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Dear Rachel

NON-DOMESTIC SUPPLY MARKET REVIEW

British Energy welcomes the opportunity to comment on the issues raised by your consultation paper on the above as published in November 2005. Please note our comments below relate solely to the electricity market.

Key Points:

- **Ofgem should consider conducting an open and comprehensive review of the issues surrounding vertical integration and should give substantial weight to the potential effects on liquidity and competition when appraising and advising on any potential merger/or take-over.**
- **In contrast to the residential sector, the non-domestic supply market is broadly competitive. We do not therefore consider a full market review is required at this time. However, there are a number of generic and specific issues that effect the operation of this sector which if addressed would better promote competition and protect the interests of consumers.**
- **Ofgem should review the existing metering services arrangements and their effect on the market with a view to establishing improvements to further facilitate effective competition in supply.**
- **Greater stability and certainty should be introduced into the transmission charging regime. For example, the timing of charging structure reviews could be linked with that of transmission price controls reviews.**
- **Ofgem may wish to consider whether it (or the FSA) should investigate the sale of sophisticated flexible retail products and in particular the extent to which these fall within the scope of FSMA.**

Supply Market Concerns:

We note that customer concerns described in the consultation paper relate primarily to the SME sector of the supply market and are focussed in the main with the current level of retail prices and whether this is a signal that there is inadequate supply competition. Furthermore,

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it is argued by certain customer groups that prices to SME's are increasing faster than prices in the domestic market.

On the overall level of energy retail prices it is widely recognised that these are being heavily influenced by more upstream issues and do not themselves indicate a significant problem within the non-domestic supply market. Ofgem is already monitoring and analysing domestic energy markets, whereas the European Commission is undertaking a wholesale review of European energy markets. Therefore, we do not consider that both Ofgem and industry resource should be diverted from these current reviews in order to undertake a specific supply market review on the basis of customer concerns about prices at this time.

Regarding the differential between price rises in different market sectors, British Energy's supply business does not operate in either the SME or domestic market and therefore we have no evidence or performed any analysis on this issue. However, we note that domestic prices have risen by 30% between 2003 and 2005 and industrial retail prices have risen by 35% over the same period. Consequently, on this basis we are not convinced that there is currently a significant divergence in price rises between domestic and non-domestic sectors.

Notwithstanding the above, we have for some time expressed concerns to Ofgem about the relationship between wholesale prices and retail prices and the level of true competition within the supply market. Our concerns predominantly related to the domestic market where wholesale price reductions were never truly reflected in domestic tariffs whereas wholesale prices rises were quickly passed through to domestic customers. It could be argued that to a lesser degree a similar position could also be found in the SME market. We have argued that supply competition and the effective development of a healthy wholesale market are being distorted by the level of vertical integration and the dominance of the VI entities in the domestic (and SME) market. Our concerns about vertical integration are summarised further below. However, in the interests of transparency, we consider as a minimum, and as a direct response to the customers concerns' highlighted above, Ofgem should monitor typical customer prices against wholesale and other market costs and publish its analysis on a routine basis.

As indicated above, we do not consider a full market review is required at this time. However, there are a number of specific issues that effect the operation of the non-domestic supply market which if addressed would better promote competition and protect the interests of consumers. Namely,

1. Metering Services:

We are concerned at the way in which competition in metering services is evolving and in particular the withdrawal of many incumbents in providing metering services to independent suppliers. It is vital that independent suppliers are able to obtain adequate metering services at an acceptable price in order that they can compete with the incumbent supply business. Whilst the introduction of smart metering has the potential to remove many of these concerns in the long-term, in the short-term Ofgem should review the existing metering arrangements with a view to establishing what improvements are needed to further facilitate effective competition in supply.

We are of the opinion that it would be timely for Government/Ofgem to conduct a full review into the issue of 'smart' metering. Such a review should include an assessment of the costs and benefits of 'smart' metering and an evaluation of the most appropriate way of encouraging or obliging the widespread take up of such technology. The cost of metering technology continues to fall and there is increasing evidence that the installation of smart metering has the potential to deliver real benefits for customers. These include improvements in energy efficiency, reductions in metering service costs, scope for competition and the accuracy of meter readings and the knock on benefits to settlement systems. Clearly, there are some significant barriers that would need to be evaluated, such as the needed investment and meter ownership/stranded assets. On this latter point, Ofgem should review the meter ownership arrangements and explore the possibility of transferring ownership to the distribution network operators.

2. Network Use of System Tariffs

Recently, we have been concerned with the process adopted by Ofgem during its reviews of the structure of transmission charges. When significant regulatory proposals are taken forward it is vital that sufficient lead times are allowed for market participants to factor in the changes. For example, sufficient notice of material changes to transmission charging arrangements is essential in order that the changes in costs faced by suppliers can be reflected in the preparation of customer offers. Furthermore, we are concerned with Ofgem's apparent policy of seeking fundamental reviews of transmission charging arrangements on an annual basis. This trend damages market confidence and does little to improve the perception of market/regulatory risk over the longer term which ultimately is detrimental to the interests of consumers. A possible solution to this problem would be to explicitly link the timing of charging reviews with that of transmission price controls reviews. This solution would introduce some stability and certainty into the transmission charging regime.

