



House of Commons
Business and Enterprise
Committee

**Energy prices,
fuel poverty and
Ofgem**

Eleventh Report of Session 2007–08

Volume II

Oral and written evidence

*Ordered by The House of Commons
to be printed 16 July 2008*

The Business & Enterprise Committee

The Business & Enterprise Committee is appointed by the House of Commons to examine the expenditure, administration, and policy of the Department for Business, Enterprise & Regulatory Reform.

Current membership

Peter Luff MP (*Conservative, Mid Worcestershire*) (Chairman)
Mr Adrian Bailey MP (*Labour, West Bromwich West*)
Roger Berry MP (*Labour, Kingswood*)
Mr Brian Binley MP (*Conservative, Northampton South*)
Mr Michael Clapham MP (*Labour, Barnsley West and Penistone*)
Mr Lindsay Hoyle MP (*Labour, Chorley*)
Miss Julie Kirkbride MP (*Conservative, Bromsgrove*)
Anne Moffat MP (*Labour, East Lothian*)
Mr Mark Oaten MP (*Liberal Democrat, Winchester*)
Mr Mike Weir MP (*Scottish National Party, Angus*)
Mr Anthony Wright MP (*Labour, Great Yarmouth*)

Powers

The Committee is one of the departmental select committees, the powers of which are set out in House of Commons Standing Orders, principally in SO No 152. These are available on the Internet via http://www.parliament.uk/parliamentary_committees/parliamentary_committees

Publications

The Reports and evidence of the Committee are published by The Stationery Office by Order of the House. All publications of the Committee (including press notices) are on the Internet at http://www.parliament.uk/parliamentary_committees/berr.cfm

Committee staff

The current staff of the Committee are: Eve Samson (Clerk), Emma Berry (Second Clerk), Robert Cope (Committee Specialist), Louise Whitley (Inquiry Manager), Anita Fuki (Committee Assistant), Lorna Horton (Committee Secretary) and Jim Hudson (Senior Office Clerk).

Contacts

All correspondence should be addressed to the Clerks of the Business and Enterprise Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5777; the Committee's email address is becom@parliament.uk

Witnesses

Thursday 31 January 2008

Page

Malcolm Wicks MP, **Minister of State for Energy**, and Dr Nick Palmer MP,
Department for Business, Enterprise & Regulatory Reform

Ev 1

Tuesday 20 May 2008

Mr Allan Asher, Chief Executive, **energywatch**

Ev 22

Tuesday 3 June 2008

Mr Hugh Conway, Chairman, MEUC Electricity Group, **Major Energy Users' Council**, Mr Jeremy Nicholson, Director, **Energy Intensive Users' Group**, Mr Chris Tane, Chief Executive, **INEOS ChlorVinyls**, also representing **Chemical Industries Association**

Ev 38

Mr Robert Armour, Director of Corporate Affairs, **British Energy**, Dr Steven Riley, Executive Director, Europe, **International Power**, and Mr Ian Foy, Head of Energy Management, **Drax Power**

Ev 49

Thursday 5 June 2008

Jenny Saunders, Acting Chief Executive, **National Energy Action**, and Lesley Davies, Chair, **National Right to Fuel Campaign**

Ev 60

Professor John Chesshire OBE, Acting Chairman, **Fuel Poverty Advisory Group** and Mr John Clough MBE, Chief Executive, **eaga**

Ev 69

Tuesday 17 June 2008

Mr Alistair Buchanan, Chief Executive, and Dr Andrew Wright, Managing Director, Markets, **Ofgem**

Ev 78

Mr Nigel Wooley, Supply Director, **BP**, Mr Richard Guerrant, Director, Europe, **ExxonMobil**, and Mr Paul Trimmer, Vice-President, NW European Business Operations, **Shell**

Ev 90

Tuesday 24 June 2008

Mr Keith Munday, Commercial Director, **BizzEnergy**, Mr Peter Bennell, Chief Executive, Supply, **Welsh Power**, Mr Graham Paul, Sales and Marketing Director, **Electricity4Business**

Ev 101

Mr Sam Laidlaw, Chief Executive, **Centrica**, Mr Ian Marchant, Chief Executive, **Scottish and Southern Energy**, and Mr Rupert Steele, Director of Regulation, **Scottish Power**

Ev 110

Mr Andrew Duff, Chief Executive, **RWE Npower**, Mr Vincent de Rivaz, Chief Executive, **EDF Energy**, and Dr Paul Golby, Chief Executive, **E.ON UK**

Ev 121

Thursday 26 June 2008

Mr Heinz Hilbrecht, Director, Security of Supply and Energy Markets, DG Transport and Energy, Mr Philippe Chauve, Deputy Head, Energy and Environment Unit, DG Competition, Mr Ricardo Cardoso, Anti-Trust Energy and Environment Unit, DG Competition and Mr Jan Gerrit Westerhof, Electricity and Gas, DG Transport and Energy, **European Commission** Ev 134

List of written evidence

1	Department for Business, Enterprise and Regulatory Reform	Ev 143, 144
2	Association of Electricity Producers	Ev 151
3	Alan Barton	Ev 154
4	BizzEnergy	Ev 156, 158
5	BP	Ev 167
6	Dr Gail Bradbrook	Ev 171
7	British Energy	Ev 172
8	Roger Brocklehurst	Ev 176
9	Centrica	Ev 178, 179, 193, 194
10	Chemical Industries Association	Ev 196
11	Citizens Advice Bureau	Ev 200
12	Corona Energy	Ev 204
13	Drax Power	Ev 204, 207
14	Eaga	Ev 208
15	EDF Energy	Ev 211, 213, 233
16	Electricity4Business	Ev 234
17	Energy Action Scotland	Ev 241
18	Energy Information Centre	Ev 243
19	Energy Intensive Users' Group	Ev 248, 252
20	Energy Networks Association	Ev 253
21	Energy Retail Association	Ev 256
22	Energywatch	Ev 262, 268, 305, 337, 351, 356
23	E.ON UK	Ev 358, 360, 373, 375
24	ExxonMobil	Ev 375
25	Fuel Poverty Advisory Group	Ev 378
26	GMB	Ev 386
27	Good Energy	Ev 389
28	Green Energy UK	Ev 392
29	GrowHow UK	Ev 393
30	Professor Dieter Helm	Ev 394
31	John Huggins	Ev 396
32	INEOS ChlorVinyls	Ev 397, 402
33	International Power	Ev 405

34	Local Government Association	Ev 407
35	Major Energy Users' Council	Ev 408
36	Morgan Stanley & Co.	Ev 411
37	National Energy Action	Ev 412
38	National Grid	Ev 419
39	National Housing Federation	Ev 424
40	National Right to Fuel Campaign	Ev 426
41	NHS Purchasing and Supply Agency	Ev 429
42	Ofgem	Ev 432, 435, 463, 470, 471, 584
43	Opus	Ev 472
44	RWE Npower	Ev 473, 475, 480
45	Scottish and Southern Energy	Ev 481, 483, 493
46	Scottish Power	Ev 495, 496
47	Shell	Ev 505
48	Sussex Energy Group	Ev 506
49	Trading Standards Institute	Ev 509
50	University of East Anglia	Ev 510
51	University of Greenwich	Ev 537
52	Utilita	Ev 552
53	Welsh Power	Ev 553, 556
54	Professor Michael Waterson	Ev 558
55	Dominic Whittome	Ev 559
56	Professor Philip Wright and Dr Ian Rutledge	Ev 562

List of unprinted evidence

The following memoranda have been reported to the House, but to save printing costs they have not been printed and copies have been placed in the House of Commons Library, where they may be inspected by Members. Other copies are in the Parliamentary Archives, and are available to the public for inspection. Requests for inspection should be addressed to The Parliamentary Archives, Houses of Parliament, London SW1A 0PW (tel. 020 7219 3074). Opening hours are from 9.30 am to 5.00 pm on Mondays to Fridays.

Oral evidence

Taken before the Business, Enterprise and Regulatory Reform Committee

on Thursday 31 January 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
 Roger Berry
 Mr Michael Clapham
 Mr Lindsay Hoyle

Mark Hunter
 Miss Julie Kirkbride
 Mr Mike Weir
 Mr Anthony Wright

Witnesses: **Malcolm Wicks, MP**, Minister of State for Energy, and **Dr Nick Palmer, MP**, Department of Business, Enterprise and Regulatory Reform, gave evidence.

Q1 Chairman: Minister, welcome. I normally begin by asking witnesses to introduce themselves, and any officials they have with them, for the record but it seems a little otiose today, so I will dispense with that part unless you particularly want to introduce yourself.

Malcolm Wicks: Malcolm Wicks. I am the Minister of State for Energy.

Chairman: Thank you. I understand you might be joined by your PPS later on. This session will be in two halves. We will look at energy prices, fuel poverty and the structure of the market in the first half, and then we will turn to supply issues, security of supply, generating capacity and so on in the second half of the session. We will begin with the price issues.

Q2 Mark Hunter: Minister, good afternoon to you. You will be aware, of course, that you join us today on the very day that Shell have declared record UK profits. I would like to start with a couple of questions about energy price rises. You may feel there is some connection between these matters and I would like to explore your views. Could you tell us what you think are the underlying reasons for several energy suppliers deciding to increase the price for gas and electricity in the past month?

Malcolm Wicks: I think there is one major reason and there might be one or two others that are also important. The major reason is the huge global demand for energy which, by definition, we are seeing around the world which is leading to a huge increase in energy costs, including the wholesale prices that the supply companies themselves have to pay. The reason for the global demand is, I think, familiar territory. It is about the great emerging economies. China perhaps comes to mind first, but also India, but many other economies are growing too, South Africa and South America, *et cetera*, as well as the continued demand for energy in the developed world. Perhaps I could give you some figures for wholesale gas forward prices since January 2007. These are the prices that the supply companies have to pay. Since January last year, in other words over last year, gas forward prices have increased by 50% and coal forward prices by some

85%. Whilst one does not welcome it, one should not be surprised that the retail price to our constituents and to business customers has increased. I think that is the major factor. If I could just give you a little bit more information, I am advised that wholesale prices make up around half of the increases that we are now seeing in the domestic electricity and gas sectors, whereas, when it comes to the industrial users, wholesale prices are making up more like 70% and 91% of those prices increase. I think that is the major factor. Another point I would make through you, Chairman, to Mr Hunter, which I think this is only just being understood is that, as we seek to tackle the great challenge of climate change and global warming, and we put in place mechanisms here in the UK such as the renewables obligation and across Europe we put in place the emissions trading scheme, these factors themselves raise the price of energy, because at the moment many of these technologies, renewables, are expensive compared with producing our electricity in the conventional way, from coal and gas, and that is also now being reflected in prices. There is an inevitability about that. The lesson is that saving the planet does not come on the cheap.

Q3 Mark Hunter: I would accept that entirely. I was going to ask a supplementary about climate change policies, which you have partially answered already. In the light of the profits of the energy suppliers in the UK and also the reference I made earlier to people like Shell and so on, do you not have any concerns that this is a difficult argument/debate to win with the public about the cost of climate change policies, when the consumer sees suppliers apparently profiteering at their expense?

Malcolm Wicks: I think it is a difficult argument to win actually.

Q4 Mark Hunter: What is your view on it?

Malcolm Wicks: To say there are rip-offs going on, there is no proper competition, the customer is the victim—that story—through numerous press notices, is, as it were, around the media before what I think is a slightly calmer analysis gets out of the starting blocks. I just think that is inevitable. I am

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

not complacent about the competitive market. I want to see the market competitive and I ask questions almost every day in my department about this.

Q5 Chairman: We will come on to the competitive elements a bit later on.

Malcolm Wicks: So you do not want me to pursue that?

Q6 Chairman: Not at too great a length. We will come on to competition elements later.

Malcolm Wicks: Okay. I must not disrupt the order, as it were. There are issues about competition. In terms of climate—which was your question—that is the fact of the matter. If you look at the renewables obligation, which is, I suppose, our major way in which we bring forward investment in renewables technology, by simply saying to supply companies, “You will source so much of your energy from renewables” is costing £1 billion by 2010 and inevitably that gets passed on to the customer. I think we have to get used to this idea that tackling climate change does increase energy costs at the moment, given the state of the technologies.

Q7 Mark Hunter: As I said earlier, I do not think there would be any disagreement between us about the fact the climate change policies rightly are needed and do come with a price tag attached to them, but I am just interested—and I will ask one last time before we move on—about whether or not you see there is a role for government in trying to have a more constructive dialogue with the energy suppliers in this country about the speed and regularity with which they pass on price rises directly to the consumer—very substantial price rises now—which are directly and adversely affecting people on fixed incomes in particular.

Malcolm Wicks: The main thing I worry about now is what we currently call fuel poverty: the impact on our most vulnerable constituents. That is the thing I most worry about at the moment.

Q8 Chairman: We will give you an opportunity to talk about that as well, Minister.

Malcolm Wicks: I am sorry.

Q9 Chairman: Do not apologise. I am trying to help.

Malcolm Wicks: We frequently meet with the supply companies on a whole range of issues. In terms of the competitive issue—which we will return to later, I am told—it is for Ofgem, the regulator, to make sure that proper competition takes place. I think they are convinced at the moment that that is the case. From the evidence I see, I think that is the case, although, I repeat, I am not complacent, and we can get on to some of the issues there.

Q10 Mark Hunter: But you think they are listening? You referred to regular meetings with the suppliers, and you think they are listening?

Malcolm Wicks: We are coming to fuel poverty later, I understand, and I can say something about the meetings I have personally had with the supply companies on that very important issue.

Q11 Mark Hunter: You touched on the wholesale prices earlier. How much of the rise in the wholesale price of gas can be accounted for by gas price increases on the Continent, in your view, as opposed to the more UK-specific factors, such as the delays at Milford Haven?

Malcolm Wicks: I have mentioned what I think is the key background fact, the global prices, wholesale prices, and I have cited figures of how they have increased. We now have to be aware that the energy market is increasingly becoming global. Gone are the days, frankly, for good or ill, when, in a sense, you could talk about a national energy market related to the costs of exploitation of the North Sea oil and gas and how that would impact. Increasingly now, certainly, there is a European market, albeit an extremely imperfect one—and we can talk about market liberalisation at the appropriate point.

Q12 Chairman: And we will.

Malcolm Wicks: If necessary. That is something else I have anticipated!

Q13 Chairman: Everything is connected to everything, Minister. We are just trying to keep it as distinct as we can.

Malcolm Wicks: I wonder if I might just be quiet for 20 minutes.

Q14 Chairman: No, you are doing very well.

Malcolm Wicks: My point being that, with interconnections now with the European market and without needing to import gas and, yes, from time to time our exporting of gas in the summer, inevitably I think we are going to see an increasing connect between prices here in the UK and prices on the Continent.

Q15 Mark Hunter: The delay at Milford Haven? A small factor? A big factor?

Malcolm Wicks: I think it has only been a small factor. That would be my judgment. I am disappointed, there has been a delay, but I think it is only a delay by I had better not say off the top of my head. Six months to a year is what I have in mind, but we can try to verify that sort of figure with you. I think I am more enthused—and I have been to both ends of it, as it were, I have seen it in Qatar—by the fact that Qatari liquefied natural gas will be flowing from Milford Haven really quite soon, alongside the gas from Langeled, the Norwegian pipeline is going to be a huge bonus to us in the future.

Q16 Mr Wright: Specifically what you have said on the interconnector, and that we export a lot of gas in the summer months, when obviously demand is at its lowest, and presumably at that time when demand is at its lowest the price of the commodity is at its lowest, is not one of the problems that the capacity we have to store gas during the summer months is

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

less than they have on the Continent? Instead of exporting gas at a low price, we could build our storage capacity so that we could maintain those levels at the lower price.

Malcolm Wicks: There are two things there you have asked about. Given that this is a competitive marketplace, where private companies, as it were, like any other companies, seek to sell the commodity at the highest price, storage itself would not stop them selling at a better price in the summer than they might get here in Britain. But I think you have touched on a very important and strategic issue about our need to develop more gas storage in the future. Until recently we could say, I think with some security rather than complacency, “Our natural store has been the North Sea.” It is on our doorsteps, we have had storage. Centrica’s Rough storage has been very, very important to us, but we now need to store more gas for a number of obvious reasons. That is an objective of our energy strategy and it is one of the reasons, but only one reason, why we need to streamline planning in this country so that that can come about. Where are we now? These are rough figures, but let us say 20% of our gas at the moment is imported—and we have only just become an importer of gas really because of all the riches of the North Sea. If you roll forward to 2020, and that is really quite soon, our gas being imported could be somewhere between 50% and—as some even say—80%. That in itself raises challenges, but one of those challenges is to have more gas storage.

Q17 Mr Wright: You mention that as one of the plans or proposals, but surely to goodness we should be looking at the median rather than planning for the future, because, when 2020 comes and we are relying on 80% importation of gas, it is too late. Our ability to use our own gas on our own continental shelf has gone because we have exported it all to mainland Europe, they have stored it to use for their own customers at a much cheaper price. Surely we are missing the trick here.

Malcolm Wicks: We are not going to delay until 2020. There are already some proposals in—no pun intended—the pipeline in terms of gas storage. Sometimes they hit planning impediments. We always have to maintain the right of people to object to a particular proposal but we do need gas storage and I think we are on course to have more gas storage.

Q18 Mr Wright: Would you give a time scale as to when the proportion would increase? Is it increasing already? Are we relying on LNG?

Malcolm Wicks: Chairman, I like to be accurate about these things, as it were, rather than speculating. Perhaps I could write to try to give you a timeline on some of this. It is a little awkward, of course, when it does come down to planning authorities saying yea or nay to some of these things, but as an aspect of—and I would use the word—“national” security, we need a greater capacity to store gas in the future.

Q19 Mr Weir: Following on from that and without treading too much on the differences between the continental European market and our own market, one of the allegations made about the interconnector is that continental companies often buy gas when it is cheaper in the UK for use on the Continent and that is one of the reasons why prices in the UK have pushed up. Is there any evidence for that? Is there any investigation by your department into whether that is happening?

Malcolm Wicks: Yes, we have looked at that. Ofgem themselves have looked at that. I have discussed it with the company that runs the interconnector and the companies that supply the interconnector. My particular concern, certainly two winters ago when things were relatively tight—although, contrary to the pessimists’ view, the lights stayed on—and when spot gas prices here were extraordinarily high, the gas should have been gushing towards us through the interconnector and it was not. That is the thing that concerns me and I think there is still an issue. The interconnector has not been such a big feature this winter because of the relatively mild weather and because of greater gas supplies from elsewhere. But it is evidence to me of the fact that we do not have in continental Europe a liberalised energy market. Otherwise, those companies, to make money in that winter two years ago would have been selling us lots and lots of gas. That is the issue that does concern me.

Mr Weir: We had this debate in the House about the Lisbon Treaty. What is your feeling about if and when we are ever going to get a liberalised market?

Chairman: No, we will do that later. Good try Mike.

Q20 Mr Hoyle: What seems to be apparent is that good old UK public are the losers, are they not? We export cheaply when we have plenty of gas around in summer. It is stored in Europe. Presumably some of it is exported back to us and we import more expensively. We are the loser in both ways. If we had the storage capacity, I know you say they would not but there would be an ability to store our spare capacity in summer, use it in winter, just like the rest of the Continent does. The only people who are the losers are business and the public that they represent. We keep coming around to this conversation—we had it last time you were here Minister—that we have to make these companies take seriously storage capacity. We can say it is about planning permission but the fact is we have not seen an increase like we should have been seeing and we have had a lot of promises. How do we turn those promises into factual storage?

Malcolm Wicks: That is the question. I think the answer is that a number of companies have plans for storage. We cannot just do it overnight. There are planning regulations. I repeat: it is one of the drivers, only one of the drivers, behind the planning bill that is currently before this Parliament. Mr Hoyle, perhaps I could, through the Chairman, ask you to look at this picture.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Q21 Chairman: Could I ask Mr Hunter to ask his question and then we will look at the picture. You will see how relevant it is, if I have understood your comments correctly. I think it help and it will save the Committee time.

Malcolm Wicks: All right.

Q22 Mark Hunter: Thank you, Chairman. I was going to acknowledge the Department's assistance in helping us understand these issues, because we have had the picture, as you put it, circulated twice: one in black and white and one in glorious Technicolor, just to make sure that we got the message.

Malcolm Wicks: Excellent.

Q23 Mark Hunter: It is quite helpful.

Malcolm Wicks: I wanted you to get the message at least twice.

Q24 Mark Hunter: Absolutely. We talked earlier on and you made your views clear about the factors behind price rises. If I were to put to you the feeling about wholesale price increases being passed on to the consumer rather more quickly than reductions in price are passed on to the consumer when the reduction in energy itself is coming through to the companies, would you feel that was a fair criticism of the energy suppliers themselves?

Malcolm Wicks: No, I do not think it is. Certainly last year, 2007, as the graph shows when the yellow line goes down at the bottom—these are retail prices for gas—prices were going down at that stage.

Q25 Chairman: Would it be helpful to explain to the wider audience what the graph shows.

Malcolm Wicks: The black and white copies will become the rarity items—so hang on to those! I suppose in an ideal world it would be nice to be able to give the Committee, maybe through my officials, a more detailed presentation on some occasion, because there are a number of graphs and there are complexities about this and it is always awkward doing this. Let us be clear that this is about retail prices—in other words, to our constituents, the domestic consumer—for gas. There is another picture for electricity which we can send you later. During the period since July 1998—which is when this graph starts and I should be accurate in saying this is comparing the EU of 15 States, because of the time series, I guess—our domestic gas prices have been consistently lower than the European average. As you can see, Germany is in red and France is in dark blue, and we have always been lower than both Germany and France for the domestic customer. I was thinking of that when Mr Hoyle was questioning me. He raises an interesting point but his point would be a stronger one, I think, if our gas prices were higher than Germany and France because of all this wheeling and dealing, whereas they are still lower. I am also advised that in 2007 it was in Britain and not continental Europe that gas prices went down, when wholesale prices were going down.

Chairman: Roger Berry, a statistician, wants to make a point here.

Roger Berry: This document is headed “Only UK saw retail prices come down substantially in 2007”. As the Minister will acknowledge, these graphs show nothing of the kind. They give us the information for Germany, France and the UK and the EU 15 median. They do not. We have a departmental document here with a headline for data which the data cannot support.

Chairman: There may be additional data which supports the headline, of course.

Roger Berry: The data does not support the headline and you might have a word with whoever did that. It is a bit naughty.

Mark Hunter: It is a bit crude.

Q26 Roger Berry: No, it is inaccurate. If it was GCSE stats, for example, you would be in real trouble on this one. Not you personally, Minister, but the person who did it.

Malcolm Wicks: I will send you more information. I suppose I was mainly using the graph to show the yellow line as being consistently below the other line. I did say to the Chairman that in an ideal world we would be able to give you a more detailed presentation.

Q27 Roger Berry: I hate to labour this but I am not saying it is the detail; I am pointing out that a departmental document is inaccurate in its labelling, which I think is unfortunate.

Malcolm Wicks: Okay. I am sure, nevertheless, that Mr Berry would agree it does show that UK gas prices have been lower than the European—

Q28 Roger Berry: You have described it correctly. Your Department's document does not.

Malcolm Wicks: Okay.

Roger Berry: That is the fourth time.

Q29 Chairman: That is a useful clarification which I do not think we will labour at too great a length.

Malcolm Wicks: It was my mistake in trying to be helpful to the Committee.

Chairman: You are being very helpful.

Q30 Mark Hunter: To come back to the point I was making, that was not about the prices relative to that of other countries, it was about the speed with which energy suppliers in the UK are perceived to pass on price rises and the slowness with which they are perceived to pass on price reductions. I was asking the Minister's view on that, not the relativity of our prices in the UK to those of other European partners.

Malcolm Wicks: I think Ofgem have looked at that and they are satisfied there has been no skulduggery.

Q31 Mark Hunter: Your view is the same, is it?

Malcolm Wicks: I have not seen evidence to the contrary. At the moment, when clearly we are in the middle of a series of price rises being announced by supply companies, nevertheless one company, Scottish and Southern, despite the wholesale price

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

movements have said that they are not going to look at price rises until April at the earliest. Arguably that shows competition in the market—and I note that that is a company that in recent times has gained market share, perhaps because of that kind of strategy.

Mark Hunter: I think we will come on to points about structure later on.

Q32 Mr Hoyle: Minister, you wanted to mention your graph, but you are missing the main point. France and Germany do not have the gas fields. We in the UK have the gas fields. That is why the public are disappointed. That is why we are disappointed. That is why you would expect to see gas prices higher in France and Germany. That is why we should expect to see lower gas prices and we should not see the spike which it shows in January 2007 as being at its highest. All I am saying is that we should do better and the reason we do not is because of lack of storage facilities.

Malcolm Wicks: I am not sure that is the case. If we operated just as one nation, if we were not a member of the European single market, then no doubt we could run our economy not just in terms of gas but all sorts of things where we would do it only on a national basis. But in a European energy market I do not think you can stop companies selling gas to the highest bidder.

Mr Hoyle: Except they have not liberalised their market—and I do not want to go into that.

Chairman: We are doing liberalisation later.

Q33 Mr Bailey: I am just trying to disaggregate the different issues here. Gas market, domestic consumers. In terms of domestic, is this just residential or is it business as well? Is domestic in this interpretation just consumers located in this country?

Malcolm Wicks: It is the householder.

Q34 Mr Bailey: It is just the householder.

Malcolm Wicks: Yes.

Q35 Mr Bailey: No reference at all to business users.

Malcolm Wicks: No. That is my understanding of the graph. We could supply other graphs on business users. We have data on businesses.

Q36 Mr Bailey: It might be helpful if we could have that.

Malcolm Wicks: Yes.

Q37 Miss Kirkbride: We have been talking about rising energy prices—Mr Hunter mentioned that very briefly—and of course most people notice rising energy prices when they go to fill their car up at the pump and they have to take out a mortgage to pay the bill at the end of it. Today Shell announced the biggest profit ever made from a British company, ever in the history of time. That is a bit unfortunate, that the two should come together like that.

Malcolm Wicks: Things like that come together, do they not, in politics? I do not think it is right for me to comment on the profits of any one company. It is

an international company. I am sure they would argue that they themselves need to make massive investments, that they are making massive investments. I am not going to get into the business—you would not want me to, would you—of trying to regulate the profits of different companies.

Miss Kirkbride: When I heard the story on the BBC this morning, it said that they had made this massive profit—

Mark Hunter: Record profit.

Q38 Miss Kirkbride: Thank you—record profit—and that was because of rising oil prices. That seemed to me even more unfortunate because, basically, we are paying at the pump—and we have very little choice—for huge prices on which they then run the biggest profit ever.

Malcolm Wicks: Surely it should not be altogether a surprise that when prices are rising people make more profits, when they are decreasing they make lower profits. Is that not the nature of the market?

Q39 Miss Kirkbride: I would have thought that if prices are going up wholesale, they are paying more money to whoever is supplying them and, therefore, there does not necessarily need to be an increase in profit. It depends where the supply is coming from.

Malcolm Wicks: I do not think it is helpful for a government Minister to get involved in a detailed discussion about the profits of any one company. Chairman, perhaps I might say—and it may be a bit later down the agenda—that there is a need for massive investment in energy infrastructure in this country. Given the reliance on fossil fuels in the future, there is a need for massive investment in the exploration of fossil fuels. No doubt committees of this kind and ministers like me would be the first to criticise if that investment was not coming forward. I guess high profits helped that investment come forward.

Q40 Chairman: That is what Shell have said, I believe, in their statement today, so I think we will leave it there for that. Before we move on to the next session of questions, could I check two things. The graph here—which Dr Berry helpfully pointed out did not entirely justify the claim made for it—nevertheless does show that British prices have been consistently below the EU average and fell last year uniquely, or not necessarily uniquely—I am corrected immediately—but fell compared to the EU average last year. Nevertheless British Gas gave us evidence—and we are grateful to the energy companies, all of which have produced evidence for today, and the regulator and the watchdogs and so on—in which they said, “Average UK electricity prices including taxes are the fifth lowest among the EU 15.” So electricity is the fifth lowest. “Britain’s gas bills are also still amongst the cheapest with the UK average gas price the second lowest in the EU 15.” That means we are the most liberalised market in Europe—and we will come back to liberalisation issues later—and we still do not enjoy the lowest prices, if those claims are right from British Gas.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: We need to compare and contrast evidence. My evidence shows that compared with the EU 15 over that long period, domestic customers enjoyed the lowest prices. It is more mixed when it comes to business customers.

