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Dear Ms Fletcher

Non Domestic supply market review: consultation

Thank you for the opportunity to express our views on whether a review should be undertaken of the non domestic supply markets for gas and electricity.

I apologise for the late submission of this response but trust you will nevertheless find it helpful in considering whether a review is justified.

ESPO is a local authority purchasing consortium accounting for annual expenditure on energy of over £55m across some 5,000 sites comprising local authorities, educational establishments, emergency services, Housing Associations and registered charities.

The last market review was undertaken in July 2003 and concluded the markets were broadly competitive. Like many industrial and commercial consumers we did not share your views then, and we believe the situation has not improved.

You have requested views on whether a market review would be justified and have requested evidence relating to a number of indicators. Where possible we have attempted to attribute our comments to the indicators you have proposed.

However, whilst the indicators are no doubt fairly standard measures of market competitiveness and effective, we do not believe they provide a complete picture or that they necessarily reflect the unique nature of the UK energy markets, which are a mix of regulated monopolies and liberalised retail supply, dominated by a small number of vertically integrated companies, but which are which are inextricably linked to the less liberalised European energy markets – in which the same vertically integrated energy companies are also dominant.

Consequently, some of our comments do not readily fit with your indicators but we trust you will bear with us on these points.

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Parallel Movements in Prices Offered by Suppliers or other evidence of collusion

- Market price is set by very few trades in an illiquid market, frequently with no trading beyond 3 months ahead – although a market price is still determined
- All suppliers price against the same 'market price' event though they actually source their supply from a variety of sources (for example, BG's average realised gas price from North Sea fields was around 36p/therm at the end of 2005, compared to 21p in other parts of the globe – but their retail prices were somewhat higher than this).
- Consequently the difference between suppliers is marginal (typically no more than 5% at the extremes, but with the bulk of prices being in a narrow band of less than 1-2%). Furthermore, suppliers' prices broadly move up or down in unison
- Suppliers without access to the source of production are therefore reliant on the spot markets and at a disadvantage to the vertically integrated companies

Sustained Increases in Retail Margins

- The energy retail markets are widely reported to be 'low margin' business, with margins of typically 2-3% being reported
- This does not reflect the full picture, however, as the vertically integrated companies – who own the means of production – are able to keep their retail margins low whilst maximising revenues for production (at prices which have no bearing to the cost of production) through the spot markets – as borne out by the profits reported by these companies in the last year
- BG's average realised gas price from North Sea fields was around 36p/therm at the end of 2005, compared to 21p in other parts of the globe

Barriers to Entry, or expansion, for supply companies

- vertical integration of energy companies presents a barrier to entry, leads to dominant market positions, and excessive upstream profits
- most of them control large parts of the supply chain from production to retail, including storage and distribution assets
- this enables them to keep retail margins low whilst generating excessive production revenues
- there have been relatively few new market entrants and of these, most have subsequently ceased trading in one way or another; e.g. Independent Energy, Atlantic Electric & Gas
- there is a high cost of entry in terms of investment in systems and administrative support, whilst low retail margins mean large customer bases are required
- several suppliers have decided to exit the markets; BP, ESSO, Mobil – all of which have a significant upstream presence

Impediments to Customers Switching supplier

- customers do not yet have free and unfettered access to data on their own sites, particularly in the electricity market. The proposed On-line data service is a welcome step but the service will be fairly limited in its scope and will only go some way towards addressing this issue – for example, the service will not provide customers with details of "associated" electricity mpans, without which a supply point cannot be successfully transferred to another supplier.
- Many suppliers' contract terms provide for customers' contracts to be automatically renewed. Whilst this may be a case of *caveat emptor,* for the majority of consumers there is no realistic scope for negotiation of supplier contract terms, very little difference between suppliers' contract terms, and the majority of supplier contracts are virtually unintelligible to all but specialists
- The marginal differences between suppliers' prices, the complexity of transfers, and the risks associated with failure to transfer at the due time, represent a disincentive to customer switching
- The poor service performance across the industry and lack of independent or any information about supplier performance, in a market where the customer cannot "try before they buy" and in which it is very difficult and costly to change supplier mid-contract, is a significant barrier to customer switching ("better the devil you know").

