4. Price and non-price offers

4.1. This chapter considers a number of issues about the prices that domestic customers pay for their gas and electricity supply and includes a discussion about factors other than price ('non-price offers') that might influence customers' decisions to switch.

4.2. The chapter starts by explaining why price and non-price offers are an important factor in assessing the development of competition in the domestic gas and electricity sectors. It then discusses several key issues that have been raised as areas of concern:

- whether domestic customers are benefiting from changes in wholesale prices to the extent that would be expected in a competitive environment
- what the implications are of ex-PESs charging their in-area customers more than customers in other areas, ('two tier pricing') bearing in mind that that this is a commercial decision taken by those suppliers and not the result of any regulatory requirement, and
- whether all categories of customer (especially prepayment customers, those in Scotland and customers with dynamically teleswitched meters) are benefiting to the same extent from competition.

4.3. The chapter then discusses what the results of the pricing analysis mean for the development of competition, including the potential impact on new entrants. The section on non-price competition discusses some of the different types of offers available and how these could be analysed in the context of the development of competition.

Background

4.4. Information from customer surveys (see Chapter 2) and the analysis of the drivers of switching (see Chapter 3) show that price is the main factor that customers consider when deciding whether to switch and to whom. The price on a customer's bill comprises a number of different costs, for example:

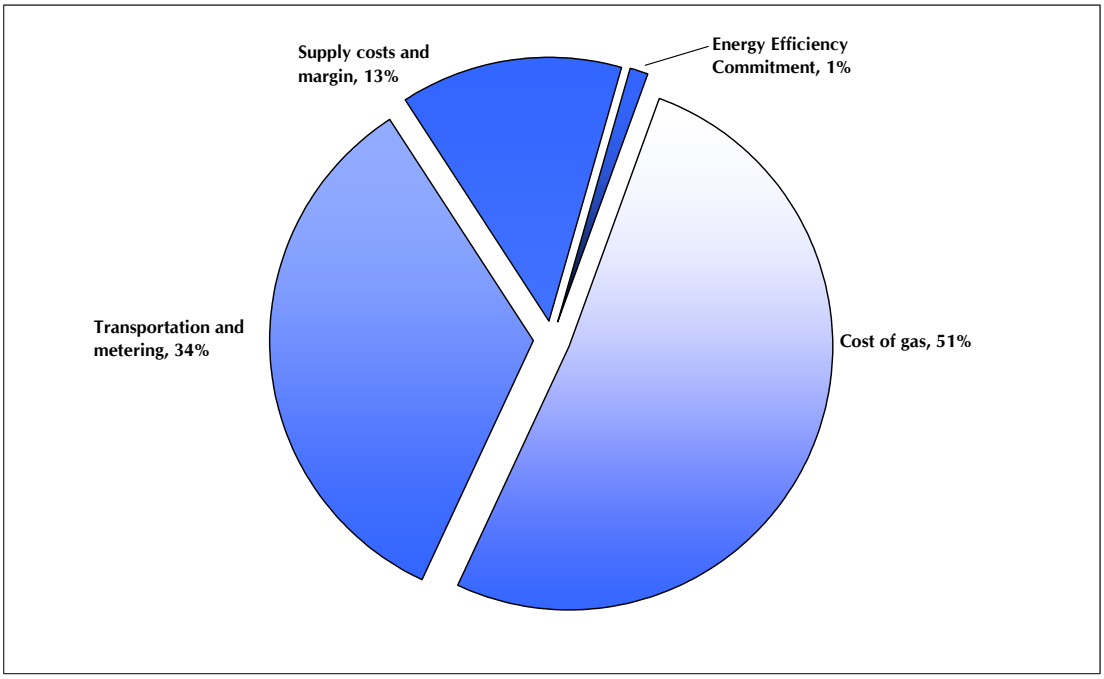
- the cost of buying gas and electricity in the wholesale market

- the network charges that a supplier must pay for electricity distribution, electricity transmission and gas transportation (including the costs associated with transmission and distribution losses and shrinkage on the gas network)[1], and

- suppliers' other costs, for example those arising from marketing, advertising, call centres, metering charges, billing systems, etc.

4.5. Figure 4.1 shows the breakdown of an average domestic gas bill where the customer is paying by direct debit (see Appendix 5 for methodology).

Figure 4.1: Breakdown of domestic direct debit gas bill



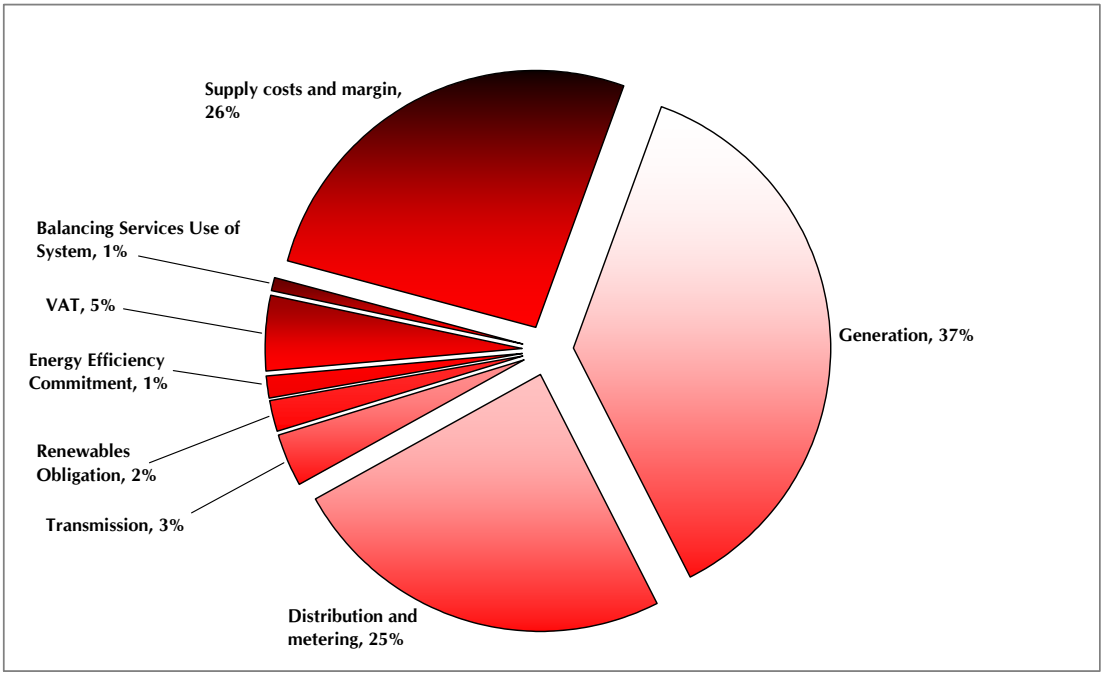
Source: Ofgem

4.6. Figure 4.2 shows the breakdown of an average domestic electricity bill for a customer paying by direct debit (see Appendix 5 for methodology)[2].

[1] These charges are regulated by Ofgem and, although they vary by region and meter type, are applied in the same way to all suppliers. Variations in suppliers' prices within a particular area are therefore unlikely to be due to differences in network charges. Variations in suppliers' prices between different areas may be due to differences in network charges and/or to suppliers' own pricing strategies.

[2]The generation costs in this diagram differ from those previously published by Ofgem. This may be because the costs in this review were calculated without using information about historical bilateral contracts. See Appendix 5 for further information.

Figure 4.2: Breakdown of domestic direct debit electricity bill



Source: Ofgem

4.7. Ofgem monitors suppliers' prices across Great Britain. Prices are determined by market conditions and analysing prices can provide information about a number of features of competition (which are to some extent inter-dependent). For example:

- cost savings made by a company are usually passed through to customers in the form of cheaper prices. However, the extent of this pass through depends on the market structure, with less pass through by a monopolist than in a competitive market
- more efficient companies will be able to pass on their efficiency savings to customers. These efficiencies may arise because of the size of the company or because of some innovation by the company
- the level of prices provides a "signal" to potential entrants about the scope for profitable entry (providing entry barriers are not too high), and
- prices can indicate whether some companies are able to set their prices independently of their competitors and customers, thereby indicating that they have market power.

4.8. Even though gas and electricity prices vary between suppliers, the gas or electricity supplied to customers is identical, whoever the supplier is. In this type of market where the products are 'functionally identical', suppliers may try to differentiate themselves from their competitors by competing on price or non-price (or both). Non-price offers may include add-ons such as supermarket bonus points or Air Miles or links with third parties such as charities. Although customer survey information indicates that many of these issues are not particularly important compared to price, Ofgem is interested in the influence they may have on switching behaviour.

Terminology and data

4.9. This section explains some of the terms used in this Chapter. The Glossary at the end of this document explains other concepts that may be useful in understanding the issues raised.

- DUoS – Distribution Use of System charges – the charges paid by electricity suppliers to electricity distribution companies
- National Balancing Point ('NPB') - a notional position used as point of reference for pricing. It is not necessarily a physical location, but a hypothetical position which can be used as reference. When a generator or gas producer sells electricity or gas at the NBP it has already paid network access/entry charges
- non-price offers – for the purposes of this review, this term refers to a broad range of inducements offered by a supplier seeking to alter a customers' valuation of functionally identical products (ie gas and electricity)
- TNUoS –Transmission Use of System charges – the charges paid by electricity suppliers to National Grid Transco for use of the electricity transmission system
- BSUoS - Balancing Service Use of System Charges include: the costs of the Balancing Mechanism, Balancing Services Contract costs, National Grid incentive payment (or receipt) and internal costs of the System Operator, National Grid, and

- two tier pricing – is the commercial decision taken by ex-PESs to charge lower prices for customers out-of-area than in-area.

4.10. Throughout this document, Ofgem uses a medium gas consumption level of 19,050kWh a year. In February 2004 energywatch stated that it would use a medium gas consumption level of 20,500kWh a year. The way in which the percentage savings are presented in this document and its appendices means that savings can be analysed at any consumption level. Where a range of monetary savings are presented, the difference in the consumption levels does not materially affect the values presented. In addition, maintaining the 19,050kWh level for the purposes of this review provides consistency with previous publications.

Key facts and trends

4.11. Key findings presented in this chapter are:

- on the basis of the analysis carried out for this review, changes in electricity retail prices appear to be largely unresponsive to changes in electricity forward wholesale prices. There may be a number of reasons for this and they are considered in more detail in this chapter
- two-tier pricing is more varied in its incidence and extent than is often implied. In particular it seems that not all suppliers are competing vigorously out-of-area for prepayment customers
- savings are available for customers who have not switched (and to a lesser extent for those that have switched) for all payment types and at across consumption levels, and
- the differential between electricity and gas prepayment and credit prices continues to narrow.

Analysis

Responsiveness of domestic retail prices to wholesale price changes

4.12. In a competitive market, prices will tend to reflect the cost of supply. In the electricity supply sector, these costs will include a range of bought in costs, including generation, transmission and distribution, as well as operating costs for the supply business (eg metering, meter reading, billing, customer service and marketing). Of these costs, fuel costs represent the single largest component (approximately 37 per cent of an electricity bill and 51 per cent of a gas bill) of the cost to serve a domestic customer.

4.13. Since the introduction of NETA in March 2001, debate has focussed on whether domestic electricity customers have benefited fully from significant reductions in wholesale prices. The Public Accounts Committee (PAC)[3] questioned recently whether domestic customers had seen reductions consistent with reported reductions in wholesale prices[4].

4.14. A key criticism is that when electricity wholesale prices fall, suppliers do not change domestic electricity prices as quickly (or by as much) as they do when wholesale prices increase.

4.15. This debate continues, particularly in light of recent significant increases in wholesale electricity prices. Between May 2002 and January 2004, annual baseload forward prices increased by 30 per cent. Many suppliers have cited the higher forward price as the main reason for increasing domestic electricity retail price increases.

4.16. This section provides an initial assessment of the criticism that domestic prices have not moved in line with wholesale prices. This is only a preliminary analysis and Ofgem is likely to carry out additional work on this issue in the future.

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[3] House of Commons Committee of Public Accounts: The new electricity trading arrangements in England and Wales, Second report of Session 2003-04.
[4] PAC commented that reductions in prices for I&C customers were consistent with the fall in wholesale prices.

4.17. The analysis:

- considers the relationship between wholesale and retail prices, including the long run 'responsiveness' of retail prices to wholesale prices, and whether domestic supply prices are equally responsive to both increases and decreases in wholesale prices, and
- considers related factors that might influence how responsive retail prices are to wholesale prices (eg how suppliers may structure their energy purchasing to match their customer portfolio, and that they might smooth prices for domestic customers).

4.18. This analysis alone is insufficient to determine whether supply markets are competitive but, within the limits of the available data, it will provide some insights into whether supply competition is securing the full pass through of wholesale decreases as well as increases in costs.

4.19. This analysis considers gas and electricity prices separately. First, it identifies and explains relevant wholesale and retail price data. It then provides a descriptive analysis of the relationship between wholesale and retail prices. Next it presents and discusses the results of a more robust formal analysis carried out by Frontier using econometric regression methods. (Details of the methodology and specification for the regression analysis are in Appendix 6.)

4.20. The section then considers possible explanations for the results of the analysis. It concludes by outlining areas where Ofgem may expand and refine the analysis in future.

Electricity

Methodology and data

4.21. For the analysis, a wholesale electricity price series from the period April 1999 to January 2004 is used, comprising:

- annual baseload (daily) prices, and

- annual peak (daily) prices[5].

4.22. Annual baseload and peak prices are forward prices (ie prices paid today for the delivery of an annual wholesale product in the future).

4.23. There are two main reasons for choosing forward wholesale prices for the analysis:

- forward prices reflect the market's expectation of the additional energy cost to meet demand for an additional customer. In that sense, they provide a good measure of prices (and therefore costs) that are faced by both the expansion of existing suppliers and entry by new suppliers, and

- suppliers typically cite increases or decreases in the forward price as the main cost driver for raising or lowering retail prices. Ofgem will use this series to examine whether this stated cost driver is in fact relevant in explaining retail price movements.

4.24. Retail prices were estimated from average nominal direct debit customer bills. Ofgem has retail prices for the 14 ex-PES regions on a monthly basis, from June 2000 to January 2004[6]. Information on the price charged by the ex-PES, the best offer and the average price were used. For the purpose of better capturing the impact of wholesale prices on the competitively driven elements of the domestic price, the TNUoS and DUoS components of domestic electricity prices were removed.

4.25. Direct debit prices were used because price controls were lifted from these prices at a relatively early stage of competition (April 2000). Direct debit is also characterised by higher levels of switching activity, suggesting that competition for this group of customers is the most vigorous of all three major payment types. It would therefore be reasonable to expect direct debt prices to be most responsive to changes in costs/competitive forces.

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[5] Wholesale price data is sourced from Ofgem and John Hall and Associates.

[6] Retail price data is obtained from several sources. Data from: April 1999 to May 2000 is taken from Which? Price fact sheets; June 2000 – August 2001 is taken from Ofgem pricing fact sheets; October 2001 to September 2003 is taken from energywatch pricing fact sheets, June 2003 onward, is sourced by Ofgem.

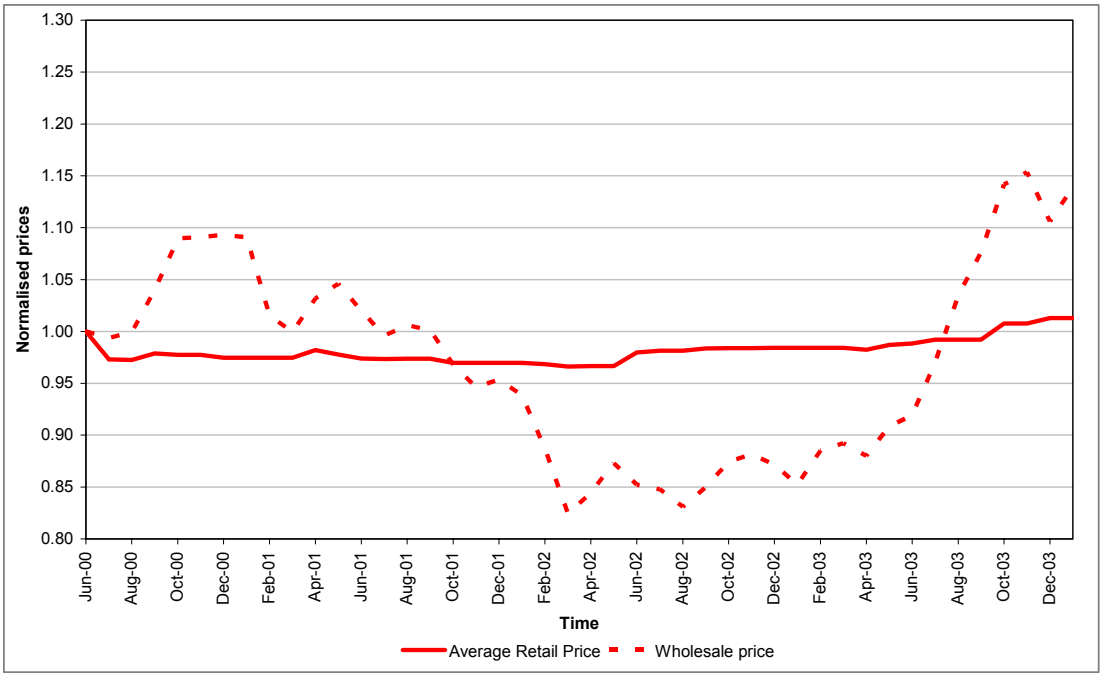
4.26. The analysis also used several domestic price series in order to test whether the prices of ex-PESs are more or less responsive than those of other suppliers[7]:

- the unweighted average of ex-PESs in-area prices
- the unweighted average of minimum prices available in each region, and
- the unweighted average of regional average prices.

Descriptive analysis

4.27. Figure 4.3 shows the movement in retail and wholesale electricity prices from June 2000 to January 2004. The retail price is the average of direct debit prices. The wholesale price is the monthly average of annual (daily) prices. In order to avoid problems with scaling on the graph, prices have been normalised to June 2000. The figure shows very limited response in retail prices to changes in the wholesale electricity price. This leads to an expectation that a more formal analysis will reveal only a weak relationship between the wholesale price and the retail price.

Figure 4.3: Monthly wholesale electricity prices, average direct debit prices (nominal prices, retail prices exclude TNUoS and Duos)



Source: Ofgem

[7] It should be noted that Ofgem's analysis of domestic prices is based on published rates, and will not include any inducements that vary from the published rates.

Regression analysis

4.28. The key findings of the regression analysis are:

- changes in domestic retail electricity prices appear to be only weakly related to changes in the wholesale electricity price, with the percentage change in retail prices reflecting only six per cent of the change in the wholesale price[8]. (With full pass through, changes in the retail price would reflect 37 per cent of the change in the wholesale price (since wholesale prices represent 37 per cent of the customer bill, see Figure 4.2), and

- in as much as they do reflect changes, domestic prices are as responsive to wholesale price decreases as they are to wholesale price increases in terms of the size of the response. (Further analysis is needed to identify whether the timing of the response differs.)

Additional checks

4.29. Ofgem carried out a 'sense check' of these results to see whether the formal econometric results match observed price movements over the last four years. To provide a more intuitive feel for the responsiveness, consider the following table which compares the change in prices for two periods, one in which wholesale prices are falling and one in which wholesale prices are rising.

4.30. In the period from June 2000 to April 2002, wholesale prices fell approximately 15 per cent, while retail prices fell 2 per cent. From August 2002 to January 2004, annual baseload prices rose 30 per cent, while the average direct debit price rose 5 per cent.

4.31. Table 4.1 looks at these recent domestic electricity price changes. Note however, that these prices are final prices and hence do not exclude network charges which would have varied across regions and over time. The retail price used is therefore different to that used for the formal analysis.

[8] That is, if wholesale price changed by 100 per cent, retail prices would change by 6 per cent.

Table 4.1: Additional check – Supplier direct debit price changes since June 2000

	June 2000	April 2002	March 2004	June 2000-July 2002	June 2002-March 2004
	bills	bills	bills	% change	% change
Average retail price	233.34	225.86	240.32	-3	6
Wholesale price				-18	31
Retail/Wholesale ratio				18	21
Formal result				6	6

Source: Ofgem

4.32. Table 4.1 illustrates that retail price falls are roughly half the size of increases for wholesale price for the period between June 2000 and March 2004. Dividing the retail price change by the corresponding wholesale price change for that period shows that retail prices increases have been passed at a slightly higher rate than for price reductions (18 per cent compared to 21 per cent).

4.33. This result suggests a higher degree of pass through than the formal analysis. One reason for this difference could be the inclusion of TNuoS and DUoS, which may have smoothed underlying price movements.

Gas

Methodology and data

4.34. The analysis used daily wholesale prices from March 1996 to February 2004 using annual NBP prices.

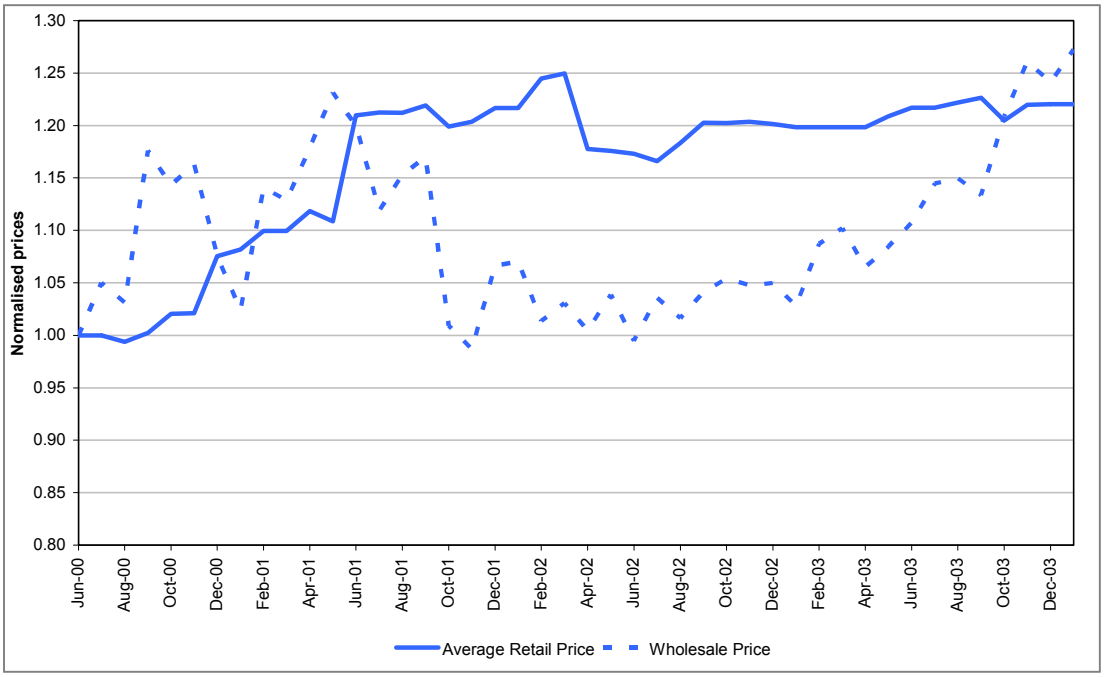
4.35. Ofgem has retail prices for licensed gas suppliers on a monthly basis, from June 2000 to February 2004. This information was used to estimate the direct debit prices charged by BGT, the best offer and the average price. For the purposes of better capturing the impact of the wholesale prices on the competitively driven elements of the domestic price, the average transportation charge in Great Britain has been subtracted from these charges.

4.36. As with electricity, if retail prices are responsive to movements in wholesale prices, then the relationship would be strongest for direct debit prices, since competition for these customers is the most intense.

Descriptive analysis

4.37. Figure 4.4 shows the movement of the retail and wholesale gas price over the period analysed. The retail price is the average of direct debit prices. Prices have been normalised to June 2000. The figure shows a greater response in gas retail prices to changes in the wholesale price than in electricity. This leads to an expectation that a more formal analysis will reveal a more significant relationship between the retail and wholesale gas prices than the corresponding electricity analysis.

Figure 4.4: Monthly NBP gas prices, direct debit gas prices (nominal, retail price excludes transportation charges)



Source: Ofgem

Regression analysis

4.38. Key findings of the regression analysis are:

- that changes in domestic retail gas prices appear to be fairly strongly related to changes in wholesale gas prices. In the long run, the percentage change in the retail price is 43 per cent of the change in the wholesale price. In a perfectly competitive market, changes in the retail price would reflect 51 per cent of the change in the wholesale price (since wholesale prices represent 51 per cent of the customer bill) (see Figure 4.1), and

- there is a small asymmetry in the way in which the size of domestic price changes respond to wholesale prices but Ofgem does not consider that this is statistically significant. (As with electricity, further analysis is needed to identify whether the timing of the response differs.)

Interpretation of results

4.39. A key question is why domestic electricity prices appear to be largely unresponsive to movements in the forward electricity price.

4.40. Ofgem considers that a number of alternative interpretations could plausibly explain the lack of relationship between retail electricity prices and wholesale prices. These include:

- suppliers may not price solely according to forward prices, in particular complex contract structures may affect how suppliers price their overall domestic portfolio
- vertical integration may dilute retail price responsiveness
- suppliers 'smooth' prices to domestic customers
- it is too early to assess whether 'shocks' (such as NETA) have come too close together, relative to the pace at which one would expect prices to revert to pattern, and
- suppliers' retail prices may be influenced by their competitors' prices more than by actual changes in wholesale costs.

The forward price influence on retail price levels

4.41. Retail prices may not be solely determined by forward prices but may better reflect the weighted average cost of energy (WACOE), which will include not just forward contract prices. In electricity, suppliers will purchase many individual contracts to meet an aggregated demand profile for their customers. From this single portfolio of contracts, the WACOE is calculated and reflected in the retail price, representing the average energy cost of serving a typical customer.

4.42. Suppliers may enter the contracts that make up the WACOE either internally, or they may minimise wholesale price risk by entering into risk management contracts with trading affiliates. The supplier relies on the trading arm to hedge price risk on its behalf. Retail prices would then tend to reflect the risk-managed, hedged price rather than the forward price.

4.43. A number of suppliers cite forward price movements as the main driver for changing retail prices and it seems likely that if suppliers are indeed exposed to a wholesale risk that they would increase their retail prices. However, the evidence presented in this review does not appear to support suppliers' claims.

Vertical integration[9]

4.44. All ex-PESs are within vertically integrated groups in electricity; BGT is vertically integrated in gas. Suppliers within these vertically integrated groups may face fewer incentives to adjust retail prices significantly in response to movements in wholesale prices, knowing that overall profits for the group will remain largely unchanged. That is, if wholesale prices increase, suppliers may choose not to increase retail prices, recognising that lower profits in the retail supply business will be offset by higher profits upstream (ie generation). This will, however, lead to lower margins and profitability in the supply business. The company may adjust retail prices to increase profits from wholesale activities whilst leaving supply profitability unchanged (assuming that other competitors also adjust their prices to reflect increased wholesale costs). If wholesale prices have increased then the price at which companies will consider entering the market will also have increased.

4.45. Fixed effects, for example, are a significant component of switching behaviour which could be a factor in suppliers choosing not to adjust retail prices. Suppliers could decide to maintain higher prices when wholesale prices are falling because the supplier's fixed effects mean that some customers will not switch.

[9] The comments on vertical integration do not imply any Ofgem view or specific knowledge that consideration of group positions is taken into account in these businesses.

Suppliers 'smooth' prices to domestic customers

4.46. Suppliers may believe that domestic customers do not like frequent price changes and may switch supplier in response to a price increase. Suppliers may therefore 'smooth' prices to domestic customers to try to reduce the incentive to switch away. Suppliers that do not change retail prices immediately in response to changes in wholesale prices absorb the changes in their margins for a period of time.

4.47. If a supplier has a choice between first raising prices and then lowering prices in response to wholesale price movements – or simply leaving prices unchanged at the average price - it may choose not to adjust prices at all.

4.48. Linked to this approach is also a possible interaction with direct debit charging. Because consumption is higher in winter than in summer, a fixed direct debit price provides income for a supplier so that it over-recovers in summer (when consumption is low) and the opposite in winter. Suppliers may therefore wait until an optimal point in the year to change the retail price.

4.49. If supplier margins, rather than prices, are adjusting to movements in the wholesale price this could be considered as a competitive outcome. More recent wholesale price increases have placed pressure on margins, since retail prices have not adjusted to fully reflect the increase. If supplier margins are being squeezed, customers may benefit to the extent that increasing costs are not passed through to them immediately.