Q41 Chairman: Which is the point Mr Bailey was making. There is some evidence—and we will come to this again later—of mis-functioning of the market, if, given that we are the most liberal market, we do not enjoy the lowest prices. That may be the European markets. We will come to that later. As a matter of record, before we move on, Mark Hunter was asking about climate change costs to consumers not of their fuel bills. We have had very good evidence from Scottish and Southern who say—and I would like to know if this order of magnitude sounds right to you—“The total costs to customers in delivering network infrastructure and environmental policies”—both and not just the environment—“have risen by almost 50% in the last four years and almost £170 on electricity and gas bills in 2004 to almost £250 in 2008.” That is £250 on the average consumer’s gas bill for network infrastructure and climate change considerations. Would that seem an order of magnitude that is right to you?

Malcolm Wicks: I am not surprised about the very significant increases. But I do not want to commit myself to that figure. I have no reason to doubt it.

Q42 Chairman: But the order of magnitude does not seem intrinsically wrong to you anyhow.

Malcolm Wicks: Not intrinsically wrong, no, because I mentioned myself earlier that climate change does not come on the cheap. Part of the investment we are needing and we are seeing is in terms of the grid infrastructure *et cetera*.

Q43 Chairman: We have at least three factors driving prices: the markets, infrastructure requirements and climate change.

Malcolm Wicks: Yes.

Q44 Chairman: At least three. Good. Could I ask you a question about your old boss, now Chancellor.

Malcolm Wicks: I have had several old bosses. Which one can I tell you about?

Q45 Chairman: In the words of the old song, “You’re still there anyhow,” after a brief interlude somewhere else.

Malcolm Wicks: Okay.

Q46 Chairman: The Chancellor of the Exchequer was at the DTI—the beloved DTI—and he was in charge of energy policy. He gave evidence to this committee: very convincing, very good, very powerful, very competent evidence, as you would expect from a man of his intellectual abilities. Why did he need to talk to Ofgem earlier this month about how markets work? Surely he knew.

Malcolm Wicks: I think it is not unreasonable, given public and parliamentary concern, as we are seeing today, about the impact of rising prices on the

vulnerable, in particular, that the Chancellor wanted to reassure himself that Ofgem were looking at this critically and wanted to hear Ofgem’s own analysis of the relationship between wholesale and retail prices.

Q47 Chairman: I have the letter here that he wrote, and it is a pretty harmless letter—I mean, one can get too excited about it. “I am particularly interested in your views on the relationship between wholesale price movements and feed-through to domestic retail prices” and so on. If he wrote that kind of letter to the Governor of the Bank of England about interest rates, all hell would break loose in the international currency markets. Was it an appropriate intervention by the Chancellor of the Exchequer?

Malcolm Wicks: Yes. For the reasons I have given, really. It clearly would not be sensible for chancellors or their ministers of state to somehow write to Ofgem every day, as it were, but I think this is a critical issue. We are seeing prices rise at very considerable levels. There is a great deal of criticism reflected in this Committee understandably about the relationship between all this stuff, wholesale and retail, particular worries about the impact on the vulnerable. It is perfectly proper, in my view, that the Chancellor should want to reassure himself.

Q48 Chairman: He was only minister of the issue six months ago at DTI. He would know all this stuff. What has happened tangibly, as a result of that meeting that flowed from the letter?

Malcolm Wicks: There has been a meeting now between the Chancellor and Ofgem where Ofgem put forward their analysis and sought to reassure the Chancellor—I think he was reassured—that, regrettable as it is, there is a proper relationship going on between the different factors, including wholesale and retail.

Q49 Chairman: What is interesting about this is that the media, the lobby were very heavily briefed about the significance of this intervention by the Chancellor. You tell me he was just doing it for information: a sort of tutorial in gas prices to satisfy himself. But they were briefed rather to the contrary. It looked like action the Government was taking. Surely the only action that is possible is interference with the independence of the regulator.

Malcolm Wicks: No. I am sorry, I am now repeating myself. It was the Chancellor wanting to reassure himself and therefore the Government that Ofgem were satisfied that there was no wrongdoing going on, that the competitive market was working, and that there was a reasonable relationship between wholesale and retail.

Q50 Chairman: I hold you in high regard, Minister. You know that. That is your job. Were you at the meeting?

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: No.

Q51 Chairman: Should you not have been? Should you not have been able to provide the Chancellor that reassurance without giving the appearance that the regulator was being interfered with?

Malcolm Wicks: I do not think he was being “interfered with” to use your term.

Q52 Chairman: A slightly unfortunate turn of phrase, I agree!

Malcolm Wicks: I think it was perfectly proper that the Chancellor of the Exchequer, among other things, concerned about inflation and all those issues, should reassure himself about this vital sector at a time when prices are rising, and not unreasonable that the public and Parliament should, as it were, know about that meeting. I think it was perfectly proper.

Q53 Chairman: But nothing happened as a result. There was no tangible outcome from that meeting.

Malcolm Wicks: The tangible outcome is Ofgem having their opportunity to present their analysis to the Chancellor and, out of that, a reassurance that, despite what others may say, the market is working as well as it can and at a time of some difficulty in terms of global demand.

Q54 Chairman: So the Government have no plans to change the remit of Ofgem or to encourage it to work in a different way?

Malcolm Wicks: No. I mean, there is nothing in the Energy Bill about that. It is important, of course, that alongside Ofgem’s primary objective, which is about competition, that there is also an emphasis on secondary objectives, which are about sustainability and, if you like, the social policy around vulnerability. I am very keen that Ofgem should focus on all three.

Q55 Chairman: Do you understand why the cynical might regard the whole exercise as more of a publicity stunt than a serious contribution to the debate about energy prices?

Malcolm Wicks: I cannot understand that at all.

Chairman: I thought you probably would not be able to.

Q56 Mr Clapham: Can we go back to the market. As we have just been talking—

Malcolm Wicks: I think we went back to the market a few decades ago.

Q57 Mr Clapham: Well, here we are to examine what we went back to. We have companies that have interests in the wholesale side of the market, and they also have interests in the retail side. Do you think that has been a development that has been helpful to competition in the energy market?

Malcolm Wicks: I think that is an interesting and good question and one that I have asked colleagues. I am often told—and there may be an opportunity one day for the Committee to ask the companies themselves—that quite often there is little profit on

the retail side. The margins are quite tight from time to time, and without that integration with the wholesale market it might be difficult to run retail businesses. That is what I am told.

Q58 Mr Clapham: Nevertheless, given that there are six companies that virtually dominate the market, and bearing in mind that it is only a matter of weeks ago that the Sunday papers were reporting meetings between the six that were allegedly to ensure that all their prices kept in step, given that we have this sort of vertical integration, that we have companies meeting to ensure that they are keeping step on prices, surely that is not helpful for competition. In fact, it is not a competitive market, is it?

Malcolm Wicks: Do the companies meet together? Yes, they do. They discuss a range of matters and sometimes with me. Indeed, I have a meeting with the CEOs of all six companies later this afternoon—to which I will refer later—and they have an association through the Energy Retail Association, where they meet. I am sure it is just an allegation that they use those meetings to fix prices. I am assured by the companies that for reasons of “commercial in confidence” they do not discuss prices and they never would.

Q59 Mr Clapham: They could never say they did, could they?

Malcolm Wicks: Actually I believe them. I believe them. It is easy to write the story or make the speech but if people have proof they should come forward to Ofgem with it. I do not believe that happens; I really do not.

Q60 Mr Clapham: Is it something you are likely to raise with them when you meet them this afternoon?

Malcolm Wicks: Off the back of that story, I was certainly reassured by one of them that it is just nonsense. I do think it is nonsense, but, if I am wrong, let people bring forward the evidence.

Q61 Mr Clapham: Given the fact that there are just six companies, there is no room in the market for new companies to come in. Again, there are great restrictions on competition. When the market was privatised we were told there were going to be numbers of companies that would be competing with each other; that this would lead to much lower prices. But the market has developed in such a way that new companies cannot get into it. That cannot be good for competition.

Malcolm Wicks: My own view about this is that, where you have markets, they have to operate as markets. I can readily understand that, in the supply business, which is what we are discussing, you probably would never have 100 companies competing because of the investments needed and so on. However, there is an interesting issue as to whether six companies is enough competition. I am interested in that question. I would be even more interested in it if it was not six, it was fewer than that. I think it is an interesting question: What is the difference between a market and an oligopoly? I am not saying that it behaves oligopolistically but I am

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

concerned about that. I am particularly interested in whether there are barriers to new entrants which should not be there. In a competitive market like this at the moment, where wholesale prices are going up, when there are new forms of energy coming into the system from renewables, when there are new ideas about decentralised energy systems, combined heat and power, and all of that, when that is going on I would rather like to see more competition in the market. I would rather like to see new entrants—and some of them could be relatively small, at local or regional level. I want to discuss that further, without interfering with their great independence with the regulator. I think that is a serious, interesting question when we do have just the six supply companies.

Q62 Mr Clapham: Which is one of the reasons we want to avoid a centralised energy market, but we will leave that for a later time. Do you feel that if we had liberalised our market in the UK in step with what is happening in Europe, that the competition may have been more protected, rather than going ahead, as we did, and then seeing a European energy market that is not liberalised and may take a decade to liberalise?

Malcolm Wicks: We are pressing, as the UK, for the liberalisation of the energy market. That is what a single market is meant to be about after all. We have been, I think it is fair to say, the major voice in the European Union on that.

Chairman: I do not want to get too far into liberalisation of the European energy market at this stage. We will come back to that at some length later.

Q63 Mr Clapham: In order to be able to take advantages and opportunities within the market, domestic customers need to be well informed. It would appear from the way the market has developed that that information just is not there. We know that half of domestic customers have not switched and the third who have switched have switched to a higher tariff, so it is clear that there is not the information there for customers. Is that something that troubles you? If it does, are you looking at ways of making more information available to domestic customers?

Malcolm Wicks: Yes, I am. It does trouble me, to be blunt. I do not buy the line that switching is universally the way in which our constituents always benefit from competition. I do not buy the line on that. I do recognise that the evidence suggests that when most people switch, they switch to a better deal. One could cite some figures on that. I am also aware, however, that some of our more vulnerable constituents can be subject to mis-selling, and I want to satisfy myself that the codes in place on that are rigorous enough. I am going to talk to the supply companies about that. A final point—and I think this is the most important point—is that those who are more confident about switching as a key solution here are people who take for granted that everyone has access to a flat-screen computer, can go to the different sites and get the best deal, and has the wherewithal to then revisit and re-switch in x

months' time. You know as well as I do that many of our constituents are nowhere near a computer and have so many issues on their mind that they are not readily able to make use of switching. Indeed, I was looking at survey evidence this morning and the evidence I am shown is, not surprisingly, that many of the most vulnerable, in the lower income groups, are the least likely to have switched. I do not want an egalitarian switching to depend on the wherewithal and the access to technologies which our constituents do not have. As to where you go from that, I do not have all the answers, but it is a debate that I think we should open up and I am pleased to have this discussion with the Committee. It is a discussion I am having with the companies and, without interfering with them, it is a discussion I will have quite rigorously with our good colleagues in Ofgem.

Q64 Mr Wright: Is not one of the problems, as well, that the most vulnerable in society cannot switch because they are on a prepayment meter, which is a bigger cost and so they are stuck.

Malcolm Wicks: That is an aspect of it. Some people have reassured me that you can switch with a prepayment meter. Whether there are particular complications where that person might have a history of debt, I want to look at that. Yes, I understand that issue. I also understand the concern you are touching on that the costs for prepayment meter customers have got higher than paying in the ways in which probably most of us in this room pay for our energy. I am concerned about that. That is another aspect of the dialogue I am having with the supply companies.

Q65 Mr Wright: Of course they pay for it in advance, whereas we pay for it as we have used it.

Malcolm Wicks: Yes.

Q66 Mark Hunter: Minister, I wonder whether or not you would agree that the whole issue about switching is over-hyped in terms of the benefit it brings to the consumer because for those who do switch and find themselves on a lower tariff as a consequence it tends to be only a short-term advantage before things change again. According to figures supplied to us by energywatch, not only, as Michael Clapham has just said, have half of energy consumers never switched supplier at all, but they tell us that 65% of pensioners have never switched supplier, six million people on prepayment cannot switch supplier, and two million people cannot switch because they are in debt to their supplier. Do you not accept that the whole business of switching to get more competitive rates is as much to do with marketing advantage rather than it is real benefit to the consumer.

Malcolm Wicks: I would not go there. I think the ability to switch is an important part of the market because it is a way of bringing competition to you and me and to our constituents. I think that is very, very important. I have also said, because I want to get the balance right here, that I am sure for many people switching is something they are getting used

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

to and from which they have benefited—particularly if they do not just switch once but revisit, as it were. I have also made the point, and I think colleagues are agreeing, that the people about whom we should be most concerned at the moment, when prices are rising, is whether switching is working for the most vulnerable. As a generalisation, though many will have benefited—

Q67 Mark Hunter: Many of them cannot switch.
Malcolm Wicks: -- the answer is no at the moment.

Q68 Mr Weir: Whatever the pros and cons of switching, if it provides evidence of competition that is only on the retail side of the market. One of the problems with new entrants, perhaps, is in the wholesale market and obtaining supplies in the first instance. What evidence do you have there is effective competition in the wholesale markets regarding electricity?

Malcolm Wicks: I think there is evidence that there is competition. I recognise that from time to time Members of Parliament on behalf of constituents will write to me with contrary evidence and I do my best to take those issues up with the regulator. It is a rather different market there. But if you feel there are barriers, if you feel that effectively there is not competition, I would like to see that evidence and I will pursue it.

Q69 Mr Weir: Given that most of the energy companies have long-term contracts with their own electricity generating capacity, can you give us an estimate of the amount of electricity that is traded within the market and the level of liquidity that is in the market?

Malcolm Wicks: I can give you some things about the liquidity in the wholesale market. I think the evidence suggests that it is highly competitive. I have some figures here for the Financial Services Authority which report that between the financial year 2005-06 and 2006-07 the volume of wholesale electricity traded in the UK increased by 52%, which *prima facie* would suggest quite a lot of liquidity in the market.

Q70 Mr Weir: Given there has been a lot of publicity recently about the energy market, calls for it to be referred to the Competition Commission, have you ever given any consideration to doing that?

Malcolm Wicks: No, not at the present time, and that is not the view of Ofgem either. Not that you are, Mr Weir, but it is easier to assert wrongdoing, as it were, than to have the reasonable, balanced, evidence-based argument about it. I am really not an apologist for the companies. I ask these questions myself, but at the moment it seems to me that competition is working. I have cited Scottish and Southern not increasing their prices. I have cited—albeit with a controversial headline—that for the domestic customer our price is a bit lower than the EU 15 median and lower than in France and Germany, but I do appreciate, at the moment, that when I argue this way very few people will believe me

because the contrary story is a more colourful one. I do think we need opportunities of inquiring into this very carefully.

Q71 Mr Weir: Is that not the whole point about a reference? You talk about price being lower than the median. Perhaps that is true, but it is the relative price that affects consumers. Consumers see a situation where one company will stick its head above the parapet and raise prices, a couple of weeks later another one will follow suit and another, and you will have similar price rises. The whole point about the investigation is to find out whether it is happening but it certainly gives the impression that they are not all acting independently.

Malcolm Wicks: I think it does give that impression. It is a challenge for me as Minister for Energy; it is a challenge for those companies; it is a challenge for the regulator. Because, as I have implied, that is a strong impression which is gaining currency, and I think one has to balance that against whatever evidence we have. At the beginning of this session, Mr Weir, I was citing wholesale gas forward prices going up by 50% in one year, coal forward prices going up by 85% in January 2007. When you look at that, then, as it were, the alternative hypothesis that it should not be so surprising that retail prices are increasing, is at least worth considering.

Q72 Mr Weir: I do not think anybody is arguing that retail price would not increase in these circumstances. What is arousing suspicion is that all the companies are having similar increases within a very short time. One could argue that that is because that is a reflection of the increase, but at the same time you could also say in a true competition surely some of the companies would be seeking to take advantage and gain market share in that situation.

Malcolm Wicks: Mr Weir, I said to you Scottish and Southern. With respect, should you not take that on board in your critique? An important Scottish company have decided they are not going to follow the others and they have said they will not consider price increases until April, which brings comfort to their customers in the winter and some might say is quite smart commerce because they are the company, as I said, that are gaining market share at the moment. Is that not evidence of at least some competition here?

Q73 Mr Weir: I should declare an interest as a customer of Scottish and Southern.

Malcolm Wicks: There are worse scandals!

Q74 Mr Weir: There is still some suspicion there. Indeed, the Chairman of the Competition Commission has stated concern at the lack of regulated sectors being referred to it. How do you respond to that? That is coming from the Competition Commission not from politicians or customers.

Malcolm Wicks: I have not seen that comment. If it is not getting enough business that might be because all is well, in some senses.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Q75 Mark Hunter: That is why people do not vote!
Malcolm Wicks: I am sure they will find ways of keeping busy.

Q76 Chairman: I do not necessarily think you can answer this question. It is a factual question now. You used a measure of the increased electricity being traded in the wholesale markets earlier on and said that is up by 52%—although I cannot remember the period you said now. That is an interesting figure, but 52% of not much is still not very much. Do you know what percentage of electricity in total is traded on the wholesale market? There is no reason you should know that off the top of your head.

Malcolm Wicks: No, I do not think I do.

Q77 Chairman: I think that is a much more important measure.

Malcolm Wicks: We will let you have that.

Q78 Chairman: I should declare an interest here because I have in my constituency the seventh largest energy supply company in the country, BizzEnergy, who have 1% roughly of the SME market. They say in evidence to our committee: “As a matter of practice, vertically integrated suppliers are likely to contract with their own generation before trading in the market, thus removing vital liquidity from the energy market. This has a direct impact on independent energy suppliers such as BizzEnergy and its potential new customers.” Of course, if they are contracting their own generating capacity, one does not know at what price they are contracting either, so there is invisibility as well as a lack of competition. Is that a concern that you could understand?

Malcolm Wicks: It is a concern I would like to explore, yes. I am certainly aware that in general terms it goes back to Mr Weir’s line of questioning. I was arguing that if the wholesale price going up you should not be that surprised. But of course supply companies make their own deals. It is a speculative market in terms of when you buy forward and so on. I am certainly, as it were, aware that some do that rather well, and some seem to have done that rather badly, I am advised in confidence.

Q79 Chairman: What is interesting is former Ofgem executives, two senior executives, left recently. I am sure they can be identified quite easily but they were quoted in the *Sunday Times* last weekend as saying: “The wholesale prices don’t represent what the energy companies are actually paying. There is a problem in the wholesale markets which Ofgem have failed to get to grips with.” That is two quite senior and well-placed people making that criticism of the wholesale markets.

Malcolm Wicks: I do not think I could comment on that. I am not sure who they are.

Q80 Chairman: But you do have at least intellectual curiosity about the way the wholesale markets are working.

Malcolm Wicks: I do have an intellectual and political curiosity about it. On two aspects I have said there are things that I particularly want to pursue. One is whether there are barriers to new entrants. I am not saying there are, but whether there are. I would like to see more new entrants and I have indicated that around decentralised energy you would think in principle there should be opportunity. I have also indicated that in terms of the impact on our most vulnerable constituents, I want to investigate quite rigorously how switching can be of benefit to all and not just to some.

Q81 Chairman: I want to move on to the liberalisation of European energy markets, but I note in passing that energywatch, in their very interesting evidence to this Committee, say they do not believe there is collusion in the market. They do not believe the *Sunday Times* reports of people in a dark room, (if they are still allowed to smoke) a smoke-filled room, agreeing the prices. The market is so imperfect they do not need to collude. It just happens automatically because of the imperfections in the market.

Malcolm Wicks: Yes.

Q82 Chairman: That is a plausible explanation.

Malcolm Wicks: Yes. I would urge them to bring forward evidence.

Chairman: We might well find ourselves doing that.

Q83 Mr Bailey: We have almost strayed into the issue of the so-called level of liberalisation of Europe’s energy market or, appropriately perhaps, the sclerotic nature of the European energy market, and you yourself conceded earlier that, at a time when you would have expected gas to have been flowing from Europe to this country, it was not so. Basically, what are you doing to improve matters and what progress do you think is being made?

Malcolm Wicks: As I indicated earlier, I think we can say with some satisfaction that we led the charge in the European Union on the need for a liberalised energy market. We have discussed whether there are imperfections, but we have liberalised. Other countries have been slow to do so. It is a matter of policy that we should do this. It is an aspect of the single market, after all. It is what the Common Market in part is meant to be about. We raise this regularly at European level. I am on the Energy Council of Ministers. It is a standard thing that I and my colleagues talk about. We feel there is progress being made. You have now got strong commissioners. The Competition Commissioner, Neelie Kroes, is very, very strong on this. Indeed, there have been dawn raids on energy companies, I understand, to take away documentary evidence. She is a very tough lady and is acting very toughly on this and we are in the middle of negotiations across the Member States about this. This is not just something we want to do in principle and, although this is our primary concern, it is not just something which would benefit the UK and get that gas flowing through the interconnector, et cetera, when we need it, actually it would also be of benefit to German

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

businesses and German customers who are paying too much for their energy at the moment compared with what we are paying in Britain.

Q84 Mr Bailey: There are two issues arising. I suppose one of the counter arguments is that, under the current system, because we have a highly liberalised market in this country and Europe does not, they get the best of both worlds. They can buy from this country when ours is cheap and we cannot buy from them when theirs is cheaper than ours. That is one issue I would like your views on. The second point is that you mentioned the European Commission's commitment to liberalising the market, and I think that is welcome, but to a certain extent should there not be an initiative or pressure from the respective national governments to do the same? Is that not rather lacking at the moment?

Malcolm Wicks: National governments to do what?

Q85 Mr Bailey: To liberalise the energy market in Europe.

Malcolm Wicks: They should. You say "the best of both worlds". Germany and France are not getting the best of both worlds, because their people are paying more for their energy than they would do if there was a liberalised market. I had better not go back to my controversial chart and arouse the fury of Mr Berry again, but that is what it shows. The domestic customer is paying less in Britain than in France and Germany—I think that is what that shows—so the key people in those countries are not benefiting from it. But, no, I agree, we are absolutely committed to pushing forward the liberalisation agenda in Europe. The European Commission agrees with us and we are in the middle of discussions about that.

Q86 Mr Bailey: Can I pursue this point a bit more. Certainly, on the surface of what you say, if the consumers are getting a bad deal—

Malcolm Wicks: The national governments, yes.

Mr Bailey: ---you would expect there to be a stronger response from the national government in response to consumer pressure, but it does not seem to be happening.

Q87 Chairman: Can I add before you answer, Bill Cash, when we were debating the Lisbon Treaty, said something interesting. He said he thought the French and Germans were making some kind of public announcement about their policy in opposition to liberalisation. Have you heard any rumours to that effect?

Malcolm Wicks: A great European, Mr Cash. Obviously the national governments are represented around the table of the Council of Ministers. It is not for me, I do not want to say what they should be saying, but you would hope, would you not, that democratically elected politicians would represent the needs of their constituents and their businesses and not vested interests. This is quite a battle we are having and we are in the middle of it.

Q88 Mr Bailey: Getting to the point that I was pursuing, there do seem to be some very powerful vested interests that work against the consumer both in this country and in the rest of Europe. That leads me on to the next question. Four out of the six major players in the UK are owned by big European companies. Are you concerned by this domination of our energy market—I appreciate this has been touched on—by a few large companies but also the fact that they are not, by and large, British companies?

Malcolm Wicks: No, I am not concerned about that. I understand the anxieties. Obviously I can understand the question in all sorts of ways, but we have been champions of free trade and removing trade barriers and we have been champions of a new Europe and I think we are relaxed about foreign ownership. I am not a Liverpool supporter, so I cannot talk to you generally, but I think we should be relaxed about foreign ownership of companies as long as those foreign companies, as it were, behave properly and do not try to erect barriers and operate in a liberal and competitive way, and so I am relaxed about European companies being key players in this country. What I am less relaxed about is that because of the timing, because we liberalised earlier than the rest, I am frustrated by the fact that, given the illiberalism of energy markets in Continental Europe, great British companies, good British companies like Centrica, like Scottish and Southern, have not had a fair chance to compete and invest in other European countries. I am irked by that. One of reasons why we have got to drive forward liberalisation is so that those very good companies can have a level playing field in which to operate.

Q89 Mr Bailey: I am trying to recall my undergraduate economics course, which was an awfully long time ago, but even in a free market there is a tendency for oligopolies to emerge to exploit it against the interests of the consumer. Would you accept that this could be one of the reasons why it is so slow to develop—a liberalised market that is—in Europe?

Malcolm Wicks: Yes. There are some very powerful companies with quite close connections with government, and that is one of the major barriers to liberalisation in Europe, yes.

Q90 Mr Bailey: You feel that is what we need to tackle?

Malcolm Wicks: Yes, and we are.

Chairman: Thank you.

Q91 Mr Weir: Following on from that point, is that not one of the main problems with trying to liberalise the European market, in that France Germany in particular have a totally different attitude to energy security in the market and have built up their national champions. In the French case, in fact, I believe the French Government is a major stakeholder in EDF and I understand, as the Chairman said yesterday, in the debate the EDF are now trying to takeover Iberdrola of Spain, which owns in turn Scottish Power. While the UK

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Government, quite rightly, is trying to liberalise the market, there is a procedure going in the other direction, if you like, with state companies with a large state impact trying to consolidate on the Continent. I ask the question I tried to ask earlier: what is the timescale for liberalising the European market, if there is one?

Malcolm Wicks: It is certainly a fair point to say. There is clearly a great argument going on at the moment in Europe and other parts of the world between the proponents of a competitive market and the proponents of national champions. That to some extent is what this is all about. I cannot give you a precise timescale, all I can say is that we are now in the middle of a great argument in the European Union about moving towards a proper market in energy. I think both France and Germany do recognise the fact the tide has turned and, indeed, I understand that both France and Germany, working together, are going to come forward with proposals for a different approach to liberalisation in Europe. I have not seen those proposals yet but that is happening.

Q92 Chairman: Before we move on to Roger Berry and the impact of fuel prices on those who can least afford the increases, we have agreed on four separate areas that drive energy prices: failing to liberalise the European energy market, the overall wholesale markets, network investment and climate change, and levies, taxes, measures and things like the Renewables Obligation, and so on.

Malcolm Wicks: If they do not appear magically from behind me on climate change, there are figures on—

Q93 Chairman: Exactly. I have got Ofgem's figures for 2008. The climate change staff was about £22, £21.50, which is not very much, actually to be fair—about three pounds—but a wholesale price of £193; but what we are agreed is, given the average fuel bill is now in the order of £1,000 for a household, give or take, a small change in UK conditions that could be brought about by regulatory intervention here could have significant beneficial impacts on domestic consumers. So, imperfections in the UK market, nuclear regulation, if put right, could actually bring real benefits notwithstanding the rises in wholesale prices on international markets?

Malcolm Wicks: If you are saying, Chairman, that there is a need for Ofgem to be ever vigilant, then, I would agree, yes.

Chairman: I think we will leave that topic.

Q94 Roger Berry: Minister, you said earlier that fuel poverty is the problem that you worry most about, and I appreciate that. Could you give us your latest estimates of the number of households or, indeed, the number of individuals who are currently defined as being fuel poor? What are the latest estimates that we have for this?

Malcolm Wicks: Yes, I can. Always our difficulty is the time lag, of course, in data.

Q95 Roger Berry: Sure.

Malcolm Wicks: Let me point out before you or your colleagues do that, of course, at the moment the thing is moving rapidly—

Q96 Roger Berry: Exactly. That was going to be my next question. You are always ahead of Committee.

Malcolm Wicks: ---in the wrong direction. From the most recent published figures for the United Kingdom, but they go back to 2005, there were around 2.5 million, two and a half million households living in fuel poverty. It may help the Committee, Chairman, if I say that by "fuel poverty" we mean people who have to spend over 10% of their income on energy. This is a precise statistical definition. I have got more recent figures for England, if Mr Weir will forgive me. Estimates for households living in fuel poverty in England in 2006 indicate an increase from 1.5 million in 2005 to 2.4 million in 2006. The UK figures for 2006 will be finalised later this year, but, of course, these are out of date figures, I recognise that. Because of the price increases that we have been discussing, the numbers in fuel poverty will now be increasing quite significantly.

Q97 Roger Berry: Do you have any best estimates of what the current figure might be following the recent price increases?

Malcolm Wicks: No, I do not, but if, in writing, I can help the Committee on that, I will do so.

Q98 Roger Berry: Thank you.

