

## Give thy thoughts no tongue? We offer Ed Davey some gratuitous advice

Ed Davey has been the new energy secretary for just over a week. Already he has had no shortage of advice. We asked ourselves what letter we might write if we were asked to. We have enlisted a little help from William Shakespeare in the form of Polonius advice to Laertes from Hamlet, and this is what we have come up with, ignoring that advice ourselves along the way.

“Dear Secretary of State,

First a very warm welcome to your new post. It is a key—some would argue the key—post in the government, and you come to it at a critical time in energy policy formulation.

You have a hard act to follow. Media views of Mr Huhne, your predecessor, have been mixed. But on the handful of occasions we met him, we were very impressed by his mastery of his brief. Older and wiser heads than ours have also been complimentary of Mr Huhne’s willingness to stand up for his department and above all to face up to the Treasury. If this is the case, long may it continue.

You are probably awash with briefings from officials and advice from stakeholders, and I am sure that all of it is well-intentioned. Some may even be sound. But we thought we would add our two-penn’oth before expectations get set.

### Do not dull thy palm with entertainment

Easily the biggest challenge you have taken on is to translate Electricity Market Reform (EMR) from high-level policy to detailed legislative proposals and then implement them. There remains an immense amount to do here, and some stakeholders are beginning to argue that the process lacks transparency and that key details are still missing.

Perversely the changes come at a time when the market has now got used to the current low-carbon incentive mechanism, the Renewables Obligation, with all its imperfections. We have seen 1.1GW of new renewable capacity added 2010-11, and 800MW financial year-to-date. That includes 463MW of new offshore wind, which is where the government has sought to focus incentives. With the help of a severe recession (which has shaved 8% off power demand), it now appears as if we may well hit the old 15% renewable generation target by 2015. But we are told the RO must be closed out to new investment from 2017, despite the fact we do not know the specifics of what is to replace it.

The CfD FiT mechanism is clearly the right way forward for many large-scale low-carbon developments. But many investors have said they would prefer to stick with the RO or some form of premium FiT. Many smaller low-carbon developers (say those below 100MW) are being told they must enter the traded markets whether they want to or not. Most independent developers of this size prefer the certainty of offtake agreements but will have in the future to go down other, complex contractual paths to realise the green premium. With continuing uncertainty over how the new contractual arrangements will work, we also hear anecdotal evidence that the terms on offer in the conventional offtake market from incumbent players are deteriorating. We urge you to reconsider this one-size fits all solution.

Similarly, while we support the concept of a market-wide capacity mechanism, more than a year on the details remain thin. It is all well and good to say this will bring the demand-side into the market, but it needs to be shown how. On the supply side most new large-scale generation projects take upwards of six years to bring to market, but the capacity mechanism will be based on a four year auction. This decision urgently needs to be revisited. We also believe that the mechanism will be required sooner than presently planned, so implementation timings also need to be revisited.

**Give every man thy ear, but few thy voice**

As energy bills have been on the rise for the best part of a decade, there has been a growing tendency to beat up the industry. We understand the rationale for this, and we sometimes do a bit of this too. While the action to make the supply market as competitive as it can be rests with Ofgem, expectations must be realistic. International commodity prices are volatile, and “rewiring Britain” with green generation does not come for free. And both these issues are outside the control of suppliers whatever their structure. Furthermore it is simply not feasible to assume (as officials seem to) that credible competition to the Big Six will emerge in the domestic energy markets overnight or without specific interventions.

Big Energy Week, which you were part of in your former role, was a worthwhile effort to try to get customers to engage with the market, and it showed how a range of consumer bodies can function effectively in tandem with politicians and the regulator. It will, we hope, have encouraged consumers to switch and others to take advantage of insulation opportunities. But it will have done nothing to bring new suppliers into the market. The keys to unlocking competition across the retail markets are to ensure wholesale markets function efficiently and to bring much greater transparency to the Big Six’s operations.

In this context we have heard rumours—shocking ones if true—that Alastair Buchanan indicated at an industry event recently that Ofgem was minded to abandon proposed interventions into the wholesale electricity market to boost liquidity. Admittedly, many of the smaller and independent players with whom we mix are worried about the distorting effects of mandatory auctions. But this mechanism is only one of several that have been proposed, and building liquidity is not a one shot policy. Other remedies, particularly the market maker concept and the self-supply restriction, should be developed and quickly irrespective of how much trading develops under N2EX.

The decisions here will be critical across the policy spectrum. Ofgem was clearly actioned by your predecessor with addressing liquidity. If it does not seize the opportunity, a condition precedent to pave the way for implementation of EMR will not have been achieved. Your officials should re-engage in this matter to ensure the necessary measures are introduced.

On a related matter we do not see how Ofgem’s recent proposals to reform segmented accounting by the Big Six can be made to work if there is no transparency of transactions involving their trading business. This may seem a point of detail that should be left to the regulator, but we think it is fundamental to understanding the relationship between wholesale and retail markets.