'Shocks' have influenced price changes

4.50. NETA started in March 2001 and it may be that its introduction has not yet had a significant impact on the way in which changes in wholesale prices are passed through to domestic customers. However, from inspection of the data series used in the analysis, there was no visible structural break in the data at the introduction of NETA. This suggests that NETA may have been factored into wholesale and retail prices before its actual operation, perhaps from the announcement in October 1998 of its final design.

Influence of competitors' prices

4.51. The analysis in Chapter 3 indicated the importance of relative prices and that may be indicative of inadequate incentives to constrain the prices of those suppliers with the strongest fixed effects.

Possible additional analysis

4.52. Ofgem considers that the analysis presented in this chapter is a preliminary analysis, which can be built upon and developed in the future as new evidence is gathered and refinements to the methodology are explored. These may include:

- whether wholesale gas and electricity prices jointly or separately explain movements in dual fuel prices
- an examination of how suppliers contract directly with generators for bespoke contracts. This may provide more information about the true cost of purchasing energy for domestic customers
- an examination of the lag between wholesale and retail price changes within the model specifications
- extending time series data back to identify possible longer term relationships not present in the existing series, and
- comparing pass through for non-domestic customers to that for domestic customers.

What does two-tier pricing mean for domestic electricity supply competition?

4.53. The commercial decision taken by ex-PESs to charge lower prices for customers out-of-area than in-area is referred to as 'two-tier pricing'. The chief implication of this pricing strategy is that domestic electricity supply customers who switch pay lower prices than non-switchers or customers who switch back to the ex-PES. Two-tier pricing is not generally seen in gas.

4.54. The difference between the price paid by an in-area customer compared to an out-of-area customer has been the subject of debate, with some people questioning whether this outcome benefits domestic electricity customers.

4.55. For instance, the Public Accounts Committee (PAC) recently commented on the implication of this pricing strategy for in-area customers, saying "Customer loyalty is penalised. Customers who have stayed loyal have benefited much less from competition and pay much more than those who have switched"[10].

4.56. This section will present pricing data to quantify the incidence and extent of two-tier pricing. It also considers some key hypotheses that could explain whether two-tier pricing strategies appear transitional or more permanent.

Two tier pricing: background

4.57. The incidence of two-tier pricing can be traced back to market opening, which started in September 1998 and was finalised in April 1999. Prior to domestic electricity market liberalisation, domestic electricity customers could only be supplied by one of 14 regional monopoly suppliers, each with an exclusive franchise to supply customers in their franchise region. Monopoly regional prices were regulated by price controls.

4.58. Upon market opening, any licensed supplier could supply any domestic electricity customer throughout Great Britain. This led to supply competition for all customers across all 14 ex-PES regions. To attract new customers, many suppliers chose to offer lower prices out-of-area than those offered in-area under price controls.

4.59. From April 2002, price controls on in-area prices were lifted on the grounds that supply competition was sufficiently developed, that the detriments from further controls were likely to outweigh the benefits.

[10] The new electricity arrangements in England and Wales, Second Report, 16 December 2003.

Two tier pricing: incidence and extent

4.60. This section explains some of the key assumptions for analysing two-tier pricing. The analysis derives an in-area and an out-of-area price for each of the ex-PESs. This provides:

- an analysis of two-tier pricing over time (supply groups change, whereas ex-PESs remain separately identifiable entities over the entire period), and
- greater transparency (this can show, for example, how consolidation affects differences for each supplier within a group).

4.61. The table below can be used when reading the analysis to cross-reference each ex-PES with the current supply group to which it belongs[11].

Table 4.2: List of ex-PES suppliers and supply groups

Ex-PES	Supply Group (as at March 2004)
Eastern	Powergen
East Midlands	Powergen
London	EDF
Manweb	ScottishPower/Manweb
Midlands	npower
Northern	npower
Norweb	Powergen
Scottish Hydro	SSE
ScottishPower	ScottishPower/Manweb
Seeboard	EDF
Southern	SSE
SWALEC	SSE
SWEB	EDF
Yorkshire	npower

Source: Ofgem

4.62. To capture more accurately the competitively determined elements of the differential between in-area and out-of-area prices, non-competitively determined elements of the bills (DUoS and TNUoS charges) have been removed. This enables better detection of underlying competitive drivers for the relative in/out-of-area prices[12]. Nominal prices are used rather than real prices

[11] The only exception to this rule, is that ScottishPower/Manweb are treated as one ex-PES.
[12] For example, a final bill analysis of prices could identify higher in-area than out-of-area prices, suggesting the presence of two-tier pricing. However, if this result is driven by relatively higher in-area TNUoS and DUoS charges, then the result will be misleading.

in this analysis to enable a more transparent understanding of underling changes in the ratios overtime.

4.63. The incumbent price is always taken as the price of the ex-PESs. For out-of-area prices, if the ex-PES has been acquired by another supplier, the analysis excludes other ex-PES prices within the acquiring supply group from the out-of-area average[13].

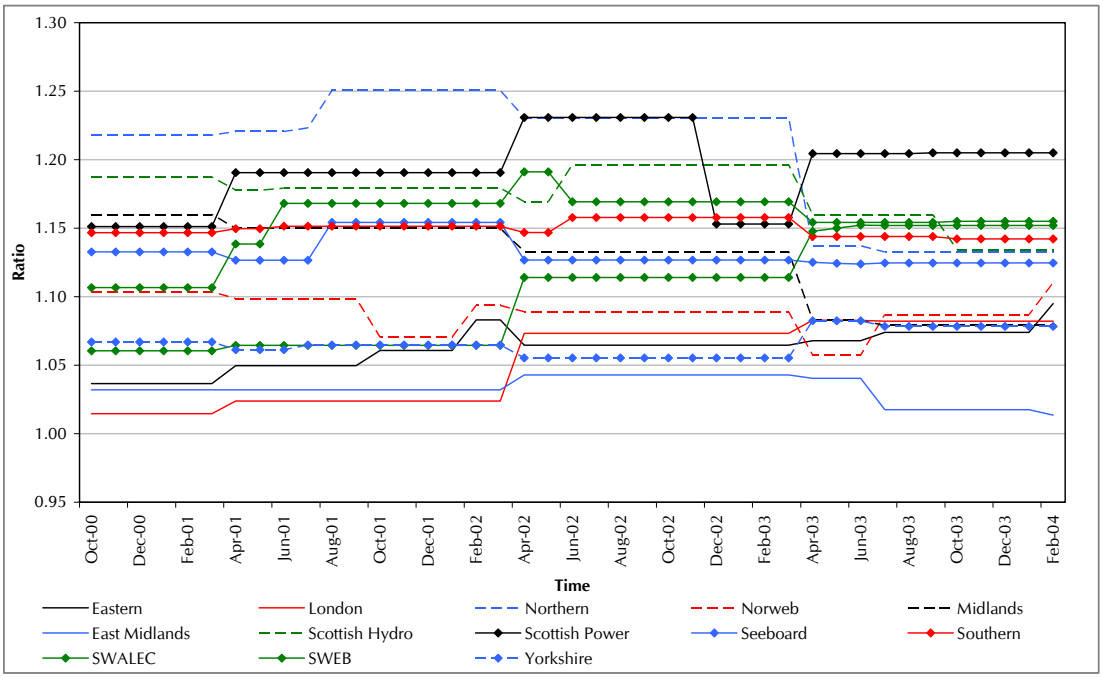
Direct debit

4.64. Figure 4.5 measures the incidence and extent of direct debit two-tier pricing from October 2000 to February 2004. For each ex-PES, it reports the in-area direct debit nominal price divided by the average out-of-area direct debit nominal price[14]. A value of one or greater therefore indicates that the average of the ex-PES out-of-area prices is less than the in-area price.

[13] For example, when calculating the out-of-area price for the Northern supply business from March 2003, the analysis excludes npower's in-area prices in the Yorkshire and Midlands regions, since these reflect incumbency prices.

[14] The measurement of the relative prices is straightforward. The differential between in-area and out-of-area prices can be expressed as the difference between the two prices (ie subtracting the out-of-area price from the in-area price), or by a ratio of the two prices, (ie dividing the in-area price by the out of area price). For this review, Ofgem reports on the ratio of prices.

Figure 4.5: Two-tier pricing: nominal direct debit prices, excluding TNUoS and DUoS charges, October 2000 to February 2004



Source: Ofgem

4.65. Two-tier pricing strategies differ across time and by supplier. For example:

- within the present npower supply group, the value for Midlands has fallen from 1.15 to 1.07, since October 2000. The value has also fallen more recently for the Northern supply business from 1.24 in March 2003 to 1.11 in February 2004 (previously, Northern had one of the highest values among the ex-PES). The value for Yorkshire has changed only slightly since 2000 and the ratio is the same at February 2004 as at October 2000 (1.06)

- within the present Powergen supply group, for the supply licensees East Midlands, the value indicates that two-tier pricing has been almost been eliminated (value of 1.01 at February 2004). For supply licensee Eastern, (also within the Powergen supply group), the value has increased to 1.08 (from 1.05 in October 2000). For Norweb, the value has increased recently, but still remains below the level at October 2000 (value is now 1.10 compared to 1.12)

- for London and SWEB (EDF group), the value has increased steadily since October 2000. For London, the value has increased from 1.01 to 1.09, and for Seeboard from 1.05 to 1.17. This differs from the trends seen with present

npower and Powergen supply licensees, where values are falling for four of the six supply businesses

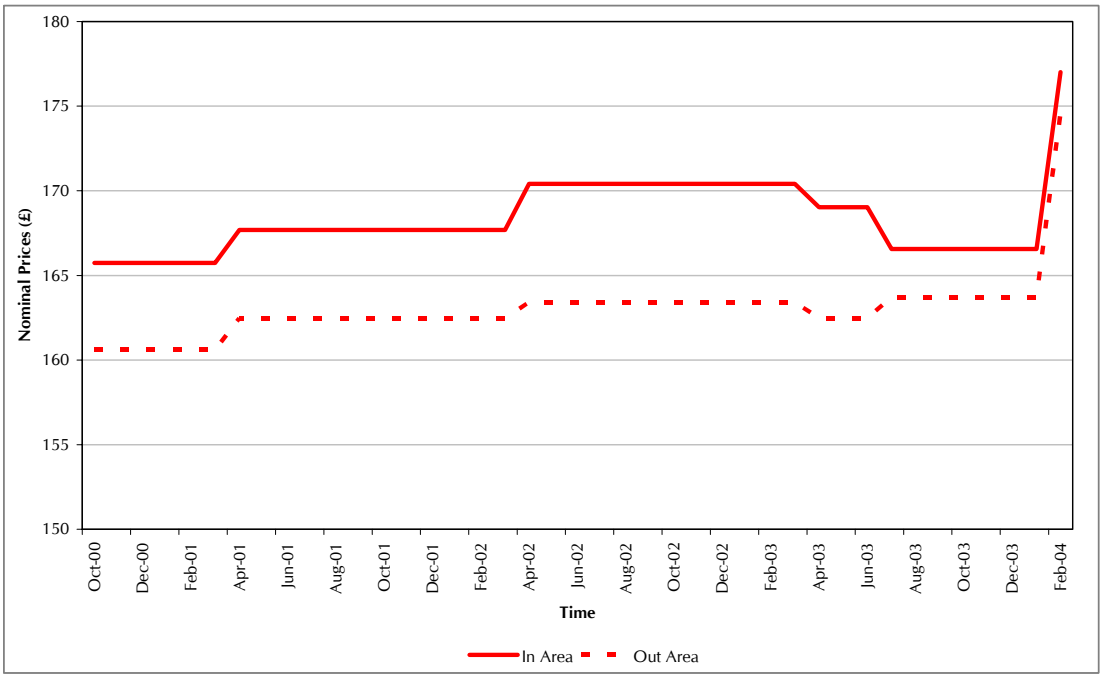
- for licensees within the SSE group, the value is fairly stable for Southern, falling for Scottish Hydro, and increasing for SWALEC, which has one of the highest two-tier price values, and

- ScottishPower/Manweb has increased its two-tier ratio since October 2000 and now has the highest ratio of any supplier (1.14 in October 2000 to 1.24 in February 2004).

4.66. Changes in the ratio are being driven by changes to the levels of both in-area and out-of-area prices. To illustrate this, Figures 4.6 and 4.7 show how two suppliers' in-area and out-of-area prices have changed since October 2000[15]. Figure 4.6 illustrates how the decrease in the two-tier differential for Powergen (East Midlands) has resulted from a reduction in in-area prices and an increase in out-of-area prices between April 2002 until recently, when both in-area and out-of-area prices were increased. Figure 4.7 illustrates how EDF (London) has raised in-area prices and lowered out-of area prices, thereby increasing its two-tier pricing differential.

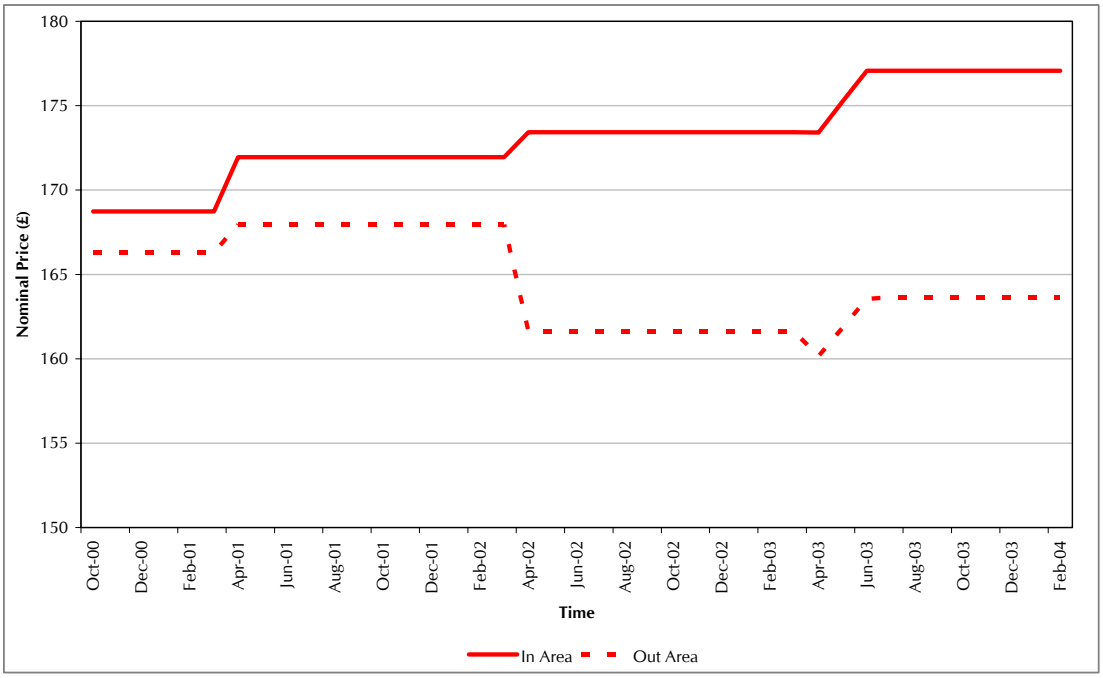
[15] The examples here have been chosen for their illustrative value and not because Ofgem has any particular regulatory interest in these suppliers.

Figure 4.6: Powergen (East Midlands) - In-area and out-of-area nominal direct debit prices movements



Source: Ofgem

Figure 4.7: EDF Energy (London) - In-area and out-of-area nominal direct debit prices movements



Source: Ofgem

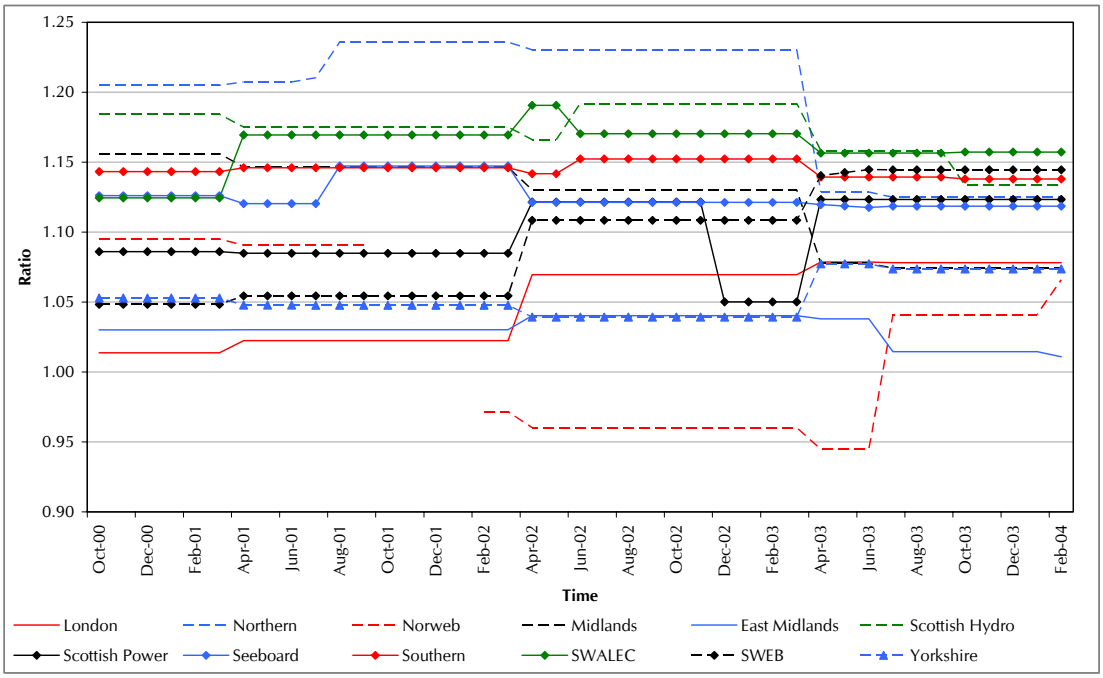
4.67. These figures illustrate how suppliers are making discretionary changes to both in-area and out-of-area prices (which are driving changes in pricing ratios).

4.68. It is also important to note that the withdrawal of certain supplier tariffs for new business after mergers and acquisitions will also change some pricing ratios.

Standard credit

4.69. Figure 4.8 illustrates the differential of the average standard credit in-area price compared to the average standard credit out-of-area nominal prices for each ex-PES from October 2000 to February 2004.

Figure 4.8: Two-tier pricing: nominal standard credit prices, excluding TNUoS and DUoS charges, October 2000 to February 2004



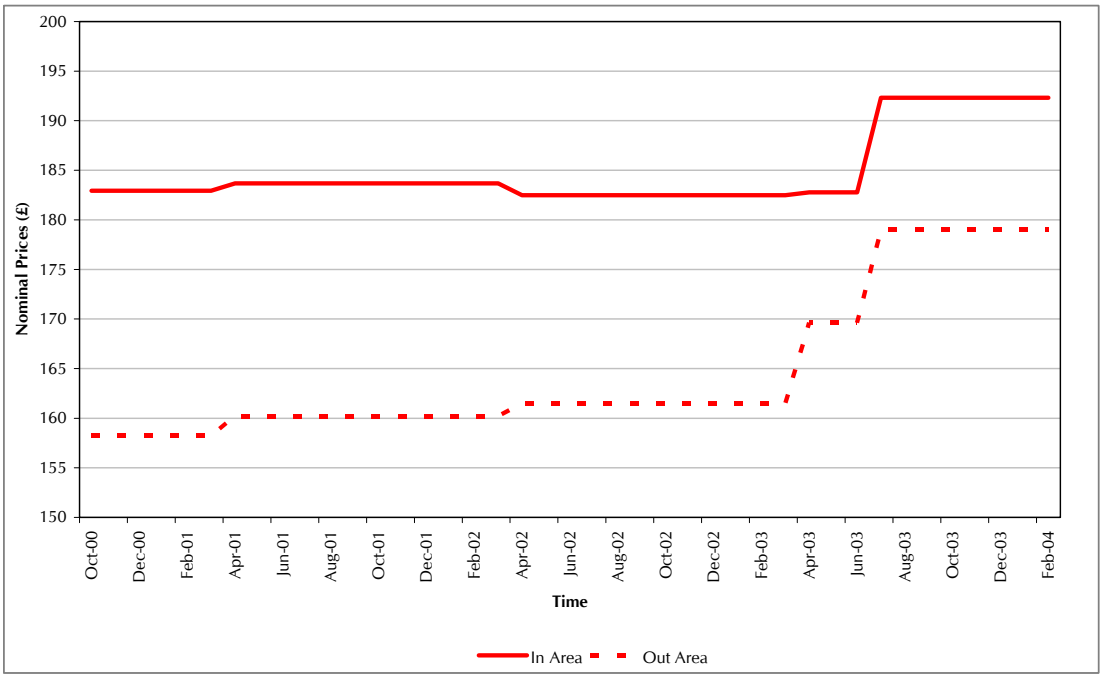
Source: Ofgem

4.70. The pattern of two-tier pricing is similar to direct debit, with most suppliers charging more in-area than out-of-area.

4.71. As with direct debit prices, npower and Powergen appear to be reducing the differential between in-area and out-of-area prices for some of their ex-PES supply businesses, with the differential eliminated for the East Midlands supply business. EDF Energy and ScottishPower/Manweb appear to be increasing the differential.

4.72. Figure 4.9 illustrates how npower has raised out-of-area and in-area prices.

Figure 4.9: npower (Midlands) - In-area and out-of-area nominal standard credit prices movements

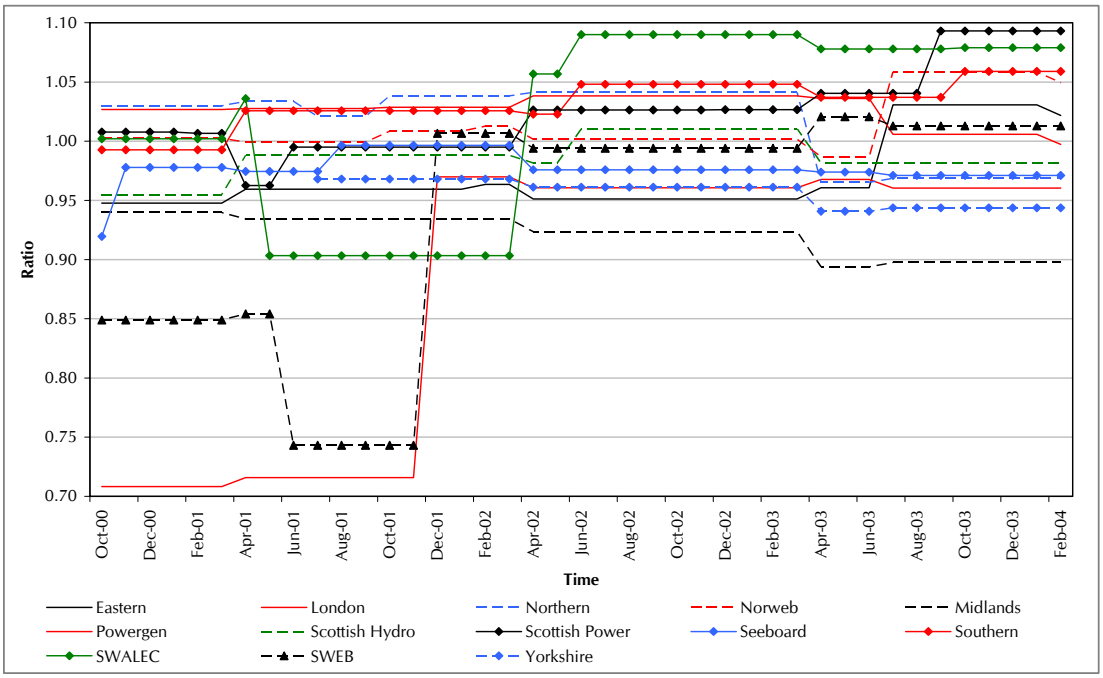


Source: Ofgem

Prepayment

4.73. Figure 4.10 illustrates the in-area and out-of-area differential for prepayment.

Figure 4.10: Two-tier pricing: nominal prepayment prices, excluding TNUoS and DUoS charges, October 2000 to February 2004



Source: Ofgem

4.74. For prepayment, the pricing pattern is reversed, with many suppliers pricing lower in-area than out-of-area, resulting in seven suppliers' in/out-of-area pricing differentials below one. For those remaining six suppliers that do price lower out-of-area, the ratio of prices is significantly less than for suppliers' two-tier pricing differentials for both standard credit and direct debit payment methods. Key observations include:

- London/SWEB prices were almost 30 per cent more out-of-area until December 2001 when the differential narrowed significantly
- Powergen prices are 11 per cent lower for prepayment customers in the East Midlands region than out-of-area (value of 0.89), but charges are one per cent and six per cent higher in the Eastern and Norweb regions respectively, compared to out-of-area, and
- ScottishPower/Manweb did not price differentially price at October 2000, but now prices 12 per cent higher in-area than out-of-area (half the differential for direct debit of 24 per cent).

Summary

4.75. A chief concern with two-tier pricing outlined at the beginning of this section was that it penalised customers who remain with their ex-PES compared to newly acquired customers out-of-area, who benefit from lower out-of-area prices.

4.76. The analysis presented in the chapter shows that two-tier pricing is far more varied in its incidence and extent than is often implied:

- for direct debit and standard credit payment methods, suppliers continue to charge higher prices in-area than out-of-area, with significant variation in the extent of the differential (in-area prices range from one per cent to 21 per cent higher than out-of-area prices at February 2004)
- prepayment prices are less in-area than out-of-area for seven suppliers. Where suppliers (six) price higher in-area than out-of-area the extent of the differential is considerably less than for direct debit and standard credit

(differential range of one per cent to 21 per cent for direct debit, compared to one per cent to 10 per cent for prepayment)

- players with national brands (eg npower and Powergen) use two-tier pricing to a lesser extent than regional players such as SSE and EDF Energy, who have tended to emphasise their regional brand association, and

- the reasons for changes in two-tier differentials are varied, being driven by suppliers changing both in-area and out-of-area prices, as well as through consolidation.

4.77. In general any domestic electricity customer who pays by standard credit or direct debit and has chosen to stay with (or switched back to) their ex-PES, continues to pay a higher price than someone being supplied by that same supplier out-of-area. There are several possible interpretations of this result.

4.78. One explanation for this finding is that suppliers may be pricing according to the way in which they allocate costs. Two-tier pricing could therefore be a result of suppliers allocating more common or joint costs to in-area customers. However, it is not obvious how supplier acquisition or other costs could differ between in-area and out-of-area customers to the extent implied in two-tier pricing differentials for direct debit and standard credit.

4.79. Another possible interpretation is that suppliers are charging whatever they consider the market will bear. For instance, suppliers may be able to load sunk costs such as out-of-the-money independent power purchase agreements signed with independent power producers (IPPs) onto in-area customers. While many of the contracts will have been written off or renegotiated, suppliers may continue to recover the historic costs of these agreements. It could be argued that customer inertia may be placing a weaker restraint on suppliers' ability to pass sunk costs on to in-area customers.

4.80. One further explanation may be that suppliers engaged in two-tier pricing could be trading off greater per customer revenue from higher in-area prices against the loss of revenue from higher in-area customer losses. This would mean that in-area prices will be higher than out-of-area prices until the number of switchers

in-area makes the loss of revenue from customer attrition greater than the increase in per customer revenue from the higher price[16].

4.81. For prepayment customers, in-area customers may pay less than out-of-area customer for two reasons. It may be that the costs of serving prepayment customers out-of-area exceeds that for in-area customers. This could be due to the cost to suppliers of having to enter into different prepayment infrastructure charges across the other supply services areas. However, all suppliers must enter into the same agreements for these services and six suppliers do offer prices that are lower than the ex-PES.

4.82. A second reason may be that suppliers are less interested in pricing aggressively to obtain prepayment customers, preferring instead to offer uncompetitive prices out-of-area.

4.83. Ofgem considers that customers who switch will necessarily gain a larger share of the benefits of supply competition than non-switchers. Ofgem considers that in the transition from monopoly to mature competition, this difference in the share of benefits, reflected in the two-tier price, provides for the dynamic incentive for customers to switch away from their ex-PES. It may be indicative of suppliers' different competitive approaches, either through building a national brand or because customer losses are reaching a point where suppliers' in-area pricing strategies have to change.

