BRIEFING

WHOLESALE ENERGY MARKETS, DECARBONISATION POLICY AND CONSUMERS

AN IPPR DEBATE ON TWO NEW REPORTS BY WHICH?

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Introduction

On 17 July 2013, IPPR hosted a high-level roundtable – held under the Chatham House rule – to debate the findings of two new reports on energy policy by Which?. The two reports in question were *Wholesale costs and retail prices* and *The challenge of decarbonisation*,[1] both of which form part of Which?'s 'Imbalance of Power' series, addressing a number of energy policy issues. Senior representatives from key industry players and the energy markets regulator Ofgem, as well as MPs or senior advisers from each of the three largest political parties attended. A list of the participants is set out in the annex to this briefing.

This briefing summarises the main themes and points of the discussion. The need to improve consumer trust in the energy industry and energy policy, in particular by improving transparency on the costs that make up bills, featured prominently throughout.

Wholesale market reform

Which?'s report *Wholesale costs and retail prices* argues that the wholesale electricity and gas markets demand greater attention within policy debates. It highlights how wholesale costs account for the largest part of consumers' energy bills (60 per cent) and are the main cause of recent bill increases. However, most consumers (84 per cent) believe energy company profits are the cause of the increases. Which? argues that consumers will only be confident that they are getting a fair deal when there is more effective competition within the wholesale markets alongside greater scrutiny of energy suppliers' costs.

The roundtable participants were generally welcoming of Which?'s attempt to focus attention on the wholesale markets. However, there was considerable disagreement in relation to one of the report's core recommendations: to ringfence the supply and generation businesses of vertically integrated companies. The roundtable discussion focused primarily on this proposal.

Ringfencing supply and generation

Which? believes that the ability of vertically integrated energy companies (that is, those with both supply and generation capabilities) to self-supply undermines competitive pressure in the markets to reduce costs for consumers. According to Which?, putting a ringfence between supply and generation, so that separate licensing arrangements would apply for each stage, could:

1. ensure cost-efficiency is prioritised by market participants and that the interests of customers are more closely aligned with those of shareholders
2. increase volumes of energy traded on the open market (supporting a boost in liquidity) and support a greater range of market participants
3. improve the quality and quantity of price information available, which could then be used to produce more robust price indices.

There was a consensus among the roundtable participants on the need to improve liquidity in the wholesale power market. It was believed this would help to ensure that competition was effective and would be beneficial in terms of transparency. However, there was disagreement on how best to achieve it.

1 Respectively, http://press.which.co.uk/wp-content/uploads/2013/08/The-Imbalance-of-Power-Wholesale-Costs-and-Retail-Prices-LOW-RES-July-2013.pdf and http://press.which.co.uk/wp-content/uploads/2013/08/The-Imbalance-of-Power-the-Challenge-of-Decarbonisation-LOW-RES.pdf

Broad support for Which?'s ringfencing proposal was expressed by some political and industry representatives. Participants discussed the Labour party's proposal to introduce a 'pool' system for trading energy which would, in essence, put a break between the generation and supply arms of vertically integrated companies, in order to achieve similar objectives to Which?'s proposal. Others suggested that placing a self-supply restriction on vertically integrated companies could produce similar outcomes.

Other participants expressed scepticism about whether Which?'s proposal would achieve it's desired aims. Criticisms of the proposal fell into three main areas.

First, some participants felt that the 'secure and promote' licensing conditions proposed by Ofgem[2] would be sufficient to increase liquidity and transparency without the need for ringfencing supply and generation. Which? believes that Ofgem's proposals may help to improve liquidity but are flawed because the role for the six largest firms in delivering the proposals embeds them further in the energy markets. As such, Which? argues that the new conditions will undermine the aim to achieve balanced and open markets and will not produce the right incentives to create effective competition.