Malcolm Wicks: Can I say (and I would like to add this), this picture of increasing numbers in fuel poverty, of course, follows a number of years where we saw quite a dramatic decline because prices were relatively low, because of home energy efficiency schemes and because of the different social security measures we were taking and high levels of employment, et cetera.

Q99 Roger Berry: I entirely agree, but given Defra's target is to eliminate fuel poverty in vulnerable households by 2010, which is two years away, and given that in recent times the number of people in fuel poverty has increased quite significantly, is there any chance of meeting that target and, if so, how?

Malcolm Wicks: I am not giving up on the target, but I am being realistic. I am recognising the difficult global circumstances of rising energy prices. Would it be helpful if I say something about the different instruments we have to tackle fuel poverty?

Q100 Roger Berry: Everyone is agreed that there are three things that determine the number of people in fuel poverty. One is prices, then it is housing conditions and then it is income. You cannot control prices, so it is presumably what the Government is doing in relation to energy efficiency in people's homes where Warm Front and other things are happening, of course, but also people's incomes, fundamentally. What is the Government going to do over the two areas, the two instruments, it can have some influence on?

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: Let us recognise that, the statistical target, which is an important one because if people are having to spending too much, often on quite low incomes, on energy, that is problematic for them—of course it is—but I think other indicators show a great deal of process. I think we should all be proud of the fact that across the United Kingdom some two million households have benefited from the range of different energy efficiency schemes that we have and, as colleagues will know from visiting these homes during Warm Homes Week, when you see someone benefiting from better loft insulation, a more efficient boiler, decent heating systems, it is a real gain for that individual, and some of us have seen the human faces behind that two million figure, and that is important.

Q101 Roger Berry: With respect, I think they are important, I think they are very significant, but despite all of that, where we are today—you have just described the extent, we are talking about a few million people whatever figure we take—for the UK as a whole we are probably talking about three million, I guess, people in fuel poverty. The question is what, over the next two, or three, or four years, is the Government going to do what further measures to address that problem? Why, for example, did you decide not to mandate the implementation of social tariffs by energy companies? That would have been one way.

Malcolm Wicks: I will come to that. One thing, of course, is that there will be an extension of home energy efficiency schemes through the successor to EEC (the Energy Efficiency Commitment) and that, together with the programmes like Warm Front and the equivalent in the other nations of the United Kingdom, will mean more people benefiting from energy efficiency schemes in the future. That is a very, very important and lasting investment and I put a lot of store on that. You will understand, Mr Berry, that in terms of other social security benefits, levels of winter fuel payments, I have to do the customary thing and say, “That is a matter for the Chancellor”. The third area which you mention, social tariffs: the judgment at the moment, but I emphasise “at the moment”, is that we do not need to legislate to require companies to develop their social tariffs. All companies have social programmes of different kinds. I have met with each of the chief executive officers of the six supply companies on a one-to-one basis, by which I mean not collectively, we have had individual meetings with them, to urge them to do more and to review their programmes. As a result of that the help available has increased from £40 million this is for this coming winter, the one we are in, 2007-08—to £56 million and that will benefit some 700,000 households.

Q102 Roger Berry: But Energywatch is saying that only one in 15 fuel poor energy accounts are being reached by the current schemes offered by the ‘Big 6’. That does not suggest that they are a very significant instrument.

Malcolm Wicks: One in fifteen of the fuel poor households, is that?

Q103 Roger Berry: Yes, one in 15 of the fuel poor.
Malcolm Wicks: Yes, sure.

Q104 Roger Berry: For 14 of the 15 these schemes mean nothing. It is not much of a strategy, is it, really?

Malcolm Wicks: I am meeting, after this meeting (and the timing is purely coincidental), all the CEOs, or their representatives—I hope they are all coming—to discuss this very issue, the very issue being that because of widespread parliamentary and public concern can they do more, are they doing enough, where are we on a range of issues, including pre-payment meters? That is my main meeting this afternoon after this one.

Q105 Roger Berry: May be the view will be expressed to you, as Npower expressed to Ofgem, that the interests of the fuel poor is best served by a mandatory social tariff and this is the only means by which the Government’s 2010 and 2016 objectives can be achieved. Npower believes that. Why does not the Government?

Malcolm Wicks: We are not convinced. My Secretary of State, John Hutton, has made it clear in the House of Commons that we are looking at this and if we feel in the future it is necessary to do it, we will do it. We are not convinced at the moment (a) because we are seeing some movement in the right direction in terms of social tariffs and (b) because there is, I think, a very serious concern that there could well be a situation, if you mandate social tariffs, that that simply becomes the minimum that they all do and that there would be no competition between them. Where would be the incentive to do more? They would come up to the minimum and they would think they have done that. I think that is a very real danger, Mr Berry.

Q106 Roger Berry: You raised winter fuel payments, which was interesting, I think, because winter fuel payments are allocated not on the basis of people’s need for financial support to pay winter fuel bills, they are a non-taxable supplement to the basic state pension. Notwithstanding the fact that other arms of government may have different views in terms of the fuel poverty strategy, do you accept there is a case for having winter fuel payments that are addressed towards those who have extra need for paying their fuel bills: for example severely disabled people under the age of 60 who at the moment are not entitled to a winter fuel payment?

Malcolm Wicks: Can I make one point, before I answer that, about winter fuel payments? It sounds a rather technical point, but the way in which we have drawn up our target that fuel poverty is about paying more than 10% of your income, we are not going to revisit this but it is worth pointing out that the winter fuel payment at the moment, which after all, by definition, is to help with your winter fuel, is actually counted—

Q107 Roger Berry: Initially it is available for people over 60, whatever their winter fuel position might be.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: It is counted as income when you do the analysis, rather than, as it were, knocked off one's expenditure on fuel. I make that point because that has always struck me personally as rather curious, given that the intention is to help with winter fuel. It would slightly change the fuel poverty statistics if you said against the expenditure (someone said nearer £1,000 now) we can knock off the £300 for the over eighties. If you add £300 simply to the income, then statistically it makes life more difficult in reaching the target. It is just useful to point out that statistic.

Q108 Roger Berry: Your statistic, of course, is that disabled people and their families are twice as likely to be in fuel poverty as non-disabled people and their families. Your department's figures show, twice as likely to be in fuel poverty. That is the critical statistic.

Malcolm Wicks: I am coming to your point, but occasionally I have this desire to be fair to myself in terms of the statistical presentations and weakness. We have discussed this before actually on different occasions, and I understand the point, but the winter fuel payment is there to help elderly people—the £200, the £300 for the over eighties. It is worth citing the statistic, Chairman. I think I am right in saying it is some two billion pounds public expenditure every year which the former Chancellor, or the Prime Minister, has committed ourselves to for this Parliament.

Q109 Roger Berry: With respect, that is not the question. I support that. Of course, I do. I am asking why is it that the people in fuel poverty under 60 who have particular needs for warmer homes do not get a penny from what is a "winter fuel payment scheme"?

Malcolm Wicks: Because of the concern about the particular vulnerability of elderly people, and, obviously, for people with disabilities of different kinds, there is a range of other benefits, disability living allowances, which are looking at their needs, but it is a perfectly reasonable argument for you to present to the Chancellor.

Q110 Roger Berry: Does your department have an estimate of the number of disabled people under 60 who are living in fuel poverty?

Malcolm Wicks: I do not certainly have that in my head. If we have that kind of data, I will send it to you.

Q111 Roger Berry: I would be grateful if you would inform us if you keep that data. A final question.

Malcolm Wicks: I certainly recognise the issue. A lot of people with specific disabilities and in general, as a generalisation, people with disabilities, spend more time living at home than the rest of us and these issues are not just about some magic cut-off point of over 60 or over 80, they affect other people. How one addresses that is, I guess, a more interesting and controversial issue.

Q112 Roger Berry: Part of the answer, clearly, in terms of fuel poverty, is if we accept the fact that what the Government can do relates to the conditions of home energy efficiency on the one hand and people's incomes on the other, then, as in one of your many publications on the Welfare State that I have read, the benefit system is actually quite important, is it not, and so I look forward to an answer too. I hope the Government can continue to keep this under review. A final question, because colleagues have other questions. Ofgem, interestingly, has come up with a windfall tax proposal, you will be well aware of, that you should take some nine billion windfall from the UK energy companies that they are set to receive from the free allocation of permits under Phase II of the EU Emissions Trading Scheme and use this to help those in fuel poverty. A windfall tax seems to me very commensurate with New Labour policy. It was there at the very beginning. Is it worth going back to consider it, do you think?

Malcolm Wicks: If it is, it is a matter for the Chancellor of the Exchequer.

Q113 Roger Berry: You appreciate the frustration we have here, in the sense that the key issue in terms of raising resources to tackle fuel poverty you are very reluctant to explore other than to say we should contact the Chancellor.

Malcolm Wicks: I do not think it would entirely help the Chancellor if I speculated wildly—

Q114 Roger Berry: It would help us, though, when you are giving evidence to this Committee?

Malcolm Wicks: ---about what we should do. I am bound to say, Chairman, reflecting on Mr Berry's comments, you will forgive me as Energy Minister, but I do want the energy companies to have money to build power stations as well and wind farms.

Q115 Roger Berry: You were the one who said—this is my final comment and I simply remind you, with respect, I believe this, I know it is your view that fuel poverty is the issue you worry most about. That is what you said and I believe that and I just put that back on the record.

Malcolm Wicks: I worry most about it because it remains a disgrace that in a civilised society there are some people who are cold when many of us at a macro level are worried about global warming. Of course I worry about that. I am pleased with the progress that we have been making in recent years in home energy efficiency schemes and social security measures; I am distressed that we are now being knocked off course because of global factors contributing to rising energy costs and I, in my own way, am going to do what I can to try to move us back in the right direction. I am very concerned about these matters.

Q116 Chairman: Your answer just then very usefully links us from the section on energy prices to the section on security of supply. I have heard it said quite often actually by various industries that, for example, the nine billion windfall that the

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

companies have received you are very happy with because it will help give them the money to build nuclear power stations. You sort of endorsed that in your answer just then.

Malcolm Wicks: I suddenly realise it would not be parliamentary language to say, “Steady on” to a Chairman of a select committee, but I think that is a little leap.

Q117 Chairman: You did say it was good for them to have money to build power stations though.

Malcolm Wicks: Maybe we are coming on to this.

Q118 Chairman: We are.

Malcolm Wicks: But we are going to need a great deal of investment in our power infrastructure.

Chairman: Let us talk about that. Tony Wright.

Q119 Mr Wright: Let us move on to the nuclear issue.

Malcolm Wicks: Less controversial. Thank goodness!

Q120 Mr Wright: At the beginning! In 2006 following that, the High Court ruled in favour of Greenpeace. Are you confident that you will not face another High Court challenge from Greenpeace?

Malcolm Wicks: That is up to them and their members’ money, is it not? It is not up to me. I cannot foretell these things. We were challenged by Greenpeace; the judge did find, as it were, in favour of Greenpeace. We then did an extremely full consultation, I think, as someone interested in political science, probably the fullest public consultation on a major policy issue we have ever had in this country. It was not just getting evidence from the usual suspects—that was very helpful—but random samples of electors were drawn from the registers, we talked through the issues in an objective way at arm’s length via an independent company with over a thousand people in major city centres across this country. I sat in on one in London; I thought it was a fascinating exercise. Then, as governments have to do, we made a judgment, and the judgment was that there should be a place for new civil nuclear. I would rather these things be settled, as it were, within the Parliament and in government rather than in other ambits, but let us see.

Q121 Mr Wright: I would tend to agree.

Malcolm Wicks: I think the argument has moved on. A lot more people are interested in the arguments about civil nuclear power—they are concerned about climate change, they are concerned about energy security—and I think we have had a much more reasoned debate that probably would not have been possible ten or 20 years ago about nuclear.

Q122 Mr Wright: Do you think it has been quite helpful in trying to change public opinion towards new nuclear and achieving political consensus in that in as much as the previous submission from the High Court judge was saying that the consultation process has been misleading, seriously flawed and

procedurally unfair? Are you confident that since 2006 we have moved on and the public are more tuned in to the debate on the nuclear question?

Malcolm Wicks: I am very confident we had the fullest possible public consultation. I thought it was a very successful and, indeed, interesting exercise. A little bit of me is pleased we were enabled to do that. There is, as I say, a much more reasoned debate out there. There are still those who are fiercely opposed to nuclear, and I have a great deal of respect for the position. There are big issues around waste, security and safety. Equally, there are vociferous proponents of nuclear—some were in the middle on this issue wanting to look at the arguments—and, as I say, the Government has now made its judgment.

Q123 Mr Wright: One of the concerns certainly from my point of view and, I know, of other members of the Committee is not the question of building power stations, it is the decommissioning and obviously the question of the waste management. What you have said there is that they will meet the full costs of decommissioning and their full share of waste management costs. What do you mean by “the full share of waste management costs”?

Malcolm Wicks: I mean 100%. That is what I mean. This is a feature of the Energy Bill, and the only feature of the Energy Bill which is about nuclear is setting up arrangements to make sure that our principle that they should meet the full share is put into practice. It is not just their full share of building the reactors and all the construction costs and the running costs, but, as you imply, it is the full share also of the eventual decommissioning of those nuclear reactors safely and the full share of their disposal of the waste.

Q124 Mr Wright: I suppose it was in the terminology, because, I repeat, what you said at the time was “meet the full costs of decommissioning and the full share of waste management”. What you meant to say was “the full costs of decommissioning and the full costs of waste management”?

Malcolm Wicks: Certainly that is what it means, and it includes, for example, a contribution towards the fixed costs of constructing the geological disposal facility, because, after all, that disposal facility would have to be somewhat larger than simply what we need to dispose of the legacy of nuclear waste. It involves that. We are going to put in place arrangements whereby from the moment that the nuclear reactor is built and is up and running from year one the company has to set aside money for the eventual decommissioning and disposal of the waste into a separate fund altogether different from the company’s own funds, and we are going to set up an independent board, which will include, I guess, people like accountants and others, to advise us on how we determine those costs over time.

Q125 Mr Wright: Are you still confident that from the beginning there will be no government subsidy from the construction of the nuclear sites right the way through to the nuclear waste: no government subsidy whatsoever?

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: There will be no government subsidy, no. Indeed, in terms of developing the costs that they will have to pay, there will be a premium put on it. In other words, we are going to ask them for rather more money than probably we think is needed, just to safeguard the taxpayer on this one.

Q126 Mr Clapham: Minister, just a couple of quick questions. On the one hand we talk in terms of building nuclear and a little earlier, when we were discussing the market, you recognised that there was a need for a decentralised energy market, but here we are likely to see the development of nuclear power, and once the rods are in that reactor and the electricity is flowing, it has to flow. Consequently, we get centralisation, which is going to prevent the kind of energy market developing for the future that you would like to see, a much more decentralised one, one where communities can actually have an input. Secondly, are discussions taking place with EDF? EDF, a French electricity company, a nationalised company, has shown an interest in wanting to build a nuclear power station. Are we likely to see them drawing a profit from that electricity provided by their nuclear station but leaving us with the decommissioning costs? Are negotiations taking place with the company?

Malcolm Wicks: That is the policy. In no way are we going to allow someone to build the thing and then let the taxpayer clear up the waste and pick up the considerable bills. The whole purpose of our strategy is to state that principle very clearly, that they will pay 100% of the costs, and the Energy Bill sets up a framework to start to move from principle to practice over time. We are absolutely committed to that, it is very, very vital, and I am confident that actually it will happen. On your earlier point, although you have proponents of both sides, I myself feel it is perfectly sensible in the future to think that alongside a National Grid, which I am sure will be there for decades to come, based on big power station like coal or gas or nuclear, you start to see the development in different localities of decentralised energy systems. I visited one recently in Barkantine on the Isle of Dogs. It was owned and run very well by EDF but this was a relatively small power station in the community, it combined heat and power, which was a particularly important feature, serving the local community and providing heat to several hundreds of local dwellings and the local school that I visited and soon the local community centre that I visited. That struck me as an extraordinarily interesting model of what we could see in the future and linking it in to where the housing ministry is, Department of Communities and Local Government. There we have set ourselves as a government an extraordinarily radical objective that by 2016 we will only build in this country low carbon housing. That is interesting because, apart from anything else (and I am on the committee with the Housing Minister on this as we think this through), what that means is we have got to connect up our thinking about housing and the design of that kind of housing, very firmly efficient and so on, with all this talk about decentralised energy and

renewables and micro-generation, and I think that is an extremely exciting project. Why do I mention that? Because that will itself, I think, bring forward decentralised energy systems which will be very different from the big power station, National Grid model that we have at moment, and it is one of the reasons why I am interested in new entrants to the market, because I do not think they all need in the future to be a big player; some of them could be relatively small serving local communities and maybe in part owned by local communities.

Q127 Mr Hoyle: It is obviously very interesting what you have said, but the truth of the matter is you cannot manage without the National Grid. That is the reason why the lights go out, is it not? If you are reliant on the local source and something goes wrong, you have no other choice. The other thing is, if they have got spare capacity, you need to put it into the National Grid. What we have got to say is we do not want to get rid of the National Grid, we want to work with the National Grid for the future.

Malcolm Wicks: I agree with that.

Q128 Mr Hoyle: That is a good start. The cynics are saying that the Government is more than happy to watch energy prices rise, Ofgem are happy to sit back as well, in order to allow profits to be made and justification for nuclear. Is that fair or have the cynics got it completely wrong?

Malcolm Wicks: Cynics are normally cynical. I do not think that relates to the truth at all. I am reflecting on what you have said. I think one grain of truth in that is that we are going to be in a world of high energy costs and, just as that raises particular challenges in terms of tackling the fuel poverty issue—Mr Berry was leading on that—it is also an encouragement to energy conservation and energy efficiency. This is one of the dilemmas we have got now. If we were simply people looking at global warming, you might welcome rising energy costs. If you are looking at the social policy thing, you are in some difficulty about it. The challenge for us all now in an era of high energy costs, when, perfectly properly, to tackle climate change, we will adding to those energy costs as we bring forward renewables and carbon capture and storage and clean coal technologies and all of those things, is how do we then redouble our efforts to protect the poorest? It is a dilemma, it is something I think we can move our way through, but it needs quite radical thinking.

Q129 Chairman: Filling in the sandwich between nuclear—we can ask you a lot more about that but there will be other opportunities I am sure—and renewables, which Julie Kirkbride will ask you about, one of the common features here is the need for these national policy statements which are part of the Planning Bill's proposals to speed major infrastructure investments, which is the National Grid as well and, because we believe the Government thinks there is a role for Parliament in scrutinising these statements, there are a few questions I would like to ask you, which I have told your officials about, to make sure we understand

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

exactly what is involved. We do not really know even how many of these policy statements there are going to be, so the first question is: is it correct that there will be a single over-arching national policy statement on energy, with subsidiary statements on specific energy technologies beneath that? Is that the way it will be done?

Malcolm Wicks: Yes. That is the simple answer to that question. We will certainly have an over-arching national policy statement on energy, for all sorts of obvious reasons. We need to bring these things together. We are expecting that that will be published sometime, I cannot say exactly when, next year, in 2009, but also under that we need to see the need for a number of other statements on renewables, obviously, and on nuclear. Exactly how they will fit together, the big statement will come first, but whether these other statements will be technical appendices or whether they will be separate documents coming later I do not think at the moment we know, to be blunt, and I do not think that is unreasonable at this stage.

Q130 Chairman: Would you expect there to be more than one policy statement on the renewable sector, because there are different technologies involved?

Malcolm Wicks: We certainly see the need for additional statements or, as I say, annexes—I would not worry too much about the detail on fossil fuel generated electricity, on renewable energy, on gas storage and transportation, obviously on nuclear, and actually a kind of cross-cutting one on electricity networks, which is very important too.

Q131 Chairman: So that is at least one over-arching statement and five subsidiary statement annexes?

Malcolm Wicks: Yes, but I do not want to say it will never be six.

Q132 Chairman: No. The difficulty we have is that we have got to make decisions very soon, while the Planning Bill is going through, as to how Parliament can best cope with these statements. We do not really know what is involved. We do not know how long they are going to be, how much detail they are going to go into. For example, a particularly important question for parliamentary scrutiny will be: will there be site specificity in these statements? Will the nuclear ones say, “The Government wishes to see X nuclear power stations and they will be on these, X, sites”, because that will have big implications?

Malcolm Wicks: That is our expectation.

Q133 Chairman: Because, in that case, it will become more like the Crossrail Bill, a Private Bill Committee. Rather than a scrupulous policy statement, it becomes a much more detailed scrutiny process?

Malcolm Wicks: Yes.

Q134 Chairman: You expect currently that the—

Malcolm Wicks: I do not know where I will be then, but I will not have time to be on that committee.

Q135 Chairman: That is rather my concern, Minister. I do not think the Government has quite thought through how much scrutiny these documents might need if they go into that level of detail. You think it will not just say, “We believe in new nuclear power stations to help the UK meet its objectives”, it will actually say, “We think need a new Sizewell C or a new Dungeness B”, or whatever it is?

Malcolm Wicks: Yes. Obviously Parliament has to scrutinise—

Q136 Chairman: These are not catch questions. I am giving you all the information.

Malcolm Wicks: ---the national policy statements, yes. It will be for the planning process, as hopefully reformed by the Planning Bill, to decide on the specific issues about specific sites.

Q137 Chairman: It does sound as if you are eventually, after consultation initially, picking the number of nuclear power stations you will actually want built at some stage. If they are going to be site-specific, you have got to have a national policy statement which encompasses the sites.

Malcolm Wicks: We are not going to be in the business of saying there should X nuclear power stations.

Q138 Chairman: You just said you would in answer to my question.

Malcolm Wicks: No, I said that to be helpful to Parliament and the public, we would want to talk about siting. We are not going to talk about how many there would be on this site or that site.

Chairman: You are not. I am not quite sure where that leaves me. We may need some further private dialogue on this, because these are very important issues for the conduct of energy policy and the way Parliament scrutinises energy policy.

Q139 Roger Berry: Part of the issue, of course, is that the Government has said it is not its job to pick winners and so it will set an environment in which the energy companies will decide whether or not to say, “We want to build a nuclear power station here, or here, or here.” So, as I understand it, the Government is not planning a strategy, the Government does not actually have a strategy as such for nuclear energy, it will have a benign climate, it will have incentives, it will have an infrastructure that you believe will encourage companies to want to come forward and do it, and so in that sense you leave it to the market to say how many nuclear power stations there will be and where they want to go. Is that my understanding? Is that not what this is all about?

Malcolm Wicks: It is a combination of, yes, the market, the companies coming forward with proposals for nuclear power stations, but government, through the different agencies, establishing criteria about what sites are appropriate.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Q140 Roger Berry: That I understand.

Malcolm Wicks: And, by definition, what sites are inappropriate.

Q141 Chairman: Indeed, some of the off-shore wind proposals, which are sometimes controversial in this area. What you are saying is, "We will say this list of sites appears to us to be suitable. It is up to the industry to decide how many of those it wants to take forward." Is that the position?

Malcolm Wicks: Yes. The expectation is that this statement will include agreed site and criteria and a list of sites that meet the criteria.

Q142 Chairman: I think I probably falsely put words into your mouth by the way I asked the question earlier. You are not mandating a specific number of sites or a specific number of power stations?

Malcolm Wicks: No. According to the criteria, site X might be okay against the criteria; it does not mean someone will come forward with a proposal. I have been reminded, as they say on these occasions, that there is a certain timescale of the process, but I think it would be tedious if I, as it were, read out my note. Would it be appropriate if I sent that to you?

Q143 Chairman: Yes. If you could send it to us before we have our meeting with the Leader of the House next week to discuss in more detail how this matter is conducted.

Malcolm Wicks: Yes. On the parliamentary process, obviously it will be for Parliament to determine, but I think there has been a suggestion that the joint expertise of four select committees might come to bear on this matter and I also understand that John Healey is seeking with the Leader of the House to meet the Chairs of the committees to discuss this.

Q144 Chairman: We are actually seeking a meeting with him and her, but we have got it now.

Malcolm Wicks: Whatever. There will be a meeting of minds anyway, I hope, on 7 February.

Q145 Chairman: Indeed. We do not want to labour this point, this is a rather tedious parliamentary point, but we were rather concerned when the Government announced as part of the Planning Bill that there would be a new joint committee of the four select committees, which we think is a possible way forward. I must say, we are strongly in support of these national policy statements, they are a very good idea, but some of us have reservations about what happens after that when we instruct a planning commission. They will help the nuclear sector, the renewable sector, the National Grid and others bring forward proposals in a much more efficient way, but we are anxious to make sure scrutiny is done well and effectively and uses our resources effectively and actually serves the Government's purpose, because we share the Government's objectives entirely. I think that is probably all we need to discuss on that for the time being. Thank you very much, Minister, for those answers, which are genuinely helpful in helping you meet your objectives.

Malcolm Wicks: Chairman, thank you very much.

Q146 Miss Kirkbride: Moving on to another issue.

Malcolm Wicks: I thought we had finished. No?

Q147 Chairman: We have got a few more yet.

Malcolm Wicks: Such effusive thanks from the Chairman!

Chairman: I was softening you up for the killer blow, Minister!

Q148 Miss Kirkbride: The EU's renewable energy targets are clearly very demanding. I would like you to have a few words on how you see it being possible and if you could also specifically, in giving your answer, say how much you expect of that renewable energy target to come from electricity?

Malcolm Wicks: First and foremost, we are fully signed up and in agreement with the objective for the European Union to have 20% of all of its energy from renewables by 2020, and the key words there are "all of its energy", because in the past many countries, certainly the UK, have set targets for only electricity. This is all energy across the piece, including the stuff we put in our motor cars and fuel industry with and so on. Let us recognise that that is an extremely demanding target. We have now received documentation from the European Commissioner, Andris Piebalgs, where, as part of a broader range of proposals about British contribution on the Directive, he is suggesting that the UK target should be 15%. We, alongside many other Member States, are now negotiating about all of that, and that is a perfectly proper process, but whatever our target will end up being, it is going to be huge. It is going to be, whatever, a seven-fold increase, or something, on where we are now. Where we are now is that, whilst 4 or 5% of our electricity comes from renewables, I think slightly less than 2% of our total energy comes from renewables, so you can see, Miss Kirkbride, this is a hugely demanding target for us. Did I miss one aspect of your question there in my answer?

Q149 Miss Kirkbride: You raised quite a number of things there. When we discuss this in the European Commission what figure are we asking them to put in instead of 15%?

Malcolm Wicks: I am sorry.

Q150 Miss Kirkbride: You say we are discussing this with the European Commission, so what figure is the British Government plugging for if it is, presumably, less than 15%?

Malcolm Wicks: We are discussing this. I do not want to reveal our negotiating hand. One of the things we have pointed out to the Commission is that when you look at our share here, our share of the costs (because costs are quite considerable in Britain) will be really very high compared with other Member States, and I think it is perfectly proper that we feed that into the equation.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Q151 Miss Kirkbride: So, whatever the figure is, somewhere around the 15% mark, the assumption is that we will have to get most of that renewable target out of electricity production rather than the wider energy market?

Malcolm Wicks: Yes.

Q152 Miss Kirkbride: Do you have a figure for what that might be?

Malcolm Wicks: Yes. I do not want to predict this, it is not becoming a target before we have agreed the other target, but some suggest that this could mean a contribution of over 40% renewable energy.

Q153 Miss Kirkbride: Renewable electricity.

Malcolm Wicks: Sorry, what did I say?

Q154 Miss Kirkbride: You just said renewable energy.

Malcolm Wicks: I stand subject to correction, but this could mean say 30, 40%. I am suddenly reminded I should be more general, 35 to 45% of our electricity.

Q155 Miss Kirkbride: Is that the average?

Malcolm Wicks: It is encouraging. The lights are still on and I can read my notes!

Q156 Chairman: This is a serious point.

Malcolm Wicks: It is a very serious point.

Q157 Chairman: Because it is a huge figure.

Malcolm Wicks: Obviously, this reflects the fact that suddenly having more renewable fuel in our cars is a more demanding objective in this time period than seeing more electricity from renewables. It reflects that. I will not be committed to that figure, but I want to be helpful, as ever, and this could be the kind of range, and it is a huge proportion, of course it is, given that, as I said earlier, only 4 or 5% of our electricity at the moment is from renewables. This is a revolution.

Q158 Miss Kirkbride: It certainly is. On the subject of being helpful, can you answer some of the speculation there has been when Tony Blair went to discuss these very demanding targets with the European Commissioner, the European Union, that he had not quite twigged the difference between renewable energy targets and electricity renewable energy targets?