4.84. For prepayment customers, the fact that many suppliers price less in-area than out-of-area could be evidence of fewer suppliers actively competing out-of-area for this customer group. However, some suppliers do offer lower prices than the ex-PES. This suggests that suppliers can price competitively for this customer group. It is possible that the different prepayment infrastructures provided in each ex-PES region are a barrier to expansion for ex-PESs outside their own areas.

4.85. Ofgem will continue to monitor movements in both in-area and out-of-area prices. To help in reducing the costs of supplying prepayment customers, Ofgem

will continue its work on the removal of barriers to innovative metering and will bring forward proposals as part of the distribution price control review.

Analysis of price savings available

4.86. This section identifies how suppliers' discounts differ across payment type, region, and consumption level.

Dual fuel prices

4.87. Ofgem's analysis begins by examining dual fuel offerings. It focuses on dual fuel savings available to customers who are currently with BGT for gas and their ex-PES for electricity (ie those who have yet to switch either gas or electricity). Savings relative to this 'double incumbent' supplier are presented for the East Midlands. East Midlands is representative of the results which appear across most of the 14 supply services areas in dual fuel direct debit and standard credit (see Appendix 7 for a detailed illustration of savings available across all 14 supply service areas)[17]. This review does not consider dual fuel offers for prepayment customers because suppliers do not generally target specific dual fuel offers towards these customers.

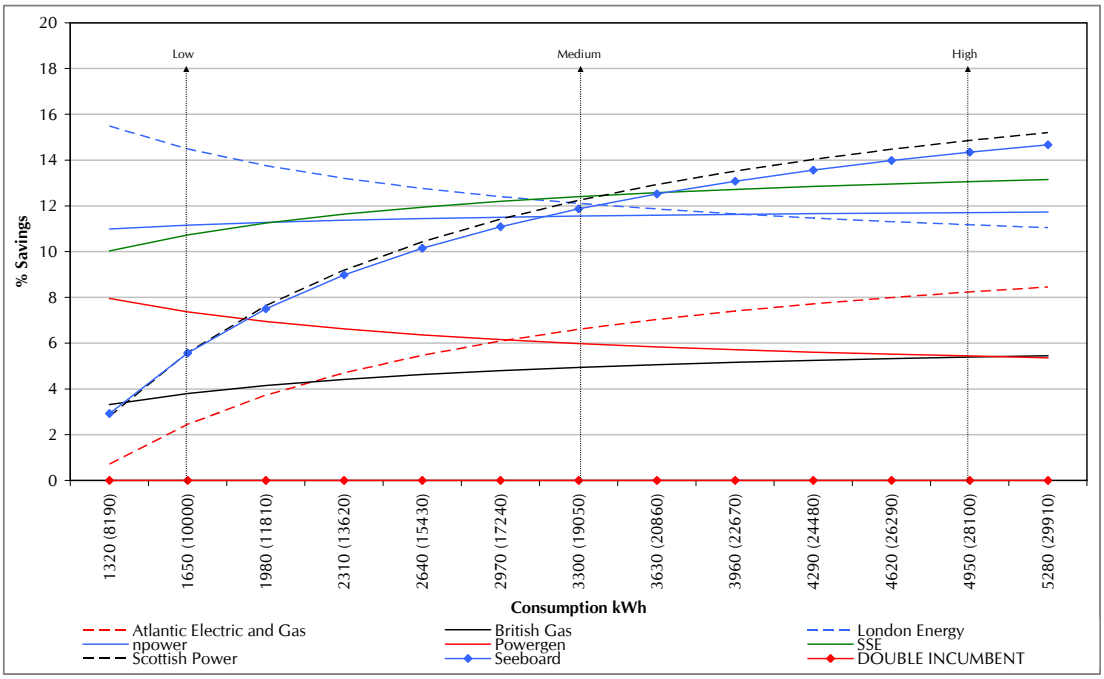
4.88. Figure 4.11 illustrates direct debit dual fuel savings in the East Midlands region. Note that the consumption scales for gas and electricity are aligned (eg the medium consumption levels (19050kWh in gas/3300 kWh in electricity) are aligned at the same point on the graph). The figure illustrates that the double incumbent bill is the most expensive, with all other dual fuel offers representing a saving to the double incumbent.

4.89. Of the suppliers offering dual fuel in the East Midlands region, BGT is the most expensive, with the highest dual fuel price and lowest saving relative to the double incumbent for customers on medium consumption.

4.90. The incumbent ex-PES, Powergen, also represents among the lowest savings possible in the East Midlands region at medium and high consumption levels.

[17] The examples here have been chosen for their illustrative value and not because Ofgem has any particular regulatory interest in these suppliers.

Figure 4.11: Direct debit dual fuel savings in East Midlands, February 2004



Source: Ofgem

4.91. Table 4.3 illustrates that the range of percentage savings nationally does not differ significantly across consumption or supply services area.

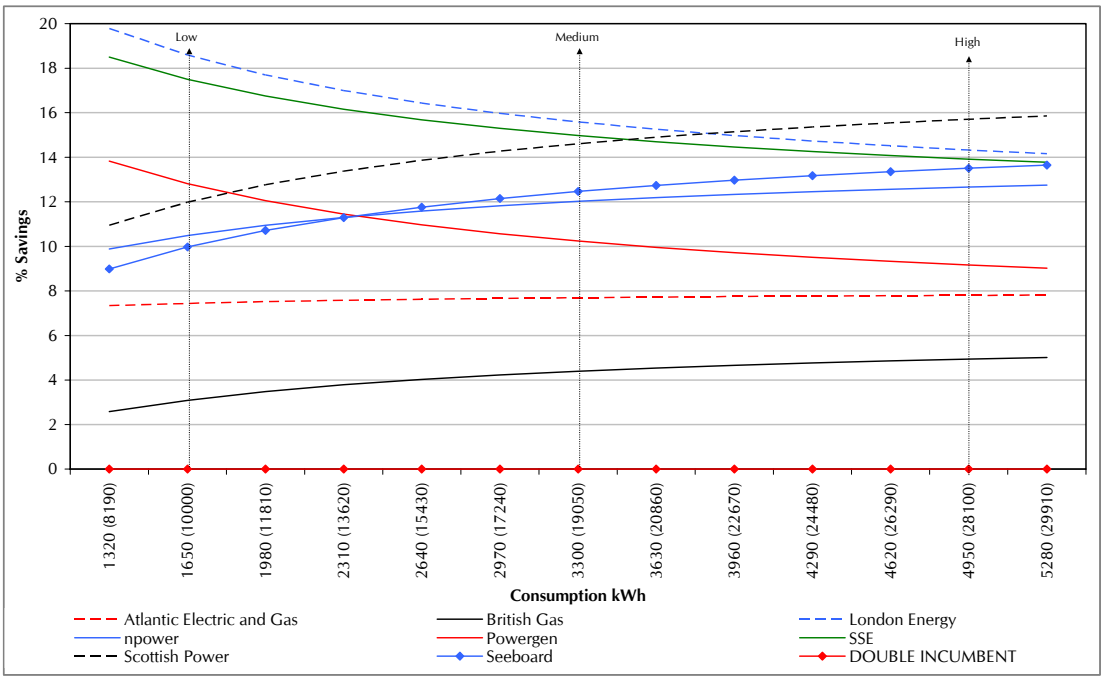
Table 4.3: Dual fuel direct debit savings across Great Britain analysis – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	0-14	36-61	0-4	11-18	4-11	6-9
Medium	14-30	67-98	2-5	11-17	8-12	7-9
High	20-46	107-157	2-5	13-18	7-12	7-9

Source: Ofgem

4.92. Figure 4.12 illustrates a similar pattern of pricing discounts for standard credit (see Appendix 7 for presentation of results for all 14 supply services areas). Again all suppliers offer dual fuel price that represent a saving relative to the double incumbent.

Figure 4.12: Standard credit dual fuel savings in East Midlands, February 2004



Source: Ofgem

4.93. Table 4.4 identifies a summary of savings available across all 14 supply services areas.

Table 4.4: Dual fuel standard credit savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	1-23	56-89	0-6	15-22	8-13	7-9
Medium	12-35	79-126	2-5	13-20	10-13	7-9
High	19-47	121-178	2-5	14-19	10-13	7-9

Source: Ofgem

4.94. Table 4.4 illustrates how the range of minimum, maximum and median percentage savings compared to the double incumbent do not differ significantly by low, medium and high consumption levels, nor across the 14 supply services areas. These savings are slightly higher for standard credit than for direct debit.

4.95. An inspection of the detailed savings indicates that BGT is the most expensive dual fuel supplier at low, medium and high consumption levels in at least 12 out of 14 regions.

Summary

4.96. The evidence on savings for dual fuel customers on direct debit and standard credit suggests that customers who remain with BGT for gas and their ex-PES for electricity can make sizeable savings from switching to a dual fuel supplier. Median savings at medium consumption are 8 to 12 per cent for direct debit customers and 10 to 13 per cent for standard credit customers. Maximum savings at medium consumption are 11 to 17 per cent for direct debit customers and 13 to 20 per cent for standard credit customers.

4.97. Interestingly, BGT (which has 44 per cent of all dual fuel customers) consistently offers the most expensive dual fuel price at medium and high consumption levels (in at least 9 out of 14 areas) for direct debit and at all consumption levels (in at least 12 out of 14 areas) for standard credit. Although BGT still represents a saving for first time switchers, its dual fuel price represents the least best saving in these regions.

4.98. A key policy question is therefore why almost half of all dual fuel customers are currently with the supplier offering one of the most expensive dual fuel prices, when customer survey results suggest that price, rather than brand or reputation, is the key driver for switching.

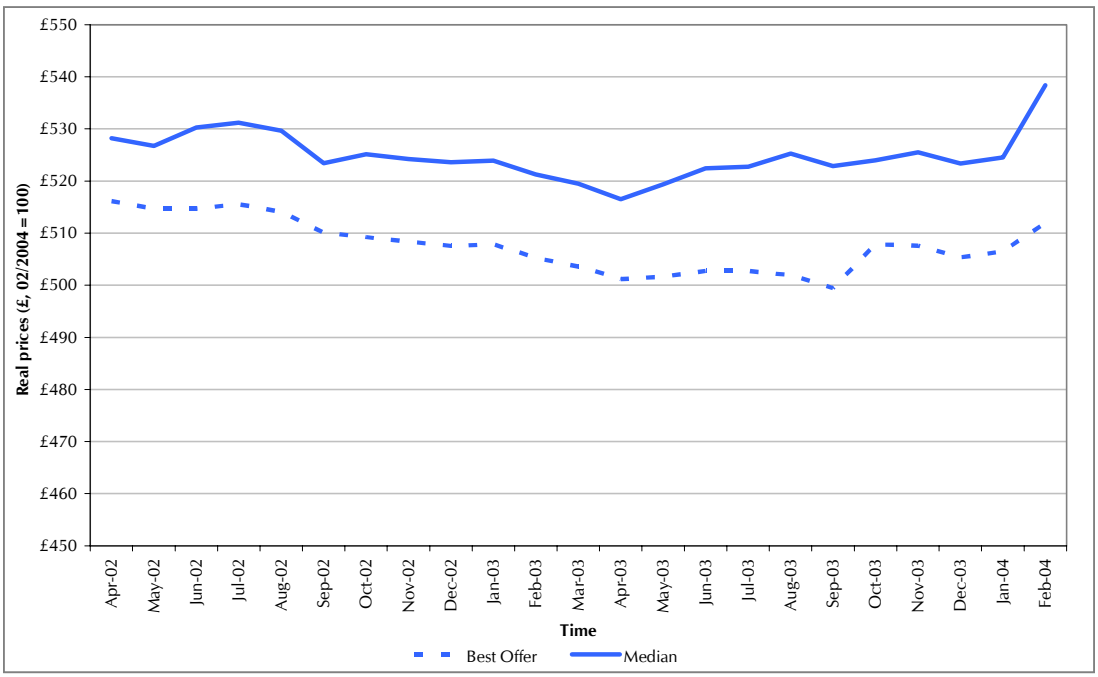
4.99. Reasons may include:

- customers may value the BGT brand and reputation, as reflected in the 'fixed effects' observed in Chapter 3
- customers are concerned with making a saving, but are less concerned with the extent of those savings, and
- customers are reactive in their switching decisions and take the first saving offered. To the extent that BGT may have been more prolific in doorstep selling, it may simply have been the first supplier to doorstep a majority of prospective dual fuel customers, without having to offer the cheapest prices.

4.100. Figure 4.13 illustrates real price trends for dual fuel direct debit customers since April 2002. The trends show real prices falling between 2002 and 2003, and then increasing more recently, with prices increasing in real terms by six per cent for median bills and one per cent for best offer bills. Real increases in

component gas and electricity prices are the key drivers of this increase (ie not a reduction in the dual fuel discount, where available).

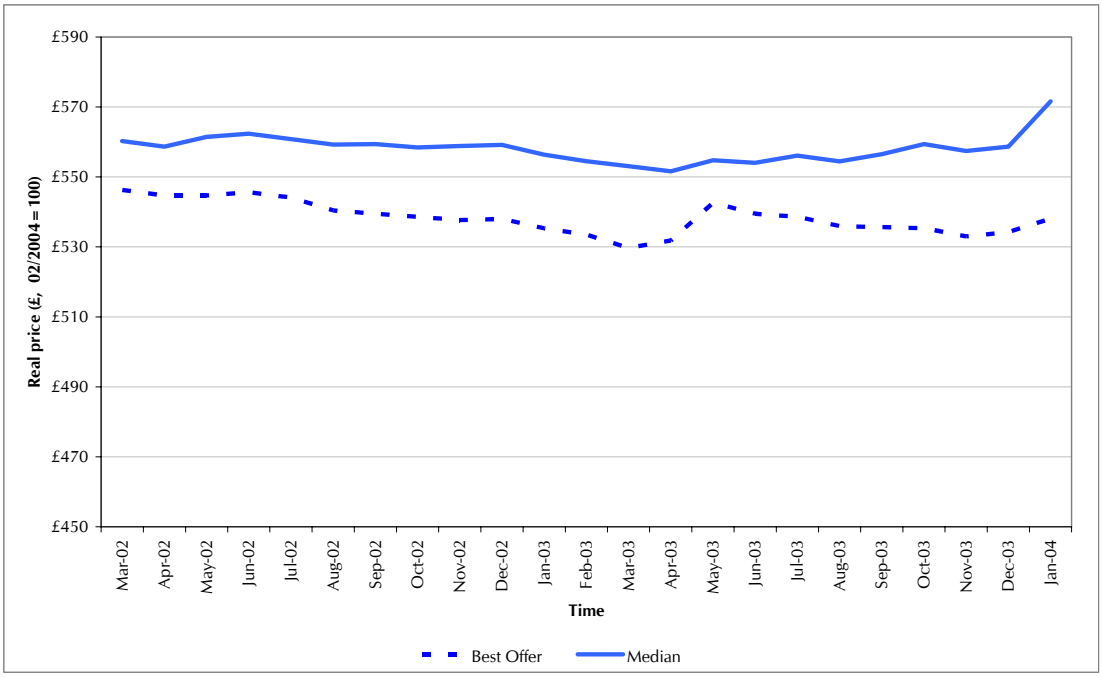
Figure 4.13: Dual fuel direct debit prices (April 2002 – February 2004)



Source: Ofgem

4.101. Figure 4.14 illustrates a similar pattern for dual fuel standard credit prices.

Figure 4.14: Dual fuel standard credit prices (April 2002 – February 2004)



Source: Ofgem

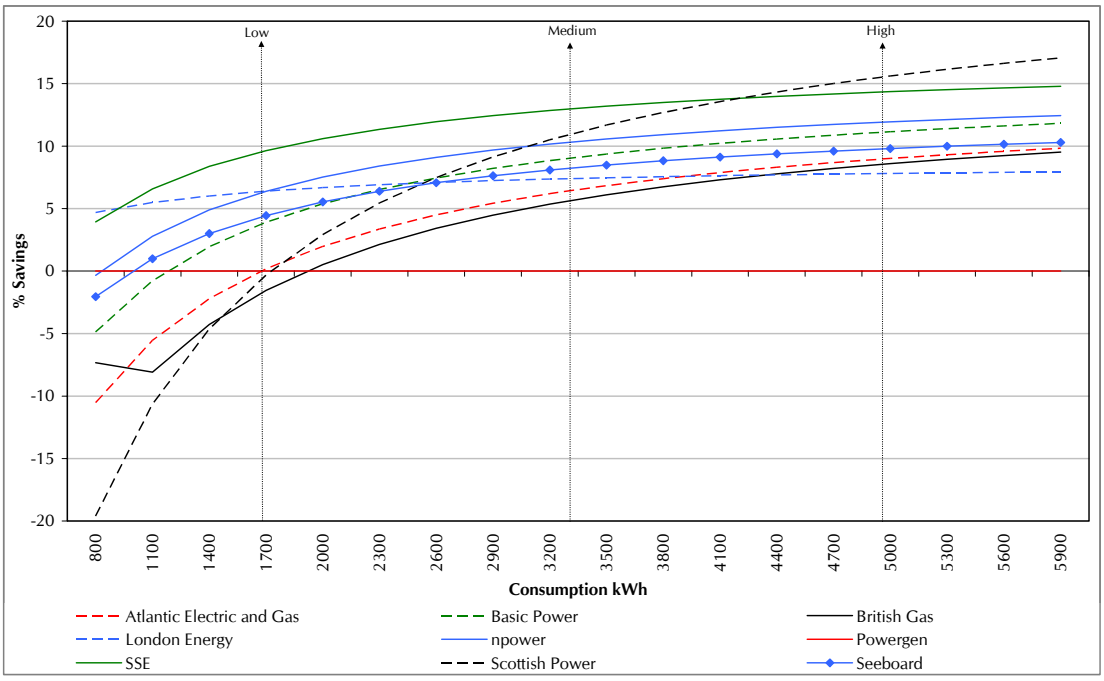
4.102. The trend shows credit prices increasing in real terms by nine per cent for median bills and two per cent for best offer bills.

Electricity

Direct debit

4.103. Figure 4.15 illustrates savings available for a single fuel electricity customer in the East Midlands region, relative to the ex-PES (Powergen)[18] (see Appendix 8 for presentation of results for all 14 supply services areas). Discounts relative to the ex-PES increase in percentage terms as consumption rises, with maximum savings of 9 per cent at low consumption and 16 per cent at high consumption. At low consumption the number of suppliers offering lower prices than the incumbent falls from eight to five.

Figure 4.15: Direct debit savings in East Midlands, February 2004



Source: Ofgem

4.104. Table 4.5 summarises electricity direct debit savings for Great Britain (see Appendix 8 for detailed tabled regional results).

[18] The examples here have been chosen for their illustrative value and not because Ofgem has any particular regulatory interest in these suppliers.

Table 4.5: Electricity direct debit savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	1-6	4-25	0-5	4-16	2-10	1-8
Medium	1-15	19-45	0-6	8-18	3-13	5-8
High	1-30	30-81	0-8	8-22	4-12	7-8

Source: Ofgem

4.105. Table 4.5 illustrates direct debit savings available in electricity. The results indicate that:

- at medium and high consumption, customers can choose from between five and eight suppliers offering cheaper prices
- at low consumption, there is a wide range in the number of suppliers offering savings relative to the incumbent, with only one or two suppliers offering cheaper prices in some areas (eg Midlands, Northern, London), contrasted with eight suppliers offering cheaper prices in other areas (eg Eastern, Scottish Hydro, Norweb and Southern areas)
- at medium consumption, maximum savings (ranging from 8 to 18 per cent) have remained broadly at the same level as in May 2003[19] (ranging from 9 to 17 per cent), and
- at medium consumption, the number of suppliers offering discounts has fallen from between 10 and 11 in May 2003 to between five and eight in February 2004. This latter result partly reflects consolidation which removes TXU and Amerada prices from the savings analysis[20].

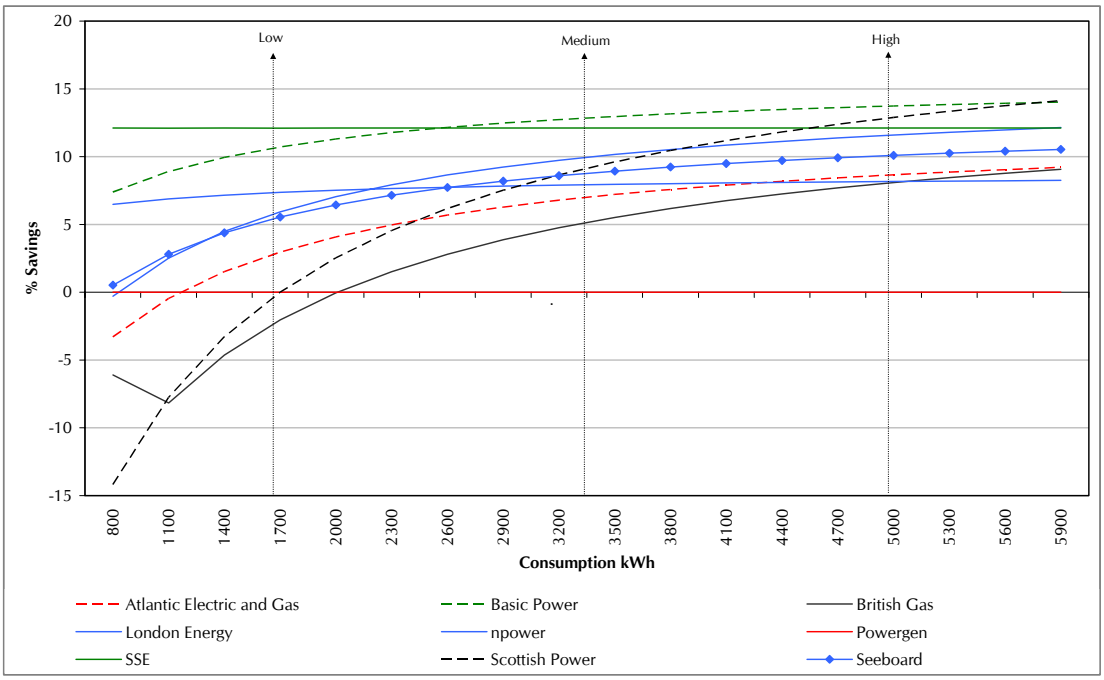
Standard Credit

4.106. Figure 4.16 illustrates savings available for standard credit customers in the East Midlands region (see Appendix 8 for presentation of results for all 14 supply services areas). A similar pattern emerges to that in direct debit, with percentage savings typically increasing with consumption (eg with savings of up to 12 per cent at low consumption and up to 14 per cent at high consumption). At low

[19] In Ofgem's Recent Developments document.

consumption, the number of suppliers offering lower prices than the incumbent falls from eight to six.

Figure 4.16: Standard credit savings in East Midlands, February 2004



Source: Ofgem

4.107. Table 4.6 summarises electricity standard credit savings for Great Britain (see Appendix 8 for detailed tabled regional results).

Table 4.6: Electricity credit savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	0-8	8-24	0-6	6-15	4-9	1-8
Medium	0-13	20-47	0-5	8-18	4-10	5-8
High	4-29	28-80	1-8	8-21	5-12	6-8

Source: Ofgem

4.108. The results indicate that:

- the range of maximum and median percentage savings are broadly equivalent to those for direct debit

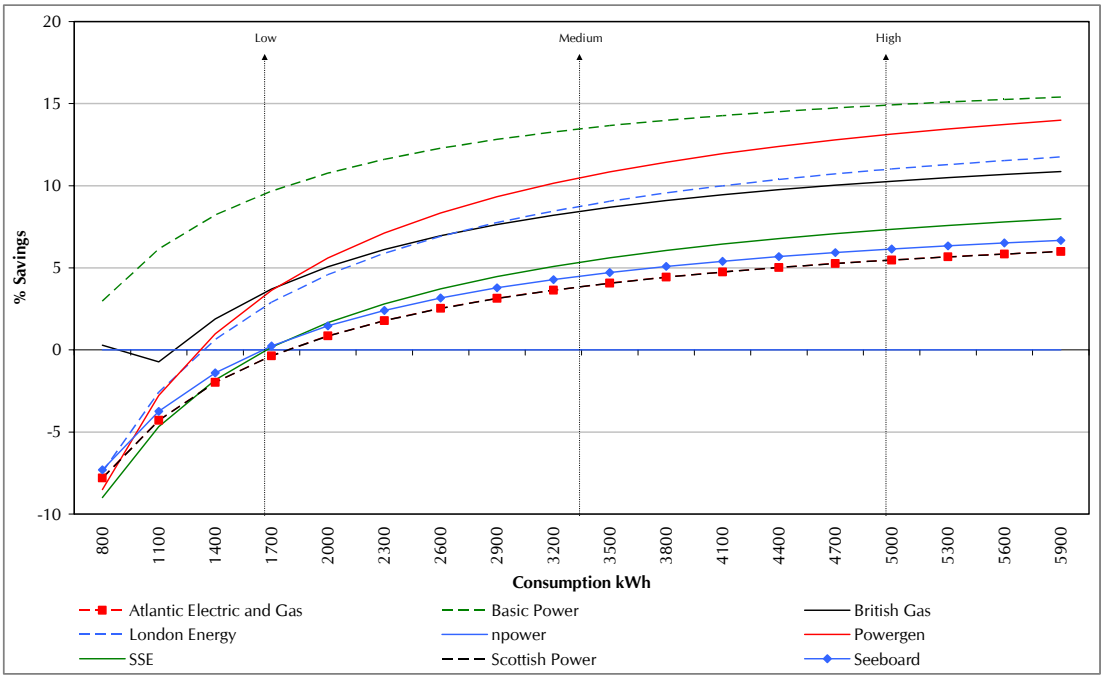
[20] For previous savings analysis, see Ofgem's Recent Development's paper.

- at medium consumption, maximum savings (range of 8 to 18 per cent) remain at similar levels to those at May 2003 (range of 9 to 16 per cent), and
- at medium consumption the number of suppliers offering cheaper prices has fallen to a range of 5 to 8 suppliers, depending on locality, compared to May 2003 (between 9 and 11 suppliers offered cheaper prices).

Prepayment

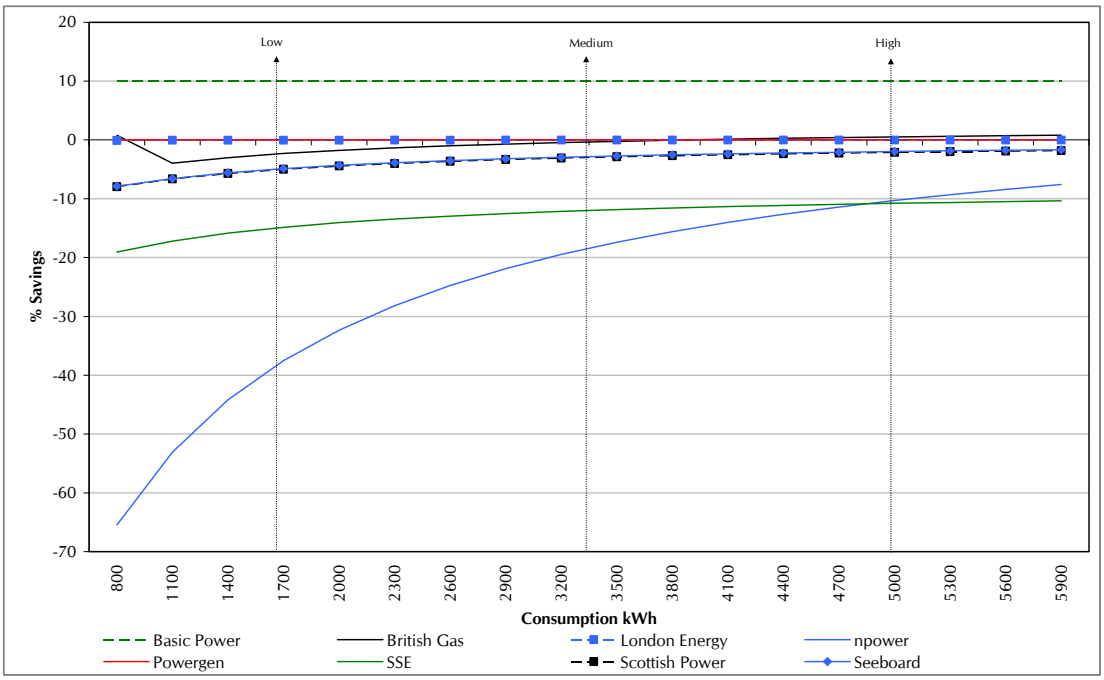
4.109. The picture varies for prepayment customers, across consumption and by region, with many suppliers charging higher prices than the ex-PES. Only Basic Power consistently prices below the incumbent for all consumption levels. Unlike direct debit and standard credit, however, the pattern of prepayment savings varies significantly by region. For instance, in the Midlands region, where npower is the incumbent supplier, it has the most expensive prepayment prices at medium and high consumption. These prepayment customers can make savings between 4 per cent and 13 per cent by switching to another supplier. Prepayment customers with low consumption are offered savings by four suppliers. Savings in East Midlands and Manweb (see figures 4.18 and 4.19) further illustrate the regional variation in savings.