Poor Information on prices, services or other evidence of restrictions on ability of buyers to engage fully with commercial opportunities the market should present

- there is a distinct lack of independent information about supplier performance e.g. compared to telecoms – on meter reading performance, timeliness and accuracy of billing, supply point registrations, completion of site works, responses to queries etc.
- the markets suffer from a general lack of transparency, in particular information relating to the supply/demand balance
- pricing is complex, and becoming increasingly so, which represents a major problem for the smaller consumers
- Ofgem does not regulate offshore and does not have same powers as it has in inland markets for collecting data or to require its publication

Low rate of Innovation/Product Differentiation

- in our segment of the market, multi-site public sector, the majority of products (in terms of pricing) are broadly the same from one supplier to another
- the increased price volatility of recent years has lead to new pricing products for some market segments but, whilst it has been talked about, it has not materialised for the multi-site sector; there have been no products developed for the smaller end of this significant sector.
- It is surprising that there has been no new products developed to date for un-metered supplies of electricity – generally public lighting, which especially for the larger authorities aggregating requirements through consortia represent very significant volumes with predictable and consistent demand patterns.

Poor Quality of Service

- Service levels are as poor as ever; suppliers still struggle to provide even the most basic levels of service in terms of timely, accurate billing.
- The majority of suppliers have reduced Account management and customer service resources in recent years
- In many cases the Account managers are handling too many accounts; we know of two Account managers at different supply companies that are responsible for 16,000 accounts. There is very little proactive account management undertaken – identifying meters that have not been billed, for example, and even business critical tasks such as registrations are not effectively managed in many instances, simply because the Account managers are too busy. This is also having an impact on the ability of Account Managers to respond to Requests for Quotations and, consequently, is having an impact on the level of competitiveness within the market.
- The rate of supplier acquisition and merger in recent years has contributed to poor service levels, as suppliers' focus has been diverted to extracting the value from these mergers which, in many cases, has involved systems migrations which has resulted in billing and account management chaos for the next two to three years
- The advent of smarter metering may help to improve meter reading performance but the early indications are that despite the technology offering suppliers significant administrative and balancing benefits, the costs are being borne by the customer. Effectively, the customer is paying a premium to secure the level of service they should have been provided with from the outset and, in some cases, the cost may prove a barrier to adopting the technology.

We believe these factors alone justify a review of the non-domestic gas and electricity supply markets. However, the case for a review is even stronger when considered in the context of the UK market framework and how it is positioned in relation to other, particularly European markets;

- The number of active UK suppliers (NOT generators) has reduced from over 20 in 1999 to around 6 currently
- The supply side of the market is not responding to high prices: inter-connector and LNG terminals' capacity is being under utilised even when market signals suggest it should be

fully utilised – gas was 38p/therm in EU at beginning of December whilst in UK it was >£1/therm

- There is no underlying problem with gas supply and no material increase in demand – compared to previous years – to account for the magnitude of the prices increases experienced in the last year; gas prices also remain high despite steady demand and milder temperatures
- Market price is set by very few trades in an illiquid market, frequently with no trading beyond 3 months ahead – although a market price is still determined
- There is significant scope, therefore, for 1 or 2 dominant buyers to support prices or to have a distorted influence on prices
- Conversely, a large sales/demand turn down by I&C consumers appears to have no impact on prices
- Part of the problem appears to be the release of gas from the EU to come through the inter-connector, apparently because of the reluctance of parties to release gas at times of supply uncertainty, and/or logistical constraints at/around Zeebrugge
- Efforts to encourage and speed up liberalisation in Europe are welcome, but are not sufficient to restore functionality to UK markets in the medium term – full liberalisation is likely in any event to take many years to achieve as the Trade and Industry Committee recently acknowledged

We conclude a review of the non-domestic gas and electricity supply markets is not only justified, it is absolutely necessary.

Yours sincerely

D. A. Kwiatek
Group Buyer, Energy