Malcolm Wicks: That is nonsense.

Q159 Miss Kirkbride: He did not mind signing us up to something that is going to be jolly tricky do.

Malcolm Wicks: He fully understood the difference and, indeed, was a leading proponent that we should be ambitious, given climate change, to set a demanding renewable target for the European Union. I really can assure you, I do not have to curry favour, not that I ever would.

Q160 Miss Kirkbride: It is fine to tell us the truth.

Malcolm Wicks: There is another guy now, I think, at Number 10, but the reality of the matter is that when I led the energy review for the Prime Minister, Tony Blair, this man knows his energy, he really does. He has expertise in this area. I think that expertise includes knowing the difference between just electricity and all energy, really.

Q161 Miss Kirkbride: Given other outside electricity, what are you going to do to make that step change difference?

Malcolm Wicks: Some of the things we have announced already. The Secretary of State, John Hutton, announced some weeks ago in terms of the new licensing round what will be a very considerable expansion of off-shore wind turbines: because one of our obvious renewable sources in this country, and it varies from country to country depending of geography, terrain, rivers, all that stuff, is wind, and I think much of the expansion of wind power is going to be off-shore and we are in the process of enabling that to happen. That is one answer. I should say that next year we overtake Denmark in being the leading world nation in terms of off-shore wind, the London Array outside the Thames Estuary will be, I think, the world's largest off-shore wind farm, but we do not want to go just for wind. We have announced recently at Port Talbot what, again, I think will be the world's largest biomass plant, and you know about the feasibility study on Severn Barrage. All these things are pretty ambitious, but will they take us to X% by 2020? No, they will not on their own, and, therefore, we have now got a review going on and we are going to publish a consultation document in the coming months, I think, on the next stages on renewables. We are not complacent. This is a revolution—I say this as a gradualist—this is a revolution in terms of renewables, and, therefore, Chairman, through you, a huge opportunity for British industry, following the Nick Stern analysis, about the economic opportunities to get in the right place in terms of these new cleaner, green energy industries that we need to see in Britain.

Q162 Miss Kirkbride: That is an optimistic scenario. It could also be a huge cost to the British industry when it is forced to go further and faster than is realistically possible. Therefore, is it likely that the Government is going to have to buy-out some of its share because it is simply not going to be doable on the present forecast?

Malcolm Wicks: The proposals as they stand at the moment do involve some trading, I suppose is the word, across European nations, if it is felt to be less expensive to develop our share, and a small part of that is in another European country all that is being discussed but I certainly see for the great bulk of this the British commitment being in Britain, and that is important for reasons of energy security as well as climate change. I think that more and more parts of British industry now, instead of just seeing the costs, which, I think, was where it was five years ago, are now seeing the economic opportunities of moving towards a low-carbon economy. We will see that in

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

housing, we will see that in renewables, we will see it in terms of carbon capture and storage and in many other parts of life. If anything, it will sometimes be the companies urging government on rather than the other way round.

Q163 Miss Kirkbride: Are you happy to sell to the electorate in the future the idea of being taxed by Europe for our dirty energy?

Malcolm Wicks: I do not understand the reference there.

Q164 Miss Kirkbride: At the end of the day, whatever you want to call it, there is essentially a tax if we do not meet these energy requirements. If it ends up being 15 % and we do not meet it, the buying-out amounts to money that the British public will be giving to other countries in Europe because it has not met those targets. Do you think that is going to be terribly popular with the electorate?

Malcolm Wicks: I think the British public are increasingly becoming concerned about global warming and climate and, if anything, they will be frustrated if we do not take radical action. I think that is where the pressure comes from, and it is a pressure I welcome, but we are not gung-ho about this, we have to, obviously, be aware of prices and competitiveness and develop renewable energy with more than half an eye to the costs involved—of course we do—which is why the issue about training is something that may seem sensible.

Chairman: There is the possibility of a vote shortly, we are informed. I think we have ten or 12 minutes ideally of questioning to do. If colleagues ask their questions quite snappily I think we might be able to get through and not have to come back.

Q165 Roger Berry: Some cynics are suggesting that the Government might redefine renewables to include nuclear. Can you dispel that myth?

Malcolm Wicks: No, nonsense, because it is not a renewable. It has many of the features, but uranium is not renewable, as I understand it.

Q166 Roger Berry: Thank you. We very much welcome, in terms of reference, the feasibility study into tidal power, nominating the Severn, whether it is a barrage or two or three little barrages or tidal lagoons, whatever. Do you think this can all happen fast enough so that tidal power in the Severn will contribute to the 15% renewable target by 2020? Can things happen over 12 years and, if so, how much will it contribute to that target?

Malcolm Wicks: I think we would be lucky for the Severn Barrage to be up and running by 2020. First of all, we do not know yet whether we are going to build it, the environmental considerations are very important in terms of feasibility, the unique ecosystem there. We have got to take that very seriously. It is just possible that it could be up and running by then and help us with the target, but one of the things we are discussing with the Commission is urging them to be sensible. If you have a unique infrastructure project taking many years to build and develop and it just slightly goes over the 2020,

we hope those looking at the arithmetic of targets will be sensitive to that kind of factor. One of the answers to your question—no, it is not really. I was going to say you know it. It could be 4 or 5% of our electricity. Your question was more about—

Q167 Roger Berry: That is probably about 2% of the target. Again, as indeed the Secretary of State did in the House, you have focused on the barrage as if that is the only—

Malcolm Wicks: Well, it could be tidal lagoons.

Q168 Roger Berry: That is right. The issue here, of course, is that the percentage tidal power is so great that if we are serious about any tidal power in the UK something will have to be done in the Severn. It may not be the Severn Barrage, in which case it may it not have the environmental impacts that you have referred to.

Malcolm Wicks: No.

Q169 Roger Berry: That is what feasibility study is all about?

Malcolm Wicks: As I understand it, the barrage would probably be the big gain in terms of electricity and CO₂.

Q170 Mr Weir: The Committee has sometimes been calling for action on space heating, which is responsible for almost half of carbon emissions. Given that we are talking about a renewable energy target, is it your intention to bring forward proposals, such as a Renewable Heat Obligation, to address issues of space heating?

Malcolm Wicks: Heating is absolutely crucial to this and it is sometimes the kind of Cinderella. Cinders is going to come to the ball, as it were, in terms of climate change and energy. Heat, I think, is some 47% of CO₂ emissions, from memory, not just the heat to keep us warm in our homes and our offices but also the heat used for industrial processes of different kinds, and so it is a very considerable part of the situation. The relatively new Office of Climate Change, which has been established as a new unit across government, has done important work on this and only today we have published details of a consultation that we want to launch on this. We have got to take it very, very seriously, and, as I indicated earlier, I recently visited a combined heat and power plant on the Isle of Dogs, I have been to Denmark and looked at it as well, I am very committed to looking at this very carefully because it is part of the equation which, frankly, has not been there in the recent past and it should be.

Q171 Mr Weir: But no specific Renewable Heat Obligation in the mean time.

Malcolm Wicks: I do not think in the mean time---. I do not think that is where we are at the moment, but clearly we need to think how we would bring this forward.

Q172 Chairman: Because it was ten pages in the White Paper last year out of 300, so I am encouraged by your newfound enthusiasm, Minister.

31 January 2008 Malcolm Wicks, MP, and Dr Nick Palmer, MP

Malcolm Wicks: But all the other ten pages were vital too.

Chairman: The other 290 pages were very important, yes. Briefly, carbon capture and storage.

Q173 Mr Clapham: If we are going to impact on CO₂ over the next 50 years, we have got to have technology that we can transfer and carbon capture and storage is one of those technologies. For obvious reasons, such as proliferation, we are not going to be able to transfer nuclear. When are we likely to see a fully operational demonstration plan?

Malcolm Wicks: I am proud of the fact that the UK Government is going to fund and facilitate a demonstration project. The competition has now been launched and it is up to different companies to come forward with proposals around a coal power

station to have a post-combustion technology. I think it is difficult to predict the timescale on that, but I am proud of the fact that we are a leading nation on that with huge potential to help climate change, not only in the UK but also in China.

Chairman: Minister, there are a few more things we want to ask you, there is not really time and it is not worth coming back after the division to ask those questions. We will break off there, consider what you have said and decide how to take forward the matters we have been debating today. Thank you very much indeed.

Q174 Mr Hoyle: Can we have your draft as well?

Malcolm Wicks: I will send you another draft, yes, but I will check the headline on it first!

Chairman: Meeting closed.

Tuesday 20 May 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Roger Berry
Mr Brian Binley
Mr Michael Clapham

Miss Julie Kirkbride
Mr Mark Oaten
Mr Mike Weir
Mr Anthony Wright

Witness: **Mr Allan Asher**, Chief Executive, energywatch, gave evidence.

Q175 Chairman: Thank you very much indeed. Welcome to this first public evidence session of the Committee's inquiry into energy prices. I meant to bring with me the folder of evidence we have received from organisations to this inquiry. I think I can say we have never had such a large volume of submissions from the outside world. Your own submission was a particularly significant contribution to our inquiry. I think I have coped with most of it. The public have access to the first volume of your five volumes of evidence to us, the technical submissions, but thank you very much indeed for that very detailed work. Can I also express my gratitude to you for coming on your own. It always helps the Committee when witnesses are single-handed and shows great confidence. It also means we can get through the questions much more efficiently, so thank you very much indeed for that. Can I begin by asking you to introduce yourself for the record and, although this Committee knows, to explain the remit of energywatch and who constitutes the organisation.

Mr Asher: Thank you. I am Allan Asher, Chief Executive of energywatch. energywatch is the statutory consumer watchdog for energy. We have three very simple tasks: to try and promote efficient energy markets, responsible energy markets and sustainable energy markets. Sadly, we have not succeeded in any of those three goals yet. For this inquiry we have closely interviewed 50 industry experts, that is, traders and large buyers and sellers, but, most importantly, we have drawn on our records. We have helped five million consumers since 2002 and we genuinely believe we know what circumstances consumers face, how the market works and, sadly, how it does not work.

Q176 Chairman: When you say consumers, are you meaning just retail consumers in the home environment or small businesses as well?

Mr Asher: energywatch's remit is for all consumers. Most of our work is, of course, with domestic consumers and we have a particular programme for the fuel-poor. However, we find that micro-business and small business are also in a very bad way. They do not have access to any of the protections that domestic consumers have, and yet they do not have the buying power or the ability to negotiate good deals like big business, so often they are even worse off.

Chairman: Thank you. That is helpful. There is one issue that Mr Oaten would just like to explore about your remit.

Q177 Mr Oaten: There seems to be a little bit of a gap in the regulation and support for consumers. Many of us around this table represent large rural constituencies where constituents are dependent on fuel oil, where they are dependent on liquid petroleum gas, or Calor gas, and in some cases LPG prices have gone up by 82% over a two-year period. What role do you have in that area and, if you do not, do you think that somebody should be stepping in to regulate this particular sector?

Mr Asher: Yes, I agree there is a gap. The way that the law was written, our jurisdiction is where there is gas conveyed by pipes or power conveyed by wires. So for people off the gas network—and, sadly, there are several million of those and they really face a tough time, especially in rural areas or in the north of Scotland and things like that—we help where we can. We were active witnesses at the Competition Commission inquiry into LPG. Also, we think that, for sustainability reasons, we have just got to find ways of being able to support those combined heat and power installations and all those non-grid applications. For us though it is a bit irrelevant as we are to cease existing at the end of September. We can only hope that the National Consumer Council, which will take over, has a wider remit.

Q178 Mr Oaten: So you would welcome bringing these into the family, if you like?

Mr Asher: Certainly. There are consumers with problems with heat and warmth, and that is really what we should be about.

Q179 Chairman: That would require statutory change to effect that for the National Consumer Council.

Mr Asher: I do not think so, in that, as an advocacy organisation, they have a remit at large. I do not think it requires that. It just requires enough resources so that they can do it.

Q180 Mr Weir: Can I just follow that up? Obviously, like Mark, I have a similar problem. If it is coming under the National Consumer Council, has any thought been given to including that within the energy remit of the National Consumer Council to make sure it just does not disappear and fall between two stools?

20 May 2008 Mr Allan Asher

Mr Asher: We have been invited by the Chief Executive, Ed Mayo, to put forward to him ideas about a forward work programme and, as part especially of our responsible markets work, we have been very active in some of these areas. Indeed, with the Rural Advocate, we have a very close working relationship and we have been major information providers. I cannot say what is going to be in their work programme. What I can say is that Parliament just three weeks ago stated that the new NCC needs to come up with a work programme over the next 12 weeks or so for public consultation and that that will be the work programme they need to work on from 1 October this year to 31 March 2010. So I think there is ample opportunity to inject those ideas, and we certainly will.

Chairman: We certainly welcome your enthusiasm to encourage the Council to take this on board, though it is a shame that both you and Postwatch are being abolished at probably the most sensitive moments for the industries you oversee. It is going to be quite a burden for the new Council to effect the transition.

Q181 Mr Wright: Just very quickly on a similar point, as has been said, many of us have rural constituencies, which is a major concern in terms of energy supplies. Would you suggest, for instance, that because the energy by pipe or wire has been controlled by yourselves since 2000, when you were set up, companies have taken advantage of the fact that there is no regulation of liquefied gas?

Mr Asher: Undoubtedly competition problems have been even worse in off-gas and off-power networks and the Competition Commission spelt this out in its LPG report. One of their draft recommendations was that our remit be expanded to deal with that but at the time I think the Government did not want to pursue that. Of course, because so many people in rural areas usually only have access to a single source of energy, it is usually going to be power, and so the prices are always considerably higher. Even in Wales and Scotland power prices are considerably higher than in the rest of GB.

Q182 Mr Wright: Would you consider, for instance, that had it been regulated, the prices would have been much lower?

Mr Asher: In bits. For example, with LPG, what was happening was that the few competitors would not allow one another to use the same cylinders and things like that, and that hugely increased the cost, suppressed competition and, of course, consumers paid the price. That sort of thing happens all the time, sadly, even in what should be a competitive sector of the market.

Q183 Chairman: Thank you very much indeed. Can we move on to some of the issues that we want to talk to you about, starting with retail market concentration. This is a difficult inquiry for politicians because we get into very technical economic areas quite quickly. Both Roger Berry and I studied economics at university but we are not actually with the Herfindahl Hirschman Index or

how it is composed. We will take it at face value. I notice that a highly concentrated market is 1,800 on the HHI score. Ofgem say that the index has fallen since 2002 from 4,300 to around 2,830, so despite the fact that 14 suppliers are out of the market, it is becoming more competitive, though it is still highly concentrated. Can you explain this conundrum to me?

Mr Asher: It is very easy to do if you change the definition of the market. Put in its most simple form, the HHI is just an indicator of when markets reach a certain level of concentration. It is based on the square of market share and a few other technical details but it is used widely around the world by competition authorities to give themselves the idea of where to look more closely. It is not conclusive of anything but it is a sort of smoke signal. All of our markets—and we can give you very detailed information about this—are well over the 1,800 level, regardless of whether it has fallen or increased, but the point that we make is that Ofgem regard GB as having a GB-wide market whereas our evidence is that in any particular area, say, in the north of Scotland, 89% of consumers are going to just deal with one or two competitors, and around the whole of GB that is the pattern. It is the old RECs, the old electricity franchises, which form the backbone of markets, and typically a supplier will be able to charge a lot more in their old monopoly area and then they will do a bit of discounting in one or two other markets just to keep their toe in, but the markets are quite anti-competitive and under any standard competition test people would say there is alarm. I will happily submit to you the full tables that we have calculated by area. I think for MPs in this room, we have looked at most of your electorates and most of them, or in fact every one of them, should raise competition concerns.

Q184 Chairman: Am I right in saying that in the gas market British Gas is the incumbent across the country, whereas in the electricity markets it is the regional electricity companies?

Mr Asher: Yes, British Gas of course had 100% a decade ago and it is down to about half that now, but in power it is more widely distributed. Market shares actually do not change all that much from year to year. There is a lot of pretence of competition and huge amounts of churn but it does not amount to really good companies winning and really bad companies losing and, again, we have sad and detailed data that show the bad do prosper and the good fail.

Q185 Chairman: So the reason for the stickiness of the consumer in the retail market on electricity is presumably not because they are loyal to a name of their supplier, because most of us do not know who supplies us now as the names change so often. The old names we are familiar with have all gone. It is just incumbency fact. You do not have anything to do. You just stay with the supplier.

20 May 2008 Mr Allan Asher

Mr Asher: There are a range of factors. One is incumbency and, particularly amongst prepayment meter customers, it is very hard. There are huge anti-competitive obstacles to them switching. Often you will not be able to switch on the websites, access to a bank account, access to the internet, lower levels of information, being in debt, and the companies actively ensuring that those people do not switch, mean that of the 5.9 million PPM consumers, one million are really closed out of the market. There are another 268,000 with dynamic telemetering, a form of technology used in Scotland and elsewhere; only one supplier in each region operates to those. So sadly, we have 20 suppliers 10 years ago shrunk to just six in a comfortable oligopoly who really do not feel the need to innovate or compete and, sadly, consumers are the losers.

Q186 Roger Berry: In a comfortable oligopoly there is usually a leader or two and the rest are followers in terms of price setting. Have you been able to identify in particular markets who the leaders are in terms of price setting and who the followers are?

Mr Asher: Quite clearly, in our market the first mover is typically British Gas, with a huge market share and lots of signalling. Already we have seen that at their last annual meeting, where they scratch their chins and say, "Oh, it looks like prices will have to go up again in the Spring," and then others will respond in similar ways, and sadly, lo and behold, that will come about. There is a myth that there is vigorous price competition between them. If I were to tell you that for the main product, the one that they most actively sell, which is direct debit for dual fuel, selling both gas and electricity using direct debit, the price difference between the cheapest and the most expensive right now is about £16 a year; it is just a few pence a week.

Q187 Roger Berry: So there is no evidence of collusion in the unlawful sense.

Mr Asher: Yes.

Q188 Chairman: That is a very important point. There is no evidence of collusion in the lawful sense.

Mr Asher: I think that in oligopoly markets you do not need to meet in smoke-filled rooms because it is called "conscious parallelism" or "combined effects" or "tacit collusion". There are all sorts of economic terms for it but the manifestation that we see is that consumers get it in the neck.

Q189 Roger Berry: That was going to be my second point, that if you have an oligopoly with a market leader and followers situation, you actually do not need to meet in smoke-filled rooms.

Mr Asher: That is right. Can I just give you one more illustration? People will constantly say "Ah, yes, but what about that well-known maverick, Scottish and Southern, who do not behave in that way?" They have a marvellous marketing department, but if I were to tell you that the difference between them and the next company is at the moment something like £3, that will tell you that what they did was delay

their price rise for 90 days, and they have been able to trade all year on that, but their prices are also in that very tight batch for direct debit dual fuel.

Q190 Chairman: Is it not possible that this is a sign of a highly competitive market operating in a very low margin environment? Tesco's and Sainsbury's are pretty competitive organisations.

Mr Asher: Yes, that is right, and the economists will say that perfect competition and price fixing can look just the same. However, in this sector, when one looks at company profits and actual high levels of inefficiency—and it is not necessarily huge profit. It is a mistake to think that oligopolies always make huge profits. Often they have just bloated cost structures and they are inefficient and, sadly, that is what we have: tens of thousands of people to fix up the errors they make in their billing systems; one in three bills that they send out are wrong. These anti-competitive dimensions just go right through this market and it is highly ineffective and consumers are losing out. It should be manifested in keen pricing, but I have a number of charts here that, if we get a chance, I will show you that show that far from all the information you get from public officials here about how low our prices are, prices in Great Britain are systematically rising much more quickly than in Europe, and that our electricity prices are the fourth highest in Europe and, according to a recent European Commission survey, our gas prices are the 10th highest.

Chairman: The European market is something that will concern this Committee greatly, of course, during the course of this inquiry because of the problems of liquidity there.

Q191 Mr Weir: I was just interested in what you were saying about going down to the big six. Obviously, there have been a lot of rumours in the business market recently about perhaps some of the Continental companies concentrating in takeovers could lead to a reduction from six to perhaps five in the UK. Would you consider that to be very bad for competition in the UK, this further concentration in the market?

Mr Asher: The only relevant test for that is if after the merger a company can give less and charge more, it is bad, and on that test I think quite clearly that is the case. Even Centrica expressed huge alarm at the prospect of British Energy being snaffled by EDF. That would mean that at the moment at the generation level, where the independents have just about 45% of the market, that would fall to 25%. So the six vertically integrated suppliers would control three-quarters of that market. Sadly, the only logical consequence of that is worse service and higher prices.

Q192 Mr Weir: But if we are in an oligopoly of six, possibly going down, what measures should be taken to introduce more competition into the market?

Mr Asher: I think the very first thing is to stop it getting worse, and then to find ways of promoting new entry. It is not just that there are only six. It is,

20 May 2008 Mr Allan Asher

unfortunately, that our policy makers have allowed us to go from six retailers and a competing upstream market to vertically integrated, so that the six suppliers acquired more than half the generation, so that they now self-supply and all of that trade has gone from the wholesale market. We need to find ways of forcing open contestability in both wholesale and retail markets. It is about removing barriers to entry, the credit rules, and all sorts of things that have seen 20 suppliers and 20 generators crushed out of this market since 2000.

Q193 Chairman: We will look at the wholesale gas market separately later during the questioning. The Committee intend to explore some of that in a little more detail because it is an important point. Can I just ask two last questions, small points but I think quite important ones, before we move on to my colleagues. First of all, do you accept that world energy prices are rising and consumers would have to see price increases in this market irrespective of the level of competition that exists in the market here?

Mr Asher: Of course.

Q194 Chairman: And significant increases?

Mr Asher: Energy is a complex mix and oil prices clearly are sky-rocketing but I would draw the distinction between some of those commodities which are in a globally traded market and the natural gas that we consume, 75% of which is still coming from territory under our legislative and regulatory control, more of it from Norway but some from the Netherlands, and so the bits that are hotly traded in China do not include the gas that we burn.

Q195 Chairman: Before we move on to the question of retail prices specifically, can I just ask you a question about prepayment meters and standard credit? The possession of a prepayment meter does not indicate poverty necessarily, does it? People on standard credit terms can be just as poor as PPM customers.

Mr Asher: That is right. About a third of the 5.8 million prepayment meter customers you would describe as being poor, not necessarily the fuel-poor definition of more than ten% of income but, sadly, if you are looking for the people at the bottom of the pile, you are more likely to find them amongst prepayment meter customers. They are the ones who are going to have debts, they are the ones who cannot switch, and they are the ones who have to pay these punitively higher prices.

Q196 Chairman: But two thirds of those people with PPMs are not in fuel poverty?

Mr Asher: They are not in fuel poverty.

Q197 Chairman: Do you have an estimate of the number of people on standard credit terms as opposed to direct debit who would be in fuel poverty?

Mr Asher: I guess the other two thirds spread across various...

Q198 Chairman: Predominantly the standard credit group—is that right?

Mr Asher: That is right, but there is still a huge number who just have ordinary credit accounts where you are billed. That is where most are.

Q199 Chairman: Those people could be very hard up indeed.

Mr Asher: Indeed. Millions are, sadly.

Chairman: I think there is a slight laziness in the debate sometimes that prepayment meters becomes a surrogate for fuel poverty and that is not acceptable; it is wrong.

Q200 Mr Weir: You have mentioned already the difference in the spread of prices between those on direct debit and those on prepayment meters. Can you tell us why in your view there is such a narrow spread in one and a larger spread in the other?

Mr Asher: The actual spread in prices is about the business models and for direct debit there is huge transparency, these things are seen on the internet and there are lots of very efficient services now which help people switch between them, and that means that their business model keeps that tight. Not so for prepayment meters, where that is far less visible and typically people are going to be in debt. If you are in debt, you are prohibited from switching if you owe more than £100, and even if you owe less than that you cannot switch. Often you are not going to have access to the internet so you cannot get those good tariffs. The better question is to ask why it is that prepayment meter customers are paying £200, £300 up to £400 a year more for the identical commodity that those on direct debits have. There is no justification for that gap. There is, of course, a slightly higher cost of service and Ofgem calculate that as £85 per annum but the difference is a minimum of £201 up to £361.

Q201 Mr Weir: That does not answer the question as to why there is such a huge difference. I think it is £107 as opposed to £26, basically four times that. Are some companies taking a more reasonable attitude with prepayment meters? What is the reason?

Mr Asher: I fear I would put it in a different way. I would say some are not being as exploitative as others, and I mean that, because a difference existed up until recently where Npower was charging £452 a year more for its prepayment meter customers over those with their online tariff. I think it is close to immoral. Many others have compressed those rates and I am really pleased to say a couple of companies have now normalised their prepayment and standard credit rates and I think with Scottish Power you can get a prepayment meter for power slightly less than the others. So practices do differ. Some are good in that respect but none will give you for both gas and electricity prices equivalent certainly to their online nor even to their direct debits.

20 May 2008 Mr Allan Asher

Q202 Mr Weir: In your submission to Members for the Energy Bill Report Stage you did a piece on smart meters, and you indicated in that that payment meters were being installed, I think, from memory, at a rate of 100,000 every month.

Mr Asher: Yes, that is right.

Q203 Mr Weir: So it would appear to be a problem that is increasing and likely to increase. Do you think smart meters is a way to tackle this problem, and in what way will it tackle it given the nature of a prepayment meter tends to be to key in the money.

Mr Asher: The best evidence I can give you is that in Northern Ireland four or five years ago the regulator there encouraged the suppliers to get rid of the old prepayment meters and put in what you would call semi-smart meters, keypad meters, and that so drastically cut the cost of service that typically in Northern Ireland prepayment meter customers pay less than standard credit rates, not more. A roll-out of smart metering would certainly have that benefit across GB. Of course, it will take some years for that to happen and that is why we argue that when the roll-out does occur, there should be a priority for a prepayment meter consumers. That will make the market work better, it will cut the huge number of billing errors—as I said, one in three bills are wrong because they are based on estimated readings—and actually, it will help consumers know how much they are consuming, and moderate their consumption for carbon saving purposes.

Q204 Mr Weir: You mentioned that according to Ofgem a true price or a difference of £85. Do you think that is reasonable?

Mr Asher: No, I do not, because I cannot not see why the companies should treat themselves as being entitled to that premium when there is available technology which actually makes it cheaper for them to serve than for ordinary credit accounts. Remember, people are paying in advance. There is no credit risk, there is no collection risk, and they should reflect that in their pricing. Instead there is this immoral premium. Indeed, I do not think we should call them prepayment meters; we should call them “the poor pay more meters”.

Q205 Mr Weir: It seems to me the only example where you are charged more for paying cash in advance.

Mr Asher: Indeed.

Q206 Mr Weir: Going back to direct debit, there seems to be a very narrow band. We have all seen that when prices go up, one company takes the lead and the rest duly trot along behind fairly shortly, yet everybody says there is no collusion in the market. It is very difficult to collate the two because, clearly, if there is a very narrow band and everybody puts up their prices one after the other, it does seem that there may not be collusion but at least they are all acting together.

Mr Asher: The economists have done a lot of work on this and there is a theory called co-ordinated effects, and the Competition Commission itself in its

store card study—and several others have looked at this—and they say if you have a market where people can readily see the price, you can block out competitors so there is no new entry and it is very hard for consumers to negotiate.

Q207 Chairman: Mr Binley wants to explore this in detail later.

Mr Asher: However, there is well-developed literature on this point.

Q208 Mr Binley: In order for me to understand where you are coming from, can I ask if you have ever been in the private sector and can I ask, secondly, whether you understand that there is a difference between theory and the actual practice and culture of running a business? Can I hear a little about your thoughts on that?

Mr Asher: Certainly you may. In fact, for 13 years I was Australia’s gas and electricity regulator, so I have had quite extensive experience in the regulation of these markets.

Q209 Mr Binley: I did not ask that question. That is not the question I asked.

Mr Asher: I worked for an international telecommunications company.

Q210 Mr Binley: How long for and which one?

Mr Asher: I worked there for three years. It was an international telecoms company. I worked for chartered accountants, where I was an auditor for five years, and I worked for an international credit analyst, Dun and Bradstreet, for three years.

Q211 Mr Binley: So you feel you truly do understand the difference between theory and the actual working culture of business? Because I am hearing an awful lot of theory and I am hearing little understanding of the working culture of a business, and I want to clarify that.

Mr Asher: I think you are perfectly entitled to do that. I thought I said at the beginning we based our evidence on the experience that we obtained from 50 of the most senior business practitioners, real people doing real business, and drawing from our direct experience of 5 million consumers. In our submission we have dealt only in fact. We have given you price movements, we have given you concentration ratios, we have given you entry and exit issues, we have given you lots of examples, and I have to say that we are not in the business of theorising. Our problem is the real damage being caused to real people by our broken markets.