Figure 4.17: Prepayment savings in Midlands, February 2004



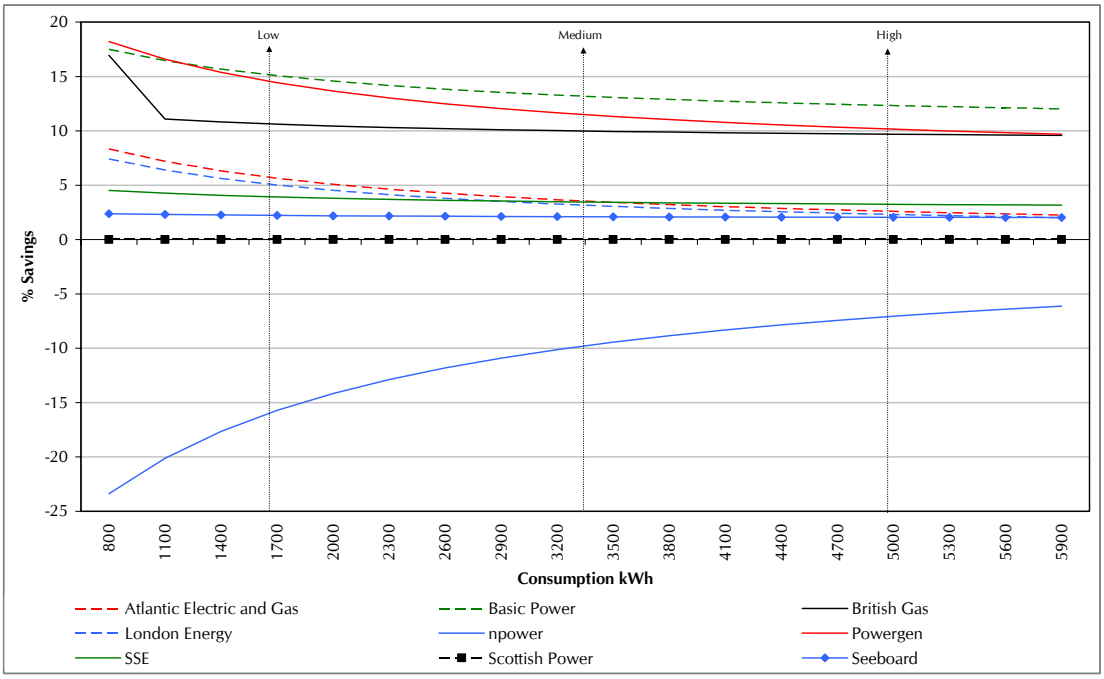
Source: Ofgem

Figure 4.18: Prepayment savings in East Midlands, February 2004



Source: Ofgem

Figure 4.19: Prepayment savings in Manweb, February 2004



Source: Ofgem

4.110. Table 4.7 summarises electricity prepayment savings for Great Britain (see Appendix 8 for detailed tabled regional results).

Table 4.7: Electricity prepayment savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	0-14	13-30	0-10	8-16	0-7	1-8
Medium	0-24	24-42	0-10	9-15	1-8	1-8
High	0-23	34-62	0-6	9-15	0-9	2-8

Source: Ofgem

4.111. The results indicate that:

- median savings from switching are lower than for direct debit and standard credit.
- maximum savings are comparable to direct debit and standard credit at low and medium consumption, although at high consumption, the median is lower (maximum of up to 15 per cent compared to 22 and 21 per cent for direct debit and credit, respectively)
- at medium consumption maximum savings (range of 9 to 15 per cent) are at similar levels to those at May 2003 (range of 9 to 12 per cent), and
- the number of suppliers offering cheaper prices lies within a range of one to eight suppliers, depending on locality, compared to May 2003 (between one and 10 suppliers offered cheaper prices).

4.112. The pricing analysis conducted for electricity illustrates three key results:

- customers can make best savings of between £19 and £45 for direct debit, between £20 and £47 for credit and between £24 and £42 for prepayment, depending on locality
- savings (maximum) are comparable to May 2003, and
- the number of suppliers offering cheaper prices than the local ex-PES has fallen compared to May 2003. This partly reflects consolidation activity that has seen former TXU and Amerada prices rebranded within the Powergen group.

4.113. The results suggest that customers can continue to make savings across all payment types and at low, medium and high consumption levels. However:

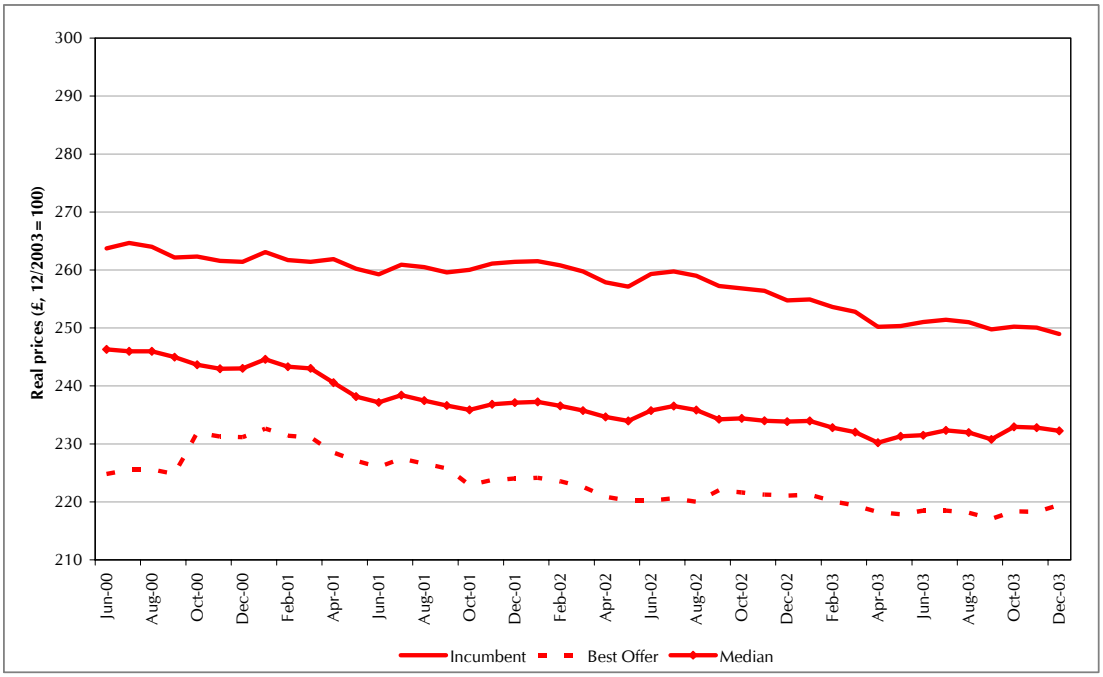
- customers on all payment types at low (and particularly very low) consumption levels need to exercise greater caution when switching, to ensure that they are choosing a cheaper supplier, and

- although prepayment customers can make savings from switching, these savings may not be as large as other payment methods.

4.114. Ofgem will continue to monitor electricity prices to assess the extent to which all electricity customers continue to benefit from domestic electricity supply competition.

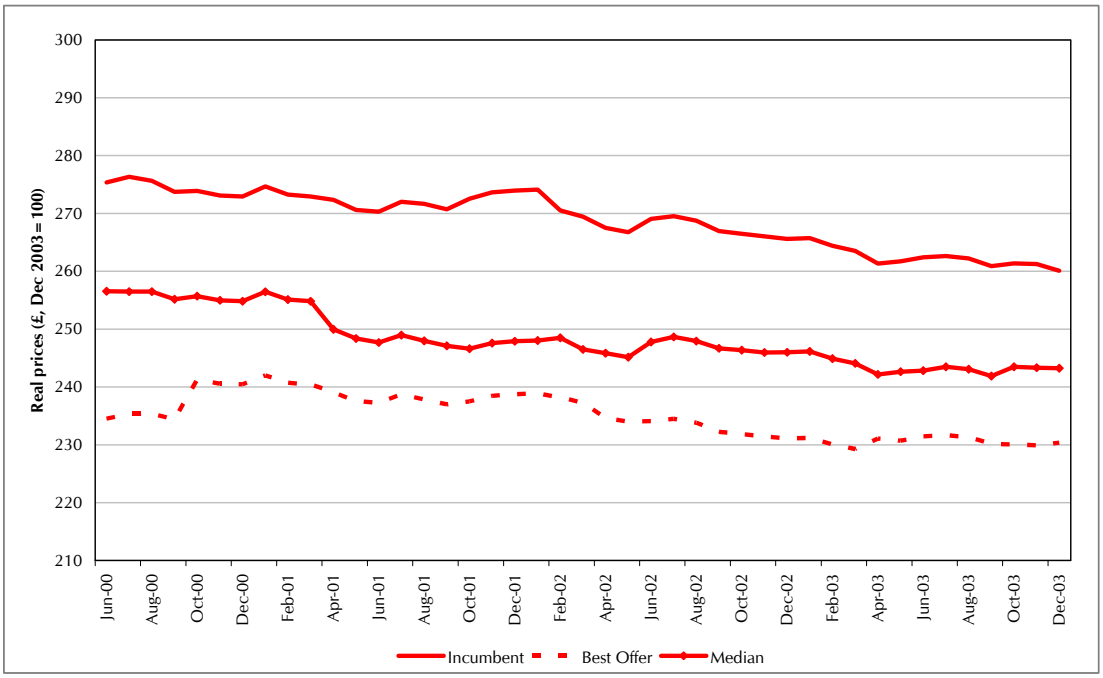
4.115. Figures 4.20-4.23 identifies these trends in aggregated form (ie average prices for Great Britain) since June 2000.

Figure 4.20: Trends in incumbent, median and best electricity prices, direct debit, medium consumption (June 2000 - December 2003)



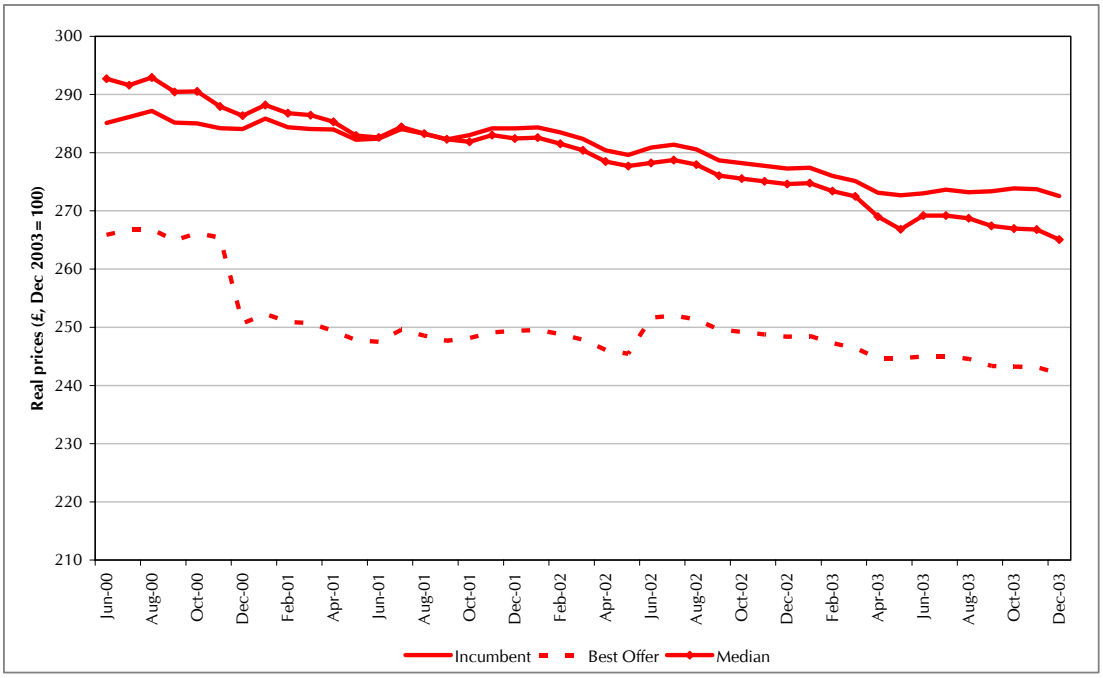
Source: Ofgem

Figure 4.21: Trends in incumbent, median and best electricity prices, standard credit, medium consumption (June 2000 - December 2003)



Source: Ofgem

Figure 4.22: Trends in incumbent, median and best electricity prices, prepayment, medium consumption (June 2000 – December 2003)



Source: Ofgem

Key points include:

- the discounts available to the incumbent's price appear to have remained stable over time, and

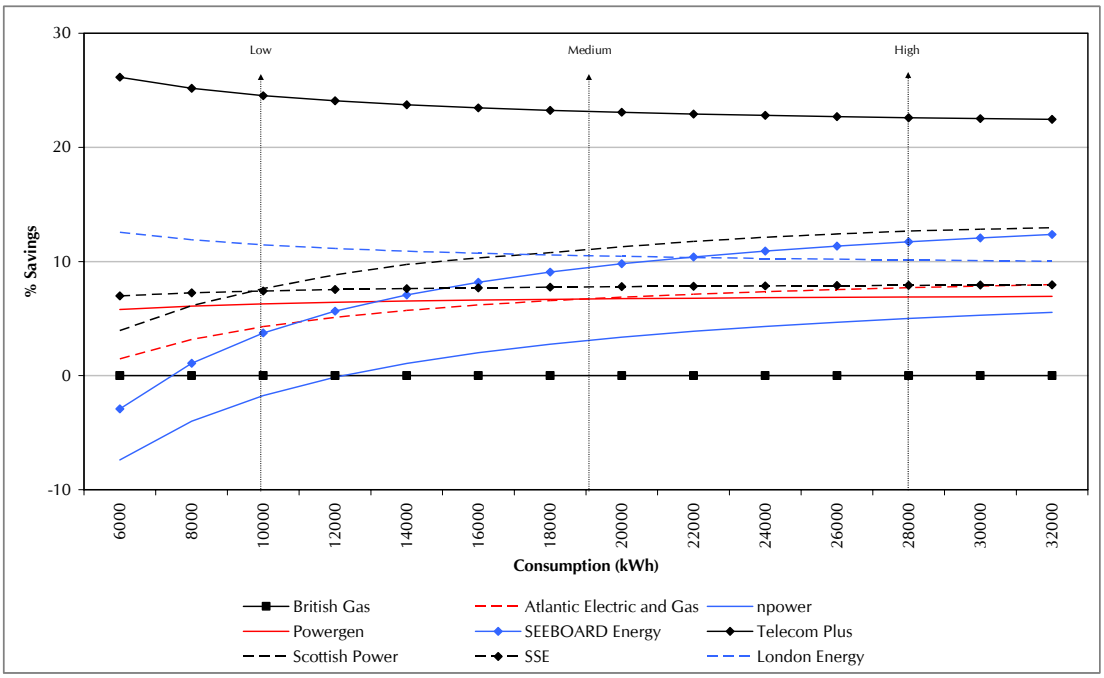
- the average of median regional prepayment prices fell below the average of regional incumbent prices over two years ago. Since then, the median offer has progressively fallen against the incumbent price. This means that although some prepayment customers who did switch before the middle of 2001 may have switched to a more expensive offer, prepayment customers who have switched since are now more likely to be switching to cheaper prices although, as stated in the above analysis, available savings vary by region.

4.116. In summary, the pattern of competitive discounts within payment types is similar across the regions. For prepayment, there are fewer suppliers offering savings than for direct debit and standard credit. Customers on prepayment meters and those with low and very low consumption levels should shop around and not necessarily take the first offer available to them in order to ensure they choose a cheaper supplier.

Pricing analysis in gas

4.117. This chapter has so far considered patterns in pricing for dual fuel and single fuel electricity customers. This section considers pricing patterns in gas. Figure 4.23 illustrates current gas pricing strategies of the suppliers.

Figure 4.23: Gas direct debit savings for Great Britain (February 2004)



Source: Ofgem

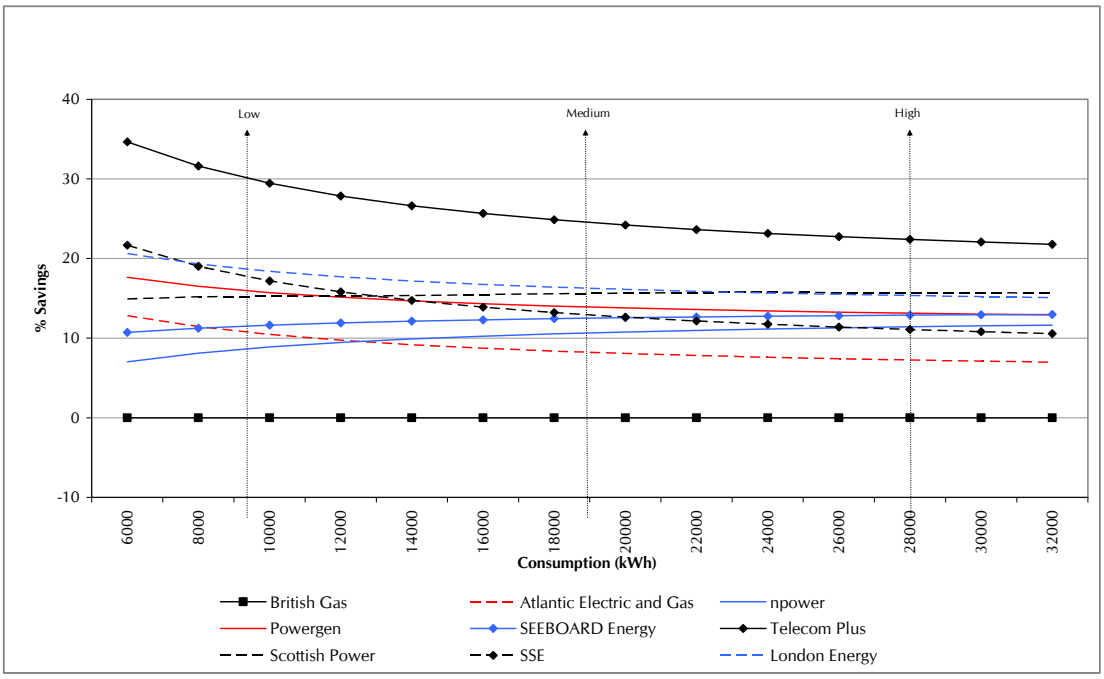
4.118. Table 4.8 illustrates these savings further.

Table 4.8: Gas direct debit savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	7	47	4	25	7	7
Medium	10	78	3	23	9	8
High	24	109	5	23	9	8

Source: Ofgem

Figure 4.24: Gas standard credit savings for Great Britain (February 2004)



Source: Ofgem

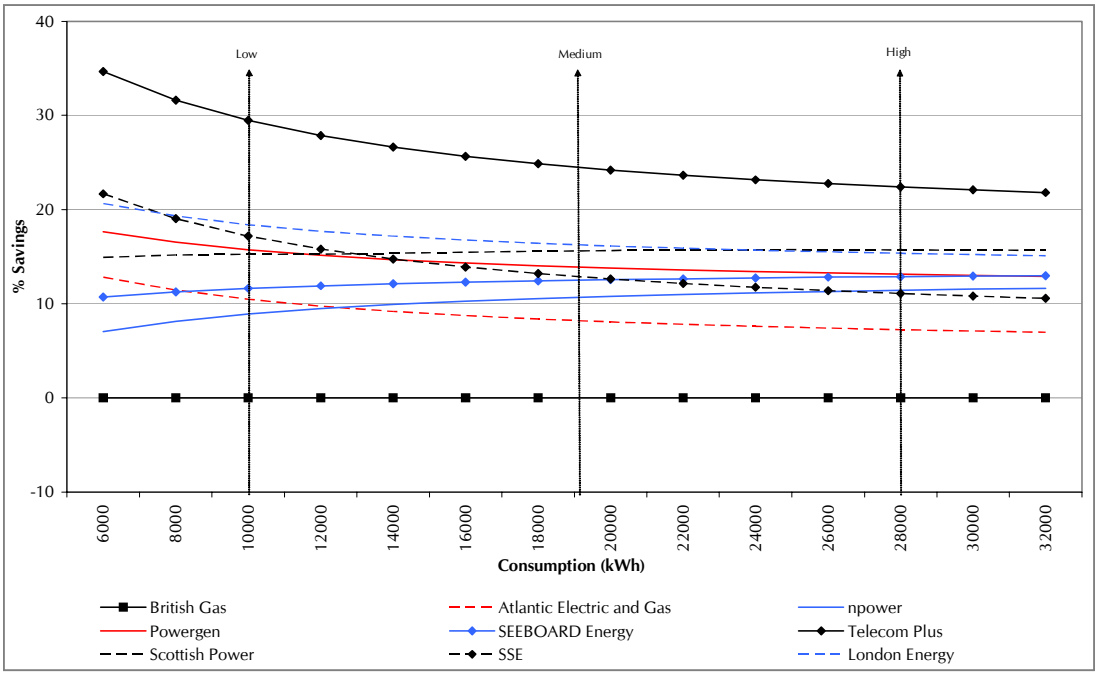
4.119. Table 4.9 further illustrates the savings across Great Britain.

Table 4.9: Gas credit savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving (%)	Number of suppliers offering discount
Low	20	67	9	29	16	8
Medium	31	92	8	25	13	8
High	38	118	7	22	13	8

Source: Ofgem

Figure 4.25: Gas prepayment savings for Great Britain (February 2004)



Source: Ofgem

4.120. Table 4.10 further identifies prepayment savings.

Table 4.10: Gas prepayment savings across Great Britain – February 2004

Consumption	Min saving (£)	Max saving (£)	Min saving (%)	Max saving (%)	Median saving	Number of suppliers offering discount
Low	7	26	3	12	6	6
Medium	2	34	0	10	4	5
High	7	42	1	8	3	4

Source: Ofgem

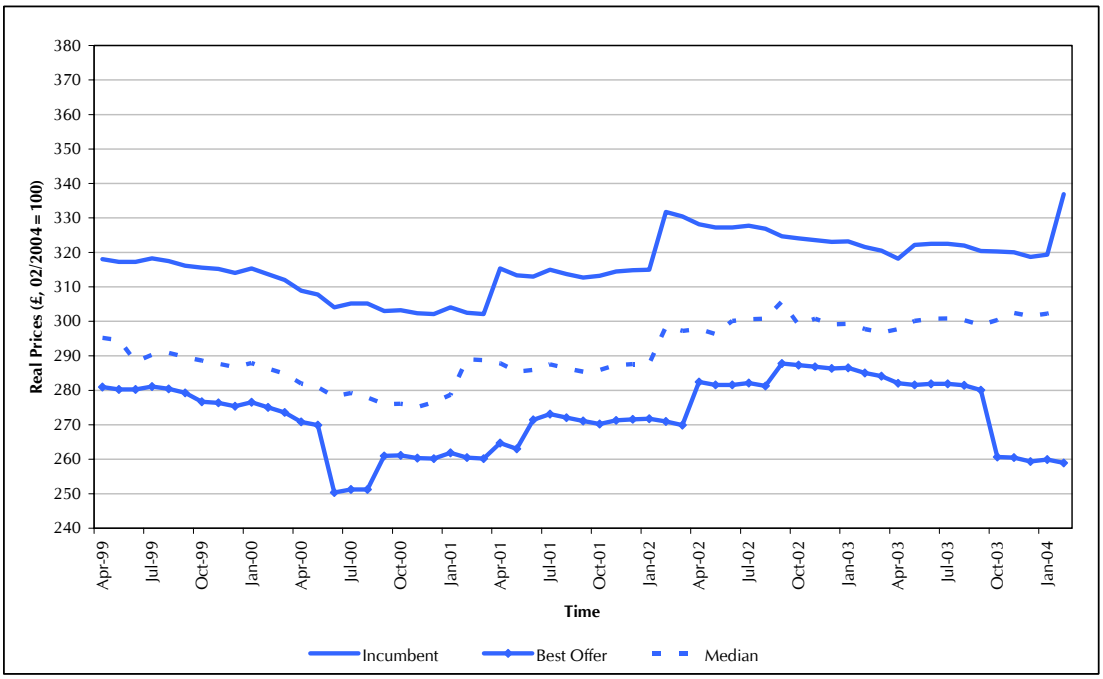
4.121. Key points include:

- all direct debit and standard credit customers can save by switching from BGT. All suppliers are cheaper for standard credit, with most suppliers cheaper for direct debit
- this indicates similar levels of intensity of price competition across consumption levels, and suggests suppliers do not differentiate themselves by targeting particular consumption levels with higher percentage savings, and

- for prepayment customers, the pattern is slightly different - fewer suppliers offer savings relative to the incumbent compared to standard credit or direct debit.

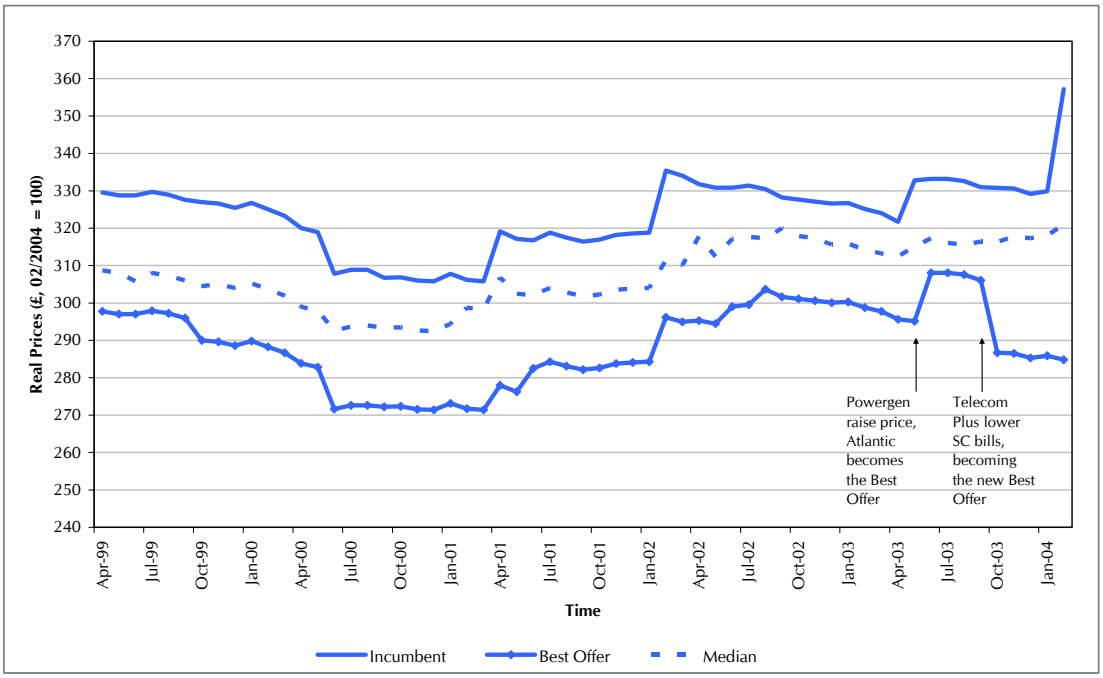
4.122. Figure 4.26 illustrates key pricing differentials over time for gas.

Figure 4.26: Trends in incumbent, median and best gas prices direct debit, medium consumption (April 1999 – December 2003)



Source: Ofgem

Figure 4.27: Trends in incumbent, median and best gas prices standard credit, medium consumption (April 1999 – December 2003)



Source: Ofgem

4.123. Although suppliers' pricing strategies show some consistency over time, there seems to be slightly more variation than in electricity. Recently the difference between the best offer and the incumbent's price has widened. BGT's price increase in January 2004 will further increase this differential.

