

Your Ref:
Our Ref:
Direct Dial: 020 7901 7194
Email: philip.davies@ofgem.gov.uk

11 November 2005

Dear non-domestic market stakeholder

Non-domestic supply market review: consultation

1. In line with its Corporate Plan commitment, and in response to concerns raised by industrial and commercial customers, Ofgem seeks your views on whether it should conduct a review of the non-domestic supply markets for gas and electricity and on the appropriate scope of any such review¹.
2. Ofgem last undertook a review of competition in the non-domestic gas and electricity supply sectors in July 2003². That review looked at competition in different segments of the gas and electricity supply markets and identified specific initiatives (such as the Customer Transfer Programme) that were underway to improve the way the markets were working. The review concluded that the supply markets were broadly competitive and that there was no need for any further non-domestic market reviews³. Against this background, we invite stakeholders to provide specific evidence that a further review is necessary.
3. This letter sets out the recent developments in the non-domestic supply market, current initiatives aimed at monitoring and improving the market, the evidence we would require to

¹ All non-domestic customer categories would be included in any review, but domestic customers would be out of scope.

² Ofgem: Review of competition in the non-domestic gas and electricity supply sectors. Initial findings 72/03 July 2003

³ Feedback on the review demonstrated that some non-domestic customers did not feel that the review addressed their concerns and that the picture of the markets presented in it did not match their direct experience.

justify undertaking a review of the market, and the particular questions we seek to answer through the consultation exercise.

Developments since July 2003

4. Since the summer of 2003 there have been a number of important and positive developments in the non-domestic gas and electricity supply markets. Most notable is the emergence of new products to assist buyers to manage the risk of increasing and more volatile wholesale prices and, to a lesser extent, the introduction of products to allow improved energy management. The increased use of third party intermediaries, for example, indicates a supply market response to changes in wholesale market conditions⁴. Similarly, customers are increasingly changing buying behaviour (for example avoiding the traditional months when going out to tender, or striking flexible pricing deals⁵) in order to obtain better contract outcomes. These trends suggest that the non-domestic supply markets may be maturing both in terms of the products on offer and buyer behaviour in the market.
5. Concentration in both gas and electricity supply markets has reduced since 2003 and there are indications that new entry by some larger suppliers (such as EdF, Gdf, Total Final Elf or more recently, Gazprom) may be placing competitive pressure on the big six incumbents at least in some segments of the non-domestic market⁶. Similarly, surveys showing improved customer satisfaction with suppliers in the non-domestic markets⁷ suggest that the markets may, in general, be becoming more successful in meeting customers' service requirements.

⁴ Currently upwards of 60% of the volume in both the gas and the electricity non-domestic markets is traded with the assistance of a third party according to Datamonitor (The role of Third Party Intermediaries in UK Electricity and Gas Retail, July 2005). Services can take the form of the provision of market information, consultation on flexible purchasing, online and traditional brokerage. Large public sector buying groups and major energy users are currently the key users of these services.

⁵ John Hall Associates Ltd note that 45% of electricity contracts and 60% of gas contracts (by volume) are now priced on a flexible basis.

⁶ The overall concentration index (Hirschmann-Herfindal Index) in the electricity market has decreased from 1695 in November 2003 to 1575 by the end of 2004. The corresponding figure for the gas market has fallen from 1339 to 1309, with a much greater reduction in the HHI in the small firm gas market (1955 to 1586 over the same period). In both electricity and gas markets there have been frequent shifts in the relative positions of the six largest suppliers in the market and in the last year differences in the market shares across these firms have very significantly narrowed. (Based on market share data provided by Datamonitor).

⁷ Datamonitor: UK I&C Buyer Market Perspective, August 2005 and other Datamonitor research.

6. Despite these encouraging developments, a fresh set of concerns regarding the health of competition in the non-domestic supply markets have been brought to Ofgem's attention by customer groups, smaller suppliers and through consultant reports.⁸ The most pressing concern raised by customer groups is that the scale of retail price rises⁹ may reflect inadequate supply competition. This is supported by reports from some customers of retail price increases in excess of wholesale price inflation and concerns that prices to SMEs (small and medium enterprises) may be increasing faster than prices in the domestic market. It is unclear to what extent these reports are indicative of a general and sustained divergence between wholesale costs and retail prices – which would indicate inadequate competition - or whether reported price increases are the result of individual changes in contracting strategies and positions. Neither is it clear which of the many indicators of wholesale prices are being used as a benchmark in these instances, making it difficult to draw conclusions about the health of supply markets from these reports alone.
7. In addition to concerns about price increases, some customer groups (particularly SMEs and multi-site user groups) have voiced concern about inadequate market response to their specific needs, especially as regards billing and the provision of energy consumption data. There is concern about the practices of some marketing agents and an impression that suppliers are not yet adequately focused on customer service. Added to this, smaller suppliers complain that their participation in the supply markets is constrained by barriers to entry and barriers to growth. Some barriers are argued to be related to vertical integration within the industry – concerns for example about inadequate wholesale market liquidity – while others indicate that market entry requirements, poor customer data and information systems may impede the entry and survival of smaller companies. Again, it is unclear whether these concerns suggest insufficient competition in the supply market or instead reflect inadequacies in particular industry systems and practices which could be addressed through targeted initiatives rather than a full scale market review.

