cornwallenergyassociates

Rachel Fletcher
Consumer Markets
Ofgem
9 Millbank
London
SW1P 3GE

10 January 2006

Dear Rachel,

Re: Non-domestic supply market review: consultation

Introduction

The open letter from Phillip Davies of 12 November invites responses to Ofgem on this important consultation.

Cornwall Energy Associates is an independent company which provides market intelligence and consultancy services to energy market participants, including supply market issues. In 2004 we undertook a major review of competitive supply markets for Energywatch, and we have since then undertaken assignments for others that address similar issues. We also undertake a regular market share tracking survey for energy suppliers. We do not broker energy purchase transactions on behalf of customers. We also provide technical support to the Small Suppliers Forum, a network group for energy suppliers without major production facilities of their own.

This letter sets out Cornwall Energy Associates response to Ofgem's letter of 11 November and comprises:

- our perspective on recent competitive market trends;
- some comments on information and data issues; and
- specific responses to Ofgem's questions (paragraphs 12, 13 and 14 of Philip's letter).

In summary we believe that a full review of the non-domestic supply markets is necessary and timely. The initiative provides an opportunity for Ofgem to put in place a mechanism that is effective from both operational and cost perspectives to monitor activity in the non-domestic supply sector and facilitate improved policy making. We also believe it provides an opportunity to evaluate the effectiveness of current market structures that are experiencing a period of acute stress. In our opinion, the complexity of supply markets and the very close correlation to wholesale markets, both in terms of price direction and participants, means that judgments on their effectiveness cannot be taken in isolation from the wholesale sector, and Ofgem should take this relationship into account in its assessment.

Recent competitive market trends

We have taken the opportunity afforded by the consultation to review the conclusions of our Energywatch report and believe they are still robust. Further, and most relevantly, we believe developments in issues we noted then are acting further against customer interests.

We also believe that access to upstream assets is a direct determinant of suppliers' ability to compete in supply markets. In business markets, scarcely 2pc of power volume is supplied by operators which do not own at least one major power station. In gas, the situation is better, but not by much. The recent track record of exit

Heath Farm Cottage, Paston, North Walsham, Norfolk, NR28 0SQ, T: +44 (0)1692-407865, F: +44 (0) 870-705-2249
e-mail: info@cornwallenergy.com, www.cornwallenergyassociates.com, Company Registration No: 5379768

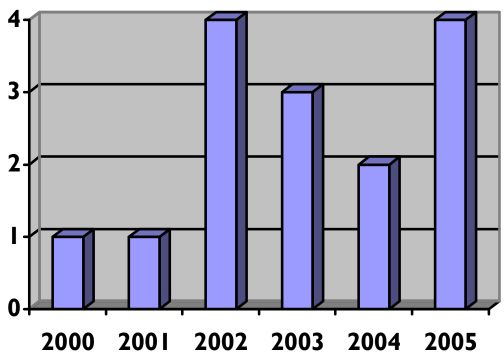
by four independent stand-alone supply businesses so far this winter underlines this point (for information we have appended a list of supplier exits since 2000 to this letter).

We believe the competitive position is much less vigorous than is implied in the 12 November letter. One specific example, we highlight is paragraph 5 which makes reference to “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 market.” Whilst we agree that an important insight into the state of competition in a market can be gained from an understanding of the number, and health, of suppliers operating in the market, we believe that this statement requires further context. Specifically this is because:

- EDF Energy has become a major supplier by the acquisition of diverse electricity supply and generation assets and is one of the ‘big six’ suppliers serving domestic users; and
- Total Fina Elf has been involved in competitive gas supply since its inception through a holding in the then Associated Gas Supplies. It has been continuously involved in the development of this business since then either as joint or whole owner. It is developing an electricity supply operation for business customers running alongside its significant established gas operation.

These comments notwithstanding, if we accept there are competitive pressures emerging as is suggested, we also believe that a stronger trend of at least 15 supplier exits in the last five years, commencing with the failure of Independent Energy in the autumn of 2000. This counter trend is one which does not indicate a market framework in rude health. This is particularly when one considers the variety of operator which has exited. All bar one of these, the trade sale of Electricity Direct, can be argued as being forced, including two cases involving the failure of international parent companies (TXU Europe and Enron). Notably, since Ofgem launched this current process, there have been four market exits by small energy suppliers (Eledor, Team, Utilita and Reepham Energy) and a further one, Utility Link, looks set to follow. There are also four instances of gas producers exiting from the business supply market over the five year period. Between 1995 and 2002 there was significant consolidation of the privatised electricity companies in Great Britain as 14 regional suppliers and two generators reduced to five integrated generator suppliers (plus the successor company to the privatised British Gas supply business). We believe this evidence of market exit and consolidation goes at least some way to substantiate the concerns expressed to us by many larger customers about declining competition for their requirements and by small suppliers about the general market environment.

Exits from competitive electricity and gas supply markets 2000-05



Further practical evidence of declining competition comes from a consideration of SVA market volume information. The Table below compares all electricity volumes supplied (domestic and business) through GSPs in England and Wales from non Big 7 (Big 7 = British Energy, British Gas, EDF Energy, E.ON UK, RWE npower, Scottish and Southern Energy and Scottish Power) sources in February and March 2004 with October and November 2005. Non Big 7 suppliers saw their volume share drop of over 15% from 5.8 to 5.0% over that period and absolute volumes are lower for the 2005 period despite overall higher consumption. Similar information on the gas market does not, unfortunately, seem to be available.