Differential between prepayment and credit bills

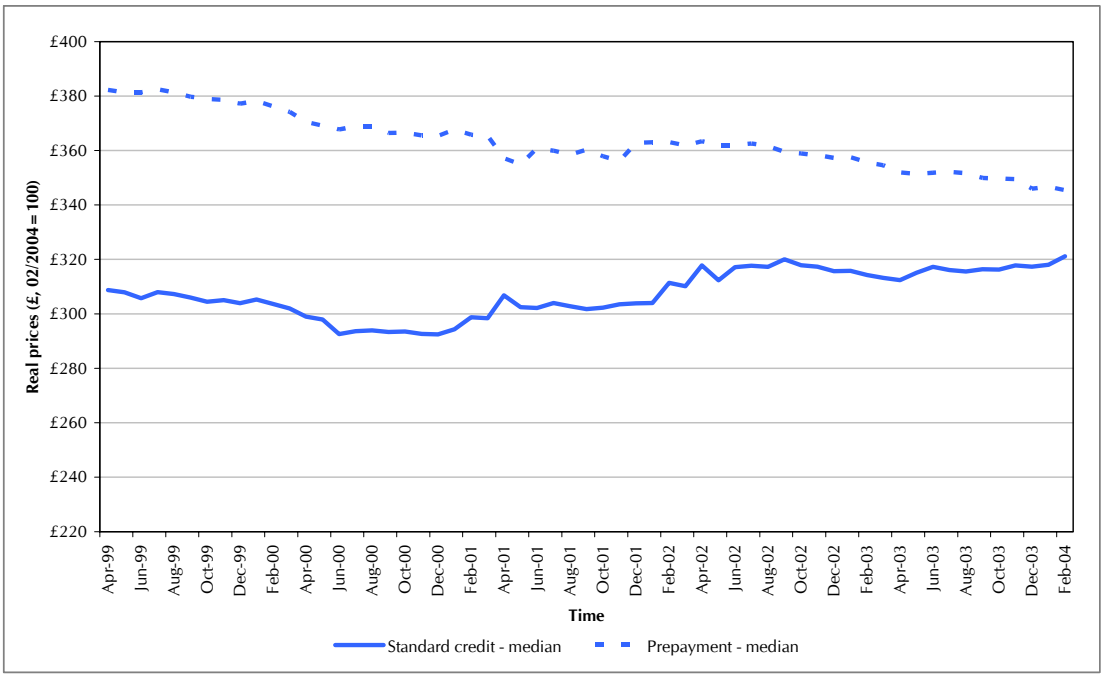
4.124. Prepayment customers tend to pay higher prices than credit customers. One reason for the additional cost is that suppliers incur charges relating to the provision of cards, keys or tokens to operate prepayment meters as well as providing pay points at which customers can place credit on these devices[21]. Another reason is that prepayment meter asset provision costs, including provision and maintenance, are higher than for credit meters.

4.125. The costs of serving prepayment customers may be higher than for credit customers at present. To help in reducing these costs, Ofgem will continue its work on the removal of barriers to innovative metering and will bring forward proposals as part of the distribution price control review.

[21] These charges are referred to as prepayment infrastructure provision charges.

4.126. Figure 4.28 illustrates that the differential between prepayment and credit prices narrowed between April 1999 and February 2004. The differential has also reduced since the removal of domestic retail price controls in April 2002.

Figure 4.29: Gas median prepayment – credit bill differential



Source: Ofgem

4.127. Table 4.11 summarises the above results for median bills.

Table 4.11 Gas median prepayment – credit bill differential

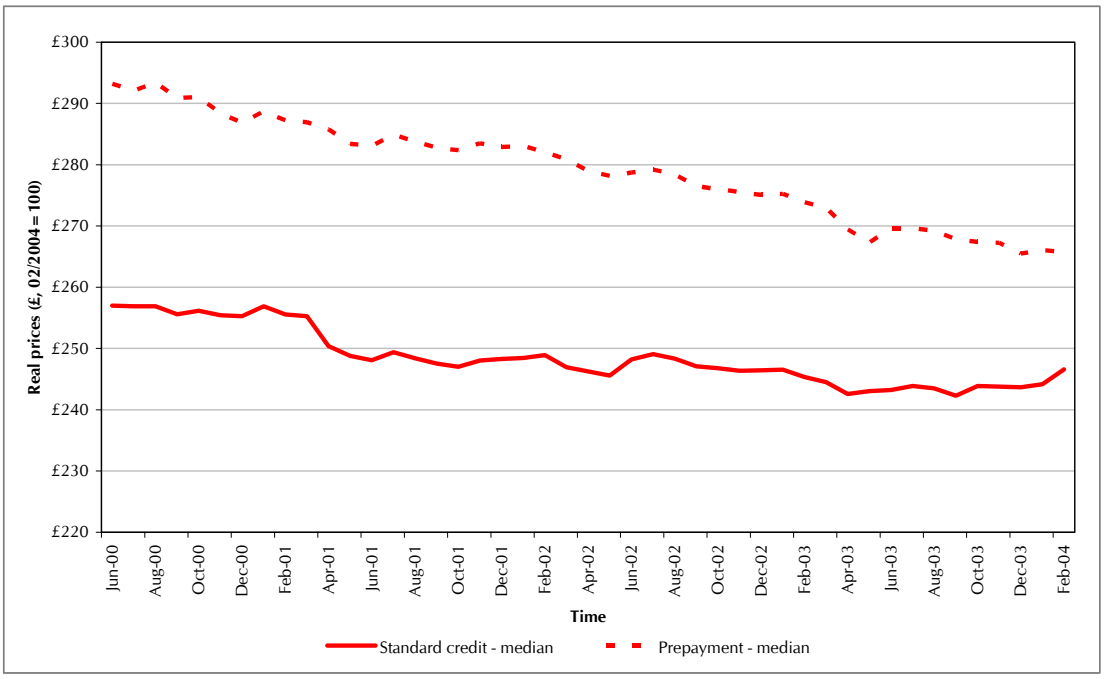
	Price differential (£)	Price differential (%)
April 1999	73.50	24
April 2002	45.61	14
February 2004	25.10	8

Source: Ofgem

4.128. See Appendix 9 for similar results for incumbent and best offer).

4.129. Figure 4.30 illustrates a similar trend in electricity, with the differential between prepayment and standard credit prices narrowing between June 2000 and February 2004. The differential has also reduced since the removal of domestic retail price controls in April 2002.

Figure 4.30: Electricity median prepayment – credit bill differential



Source: Ofgem

4.130. Table 4.12 presents the above results for median bills.

Table 4.12: Electricity median prepayment – credit bill differential

	Price differential(£)	Price differential (%)
June 2000	36.20	14
April 2002	32.70	13
February 2004	19.10	8

Source: Ofgem

4.131. See Appendix 9 for similar results for incumbent and best offer prices.

4.132. For both gas and electricity, the differential has reduced significantly since 1999/2000 and now stands at eight per cent for both fuels.

4.133. In both gas and electricity, the pricing analysis extends to February 2004 and therefore includes recent credit price increases for some suppliers, but does not capture price increases for prepayment customers that will become effective in March 2004. Preliminary analysis suggests that these increases will not materially widen the differential beyond the 9 per cent differential that existed at December 2003.

4.134. Ofgem will continue to monitor the differential between prepayment and credit prices to assess the extent to which prepayment customers continue to share the benefits of supply competition.

Non-price offers

4.135. In addition to a wide range of price offers, suppliers also offer a variety of non-price inducements that are designed to alter the value that customers place on the particular supplier's offering. This section examines specific forms of non-price offers available in the domestic gas and electricity supply markets.

4.136. Ofgem examined a range of non-price offers in its Occasional Paper, when it considered classes of offers in the market including:

- tie-ins, and
- bundled goods and services.

The Occasional Paper stated that, whilst aiming to retain customers is clearly not in itself anti-competitive, Ofgem would pay particular attention to focused initiatives aimed at prospective or past switchers that aim to reduce switching in the incumbent's favour and hence may foreclose the market.

4.137. Although this section considers examples of offers that might be included in these broad categories, it does not attempt to define these offers into particular categories.

4.138. Ofgem is interested in the incidence and extent of non-price offers, as these offers can represent another form in which suppliers compete against each other for the benefit of customers. Gas and electricity supply are functionally identical products and Ofgem is interested to see how suppliers in practice add value to gas and electricity supply for the benefit of customers.

4.139. For instance, differentiating a functionally equivalent product can benefit customers through increasing choice and offering innovation to the basic product. Equally however, Ofgem is interested in whether innovation and product differentiation may come at a cost , either through higher costs or reduced choices in the future.

4.140. This section considers three different types of non-price offers:

- affinity deals or partnerships
- product diversification, and

- product differentiation.

4.141. The section then assesses whether, on balance, non-price offers reflect 'efficient' outcomes arising from supply competition.

4.142. It is important to note that the examples of the types of non-price offer used in this chapter are illustrative only, and do not imply any Ofgem view on the specific offers discussed.

Affinity deals

4.143. Most ex-PESs and BGT have affinity partnerships with other well known brands. Some key affinity partnerships include:

EDF/Nectar

4.144. EDF Energy offer Nectar card holders 100 Nectar points per fuel for existing customers or when a customer switches gas or electricity to EDF. Partnership members include Sainsbury's, Barclaycard, Debenhams, BP and Vodafone. An extra one-off bonus of 100 points per fuel is offered when registering on-line. Customers earn 150 additional points on each fuel for each complete quarter the customer remains with EDF. A customer who switches gas and electricity accounts on-line and remains with EDF on both fuels for a full year would therefore earn 1,600 points. Depending on payment method, self meter reads and prompt payment, customers can earn up to 3,200 points in one year. The value of these points to an individual customer will vary according to how they choose to use them.

Powergen/Tesco Clubcard

4.145. Powergen, in partnership with Tesco, offers Tesco Clubcard points to customers who switch household gas or electricity to Powergen. Switchers receive 500 points for each fuel (ie if a customer switches both fuels, they receive 1000 points. After switching, customers receive 1 Tesco Clubcard point for every £1 they spend on their bill. The value of these points to an individual customer will vary according to how they choose to use them.

SSE/Airmiles

4.146. SSE offers Airmiles to customers who register with SSE for gas and electricity. Specifically, SSE offers:

- 150 bonus miles for switching electricity supply
- 150 bonus miles for switching gas supply
- 1 mile for every £2 spent on electricity (ex VAT)
- 1 mile for every £2 spent on gas (ex VAT), and
- 25 bonus miles every 3 months for switching both gas and electricity supplies.

4.147. The SSE website indicates that a customer switching to SSE and spending £50 a month on energy could, in the first year, earn up to 700 miles. The value of these Airmiles to an individual customer will vary according to how they choose to use them.

Summary

4.148. With point rewards schemes, customers gain because they have greater purchasing power with all members of the partnership. However while the offer provides savings and increased choice in the short run, it may reduce the incentives for customers to switch away in the long run. However it appears to be open to other suppliers to create these types of schemes.

Product diversification

4.149. Almost all energy suppliers have diversified to supply both gas and electricity to the domestic market. Many suppliers have also diversified into ancillary goods and services, such as appliance services and wiring insurance. Other suppliers have diversified into less related products, including financial products, and home security.

4.150. Product diversification can enable a supplier to sell goods that were not previously available together. In many cases, these attract a customer discount.

Dual fuel

4.151. A successful form of product diversification by energy suppliers has been dual fuel. Customers have benefited from this product diversification through factors that they may value such as price discounts and/or the convenience factor of having one supplier[22]. On this basis, dual fuel offers have been highly beneficial to customers, with millions of customers making savings from dual fuel discounts, even if they do not choose the cheapest supplier. Suppliers have benefited through the ability to retain and acquire new customers.

Product differentiation

4.152. Product differentiation differs from diversification in that suppliers seek to differentiate a functionally identical product from a competitor's product. (Whereas diversification entails selling a range of goods which can then be sold together, possibly with a discount.)

4.153. Product differentiation will act to raise customer choice. However this choice can come at a cost, including higher prices, if customers ultimately pay for the way in which the product has been differentiated (eg through expensive marketing).

4.154. Products can be differentiated a number of ways. Suppliers may choose to differentiate their product through direct marketing, or more general brand awareness. This section only seeks to consider direct marketing (since this relates to specific, identifiable offers).

Internet offers

4.155. Some suppliers now offer less expensive internet tariffs (eg Atlantic Electric and Gas, British Gas, Powergen Online, ScottishPower.co.uk). These offers combine online registration, access and management of bills/accounts and facilitate meter readings submitted online by the customer. Most suppliers offer paperless billing as part of their internet proposition.

4.156. Internet offers differentiate themselves from standard offers by targeting customers who may not value the traditional customer service provided by suppliers but prefer to manage contact with their supplier electronically.

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[22] This benefit will be less important for those customers who do not regularly contact their supplier.

Other offers

4.157. SSE is in partnership with the Royal Society for the Protection of Birds to provide RSBP Energy. Under this offer, SSE makes contributions to the RSBP in return for customers paying a premium price to reflect the cost of renewable sourced energy.

Summary

4.158. By differentiating what are essentially functionally identical products, suppliers can increase customer choice. In some cases this may result in lower prices (eg internet prices), in other cases it may result in higher prices (eg green tariff prices). In addition to suppliers' own offers, affinity partnerships may also increase choice to domestic gas and electricity customers.

Conclusions

4.159. Ofgem continues to monitor the development of non-price offers, to assess whether these offers are benefiting domestic customers in both the short run and the long run and in particular to consider their influence on customers' switching decisions.

5. Profitability assessment

5.1. This chapter examines some issues relevant to the level of profits made by domestic gas and electricity supply companies. This includes:

- estimating the discount that a new entrant could potentially offer relative to the ex-PES in electricity supply or BGT in gas supply, whilst aiming to operate profitably, and
- comparing valuations suggested by more recent merger transactions with utility analysts' estimates of the profit levels of some supply businesses.

Background

5.2. Ofgem would expect domestic gas and electricity supplier profitability to reflect the extent of competition and the risk of operating in the sector. If suppliers are highly profitable, in the absence of significant barriers to entry or expansion, new companies would be expected to see opportunities to profit and therefore enter the market. In doing so, existing suppliers' profits are likely to fall. Credible new entry – or the threat of it – therefore exerts competitive pressures on existing suppliers, to the benefit of customers.

5.3. However 'high' profits are not of themselves evidence of a lack of competition. Profits can also fund investment in service levels and product innovation. If profits are relatively high in the short or medium term, this can have positive benefits for customers if there is also adequate competitive pressure to stimulate such investment.

5.4. In addition, gas and electricity suppliers no longer operate as monopolies. Opening the supply markets to competition is likely to have increased the risks faced by many of these suppliers in running their businesses. Profit expectations in these sectors could therefore be expected to increase to reflect any increase in risk.

5.5. However, if some suppliers are insulated to some extent from competitive pressures, this is likely to manifest itself in inefficiencies and/or sustained and

high levels of profits without associated benefits to customers. An understanding of profit levels therefore complements other chapters in this review.

5.6. A number of concerns have been raised about the level of profitability in the domestic supply market relating to areas such as:

Incentives on ex-PES and BGT suppliers to compete

5.7. The Public Accounts Committee[23] has recently suggested the domestic retail market has been less competitive than the industrial and commercial sector and has recommended that Ofgem carry out a review to determine whether the suppliers are acting in an anti-competitive manner to the detriment of domestic customers.

5.8. There are six major groups that supply the majority of domestic customers with gas or electricity. Unlike other new entrants who have no legacy customers and are therefore dependent on acquiring customers from other suppliers, each of the major supply groups have a substantial number of customers which they supplied prior to entering the competitive market. The question as to whether adequate incentives exist on ex-PES or BGT suppliers to compete more aggressively, given that they have these established and large scale businesses, has therefore been raised by some parties.

Some customer groups pay more than others for the same product

5.9. Those customers who have never switched from their ex-PES or BGT tend to pay more than those who have switched. Some observers have suggested that these suppliers therefore earn profits from these customers that are inconsistent with a competitive market that has been open for several years.

Switching activity may not reflect savings

5.10. While survey evidence suggests switching activity is driven by expectations of price savings, the quality of information available to customers when making a decision to switch raises questions about the extent to which these expectations

[23] 2nd Report (HC 63), *"The new electricity trading arrangements in England and Wales"*. The Committee of Public Accounts is appointed by the House of Commons to examine "*the accounts showing the*

have been realised. A number of suppliers have employed direct selling techniques to encourage customer switching and it is possible that, in these circumstances, customers may not always be in a position to choose from all of the available options. It is therefore possible that suppliers charging less competitive prices may have gained customers to a greater extent than would otherwise be expected.

Poor quality of market information

5.11. Since the efficiency of markets is dependent on the accuracy and timeliness of profit signals and ease of access to market information, limited public information in this area and the complexity of acquiring the necessary information suggests the gas and electricity supply markets may not be efficient in terms of information availability[24].

5.12. A comprehensive assessment of the validity of these concerns requires a significant level of information which Ofgem does not believe it is justified in seeking from the industry at present. The analysis in this chapter therefore seeks to assess suppliers' profitability using a headroom analysis and indicative levels of profits derived from published sources.

Terminology and data

5.13. This section explains some of the terminology and data used in this chapter. The Glossary at the end of this document explains other concepts that may be useful in understanding the issues raised.

5.14. Headroom is the discount that a new entrant can offer relative to the ex-PES or BGT. Ofgem has in the past conducted an analysis of the differential between the estimated costs of a new entrant in the electricity and gas supply markets and

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appropriation of the sums granted by Parliament to meet the public expenditure, and of such other accounts laid before Parliament as the committee may think fit".

[24] Publicly available information on profitability does not provide adequate detail or comparable information on profits earned by gas and electricity suppliers to answer many of the questions raised above. While some suppliers, such as BGT and Powergen, do publish information on operating margins for supply to residential customers, there are issues relating to compatibility of financial reporting which limit inferences that can be drawn about the extent of differences in these profit levels. Also, since many of the ex-PES or BGT suppliers are part of vertically integrated groups, all of whom supply more than a single product, issues of cost allocation and differences that may exist between profitability in gas supply compared with electricity supply prevent more detailed analysis of these areas.

the prices charged by ex-PESs or BGT. This 'Headroom analysis' was last published in December 2001 and assessed the discount that a new entrant can offer relative to the ex-PES or BGT supplier. It suggested that for gas supply, a headroom (net of the risk free rate) of between 5 - 8 per cent existed depending on payment type. For electricity, headroom varied across regions, with an average of around 8 per cent for standard domestic and around 3 per cent for domestic economy 7 where the method of payment was direct debit.

5.15. A further area of information on supplier expectations of potential profits is derived from the prices paid for domestic customers in the event of a merger. These prices reflect the anticipated level of profits from acquiring another supplier's domestic customers and provide a useful indicator of views about profit levels in the domestic supply market. This analysis is also presented in this chapter.

Key facts and trends

5.16. The analysis in this chapter provides some insight into profitability in the supply of gas or electricity.

5.17. The evidence from the headroom analysis suggests that entrants could still profitably enter the retail supply market although supply margins for a new entrant are relatively low for smaller suppliers, particularly in gas. New entry may require access to existing distribution and marketing channels and/or an established brand unless the new entrant can lower costs through innovation below those assumed in this analysis. There is no evidence that this is deterring new entry, but it appears to constrain what kind of business plan entrants pursue, eg to enter on a large scale based on an existing brand and/or distribution channel.

5.18. Published sources suggest that supply businesses may be earning profit margins of between 5 and 8 per cent. This implies customer valuations lower than those paid in more recent merger transactions involving domestic supply businesses. This may be because the price paid in mergers takes account of a wide range of factors which may account for approximately a third of the price paid.

Analysis

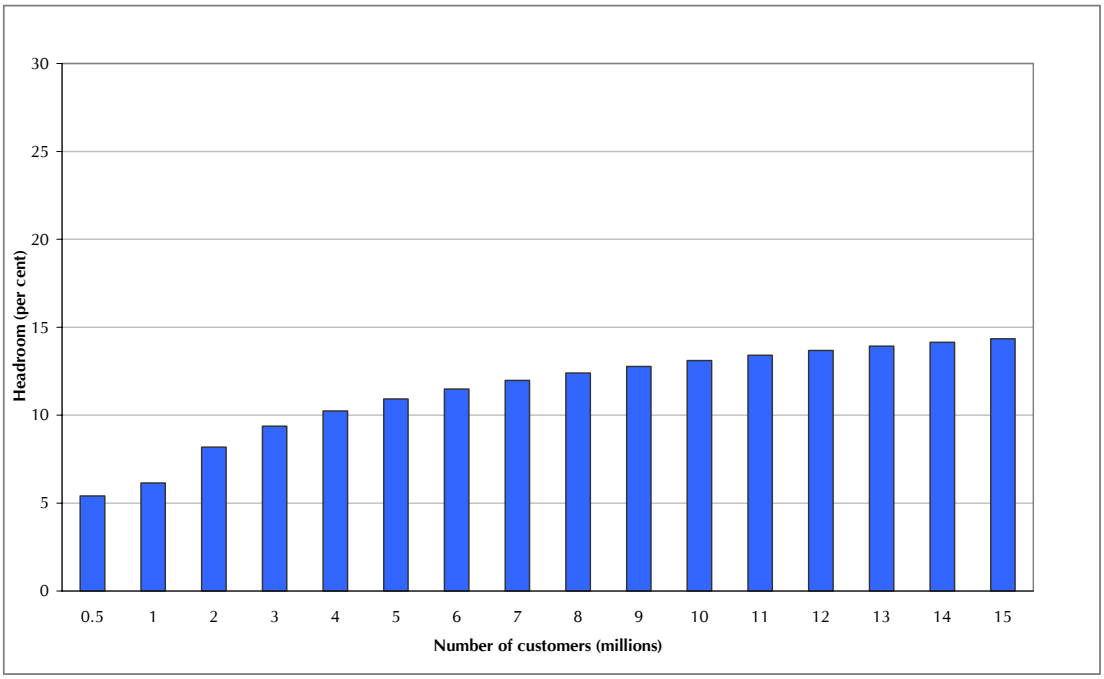
Headroom analysis

5.19. This review updates Ofgem's headroom analysis published in December 2001. The analysis aims to gauge the level of headroom for new market entrants in the domestic gas and electricity supply sectors. In obtaining the results presented below, the costs faced by a new entrant have been compared to the ex-PES or BGT suppliers' prices for electricity or gas respectively. Scale has been allowed for in the analysis of the costs faced by a new entrant as it is likely that a number of cost components are sensitive to the number of customers that a new entrant acquires. The process of estimating new entrants' costs is sensitive to many assumptions, and the results should be interpreted with this in mind. Changes in certain assumptions since the headroom analysis of December 2001 mean that the headroom figures presented below provide a snap-shot rather than a comparison with previous analyses. For reference, the underlying costs and the ex-PES or BGT's prices used to obtain the results for the gas and electricity headroom analysis are provided in Appendices 10 and 11, along with the assumptions that have been made.

5.20. Figure 5.1 shows the headroom that a new entrant gas supplier could achieve given a specified number of customers. The headroom levels presented in the graph have been formulated by assuming that some supply costs and marketing costs are sensitive to scale (ie the number of customers the new entrant is able to acquire). The costs and BGT prices have been calculated assuming a medium level of consumption[25] for each payment method and then weighted by assuming that 45 per cent of customers pay by standard credit, 45 per cent pay by direct debit and 10 per cent pay by prepayment. The analysis is based on the most recent data available for each cost and price component.

[25] The medium levels of consumption used for the gas headroom analysis were 19,050 kWh for standard credit and direct debit, and 12,300 kWh for prepayment.

Figure 5.1: Gas headroom (per cent) potentially available to a new entrant across varying levels of scale

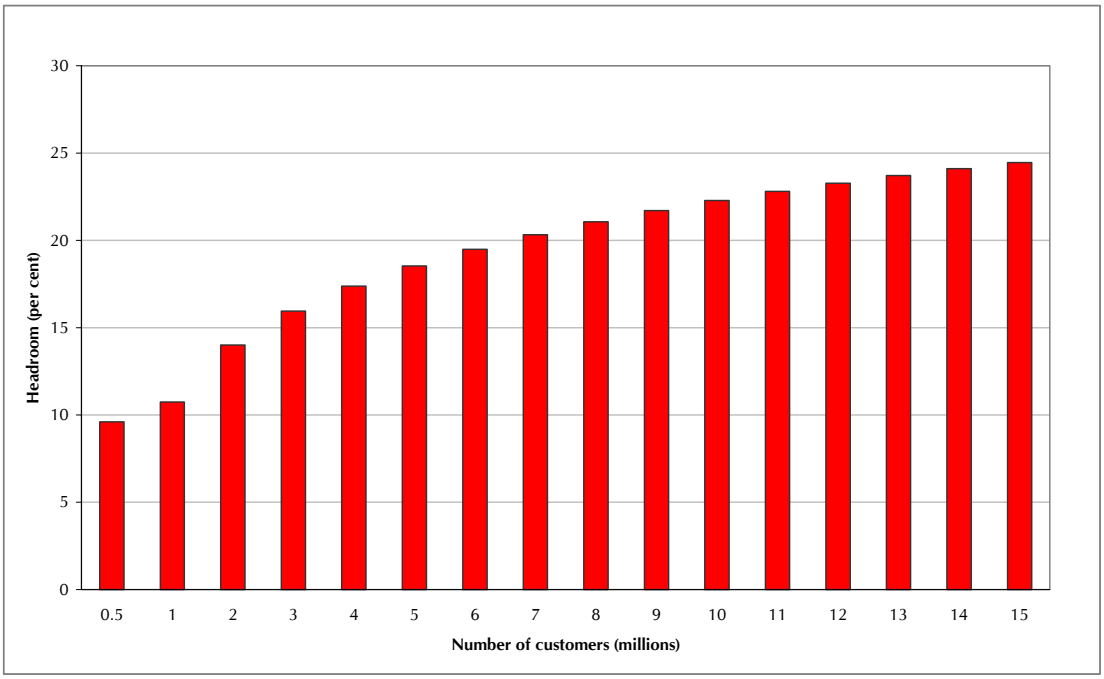


Source: Ofgem research

5.21. Figure 5.2 shows the headroom that a new entrant electricity supplier could achieve given a specified number of customers. As with gas, the headroom levels presented in the graph have been formulated by assuming that some supply costs and marketing costs are sensitive to scale. The costs and ex-PES prices have been calculated assuming a medium level of consumption[26] in line with that of a standard domestic customer and for each payment method. They have then been weighted by assuming that 45 per cent of customers pay by standard credit, 40 per cent pay by direct debit and 15 per cent pay by prepayment. The graph does not illustrate headroom where customers are on an Economy 7 tariff but costs relating to these types of tariff and the corresponding headroom figures are given in Appendix 11. The analysis is based on the most recent data available and assumes that the new entrant has the same costs that are presented in Appendix 11.

[26] The medium levels of consumption used for the electricity headroom analysis were 3,300 kWh for all payment methods.

Figure 5.2: Electricity headroom (per cent) potentially available to a new entrant across varying levels of scale



Source: Ofgem research

5.22. The results in Figures 5.1 and 5.2 suggest that entrants could still profitably enter the retail supply market. However supply margins for a new entrant are relatively low for smaller suppliers, particularly in gas. New entry may require significant funding as well as access to existing distribution and marketing channels and/or an established brand. However it is also possible that a new entrant can lower its costs below those assumed in this analysis, for example on its own billing systems or customer service costs or through innovation. Many of the incumbents are investing significant sums of money in new IT systems and processes, suggesting that there may be some scope for further innovation and/or efficiency savings. There is no evidence these issues are deterring new entry, but it appears to constrain what kind of business plan entrants pursue.

