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Utility Regulator
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Response to Draft Consumer Protection Strategy

Dear Sinead

The strategy for protecting consumer interests, identified by NIAUR, has much to commend it. It will add to the toolkit the Authority has at its disposal for ensuring that customers continue to pay broadly speaking only what is necessary to secure their electricity, gas and water supplies.

In the course of this note, I want to add my contribution to the debate on how best to realise the aims of the strategy. At the same time I would like tentatively to advance a proposal which I believe would be in the interests of electricity consumers. It would be dependent on the widespread roll-out of smart meters, a development which is now subject to a cost benefit analysis by DETI.

Let me deal with the more immediate issues first. As the owner of the, as yet, only local interactive price comparison site devoted to electricity, I applaud the idea of focusing more attention on this means of empowering consumers.

While I might take issue with the comment within the report that users are unable easily to access tariff comparisons at least as far as electricity is concerned, I agree with the thrust of the review on this matter.

The price comparison site I run is available to consumers free at all points of access. That means that neither do households have to pay to find the best deals, nor do I seek or receive payments from suppliers from, in effect, bringing them new custom. It is my strongly held view that this model has much to commend it.

The main reason for arguing thus is that there is famously no such thing as a free lunch. Any payment from supplier to website must ultimately be covered by customers in higher bills.

That is not to deny the benefits delivered by UK price comparison websites which cover energy and other services and which charge suppliers commission. They enable consumers to make savings. Without them households would be worse off. Research does indicate that consumers do worry whether some sites are always comprehensive in their coverage and whether the ranking of results can be influenced by suppliers. But that said, there is evidence that the overwhelming number of consumers think price comparison sites are at least fairly reliable.

If there were no better alternative to commission charging price comparison sites, that would be the end of the matter. However, as I've demonstrated, there is another way which could deliver a cost effective solution for those who wish to check tariffs and switch to cheaper deals.

It might not be applicable in Great Britain where there is a multitude of energy suppliers but would work here in Northern Ireland. A centralised energy price comparison site, paid for out of public funds, could provide cost effectively the means of identifying the best and cheapest deals for customers. Operating to strict standards, its performance overseen by the Regulator and lacking any economic incentive to present a less than comprehensive picture of the market, it should, in theory at least, command a very high level of confidence.

I recommend that the provision of an energy price comparison site should be put out to tender by NIAUR.

In the longer term though I suggest there is a better strategy for protecting consumer interests in regard to electricity.

The development of the Single Electricity Market has created an unprecedented transparency in the pricing of power. It is possible to start with the pool price and see how, through the accretion of largely fixed and flat charges, the final retail bill is arrived at.

That has several consequences which however are negative for competition. Since suppliers are faced with pretty much the exact same costs apart from supply which is a minor portion of the overall bill, there is little scope for them to offer markedly different tariffs, at least on a sustainable basis.

It is not just transparency in costs which militates against competition, it is the design of the market itself that frustrates any attempt by a supplier to undercut his or her rival. Suppliers have almost no scope to address their costs in the way that their counterparts can do in other forms of retailing. They cannot negotiate their own terms with the network owner, they cannot sidestep levies imposed by the Energy Regulator and they cannot avoid paying for energy they've never even sold, namely those MWhs dissipated through the wires. Even if they were to lobby successfully for some modification of the various charges which make up the retail bill, any reduction would have to be offered to their competitors. There is virtually nothing they can do to secure an advantage over their rivals. Not only that even if they were to secure lower charges, the result would not be, for domestic customers at least and many SME's, an increase in sales. No one is going to put the toaster or television on for longer just because electricity costs are coming down. Nor will the average office business use their printers and computers more simply because bills are reducing. The savings consumers make from a reduction in tariffs I submit, are just pocketed and spent on other items.

All of this means that the key driver for competition, an economic incentive, is largely missing from the supplier market. The remaining choice left open to suppliers is to cut the only cost they can control - their own margin - in order to win market share. With supplier costs just 9% of the bill, the scope to undercut the opposition through reducing profits is limited which is why ultimately tariffs end up being so close together.

