefits. Indeed, independent supply is at an all-time high and rising in response to recent price rises. We believe that it is the independents who have transformed the non-domestic energy markets, where they have a 77% share of the gas market and 21% of electricity. Allowed to compete fairly, they will do the same in the domestic markets.

This momentum—albeit relatively small expressed as a share of the total market—has resulted in a domestic energy retail market that is the most competitive that it has ever been, nearing 5%, with the highest number of active suppliers. Substantial growth of the independent suppliers has been driven by competitive pricing, resulting in customers moving to them in their disillusionment with the Big Six. As a consequence, the Big Six are taking notice of their smaller counterparts and are reacting to the new tariffs and innovations from these businesses. The influence of the independent suppliers therefore already extends significantly beyond the customers that they directly supply.

Labour has set out its rationale for the 20-month price freeze, but to date has provided no specific information on how it would be applied. Available information suggests it would be set across the market and would not differentiate between market segment (gas or electricity; non-domestic or domestic) or customer type (switched or unswitched; standard variable vs. fixed). Practically we believe that it could be introduced no earlier than July 2015, given the need to consult on and implement legislation, and would apply to at least April 2017, though we would question the prospects of introducing the longer-term reforms flagged by Labour in such a short period. We have analysed the costs that we believe domestic suppliers will face over this period and how these changes will impact on their total costs.

Survival of the fittest

We conducted "top-down" analysis looking at observed differences in current supplier offers. This suggests that suppliers are expecting to see an uplift in costs to the order of £80/household over the price freeze period.

The "bottom up" analysis reveals that both independent suppliers and the Big Six are forecast to incur increased charges as we progress towards 2017-18:

- for independent suppliers, gas costs are estimated to rise 3.6% from £448 to £464/household/year by 2017-18. Over the same period, electricity costs are forecast to increase 13.1% from £360 to £407/household/year. The total increase is £63 on the household bill; and
- for the Big Six suppliers, gas costs are estimated to rise 4.3% from £463 to £483/household/year by 2017-18. Over

the same period, electricity costs are forecast to increase 11.6% from £380 to £424/household/year. The total increase is £64 on the household bill.

An important point often over-looked is that different types of supplier tend to face different energy procurement costs, especially as independents struggle to access long-term product. For the purposes of a price freeze, this analysis means that suppliers will almost certainly have to anticipate these known cost increases through to 2017-18 levels as a minimum ahead of the price freeze. They may also be compelled to factor in a risk premium to hedge against unexpected volatility in wholesale prices and third party charges up to two years ahead, suggesting that the £80 figure cited from the "top-down" assessment is very credible.

A cost increase to the order of £64 introduced ahead of a price freeze would add just over 5% to the typical dual fuel household bill. Allowing for the £80 estimate, this would increase the same bill by 6.3%.

We have conducted the same "bottom-up" analysis for typical non-domestic customers, although not at this stage to the same level of detail. While the cost estimates differ, the implications of the analysis are the same. Indeed, third party charges tend to represent a higher share of the bill for non-domestic customers, so the implied increases in terms of £/MWh are greater.

Common descent

There has been a lot of misinformation in the media about supplier profits and over-charging.

On levels of profitability many of the non-Big Six suppliers are relatively new to the supply market and have faced high fixed entry costs plus high acquisition costs often chargeable fully upfront. This, combined with higher costs of doing business than the scale players, has seen the independent suppliers generally making a loss, especially in the infant years of the businesses. More established parties (First Utility, for instance) have begun to achieve a profit following a number of years of losses. However, these profits are still below the actual levels achieved by the Big Six.

Should Labour pursue its price freeze policy in government, we believe it must as a priority undertake a thorough assessment of the likely consequences for the retail market landscape, the impact on different types of supplier and outcomes for consumers.

Market interventions involve considerable risk and, where deemed necessary and backed up by the appropriate impact assessment, they should focus on the improvement of competition, and be properly targeted. We set out a list of possible exclusions from any price freeze and mitigations that should be examined before final decisions are taken. In more detail the implementation of a price freeze should:

- be thoroughly assessed, with the benefits and disadvantages identified and evaluated;
- focus on ensuring disengaged consumers are the main beneficiary;
- carve out from the proposal consumers on fixed-term tariffs and larger non-domestic customers with non-tariff contracts;
- exempt green and smart offerings as customers choose to (typically) pay a premium to deliver additional benefits; and
- be framed in such a way that all affected suppliers and customers understand the rationale for the intervention and mechanisms to allow uncontrollable costs to be recovered from customers.