**Nor any unproportion'd thought his act**

The Retail Market Review (RMR) has reached a critical phase. Ofgem’s blind faith that retail markets will work in energy has lapsed, and regulatory policy has come almost full circle. On the plus side, some of the proposed interventions are needed, and formalising standards of conduct has merit and should be universal in application. The same goes for tackling transfer objections.

But the proposals on evergreen tariffs are misconceived. They will constrain those areas of the retail market that have seen most innovation. Based on other markets, many customers will not want fixed deals but will see unpalatable choices if they opt for a standard tariff. How would you react if you were not permitted a credible pay-as-you go tariff from your telecoms operator? We also think the fixed standing charge approach is unworkable and tries to impose uniformity where—whether we like it or not—there is diversity. Your government’s moves on smart metering and the Green Deal should pave the way for more enduring relationships between suppliers and their customers, but Ofgem’s proposals will frustrate this happening.

It is also perplexing as to why a series of remedies devised to eliminate complexity and practices adopted by the Big Six are being applied uniformly across all players. In the domestic markets, less than 1% of supply comes from outside the Big Six. But the process complexity and compliance cost introduced by the RMR proposals are significant, and they present very different costs per customer and compliance burdens for a supplier with less than 50,000 customers than one with in excess of five million. The competitive distortions that will arise are significant, and the moves if not properly targeted will unnecessarily raise barriers to entry in the market at a time when you are expecting to see increases in competition.

Given ministers stated concerns over the need to increase competition in the retail markets, we would urge you to get Ofgem to specifically consider the impacts its proposals will have on smaller suppliers and prospective new entrants.

### **Bear't that th' opposed may beware of thee**

The Green Deal is rightly seen as the government's flagship policy on the demand side, and it is an excellent example of innovative policy. But we know from the last government the dangers of hurrying a policy through; the mess the industry had to sort out to ensure the micro-generation feed-in tariff arrangements—as a set of processes—could work was significant.

October is not far away, but it is appearing increasingly likely that central systems will not be in place. As important key agreements have yet to be developed. Clearly the industry needs to see firm timescales, but these need to be realistic.

Most smaller suppliers seem to be taking the view that they will need to participate under the scheme if they are not to be foreclosed from large parts of the market. In the business markets many supply contracts extend across multiple sites. It is not credible that suppliers will walk away from a large corporate customer simply because it finds Green Deal sites amongst its portfolio. This situation in turn means that smaller players will be faced with system upgrade costs to ensure they can register and bill such sites correctly. As we have noted already, with many times fewer customers to recover the costs over, a £3/plan allowance as proposed is simply inadequate. Officials should be asked to reconsider this aspect of the policy.

### **Beware of entrance to a quarrel**

Many in the industry think the smart meter programme is a disaster waiting to happen. We thought it right that ownership of the programme should be assigned last April to the government, away from the regulator. But there is too little transparency for such a large programme, and we think the cautionary notes struck recently by the Public Accounts Committee and Which? need to be heeded. Many smaller suppliers, many of whom have been smart pioneers, simply cannot keep up. Communications surrounding the programme need to be dramatically improved and working decisions explained much more clearly and in a timely manner.

You also need to decide whether the programme is mandatory or voluntary (or rather whether the basic programme assumptions make sense in a world where customers can readily opt out). But, if there is a real risk that many domestic customers will not engage, programme assumptions need to be revisited. The costs of the programme at £11.7bn are considerable and will be real. We fear many of the stated benefits may well prove illusory.

In the meantime to ensure impetus is built up, we recommend that all suppliers replacing meters should be mandated to make these smart. The government also needs to give a clear steer on when it wants periodic data to be used for settlement, starting with higher profile classes but eventually covering the entire market.

### **Costly thy habit as thy purse can buy**

The position on solar FiTs is a mess. Hindsight is a valuable commodity, but it is now clear to all that the arrangements set in place in April 2010 were shockingly generous. We supported an early reduction in the PV tariffs, but the way the changes have been handled has been poor.

Your department's latest proposals on revised rates for other technologies show the extent to which an over-spend will occur irrespective of pursuing the appeal to the Supreme Court. Mitigating this by further challenge over the solar rates will prolong the uncertainty and, whatever the outcome, will be a major PR own-goal for your department.

The basic problem is that, if you continue with this challenge, the issue will still overhang investors. It will be taken to mean that the government could change its mind on important aspects of policy and enforce change retrospectively. With EMR at a delicate stage, this would be foolhardy.

**Take each man's censure, but reserve thy judgement**

We hope the contents of this letter do not seem hectoring or unduly negative. Invariably we strive to direct our efforts at turning government and regulatory policy into workable arrangements that do not disadvantage the smaller players in the market-place. But a change in minister is a time to take stock of the baggage we all have brought with us, bring a fresh perspective and challenge some assumptions.

The government's programme remains bold and very wide-ranging, but it is also complex and being implemented in many cases very quickly. Sometimes it is better not to act in haste to avoid having to repent at leisure."