Q212 Mr Binley: Let me move on then and talk about your view that transfer of prices can be used to block out competition. You do understand that there is not a business in the land that is not totally aware of all of its competitors’ price structures. Do you understand that that is a vital part of ensuring you know the marketplace you are competing in? Do you understand that?

Mr Asher: If I were in business, of course I would seek to do very close competitor analysis.

20 May 2008 Mr Allan Asher

Q213 Mr Binley: That is not what I asked you. I said do you understand on this particular matter of prices, that that is vital to the competitive nature of a business?

Mr Asher: If you are talking about prices, that is one thing, but costs are quite a different thing and the different costs of capital, the different supply costs and all of that in this industry are endemic. Let me suggest to you that the long-term costs of gas purchase are totally opaque as between all of the suppliers. Seventy per cent of the gas is currently traded outside open markets and nobody knows from one company to the next about the contractual terms, the volumes, discounts, or all of those things, and all of that again adds up to a conspiracy against an effective forward market. In most markets of this sort, commodity markets, you would have liquid forward markets with lots of volume traded, and buyers and sellers would be contending for customers. Not so in our power market or gas market, where liquidity more than six months out on power you just will not see a single transaction. That is an indictment of the market.

Q214 Mr Binley: How do you free up the market?

Mr Asher: Most importantly, we need to force some of the gas sales and power sales from the vertically integrated bodies back into that forward market. We need to get rid of some of the insurance rules, the costs of business, we need to ensure that the rules are not stacked against new entrants and others, and customers to be given back some buying power; they have lost it in these markets.

Q215 Mr Binley: So what you are telling me is that you have failed as a regulator.

Mr Asher: I am telling you we are not regulators. We are a consumer group.

Q216 Mr Binley: I understand that but the regulator has failed. You feed a lot into the regulators, as you know. The regulator has failed. That is what you are saying.

Mr Asher: I think the regulator is failing, although Alistair Buchanan just last week expressed alarm at this price behaviour, and he said that he thinks it is time that there was a reference to the Competition Commission if structural problems can be found and if consumers are suffering. We think we can demonstrate both of those, and I think the best role for the regulator is to refer this sector to the Competition Commission for a thorough review.

Chairman: We are beginning to tread on all the other areas of questioning. Understandably, that addresses Mr Binley's question. I am ruling more questions like that out of order. That is for a little later in the agenda.

Mr Binley: I am totally happy with the answer, thank you, Mr Chairman.

Q217 Mr Wright: In regard to retail switching, you have certainly tried to persuade people to switch between companies to make significant savings. In 2006 you had your campaign "Are You Missing Out?" but really you did not hit the majority of the

market, did you? Although there were significant savings, some up to £600 a year in savings, yet you only persuaded 50% of people to transfer. Why do you think that is? Why do you think people did not switch but stayed with their company?

Mr Asher: I think there are a couple of reasons, but firstly I can say that we actually actively encourage people to switch. It is a good thing to do. If people especially have not switched, there are big savings possible. We suggest that they switch payment method to direct debit where they can, dual fuel where they can, for savings from prepayment to those methods. We also encourage people to do all sorts of money-saving and energy-saving things, but research, not just in GB but around the liberalised world, shows that typically only about half of consumers are going to be active in these markets. That is true across credit cards and mortgages. Car insurance is a bit different. There is this large group, around 50% in GB, who have not and are not likely to switch. We have concentrated our efforts in recent years on those for whom the burden is worse, the fuel-poor, those on prepayment meters, and we have actually had teams helping people through the switching process. Two things: if for direct debits the difference in price is about £30 a year, that is hardly worth the effort, and sadly, for a group of people that we helped switch prepayment meters, many of them actually turned out before long to be worse off because the company they had switched to increased prices by even more. So sadly, in a market that is structurally uncompetitive, switching becomes just meaningless churn.

Q218 Mr Wright: You mentioned earlier one company that had attracted a lot of customers and then within 90 days increased the price. Is that not a problem with switching? Is that why people, you would suggest, would not switch companies? The other side of the coin is, is it more difficult to switch companies if you are on a prepayment meter?

Mr Asher: Yes. It is almost impossible to switch if you are on a prepayment meter. You have a look on the website and you will see a number of very active companies—uSwitch and many others—who will happily help you to switch but not if you are a prepayment meter customer. The companies seem to be discouraging that hugely. I have written to each Chief Executive demanding to know why they are not allowing prepayment customers to switch so readily, and there is no good explanation, except that they are being a market targeted and that the companies make an extra £0.3 billion a year by charging them that premium. Sadly, it is an area where all of the regulators and groups like us have not succeeded in changing that. The debt blocking needs to go. At the moment, if you owe money to a company, they are able to prevent you from switching to another, or the ones with this technology trap, the dynamic telemeter; if you have that, you simply cannot switch. In rural areas, where you only have a choice of one energy source, it is even worse.

20 May 2008 Mr Allan Asher

Q219 Mr Wright: So rural communities fare worse.
Mr Asher: They certainly do. We have recently done work in rural Wales and the north of Scotland and the prices are bad and the service is worse.

Q220 Mr Wright: In theory, I suppose if we could persuade every single consumer, where possible, to switch to the cheapest supplier, that would drive down the market price.

Mr Asher: In theory it would not, because what would happen is the prices would then be redistributed as the companies gained their revenue across a wider base but, nonetheless, a certain amount of switching will discipline prices, and we wish we could say that it would improve their quality but Npower, which is by far the worst supplier in terms of customer service in the last year or so, has seen its market share go up and E.On, which has been the best improving company in terms of its conditions, has seen its market share go down.

Q221 Mr Wright: Why would that be? Is it just marketing strategy?

Mr Asher: It is advertising campaigns, local strategies and things like that but, by the way, these market shares move by just tenths of a percent. There is no major change in power markets. There has been in gas, of course, because over ten years British Gas have lost 50% of its market.

Q222 Mr Wright: What would be the maximum saving from the worst to the best in the current market?

Mr Asher: For direct debit dual fuel, it is a matter of £16 a year. With prepayment meters it goes up to £150 or so. However, there can be quite substantial savings if you are able to switch from a bad prepayment deal to a very good direct debit one, especially if it was an on-line one. Hundreds of pounds a year could be saved in that way.

Q223 Mr Weir: You mentioned, very interestingly, that many of those who switched then found themselves in a worse position because of rising prices. Is that not inevitable when the companies stage their price rises one after another? Putting it bluntly, do you think there is a deliberate strategy by the companies to undermine switching?

Mr Asher: Actually, there are two elements there. One is the business model that leads them to act more or less in parallel but there is another phenomenon as well. Most people actually do not wake up and say, "I know what. I'm going to go and switch my energy." Most people switch because they see an attractive ad on television, get a phone call, or somebody knocks on their door, and sadly, the evidence there from the University of East Anglia is that around a third of people who do switch actually switch to a company which charges them more, because you do not know. When somebody is at the door and promises you a saving, there is no way that you can actually tell whether or not you will have saved. The evidence is that many consumers are worse off, not better off.

Q224 Mr Weir: Does that not make a mockery of the whole idea of switching?

Mr Asher: It makes a mockery of those who say we have got a vigorously competitive and healthy market. We do not.

Q225 Chairman: People could switch for reasons other than price. There might be service considerations, environmental, green tariffs, they might be fed up with the supplier for some reason. There are other reasons for switching apart from price.

Mr Asher: That is certainly true. If this were an inquiry about green tariffs, I would have to tell you that there is a huge amount of fraud there too.

Q226 Mr Oaten: That is a great comfort because I switched to a green energy supplier last week! I am really confused on switching, because when we talked to Ofgem they said it is fantastic, it is the way forward, and £70 a year was the average saving that could be made. You described it this morning as "meaningless churn" and I am really confused. Could you give me an estimate as to what you think the annual saving is? Do you agree with the Ofgem £70 figure or are you actually saying that they are over-estimating the value of switching?

Mr Asher: We were talking earlier about theory and practice. It is one thing for somebody to look at price levels and say if theoretically somebody went from that tariff to that tariff, they could save that amount of money, but what I am saying is that often that is just not what happens because there are all sorts of barriers, serial price rises and things like that. Many people do switch and save money, especially if they are going from a credit account to a dual fuel direct debit one. A third of customers still buy gas and electricity from different companies, and in bringing those together there are of course some savings. It would be wrong for me to be saying switching is bad. It is a useful thing. All I am saying is that nobody should see that as an indicator of a perfect market. It is really a marginal thing as between groups in this way.

Q227 Mr Oaten: Is it possible to have a note on why eco-switching is possibly a bad thing? I cannot let that comment go un-noted.

Mr Asher: I will see you separately.

Q228 Roger Berry: How often do you consider switching?

Mr Asher: I have switched four times now. Two of them have gone without error and the other two were, like many consumers face, a source of frustration and delay. I have not switched necessarily for the purposes of saving money but so that I could get a different experience of the different suppliers and because I am a practical person.

Q229 Roger Berry: Four times over what period of time?

20 May 2008 Mr Allan Asher

Mr Asher: Over four years, so once a year I switch.

Q230 Roger Berry: Would your advice to consumers be to consider switching once a year?

Mr Asher: If you have already switched, the evidence is that you are not likely to benefit by more than a few pounds a year. The first switch can be very valuable, because you are going from being trapped with the incumbent supplier, and possibly with an in-area supplier of the other fuel, and on that first switch £70, £80 or even £100 can be saved, but we are down to that rump of 50% of people who are not likely to switch. There are abundant surveys in GB and elsewhere about that.

Q231 Roger Berry: So your advice is do it once.

Mr Asher: Yes.

Q232 Mr Wright: Finally, you mentioned the question of somebody standing at the door selling you energy. Do you think that Ofgem are doing enough to tackle that particular problem? Surely, when you have a salesperson at the door, or even at the end of the phone, and they are giving you this message that they can save you money on your energy costs, it is very difficult to go against that, but when you get the bill, you find out it is not as good as you anticipated. Surely there are other ways of doing it. Do you think that Ofgem are doing enough to tackle that issue?

Mr Asher: I think a lot more could and should be done. It is not much more than a year ago that there were proposals to remove all of these licence conditions entirely. We have been delighted to say that Ofgem have recently announced a probe into the marketing behaviour of Npower, who have been engaged in the most disreputable tactics, pretending not to be salespeople. Their pricing practices and their behaviour goes right back to those cowboy days of early liberalisation. We have written often enough, and we are delighted to see that after writing with more than 400 specific complaints, Ofgem are now enquiring into this sector and we look forward to an investigation that changes this marketing behaviour. From July 1 this year, by the way, there will be mandatory complaints handling standards applied to all those companies—only ten years late.

Q233 Mr Wright: What would you suggest a consumer does to find out whether they are getting value for money or how to get the cheapest option available?

Mr Asher: For those with access to the internet, or perhaps with children or friends who can assist, we would certainly encourage people to use some of the online services. energywatch, for example, has a service where if you put in your postcode, we will give you all of the range of prices and service information, and we will also give you a list of the online services that will help you switch. Lots of people use those. In fact, of the 4 million or so incidences of switching each year, I suspect a lot of these, perhaps like me, are serial switchers.

Q234 Mr Wright: So energywatch is the one to go to at the moment?

Mr Asher: At the moment. It is unclear when we disappear whether that will be done by Ofgem or the new NCC but we are quite happy to see that both of those groups realise that this is a vital market confidence-building service.

Q235 Mr Wright: Would you also advise people not to switch on the case of a phone call or a door-to-door salesman?

Mr Asher: I would never advise people not to switch. What I would advise them is to ensure that they get objective information, that they are able to compare prices, that they have a look at the customer service record of the company. After all, we do want the market to work well for all consumers. The best form of consumer protection is vigorous competition in fair and informed markets. Sadly, we have neither of those.

Q236 Chairman: I was inclined to say doorstep sales techniques should be banned, but actually they are about the only way that companies have of reaching the hard-to-reach consumers, are they not? In practice, the people you most want to switch are most likely to be reached by doorstep selling.

Mr Asher: I guess that could be true for some. There are lots of local council areas now that are introducing these cold call bans and this has been a subject of great interest and a super-complaint to the Office of Fair Trading. At one level, you want people to have access to new goods and services but at another level you want to ensure that people are not deceived or subjected to poor practices. It is a tough one. We want the market to work but we do need to put in place protections so that the most vulnerable are not exploited.

Q237 Chairman: One last question from me: smart meters. Just to clarify, their major impact could well be in the competitiveness of the market because they could give much more information to consumers about the price of electricity and gas they are consuming at that time.

Mr Asher: I believe smart metering would transform the competitiveness of the market. It would transform it from a sluggish, inefficient market to a very efficient one, but I think it also has incredible sustainability benefits and potential benefits for the fuel-poor.

Chairman: The reason I made that point is that I think the sustainability benefits are well known in political circles, and talked about. Competitive effects are not so well discussed, and could be even more important.

Q238 Mr Binley: There has been some delay and some prevarication in terms of installing smart meters, as you well know.

20 May 2008 Mr Allan Asher

Mr Asher: That is right.

Q239 Mr Binley: What can we do more, other than kicking Malcolm Wicks on a regular basis, to ensure that it happens? The Government is still not overhappy about this movement, is it?

Mr Asher: Unfortunately, the UK decided to make the metering part of the market a separate competitive market. Nobody else in the world has done that. It was a clever experiment but one which failed dismally. It is not a competitive market, and now we are stuck that the suppliers are responsible for the meters and not the distributors, as in the rest of the world, where rapid roll-out can happen, and that is a huge block in this market. Sadly—I have said “sadly” seven times now; it is terrible—the problems that we face in unwinding this are fairly deep, but pressure is the thing.

Chairman: Mr Asher, as I explained to you earlier, I am afraid an unavoidable diary clash means I have to vacate the chair but I am going to hand over to my colleague, Roger Berry, who will take the rest of the session. Thank you very much indeed for the evidence so far. I am sorry about this.

In the absence of the Chairman, Roger Berry was called to the chair

Q240 Mr Bailey: On wholesale electricity now, I would really seek some sort of clarification on your submission, in that you said traded electricity volumes appear to be heavily skewed to shorter durations, particularly in the front quarter or season. Then you go on to say “The volume traded is only three times physical consumption—considerably below the ten times level said to be evidence of a healthy market.” To a lay person such as myself, volume traded something three times physical consumption might seem a reflection of a fairly liquid market. Just how is the level of liquidity related to physical consumption and volume traded? Could you just clarify that?

Mr Asher: If we go back to 2002, the markets, say, just for electricity in GB were very, very active ones. You had lots of traders who were buying and selling, generators who were buying and selling, and the way in which forward markets and liquidity is measured is the amount of times that that power is wheeled before it is actually consumed. Ours were at the rate of seven. It is a small chart and I will happily submit it to you, but since then our market is the only key market in Europe where liquidity has been plummeting, and we find Germany and the Netherlands are now much more actively traded markets than ours, and Belgium, Spain and France are all increasing in liquidity while ours is falling. What that means is that the ability for buyers to be able to negotiate with sellers and get efficiency and predictability is harder and harder, which explains why our prices are going up at a rate faster than our European competitors for business and for domestic consumers. If you wanted to buy power more than six months out on the forward market, you simply cannot get it, and that means that our businesses are at a huge disadvantage—I am sure subsequent

witnesses will spell that out in more detail—and it has been, practically speaking, the source of a loss of 100,000 jobs in the GB market in 2005-06.

Q241 Mr Bailey: Why do Germany and Netherlands have this increased liquidity despite deregulating after this country?

Mr Asher: Because over the last five years there have been a number of European Directives to liberalise markets. GB was of course ahead of the world. At the beginning, during the last decade, GB had some of the best markets, liquid markets, good competition, innovation, lower prices, all of those things. We have allowed that to dissipate. We have allowed vertical reintegration, we have allowed concentration, and we have taken our eyes off that competition ball. All of the European partners are doing the opposite. In the Netherlands and even in Germany there are structural changes to make the market more competitive. Some of the big conglomerates are talking about selling off parts of their networks and these trading hubs are growing up. The Nord Pool is a very powerful example. In the Netherlands they might take over as being the gas trading hub of Europe because ours are failing and European markets are succeeding. Their prices are starting to come down as they liberalise. They have a long, long way to go. Please do not understand me to be saying that we are generally worse than Europe but the big problem is our trajectory is down and theirs is up.

Q242 Mr Bailey: That is very interesting, because certainly my perception was that in fact Europe had lagged, and indeed, there is resistance to further “unbundling” requirements by the EU, and that lower prices in Europe were a reflection of the cosy relationship between the generators and suppliers not experienced by consumers in this country. What you have said would seem to be in contradiction to that.

Mr Asher: There are many in Europe who resist change, and the big conglomerates still do not want to be broken up. They are happy to have interests in production, to own the pipelines and wires, and the distribution businesses and retail. Of course they are, but the pressure from the European Commission is to break that up. In fact, the European Commission Competition Directorate last year published the most extensive report ever on European markets. One of their findings, by the way, was that GB was the only market where liquidity seemed to be systematically falling.

Q243 Mr Bailey: That really is interesting, because it would appear from what you have said that, although there is a long way to go in Europe, the perception has been that prices were lower in Europe because of, effectively, a cosy arrangement and cartels and so on.

Mr Asher: I have never heard of a cartel that charges artificially low prices.

20 May 2008 **Mr Allan Asher**

Q244 Mr Bailey: Sorry, I will rephrase that. Cosy relationships between the generators and suppliers. However, from what you have said, that really is not the case. It is actually that, although they have a long way to go, they are more liquid than this country and the problem is in the liquidity...

Mr Asher: I do not want to over-simplify. There are serious market problems in much of Europe and there are a number of Member States who still have price controls. What that often does is transfer welfare between businesses and consumers in some cases, or consumers to businesses in others, but nonetheless leads to terrible investment distortions, and they are undesirable. On the whole, the moves in Europe are to far more open markets, more liquid markets, more competition, hence more investment and growth, whereas ours are atrophying and it is no wonder that we are speaking of a crisis in investment for generation for 2013.

Q245 Mr Bailey: Why is it so poor here?

Mr Asher: It is so poor here because I think, having reached that excellent stage of a really good competitive market and lots of competition, we started to believe our own rhetoric and went to sleep at the wheel, and we just have not noticed that the rest of the world is whizzing on. We have stuck, and we do not see that to win is not to stand still, no matter how good you are. You need a solid competition focus on this all of the time, and that is why we have been calling for the Competition Commission to put the cleaners through what is a sclerotic sector which is so vital for the welfare of individual consumers and industry.

Q246 Mr Bailey: You have partly anticipated my next question, which is, how could it be improved? Is there anything that you want to say over and above that?

Mr Asher: I think there are short-term and longer-term issues, and I have made the point that really, in our system of markets we have the sectoral regulators, who are given specific jobs, and they are there to spot price-fixing and, in the case of Ofgem, their main job, after all, is about network regulation. They do that passably well. I think they make some mistakes but on the whole they do that reasonably well. They do not have particular expertise in these issues of competition. We established the Competition Commission. It is a hugely well-funded, globally recognised authoritative body but they have never had a reference from the sectoral regulator, and they say that they are puzzled as to why this is, and that they are ready, willing and able to do it and there is a need there, but, for some reason, it is not happening.

Q247 Mr Bailey: Just two quick questions. New entrants would obviously help matters. What are the problems for new entrants? Secondly, how would you assess the impact of selling British Energy to an existing electricity generator?

Mr Asher: New entrants are of course what we want to see. We want open markets and, by the way, GB desperately needs vast new investment; whether it is

for nuclear or renewables or clean coal, all of that, we need tens of millions of pounds. They are not going to come here if they think that they are facing a vertically integrated industry with the suppliers who exist owning the generators. You ask what the barrier is. It is this: if you were somebody, even like Tesco, a big, ugly, company like Tesco, powerful, it cannot enter this market because it knows it has to buy its gas and power from the people who own it and who compete against them. So they just will not be in that market. If you were perhaps a global generator, you might see this market and you might see some of the hugely fat margins. After all, Ofgem said the generators are going to make £6 billion in unearned profits over the next few years that are not going to be competed away, a very tasty target, but no generator will enter this market because they know they have no way to market. The vertically integrated companies own all the customers so they are locked out. That brings us to British Energy, which actually is able to produce power at a very low cost per unit but again, they are stuck. They do not have a retail outlet in a vertically integrated market and so they are trying to sell out. If that was sold to an incumbent, it is a perfect formula for them charging more and giving less, in other words, anti-competitive conduct, and you will see statements by Centrica and any sentient economist will say that is a bad thing to do if you want an efficient market with good investment signals.

Q248 Mr Oaten: There was a rumour that Asda were seriously looking at it. Have you heard that?

Mr Asher: I have heard a number of rumours, and indeed, at the inquiry conducted by Lord O'Neill just a few years ago, the last time this group looked at this issue, I think it was Alistair Buchanan who reeled off the names of dozens of people who had licences and were going to enter. All I say is that at the gym I go to there are thousands of people who have a membership but never turn up.

Q249 Miss Kirkbride: It seems to me a logical conclusion of what you are saying is that there should be a law prohibiting vertical integration and that companies should be forced to divest themselves of one or the other, either generation or their retail customers. Do you think that? Do you think that might be the conclusion of a Competition Commission investigation into them, and what powers do Europe have in all of this versus the British Government and how are they flexing their muscles to make that happen?

Mr Asher: Exactly a century ago this was the debate that was raging in the United States that led to the establishment of the Federal Trade Commission and the trustbusters. It was the oil industry then doing exactly these same sorts of things. In the end they did break them up and for a century had some of the most competitive markets with the highest levels of consumer welfare in the world. I work in many countries, advising governments about deregulation, and the first thing you do with this industry is both vertically and horizontally disaggregating power so that you get those fierce

20 May 2008 Mr Allan Asher

winds of competition and innovation. Sometimes it does not work very well, sometimes it does. What we have had though for the last six years is everything to be fast reversed. So first, stop it getting any worse, then secondly, try to lever it open. I doubt that our political climate would readily cope with unbundling the suppliers because of their huge power; we have become so dependent on them. Economically, it would be a sensible thing to happen but you can just see in Europe the sort of opposition that comes out when you start to threaten the economic interests of incumbents. One of the values of the Competition Commission is that they are an objective body and they have industry experts, they have all of these specialist panels, and they can spell out the actual costs and benefits. The market I am talking about is not one for tomorrow but if we want a market that is effective for the next 20, 30 years, now is the time to get these signals right so that we can get new entry from vigorous competitors at either the supply or generational level. Do not let the incumbents own wind, do not let them own nuclear, and we have a chance of the diversity that we had briefly years ago, when prices here were genuinely the most competitive in Europe.

Q250 Miss Kirkbride: What is to stop that? There is nothing to stop that. You are saying (inaudible) will not break up the market, so why should all this stuff not be provided by the existing big six? Why should anybody come into the market? You have already set out good reasons why no-one would want to come and build on this, because they would not get access to the consumer market.

Mr Asher: There are some other ways of perhaps levering the market open more gradually. I hope the Competition Commission would come out with a finding that we would be much better off in welfare terms and investment terms and sustainability terms with vertical disintegration.

Q251 Miss Kirkbride: If it did that, what would happen?

Mr Asher: What would happen is that lots of new entrants from different parts of the world, different business models, different technologies would come in, and we would have a whole raft of innovation which would transform our economy into a different sort.

Q252 Miss Kirkbride: I do not understand why the Competition Commission saying that would make any difference. Surely it would have to have some legislative force.

Mr Asher: Two things would happen. Them saying it would have a little more authority than me saying it. Of itself, you are quite right, but in addition, there are a number of other measures where we think that there ought to be much more disclosure of some of these secret contracts, these long-term contracts by which gas and power are dealt with. A lot more of that should be brought into the forward market. I think the vertically integrated bodies should be forced to trade a proportion, perhaps 20%, of their power and gas on the forward markets. They could

buy and sell too perhaps but at least then we would start to get these signals that would allow people who see a profit to move in or, if it were the case that there was a loss, to move out, and you would get the dynamism that makes a market economy. We lack that and it is not getting better; it is getting worse.

Q253 Miss Kirkbride: In short, it would be legislative changes which fall short of requiring them to disaggregate their vertical and horizontal investments.

Mr Asher: Yes, partly legislative, but the Competition Commission has the power to recommend those sorts of split-ups if it wanted to, as does the European Commission in some circumstances.

Roger Berry: We will come back to the Competition Commission in a moment but I want to move on to wholesale gas.

Q254 Mr Binley: Mr Asher, I just want to pursue this a little further. In terms of the supply market, what you are advocating could lead to not having a British champion, quite frankly. Does that worry you?

Mr Asher: If you look at the track record, there are now just two suppliers still remaining in British ownership, and part of the reason for that is that we allowed our market not to be as efficient and competitive. If it were competitive and making higher earnings, they would not have been acquired. I do not think there is anything, short of absolute protectionism, that is going to stop those companies being acquired unless there is a more competitive market. I believe actually that Centrica is keen on having a vigorously competitive market. I have had many discussions with their Chief Executive, and I hope when they are giving evidence, if they do, you will ask them some of these questions about what they are doing to break this toxic gas-oil indexation and lots of those things.

Q255 Mr Clapham: That is one of the points I want to come to but, first of all, just looking at the way, for example, in the early Nineties we disaggregated the energy industry, it seems that one of the things that we failed to do was to ring-fence each particular disaggregation to avoid the re-aggregation. Had we done that, but allowing competition in each of the sectors, we would have had a much healthier market today.

Mr Asher: I think so, but remember it happened in two ways. Initially 20 vigorously competing suppliers—and I guess that was never going to be sustainable. You would never have that number, but we just took the brakes off altogether and that aggregation from 20 to six, remembering that in many regions there are really effectively only two or perhaps three, so it is not even six people competing for each consumer, but at the same time we allowed that vertical acquisition, and that had the double whammy of, firstly, that sort of concentration but also the vertical concentration. In the gas markets, of course, it was a slightly different area where we provided 110% of our own gas to this current state where it is only 75.

20 May 2008 Mr Allan Asher

Q256 Mr Clapham: British Gas still has a 50% market share.

Mr Asher: Yes. 48, I think.

Q257 Mr Clapham: Given that we see, and have seen over the last 18 months, the increase in oil prices—and it must send shivers through some consumers when they see a year again when oil prices have increased and there are now well above \$100 a barrel and there is talk about it reaching \$200 a barrel. Each time that happens, of course, as you have said, British Gas will be rubbing their chin and thinking “Well, we have got to increase our prices.” What is the rationale for that indexation of oil to gas and could it be broken?

Mr Asher: I think it is an absolutely excellent rationale if you own the gas, and if you are a gas producer, and if you are a European one who lives and works in a market where there is the rule of law and vigorous competition laws that would prohibit you from illegally agreeing on a price, if however all of the gas producers independently say, “I know what, we will relate our prices to this external variable, oil prices, which are inexorably going up. That gives us a perfect way of co-ordinating our conduct without breaking the law and making a fortune.” There is no rationale behind that in economic terms and there is no rationale in resource terms and in fact, the UK, when it had a deregulated market, had a fully functioning market where the prices were determined by competition between demand and supply. Sometimes that went up when there was an outage or a crisis, and you would expect that, or if there was inadequate supply prices would go up. You want that; it draws in new investors and it would go down. Now it does not. It is just inexorably going up, and that is a very negative thing. Once the inter-connector between the UK and Europe was opened and we were starting to import more and more gas from Europe as North Sea supplies have started to run down, we have been affected by the contagion of this gas-oil indexation. Half of our contracts are now tainted by this oil indexation. We criticise the competition authorities in Europe and in the UK for not being much more vigorously attacking that. They have attacked all the other bits, the vertical integration, long-term contracts and all of that, but for some reason they have allowed this virtual gas OPEC to survive and it is a toxic thing. It is not as though the gas that is traded here is in shortage. As Jake Ulrich from Centrica, who knows much more about this than I do, said, we are surrounded by gas. We just cannot get it here. That is about this indexation issue and the monopolistic control over networks and lack of liberalisation. They are the things not just in Europe but in GB that need to be focused on.

Q258 Mr Clapham: Given what you have just said and given the importance of gas prices, because of course, 40% of our electricity is generated by gas so it pushes up the price of electricity, has there been any real, meaningful endeavour to break that indexation? If so, why has it failed?