In a market beset by so many constraints, it is a fiction to believe competition can of itself really drive down prices. In these circumstances, I contend the most sensible policy to protect consumers is simply to shear electricity bills of all unnecessary charges.

To take just one example: is it fair to impose on poorer households the same pro rata costs of supporting wind farms, solar panels and other forms of renewable energy as those imposed on better off families. The argument against the current arrangement is that it leaves the fuel poor paying a bigger share of their income than middle class households to support investments they cannot afford to participate in themselves. Should the renewable obligation charge not be removed from electricity bills and paid for out of central government funds? More broadly is it not time to review the whole system of levying charges on electricity?

In the meantime I am proposing a yet more radical reform.

I recommend that NIAUR explore whether households should have the same option as business customers to pay bills based on the wholesale cost of power plus pass through charges instead of having a flat tariff forced on them.

The Single Electricity Market is set for reform. In less than two years time it will be transformed into the I-SEM. Like many changes it has prompted rival and contradictory claims, namely that it will cut prices and that it will put up prices. The new market may work effectively from the word go or it may not. The latter outcome is not desirable but neither is it catastrophic. If prices are seen to lurch upwards for no good reason, the system can be reformed.

Much may change with the I-SEM but one aspect of the market will definitely not. Domestic and small business customers will continue to have their charges mediated through a hedging process. They will be denied the option of paying wholesale energy costs plus pass through charges.

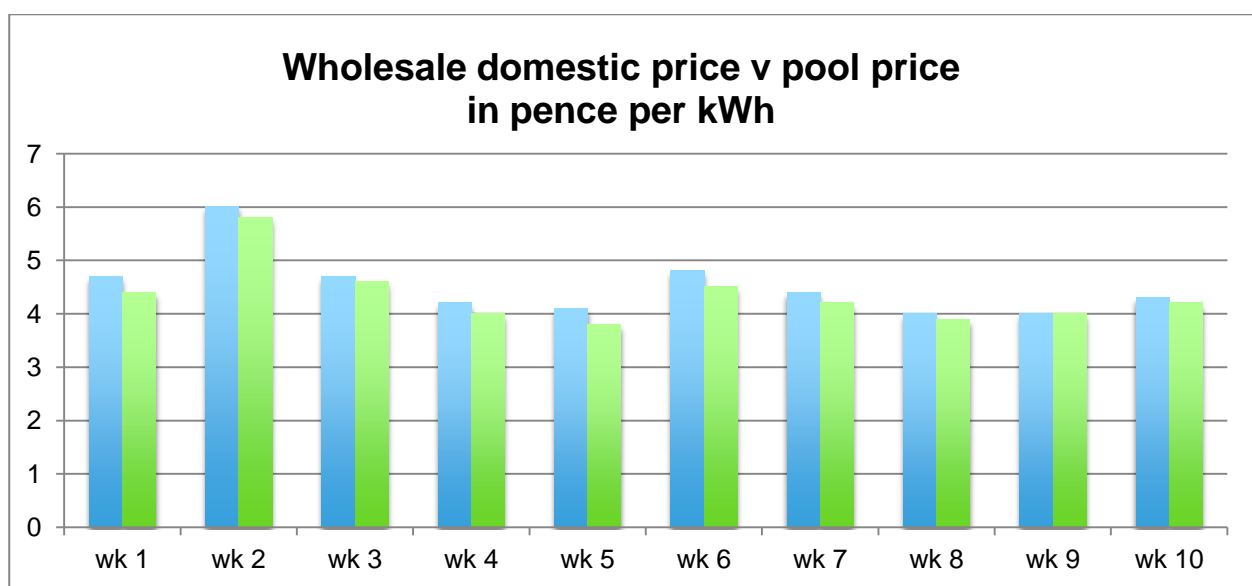
Hedging incontrovertibly insulates consumers from market volatility. However while they may escape the spikes they are also denied the immediate benefit of sharp drops in wholesale prices. Furthermore since it is implausible to believe that traders using hedging strategies can, over the long term, beat the market, there is likely to be a cost benefit, to consumers, from paying the wholesale price plus accompanying charges and levies. Such a reform would do away with the apparatus and costs of hedging which I note, from the Generator Financial Performance assessments by the SEM Committee, produce substantial revenue for the power station owners.