Second, others felt that regulatory measures recently enacted or soon to come into force at the EU level – specifically the EU regulation on Energy Market Integrity and Transparency 2011 – would achieve Which?'s aims. However, these participants conceded that while these measures might improve transparency for those active in the market, they may not be sufficient to increase transparency for consumers.

Third, some argued that Which?'s ringfencing proposal did not sufficiently consider differences in how the electricity and gas markets operate. In addition, the proposal was criticised for focusing solely on companies that supply energy to consumers, rather than those supplying to industry. Roundtable participants pointed out that trading by banks was a large driver of price movements in the wholesale gas market, and that companies which sell energy to industrial customers, such as International Power/GDF Suez, are traded energy in large volumes. In response, Which? has stated that it focused on supply to consumers because therein lies its interest as an organisation. Nonetheless, they envisage the ringfencing of supply and generation going beyond the residential sector.

Impact of ringfencing on retail prices and consumer confidence

A key area of discussion in relation to the ringfencing proposal was on the outcomes it would produce for consumers. Two types of outcome were discussed: first, how the price consumers pay for their energy would be affected; second, whether consumers would be more confident that they are paying a fair price.

Some participants raised the concern that ringfencing might increase financing costs for thinly capitalised supply businesses, thereby negatively impacting competition and leading to price increases for consumers. In contrast, others believed the effect on costs would be minimal. Indeed, in their report, Which? said that ringfencing would have a differential impact on energy companies according to the specifics of their business model. As such, there is unlikely to be any one definitive account of the cost implications of the reform.

2 The first part of the 'secure and promote' conditions are the 'supplier market access rules' that aim to improve access to the wholesale market for small suppliers. The second part is 'market making' in electricity products that cover designated time periods ('forward' or future products) to ensure that opportunities to trade are present and to improve the robustness of price signals along the forward curve (that is, for products that commence at different points in the future). See: https://www.ofgem.gov.uk/ofgem-publications/39303/liquidity-draft-ia-120613.pdf

Overall, no consensus was reached as to whether ringfencing would lead to increases in retail prices.

A view shared by the majority of roundtable participants was that the retail price of energy would not fall in the short to medium term as a result of the reform. It is Which?'s view that prices would be kept in check, due to improvements in competition that would result from the reform. The low likelihood of price reductions in the short term was attributed to the influence of market participants who will not be affected by ringfencing (such as non-vertically integrated generators, industrial customers, and financiers involved in energy trading) and the fact that current gas prices are higher than wholesale market prices (meaning that companies make a loss on the wholesale market that has to be recouped on the retail market). This last point was queried by Which?, who highlighted recent segmental accounts that indicate companies tend to make more money in generation than in retail.

Nonetheless, the participants accepted that without greater transparency it was not possible for those outside the industry to make an independent assessment of whether retail prices are a fair reflection of wholesale costs. Indeed, a point strongly stressed by some was that even if ringfencing did not produce substantial improvements in terms of increased competition and reduced prices, it could increase consumer confidence in the market. This was argued to be a worthwhile aim in itself, as people do not presently believe that they pay a fair price. In response, other participants said that the reform would have to be proven to have a large positive impact on public confidence before they would be willing to accept it on that basis only.

Throughout the discussion on wholesale market reform, several participants expressed the need for an organisation that consumers could trust to measure competitiveness in the wholesale market, ensure that consumers are paying a fair price for their energy, and communicate the health of the market to the consumer. No thoughts were given as to who should have that role in the future, although criticism was made of Ofgem's failure to fulfil this role in the past. The Labour party's proposal to scrap Ofgem and replace it with a new regulator was discussed.

Decarbonisation policy

The second of the Which? reports under discussion, *The challenge of decarbonisation,* looks at policy issues relating to the decarbonisation of the energy system. The report does not take a position on the appropriateness of the government's overarching decarbonisation objectives. Instead, it takes as its starting point the government's legally binding emission reduction targets and the challenges faced in delivering these. It stresses that affordability for consumers should be a key consideration for the government when making decisions about how to fund and deliver decarbonisation policy.

