

# Gemserv Response to the “A Review of K-Factors and Supply Margins in the Single Electricity Market” Consultation

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## 1. Introduction

Gemserv is pleased to respond to your consultation relating to K-Factors and Supply Margins.

### 1.1 About Gemserv

Gemserv has its origins in the introduction of competition in electricity in the late nineties, where it developed the governance to support the GB wide customer switching process. To enable the inherent knowledge and expertise to be applied to other sectors, Gemserv was established in 2002 with the goal of making markets work effectively and with integrity. We provide market design and governance, standard/accreditation schemes, assurance and programme management services predominantly in the energy, environment and water sectors.

Gemserv only work at a market level (e.g. industry bodies, regulators and Government departments), rather than for individual market participants. For example, we currently manage the Master Registration Agreement (MRA), governing the GB electricity customer switching arrangements, the Independent Gas Transporters Uniform Network Code (iGT UNC), and the governance and central systems supporting the competitive water market in Scotland.

### 1.2 General Comments

We believe that the establishment of effective competition within the retail side of utilities is the best method to deliver customer benefits from this part of the supply chain. Further, any harmonisation between the two jurisdictions will act to lower any barriers to market entry across the “All Island” geographic area. Harmonisation can act to effectively increase the size of the market. This would make it more attractive to potential new entrants, with resultant potential greater scope for innovation, and will introduce more competitive pressures among the existing Market Participants in each jurisdiction. Further improved competitive forces and, hence, customer benefits should follow. Gemserv believes further harmonisation should include:

- An All Island market communication framework;
- An All Island retail side governance framework; and
- All Island market entry and assurance requirements.

The establishment of these would allow competition to more easily develop between jurisdictions and hence reduce the requirement for regulated retail tariffs and ex-ante regulation surrounding retail operations. As stated in the legislation, the regulators still have the power to audit and investigate any market manipulation under competition laws that will allow them to mitigate market distortions that may arise as a result of dominant market position.

Gemserv's view is that the use of K-Factors acts to reduce competitive pressures on the PES by providing a safety net. It also acts as a disincentive on the PES to achieve greater efficiency by capping the potential profit levels they can achieve. In addition, as pointed out in the consultation document, there is the potential for a vicious circle of events where under-recovery is followed by the requirement to increase tariffs and lead to certain customers paying the price for this because of an inability to switch.

We have approached the consultation questions from a holistic market perspective rather than representing partisan views. As a result there will be some questions where we believe it is not appropriate for Gemserv to respond or, if we have done so, we have explored the key issues to be considered rather than promoting an individual view.

We are happy for this document to be placed on the website. If you would like to discuss any part of this response please contact Alec Thompson on the contact details provided.

## 2. Responses to Specific Questions in the Consultation

### 2.1 Question A

The existence of K-Factors could influence customer switching. Some customers like the surety of only a single change per year. However if competition exists and is active then this in itself provides the customers with the necessary price signals and ability to make informed choices. This may also limit the effectiveness of K-Factors (e.g. if the K-Factor is high customers will move away in a tariff year, and if the K-Factor low will move back). If under recovery exists in a year, customers may switch away from the PES in the following year due to increases in the tariffs, potentially leading to further under recovery and higher prices again leading to further switching etc. Customers that do not or cannot switch will find that they are picking up the costs of using K-Factors (these may be vulnerable customer types that are unattractive to new entrants or those with debt problems).

### 2.2 Question B2

The provision of contractual data will potentially degrade the PESs' ability to compete. As such revealing this data will not necessarily produce more or better competition in the market as the PES's ability to compete and any commercial advantage is lessened by the provision of the information. This may also increase the likelihood of increasing tariffs as a result of the vicious cycle highlighted in the answer to A (above) occurring, where under recovery and switching away from the PES occur year after year.

### 2.3 Question B3

As a principle all of any over recovery should be passed back to those customers affected. However, tracking who should receive this is more difficult and makes the process potentially complex and costly to administer. The converse is true in the event that a PES under recovers. In practice over or under recovery can only easily be made to/ from the existing customer base. Therefore, reflecting this in the tariffs rather than a rebate to individual customers is more practical. Otherwise what if customer was only a customer for part of the year?

### 2.4 Question C2

The level of additional margin is a difficult question based on how an estimate number of customers will be ascertained. If retail tariffs are too high then customers will move to other Suppliers leading to

under recovery. This leads to potential great variance in tariff prices year on year which encourages customer price sensitivity rather than looking at innovative services offered by Suppliers.

## 2.5 Question D1

Yes, ex-post recovery is possible, but the potential complexity and cost associated to this may mean it does not warrant performing the task. For example, how do you apply this if a customer has since switched Supplier away from the PES?

## 2.6 Question D2

Unless you have full information to make a judgement on how much the PES actually requires it will be difficult to know how much margin they can be allowed. It may be better to allow competition to establish the price offerings that can be made to customers as the risk of setting it too high by the PES will drive them into competitors in any case. In this way the real price and minimum allowable margin will quickly be established using a competitive market mechanism.

## 2.7 Question E

Gemserv considers Proposal 3 to be the best solution presented as we believe that K-Factors create an artificial fallback position and distort actual costs from being established at /near real time. We believe that removing K-Factors and establishing level competitive market would be the best alternative - self regulation - and would also stop market distortions occurring due to a safety net being provided to the PES. Any predatory pricing concerns can still be dealt with under the regulators' competition provisions for investigation and auditing for market manipulation.

### 3. Response to Regulator Questions on the Consultation

Gemserv's opinion is that the abolishment of K-Factors and competition under Proposal 3 is the best solution presented in the paper. Establishment of a profit cap is more difficult as this requires accurate and detailed costs to be understood prior to establishment. However, we believe Global aggregation is required in each jurisdiction first to enable the efficient allocation of residual energy that currently falls under the PES using the differencing model. This will ensure liability for this inaccuracy can be dealt with equitably.

Under any arrangement where the PES can effectively control its profit to an allowable level they will seek to maximise recovery to this level. Regulated margin may not guarantee efficient costs, in fact if the regulated margin is set as a percentage of costs then it may create an artificial benefit from spending more inefficiently and setting prices higher based on the allowed revenue. Gemserv thinks the most effective incentive to not increase prices to customers by too much is the threat from the competitors that already exist.

Gemserv believes that complex mechanisms employed to regulate PES prices and ensure consumer protection make it difficult for new market entrants to compete due to the resource cost required to understand these arrangements. Further, these arrangements have the potential to create PES inefficiency as they know that they have a guaranteed income stream. We believe that removing these economic mechanisms would establish a cost conscious level playing field for all Suppliers in both jurisdictions.