Mr Asher: In fact, it is going the other way. Until four or five years ago we had liquid forward markets where you could buy and sell gas. There were traders in the market and this is the same story about how often the gas or power is turned over before final consumption. Those have all been falling and in part, because our wholesale markets have failed in gas and electricity, even some large buyers are saying “We are desperate. We don’t know what makes a proper price.” So they are often forced, and indeed some even say, “What we will have to do is accept a gas-oil indexation because at least that is some objective measure that we can plan and hedge against.” The much better approach would be to re-introduce a fully competitive forward market, get out all of the restrictive rules, the barriers to entry, and just get more of the commodity traded in ways that people will rebuild their confidence in the way prices are formed and to allow the market that we all want to see work work. Effective markets often require intervention. I think that is one of the errors in the UK. Somehow we have assumed full competition in effective markets means you do not have intervention. There is no market in the world like that. Indeed, markets tend toward market power and monopoly, and why not? That is exactly the intention of every supplier. The state needs to intervene every now and then when that market power reaches a certain level or where the conduct of getting there breaches certain norms and putting them back in their box. That is what we want. We want them to be fighting each other, and they are not.

Q259 Mr Clapham: And of course, that is what we have seen in the energy market. We have seen those extremes; we have gone from disaggregation back to integration.

Mr Asher: Yes, that is right, and that needs to be reversed.

Q260 Mr Clapham: Looking at what you say about the wholesale market, in gas we see that there is a parallel where we have a wholesale market, and then we have an off-market situation where we have long-term contracts. That obviously is having an enormous impact on forward markets, as you said earlier. What is going to be the way in which we could persuade government to intervene in order to ensure that we have a proper competitive forward market?

Mr Asher: Most immediately, to understand what is happening in those secret off-market contracts. Recently Ofgem were asked—it may have been at the Public Accounts Committee—about whether they felt that they understood what was happening in the market, and I think they said they found it extremely difficult to get this sort of information. I will go back to an old thing. The Competition Commission has express information-gathering powers that could gather those sorts of contracts. I do not mean they should publish people’s private information across the *Financial Times* but their experts would be able to look at the relationship between the commodity costs and the prices to see

20 May 2008 Mr Allan Asher

where these rigidities occur. In other markets, in the United States for example, and in Australia, my home country, the biggest reforms to the markets were where these long-term contracts were renegotiated. They said, "Start again, do it in a more competitive, open way so that efficiencies will come."

Q261 Mr Clapham: When we first started the session, Mark referred to liquid petroleum gas, and many of our communities are still on liquid petroleum gas. I think in fact, if you look at the number of households on gas and compare it with the number on electricity, you get some idea of just how many homes still do not have a natural gas supply. I have a number of communities. Given that situation, and bearing in mind just how much more people—I am on liquid petroleum—pay compared to somebody who uses natural gas, is there an argument to say that, given the fact that we have been disadvantaged for so many years, as we have, and that we are paying extra price, and it looks as though we are going to be paying extra price into the future, people on liquid petroleum ought to be receiving some kind of, shall we say, tax credit, particularly elderly people, to help in that increased cost and the fact that we are being kept out of a market that is much more advantageous?

Mr Asher: At the very least they should not be punished. When the Competition Commission brought some of its innovative remedies, ensuring that suppliers would allow transfer of ownership of cylinders and a number of things that could significantly increase efficiency, that would be the best result. We have to recognise though that some markets are always going to be inefficient and that there are various welfare measures. In relation, say, to prepayment meters and direct debits, we are not saying that prepayment meter customers should be cross-subsidised from the rest of the community. All we are saying is they should no longer be penalised, so that there is not that negative cross-subsidy from the poor to the better off.

Q262 Mr Clapham: Finally, given that you are going to be swallowed up by the National Consumer Council, are we likely to see a robust energy section fighting for the consumer?

Mr Asher: It would be my fervent hope that we do.

Q263 Roger Berry: May we turn to the issue of fuel poverty? We have an interesting situation where the Government is opposing mandatory social tariffs, and a number of energy companies are supporting mandatory social tariffs. Why do you think the Government is reluctant to go down the road of a mandatory social tariff given the growing problem of fuel poverty, for obvious reasons, in recent months?

Mr Asher: Double puzzling given that two or three of the suppliers themselves say unless there are some standards for social tariffs, unless there is some compulsion about that, the system will fail and, sadly, without that system, it is failing. I have had a number of discussions with government officials and

their most common comment is that if we have mandatory standards for social tariffs, that will be a race to the bottom. All of the others who are doing more would stop doing more and do less. I was struck by the absolute distinction between that view and some powerful statements made by the Prime Minister and John Hutton, the Secretary of State for Business, Enterprise and Regulatory Reform in relation to minimum pay. In March this year, just two months ago, he said in a press release from BERR that before the minimum wage was introduced workers could expect to be paid as little as 35p an hour, our legislation has ensured this could no longer happen and that he was very proud of the difference that establishing that minimum wage had made to our whole society. I think the argument is perfectly symmetrical. By establishing a minimum set of social tariffs, that is, for the fuel-poor, that are no worse than are available to the rest of us, who are well able to pay, we will be lifting up to 4.5 million households out of fuel poverty. Of course, you would need to do a lot more than that. It would be naïve to imagine that that alone would solve it. It is about measures to houses, it is about incomes, but the thing that nobody has done anything about is the price of energy. That is the biggest, most direct reform that we could make and somehow the officials have their heads in one place, the Prime Minister, the Secretary of State and the Minister for Energy have theirs in another, and sometimes I wonder if they need to meet a bit more often.

Q264 Roger Berry: I think the parallel with the minimum wage is very telling because obviously employers' organisations opposed the national minimum wage but the last thing they wanted was to not have a level playing field. The parallel is very interesting.

Mr Asher: If I could add one other element, in fact, the Prime Minister in March this year said that at the start of the minimum wage some complained that it would cost 3 million jobs and the evidence is, of course, quite the opposite. What it has done is brought wage justice to a huge part of those who had no bargaining power and not affected overall employment. Similarly, these sorts of tariffs for those who are desperate and for whom it is getting worse, every one% increase in energy prices tips another 40,000 people into fuel poverty. That could be fixed at a fraction of the cost of the £225 million that the Government is taking from suppliers.

Q265 Roger Berry: What has the evidence been so far on voluntary social tariffs, as it were, and why are companies not doing it?

Mr Asher: I think a number of companies are doing some excellent things. We have seen some really good social tariffs developed by EDF and British Gas itself invests the vast majority of all of the revenues of all the companies into social tariffs. Some, like Npower, are putting in about the least, the proportion of the market share that they have as customers compared with the amount that they are putting in. So there are some very good and exciting innovations that have occurred but, as Centrica and

20 May 2008 Mr Allan Asher

EDF said, “If the others are not required to do something similar to this, why would we continue to?” and our big concern is, sadly, when we have gone, there is going to be nobody to point that out and they are going to slip back to their bad old ways. At least, that is a fear I have.

Q266 Mr Weir: On that point about the difference between companies, it has been said to us that the former territorial company, if you like, still concentrate a large part of the market in their former territories. Does this mean there is greater concentration of fuel-poor in some of these territories where the companies are not doing enough to help fuel poverty?

Mr Asher: The distribution of fuel poverty follows the standard map of low incomes, areas where there are a large percentage of people with very poor housing, hard to heat housing, the big urban centres and in the valleys and in rural areas. They are distributed across three or so of the suppliers who have the bulk of those customers.

Q267 Mr Weir: That is to be expected, but in every area there are pockets of poverty, no matter how well off the general area is. On your analysis, there must be some people in fuel poverty who are particularly badly hit because their local supplier is not taking sufficient action to tackle fuel poverty. Is that the case?

Mr Asher: I mentioned the example of Npower in the North, where if you were obtaining your electricity from them and your gas from another company, perhaps British Gas, you could be paying £361 a year more as a prepayment meter customer than if you had their online tariff. I am really pleased to say that differential has come down by about £100, not though because the prepayment meter price has been reduced but because the online tariff has gone up.

Q268 Roger Berry: A number of measures have been proposed for addressing fuel poverty. There is the Warm Front scheme, winter fuel payments, extension of those to others and so on and so forth. Has energywatch considered those alternatives and their effectiveness in comparison with mandatory social tariffs?

Mr Asher: Yes.

Q269 Roger Berry: Do you have a view about which of those are likely to be more effective?

Mr Asher: Yes. Over a period of two years the different Ministers for Energy—we seem to have one each year—had spelt out that the Government, if suppliers did not respond adequately, would compel them to, and on constant probing, indeed, from some members of this Committee, started to spell out what he meant by social tariffs and he set out quite a good set of criteria and had asked the regulator to do a report on that. When the regulator failed to do that, we commissioned an expert ourselves and we have actually published a very detailed report that shows for every supplier every part of their programmes, what is good, what is bad,

and how it could work better. I was very disappointed to see that when we submitted that to the Government, the response was “Well, if we require everybody to meet a certain level, the level will fall.” There is no need for people to meet a certain level. There are a couple of key ingredients about ensuring that people are no worse off and having proper programmes and looking more carefully before they are disconnected, offering different methods of payment, and a whole range of things which are well known and are used in other countries that work very well. It is to our huge regret that the Government just has not appeared to want to move on this yet.

Q270 Roger Berry: Forgive me. You have not quite answered my question, Mr Asher. Are you saying social tariffs is *the* solution or are you supportive of a mixture?

Mr Asher: It is a different point. If you think about it, there is really no such thing as a social tariff. It has become a generic description of a series of measures by which those in fuel poverty will receive various forms of benefit, and you could mix in a number of things. After all, most of the companies now have trust funds and a number of them have equalisation systems, some offer credit counselling, some offer greater access to measures such as insulation and draft exclusion and low energy light bulbs, all of those, which are quite valuable measures to insulate houses. Where they are directed at the fuel-poor I think they are all legitimately part of a package, and it is actually good to see a degree of competition about that. My concern is that following the Ofgem Fuel Poverty Summit a few weeks ago, it appears that the suppliers are going to be allowed to just tip any old thing into that basket instead of them meeting some objective test. We would like to see at least an objective test as to what qualifies and what does not.

Roger Berry: Thank you very much indeed. Finally, the Competition Commission.

Q271 Mr Weir: You have mentioned the Competition Commission several times in the course of this morning, and in your submissions to see you have set out a lot of proposals that could be done through the Competition Commission. Which, if any, of your recommendations could be enacted by Ofgem without a reference to the Competition Commission?

Mr Asher: They could do a number of these things, but the distinction is that Ofgem is a reasonably small, reasonably efficient sectoral regulator. It is not set up to do these big studies where they look around the world, that they dig right into all of the contracts, where they have these expert panels drawn from business and the community and academia, and that they just concentrate; this is what they do. That is why the OFT and some other regulators often give them these industry studies to do. Theoretically, Ofgem could do it but their staffing, their level of expertise and their experience really is not up to it. The sensible thing is to realise that there is this expert body and get them to do the

20 May 2008 Mr Allan Asher

job. They are ready, willing and able. I am not getting a commission from the Competition Commission, by the way; it is just that, having seen them work, some of their remedies are much wider, their information gathering powers, and they are an authoritative body of a global scale.

Q272 Mr Weir: How long do you think such an investigation would take?

Mr Asher: It depends on the terms of reference and, in any event, you would not want them to leave everything to the end. You would ask them to say what the immediate measures are, the transparency measures, perhaps changes to licence conditions, the barriers to entry that can be readily identified, and then some longer measures that could come out after a while. They often take a year or more to do their work, but to that I would say, if you are concerned that it might take them a year or two to act on this market, I would just remind you that what we should be talking about is not what is going to happen next year or the year after, but having a sector that is fit for our economy over the next 20 and 30 years. The billions that are going to be invested in new forms of energy and all of that with the sustainability agenda desperately require the most efficient, the most innovative and the best use of scarce capital. I do not think that a “quicky” by Ofgem while people are doing their day jobs is going to get very far there. We need the best minds in the country to focus on it and give us a blueprint which will restore Britain to having the most innovative, competitive energy market in the world.

Q273 Mr Weir: You mentioned earlier new entrants coming into the market and different types of generation, particularly renewables, and you mentioned wind. What implication will Competition Commission referral have for the current energy companies’ investment decisions? For example, whether or not you agree with nuclear, the Government seems to be going down the line of persuading one or other of the big existing energy companies to lead on nuclear, perhaps EDF. Is that likely to happen if they are faced with a Competition Commission investigation?

Mr Asher: I think there are different considerations. If you are talking about an incumbent, if they are being offered more or less a secure monopoly for ever, I think they will quite happily invest in that. Whether the country will benefit is quite doubtful. If, on the other hand, you are asking some of those very hungry, efficient generators from anywhere in the world to come and set up a new competitive investment here, if they think they are facing a closed sector, a sector that they cannot get into where they are never likely to be able to compete fairly, they are not going to come. So, in a way, it could be a trade-off between investment from a lazy incumbent who is actually buying a secure revenue stream, just like a government bond, into perpetuity, or whether you really want a revolution, whether you want the storms of competition and innovation that can transform the market and transform industry.

Q274 Mr Weir: In the current sale of British Energy it seems to be an existing company, EDF and RWE that are interested in it. It is not the new generators looking to break into the market by acquiring a generator of their own, which one would have thought would have been the first step in setting up in the UK.

Mr Asher: I would not have thought that for the very reason that I mentioned. We have this vertically integrated structure and, even if you were a giant corporation with much experience and many resources, you would look and say “What is the point of me building new generation in the GB market where it is all stitched up? If I enter at the generation level, what they will do is transfer the margins to the retail level and I will never make any money. I will not have a route to customers or, if I enter just at the retail level, I will have to buy my gas and power from the people I’m competing with and I will be squeezed out as well.” That is why we have seen 40 companies, 20 suppliers and 20 generators, exit the market since 2000 and not one significant new entry that is sustained.

Q275 Mr Weir: By that argument, you are going to have to break up the vertical integration before you get new entrants into the market, and that is not going to be a quick process, as Europe has shown when they have tried to do it. The other point about that is that in the age of the inter-connector, where EDF can bring electricity across from France or gas can come from Holland or whatever, can this be done on a purely GB basis or are we having to look at it on a European basis?

Mr Asher: Nothing can be done on a GB basis any more, and that is possibly a good thing. The more that the market is opened up and that we get cross-border trading, the better. That is what the competition authorities in Europe want to do, more inter-connectors and things like that are useful, but I think resource and energy nationalism is always going to make us want to be sure that a certain proportion of our energy is generated...

Q276 Mr Weir: That does not really address the point, because it seems to me that whatever the competition authorities want in Europe, they are actually going in the opposite direction, where some of the large national companies, EDF and RWE, are trying to consolidate their vertical integration, in fact increase it by going for companies like Iberdrola, which are not going to affect the UK market. You are saying that the Competition Commission needs to break up the vertical integration within the UK, and you have accepted there has to be a European dimension to this, but in Europe the process seems to be going in the opposite direction.

Mr Asher: If I could disagree, it is true that some of the big German companies are wanting to acquire in Spain, and the Italian companies and the French companies are wanting to acquire in Belgium, but what they are wanting to do is to buy it at a horizontal level. They want to buy businesses in the same sectors as them, and there is evidence of the

20 May 2008 Mr Allan Asher

vertical companies being broken up. One of the huge German conglomerates, as part of a deal with the competition authorities, is saying that they are happy—not happy, but they would be prepared to settle an anti-trust investigation by divesting all of their transmission assets. That is a huge breakthrough, and we are seeing more and more of that happen. Could I make one more point though about effects on investment? Even if there was a fair wind to all of the nuclear investments, we are still talking ten, 12, some people think even 15 years out. In that context, a Competition Commission inquiry that might take a year or 18 months is no huge barrier, and in fact, the upside is that it might give assurance of a sound, efficient sector, with sensible investment signals, that will last for 30 years whereas the current situation is quite unstable, and I think even the incumbents, even EDF and others, are going to be very nervous about investing a lot of money without all sorts of government protections and bail-outs if in fact we do end up with some sort of competition review and they discover their big monopoly investments are not returning the monopoly rents that they are used to.

Q277 Mr Clapham: Mr Asher, given competition authorities' involvement in a study and bearing in mind that some of the long-term gas contracts that are forcing gas into the forward market and away from the wholesale market, legal contracts, how would we break that situation?

Mr Asher: It depends on whether they are currently in breach of competition rules. If they are in breach of competition rules, the contracts can be broken, but in any event, the authorities can serve notice that they require them to be renegotiated. That is a legal process but it happens. It has happened in many

countries as a way of reforming this sector. It is only when you get the forensic skills of experts to look at the costs and benefits, the detriment and gains, that one can get a picture of which are the worst and which ones are benign. 70% or so of all of the gas coming in is covered by these mysterious contracts, and we do not know whether there are restrictive clauses. It is suspected that a number of the big gas contracts still prohibit buyers, whether in the UK or other European countries, from sending the gas on to another destination. I would regard those as highly anti-competitive and needing to be exposed and broken up. Similarly with power contracts; we just do not know what sort of mysterious anti-competitive clauses are in there, and some of them might be in breach of existing laws. If I could make just one final comment about prices, because I am sure that you will have a stream of witnesses who will swear that our prices are the lowest in the world. I just got this from the European Commission for 2007, where they looked at the prices of gas and electricity to consumers across the whole of Europe. The red one is Great Britain and in both cases we are actually pretty expensive, and not very cheap.

Q278 Mr Clapham: Could we have a copy of that, please?

Mr Asher: Certainly. I will happily submit all of these tables to you, and background information on all these other points.

Roger Berry: On that note, Mr Asher, can I thank you again for the written submissions that you have made, and thank you very much indeed for this morning's session. I could tell that the public gallery was finding it as exciting as we were. It was really thought-provoking and incredibly helpful to the Committee. Thank you very much again.

Tuesday 3 June 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Mr Brian Binley
Mr Michael Clapham

Miss Julie Kirkbride
Mr Mark Oaten
Mr Mike Weir

Witnesses: **Mr Hugh Conway**, Chairman, MEUC Electricity Group, Major Energy Users' Council; **Mr Jeremy Nicholson**, Director, Energy Intensive Users' Group; and **Mr Chris Tane**, CEO, INEOS ChlorVinyls, Chemical Industries Association, gave evidence.

Q279 Chairman: Gentlemen, welcome to this evidence session of this Committee's inquiry into energy prices. We will begin with the easy questions. Thank you very much for your memorandum, by the way, which the Committee has greatly appreciated and it informed the questions you are going to get now. The easy one is if you can each introduce yourselves for the record and say what your organisation does, and also I am curious to know whether there is any overlap to your memberships, how discrete your organisations are?

Mr Nicholson: I am Jeremy Nicholson and I am Director of the Energy Intensive Users' Group. It is an umbrella group that represents a dozen or so trade sectors—steel, glass, ceramics, cement, aluminium manufacturers and so on, and including the Chemical Industries Association and the MEUC within our membership. We are solely there to represent the interests of the intensive sectors that depend on secure and internationally competitive energy supplies.

Mr Conway: I am Hugh Conway and I am the electrical Chairman of the Major Energy Users' Council. We are an organisation which was founded about 20 years ago upon the privatisation of gas and electricity and we have members who are basically buyers for large energy users, and they range from individual manufacturing companies right through to multi-site retailers and also more recently government purchasing agencies, which I think is possibly quite interesting.

Mr Tane: I am Chris Tane. I am here with two hats on today: I am representing the Chemical Industries Association, which is the trade association for the chemical industry in the UK, which is, as I am sure you know, one of the major contributors to the UK economy; and also in my real job I am the Chief Executive of INEOS Chlor Ltd, which is one of the major chemical producers in the UK and we are the largest single point user of electricity in the UK at our site at Runcorn.

Q280 Chairman: Mr Tane, you are the only member of our witnesses today with a current commercial interest. You used to be with Rugby Cement, Mr Conway, but you are now representing an organisation.

Mr Conway: And I do not have any connection with them now at all.

Chairman: Thank you very much. Mark, do you want to come in with your point?

Q281 Mr Oaten: We are going to get into the issues but just generally I am interested to understand as the three bodies which represent so many users of energy what actual power do you feel that you have yourselves to try and influence energy costs and energy prices? Are you under enormous pressure at the moment from your members who are saying to you, "Look, come on guys, you are meant to be our voice; use the muscle. We come together because we want jointly to put pressure on the Government and the suppliers; what are you doing about it?" I just wondered what power you have got and what action you have been taking to try and affect the current difficulties?

Mr Nicholson: The perception of energy users is that we are very much price takers. That is the first point. We are at the mercy largely of what events produce in the wholesale market of gas and electricity and, as you will see from our evidence, it is the wholesale market price that really underpins all of our energy costs as large consumers and it accounts for the overwhelming bulk of the bill to our sectors. We do not feel that we have the influence that is warranted in terms of dealing with government departments and the regulator and that the issue of international competitiveness, in our view, although acknowledged is perhaps not given the emphasis that it deserves on occasions, and indeed there has been some denial I think, at least for the intensive sectors, about the extent to which we are facing genuine competitive disadvantage at the moment. Maybe that is not true equally for all classes of consumer but for the large industrial users there is an abundance of evidence now that we face significant and enduring price disadvantage in power, and to a lesser extent in gas.

Mr Conway: Can I make a very simple comment which might explain some of the problems we have. Just to give you an example, if I were to buy gas for my company from October for 12 months, the current price is, shall we say, 87 pence wholesale. On top of that we might have to pay three pence for transport and the last number is 0.5% suppliers' margin, so we have no—

Q282 Chairman: We are getting into some of the detailed stuff.

Mr Conway: What I am trying to say is we have no control over what is going on; that is our biggest problem.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q283 Mr Oaten: But the point I am trying to get is that collectively with so many of you coming together can actually have no influence at all?

Mr Nicholson: In terms of on the market I think that is unfortunately the case. Chris may want to add something from the perspective of an international operator.

Mr Tane: My company of course is a major buyer of gas as it happens and we have no ability whatsoever to have any impact on the market. We are a big buyer of petro-chemical feedstocks for example and we are sufficiently big that we influence the market as a buyer. That does not happen in the gas market at all and we have no ability to either directly ourselves or through the trade association get recognition of the problem. As Jeremy was saying, it has been pretty difficult over the last two or three years. We have been saying repeatedly that we see a major problem of competitiveness emerging and, generally speaking, the response that we have seen from regulators and government has been to say there is no problem. Now it is very clear to everybody that there is a big problem but it is rather late to do anything about it, so we have not really had the influence that is needed for an industry that is as important as the chemical industry is to the UK economy.

Q284 Chairman: I think it is fair to say that a lot of the debate at present about fuel prices does concern residential customers/domestic households but we attach great importance to this issue too because competitiveness is one of your key concerns and we will come to that in a minute. Can I just ask factually, presumably you buy predominantly from wholesale markets? How do you buy?

Mr Nicholson: Most of our members buy through supply contracts. One or two of them are auto generators, they have their own power generation as well, but they are a minority, and for the most part they are on annual or longer supply contracts. Increasingly with gas there has been a trend towards indexed contracts where the price of gas moves with the day ahead price in the wholesale market, so in effect, even though they tend to be buying from the suppliers, although some may source directly from the wholesale market, the nature of their contracts means that effectively they are getting a quote based on the forward market price at the time the contract is struck or indeed a contract that is based on a day ahead wholesale market price.

Q285 Chairman: This is another easy question and you have already hinted at this in your earlier answers; how important are energy prices to your members and to your company in terms of their competitiveness internationally?

Mr Nicholson: As you would expect, if you are an aluminium smelter where 40-45 % of your costs might be energy-based, or if you are a steel maker and paper manufacturer where 20-25% or more may be energy-based, if you are an industrial gas producer where 70% of your production costs may come from energy, this is a key input cost, and plainly if there are large and enduring price

differences in energy, accepting the fact that there will be times when our energy prices are higher and lower, that is natural in markets (although we have seen a lot of volatility there) it affects investment decisions and the ability to remain located in this part of the world if our energy prices either become uncompetitive or are set to become uncompetitive in the future.

Q286 Chairman: But you have given us quite compelling written evidence suggesting that UK energy prices for your member companies are consistently above European prices.

Mr Nicholson: Recently that is true and of course there are some firms that are not able to be represented here because they are no longer trading. When gas prices hit record levels two winters ago and the system came under strain we saw demand destruction and paper manufacturers and glass manufacturers in particular whose businesses did not survive that period, and that is the risk, that it will not necessarily cause major casualties in the short term but by a process of attrition we will see continued reduction in the industrial base at a time when the demand for our products worldwide is quite high. To put some numbers on it, in the autumn after that difficult winter the ONS was reporting 100,000 manufacturing jobs lost and relative energy prices were cited as a major reason for that, and we think there is a danger of that recurring in the future.

Q287 Chairman: Mr Conway, it was your evidence that showed the graphs of electricity price comparisons and it is quite worrying electricity prices in the UK over our European competitors. The CIA has many members with foreign headquarters so loyalty to the UK is not necessarily very high in these companies.

Mr Conway: I cannot remember when I submitted that and what date it is but the interesting thing is the curve has continued upwards and it is actually a greater gap than it was when we sent in our evidence.

Mr Tane: Perhaps I could give my own example. My business manufactures our core products in the UK, Germany, Norway, Sweden and Italy, and 70% of the cost of making our basic product is energy, so when the cost of energy in the UK is as uncompetitive as it is versus those other countries, we have a very simple choice as to where we put our investment, and the longer this situation in the UK persists the more we will be driven—unwillingly actually—to put our investments into Continental plants to the detriment of our own position in the UK but also to the detriment of the UK chemical industry because we are a supplier of basic chemicals to the whole UK industry. I think the chemical industry in general is in exactly that position; it is a multi-national industry, it operates globally and generally speaking in global markets. It cannot afford to pay uncompetitive prices for one of its key inputs, in this case energy, because that means it cannot compete on the world stage.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q288 Chairman: A lot of your products presumably are commodities so price is the key determinant of who buys what?

Mr Tane: Yes, we are the UK's only manufacturer of PVC which is a commodity plastic and business changes hands if your price is 1% or 2% out they will go to the French competition or the Belgian competition, and when 70% of the cost is energy and energy is overpriced by 15% or 20 %, that is much more than 1% or 2% differences.

Q289 Chairman: We will move on to the way the markets work and some more detailed questions. Just one question from me which does not require a particularly long answer. If things remain unchanged, do you think the UK wholesale gas and electricity prices are going to remain consistently above the European prices in the medium term?

Mr Nicholson: In the medium term I think it is highly likely that electricity prices will stay above. We are approaching something of a supply crunch in electricity in the medium term. In the long term we might have some solutions. Also we are rather more exposed to carbon prices in the UK than for example markets like France. In gas I do not know whether we will trade at a premium or not but we do know that our prices are more volatile and there is greater risk so even if on average our prices are the same as they are in Continental Europe the risk of price spikes is higher.

Mr Binley: Do you ascribe this primarily to the lack of storage facility?

Chairman: I think I am going to bring in Mr Clapham straight away because that is really what Mick wanted to ask.

Q290 Mr Clapham: What we have just heard that energy prices are a threat to UK competitiveness is really worrying. One of the things that we have noted is the linkage between the oil price contracts and of course that indexation that knocks on to gas. It has been described to us as being quite an irrational linkage. Is it your view that that linkage needs to be decoupled? Is there any possibility that you can see of that being done?

Mr Nicholson: You asked two questions there.

Chairman: It slightly anticipates what Mr Bailey is going to ask about later as well so I have got to keep control of my Committee here as well as my witnesses!

Q291 Mr Clapham: I will direct that to LNG in particular. We see that the gas market is changing of course: we have got LNG coming into the market; there is what is left from the North Sea, and of course there is the Interconnector from Europe and the linkage of course with Norway, so there are a number of inputs of gas. There is a view that LNG is actually determining the price and particularly we see that in winter. Is that your view and is there anything that you feel might be done?

Mr Conway: Our view of the market in essence is that the oil price linkage in Continental Europe and in other markets is effectively putting a floor on our gas prices so they are unlikely for any length of time

to drop below that oil-indexed level from Continental Europe and elsewhere. LNG is increasingly important as a marginal fuel, particularly in winter periods, and you will have seen the projections for where we might conceivably be in 20 years' time. That influence is only going to grow. The LNG market is highly influenced by the oil price and, for reasons we might explore later, we may end up having to pay a premium over true contracted LNG in other markets in order to make sure those cargoes arrive in the UK. Therefore there is every expectation that our prices could be at least as high if not higher than Continental prices on an average basis, and on those occasions when gas prices are lower internationally countries with greater storage capacity than we have can take advantage of it; and we cannot. I do not know if Chris has anything to add on that because he has an interest in storage as well.