Natural selection

Price freeze aside, certain of Labour's energy reform proposals reflect long-held concerns among independents about the manner in which integrated players can self-supply energy and consequently undermine confidence in reported wholesale costs. They have considerable merit. But, as Labour confirms its intentions for reform of the sector, we also believe that:

- Ofgem's liquidity reforms, especially the proposed supplier market access rules, need implementing as a matter of urgency, with a clear timeline, which seems to be the case. (*More on Ofgem's latest decision, next issue*). A proportionate monitoring framework should also be introduced to assess whether the proposed benefits are being realised and be made available to the market promptly;

- the regulator's Retail Market Review should run its course, but Ofgem should be asked now how to define its success so a new government of whatever stripe could ask it if all the hard work was worthwhile come 2015;
- the Ofgem/ OFT/ CMA competition assessment should be an annual feature of the market and routinely assess barriers to growth of independents and conditions for new entry;
- credit arrangements within the energy sector need urgent review, with a view to considering whether they adversely impact working capital and barriers to entry. We believe they do ultimately to the disadvantage of consumers; and
- customer switching timescales need to be shortened and improved and win-backs need to be banned.

We believe that these measures, combined with a self-supply restriction, are more likely to reinforce competition so that the market would be best able to prosper from the longer-term reforms flagged in Labour's Green Paper.

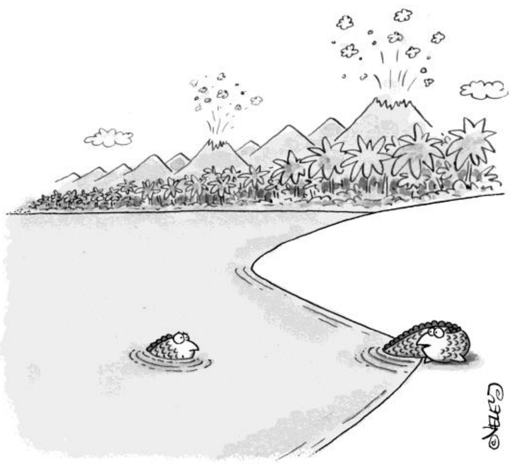
Evolution

Further contributions to our event last Thursday similarly indicated the need for Labour to look closely at the impacts that its price freeze would have. No less importantly, stakeholders suggested that a range of alternatives were available to be considered.

First Utility's Emma Piercy highlighted the impact that the price freeze would have on independent suppliers' ability to compete for new customers, and warned that it would likely leave consumers paying higher upfront prices. She highlighted evidence of improving competition in the retail markets, and in particular First Utility's addition of over 122,000 customers in Q413 following the Big Six price increases. Piercy noted that the UK's energy prices remain relatively modest in comparison to those in Europe, and called for a closer focus on poor energy efficiency as the key driver of increasing household bills.

Meanwhile, Haven Power's Peter Bennell criticised Labour's failure to provide further details of how the measure would work in practice. Options for independents to manage the risk included longer-term contracts that extended beyond the freeze period, or shorter terms ones that ended just before it.

Evaluating the impact on investment, Liberum Capital utilities analyst Peter Atherton said Miliband's announcement had had a highly detrimental impact on the valuation of UK utilities, and had led to them underperforming their European counterparts. He said the proposal had also broken the compact between policy-makers and industry over the direction of UK energy policy. Politicians, he added, had two options: to rebalance UK energy policy so as to reduce cost pressures; or to convince the public that these costs were worth paying.



"It's the PERFECT time to move up the evolutionary ladder! The climate is stable, we have no natural predators, and interest rates may never be this low again!"

To close the event, Professor Stephen Littlechild chaired a panel session on alternatives to a price freeze. Littlechild argued that rising energy prices were not necessarily symptomatic of a broken market, and that more focus should be given to helping consumers to change the way they engaged with the market. Noting the possibility of moving levies into taxation, Morgan Stanley's Olivia Hartridge suggested that there was little evidence that the energy price freeze implemented in Belgium had had a lasting effect—prices had increased quickly once the cap had been lifted.

Materials from the event can be found here.

We will continue to seek to engage with Labour both on the subject of its price freeze and its ambitious long-term reforms, keeping the price freeze report up to date. We will also shortly issue our response to Labour's Energy Green Paper.