5.23. However, it is evident from the pricing information in Chapter 4 of this review that new entrants do in fact price below the levels suggested by this headroom analysis. This suggests that:

- since the costs in this headroom analysis are total costs it is possible that some new entrants are pricing to cover less than their total costs[27],

[27] The possibility of new entrants pricing below total average cost is raised in the OFT Economic Research

perhaps to achieve scale and market share before raising their prices to achieve sustainable profitability. This sort of pricing strategy by new entrants is often seen in other markets, and

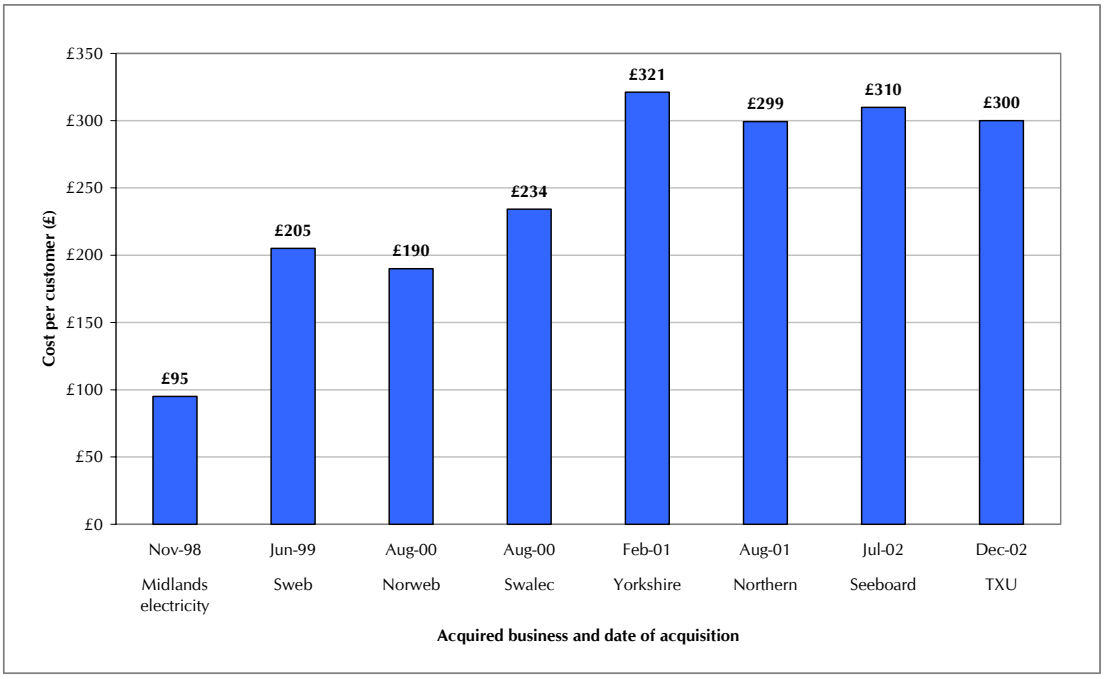
- through efficiency gains and/or innovation, some new entrants may be able to reduce costs below those levels presented in Appendices 10 and 11.

Analysis of published sources

5.24. There have been a number of mergers and acquisitions in the retail supply market since it was opened to competition. Figure 5.3 below sets out the acquisition target, date of acquisition and cost per customer (rebased to 2002 prices) for some of these mergers based on media reports and other sources. It shows that while the prices paid per customer acquired through merger activity have varied over time, they have tended to increase. Since this information is based on sources which have not been verified through Ofgem's formal powers, the discussion below should be interpreted with this in mind.

Paper *'Switching costs - Part one: Economic models and policy implications'* and *'Part two: annexes',* by National Economic Research Association – April 2003.

Figure 5.3: Merger activity in Great Britain gas and electricity supply sector (rebased to 2002 prices)



Source: Datamonitor

5.25. The prices paid in mergers provide a useful basis to assess profitability in the gas and electricity supply sector since they will take some account of the profit expectations of the acquiring business. However, merger prices do not only reflect profit expectations from the domestic supply business. They also take some account of factors such as long term strategic value or benefits in related markets arising from the merger transaction. Merger prices can also reflect the potential for additional revenue streams within the domestic supply market, for example, revenues from moving single fuel customers to dual fuel offers.

5.26. Given the above, as a contribution to the debate on profitability in the domestic supply sector, Ofgem has presented illustrative valuations for several supply businesses and compared these with merger prices paid by acquiring suppliers in merger transactions. Estimates of domestic supply profit margins and costs of capital suggested by utility analysts in their assessments of supply businesses are used in this analysis rather than the results of the headroom analysis set out above.

5.27. The valuation of gas and electricity supply businesses is made on a per-customer basis using estimates of average revenues available to Ofgem through its databases of domestic prices. In this illustration, profit margins of between 5 and

8 per cent, and cost of capital of between 11 and 16 per cent have been taken as these cover the ranges suggested by a number of utility analysts. However, these should not be taken as Ofgem's views of the reasonableness or otherwise of supplier profit margins or costs of capital.

5.28. The three supply businesses considered are Seeboard, TXU and BGT. The acquisition by LE Group of Seeboard in 2002 and of the TXU business by Powergen in 2002 are the most recent mergers in this sector. BGT is a significant player in the supply sector and is therefore included in the analysis.

5.29. The results of this exercise suggest a valuation per customer of around £186 compared to the £310 reportedly paid by LE Group for Seeboard's customers and a valuation of around £201 per TXU customer compared to the £300 reportedly paid by Powergen for the TXU supply business. The highest valuation was for BGT's customers, almost 28 per cent higher than that for TXU customers, at about £257.

5.30. The difference between these valuations and the publicised prices paid for customers in the Seeboard and TXU mergers is material. As discussed above, prices paid in mergers take account of a wide range of factors and it appears that these account for approximately a third of the price paid in these mergers.

5.31. Based on these customer valuations Ofgem has also assessed what return on sales are suggested by these valuations. Given that these are largely incumbent customer bases and therefore subject to erosion through the introduction of competition, churn rates of 4 per cent have been assumed given evidence from other sources[28]. Based on the range of estimates suggested by utility analysts, this suggests that return on sales in the supply business taken for purposes of this illustration might lie between 8 and 10 per cent.

[28] Datamonitor report "2002 UK Residential Supply Review", Table 9, page 35.

Summary

5.32. The evidence from the headroom analysis suggests that entrants could still profitably enter the retail supply market although supply margins for a new entrant are relatively low for smaller suppliers, particularly in gas. New entry may require access to existing distribution and marketing channels and/or an established brand unless the new entrant can lower costs through innovation below those assumed in this analysis.

5.33. Ofgem's analysis using the range of estimates of profitability by utility analysts suggests valuations that are approximately two-thirds of those paid in the mergers involving Seeboard and TXU.

5.34. In order to further understand supplier profitability Ofgem will assess whether price changes are justified relative to changes in supplier costs (measured by changes in market prices).

6. Concentration and indicators of competitive intensity

6.1. This chapter considers a number of issues about the structure of the gas and electricity supply sector, particularly the possible effect that recent changes in the number of active suppliers may have on competition.

Background

6.2. In competitive markets, different types of competitive activity may arise as a result of differing market structures. For example a market with many small firms would be different to one with only two or three firms. Concerns have been expressed that the recent consolidation that has taken place in gas and electricity is likely to have the effect of reducing the level of competitive activity and therefore reducing the benefits to customers of competition.

6.3. The analysis used in this chapter allows an assessment of these concerns:

- co-movement of prices may indicate similar competitive pressures on suppliers, but it may also be indicative of coordination between suppliers. The analysis therefore looks at how suppliers' gas and electricity prices have moved over time, nationally and regionally - a technique called "price parallelism analysis". This enables an evaluation of the extent to which competitive conditions may be the same for different products (gas and electricity) and in different regions

- looking at how concentrated the gas and electricity sectors are using information about suppliers' shares of customers that show how the structure of the market has changed over time, and

- discussing whether the economic characteristics of the domestic gas and electricity sectors may be conducive to coordination among competing suppliers.

6.4. As explained in Chapter 1, this document does not provide an assessment of relevant markets that would be needed for a Competition Act investigation. It should also be noted that Ofgem has never come to a formal view on the

relevant market when considering Competition Act complaints about supply competition.

Terminology and data

6.5. This section explains some of the terminology and data used in this chapter. Additional information is available in the Glossary at the end of the document.

- coordinated effects – given certain market conditions, firms may realise that it is in their mutual best interest to cease to compete actively, eg by not undercutting one another on price, and sustain existing prices, rather than face the threat of price competition (or a price war) tomorrow. If this behaviour is maintained without direct agreement between firms then the resulting impact on competition is called 'coordinated effects'. The term comes from merger analysis where the 'effects' of a merger are considered

- dominance – "…a position of economic strength enjoyed by [a company] which enables it to prevent effective competition being maintained on the relevant market by affording it the power to behave to an appreciable extent independently of its competitors, customers and ultimately of consumers"[29]

- joint dominance - also known as 'collective' or 'oligopolistic' dominance. This term is used to refer to separate legal entities that together hold a dominant position on the relevant market

- market share - a measure of industry concentration that shows the proportion of sales of a good or service held by individual companies within a market

- market definition - market definition delineates the relevant economic market in which a company competes through a product, geographic and, possibly, temporal dimension

[29] Definition used by the European Court in Case 27/76 United Brands v EC Commission [1978] ECR 207, [1978] 1 CMLR 429; and in other cases.

- market power - describes a situation where the constraints which would usually ensure that an undertaking behaves in a competitive manner are not working effectively[30]

- non-coordinated effects - also referred to as 'unilateral effects', this concept occurs where a single firm is able to exercise market power independently of other firms in the market, eg by maintaining high prices. This may occur as a result of a merger, and

- substitute - a good or service that is a possible alternative for the customer so that where good B is a substitute for good A, a change in price for good A will have an impact on demand for good B.

6.6. The price parallelism analysis (ie examining how suppliers' prices have moved over time, nationally and regionally to see if there is co-movement of prices) uses historical pricing data (from June 2000 – December 2003) extracted from Ofgem's Domestic Prices Database (DPD)31. The bills are shown in real prices (December 2003 = 100) and are inclusive of VAT. Various strands of analysis were carried out by product (gas and electricity), region (ex-PES region and nationally) and payment method (direct debit, standard credit and prepayment). See Appendices 12 and 13 respectively for more detail on methodology and different cuts of the analysis32.

6.7. The data used in the concentration section for electricity is collected by Ofgem on a monthly basis from electricity distribution companies. The gas data on concentration is collected directly from gas suppliers, also on a monthly basis. Data from surveys conducted by J.D. Power and Associates has also been used for some concentration indicators. In June 2003 Ofgem consulted on and published a decision about its intention to publish information about suppliers' market shares33; the data set out in this document is consistent with that decision or with information published in other Ofgem documents.

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[30] OFT 415, Assessment of Market Power, September 1999, page 2.
[31] For dual fuel prices data is only available from April 2002.
[32] The direct debit payment method is presented here. Ofgem uses this payment method because it believes direct debit is more reflective of competitive pressures for several reasons: this was the first payment method to have price controls lifted (in gas), most companies use direct debit as their spearhead for gaining customers and it is the fastest growing payment method.
[33] "Publishing information about suppliers' market shares – Ofgem's decision", June 2003,

6.8. Throughout this chapter, if customer shares do not sum to exactly 100 this is due to the rounding of figures up or down.

Key facts and trends

6.9. The product analysis indicates that there is little co-movement between gas and electricity prices indicating that different competitive pressures appear to influence the prices of these products.

6.10. The regional analysis indicates that competitive pressures, as reflected in prices, tend to be more uniform across regions for gas than for electricity. This is consistent with, but not proof of, a regional definition of markets for electricity and a national market definition for gas.

6.11. The section on concentration measures illustrates the continued erosion of incumbent suppliers' shares of customers. BGT now has 61 per cent of gas customers and on average the ex-PESs have a share of 59 per cent of customers in-area. The section also illustrates increases in customer shares for BGT in electricity and the ex-PESs in gas.

6.12. The section illustrates high concentration indices in gas on a national basis and in electricity on a regional basis. Although there are six large suppliers, there are a total of nine active domestic gas suppliers and 12 active domestic electricity suppliers.

6.13. The section on coordination illustrates that some of the pre-conditions for coordination exist in gas and electricity supply. However, at present there is no evidence to suggest that coordination between suppliers is taking place.

Analysis

Price Parallelism Analysis[34]

6.14. Price parallelism analysis is useful in evaluating the extent to which competitive conditions may be the same for different products (eg gas and electricity) and across different geographical regions. It considers whether prices in different sectors move together over time. If prices do tend to move together then this may indicate that competitive conditions are similar for the two products and therefore that they may be substitutes. A correlation of price movements is consistent with, but not proof of, two goods being sold in the same market[35].

6.15. Co-movement of prices may indicate similar competitive pressures on suppliers but it may also be indicative of coordination between suppliers. Coordination is discussed further in the final section of this chapter.

6.16. In some cases a visual check of the data may indicate co-movement; however a more robust approach is to calculate correlation coefficients. The correlation coefficient of two sets of data is a number ranging between -1 and 1 that indicates how much a change in one variable may explain a change in another. It indicates the degree of association between two variables but does not imply that a change in one variable causes a change in the other.

6.17. Common costs shared across products and/or regions may give a false impression of co-movement. Therefore the prices used in this analysis exclude regulated costs, ie transportation, distribution and metering costs for gas and electricity[36]. Chapter 4 shows the percentage of a domestic customer's bill that comprises these costs; they show more regional variation

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[34] Ofgem has previously published some price parallelism analysis in its Occasional Paper. The analysis in this review builds on the previous analysis extending it by including a wider spread of prices and stripping out more of the regulated costs.

[35] OFT, "*The role of market definition in monopoly and dominance inquires*", July 2001, page 11. Also see OFT, "*Quantitative techniques in competition analysis*", prepared for the OFT by LECG Ltd, Research Paper 17, October 1999, page 53 to 55 for further discussion on price correlation analysis.

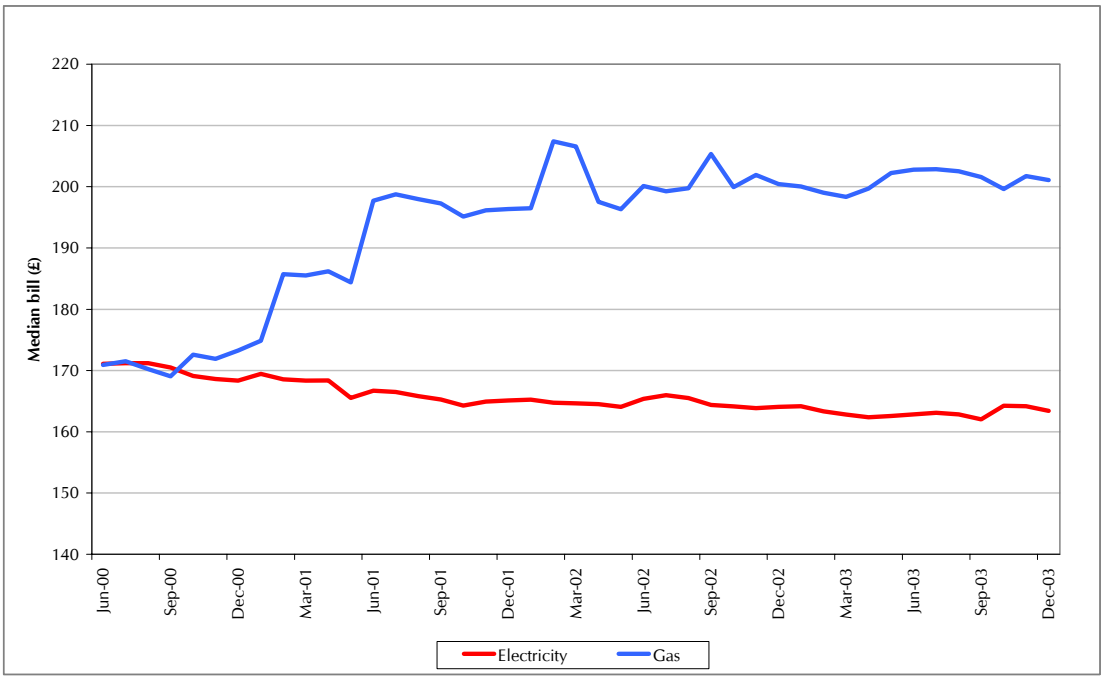
[36] For gas prices Transco charges are stripped out. It should be noted that Ofgem is unable to exclude National Transmission System (NTS) Entry Capacity charges. These are determined by auctions and if Transco over recovers on auctions shippers may be refunded. The electricity prices have been stripped of Distribution Use of System (DUoS) charges and Transmission Network Use of System (TNUoS) charges.

in electricity than gas. See Appendices 12 and 13 respectively for more detail on methodology and different cuts of the analysis.

Product boundaries

6.18. Figure 6.1 shows national median gas and electricity direct debit prices from June 2000 to December 2003. These prices have shown little co-movement since June 2000. In the early period the prices moved in separate directions with a steep increase in gas prices and slow reductions in electricity prices. Analysis of the other payment methods produced similar results (Figures A13.1 and A13.5 in Appendix 13).

Figure 6.1: Price parallelism analysis: electricity and gas direct debit median bills excluding transportation charges (medium consumption bills, inc. VAT, Dec 03 = 100)[37]



Source: Ofgem

6.19. The correlation coefficient for this price series is -0.89. This suggests a negative relationship between domestic electricity and gas prices and indicates different competitive pressures operating on gas and electricity prices. It is also consistent with domestic gas and electricity supply being in separate markets.

[37] Transportation charges for electricity include distribution use of system (DUoS) charges and Transmission Network use of system (TNUoS) charges, gas charges are sourced from Tranco. Medium consumption bills are used for gas this is 19,050kWh and for electricity 3,300kWh per annum.

6.20. These results also suggest that gas and electricity are not substitutes. Intuitively this seems right - customers are unlikely to switch from gas central heating to electricity central heating in response to an increase in gas prices, at least in the short run, and gas is not normally used for lighting. However the two fuels are related due to common costs - about 39 per cent of electricity is generated from gas38.

6.21. The results are similar to those set out in the Occasional Paper which indicated that gas and electricity are unlikely to be substitutes in the short term.

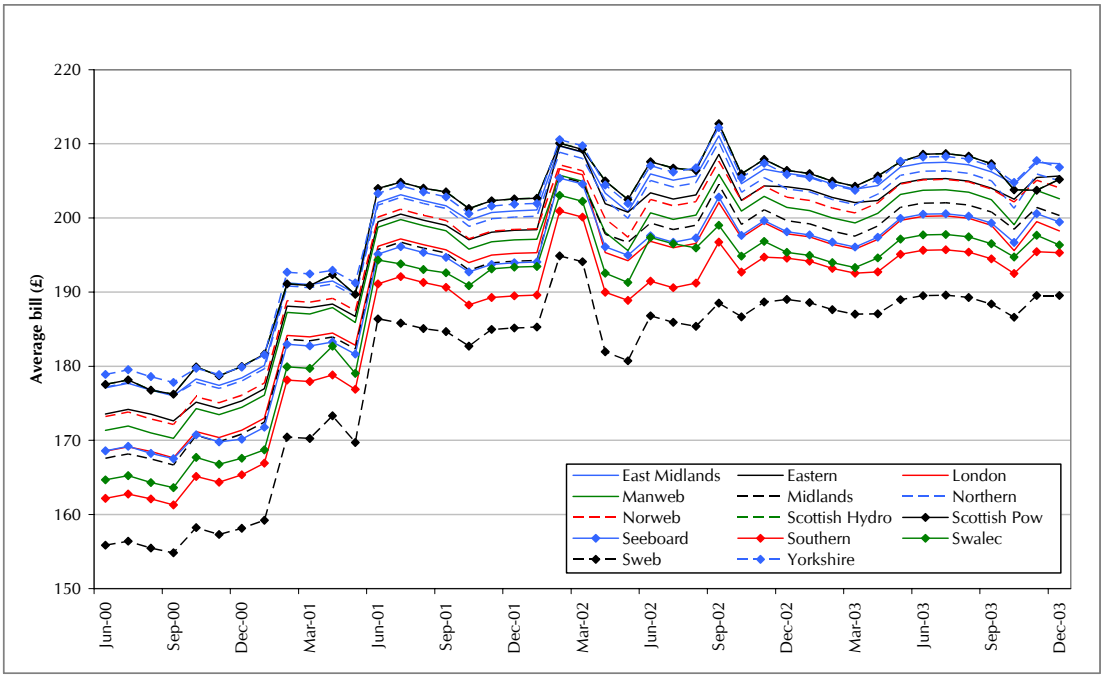
Geographical boundaries

6.22. Price parallelism analysis can also be used to assess the extent to which competitive conditions are the same across different regions. Co-movement of prices across regions is consistent with those regions forming part of the same market. As before, this is tested using historical pricing data stripped of regulated costs.

6.23. Figure 6.2 shows clear co-movement of gas prices across all ex-PES regions. The visual picture is supported by high and positive correlation coefficients which are set out in Appendix 14, Table A14.1. This suggests that competitive conditions are the same across different regions and supports the hypothesis of a national domestic gas supply market.

[38] DTI, "*Digest of United Kingdom energy statistics 2003*", a national statistics publication, 2003, page 122.

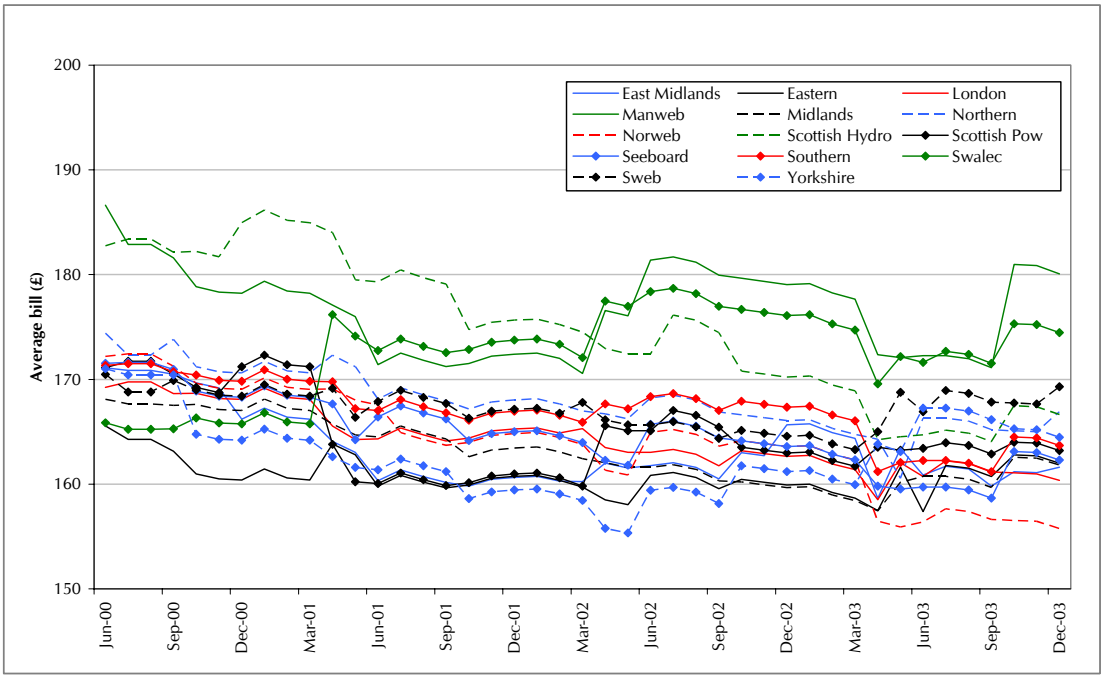
Figure 6.2: Price parallelism analysis: gas direct debit median regional bill excluding transportation charges (medium consumption bills, inc VAT, Dec 03 = 100)



Source: Ofgem

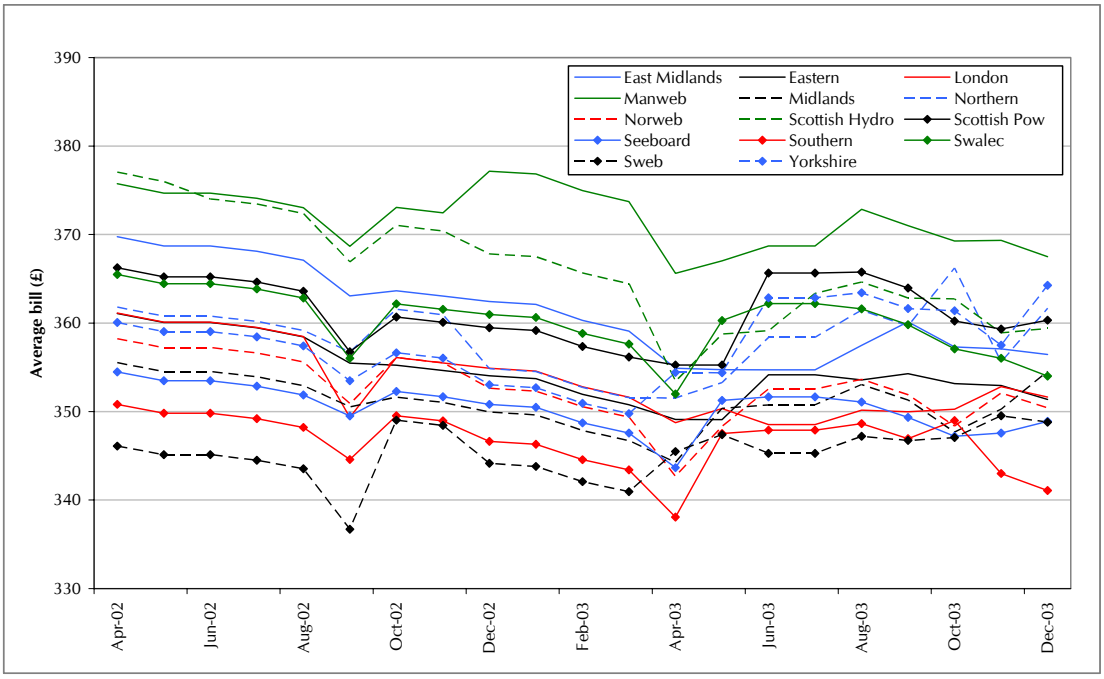
6.24. Figures 6.3 and 6.4 show the same type of regional analysis for electricity and dual fuel respectively. Here, price co-movement is not as evident as in gas.

Figure 6.3: Price parallelism analysis: Electricity direct debit median regional bill excluding DUoS and TNUoS charges (medium consumption bills, inc VAT, Dec 03 = 100)



Source: Ofgem

Figure 6.4: Price parallelism analysis: Dual fuel direct debit median regional bill excluding DUoS, TNUoS and transportation charges (medium consumption bills, inc VAT, Dec 03 = 100)



Source: Ofgem

6.25. The correlation coefficients for all regions are in Appendix 14 (Tables A14.2 – A14.3). The coefficients for electricity are not as consistently high and positive as for gas. The value of the correlation coefficients varies, many are close to zero and many of them are negative. This result is inconsistent with a national market for electricity.

6.26. The correlation coefficients for regional dual fuel prices also present a mixed result. However, Ofgem currently has fewer data points for dual fuel and the analysis is therefore less robust than for gas and electricity.

6.27. This analysis tends to confirm the view that competitive conditions in electricity are more uniform on a regional rather than a national basis.

Concentration measures

6.28. Concentration measures are an important indicator of market structure and, taken in conjunction with other factors, can also show whether a supplier has market power. Analysis of the changes in suppliers' customer shares over time can give an indication of how they have performed in relation to each other.

6.29. This section gives an overview of concentration measures in gas and electricity. It looks at how concentration has changed over time on a national and a regional basis for electricity, and on a national basis for gas. It also sets out:

- shares of customers split according to payment type
- dual fuel shares
- other indices of concentration
- total electricity and gas customer number measures, and
- the number of active suppliers.

Customers obtained through different brands

6.30. A supplier's customer share includes all its gas and/or electricity customers, including those acquired in partnership with other companies. These 'affinity partnerships' are discussed in more detail in Chapter 4 and appear to be playing an increasingly important role in encouraging credible new entry to the gas and electricity sectors.

6.31. Ofgem does not currently have information about how many customers registered to a supplier have been acquired through affinity partnerships. This information could enhance the understanding of competitive dynamics, identify the degree of competitive pressure exerted by such offers, help to identify characteristics of 'credible new entry' and could indicate how effective this type of product differentiation is.

Electricity suppliers' customer shares

6.32. Ofgem has used data on customer numbers to calculate what percentage of the total number of electricity customers are supplied by each of the major groups of electricity supplier. This information has been analysed

- on a national basis, ie Great Britain
- on a regional basis, ie 'in-area'

- over time, from September 2000 to December 2003, and
- for customer shares in Scotland.

6.33. Table 6.1 shows that BGT and Powergen have the highest number of domestic electricity customers on a national basis. BGT's share of electricity customers grew by about 10 per cent from September 2000 to September 2002 but since then has grown more slowly. Powergen's acquisition of TXU in October 2002 means that it has overtaken npower as the second largest electricity supplier on a national basis. Appendix 16 gives details of recent merger activity.