Mr Tane: Just to give you some statistics. I think after the new storage comes on-stream in three or four years, the UK will have 19 days of storage. That compares to 99 days in Germany, 122 days in France, and I believe similar sorts of levels in the States, so one thing that is clear is that this country has a very, very low level of storage and that must be one of the factors in driving the way, both the level of prices and the volatility of prices. Going back to the oil linkage point just to reinforce what Jeremy said, fundamentally what we see is that in the summer UK prices are at the same level as the Continent and in the winter they operate at a premium to the Continent, so from where I sit it will be extremely desirable if I could buy gas on the Continent on a Continental-type of contract but, for whatever reason, that appears not to be possible. My company last year bought space on the Interconnector, we went into Europe, we talked to 19 suppliers, many of whom supply our sites on the Continent and we asked them to give us gas on the same basis that we would transport it to the UK. Of the 19 we approached we got six replies and all six supplies offered us prices based on the UK pricing structure not the Continental pricing structure and adamantly refused to give us prices based on the Continental contracts that we were enjoying over there.

Chairman: We are straying into other territory and we should try and stick to infrastructure. That is very helpful but we are trying to stay on infrastructure at present so back to Mr Clapham.

Q292 Mr Clapham: It certainly is helpful in the sense that we can see that that pressure does contribute towards increasing the price. Just coming back to LNG, and the storage issue, why is it that the terminal at the Isle of Grain is not actually being used in 2008? What is your view of that?

Mr Nicholson: We want to know the reason for that but we have some suspicions, one of which centres round the access arrangements at that terminal. We understand that the arrangements there mean that there is only a relatively short number of days' notice of when a spare berthing slot comes up and that in practical terms it is almost impossible for a third

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

party to make use of that with such short notice. There may be other explanations, and perhaps you might wish to ask terminal operators or indeed the regulator their view about this, but in our view it was a mistake for the UK to exempt the import facilities from regulated third party access and more effective “use it or lose it” provisions which will give notice to the market sufficiently in advance of spare berthing capacity. I think I am right in saying that we have seen no evidence that a third party has ever been able to make use of that terminal in the entire time it has been operational. We hope this is not going to be replicated on a larger scale when the new and larger terminals open at Milford Haven.

Q293 Mr Clapham: Has that view been expressed at all to the Department for Business and Enterprise and, if so, what is the response?

Mr Nicholson: Very clearly by ourselves and indeed to Ofgem, the market regulator, who were responsible for accepting these arrangements in the first place.

Q294 Mr Clapham: Just looking at the import capacity, the opening of Milford Haven for example gives greater gas storage. What kind of effect do you feel that will have on price volatility? Is it something that is likely to be advantageous or disadvantageous to industry?

Mr Nicholson: To the extent that we need the capacity to import the gas, it is advantageous to have it. It is necessary but not sufficient to fix the problem. As we have mentioned, if you have import capacity, if you do not have adequate access arrangements and you do not have the storage to go with it, then we are not going to get the full advantage of that potential flow. There is one other aspect to it, in many other markets there is a greater degree of LNG being precontracted whereas in the UK, at least at the moment, it seems that it is very much driven by the availability of spot cargoes. That is a very risky model on which to run the security of the gas system which will ultimately depend on those cargoes being there. As we discovered in recent months and years, we may have to pay an extraordinary premium to get those cargos to arrive in the UK perhaps at a higher price than industry is able to afford for its gas.

Mr Tane: The experience with the existing terminal running well below capacity suggests that terminal capacity is not the issue so just adding more capacity is not going to do very much; the real issue is what is it that is preventing the gas actually coming through the terminal in sufficient quantity, and that is the problem that needs solving.

Q295 Mr Clapham: What kind of responses again have you received from Business and Enterprise because you have raised these issues with them and they know full well what your view is. Are they sympathetic? Have they made any suggestions with regards to solutions?

Mr Nicholson: The response we have had is that decisions have been made and it is difficult to change them. The investment has gone ahead on the assumption that there would be the current access

arrangements and we have heard nothing back, either from BERR particularly or Ofgem, to suggest that they are minded to change the arrangements, which in our view is regrettable.

Mr Clapham: I think that it is a very important issue that we may raise with BERR.

Q296 Miss Kirkbride: I was very shocked by the figure that you gave about the storage capacity that we have in the UK. Why is that and whose fault is it?

Mr Tane: I think the reason why is that until six or seven years ago the view was that we had plenty of storage, it was called the North Sea, and of course when we had plenty of gas coming out of the North Sea it was always there underground and could be turned on or off as needed. It seems to me that somehow the authorities, the market, whatever, has failed to recognise what is now happening which is the decline of availability in the North Sea.

Q297 Miss Kirkbride: How could that be? There are plenty of statisticians to tell you how much is left. How can that possibly be that someone has not worked that out?

Mr Tane: I can only join you in the question. I think it has been predictable for many years that this decline in availability would come and I am staggered to see that there was no forward thinking in terms of what difference it would make once we were in deficit.

Chairman: In the interests of making progress I think you have made your point.

Q298 Miss Kirkbride: Does the Government or the market have a responsibility that that infrastructure was not built? It is quite an important question, Chairman, because if the Government or the market has a responsibility for that infrastructure not being built—

Mr Nicholson: There is a bit of both is the short answer. I am sure that the oil and gas industry would say that planning is a big problem in doing anything at the moment on energy infrastructure including storage facilities. That does not explain the extent of the deficit but it does explain why perhaps that has been a barrier to getting things on-stream as quickly as we would like. I would come back to the point are the incentives for suppliers, particularly suppliers to the domestic sector where the big swing in demand for gas comes from, sufficiently strong to get them to invest in the storage that is necessary to secure supply? Because at the moment if the system breaks down, as it very nearly did two winters ago and we came within 24 hours of rationing gas to our members, and indeed some of our members shut their plants down for as long as three months as a result, the default position if we run short on gas is that our members get their plants shut down in order to ensure security of supply for the domestic sector. That cannot be a sustainable model for managing our energy security.

Q299 Chairman: To answer Miss Kirkbride’s question then, you blame the regulator for not putting in place the right market incentives?

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Mr Nicholson: I think we would question whether these incentives are strong enough. I think there is a separate but related question as to whether the UK for strategic reasons needs a strategic gas resource, but that is somewhat different from the market question.

Chairman: We will have to move on but thank you, that was very helpful.

Mr Clapham: Chairman, could I ask one final question of Mr Tane: the situation that you describe where you went into Europe to buy gas but you could not get the gas, even though there would have been space on the Interconnector, again have these issues been raised—

Chairman: I am actually going to say that Adrian Bailey is going to ask these questions in some detail now. Hear what Mr Clapham said and answer that when we deal with Adrian's questions.

Q300 Mr Bailey: Before I focus on some more detailed questions, I personally, and I think probably other members of the Committee, would like to get a grasp of the whole issue of the wholesale gas market and its liquidity. This is an issue which, forgive me, is jargon-ridden and you will use phrases every day that we may not be fully understanding of—I am looking at “forward supply models”, “long-term contracts”, “index-linked contracts”, the “oil/gas price link”—and I think it would be helpful before we went into the more detailed questions if you could define exactly what you mean, and the best way of doing so might be if I were to be a gas consumer and wanted to get a contract to supply gas to me, what would be the theoretical options in purchasing that gas, what would be the practical options and, if you like, what would determine what I had to do on this?

Mr Nicholson: Typically industrial consumers will sign up to 12-month contracts. There is no limit on that, sometimes you have longer contracts, sometimes you have shorter, through a supplier in principle the same way we do as domestic users, and the price quoted by the supplier will almost certainly be calculated on the basis of forward market price in the wholesale market in the UK plus some additional costs for distribution.

Q301 Mr Bailey: What is a forward market price, to get to the basics?

Mr Nicholson: That is the price in the wholesale market for a continuous supply of gas over the next 12 months or the month ahead, averaged out, or it could be done seasonally. One of the alternatives to that is to have a contract which is where the price of gas varies throughout the contract period. It is not quite a spot market price, it is the prompt market, the day ahead price that tends to determine the costs. In other words, it is not a fixed price contract, it depends what happens on a day-to-day basis. Those are the two principal options. It is rather different, by the way, in Continental markets where virtually all sales are indexed on a lagged basis not to a wholesale market price but to the price of oil products, and that is where the oil price linkage comes in.

Q302 Mr Bailey: Right so all other things being equal the normal preference would be to link to a forward market price?

Mr Nicholson: Typically yes.

Q303 Mr Bailey: So why do gas sellers not sell on the forward market, which seems to be a problem?

Mr Nicholson: The problem might actually be more acute in power than it is in gas, but it is a question that we have asked ourselves and not come to a conclusive answer. It is certainly true that we have a more liquid, in other words more trading going on forward market in gas than many other European countries, but whether it is adequate is another matter. I am sure Chris will add to this but presumably it is not in the commercial interests of those who are producing and supplying to sell their gas in this way. They perhaps would be better placed to say why but what we can see is there is no alternative for consumers out there and that relatively small volumes of trading in a thinly traded market in the future are effectively determining the price for all our members' contracts.

Mr Conway: All the suppliers link their gas prices to the forward market but as far as we can see they only buy their gas through bilateral over-the-counter deals which of course are not transparent. In that bit we do not know what is going on.

Mr Tane: Clearly volatility and unpredictability is a major factor, meaning whether to me as a customer or I am sure to the suppliers, it is very, very difficult indeed to predict what the cost or price of gas, in this case, is going to be 12 months from now in this market. On the Continent you can look at the way oil prices are moving and you can come up with a fairly good prediction where gas will be but in this market it is very, very difficult to predict that for a number of reasons. Because of that I think the suppliers err on the side of caution and they do not make commitments long term because they do not know what the cost to them is going to be 12 months from now, so they prefer to stay mostly on spot trading because they can always sell at whatever today's price is and I have got to pay it. They have no incentive to do long-term deals with anybody.

Q304 Mr Bailey: I need to get it clear in my mind.

There is relatively little gas available for the forward price market and that is because suppliers are obviously supplying gas in terms of other sorts of contracts. Exactly where are these contracts focused and what sort of percentage of the total supply is involved in these contracts?

Mr Nicholson: I am not sure we could give you figures on that. I am sure the gas producers and suppliers could, but if you look at the volumes that are being traded in forward market compared with the total volume of gas that is sold in aggregate, there is a very big difference between the two and plainly most of the rest is sold between suppliers or, in the case of vertically integrated producers, contracted internally on a different basis, and I do not think we could easily comment on the nature of those deals.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q305 Mr Bailey: Is that because of the scale of vertical integration in the market?

Mr Nicholson: It is a factor, perhaps a stronger factor in electricity than it is in gas. In gas there is more in the way of independent suppliers and separation with producers so I do not think vertical integration can be the whole explanation there.

Mr Bailey: Could you elaborate a little further on the oil/gas price link

Q306 Chairman: Why is it still there? Why can the European Commission not just say get rid of it?

Mr Nicholson: That is a very good question. In fact when we have dealt through the European organisation with the Commission we have been asking that same question. There is no reason why there should not be oil-indexed sales if producers and consumers want to do those sorts of deals; it is the fact that there is no choice in the Continental markets that should raise suspicions. I know that is a view shared by energywatch here, quite rightly. When all suppliers—and I am trying to avoid using the word “conspire”—coincidentally agree to price their product on a consistent basis right across the market, there is no choice at all. In the UK it is all on the basis of the wholesale price in our market here with the margin. In the Continental markets it is all on the basis of indexation to oil products and it offers no choice. Incidentally, sometimes they are the same players in the UK and Continental market but strangely on the Continent they will only offer one type of model and in the UK they will only offer the other. If you go to that supplier and say, as Chris and others have tried to do, “I would like one of your Continental-style deals in the UK,” they will not provide it, nor will they provide a UK-based deal on the Continent. That should raise the suspicions of any competition regulation in my view and it should be a matter for the European Commission to get to the bottom of it.

Mr Bailey: Presumably the Continental model is cheaper than the model in the UK?

Q307 Chairman: We are going to move on to the European gas market.

Mr Nicholson: That will vary from time to time.

Chairman: I am going to bring in a couple of colleagues with supplementaries on this aspect of the liquidity of the wholesale gas market here in the UK and then come back to the European market in more detail.

Q308 Mr Weir: Throughout our evidence sessions we have been talking particularly about domestic customers and it has been suggested to us that the linkage between oil and gas is pushing up prices in the UK. What I am getting from you is a slightly different story where you seem to be wishing you could get the contracts that are linked to oil. It seems to be totally the other side of the coin. Why is that? Do you believe it is beneficial? Is it beneficial because it gives certainty about price or is there another reason why you believe it is beneficial?

Mr Nicholson: That is a good question. Please do not interpret from our remarks that we like oil indexation and no choice or that we do not like the competitive market; quite the contrary. There is an interesting question however, and you will possibly have seen from the graph in the our evidence that over the last three years, if you compare the year ahead wholesale price here with the Continental oil-indexed price elsewhere in Europe, there has been no advantage to the UK from our competitive market compared with largely state-owned monopolies in the rest of Europe. What does that say about the state of competition in our market? The point is whether competition is delivering what it theoretically could in the UK. You would imagine that averaged over time it should be an advantage in the UK but at the moment we seem to have historically recently no net advantage and some considerable periods of disadvantage.

Q309 Mr Weir: Is that because in the UK the same thing is happening—people are looking at forward oil prices and, if you like, projecting their own price against where they think the oil price is going to be?

Mr Nicholson: First I should say that we all understand that it was inevitable that gas prices were going to go up in the UK given the pressure on energy prices internationally. We make no complaint about that. It is difficult for all classes of consumers but it is a fact of life so to some extent we were always going to have to absorb these sorts of increases in price because that is what is happening internationally. However, what we have seen is UK prices spiking above the Continental level in a way which we would argue is avoidable both in its frequency and its intensity, and I would go back to the central point, why are we paying either the same or a premium relative to monopolistic markets where there is virtually no choice at all?

Q310 Mr Binley: I think this is a very vital point. We have boasted about a competitive market and the truth of the matter is it does not exist. Where does the competitive edge lie and how big is that competitive edge; what percentage of the total area is that competitive edge?

Mr Nicholson: I am sure my colleagues will contribute to this but my initial comment is that we have historically benefited from it. In a period when the UK was in surplus with gas we had an extremely competitive gas market. Unfortunately, partly due to circumstances beyond our direct control, that advantage has been lost and arguably we are in a more risky situation now. In electricity the reasons are slightly different because we have seen market concentration and greater vertical integration.

Q311 Chairman: Mr Binley will be asking that question later.

Mr Nicholson: To a lesser extent that has happened in gas too. There are a number of reasons why our competitive market is not delivering competitive prices and that of course is what matters to consumers.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q312 Mr Binley: Sorry, there must be a competitive edge somewhere or people would not be competing to sell you their product. Where does it lie?

Mr Nicholson: It lies in the last 0.5 %.

Q313 Mr Binley: That narrow a margin?

Mr Nicholson: Yes.

Mr Tane: To be clear, as I said before, my business is the largest single point consumer of electricity and the third largest industrial consumer of gas in the UK. Nobody has competed to get my business. I have never ever, with one notable exception, had an approach from any gas or electricity supplier trying to get my business.

Mr Binley: That is crazy.

Q314 Chairman: That is interesting and a very telling observation you just made. Can I ask one question just to clarify stuff that has been said. Your forward price contracts are based on prices in a malfunctioning market a market with almost no liquidity where strange things can happen for whatever reason—speculation, hoarding, all kinds of bad things can happen in that market—and that badly functioning market determines your underlying price?

Mr Nicholson: Absolutely and has a knock-on effect on power prices too.

Mr Tane: And determines whether my business can compete with French, German and Belgian producers.

Chairman: Thank you very much, I think we have pinned that down. Mike, do you want to come to your main questions.

Q315 Mr Weir: I am still a bit confused by this whole linkage between oil and gas prices. Mr Tane, you said that the European supplier would not give you the same contractual terms. Did they give any reason why they would not give you these contractual terms?

Mr Tane: The nearest we got to a reason was, “The UK operates on a different pricing model and that is the only one we are prepared to offer you.”

Q316 Mr Weir: So in effect there is no European-wide model despite what the EU may be saying about competition?

Mr Tane: In my simple summary there is a Continental model, potentially a Scandinavian model and a UK model in terms of pricing structures.

Q317 Mr Weir: And you cannot get the same type of contracts from the UK suppliers as available in the European mainland?

Mr Tane: Correct and to come back to your question earlier as to why would I want to get a Continental-style contract, the first thing is I would like to have a choice. At the moment I have one choice and that is it. I would like to have more than one choice. The second thing is, as I said before, I am competing with French, German and Belgian producers (and I do not care what my price of gas is; what I care about is that it is same price or better

than the others) and at the moment I am facing the situation where my price is either the same or worse than theirs and is much more unpredictable and volatile than theirs, so I am losing out quite considerably.

Q318 Mr Weir: We have heard a lot in our evidence about this famous Interconnector between the European mainland and the UK. We are told that Sam Laidlaw of British Gas has noted that the UK is in danger of becoming a gas lender of last resort to Europe in the sense that they will take gas from us when they need it but will not give it back when we need it. Is that your experience of what is happening there?

Mr Nicholson: Yes and it leaves us very vulnerable as a highly gas-dependent nation. Maybe that did not matter so much when we had a lot more indigenous production but that is in decline. We are becoming more gas-intensive if you look at the demand from the power sector just at the time when we are becoming exposed to some very difficult price influences from outside. You have mentioned what we see as an inequitable asymmetry. In short they have got access to our markets; we have not got equitable access to theirs; we cannot access their storage facilities; we cannot get access to the pipelines; we cannot get access to contracts on the same terms. We have “done the right thing” by liberalising our market but trying to operate an import-dependent liberalised market in a less liberalised whole is leaving us in a very vulnerable position.

Q319 Mr Weir: Is the real problem then the failure of the European mainland, particularly Germany and France, to liberalise their markets and, if so, what do you feel the European Commission should be doing about it to end this situation and have a true free market across the European Union?

Mr Nicholson: It is unquestionably the case that the biggest fault lies with other European countries that have not liberalised their markets. In our view, the Commission has proposed some very sensible arrangements to help bring that about, not dissimilar to the sort of reforms we instituted here in the UK. The problem is not so much with the Commission but with a number of other European Member States who, despite what they have said publicly, have no intention of fully liberalising their gas markets, and here I think some criticism is due of BERR and DTI previously in undue optimism about this. We applaud the efforts they have made to campaign for liberalisation. Indeed, we have been supporting them in doing it in Europe but, as with so many European issues, I think there has been a level of naivety about what our competitors—and they still are competitors within this allegedly single European market—are actually going to do. We need to face up to it because our security of supply depends on this.

Q320 Mr Binley: That is my next question. Given that our European partners are not doing what they said they would do and there is no liberalisation of

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

the markets, it is clearly having an adverse effect on industry within the UK and on domestic customers in the UK, so what should the UK Government do about it, should they be rowing back from the liberalisation that they have already gone down?

Mr Nicholson: We are not arguing to go against the liberalisation agenda but we do feel that we may need to modify our somewhat fundamentalist market stance, which in an ideal world would not be problematic, to fit the reality that we are hooked up to and import dependent on a less liberalised European market and unless and until that changes we might need a more interventionist stance, for example on gas storage and other measures in order to make sure that we are not at a disadvantage.

Q321 Mr Weir: To go back to Miss Kirkbride's earlier question then, whose responsibility is it? Should the UK Government be taking this action or should it be Ofgem the regulator?

Mr Nicholson: I guess ultimately it is a political decision. We do not fault Ofgem for presuming that the best solutions are likely to lie in the market. In an ideal world that is true but a political judgment needs to be made about what realistically is going to happen within the rest of the European Union within the foreseeable future.

Q322 Mr Weir: Given the difficulties which we have heard particularly from Mr Tane about whether this will impact upon manufacturing and industry usage in the UK, what sort of timescale are we talking about for something to be done about this? We have talked about the liberalisation of markets in the rest of the EU for years now. We visited the EU Commission and I do not think those of us who were there are in any way surprised at what you are saying about the attitude of some other EU countries, despite what the Commission may be saying. What timescale are we talking about for something to be done about this and to stop chasing a dream that is never going to happen to liberalise the European market?

Mr Nicholson: When we gave evidence to the Trade and Industry Committee a few years ago, our view was that it could take ten years before we sorted out the market liberalisation, and that is still our view a few years later. Who knows whether that will actually be achieved. The problem is to effect more changes on gas storage and so on, and there are lead times there and there is a limit to what can be done in the short term, but at least we can be planning within the investment horizon ahead of us over the next three, four or five years to ameliorate some of this risk.

Mr Conway: We have to accept the fact that some countries regard their energy suppliers as strategic assets. It is not three months ago that Suez and Gaz de France merged; that would have never been allowed in this country.

Q323 Mr Oaten: Could you just repeat what you said; I did not quite catch it.

Mr Conway: Suez and Gaz de France have merged.

Q324 Chairman: Giving them what market share?

Mr Conway: I do not know what the market share is but it is a very big gas supplier in France. I am not arguing that they are right or wrong; it is just a fact.

Q325 Mr Weir: But is that not indicative of the fear that many of us have that despite what is being said publicly about European liberalisation, on the European mainland it is actually going the other way, with indications for example of EDF trying to take over Iberdrola which would have a knock-on effect on Scottish Power in the UK?

Mr Nicholson: I think that is correct. However, we should not generalise too much. There has been progress in some European markets. The Netherlands for example is moving in the right direction on liberalisation and there has been some progress, more so on electricity than gas in some other markets too. It is not universally negative but in terms of what is material and affects the UK market there are no grounds for optimism there at the moment.

Mr Tane: If I may come back to your earlier question, speaking as a company competing in Europe, it is perfectly clear that the liberalisation of the Continental markets will not happen for the next ten years. It seems really clear to me that British industry, unless something significant is changed during that ten-year period, will be damaged irreparably because once these kinds of assets close down they are not going to come back to the UK and, as we have already heard, in the last major crisis two years ago 100,000 manufacturing jobs went. My own company had to cut back production for four months; we were very, very close to stopping production altogether. Those kind of issues will keep on recurring unless something happens and saying that it will all be solved in ten years' time when liberalisation happens on the Continent is far too far away.

Q326 Miss Kirkbride: So in your view what should happen now?

Mr Tane: It is a complex question. There are a number of ideas which industry and the different bodies here have suggested, relating to things like storage, access to import assets, and strategic stocks for example. There are a number of different ideas which have been floated, many of which I am sure will not be the answer or will not be the only answer, but I think the starting point would be that government, BERR and Ofgem actually recognise that there is a problem that needs solving here rather than telling us that it will be all right on the night, which is what we have had for the last few years.

Mr Nicholson: And I would add that critical to that is making sure that our electricity supplies diversify away from gas as well.

Chairman: We are going to move on to electricity now because we are getting a bit short of time and it is Mr Binley's set of questions now.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q327 Mr Binley: I am coming on to that but I want to ask a question at the end of the other bit. Are not the next ten years the most vital ten years in the next 50 years with regard to the global challenge?

Mr Nicholson: Yes.

Q328 Mr Binley: I wanted that on the record, that is really why I asked it, Chairman. Can we now move on to this whole question of vertical integration and the need for competitiveness in the British market because the whole of the British market has closed down over the last five years not increased. We have now got six major suppliers. I think that the number of smaller suppliers has gone down dramatically and in fact people cannot now get into the market, in truth, because it is so wrapped up. This is a pretty dire situation, is it not? What can we do to change that and make this a more competitive market on that level? I have got some ideas but I wanted yours first.

Mr Nicholson: I should say that we have been raising repeated concerns with the energy regulator and with BERR about increasing concentration in the power market for some time now. If you asked us I would rather not be in this position to start with but at least let us not make it any worse. You will be hearing from the independent generators shortly, but our expectation is that we are going to lose one of them and there are precious few independent generators left within the market, so I do think it is timely to assess whether the markets have already become too concentrated in power generation and, to the extent that vertical integration has become an issue, we do not have a fundamental view that vertical integration is necessarily bad, it is the extent of it and the fact there are so few independents that worries us. Perhaps you heard some suggestions from Allan Asher of energywatch, some of which are worth pursuing, about the extent to which vertically integrated players might be encouraged by one means or another to sell power outside their own business.

Q329 Mr Binley: Can I ask the other two gentlemen to comment on that because it seems to me to be a vital issue, and thereafter can we talk about what we might do.

Mr Conway: I think there is one other point that needs to be made. As far as we understand it, the independent generators do not trade their electricity; they actually sell on bilateral, over-the-counter deals and of course it is totally opaque. We have no idea really what is going on and in fact I have been talking to one or two of our members one of whom buys at least £50 million worth of electricity a year and he has tried to persuade one of the independent generators to sell his electricity through the market but they said, "We will go and talk to"—I am being a bit naughty here—"our friendly supplier," sort of thing, and it is worrying. I think our view is that there needs to be more liquidity even if it is forced.

Q330 Mr Binley: I have got a seller of energy who sells about £100 million a year to about 40,000 business clients. He would argue that the vertical

integration integrated market is in fact a very unhelpful trend and he fears that there will not be room for his £100 million a year supply business to operate unless we do do something. Do you think that is so?

Mr Nicholson: It is a genuine fear. In response to your earlier question I said we should look at whether concentration had gone too far, but perhaps a bigger question is why that concentration has occurred in the first place and what are the drivers behind it. One of them is the complexity of operating in the market and in our evidence, I think probably consistent with that which you may have received from the power industry itself, the barriers to entry to this market, the complexity, the costs of ensuring your demand and supply portfolio are in balance have now become a big deterrent to new entrants to the market and independents in particular.

Q331 Mr Binley: It is even worse than that because the big suppliers in order to guarantee supplies are now demanding shares of that business, are they not?

Mr Nicholson: Yes.

Q332 Mr Binley: Is there not a monopolist problem here that we ought to be dealing with?

Mr Nicholson: Clearly we have got a market that is dominated by an oligopoly and much though all players in markets like to moan about regulation, the brutal truth is that large oligopolistic players quite like regulation as a means of keeping competition out. In our view, we fully understand the theoretical arguments in favour of refining the market and so on but sometimes you need to recognise there is a trade-off between theoretical market efficiency, which Ofgem is very keen on, and transaction costs, which are a big problem for the energy industry and the costs of which ultimately get passed on to us as consumers. We are not clear that we have got that balance right.

Q333 Mr Binley: What if we legislated to require all generators to auction 20% of their capacity.

Mr Tane: I would be delighted, to put it simply. One of the very strange characteristics of this market in my opinion is the absence of small independent players. Any other market I buy in, if I buy raw materials, if I buy steel, or whatever, one of the things you find in a properly functioning market is the core producers but also traders and independent operators. They are pretty much absent in the UK energy market and the key question for further consideration is what could be done to create that secondary market, or to bring it back, because I believe that if there were a bigger independent traded sector, whether that is by forcing a percentage to be sold or whatever, that would give companies like mine and industries like ours the opportunity to make choices where at the moment we have one choice and one choice only.

Mr Binley: I am perfectly happy and I think we all know about integrated markets.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q334 Chairman: Can I put a contentious proposition to you: the sale of British Energy to a existing vertically integrated supplier should only be permitted if a volume of its production is traded openly.

Mr Nicholson: I think that is an idea well worth pursuing. We should say that we value the role of British Energy not just as a key base load supplier but also as the largest supplier to the industrial sector. We do not want to lose that from the market, we do not want to see a further reduction in liquidity in the market, and if as a result of a takeover there were some compensatory arrangements which ensured that market competition and volatility were not adversely affected I think we would welcome it.

Q335 Mr Binley: May I go on very quickly to the question of British champions. You have already made the point that the European market is becoming more monopolistic and the French example is not surprising because the French do those sorts of things, quite frankly, irrespective of what the EU says. Given that scenario, should the Government be putting much more pressure on the creation of a British champion?

Mr Conway: I do not think that it would achieve anything necessarily. The important thing is the result rather than the action, if I can put it that way.

Mr Nicholson: We do not favour the national champion route, as you might not be surprised to hear. However, there are means of supporting a nationally based industry short of subsidy or unfair interference in the market, not least facilitating the sort of investment and reducing barriers on planning and so on that some of those companies wish to pursue, and especially on the nuclear issue, so there are areas of technology where British Energy for example has experience and some other players like Centrica have a very experienced role in the gas market, that could theoretically be extended elsewhere in Europe. I think they deserve support in the broadest sense and it is a shame that they do not have the opportunities to explore that experience as we would like elsewhere in Europe. I think we should be very wary of going down the national champion route.

Q336 Mr Binley: Okay but importing one from France, is that going to be any better?