On a similar theme, we have previously expressed to Ofgem concerns about the setting of distribution use of system charges by certain distribution licensees. Condition 4A of the distribution licence obliges licence holders to provide notice (not less than 3 months) of proposed amendments to use of system charges and then for final proposals to appropriately reflect the original notice. The intention of this licence condition is to provide suppliers with an indication of the costs it is likely to face and enable suppliers to then reflect these changes in pricing new supply contracts. However, we have previously experienced circumstances where final charges bear little resemblance to the form or level of charges indicated by the earlier notice. This exposes independent suppliers to unexpected (and hence unmanageable) contracting risk in respect of fixed price contracts. As such we would urge Ofgem to ensure that in future the process of setting and notifying distribution charges across all networks is sufficient so as to promote competition and protect the interests of consumers.

3. Financial Products:

Rising wholesale energy prices have resulted in energy costs becoming a much larger proportion of many non-domestic customers' total costs (particularly for energy intensive users). As a consequence, and in an effort to manage the risks of increasing and more volatile wholesale prices, there has been a growing appetite amongst the larger non-domestic customers for greater flexibility in their supply arrangements. This has resulted

in the development of increasingly sophisticated supply offerings from suppliers and third party intermediaries.

In itself this is not a problem. However, we are concerned that whilst this new breed of sophisticated 'flexible' purchasing solutions may offer benefits over traditional fixed price/fixed term contracts for some customers, they also carry with them different (and potentially) greater risks that some customers may not fully understand, appreciate or be able to manage. Moreover, and as indicated above, these 'flexible' purchasing solutions are becoming more sophisticated and increasingly exhibit the characteristics of 'financial' products, whether because of the products themselves and the way they work, or the language and marketing used to promote them.

This latter point is important because it raises a concern that contracts are potentially being entered into with customers in relation to products that strictly speaking may constitute 'investments' under the Financial Services and Markets Act 2000 ("FSMA") by persons who are not authorised by the FSA. Similarly, third party intermediaries may inadvertently be giving unauthorised investment advice in relation to such products.

In October 2004 the FSA published an information note for commodity market participants (including energy markets) because of concerns that such participants were not properly considering the application of the FSMA (and in particular the Regulated Activities Order) to their activities and whether those activities needed authorisation by the FSA. The recent developments above exacerbate that concern given there is still much uncertainty in the market regarding these products. Ofgem may therefore wish to consider whether it (or the FSA) should investigate the development of flexible retail products and in particular the extent to which these fall within the scope of FSMA.

General Market Concerns:

A number of concerns that were expressed by small suppliers relate to the general market structure as a whole rather than specific non-domestic market issues per se. Concerns about vertical integration (VI), liquidity and barriers to entry were highlighted. We also share these concerns and have long advocated an open and comprehensive review of the issues surrounding vertical integration, including an examination of the effects of increasing VI on competition in wholesale and supply markets and whether this is, or is not, in the public interest.

Evidence suggests that the trend of increasing VI is having a distorting effect on competition in both generation and supply markets. Firstly, the internal contracting by VI players is inhibiting the ability of the wholesale market to develop or even function properly. This is evidenced by continued medium and longer term liquidity problems and the continued absence of effective paper derivative markets and limited pure trader activity. As a result, the wholesale market has effectively been reduced to the role of a secondary balancing mechanism where trading is increasingly focused on the fine tuning of very short-term (within day/day ahead) power requirements as opposed to the trading of longer term positions. This has resulted in a more volatile wholesale market where relative low levels of traded activity, both in terms of the number and volume of trades executed, are resulting in significant swings in market prices. These factors, combined with the continued absence of any meaningful traded derivatives market, make it hard for independent power producers or suppliers to trade their output or requirements and manage market risk compared to the VI

entities. It also leads to a lack of confidence that wholesale prices are reflective of underlying market fundamentals.

Secondly, a consequence of the vertically integrated and illiquid nature of the market is that it will increasingly foreclose the market to new entrants. This is because new entrant suppliers will find it difficult to source the power they need on a competitive basis to enter and compete in the retail market and new entrant generators will be unable to secure the longer term contracts they need to underpin their financing arrangements. We note that a key cornerstone of the New Electricity Trading Arrangements ("NETA") introduced in March 2001 was the creation of market conditions that would attract new entry. Key to this was the emergence of deep and liquid wholesale markets in which a diverse range of derivative products would be traded well into the future. It is clear that NETA is in danger of failing in both respects – the traded market is stagnant with little prospect of liquidity, especially in longer term contracts, improving and market participants are exiting rather than entering the market. These problems have contributed to the demise of a number of small independent suppliers since the publication of the paper

Similar concerns to those expressed above were made by Stephen Littlechild in a recent publication entitled "Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations" dated 29 June 2005. In particular, one recommendation of the report called for Ofgem to give substantial weight to the potential effects on liquidity and competition when appraising and advising on any potential merger/or take-over. We fully support this recommendation particularly within the current environment where there is speculation over further significant take-overs within the GB electricity market.

Summary

We do not consider a full non-domestic market review is required at this time. However, above we have highlighted a number of specific issues that effect the operation of the non-domestic market which we believe should be targeted in order to promote competition, increase transparency and protect the interests of consumers. In addition, we concur with the concerns expressed by smaller suppliers on general electricity market issues such as the level of vertical integration and inadequate wholesale market liquidity. We would again urge Ofgem to consider conducting an open and comprehensive review of the issues surrounding vertical integration.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely



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