Table 6.1: Principal electricity supplier group shares of domestic electricity customers[39] in Great Britain (per cent)

Group	Sep-00	Sep-01	Sep-02	Sep-03	Dec-03
Powergen	8	8	8	22	21
TXU Energi	17	15	15		
BGT	14	17	22	23	24
npower	8	19	17	16	15
Northern Electric	4				
Yorkshire	7				
EDF Energy	10	10	15	14	14
Seeboard	6	6			
SSE Energy	14	14	13	14	14
ScottishPower	10	10	10	10	11
Others	0	1	0	1	1

Source: Distribution companies

6.34. Suppliers' national shares contrast with their regional shares. Table 6.2 shows that within their ex-PES regions every ex-PES supplier has a majority of electricity customers.

[39] Meter points are taken as a proxy for customer numbers, ie one electricity meter is assumed to equal one electricity customer.

Table 6.2: Ex-PES supplier 'in area' customer shares by customer numbers

Current ex-PES Owner	Area	Sep-99	Sep-00	Sep-01	Sep-02	Sep-02	Sep-03	Sep-03	Dec-03	Dec-03
		Licence	*Licence*	*Licence*	*Group*	*Licence*	*Group*	*Licence*	*Group*	*Licence*
npower	Midlands	89	78	68	60	60	55	54	54	53
	Yorkshire	91	80	69	64	61	59	54	57	52
	Northern	89	75	64	64	58	58	53	56	52
Powergen	East Midlands	88	76	66	60	60	59	56	58	56
	Eastern	89	78	71	65	64	64	60	63	59
	North West	91	79	67	58	57	55	51	53	49
SSE Energy	Southern	91	80	71	68	68	68	68	68	68
	North Scotland	94	89	83	83	83	82	82	82	82
	South Wales	90	82	72	68	67	68	68	68	67
Scottish Power	South Scotland	93	82	72	65	65	64	64	63	63
	Merseyside & North Wales	90	79	68	60	60	56	56	55	55
EDF Energy	London	92	82	73	69	68	67	66	66	65
	South West	95	85	75	70	68	66	64	64	63
	South East	89	81	70	67	64	64	62	63	61
All areas	All areas	90	80	70	66	65	62	60	61	59

Source: Distribution companies

6.35. The 'Current ex-PES Owner' column refers to suppliers who own the ex-PES business in each region as of December 2003. In 2002 and 2003, the table distinguishes between customers in the ex-PES 'Group' and customers registered to the ex-PES 'Licence'40. The 'Licence' measure shows how the inherited ex-PES customer base has eroded over time whilst the slower speed of the erosion of the 'Group' measure represents the acquisition activities of the ex-PES suppliers. The 'Group' measure represents all customers currently supplied by the ex-PES supplier.

6.36. Regional customer shares show that, despite the erosion of 'in-area' share, the ex-PES suppliers still have the majority of customers for both the 'Group' and the 'Licence' measure. Although these customer shares can indicate levels of competitive rivalry in each region they may also reflect underlying factors that

[40] The term 'licence' is used loosely here, strictly speaking market share by 'licence' refers to the number of customers registered to each supplier's Market Participant ID, or MPID, which are codes allocated to the ex-PES at the start of competition. Recently some suppliers have started re-allocating customers from old ex-PES MPIDs once they have taken them over. Because of this, from 2004 onwards Ofgem will only report on ex-

affect competition. For instance, in North Scotland, fewer customers than the Great Britain average have a gas supply. The comparatively small erosion of customer shares in that region may reflect a number of factors:

- fewer opportunities for suppliers to cross sell gas to electricity customers
- lower levels of doorstep sales activity in rural regions because doorstep sales are less cost effective in sparsely populated areas, and
- the strength of the ex-PES brand.

6.37. Table 6.3 shows the total electricity customer shares of the two Scottish ex-PESs and the share of all other suppliers for the whole of Scotland. Overall ScottishPower has the largest share of electricity customers in Scotland with 47 per cent of all Scottish customers whilst 25 per cent are with SSE, reflecting the lower population level in North Scotland. This contrasts with the fact that in the North Scotland region, SSE has the biggest in-area customer share (83 per cent) of all ex-PESs. BGT (trading as Scottish Gas) has most of the customers in the 'others' category.

Table 6.3: Electricity customer shares by supplier in Scotland (in percentage)

	Sep-00	Sep-01	Sep-02	Sep-03	Dec-03
ScottishPower	60	52	48	47	47
SSE Energy	24	25	25	25	25
Other suppliers	17	23	27	28	28

Source: Distribution companies

6.38. Appendix 17 presents charts for each ex-PES region showing the evolution of electricity incumbent group shares and entrant shares from August 2001 to December 2003.

Gas suppliers' customer shares

6.39. Ofgem has used data from gas suppliers on customer numbers to calculate what percentage of the total number of gas customers are supplier by each of the principle gas suppliers. This information has been analysed on a national basis, ie Great Britain as follows:

PES 'group' market shares.

- over time from September 1998 to December 2003 for BGT and new entrant customer shares
- as a snap shot for each major group for December 2003, and
- over time from March 2002 to December 2003 for each major group.

6.40. Table 6.4 shows the erosion of BGT's share of domestic gas customers over time. It appears that the rate of erosion has been gradually slowing. Figure 3.5 in Chapter 3 on switching illustrates the flows of customers between new entrants and BGT.

Table 6.4: BGT's share of domestic gas customers[41] over time (per cent)

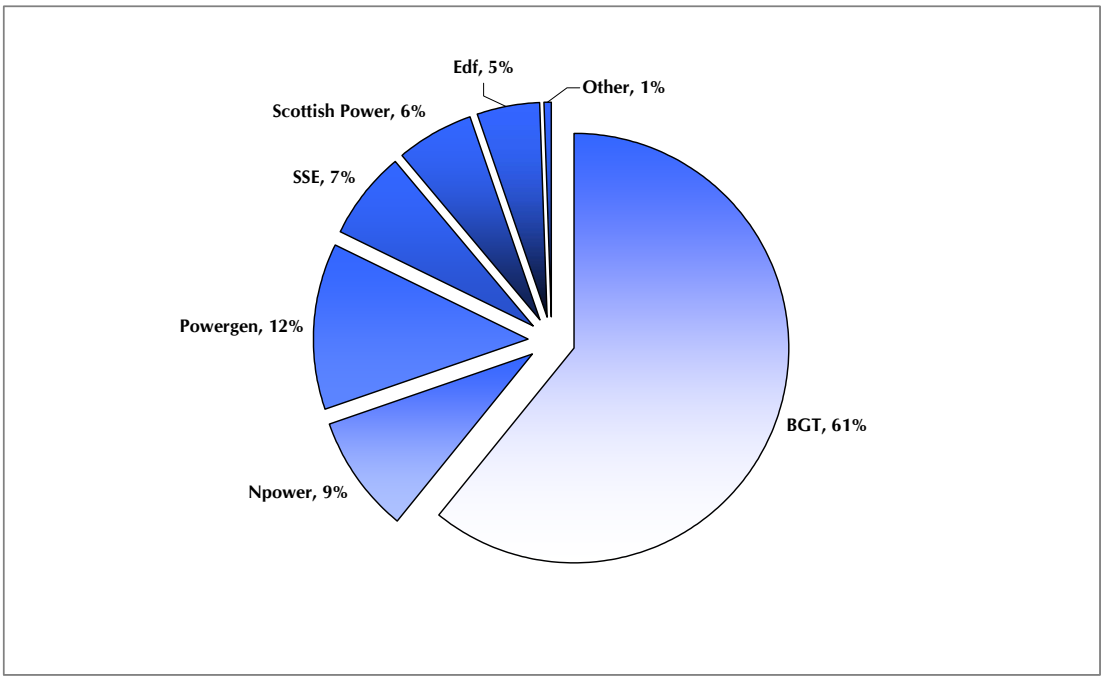
	BGT	New Entrants
Sep-98	84	16
Sep-99	75	25
Sep-00	71	29
Sep-01	67	33
Sep-02	64	36
Sep-03	62	38
Dec-03	61	39

Source: Ofgem/Domestic Gas Suppliers

6.41. Figure 6.5 shows the December 2003 national shares of the principal gas suppliers by customer numbers.

[41] Gas customers are defined as each individual supply point being supplied as defined under the network code.

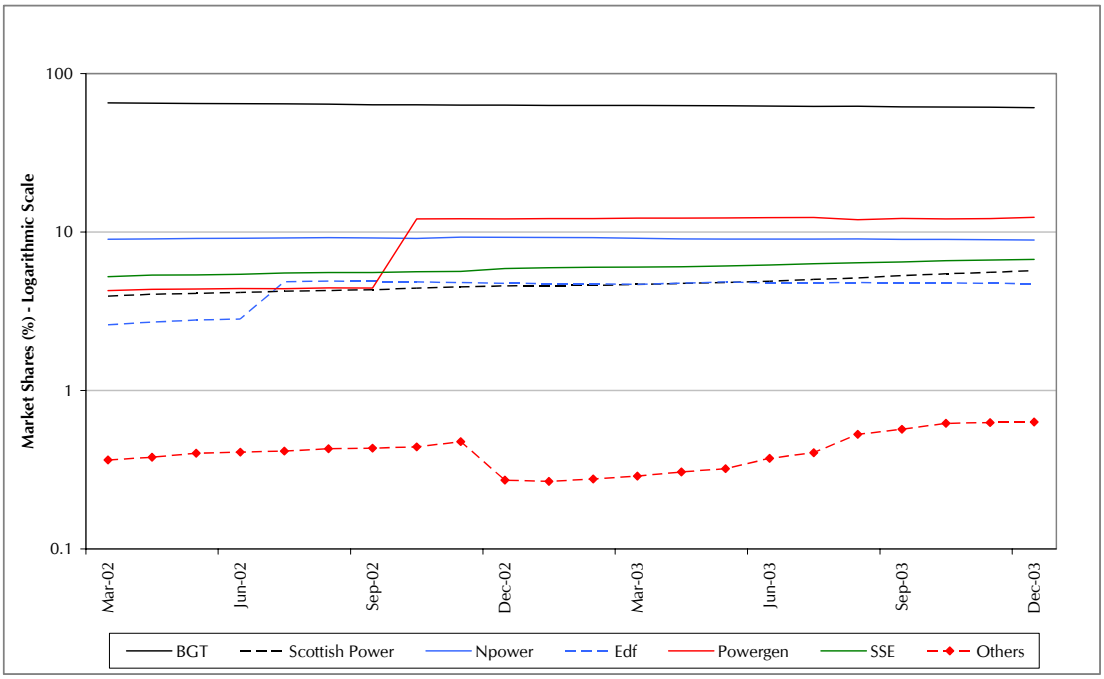
Figure 6.5: Domestic gas customer shares (December 2003)



Source: Ofgem/Domestic Gas Suppliers

6.42. Figure 6.6 shows the monthly movement of gas customer shares since March 2002. The figure uses a logarithmic scale to show the changes over time. This type of scale enables the graph to show bigger variations in the shares of the largest companies at the same time as seeing in detail how the 'others' category of suppliers has varied.

Figure 6.6: Gas national customer shares time series March 2002 to December 2003)



Source: Ofgem/Domestic Gas Suppliers

6.43. BGT's share of customers has been gradually declining, whilst SSE and ScottishPower have experienced steady increases in their gas customer numbers. EDF and Powergen increased their customer share as a result of acquisitions (see Appendix 16 for recent merger activity details). npower's customer share has remained relatively stable over the period (see Chapter 3 for more discussion on gains and losses).

6.44. The number of gas customers with 'other' suppliers has also varied over the period. In December 2002 the acquisition of Cambridge Gas and Electricity by SSE caused a sudden drop in the figure for 'other' suppliers after which a steady increase has continued. However, Atlantic Electric and Gas which has most of the customers in this group is currently for sale.

Electricity and gas customer numbers by payment method

6.45. This section presents some information about customers according to payment type. Payment types can be broadly classified into three categories: direct debit, standard credit and prepayment. At the start of competition the majority of customers paid by standard credit. Direct debit has increased in popularity since market opening and is the fastest growing payment method. The proportion of

customers on prepayment has remained approximately the same since the start of competition.

Electricity

6.46. Nationally, in December 2003 about 42 per cent of all electricity customers paid by standard credit, 39 per cent paid by direct debit and 15 per cent by prepayment. Table 6.5 shows, for each electricity supplier, the percentage of customers that use each payment type. Small suppliers have a larger proportion of direct debit customers and a smaller proportion of standard credit customers compared to BGT and ex-PES suppliers. This may reflect the fact that many customers maximise their savings when switching supplier by also changing their payment method from standard credit to direct debit.

Table 6.5: Electricity customers by payment method, December 2003 (per cent)

	Standard Credit	Direct Debit	Prepayment	Other	Total
British Gas	38	43	17	2	100
Powergen	43	40	14	3	100
npower	48	34	13	5	100
EDF Energy	50	31	15	4	100
SSE	40	41	15	4	100
Scottish Power	38	40	18	4	100
Telecom Plus	0	96	1	3	100
Atlantic	39	53	7	1	100
Unit Energy	39	51	1	9	100
Utility Link	35	58	1	7	100

Source: Domestic electricity suppliers

Gas

6.47. Nationally, in December 2003 about 42 per cent of all gas customers paid by standard credit, 44 per cent paid by direct debit and 10 per cent by prepayment. The number of customers on direct debit has gradually increased over time and is now level with the number of customers on standard credit.

6.48. For each payment method, Table 6.6 shows the change in the proportion of gas customers with BGT and with all other suppliers. The increase in other suppliers' shares of direct debit customers may reflect the tendency to switch

payment method when switching supplier, and fiercer competition for direct debit customers than customers on other payment types.

Table 6.6: Gas customers by payment method, December 2003 (per cent)

	BGT share			Other suppliers share		
	Direct Debit	Standard Credit	Pre-payment	Direct Debit	Standard Credit	Pre-payment
Sep-99	70	78	88	30	22	12
Sep-00	67	74	83	33	26	17
Sep-01	61	67	78	39	33	22
Sep-02	57	66	74	43	34	26
Sep-03	56	66	72	44	34	28
Dec-03	55	66	71	45	34	29

Source: Domestic gas suppliers

Dual fuel customer shares

6.49. The packaging of gas and electricity products into the 'dual fuel' offer has been one of the most significant market innovations to have emerged since the introduction of competition. Most suppliers offer dual fuel discounts which reflect the supply cost savings associated with combining products. It appears that the dual fuel proposition has been an important driver to switching because of the discount and convenience it brings to customers and the savings in acquisition costs to suppliers. Ofgem's analysis of the J.D. Power and Associates' gas and electricity surveys for 2003 also shows that about 80 per cent of switchers take their gas and electricity from the same supplier.

6.50. Table 6.7 shows dual fuel customer shares over time. BGT and the ex-PESs appear to be in an advantageous position relative to other competitors since they have inherited large customer bases and can use this position to cross sell products and so encourage dual fuel take-up.

Table 6.7: Dual fuel customer shares (per cent)

	Summer 2001	Summer 2002	Summer 2003
British Gas	45	46	44
EDF Energy	-	-	8
London Electricity	2	3	-
Seeboard	2	4	-
Npower	11	14	13
Northern Electric	4	-	-
Powergen	9	8	18
TXU Energi	10	11	-
SSE	9	8	10
Scottish Power	6	6	8
Total	100	100	100

Source: J.D. Power and Associates Gas and Electricity Surveys 2001, 2002 and 2003
Sample size: 2001 – 3899, 2002 – 4296, 2003 – 3792.

6.51. BGT has the highest proportion of dual fuel customers. However it consistently offers the most expensive dual fuel price at medium and high consumption levels (in at least 9 out of 14 areas) for direct debit and at all consumption levels (in at least 12 out of 14 areas) for standard credit. Although BGT still represents a saving for first time switchers, its dual fuel price represents the least best saving in these regions.

6.52. BGT's large share of dual fuel customers is an indication that customers' decisions to switch may not be driven solely by price but that other factors may play a part. These other factors are discussed in more detail in Chapter 3. Amongst other things, they indicate that, if there are no price differentials between suppliers, some suppliers would still continue to gain more customers.

6.53. Appendix 15 contains additional information on the methodology for calculating dual fuel customer shares.

Indices of concentration

6.54. The HHI[42] is influenced both by the number of firms in the market and differences in their relative sizes. The value of the HHI decreases as the number of firms in a market rises. Similarly the value of the HHI will be greater the larger

[42] Herfindahl Hirschman Index. See glossary for further details.

the degree of inequality in firm size. In general, in merger analysis, the OFT takes the view that an HHI in excess of 1800 is highly concentrated43.

6.55. Table 6.8 shows national HHIs for gas and electricity over time. In gas the high HHIs reflect BGT's large national share of customers but, as with national gas customer shares, the HHI is gradually eroding. For the national electricity picture the HHIs jump between September 2002 and September 2003 as a result of the merger of TXU and Powergen. Electricity national HHIs are now approaching the 1800 threshold.

Table 6.8: National HHIs

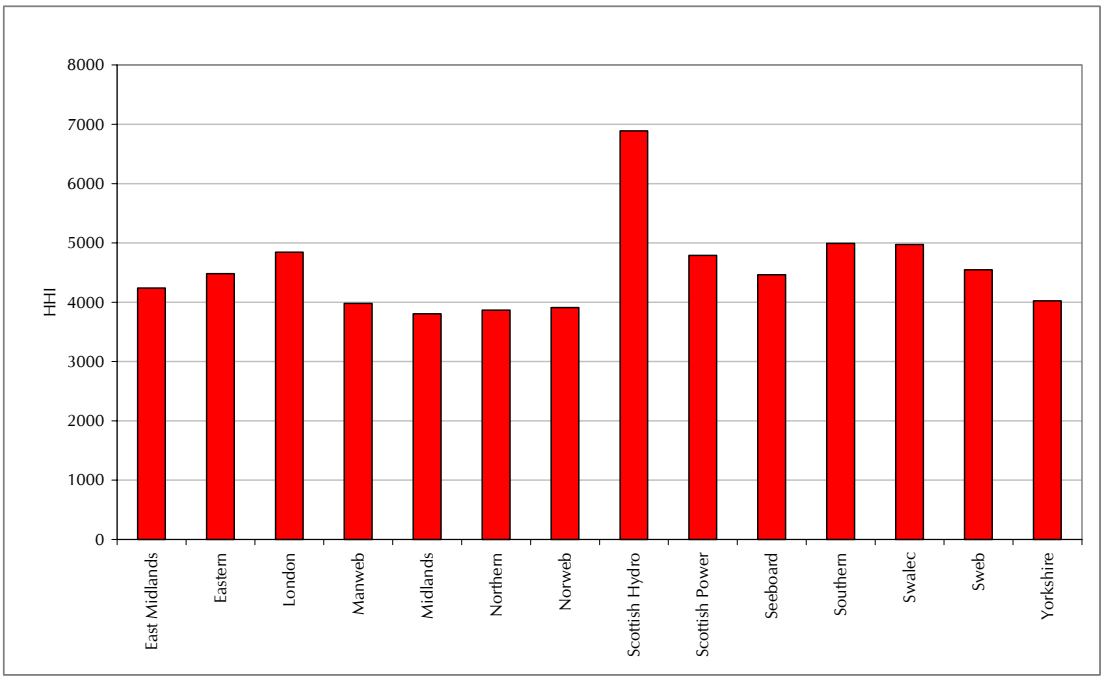
	Sep-00	Sep-01	Sep-02	Sep-03	Dec-03
Electricity	1146	1364	1551	1770	1767
Gas	*	*	4279	4129	4049

Source: For electricity distribution companies, for gas Ofgem/domestic gas suppliers
*Data not available.

6.56. Figure 6.7 shows electricity HHIs for each ex-PES region. The HHIs are well above the 1800 threshold, indicating that if viewed on a regional basis electricity markets remain highly concentrated. The HHIs reflect the picture given in Table 6.2 with a few subtle differences. For example, in the Scottish Power (South Scotland) and Seeboard (South East) regions, ScottishPower and EDF, the respective ex-PESs, both have the same group customer share of 63 per cent. However, the HHI for the Scottish Power region is higher than the Seeboard region. This indicates that in the Scottish Power region customers are less evenly distributed between suppliers than in the Seeboard region and that there are fewer suppliers, each with a larger proportion of customers in the Scottish Power region than the Seeboard region.

[43] OFT, "*Mergers: substantive assessment guidance*", May 2003, page 23.

Figure 6.7: Regional electricity HHIs



Source: Distribution companies

6.57. Table 6.9 shows the percentage share of gas and electricity customers in Great Britain for each of the ex-PES groups, BGT and other gas and electricity suppliers. The figures illustrate BGT's wider position in the energy retail sector.

Table 6.9: Total gas and electricity customers December 2003 (per cent)[44]

Group	Gas + Electricity
BGT	40
Powergen	17
npower	13
EDF	10
SSE	11
Scottish Power	8
Others	1
Total	100

Source: For electricity distribution companies, for gas Ofgem/domestic gas suppliers

Number of suppliers

6.58. One of the key benefits of competition for customers is the choice of different suppliers and supply offerings so each customer can find a package that suits

[44] This measure counts many customers twice because so many have both gas and electricity supply.

their needs. The number of active suppliers and their various market offerings is indicative of the choices customers have.

6.59. Table 6.10 shows the number of licences granted as of February 2004, the number of active suppliers as of December 2003, and the number of active brands as of February 2004. The 'active suppliers' measure indicates all licensed suppliers with customers. The 'active brands/offers' measure uses Ofgem's Domestic Prices Database to look at the number of offers available to a customer paying by direct debit45.

Table 6.10: Number of suppliers

	Domestic gas	Domestic electricity
Number of licences granted	35	34
Active Suppliers	9	12
Active Brands/Offers	16	16

Source: Ofgem Domestic Prices Database, gas suppliers, distribution companies and Ofgem Licensing

6.60. Since Ofgem last published similar data in November 2001 there has been a decrease in the number of active gas suppliers reflecting consolidation in supply. In both gas and electricity there are six main suppliers. However, the number of electricity suppliers has not changed since Ofgem's November 2001 review. Appendix 16 illustrates merger activity since November 2001.

6.61. Table 6.11 shows all the individual active suppliers excluding ex-PES suppliers and BGT. Two of the new entrants in electricity have a focus on renewable energy – Good Energy and Ecotricity.

Table 6.11: Active suppliers excluding BGT and ex-PESs (December 2003)

Active suppliers electricity	Active suppliers gas
Atlantic Electric & Gas Limited	Atlantic Electric and Gas Limited
Opus Energy Limited [46]	Telecom Plus Plc
Economy Power Limited	Countrywide Farmers Plc[47]
Basic Power Limited [48]	
Good Energy Limited	
Ecotricity[49]	

Source: Ofgem Domestic Prices Database, Gas suppliers, Distribution companies and Licensing

[45] Direct debit is used as a proxy for other payment methods.
[46] Telecom Plus acts as an agent for Opus.
[47] Countrywide does not supply in all regions of Great Britain.
[48] Operates under Utility Link's licence.
[49] Registered company: The Renewable Energy Company Limited.

6.62. Table 6.12 shows all the price offerings listed in Ofgem's Domestic Prices Database. These do not include certain affinity deals offered by suppliers in conjunction with supermarkets and other companies. The availability of some of these brand names depends on which region the customer lives in. For example, the Manweb offering is only available to customers in the Manweb ex-PES region.

Table 6.12: Gas and electricity supplier offerings (February 2004)

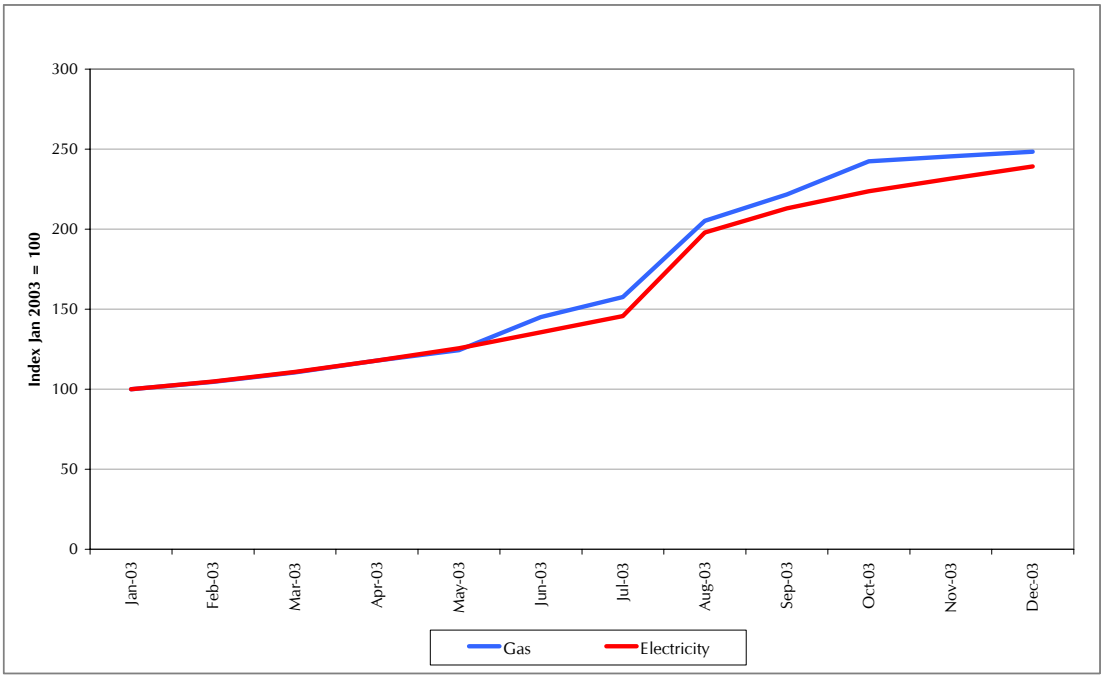
Electricity supplier offerings	Gas supplier offerings
Atlantic Electric and Gas	Atlantic Electric and Gas
Basic Power	BGT
BGT	Cambridge Gas & Electricity
London Energy	Countrywide
Manweb	London Energy
npower	Manweb
Powergen	npower
Scottish Hydro-Electric	Powergen
ScottishPower	Scottish Hydro-Electric
SEEBOARD Energy	ScottishPower
Servista[50]	SEEBOARD Energy
Southern Electric	Servista[51]
Swalec	Southern Electric
SWEB Energy	Swalec
Telecom Plus	SWEB Energy
Virgin HomeEnergy	Telecom Plus

Source: Ofgem

6.63. Figure 6.8 shows the change in non-incumbent52 customer shares since January 2003. It shows that for both gas and electricity, new entrants have more than doubled their customer bases over the past year. However their overall share of customers is very small, supplying a total of about 131,000 gas customers and 190,000 electricity customers between them. The largest new entrant, Atlantic Electric and Gas, is for sale.

[50] From 11 February 2004 Servista customers have been migrated to Powergen. Servista is no longer available to new customers.
[51] From 11 February 2004 Servista customers have been migrated to Powergen. Servista is no longer available to new customers.
[52] Gas non-incumbents include: Atlantic, Telecom Plus and Countrywide. Electricity non-incumbents include: Atlantic, Basic Power, Good Energy, Economy Power, Opus and Renewable Energy Company.

Figure 6.8: Index of new entrant customer numbers (January 2003 = 100)



Source: For electricity distribution companies, for gas Ofgem and domestic gas suppliers

Coordinated Effects

6.64. This section considers whether the current structure of the gas and electricity sectors mean that they are susceptible to tacit coordination and whether this may lead to the emergence of coordination by suppliers. Appendix 18 explains more of the economic theory behind coordinated effects.

6.65. Coordinated effects occur without active agreement when companies realise that it would be in their interest, for example to avoid price cuts that could lead to lower profitability for all suppliers. Coordinated effects can be contrasted with non-coordinated effects where the actions of an individual company with market power may lead to an increase in prices above the competitive level.

6.66. The idea of coordinated effects is illustrated by the recent Competition Commission report53 into the acquisition of Safeway plc:

'…in sufficiently concentrated markets, competitive dynamics can give way to a

[53] Page 5, Safeway plc and Asda Group Limited (owned by Wal-Mart Stores Inc); Wm Morrison Supermarkets PLC; J Sainsbury plc; and Tesco plc: A report on the mergers in contemplation, Presented to Parliament by the Secretary of State for Trade and Industry by Command of Her Majesty September 2003, Competition Commission.

recognition by the participating firms of the interdependence of their prices and sales, and that they have a clear common interest in avoiding mutually destructive rivalry, in particular, price cuts, where the response of rivals in each case would render that price cut unprofitable for the participants'.