Shares by volume of the England and Wales electricity market

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

Source: Cornwall Energy Associates analysis of SVA data sourced via Enappsys.com

Information and data issues

We note Ofgem's comments concerning evidential and resource aspects in paragraph 10 of its letter, particularly that "to be robust a supply market review must be based on good quality data from a representative cross section of market participants." However, data does not seem to exist in any form available to participants to enable meaningful judgements on the vigour and effectiveness of supply competition to be evaluated. We fear that this requirement may enable a default "clean bill of health" position to be taken by Ofgem when our experience engaging with stakeholders regularly and particularly in our review for Energywatch suggests that the reverse is the case. Conversely we believe Ofgem has a duty to make available, in an appropriate form, information that only it has access to, and not push this burden onto market participants.

In the course of our analysis for Energywatch we received feedback from 53 organisations, of which 29 were customers. Some 21 interviews were undertaken with market participants, of whom 14 were suppliers and 6 were from the customer side. We also talked to Ofgem. We had access to confidential information from all sides of the market on their business positions and from this we deduced that the business supply market is a more a series of roughly delineated sub sectors rather than a single whole.

More striking was the divergence of views we discerned: customers and suppliers with small sector presence generally told us that competitive markets were working less well than previously, whilst larger suppliers were convinced this was not the case. But beyond comparing and contrasting participant opinions, we could make few hard and fast judgements about whether competition in business electricity and gas markets was working in the interests of consumers. One of our key conclusions, therefore, was that in order to improve policy making, there was a need for much more structured and routine information gathering to enable clear market segmentation and measurement of competition. This conclusion still stands and we believe this Ofgem initiative provides a major opportunity to put such a mechanism in place and build on the market evaluation framework set out in the July 2003 document.

Ofgem's issues for response

Philip Davies' letter invites "stakeholders to provide specific evidence that a further review is necessary". It sets out a range of arguments based on maturing markets, new products it says are aimed at assisting "buyers to manage the risk of increasing and more volatile wholesale prices" and talks of reducing concentration and improved customer satisfaction. We take issue with these assertions, because we believe that many customers have adopted these mechanisms through fear of committing to budget busting (and even operation shortening in terms of their business) fixed prices rather than a desire to be more actively engaged in energy pricing. In the small and medium sector, customers in our experience prefer the certainty of fixed annual prices. It cannot be repeated often enough that outside the intensive sector, most customers have opted for ‘flexible’ deals through desperation rather than choice.

The letter also sets out a number of other questions and they and our responses are listed below:

- “which indicators of competitiveness should be the focus of this review (for example, market dominance of particular company(ies), quality of service, barriers to entry for suppliers), and why;”
    - we think Ofgem should put in place a framework to collect and analyse regularly market information including (we do not necessarily believe that its collection implies it should be published):
        - aggregate switching by profile class by month as an indicator of customer activity;
        - typical times for switching to take place by supplier;
        - objections to transfers by supplier to observe whether transfer issues might be concentrated on particular operators or market wide trends;
        - tracking typical prices against wholesale markets (DTI has end user and producer feedstock statistics, others publish traded market prices) and calculating differences from them;
        - regularly surveying key customers and their intermediaries about the levels of response they get to their tenders and the approaches they are taking to procurement;
        - tracking supplier entries and exits with exit interviews conducted by Ofgem where possible; and
        - monitoring suppliers’ relative market positions using information it sources under its own right rather than relying on external assessments (we believe our own market share assessments differ from Datamonitor’s materially, for example).
- “should the review cover all market segments (for example SMEs, medium and large gas and electricity supply markets) or focus upon a particular sub-set of these, and why”:
    - we do not believe the established definitions are robust enough to segment so the sector should be considered as a whole;
- “if you do not consider a review is necessary, are there other measures Ofgem should be taking to improve the way the supply market is working? What are these measures and why are they required?”
    - Ofgem should build on the DSWG and LUG/SMUG mechanisms to facilitate demand side engagement recognising the full benefits it can bring compared with alternative asset utilisation.

We hope this response is of use and would be pleased to provide further information or discuss our comments further.

Yours sincerely

Robert Buckley

Principal Consultant

Appendix 1: Exits from business energy supply markets 2000-05

Supplier	Date	Comment
Independent Energy	2000	Company failure with contracts procured from its administrator by npower.
Enron Direct	2001	Trade sale to Centrica after failure of parent company
Amerada	2002	Supply operation acquired by TXU Europe.
Electricity Direct	2002	Successful trade sale to Centrica.
TXU Europe	2002	Company placed in administration; contracts acquired by Powergen.
Exxon Mobil	2002	Company's gas supply contracts acquired by TotalFinaElf.
Maverick Energy	2003	Company placed in administration; contracts assumed by Atlantic Electric and Gas.
UK Electric Power	2003	Company withdraws from market by refusing to renew contracts with customers
Shell Gas Direct	2003	Exit from the power market on commercial grounds by a leading supplier of gas to business customers.
Atlantic Electric and Gas	2004	Company placed in to administration ahead of sale of contracts to Scottish and Southern Energy.
BP Gas Marketing	2004/05	Gas supply contracts lapsed rather than renewed.
Economy Power	2005	Electricity supply contracts sold to E.ON UK.
Team	2005	Company placed in administration; contracts assumed by RWE npower.
Eledor	2005	Company placed in administration; contracts assumed by RWE npower.
Reepham	2005	Company placed in administration; contracts assumed by British Gas.