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Dear Rachel

NON-DOMESTIC SUPPLY REVIEW

1. EIC is writing in response to Ofgem's request for submissions pertaining to a possible review of certain aspects of the industrial and commercial gas supply market. EIC welcomes the opportunity to respond to this request, and would be happy to discuss this with you in depth at a future date if required.
2. As the UK's leading independent consultancy to industrial, commercial and public sector energy users, EIC was established in 1975 and currently represents over 600 industrial and commercial customers - including 40 per cent of the FTSE-100 companies
3. While EIC accepts that the remit of any possible review would be the supply market only, the gas and power supply industries are concentrated and vertically integrated to such a degree that the difficulties associated with the wholesale market will inevitably be felt in the supply market. However, with this consideration in mind, we trust that you will consider our views accordingly.

Impact on UK industry

4. Understandably, most consumers have been shocked and dismayed by the extent of gas and power price rises over the last eighteen to twenty-four months. Year-on-year increases of well above 50 per cent have become the norm, with some renewals facing an increase of their delivered rate far in excess of this magnitude. The exact impact on EIC's customers and to the UK economy in general depends on the timing of when each company negotiated their respective contract.
5. However, it is becoming increasingly apparent that the cost to UK PLC of these increases is being made acutely apparent by those companies that have been forced to issue profit warnings as a result of their increased spend on energy. Indeed, a number of companies have already warned that they may be forced to lay off workers or close down entirely as a result of higher energy bills.
6. Given that some of the UK's manufacturing industries might spend as much as ten per cent of their turnover on energy, these increases will undoubtedly have an inflationary impact on the UK economy. This was made apparent by statements made by the governor of the Bank of England, Mervyn King, before the Monetary Policy Committee (MPC), where he warned that the inflationary impact of rising gas prices would have to be considered.
7. This is also clearly not a phenomenon restricted to the UK, given similar concerns about the impact of rising energy rates on inflation in the US and the Eurozone, but the increases in delivery rates seen in the UK have heightened the risk to inflation - and in turn, the economy as a whole.

The changing face of the energy supply industry

8. The advent of market deregulation in the UK energy sector in the 1980s and 1990s was part of a broader commitment by governments of the time to promote market solutions to what had typically been the responsibility of state-owned monopoly organisations. As an ideological concept,

privatisation would ultimately lead to a range of benefits for consumers, including greater efficiency in production, lower costs, and greater customer awareness.

9. While the 1986 Gas Act effectively led to the creation of an incumbent monopolist in what was supposed to be a competitive market, i.e. British Gas, subsequent legislative changes led to the establishment of a truly competitive industry structure. Although the post-privatisation period saw a number of large, vertically integrated producer-shipper-supplier companies with interests across the entire value chain, there was also a large third-party presence in the gas supply sector to ensure that competition was adequately fostered.
10. The development of competition was not without its difficulties. The early years of the post-privatisation era in the gas sector saw repeated intervention from the regulators, with British Gas having been the subject of two Monopolies and Mergers Commission (MMC) reports and one Office of Fair Trading (OFT) investigation by 1993. The post privatisation structure was – particularly in the power sector – characterised by vertical separation of generation and distribution, although the power sector was not immune from the threat of a reference to the MMC. Breaking up the dominance of British Gas took a different approach, and was based upon the unbundling of different aspects of the company.
11. This led to a comparatively large number of competing firms in both the gas and power supply sectors - a "Big Bang" approach, if you will. However, the post-privatisation experience has - not unlike certain aspects of the cosmological theory of creation - seen the industry pulled back together again by a series of mergers and acquisitions.
12. Therefore, while there is competition in the gas and power supply markets, consolidation within the sectors has led to the emergence of a market structure that can probably best be described as an oligopoly with a competitive fringe.

Implications for end users and wholesale market interactions

13. Such a concentrated industry structure will inevitably generate market power for its larger participants, many of whom have sought acquisitions in order to reach a critical mass of customer accounts, thereby generating economies of scale that will lower costs and ultimately benefit the customer.
14. However, while such acquisitions have commonly been approved by competition authorities with little in the way of protest, the trade off between economies of scale and the reduction in competition has perhaps not been considered to the extent that it should have been. This is particularly relevant in the case of vertical integration and its broader implications for both customer choice and wholesale market liquidity, and the impact of these factors on delivered retail rates.
15. While a range of factors have been cited as reasons for the increase in wholesale energy prices - the UK's shift to a net importer of gas, the EU Emissions Trading Scheme (EU ETS), and uncertainty over new nuclear build - the decline in liquidity on the forward curve has been among the main contributors, as has the increasing role played by speculative trading.
16. Speculative trading has an important role to play in any functional commodity market, but the decline in liquidity can be partially blamed upon vertical integration and consolidation. This invariably raises the possibility of informational asymmetries - with consumers and smaller suppliers among those lacking information - that hamper the efficient operation of the energy supply markets.
17. As a result, these opaque market conditions bring with them a new set of problems for consumers, sometimes making Ofgem's Pavlovian response of "switch and save" when delivered rates rise cold comfort to those affected.
18. The extent to which the issues of consolidation and integration will be addressed by the European Commission's investigation into energy sector deregulation remains to be seen, although any transaction that further reduces the number of competitors in the energy supply market should be subjected to very close investigation by the relevant competition authorities, thereby protecting customer interests. We trust that Ofgem will continue to work closely with the Commission on its investigation into the energy sector, and look forward to the publication of its findings later in the year.

19. Whether one wishes to describe this as a risk premium or an uncertainty premium, it is clear that a great deal of speculative trading has been undertaken - particularly in the wholesale gas market - as a result of informational asymmetries pertaining to gas flow. Again, we acknowledge that this is an issue currently being examined by Ofgem through the Uniform Network Code modification process, and eagerly anticipate a resolution on this issue.

We trust that this helps with your inquiry. However, should you wish to discuss this in more detail, please do not hesitate to contact me.

Yours sincerely

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