6.67. The most serious form of coordination is a price fixing agreement. Such an agreement could be explicitly set out in a document or a verbal agreement. However, other forms of coordination with lesser degrees of contact between parties can be thought of as 'tacit coordination'. This is the type of coordination associated with 'coordinated effects'. All these activities could lead to a financial penalty under the Competition Act.

6.68. In concentrated markets a smaller number of market players make coordination easier because company interactions are easier to observe and follow.

6.69. Gas and electricity are homogenous products in that electricity from supplier A is functionally identical to electricity from supplier B. Markets for homogenous, undifferentiated products are more susceptible to tacit coordination because in such markets companies can only compete on price, not service quality for example, and this means that it is easier for them to come to an agreement (whether tacit or otherwise) on market sharing or price fixing. In gas and electricity, suppliers do seem to be attempting to differentiate their products through branding, special offers and bundling.

6.70. In addition to product homogeneity and concentration the following factors may be considered when coming to a view on whether markets are likely to give scope for coordinated effects (each factor is discussed in more detail in Appendix 18)54:

- possible barriers to entry and expansion
- capacity to reach a mutually advantageous equilibrium and detect cheating
- capacity for repeated interaction between firms

[54] Variations on these factors have been discussed in many merger investigations, such as the supermarkets case and the Competition Commission ' Merger references: Competition Commission Guidelines', March 2003 also discusses them.

- credible strategies to punish firms for deviating from the mutually advantageous equilibrium, such as retaliatory pricing strategies, and
- switching costs.

6.71. Barriers to entry and expansion make it easier for incumbent firms to raise prices without attracting new entry. An anti-competitive pricing strategy would be more difficult to maintain if new firms could quickly enter and exit a market. Barriers to entry in gas and electricity supply are discussed in more detail in Chapter 7.

6.72. Gas and electricity markets are characterised by stable demand and low demand growth. Domestic prices are published and therefore suppliers are aware of each others' tariffs although the complexity of tariffs makes monitoring more difficult. Gas and electricity are homogenous, although there is some product differentiation by suppliers. Levels of domestic consumption do not vary significantly with price because gas and electricity are necessities. All of these factors indicate that there is the potential to reach a mutually advantageous equilibrium and detect cheating.

6.73. However, incumbent customer shares are characterised by steady erosion and are different for BGT and the ex-PESs. Depending on different market definitions, levels of concentration vary. In addition there are some customer switching costs. These market conditions make punishment strategies[55] more difficult and therefore make coordination more difficult.

6.74. Ofgem's on-going market monitoring pricing analysis aims to identify whether coordination may be taking place. This pricing analysis looks at gas, electricity and dual fuel prices on a regional basis and focuses on possible reciprocal supplier behaviour. From time to time Ofgem compares prices in-area and out-of-area to identify where competition for customers is fiercest and where it appears to be weaker. The most recent analysis of this type indicates that coordination is unlikely to be taking place.

[55] Punishment strategy is the ability of firms to retaliate and price low if one firm cheats. Credible punishment strategies result from stable market conditions and a broad symmetry of firms. For more detail see Appendix 18.

6.75. Whilst pricing analysis provides some useful insights into supplier behaviour caution should be taken when interpreting it because it does not capture different levels of service and the value customers attach to service levels. Chapter 3 discusses supplier fixed effects which may go some way to explaining non-price differences between suppliers.

7. Barriers to entry and expansion

7.1. This chapter:

- explains why Ofgem has considered barriers to entry and expansion as part of this review of domestic competition
- re-visits the barriers that were identified in Ofgem's November 2001 Review[56] and provides a brief update on the work that has been carried out on each, and
- discusses the findings of a more recent exercise that Ofgem has carried out to assess the potential impact of a variety of barriers on new entrants.

7.2. Further information about new entrants to the supply sector is in Chapter 6.

7.3. This review of competition has not been carried out in the context of an investigation under the Competition Act. The term 'barrier' has therefore been used loosely to refer to a number of issues which seem to have the potential to deter entry or expansion and that it may be appropriate for Ofgem (or others) to take action to change. Some of these may also be barriers to entry and expansion in the non-domestic gas and electricity sectors. This review in no way commits Ofgem to considering these issues in a similar way during any future Competition Act investigation.

Background

7.4. Consideration of the nature and extent of barriers to entry and expansion are important in the assessment of potential competition since they influence the number and type of firms in a market and their conduct. The lower the entry barriers, the more likely it is that the threat of, or actual, new entry will prevent companies already operating in a market from persistently raising prices above competitive levels. Even in a market where there are very few companies, if entry barriers are low then existing companies' behaviour may be constrained by the simple threat of credible new entry. For example, if it is observed that an

[56] Ofgem, *"Review of domestic gas and electricity competition and supply price regulation: Evidence and*

existing company is very profitable, a new entrant could potentially undercut their prices and gain some of their market share.

7.5. Obviously, new entry of gas and electricity suppliers (or the threat of it) will help to protect the interests of customers by countering the threat of entrenched market power through competitive rivalry on prices and providing incentives for improvements in service.

7.6. Economic theory presents a range of potential definitions of entry barriers. For example, a barrier to entry may be defined as any cost that is incurred by a new entrant but not by an incumbent[57]. Alternatively a barrier to entry can be defined as an advantage of incumbents over potential entrants, which is reflected in the extent to which incumbents may persistently raise their prices above competitive levels without attracting new entry[58]. This contrasts with the concept of an impediment to entry where incumbents can only benefit from the impediment for a limited period of time[59].

7.7. This chapter takes a broad view of what constitutes a barrier to entry or expansion, the aim being to identify areas where it maybe appropriate for Ofgem, or others, to take action to reduce such barriers. Some of the discussion addresses issues that affect existing suppliers as well as new entrants.

Terminology and data

7.8. The following key concepts are used in this chapter. The Glossary at the end of the document explains other concepts that may be useful in understanding the issues raised.

- barrier to entry – discussed in paragraph 7.6 above. This chapter does not define barriers in a strictly economic sense but takes a broad view of what may constitute a barrier to entry or expansion

initial proposals", November 2001, 71/01.
[57] After George J. Stigler, *The Organisation of Industry*, 1968 (p.67)
[58] After Joe S. Bain, *Barriers to New Competition*,1956, (p.3).
[59] See OFT "*Barriers to entry and exit in UK competition policy*" Research Paper 2, Report by London Economics for OFT, page 6.

- barrier to expansion – a factor that may limit an entrant's ability to increase in size. If expansion is perceived to be difficult this is likely to deter entry

- new entrant - in this chapter this means an entrant that does not have an incumbent customer base in either gas or electricity

- incumbent – a former monopoly supplier – BGT for gas and the ex-PESs in-area for electricity, and

- active supplier – a gas or electricity supplier supplying customers.

Key facts and trends

7.9. This Chapter discusses a number of areas where progress has been made by Ofgem and the industry on reducing barriers to entry and expansion. Despite progress on a number of issues, there still remain some areas of concern:

- dynamic teleswitched heating loads where the majority of customers with these types of meter have been unable to switch supplier, although they have seen similar price changes to other customers

- prepayment infrastructure facilities may be a barrier to entry and expansion, and

- the current credit cover requirements.

7.10. For new entrant suppliers without an incumbent customer base, there are a number of difficulties in obtaining information necessary to develop business plans and to enter the market, even though the information itself is not confidential.

Analysis

Previous reviews – barriers to entry and expansion

7.11. Ofgem's November 2001 Review discussed whether certain features constituted barriers to entry. This section re-visits those features that Ofgem considers may present barriers to entry and expansion for new entrants and explains the changes that have taken place. The features discussed here are:

- electricity supplier agency services and the provision of prepayment meter infrastructure services
- gas prepayment meter infrastructure facilities
- separation of electricity distribution and supply
- Scottish electricity trading arrangements
- dynamic teleswitched ('DTS') heating loads
- introduction of competition for metering and metering services, and
- debt blocking.

7.12. Appendix 19 gives brief updates on the other features identified in the November 2001 Review which include the following:

- BGT's and the ex-PES suppliers' market position and behaviour
- shared unmetered supply
- competition on gas transportation networks operated by companies other than Transco (iGTs)
- gas system entry capacity auctions
- the effect of NETA, and
- the Renewables Obligation.

Electricity supplier agency services and the provision of prepayment meter infrastructure services

7.13. The November 2001 Review noted concerns expressed about poor quality services provided by the supplier agency services of the ex-PES suppliers and/or distribution companies and that this might represent preferential treatment. Particular concern was expressed about the provision of prepayment infrastructure services. Ofgem stated that supplier agency service providers were obliged to provide these services on a non-discriminatory basis and that Ofgem would take action if this was not the case. It also noted that suppliers were able to change metering and data service providers and that Elexon was working to address any problems with the Change of Agent process.

Update

7.14. Suppliers use prepayment meter infrastructure services when a customer has a prepayment meter. Prepayment meter infrastructure services include the following elements:

- issuing a device such as a token, card or key
- the use by domestic customers of local outlets to purchase of tokens and add credit to cards or keys
- making payments to electricity suppliers which have been received by the service provider from the customer, and
- the transfer of customer data to electricity suppliers.

7.15. In electricity, prepayment meter infrastructure services are currently provided to all suppliers by the in-area ex-PES as a licence requirement. In gas, these services are provided by Siemens through contractual arrangements. There is, however, no requirement to obtain prepayment meter infrastructure services from any one company.

7.16. Ofgem has no evidence that prepayment infrastructure services are being operated in a discriminatory way. In 2003 Ofgem used its powers to settle

disputes under Standard Licence Condition 53C of the electricity supply licences of Scottish Power, npower Northern and npower Yorkshire60. This decision allowed suppliers to unbundle part of the prepayment meter infrastructure service activities from the incumbent ex-PES supplier.

7.17. In particular Ofgem stated that it supported the principle of an unbundled charge for the initial payment device since competition in the provision of the payment device is likely to improve the level of service prepayment customers receive.

7.18. Ofgem is also aware that one supplier has successfully tendered for electricity prepayment meter infrastructure services from a company other than the ex-PES supplier61.

7.19. Electricity suppliers are currently working together to improve how suppliers receive customers' payments. Ofgem will monitor the operation of a new, competitive prepayment meter service.

Gas prepayment meter infrastructure services

7.20. The November 2001 Review noted a comment by a supplier that the charge for gas prepayment services is higher than the equivalent charge in electricity. Ofgem stated that its review of metering competition had identified the issue of creating choice in prepayment metering and in the longer term there should be downward pressure on charges for using these facilities.

Update

7.21. As part of its work on the Social Action Plan, Ofgem has been working with industry parties to try to identify and remove barriers to the introduction of more efficient prepayment infrastructure providers and how the efficiency of those currently in place can be improved.

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[60] "Decision By The Gas And Electricity Markets Authority Following A Request By British Gas Trading Limited For Settlement Of Terms Of An Agreement In Dispute With Scottish Power Energy Retail Limited Under Electricity Supply Standard Licence Condition 53c", April 2003; "Decision By The Gas And Electricity Markets Authority Following A Request By British Gas Trading Limited For Settlement Of Terms Of An Agreement In Dispute With Npower Yorkshire Limited Under Electricity Supply Standard Licence Condition 53c", May 2003; and "Decision By The Gas And Electricity Markets Authority Following A Request By British Gas Trading Limited For Settlement Of Terms Of An Agreement In Dispute With Npower Northern Supply Limited" Under Electricity Supply Standard Licence Condition 53c, June 2003

[61] The same supplier also successfully tendered for gas prepayment meter services.

Separation of electricity distribution and supply

7.22. The November 2001 Review noted that as a result of changes introduced by the Utilities Act, distribution companies are obliged by their licences to maintain managerial and operational independence from supply companies and to appoint a compliance officer to ensure that this is done. These changes were introduced to facilitate competition in electricity supply, since separation reduces incentives and opportunities for owners of both supply and distribution businesses to allow the former to discriminate in favour of the latter. Ofgem stated that it would continue to monitor distribution companies' independence from other businesses and would take action where necessary.

Update

7.23. Ofgem's Corporate Plan for 2004 - 2007[62] proposes to complete research on the role of brand independence in securing effective separation of supply and distribution services. Ofgem wants to assess whether common brands for retail and network businesses are reinforcing customers' beliefs that the affiliated retail business will provide a more reliable service (see Chapter 2). This research will help to inform Ofgem whether there is a need for further work on this issue. Ofgem will also consider whether additional information should be provided to customers about the separation of supply and distribution/transportation.

Scottish electricity trading arrangements

7.24. There is no directly competitive wholesale market in Scotland and the incumbent supply businesses are not subject to the same balancing arrangements in their own areas as independent generators and suppliers.

Update

7.25. Ofgem and the DTI are introducing Great Britain-wide trading arrangements as part of the BETTA project. This is due to be implemented in April 200563 and will mean that all suppliers and generators are subject to the same wholesale and balancing arrangements, wherever they supply customers.

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[62] Ofgem Proposed Corporate Plan 2004-2007. Ofgem 59/04 March 2004
[63] Subject to Royal Assent to the Energy Bill in July 2004.

Dynamic teleswitched ('DTS') heating loads

7.26. Some domestic customers have their supply remotely switched by their supplier, for example if they have a separate heating load circuit. Ofgem considered that the operation of the DTS regime by incumbent suppliers could give an information advantage over other suppliers as to the times of day when supply was made available to heating circuits for these types of customer, and that this information advantage could deter other suppliers from competing for those customers. This issue is especially relevant in Scotland where DTS customers account for about 10 per cent of the domestic customer base and no supplier other than the incumbent appears to be actively seeking to make DTS supply offerings to these customers.

Update

7.27. Ofgem has carried out work to understand whether there are any technical constraints affecting the transfer of DTS customers. The work highlighted that there are no technical obstacles preventing a supplier from offering supply terms to these customers. However most suppliers' billing systems are not designed to deal with the additional registers on some DTS meters and information from suppliers indicates that in Scotland the DTS tariff structures are more complicated than in England and Wales.

7.28. Ofgem's work has also highlighted low switching rates among DTS customers. Although Ofgem's analysis indicates that price changes for DTS customers are similar to those for other customer groups it remains concerned that competition has not developed in this area.

7.29. Following an earlier request for information on DTS customers, Ofgem wrote to suppliers in September 2003 reminding them that they had a duty to offer terms to supply all domestic customers, that suppliers should ensure that they were in a position to do so by 1 April 2004 and that failure to do so could lead to licence enforcement action.

7.30. A number of suppliers have indicated that they have experienced difficulty getting access to market information on the numbers of DTS customers and the structure and operation of DTS tariffs. Ofgem will continue to work with the

industry on issues concerning DTS customers. In particular it proposes to hold a seminar to discuss any information or other issues that are impeding progress in this area.

Introduction of competition in metering

7.31. The November 2001 Review noted concerns about whether the introduction of metering competition would increase costs for suppliers which would be passed through to customers. Ofgem stated that the introduction of competition in metering would provide significant benefit to customers.

Update

7.32. In May 2003 the electricity industry concluded the Review of Electricity Metering Arrangements (REMA) process and introduced new procedures to facilitate competition in electricity metering services64. The equivalent process in gas, the Review of Gas Metering Arrangements (RGMA)65 is scheduled to be completed by 12 July 2004.

7.33. One large supplier (BGT) has appointed alternative providers of gas and electricity metering services and is in the process of rolling these out across the country. Two other large suppliers (Powergen and Innogy – owner of npower) have issued invitations to tender to for metering services. On 23 March 2004 Ofgem issued a survey66 to gather information for a competitive market review of the metering market.

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[64] Information on the REMA process can be found on Ofgem's website by entering the term "REMA" into the search dialogue

[65] Information on the RGMA process can be found on Ofgem's website at http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/meteringrgma

[66] http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/meteringstrategy&levelids=,1_6586#top6586

Debt blocking

7.34. The November 2001 Review discussed whether debt blocking was an impediment to the development of competition. Ofgem stated that it was continuing to work with suppliers to encourage them to stop objecting to customer transfers on the grounds of debt.

Update

7.35. In October 2003 an industry protocol was agreed and came into force in February 2004 whereby prepayment customers with less than £100 debt would be allowed to transfer to another supplier (with the debt transferred as well). Ofgem has recently imposed financial penalties on a number of suppliers that had incorrectly objected to the transfer of direct debit customers on the grounds of debt.

Recent review – impact on new entrants

7.36. In order to assess the potential impact of barriers to entry and expansion, Ofgem analysed some of the processes that a new entrant to the gas and electricity domestic supply sectors has to go through before it can start to supply customers. This analysis consisted of a 'desk-based' exercise and talking to actual and potential new entrants.

7.37. The analysis highlighted a number of areas which may create barriers for a new entrant. This section discusses some of the issues raised and what action, if any, Ofgem considers should be taken on them.

7.38. The barriers identified fall into the following (loosely defined) main categories:

- entry requirements
- regulatory requirements
- operation issues
- financial issues, and
- information issues.

Entry requirements

7.39. Gas and electricity suppliers need to be parties to a number of agreements, either as a requirement of their licence or as part of the general operation of the markets. These include:

- electricity Distribution Use of System Agreements ('DUoSA')
- the electricity Master Registration Agreement ('MRA')
- the electricity Balancing and Settlement Code ('BSC')
- the electricity Connection Use of System Code ('CUSC')
- the electricity Data Transfer Service Agreement
- Scottish electricity trading agreements, and
- agreements with metering agents.

7.40. Potential suppliers therefore need access to substantial amounts of information about how the codes work in practice, how to accede to them and what they must do to be able to comply with them. Ofgem's analysis indicated that although some information was available, there are some key areas where obtaining the information is disproportionately time-consuming, particularly for some DUoSAs.

7.41. An electricity supplier must enter into a bi-lateral contract with each electricity distribution company in whose area it wishes to supply electricity. There are 14 distribution companies: 12 in England and Wales and two in Scotland. Distribution companies' DUoSA are broadly similar, although they are not identical. Potential and actual new entrants have told Ofgem that distribution companies are inconsistent in their ability to negotiate DUoSAs with new suppliers - some distribution companies are helpful and responsive, others are not. In addition, although use of system charges are regulated by Ofgem and are therefore in the public domain, not all distribution companies provide information about their charges on their websites.

7.42. It is not clear to Ofgem why there should be such variation between distribution companies on these issues.

7.43. Ofgem has published an 'information pack' that provides high level information for parties interested in becoming licensed electricity suppliers67. It provides an overview of the structure of electricity supply, some information on relevant legislation, a brief description of the governance bodies responsible for its operation and a description of how an organisation becomes a licensed electricity supplier. The pack includes information from other organisations that administer various aspects of the electricity supply market. It also provides contact details of the relevant organisations that can provide further information.

Regulatory requirements

Licensing

7.44. All gas and electricity suppliers must be licensed (unless they fall into certain exempt categories). Ofgem assesses applications for all types of licence. In April 2003 Ofgem revised the licence Application Regulations[68] to reduce the amount of information supply licensees are required to provide. Ofgem aims to assess applications for supply licences within 12 weeks of receiving all the information required by the Application Regulations; in practice applications are often assessed much more quickly.

7.45. Ofgem's view – Ofgem considers that recent changes to the application process mean that this does not present an undue barrier to entry.

Domestic supply licence conditions

7.46. Domestic supply licensees have to comply with more standard licence conditions than non-domestic suppliers. Some new entrant suppliers have told Ofgem that they consider that some of these requirements place additional, unnecessary burdens on them.

7.47. Ofgem's view - Ofgem's Corporate Plan for 2004 - 200769 proposes to review the supply licence conditions with the objective of improving the targeting and effectiveness of regulation and to reduce barriers to entry. It is likely that part of

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[67] Ofgem "*New Entrants to the Electricity Supply Market*", Information Pack V.1, November 2002. An updated version of this document will be published shortly.
[68] Ofgem, "*Gas and electricity licence applications: Guidance document*", January 2004.
[69] Ofgem, "*Proposed Corporate Plan 2004-2007*" March 2004, 59/04.

this review will include consideration of the impact of these additional requirements on new entrants.

Operational issues

Supply on iGTs

7.48. Domestic suppliers are obliged by their licence to offer terms to supply customers on gas networks that are not owned by Transco. Ofgem understands that very few non-vertically integrated shippers have signed all the iGTs' network codes. This therefore presents a new entrant with a potential barrier to entry – if it cannot contract with a shipper that has signed all network codes, it will have difficulty complying with its duty to offer terms to all domestic customers.

7.49. Ofgem's view – Ofgem's Corporate Plan for 2004 - 200770 proposes to review the supply licence conditions with the objective of improving the targeting and effectiveness of regulation and to reduce barriers to entry. It is likely that issues concerning supply on iGTs will form part of this review.

Electricity wholesale price volatility

7.50. The introduction of NETA necessitates expertise and technical equipment to match the purchase of energy to customer demand for every half hour. The difficulty of predicting domestic demand, particularly at a time when the number of customers may be increasing rapidly, may make it difficult for new entrants to protect themselves against wholesale price volatility.

7.51. Ofgem's view – there are a number of ways in which any supplier can mitigate against wholesale price volatility; how they choose to do so is a commercial decision for them. NETA ensures that the cost of dealing with system imbalances falls on those suppliers that create them and that this creates appropriate incentives to balance a portfolio.

[70] Ofgem, "*Proposed Corporate Plan 2004-2007*" March 2004, 59/04.

Acquiring and retaining customers

7.52. A number of issues were identified that present difficulties for a new supplier trying to acquire and retain new customers.

7.53. Search and switching costs - in deciding whether to switch supplier and which supplier to switch to, customers incur costs. For instance customers are likely to want to compare different suppliers' prices, whether there are additional features that interest them (such as supermarket loyalty points, single bills, etc) or whether there are any contractual terms that might restrict their ability to switch in the future. If this information is not readily available (and easy to understand) it will take customer time (and possibly actual monetary costs such as telephone calls) to find it out. Sometimes customers experience problems with the transfer process itself or with subsequent billing. These also increase the overall 'cost' of switching.

7.54. Ofgem's view – it is essential that customers have access to accurate and up to date information about alternative suppliers and that, if they decide to switch, the transfer process is as straightforward as possible. Ofgem and energywatch have therefore taken a number of measures aimed at reducing customers' search and switching costs. These include producing free gas and electricity pricing factsheets, approving independent internet price comparison services, proposing that doorstep sales agents should provide customers with written quotes and extensive work on improving the customer transfer process.

7.55. Strong incumbent brands and advertising - strong incumbent brands and advertising can create barriers to entry and expansion since potential new suppliers may be discouraged from committing the resources necessary to compete successfully. Ofgem's research shows that although price is still the most important factor influencing a customer's decision to switch their gas or electricity supplier, the supplier's brand and other factors are also important (see Chapter 3 for more details).

7.56. Ofgem's view – some recent new entrants have used their existing strong brand from a different sector (eg banks and supermarkets) to enter the gas and electricity sectors. Other new entrants have focussed on price and/or customer service rather than brand. Ofgem considers that these types of innovation are a

central feature of a competitive market and that this indicates that these issues are not deterring credible new entry.

7.57. Economies of scale and scope - new entrants may incur large fixed costs in order to enter the gas and electricity markets. The more customers a supplier has, the more these fixed costs can be spread between them. Larger suppliers may therefore have an advantage over a new entrant while it is building its customer base.

7.58. Ofgem's view – Chapter 5 considers this issue in more detail. It concludes that scale may have an impact on new entrants' profitability. There is no evidence that this is deterring new entry, but it appears to constrain what kind of business plan entrants pursue, eg to enter on a large scale based on an existing brand and/or distribution channel.

7.59. Objections - customer transfers to new entrants could be blocked by their existing supplier, making it difficult for a new entrant to acquire customers.

7.60. Ofgem's view - in July 2003 suppliers agreed to the removal of their ability to object to a customer transfer on the grounds that the customer had not given adequate notice under their contract. A customer requested objection ('CRO') was introduced that allows a supplier to object to a transfer only if the customer confirms that they have not signed a contract with the supplier trying to transfer them. Although not all suppliers carry out CROs yet, a recent fall in the number of erroneous transfers could be explained by the fact that some suppliers are using CROs as a way to stop erroneous transfers. Ofgem is currently visiting suppliers to assess the way they are implementing CROs and will publish guidance on best practice in spring 2004.

7.61. 28 day rule - all domestic supply contracts must be able to be terminated by giving 28 days' notice. However in some circumstances a termination fee must be paid by the customer, for instance if they have a contract specifying a fixed price for more than 12 months. Although the use of fixed price contracts has not been widespread to date, new entrants have raised concerns that they could prevent customers switching for a considerable period of time, thereby dampening competition.

7.62. Ofgem's view – in April 2004 a small industry-wide trial is starting which will suspend the 28 day rule in certain circumstances71. Although these relate to energy efficiency measures, Ofgem's monitoring of the trial will consider the impact on customers' desire and ability to switch.

7.63. Transfer issues - the complexity of the transfer process in electricity (and to a lesser extent in gas) raises several issues for a new supplier:

- its IT system must be able to deal with the hundreds of data flows that make up an individual transfer, and
- electricity transfer problems involve dealing with up to 14 different distribution companies. New and potential entrants have told Ofgem that distribution companies vary in their ability to resolve problems quickly; this means that suppliers may need to devote considerable resources to this issue.

7.64. Ofgem's view – industry testing procedures help new entrants ensure that they can operate various industry processes such as the MRA and BSC. In addition, in June 2003 Ofgem and energywatch challenged suppliers to identify solutions to the problems surrounding customer transfer and to implement measures that would provide a step change in performance for customers72. As a result of this challenge, suppliers have put together a report that identifies the problems with the transfer process. This is due to be published by 7 April 200473. Stage 2 of the exercise will be to identify solutions to those problems and will start in April 2004.

7.65. Prepayment infrastructure - all domestic suppliers are obliged by their licence to offer terms to supply prepayment customers (and the ex-PES suppliers are obliged not to discriminate in the provision of their prepayment services). In certain circumstances they must also offer a prepayment meter to their existing credit customers who are in debt. However there are additional costs to supplying prepayment customers, for instance the administrative costs involved in replacing key cards or retrieving mis-directed payments. This may mean that

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[71] "Testing domestic consumer take-up of energy services: trial suspensions of 28 day rule", Ofgem, January 2004

[72] Ofgem, "Customer Transfer Process: Discussion Document", June 2003, 35/03.

new entrants are deterred from offering competitive rates to prepayment customers.

7.66. Ofgem's view – suppliers can set different charges for different types of customer and for different areas. This means that suppliers can reflect in their prices the different administrative costs incurred by customers paying in different ways. Ofgem does not agree that all new entrants are deterred from offering competitive terms to prepayment customers. However there are a number of issues concerning prepayment customers that have been highlighted in this review. These are summarised in Chapter 8.

Financial issues

7.67. New entrants are likely to require considerable financial resources to operate effectively. In addition to having robust IT systems to deal with transfers and billing, suppliers have to provide credit cover under a number of industry codes and agreements.

7.68. Ofgem's view - in February 2003 Ofgem published a second consultation74 on issues surrounding credit cover. Since then, a number of industry working groups have considered how these issues could be resolved. A further document will be published in due course.

Information issues

7.69. Other network costs - in addition to information about distribution charges (see paragraphs 7.36 to 7.38), it also seems to Ofgem that obtaining information about other network costs is not as straightforward as it could be. These include information about transmission costs, gas transportation costs, gas and electricity wholesale costs and metering costs.

7.70. Information about customer numbers – there is no central source of general information about customers (for instance non-supplier-specific information about the total numbers in each ex-PES region).

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[73] See www.energy-retail.org.cuk and follow link to 'customer transfer programme'.
[74] "Arrangements for gas and electricity network operator credit cover: Conclusions and proposals", Ofgem, February 2003, 06/03

7.71. Competitors' prices – although domestic pricing information must be published, the variety of prices in any one area means that new entrants in particular would have to spend a considerable time assessing their competitors' prices.

7.72. Ofgem's view - many of the issues raised concern over the availability of information. In particular, there is no single source for all the information a new entrant needs to plan its entry to the supply market. In many sectors this type of information might be provided by an organisation such as a trade association. There are various ways in which this type of information could be provided for the gas and electricity industries. Ofgem has considered whether it should set up a micro-website comprising links to relevant information such as network companies' use of system charges. However it seems more appropriate that the industry itself should co-ordinate and provide this information centrally. The work on licensing and new entry by Ofgem and other parties has shown that this approach can be successful in practice.