The report focuses on the costs of delivery that are funded through consumers' energy bills, highlighting their scale (including around £50 currently to fund the decarbonisation of electricity generation, rising to around £120 in 2020) and the lack of awareness of these costs, with only one in four people being aware of them. In the report, Which? argues that the government must do more to ensure that decarbonisation policies deliver value for money and that the costs of the policies should be made more transparent. – indeed, Which? has called for the National Audit Office to scrutinise all energy policies in the round. The report also makes the case for new consumer protections for those with renewable heat and district heating.

The roundtable participants were generally supportive of Which?'s recommendations and felt it was very important that the voices of consumers are fully represented in debates on decarbonisation policies. Some participants expressed concern that the focus of policy to date had been on lowering the cost of decarbonisation policies, instead of whether the cost was affordable by consumers.

A key recommendation made in *The challenge of decarbonisation* is that, because consumers cannot opt out of paying these subsidies via their energy bills, the cost of policies to promote low-carbon electricity should be subject to the same level of scrutiny as spending that comes from general taxation. Several participants agreed with this proposal, pointing out that HM Treasury has imposed a spending control framework on decarbonisation policies funded by levies on bills ('the levy control framework') precisely because it regards these levies as a tax. In addition, for the same reason, several participants believed there was a need for improved analysis on the distributional impact of these levies on consumers.

One criticism directed at the report was that it had not considered the possibility of actually financing decarbonisation policies through general taxation rather than through consumer bills. Which? commented that while there are obvious attractions to this approach, it did not feel like a pragmatic proposal. However, in their report, Which? does argue that targeted support for vulnerable consumers should come from taxation, as should the cost of exemptions for energy-intensive companies from the 'contracts for difference' mechanism, which is intended to support low-carbon generation. It was noted by attendees that greater funding for infrastructure through a new British Investment Bank or an enhanced Green Investment Bank does appear to be on the table.

Several participants raised the potential of community-based energy projects to ensure the benefits from decarbonisation flow to consumers. The policy approach in Germany was cited as having successfully encouraged such projects, although the German model was also criticised for being costly.

A final comment was that uncertainty in the energy industry about the government's commitment to decarbonisation was a key factor in increases in the costs of decarbonisation policies for consumers, because it increased the risk profile and cost of capital for investments. As such, it was seen to be important that bodies like Which? make clear their support for the government's overarching decarbonisation objectives.

Conclusion

Which?'s reports have identified a number of important issues on energy policy that warrant further consideration. The reports stimulated a lively discussion at IPPR's roundtable, centred around the general agreement that action is needed to improve consumer confidence in the energy market and government policy so that consumers do not feel they are being ripped off. Which? and IPPR would like to see debate on how best this can be achieved gather momentum over the coming months.

Annex: List of participants

- Paul Dawson, head of market design and regulatory affairs, RWE Supply and Trading GmbH
- Ashleye Gunn, programme director, Which?
- Caroline Flint MP, shadow secretary of state for energy and climate change (Labour, Don Valley)
- Philip Davies, director of regulatory affairs, Centrica Energy
- Rachel Fletcher, interim senior partner, markets, Ofgem
- Steve Hargreaves, corporate strategy director, EDF Energy
- Ian Jackson, head of upstream compliance, E.ON
- Richard Lloyd, executive director, Which?
- Dr Keith MacLean, director of policy and research, SSE
- Pete Moorey, head of campaigns, Which?
- Chris Nicholson, special adviser to the UK secretary of state for energy and climate change (Liberal Democrats)
- Nick Pearce, director, IPPR
- John Penrose MP, Weston-super-Mare (Conservative)
- Reg Platt, senior research fellow, IPPR
- Jonathan Smith, head of pricing and risk management, First Utility
- Rupert Steele, regulation director, Scottish Power
- Will Straw, associate director for climate change, energy and transport, IPPR