

Energy perspectives

23 January 2006

cornwallenergyassociates

Ofgem's non domestic market initiative is a real opportunity for demand side engagement

Disintegration ...

Whilst Ofgem deliberates whether it should take a closer look at what it thinks the non-domestic energy supply markets are, events are moving so rapidly that whatever it decides this sector is likely to be radically different than previous market reviews. A huge price spike, fed by supply fears in what has so far been another benign winter, is wreaking havoc on important stakeholders. Six energy suppliers have exited the market in recent weeks. And business users are labouring under prices pitched at absolutely unheard of levels, to the extent that many of them, hitherto generally supportive of the competitive model, are actively lobbying government seeking radical intervention.

... and integration

This is quite a context in which Ofgem has decided to turn its attention to a sector it last formally considered the best part of three years ago. Since then, integration has developed within the industry to such an extent that all but two hundred thousand or so household electricity customers are supplied by one of the Big Six integrated suppliers. In gas, their rivals serve even fewer. In business markets, scarcely 2pc of power volume is supplied by operators that do not own at least one major power station. In gas, the situation is better, but not by too many degrees of magnitude.

This situation seems to say that

it is wholesale positions that drive supply business viability and the recent exit of six independent stand-alone power supply businesses in less than six weeks underlines this point. Drawing the line between supply and wholesale markets is difficult, especially in the major user sector where activity connected with bulk end user renewals is a key driver of wholesale trading and what many end user contracts incorporate pricing that is directly correlated to movements in wholesale prices.

A distorted baseline

Ofgem last took a look at non domestic electricity and gas supply markets in 2003, giving the sector a clean bill of health in its report published in July of that year. Indeed, Ofgem's letter introducing its current process reminds us that this "review concluded that the supply markets were broadly competitive and that there was no need for any further non-domestic market reviews." The 2003 review revealed high levels of market concentration in electricity, less so in gas, but also emphasised the view that British markets for electricity and gas were more competitive

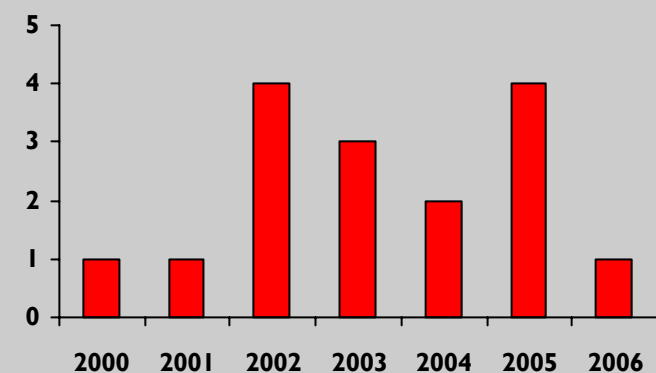
than elsewhere in the EU. Some customer issues were acknowledged, but not always sympathetically, including:

- poor service quality;
- level of supplier competition;
- the transfer mechanism and the objections process inhibiting customer switching; and
- poor data quality.

The bottom line though was "case closed".

At the time, the regulator was criticised for perceived partiality and in particular its retrospective

Exits from competitive electricity and gas supply markets since 2000



analysis in place of consideration of possible developments going forward. The 2003 review simply did not provide a view of business supply markets that many participants recognised.

A year later, in the summer of 2004, we undertook a study for Energywatch, which included a can-

vassing of stakeholder views. Customers and suppliers with small sector presence generally told us that competitive markets were working less well than previously, whilst larger suppliers were convinced this was not the case. But beyond comparing and contrasting participant opinions, we could make few hard and fast judgements about whether competition in business electricity and gas markets was working in the interests of consumers. One of our key conclusions, therefore, was that in order to improve policy making, there was a need for much more structured and routine information gathering by the regulator to enable clear market segmentation and measurement of competition. This conclusion still stands.

Keeping up with events

To underline the point about fast moving markets, Ofgem kicked off its process with an open letter on 11 November. Since then spot gas and power prices have spiked to a scale that some still see as incredible. However much we try to rationalise after the event, such pricing developments are causing significant distress to business customers to the extent that some are questioning operating at all. Their belief in the orderliness of the market has been undermined. In the short term they have stimulated not before time efforts towards greater demand-side engagement in the gas market. But, these efforts will not materially help customers this winter.

The 11 November letter saw Ofgem invite “stakeholders to provide specific evidence that a further review is necessary”. It set out a range of arguments based on maturing markets, new products it says are aimed at assisting “buyers to manage the risk of increasing and more volatile wholesale prices” and talks of reducing concentration and improved customer satisfaction. We take issue with these assertions: it cannot be repeated often enough that most customers have

opted for ‘flexible’ deals through desperation rather than choice to avoid forward prices at inflated rates. And, moreover, they have been incited to do so by policy makers and regulators that have highlighted variable supply offers in the market-place in the expectation that prices would fall closer to delivery.

Key questions

Ofgem sets out a number of questions it believes need to be answered to convince that a review might be necessary. They (and our responses) are:

- “which indicators of competitiveness should be the focus of this review (for example, market dominance of particular company (ies), quality of service, barriers to entry for suppliers), and why;”
- we think aggregate switching by profile class should be tracked on a monthly basis for tracking over time;
- we think objections to transfers should be tracked by supplier to observe whether issues might be concentrated on particular operators;
- we think typical prices should be tracked against wholesale markets (DTI has end user and producer feedstock statistics, others publish traded market prices - from them differences can be
- exits should be tracked and exit interviews conducted by policy makers with departing players (we think they should be asked about their experiences of wholesale trading);
- we think Ofgem should keep up to date with suppliers’ relative market positions using information it sources under its own right;
- we think Energywatch should build on its plans to engage with the business community. It could act as an independent information hub channelling and harmonising end user feedback in a constructive manner;
- “should the review cover all market segments (for example SMEs, medium and large gas and electricity supply markets) or focus upon a particular sub-set of these, and why”;
- we do not believe there established definitions are robust enough to segment so the sector should be considered as a whole;
- “if you do not consider a review is necessary, are there other measures Ofgem should be taking to improve the way the supply market is working? What are these measures and why are they required?”
- Ofgem should build on the DSWG and LUG/SMUG mechanisms to facilitate demand side

Shares by volume of the England and Wales electricity market

(TWh)	Non Big 7	Total	Non Big 7 (%)
March and April 2004	2.9	50.8	5.8%
October and November 2005	2.7	53.2	5.0%

Source: Cornwall Energy Associates analysis of SVA data sourced via Enappsys.com. Big 7 = British Energy,

- calculated);
- we think policy makers should regularly ask key customers and intermediaries about the levels of response they get to their tenders and the approaches they are taking to procurement;
- we think supplier entries and

engagement recognising the full benefits it can bring compared with supply alternatives. As Ofgem frequently reminds us protecting consumers is its first priority. The review should be sufficiently widely drawn to address the fundamental causes for customer distress. This is a huge opportunity.