Recent activity and on-going work

⁸ Cornwall Consulting: Business Energy Markets 2004. November 2004 (Commissioned by energywatch); Similar concerns are raised in: Stephen Littlechild: Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations. June 2005

⁹ The average industrial electricity retail price has risen by 34.6% between Q2 2003 and Q2 2005 whilst the gas price increased by 55.2%. (DTI Quarterly Energy Prices, September 2005).

8. There have been a number of recent initiatives aimed at improving the way in which the energy markets work. With regard to the wholesale markets, Ofgem's gas probe and its routine market surveillance have found that recent wholesale price increases are the result of events on the continent and do not indicate a failure of the UK wholesale markets. The European Commission is currently investigating wholesale markets across Europe and will report on its findings soon.
9. Regarding supply markets, there are several initiatives aimed at addressing data access constraints to customers and suppliers. These include the introduction of MPAS on line – a process by which electricity consumers (and suppliers) will have electronic access to supply point information; Ofgem's investigation into competition in meter reading services and its review of the case for innovative metering. At the same time, the industry is working to streamline the supply market entry processes, particularly to reduce the duplication of testing and assessment required on entry and to reduce the burden on new entrants. On consumer matters Energywatch is playing an increasing role in educating SMEs in their rights and responsibilities as participants in the non-domestic supply market while, as an extension of our response to the billing super-complaint, Ofgem continues to engage with industry bodies on the role of self regulation in delivering improved customer service and effective redress when things go wrong. There is scope to refocus or extend the remit of many of these initiatives in order to address pressing and current concerns.

Evidence required to justify a market review

10. To be robust a supply market review must be based on good quality data from a representative cross section of market participants. Given the resources required of customers, suppliers and Ofgem in undertaking a review and consistent with the Better Regulation requirement to undertake measures that are "proportionate", Ofgem would not commence the market review exercise without evidence that there are sufficient grounds for further investigation. Furthermore, where there are grounds, it will be important to ensure that the issues concerned are not already being addressed by existing work streams within Ofgem or elsewhere. Given the work undertaken and ongoing in wholesale energy markets, identified above, the scope of any potential review would be confined to the supply markets.

11. It is rare for a single indicator to give clear evidence of market failure, since a number of conclusions about the health of competition can be drawn from any given price trend or particular supplier behaviour, for example¹⁰. In examining whether a review is justified, Ofgem will include in its assessment evidence presented that relates to any of the following issues:

- Parallel movements in the prices offered by suppliers or other evidence of collusion;
- Sustained increases in retail margins;
- Predatory pricing in the supply market;
- Barriers to entry, or barriers to expansion, for supply companies;
- Impediments to customers' switching supplier;
- Poor information to customers on prices or services, or other evidence of restrictions on the ability of buyers, or their representatives, to engage fully with the commercial opportunities that the market should present;
- Low rate of innovation (compared to previous performance and/or performance in other geographic or sector markets);
- Low degree of product differentiation (compared to previous performance and/or performance in other geographic or sector markets); and
- Poor quality of service (compared to previous performance and/or performance in other geographic or sector markets).

Consultation questions

12. In the light of the above discussion, Ofgem is consulting on the following key question:

do you consider that there is sufficient justification for Ofgem to conduct a review of the non-domestic gas and electricity supply markets? Please provide specific evidence or data

¹⁰ See the OFT and Competition Commission websites as well as NERA: Observations on the Multiple Dimensions of Market Power in Antitrust Insights Fall 2005, for example

against the indicators above (or any additional indicators you consider relevant) to support your position.

13. If you do consider a review is necessary, please answer the following questions:

- which indicators of competitiveness should be the focus of this review (for example, market dominance of particular company(ies), quality of service, barriers to entry for suppliers), and why;
- should the review cover all market segments (for example SMEs, medium and large gas and electricity supply markets) or focus upon a particular sub-set of these, and why.

14. If you do not consider a review is necessary, are there other measures Ofgem should be taking to improve the way the supply market is working? What are these measures and why are they required?

15. Responses to the questions raised in this letter are due by 13 January 2006 and should be sent to:

Rachel Fletcher
Consumer Markets
Ofgem
9 Millbank
London SW1P 3GE
Email: rachel.fletcher@ofgem.gov.uk

16. Where possible, we would prefer responses in electronic format. We will treat as confidential all information so marked. Otherwise responses to the above questions will be published by placing them in Ofgem's library and on Ofgem's website.

Yours sincerely

Philip Davies