The argument against such a move rests on the claim that households are risk averse and want the certainty of flat prices and furthermore are prepared to pay for the costs of arranging them. I am not sure those propositions have ever been tested in the current Northern Ireland market. In any case there is a conflation here of risk and volatility. Hedging eliminates fluctuating prices but not the risk of paying more than one needs to.

The main argument against offering a tariff based on floating prices is that it would expose consumers to wildly gyrating charges. Certainly the pool price rises and falls alarmingly within each day. But these short term moves, frequently with durations no longer than a half hour, do not necessarily translate into hugely fluctuating monthly or even weekly bills.

Purely as a modest exercise I decided to test out how variable prices were over a number of weeks. The results were never going to be conclusive. That would require checking over a much longer timescale but if the findings revealed a degree of stability, then it might be an issue worth exploring further.

Using the Elexon domestic profile, I calculated the wholesale energy prices a domestic consumer would have to pay over a ten week period, starting on February 1, 2015. The consumption weighted average cost of a kWh did vary as the graph below shows but not drastically. The weekly average was remarkably stable, staying for almost all of the time between 4 and 5 pence per kWh. What was also interesting was the way the domestic consumption weighted average tracked the load weighted average for the market as a whole. The pool price stayed up to 0.3p below the domestic rate.



This simple sampling of prices, I fully accept, does not prove that the domestic consumption weighted average price does not exhibit extreme volatility over the long term. It is merely food for thought. It does suggest however there may be less volatility than some might imagine. In any case it can be proved either way. An investigation of prices over several years would settle the matter.

If such a study were to show that consumers had little to fear from fluctuating prices, it might not be much of a surprise. As is well known electricity prices track gas prices because gas fuelled power stations by and large set the SMP. There are various elements which determine the SMP but by far the most significant and most volatile is the cost of gas which itself is made up of two elements namely the cost of the raw fuel and a charge for transportation. At the current price, as I write, of 50 pence a therm for gas, the energy cost of generating one kWh at an efficient CCGT is about 3.3p. Were the wholesale cost of gas to increase in price by a very large degree, say thirty per cent, all other things being equal, it would only boost the cost of a unit of power by one penny. For the average household, that would mean a £2.70 hike in their monthly electricity bill. Unwelcome but

manageable for many homes. In any case were that to be a permanent increase, hedging would only delay an increase in prices, it would not prevent it.

However unlikely as it may seem, there proves to be evidence that prices vary to a degree that would be unacceptable to households, there are ways of mitigating the problem. Those who want to pay a fixed price per month rather than a variable one could do so. Overpayments could be netted off against underpayments with yearly or half yearly settling up. But for many people, such an arrangement may not be necessary.

Of course by the time these smart meters are installed in large numbers, we will have migrated from the SEM to the I-SEM. Instead of one pool price, we will have a number of different prices, the most important of which by far will be set in the day ahead market. That complicates the issue of retail price setting for suppliers. But if they can continue to manage a pass through regime for their large business customers, they can surely operate one for domestic consumers.

I suggest that the understandable policy of offering flat tariffs to domestic consumers and small businesses may unwittingly be denying them the opportunity of cutting their electricity bills. Floating prices may not be everyone's preferred option though it is the norm for food, heating oil and vehicle fuel, all of which separately make a bigger call on disposable income than electricity. At the very least this idea should be investigated in some depth to enable a proper debate on the subject

Yours sincerely

Jamie Delargy