Mr Nicholson: It would be unwise of us not to take advantage of inward investment from France or elsewhere or indeed their expertise in new build in a number of technologies.

Q337 Miss Kirkbride: It is quite clear that you see market consolidation as yet another problem in terms of what is happening in the gas and electricity markets. Why do you think that has happened? Do you agree, for example, with energywatch that it should be a Competition Commission inquiry that breaks all this up?

Mr Nicholson: My colleagues may go further than me in saying this but it was not central to our submission that we were calling for a Competition Commission referral. We said that if others had

evidence it is required we would obviously support it; equally if it was felt necessary to clear the air, we would support it too. What we would say is that we think that the market, for whatever reason, has become too concentrated. The regulator, even if it felt it could have done more to fight against this trend in the past, may find it difficult to admit that it has got things wrong in the past, so an independent investigation could have advantages. There are disadvantages as well given that we are moving into a very big investment phase of power generation which has implications for our security of supply. We recognise that the timing of such an investigation might be unhelpful from the point of view of putting in tens of thousands of megawatts of new capacity onto the system. On the other hand, maybe that will not happen sufficiently as it should do or in as timely a manner without an efficient market.

Q338 Miss Kirkbride: I would like to hear everyone else but your point of view is that you think the regulator has basically been sleeping on watch?

Mr Nicholson: All I can say is that the regulator put out a public statement in January this year reassuring the Chancellor that the market was working and then five weeks later announced an investigation to see why it might not be working (incidentally, leaving out the industrial sector as part of that investigation). At least one of those two announcements must have been flawed. I do not think that was the regulator's finest hour and that these problems have been creeping up on us for some time. We should say we are strong supporters of Ofgem and independent regulation but no organisation is perfect and I think the evidence that is staring us in the face from prices now should give them and us reasons to reconsider our views on this.

Q339 Miss Kirkbride: Again just going back to what you have just said there, you say you are strong supporters of Ofgem and an independent regulator, but from everything that you have said today, which I think is frankly quite alarming in terms of UK plc, somebody has to take responsibility for all of this and so if the regulator is a good idea in principle but is not doing it, should they not have been sacked? I just think this is such a serious situation that has been allowed to develop and yet I can see the buck been passed quickly round the table as fast as possible so that no-one ends up taking responsibility for what is a very serious situation. Where do you think the buck stops?

Mr Nicholson: You might say ultimately that the political buck stops with the government department but certainly there are devolved responsibilities for the regulator and if a market is becoming too concentrated, if it is not demonstrating in its operation that it is efficient (not within its own internal terms but by comparison with our immediate neighbours) and the empirical evidence is there that our prices are not competitive in our market, that is what matters to us as consumers, and if that is the benchmark we are judging ourselves against, our market is currently failing.

3 June 2008 Mr Hugh Conway, Mr Jeremy Nicholson and Mr Chris Tane

Q340 Miss Kirkbride: Do you think it should be the regulator or the Competition Commission?

Mr Conway: Not the regulator.

Q341 Miss Kirkbride: He has already failed.

Mr Conway: Definitely not the regulator; the regulator has already prejudged this by saying he does not want to investigate the industrial market. He is currently investigating the domestic market, and in fact he keeps on saying the market is working but he does not look at our side of it at all. Maybe he should or maybe he should not, that is another issue, but I think whoever investigates it has got to be fully independent.

Mr Tane: I would say both for my business and for the CIA, our view is not that there is anti-competitive behaviour per se going on; our view is the way that the market is structured is the heart of the problem, so to that extent a competition inquiry of course would throw up some interesting things, it would certainly focus attention on a core issue for us, but in the end I think we believe it is the structure of the market that needs to change not some competition laws that need to change.

Q342 Miss Kirkbride: When you say the structure of the market, is that about dismantling some of the vertical and horizontal integration that has taken place? If it is that, how else do you do it?

Mr Tane: For example the structure of the market issue that we have talked about already in terms of the absence of independent players is well worthy of investigation as to exactly why that is. We believe that changes could be made which would encourage new entrants rather than discourage them, and that in itself would be very helpful.

Q343 Miss Kirkbride: Who would make those changes to ensure that happens, not to just allow it to happen, because at the moment it happens if someone just snaffles them up presumably so that they cannot—

Mr Tane: I think that is a more technical question than I can answer. My colleagues here can talk about which body should be bringing those changes in.

Mr Nicholson: We have an independent regulator but nonetheless its judgments are affected by things that happen outside. We have seen this with the announcement of its investigation into the domestic and small business sector earlier on, and doubtless Ofgem will take into consideration not just what this Committee says but what might be coming to them from BERR and other government departments in terms of concern about the operation of the market and security of supply. Going back to the area we

mentioned earlier on—access arrangements, transaction costs, these sorts of things—are within the regulator's power where it would not necessarily depend on a Competition Commission referral but those are areas where they could take more action and therefore facilitate more competition.

Mr Conway: They have to acknowledge and I do not think they have as yet acknowledged that there is an issue within our markets.

Q344 Chairman: I was very surprised indeed that Ofgem did not look at the wholesale markets as part of their announcement. I do not know what the rationale for that was. This is very frustrating, we are out of time but can I just clarify one thing, in your answer, Mr Tane, on gas storage, did you say the UK now has 19 days' storage or is moving towards that?

Mr Tane: It will have 19 when the storage that is currently being invested in comes on-stream.

Q345 Mr Oaten: What is the current number?

Mr Conway: I think it is 13.

Q346 Chairman: Thank you for that. Your real plea is not so much necessarily for breaking up the consolidation of the industry but transparency, it is more the openness of the market that you need to make sure that the market works properly? I am just checking.

Mr Nicholson: That is a big component of it and without the transparent market you are not going to have an efficient one either. That applies both at a European and a UK level.

Mr Binley: With respect, can I just say this, it is all right you being able to see the figures but you want to be able to act within that market and that is what you cannot do at the moment.

Q347 Chairman: But in order for the market to function effectively the market needs to be fed with information that they are not getting at present, are they?

Mr Nicholson: Not enough.

Q348 Chairman: Thank you very much. There is lots we could ask you. We are very grateful for your excellent written and oral evidence, gentlemen, thank you very much. If any of you feel that you have not had a chance to say something the opportunity exists to give us further written submissions.

Mr Nicholson: We may well do, especially on prices which have moved a little since our initial submission.

Witnesses: **Mr Robert Armour**, Director of Corporate Affairs, British Energy; **Dr Steven Riley**, Executive Director, Europe; and **Mr Ian Foy**, Head of Energy Management, Drax Power Ltd, gave evidence.

Q349 Chairman: It seems that two or three of my colleagues have taken the opportunity for a brief respite from the intensity of the question session and they are returning as I speak. Can I welcome you gentlemen to the second part of today's evidence session. Thank you very much indeed for what you have put in writing and what you will say to us today. Can I begin as I always do by giving you a chance to introduce yourselves and explain who you are one-by-one.

Mr Foy: My name is Ian Foy and I work for Drax Power. Drax Power owns Drax Power Station which is the largest, cleanest, most efficient power station in the UK. We supply 7% of Great Britain's electricity needs. We sell power in all markets from half an hour ahead to several years ahead. We operate in the wholesale market. We do not carry supply business; we are a pure generator.

Dr Riley: My name is Steve Riley and I work for International Power plc which is a FTSE-100 listed company. Our business model is quite simple: we own and operate power stations in various markets around the world. My responsibility is for the European assets which include five stations in the UK. Again in capacity terms that is about 7% of the wholesale market. In energy terms it is a fair bit smaller than Drax because it is a portfolio that is more peaking and mid-merit in nature, so it is not a base load generator.

Mr Armour: My name is Robert Armour and I am from the General Counsel of British Energy. We are primarily a nuclear merchant generator. We have eight nuclear stations and a coal station in Yorkshire. We supply about 17% of the British market. We do not supply to the retail market. We supply to the wholesale and the industrial and commercial market.

Q350 Chairman: I think you have largely answered in your opening questions helpfully the first couple of questions of who do you sell to and how do you sell but possibly not quite about long-term contracts, spot markets and that kind of thing. What kind of contracts do you have, Mr Armour in particular?

Mr Armour: We try and build up a portfolio of contracts over a period of time. As I say, we sell about half our output on the industrial and commercial large business sector and about half into the wholesale market which tends to have as counter-parties either financial institutions or other utilities which will sell on, so that is where we are. We try and build up our contract portfolio over a period of time. In many cases it is quite difficult to get contracts that are much over a year to 18 months, except perhaps with some financial institutions.

Q351 Chairman: Does anyone else want to answer that question?

Dr Riley: I will add something to it probably. Again, we would sell all of our power through the wholesale markets and we would trade with probably about 30 different counter-parties. Ultimately all that energy

would get bought up by the suppliers to the domestic or the commercial sector, but there are probably about 30 counter-parties that we can trade with. We would probably agree that in terms of liquidity we could sell as far as two years out some of our output but not all of it. Within year we could probably sell all of our output if we wanted to.

Q352 Chairman: I think it is helpful of you to explain that link and I think that has helped build a picture of the nature of what your businesses are. Mr Armour, you are presumably absolutely a price taker given that you are basically a generator?

Mr Armour: Nuclear generation tends to be a price taker. We have a coal station which provides some peak and shape to our electricity. I suppose the market price is set largely by gas rather than coal, so it is pretty rare.

Q353 Chairman: Dr Riley and Mr Foy, how do you describe your positions as price takers or price setters?

Dr Riley: I would comment that we do not really see that there are price setters and price takers in the same way that there were in the previous version of this market. All of our sales are done bilaterally through the wholesale market but in terms of our portfolio of plant, as I said earlier, that is more mid-merit and peaking in nature, so under the old rules you would have considered those to be price setters.

Mr Foy: We tend to be, if you can describe it that way, a price taker given that we are a highly efficient coal plant.

Q354 Chairman: The retail market holds no attractions for you?

Mr Foy: In terms of Drax, our expertise is generation; that is what we know and that is what we are good at. If you do look at the retail business it appears that in order to take part you need a volume of customers and probably what are sometimes referred to in other places as sticky customers. We believe that going to market and trying to buy those is probably quite difficult, it is whether any of the big six would let them go; and we would very much doubt it.

Mr Armour: You need a different set of skills and to put in quite sophisticated systems to deal with large volumes and numbers customers, and that is something we have not invested in.

Dr Riley: In terms of domestic customers, we have no real interest because we do not think that is a business you could grow organically. That could only happen if another supply business or one of the current six came up for sale for some reason, we think, because you need some sort of scale. We do have a small investment in one of the small independent retailers, Opus Energy, but that is very much us trying to get an understanding of how the retail market works in that sector, which again is in between the large industrial sector that the

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

gentleman on my left operates in and the domestic sector that you will be talking to the vertically integrated players about some time later.

Q355 Mr Binley: Why do you particularly want an understanding in that market at that depth? What do you intend to do with that understanding?

Dr Riley: If I revert back to International Power's business model, our risk mitigation is by having power generation in different markets (which may or may not be correlated) so the risk mitigation we get for our quality of earnings long term is through that diversity of portfolio. Clearly there are other ways of mitigating those risks in various markets, and retail might be one of those, so we would like a better understanding of what is involved.

Q356 Mr Binley: So an option is to grow vertically?

Dr Riley: That is an option but I think it would be more in the industrial sector or the small/medium enterprise sector rather than the domestic.

Q357 Mr Clapham: We have seen various changes from the early pool system right from NETA and now the current cash-out arrangements. Could you tell us how the cash-out arrangement, which operates in both the electricity and gas market, actually works and what your concerns are about it?

Mr Foy: I will explain. We do not deal in gas so I will not comment on gas. The cash out arrangements with electricity which were introduced in 2001 were designed to stop any cross-subsidy, it was integral to NETA that we had a dual cash out price, so production and consumption accounts were kept separate. In our opinion, they work reasonably well. They do what they are supposed to do. There is some talk or some desire possibly to go to a change in these cash out arrangements where we go to single cash out. It is probably our view that that is a bad idea and that will lead to more short termism. What you will get is more and more plant being taken to the day ahead stage and just picking up the index price, trading off the back of that. Eventually you end up back at something that probably looks like a pool with the risk of industries getting caught up.

Q358 Mr Clapham: Is that the view of you all with regard to the cash out regime?

Mr Armour: There is some debate within the industry as to whether a single cash out—

Q359 Chairman: What is single cash out?

Mr Foy: If you fail to meet your contractual obligation—ie, the power does not meet your contract position—and if you produce too much power onto the system, you effectively spill onto of the system. NGC pay you so much for that power. If you are short and if you have not produced enough to meet your contract position, NGC will effectively go and purchase that power from very short term markets and supply you with that. These two prices are different. If you are short, if you are not supplying enough, the price tends to be punitive and tends to be higher than the price you could have achieved in the forward markets. If you spill or

throw power onto the system that is not required for contract, it will tend to be lower than the price you can get in the market or maybe equivalent, so it encourages contracting.

Q360 Chairman: What is the difference between cash out and single cash out?

Mr Foy: There are all kinds of models but the single cash out is where both the spill price and the long price—ie if you are short or if you are long—the value of that power will be exactly the same.

Mr Armour: There is a healthy debate in the industry between whether the model that penalises you for being over or under or a single cash out that gives you a balance both ways would be better. Equally, does it create a barrier to other people coming in in the same way as some of the other issues like the lack of a derivative market which gives depth to that, which we heard from Mr Tane? It is an issue in terms of pulling in more players and counterparties.

Q361 Mr Clapham: One of the things that we note from the submissions that have been made is that it does require a high degree of security with the sellers. There is that aspect of it. Is that a down side to it? Is that distorting the market?

Dr Riley: On cash out generally, I think the market needs a mechanism whereby there can be some balancing for suppliers or generators who are not able to quite deliver on their contract obligations. The details of the cash out pricing are fairly detailed and are being investigated within the industry structure already. I think it is a second order effect in terms of any of the issues of vertical integration or how this market is functioning long term. It really is a very detailed point.

Mr Armour: The issue of security that you raise is an issue, partly because post-2001 with the difficulties with Enron, TXU, et cetera., the merchant generator model has been seen as riskier by the credit rating agencies. That means that companies like ourselves which do not have an investment grade credit rating have to post collateral in terms of certain market trades. Given the volatile market, you have to be ready, the price moves substantially in a very short period of time, you may have to post substantial amounts of money to match the imbalance. You strike a deal at a certain price and as the market moves there will either be a risk that the person you have sold to will not be able to pay it or that the generator will not be able to provide it. Therefore, the collateral is there to secure it and that can be quite a barrier to market-entry as you go forward because of the amounts of money that you might have to post.

Q362 Mr Clapham: Given that, as British Energy, you are in that kind of market, do you feel that it is disadvantaging the independent generator?

Mr Armour: I think it limits the amount of trading. If you do not have an ability to deal using parent company guarantees rather than posting money, it will limit the volume of trading that you are prepared to do. Therefore, the level of trading going to the market is going to be limited by that exposure.

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

Equally, if you end up saying it will be useful to put more and more proportions of trades through the market, you have to take into account that that creates an issue for players coming in. They are going to have to post substantial amounts of collateral money or take that risk, which may in turn be a barrier to them coming into the market.

Dr Riley: If we had a more liquid and transparent market and we had the ability to trade further forward than we currently do, the amount of credit support that independent generators have to post would probably become a constraint to how much you would want to contract.

Q363 Mr Binley: Is this not just an argument for a monopoly market? Is that what you are arguing for, the status quo? Are you not arguing for the status quo with a monopoly market amongst the big six and you do not really want to widen it out?

Mr Armour: I do not think that is what we are saying.

Q364 Mr Binley: It is what I am getting.

Mr Armour: It would be much better if the market were somewhat deeper, if there were a variety of, let us say, derivative products which extended it beyond simply a limited group of maybe 30 counterparties that are prepared to play the market.

Q365 Mr Clapham: Taking the structure of the market and the way in which it has changed, I am looking here at your submission, Mr Armour. You are saying at paragraph 16 that vertical integration is largely a response to the market structure and the risks faced by the market participants. We are seeing that the current structure of the pricing system is a driver towards vertical integration. Is that the view of you all?

Mr Foy: No. The current market structure is designed to promote forward contracting and keep the generation and supply businesses separate such that the market can operate efficiently. That is what we would always argue for. We find it difficult to see how vertical integration can be a response to the market structure because that would suggest that there is some kind of cross-subsidy within the vertically integrated bodies, which helps you overcome some of the problems of the market. We would say the structure itself is fine.

Q366 Mr Clapham: Drax is quite satisfied with the market as it currently is?

Mr Foy: We are satisfied with the rules of the market. We are not necessarily satisfied with the potential for vertically integrated companies and how they would operate in that market and sell and buy their power. Are they totally transparent? That is our concern.

Mr Armour: Vertical integration is a symptom and a market response. I do not think it means cross-subsidy. If you organise yourself in a way that the credit agencies are happy to rate because you happen to have both a supply business and a generation business and that allows you to therefore compete

effectively in the market, that is not really cross-subsidy. That is a logical market response to the market structure and it goes back to the previous witnesses who said it is not *per se* vertical integration that is the issue. It is the fact that you have the market structure the way you do.

Q367 Mr Clapham: Currently we know that Ofgem is undertaking a review of the balancing market cash out regime. Given that, do you feel that an inquiry by Ofgem is going to be sufficient to address the problems that you have highlighted in the market, particularly you, Mr Armour?

Mr Armour: I would rather wait and see what Ofgem come out with in September. There has been a whole variety of reviews of this market. Last year, the European Commission. We see a variety saying this is a pretty competitive market. There are a variety of things which the industry as well as the regulator have identified that could lead to improvements in it. I would rather not pre-empt the outcome of Ofgem's inquiry.

Q368 Mr Clapham: Could I ask the three of you what you feel are the main issues that Ofgem should be concentrating on and seeking to address in the market?

Mr Foy: In the market as a whole?

Q369 Mr Clapham: Yes.

Mr Foy: I think it is transparency. I think it is convincing themselves that the vertically integrated companies have true separation between the generation, supply and trading businesses such that what may be efficient for a vertically integrated company is not necessarily efficient for the market. As the gentlemen before us quoted, what they want is a market where they can understand the prices so they can potentially hedge forward. That is the area where Ofgem need to convince themselves that the market is operating correctly.

Dr Riley: I would echo that. I do not see any reason why Ofgem could not with the resources that they have do a thorough investigation and come to a sensible conclusion on the market. Clearly, anything that aids the market's transparency and liquidity will be beneficial to players like ourselves but as we say in our submissions we do not particularly think, for the portfolio of generation stations that we have in the UK or for our business model, that this market is a bad market or is particularly broken. We still view the UK as a well functioning market, relatively attractive compared to other European markets where you heard in the previous session there is not much liberalisation at all. I think there was a question there about the status quo. We do not see that a huge amount needs to change for us to be an effective, independent power producer in this market.

Q370 Mr Clapham: You are happy with the way in which the current rules set the prices?

Dr Riley: For the business and the portfolio we have, we can trade and manage the risks in our business, in the market as it currently stands.

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

Mr Armour: I would echo all those points with one further proviso. Is this a market structure that is going to facilitate new investment? That comes back to a degree of regulatory certainty, reasonable but not excessive returns but sufficient of a signal that allows an industry that is going into an investment phase the ability to rise to that challenge.

Q371 Chairman: You are happy with a market that for the last year has been deliberately, systematically delivering higher prices to consumers than anywhere else in Europe?

Mr Armour: I am not in the retail market.

Q372 Chairman: It is very good for your investors but not so good for the consumers.

Dr Riley: You heard from the major energy users earlier. Clearly, the concerns that they raised are real concerns and legitimate ones that people should worry over. I think it is also fair to say that the bulk of the reason why the UK is facing the issues that it is facing is down to lack of liberalisation in other European markets rather than any fundamental problems with the structure or the rules in this market.

Chairman: Let us look at the liquidity of the UK market which does concern me.

Q373 Mr Bailey: It is acknowledged that the problem with liquidity is because the vertically integrated companies largely bypass the wholesale market. What role have the independent generators in improving that market? Do you feel that you have any role? As independent generators, what potential do you think you have to improve that situation?

Dr Riley: All the power we trade goes through the market. It is offered to the whole range of counterparties. There is no more of our power that we could trade through the market.

Q374 Mr Bailey: You are saying that all the power that you supply is traded through the wholesale market?

Dr Riley: Yes.

Q375 Mr Bailey: Does this relatively low level of liquidity affect your trading strategy?

Dr Riley: It limits the length of time that you could trade for. We might see that we would like to trade for the calendar year 2010 at the moment or we might be constrained on that because there are other counterparties out there who either feel that they want to trade for that particular calendar year or that they would like to buy at the price we would like to sell at.

Q376 Mr Bailey: Are you satisfied with the level of liquidity in the wholesale market at the moment?

Mr Foy: I would say no. It should be further. The longer that you can trade in the market the more liquidity there is and the less chance there is of getting prices flattened out. We try to hedge ourselves. Our business model is we hedge progressively over a number of years but it takes two to tango and at the end of the day there is only one

buyer, the big six. They do not appear to come out into the market beyond a couple of years. We would prefer more hedging and the more liquidity obviously. It gives better price signals. It takes away some of the volatility for the customers and allows the customers to put in hedges.

Q377 Chairman: I would like to hear each of you answer that question separately.

Dr Riley: We would like to see more liquidity and more transparency going forward. I would just caveat that by saying that even if that were the case there may be other constraints—for example, the amount of credit support we would have to post—that would limit our ability to trade that far out anyway. It is not just an issue of liquidity and transparency in the market. We are definitely in the position of saying that the market should not allow any transactions to go on unconditionally that would make liquidity and transparency any worse than they are. We are also in the position at the moment, maybe because we have a different portfolio to the other players here that can better manage in the short term, that we are okay with the market arrangements as they currently are. There is sufficient liquidity there for our portfolio because it is more short term responsive plant.

Mr Armour: We would be supportive of greater liquidity and transparency but mindful constraints on collateral. Effectively, if all trades went through the market, you would have to post very substantial amounts of credit and collateral for that and that would in turn be a barrier. There has to be a balance.

Q378 Chairman: I know you have slightly different perspectives. You have different portfolios for generation and different future owners as well in Mr Armour's case potentially. Looking at you, Dr Riley, you are a shareholder in Opus and Opus clearly do not think the market is anything like sufficiently open. They say in a submission to us that a broader ownership of generation assets would be a benefit to competition. They suggest a break up of the big six. They think that cannot happen because of the investment requirements of the markets. They advocate a public auction of a percentage of all generators' outputs—say, 5% to 10%. How would you feel about having a public auction of 5% to 10% of all your output?

Mr Foy: It depends what form that auction would take. Vertical integration itself is not the problem. Vertical integration can exist. It is the cross-subsidy. It is making sure the businesses are separated. The vertically integrated companies must buy all their retail power from the market and they must sell all their generation output into the market separately. If there is no cross-subsidy, it will have no impact upon them. Either that or whatever internal deals they may deal with in their businesses from the generators to the supply to the trade, they offer those to the market.

Q379 Mr Bailey: Assuming that the big six remain as they are and do not divest their generating assets, we have talked about the possibility of having a certain

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

percentage of output auctioned. Are there any other policies that might be pursued that would improve liquidity in the market?

Mr Foy: Auctions could be difficult to run. What most people suggest is an auction for generation capacity. You still have the supply side on the other side. You still have the big six. You only have one buyer. That may cause some difficulties. Somehow you have to get them to open the generation book and sell their generation as a generation portfolio on the market and buy as a retail business in the market and take away these internal trades or links.

Dr Riley: A forced auction of some of their output would bring that to market. That would aid transparency and liquidity. Whether there is something that could be done just in terms of more open disclosure, in terms of the differences between their retail and the generation businesses, that might also be an aid to understanding the real price signals in the market.

Mr Armour: Some of the big six do put some levels of their trade through the market. You might quiz them on that. Where you are looking at into a percentage going through the market may well be one possible solution but it is tempered by the other point that Opus made, which is that there are some quite chunky investments required from this market as well. The idea that you went back and broke up vertical integration and created a number of small players who then have to face up to large investment does not seem a recipe for—

Mr Bailey: I was discounting that and just looking at alternatives over and above that situation.

Q380 Miss Kirkbride: I still do not quite understand your position. The big energy players could still have money to invest in big plant, nuclear and all the things that the government and the UK want them to do. Surely what we are talking about is just having more small scale suppliers who are not going to be investing in nuclear plant. They are just going to be providing small scale energy supply and giving a choice to the people we heard earlier from to go to them, to offer them their supply of power. I do not see why these things are incompatible. You could just have more people supplying while still having really big players in the market who are doing the big infrastructure projects. Why are those two things incompatible?

Mr Armour: I do not think they are.

Q381 Miss Kirkbride: The inference of your remarks seemed to suggest that they were. We can only be a big guy because we want to invest in big things and therefore we have to have a monopolistic position in order to that we can then cash it out. That is how it sounded to us.

Mr Armour: I was going back to the Chairman's quote from the Opus statement which said that in an ideal world you do this. Alan Asher I think said the same thing a couple of weeks ago. That is fine in theory but in practice you have to balance what are the challenges facing us and is the industry structured to deal not just with the short term but with the long term.

Q382 Miss Kirkbride: I did not quite understand Mr Foy's position either. If you have a vertically integrated company so you have your power supply and your customers, your argument was that as long as those two things do not cross-subsidise there is not a problem. You have a wonderfully monopolistic situation, have you not, where you are completely in charge of supply of the market and complete control. No one really likes moving their electricity supplier. Even Energywatch only does it to find out what it feels like if you are a customer and how boring and difficult it is. No one actually moves their electricity and gas supplier because it is just too damned difficult, so you have got the market cornered. It is a wonderful monopolistic position surely. It has nothing to do with cross-subsidies.

Mr Foy: The issue is that, as long as the big six remain of a similar size and they all get into a group think and they do not take each other's markets, then that is exactly what will happen.

Q383 Miss Kirkbride: It is all very cosy.

Mr Foy: They look very stable at the moment.

Q384 Miss Kirkbride: You are saying it is all right as long as they do not cross-subsidise, but it is not all right because, as we just said, it is all too cosy.

Mr Foy: Why do they do this? How do they do this, if they are indeed doing it? They make themselves potentially look like each other. They all take an equal share, 15% or 16% of the total supply market. They have a range of powers stations which they can call on at any time. They do not have to go out into the market, compete and buy power because they know they have reasonably fixed customers. I do not know what the answer is to fixed customers. You cannot force people to move.

Q385 Miss Kirkbride: I accept that.

Mr Foy: The down side of that is you get inefficiencies within each of those vertically integrated companies. To some extent you may even see it now in the market where you have old, small, 250 or 350 megawatt coal fired power stations which are base loading and other 500 megawatt efficient units which are shutting down. You get this internalisation of costs. If they end up internalising these costs and valuing it how they value it rather than how the market values it, eventually what you end up with is an expensive fleet of power stations in the UK and generally rising prices. The vertically integrated players are going to go out there and make these big infrastructure decisions. Why cannot a small independent make these infrastructure decisions?

Q386 Mr Binley: I am seeing an argument which suggests that you as generators need to have a reasonably secure market place based on a price that gives you the confidence to invest in the future. That has created a scenario where average wholesale prices in the UK, apart from other factors—and I recognise those—are almost 30% more than they are on the continent. That is a massive price for the consumer to pay to guarantee investment and

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

therein I think lies my concern and the concern of some of my colleagues. In fact, you are not thinking about your consumer at all. That worries me in a business. When a supplier gets so divorced from the market place that there is no thinking in his philosophy about the consumer, I get worried. I have not heard any thinking at all about the balance between the interests of the consumer and the interests of the generator. Would you respond to that?

Dr Riley: Maybe part of the answer to this is what do we do when we are thinking of investing in a new generation station. Perhaps I can start there. That may or may not be in the UK. At the end of the day, there is no investment from us in a new power station if the customer cannot afford the power that comes from that. If we build in Portugal, the Netherlands or anywhere else, whether that is under a long term contract or whatever the arrangement is, there has to be an offtaker for that power. That is not likely to be us because we do not own a retail business. We do not have long term customers. In Portugal we have just started to build a new power station. That is with a Spanish company coming in as a new entrant, in the retail to the market. They are taking a view as to whether, at that price, they can gain new customers from the incumbent. Ultimately, because we do not have that direct interface with the domestic consumer or even at the moment with the large, industrial consumer, it is a bit hard for us to say do we have the customers' interests at heart. At the end of the day, if customers cannot afford to pay for electricity, we do not have a business.

Q387 Mr Binley: It is a sneaky argument for further vertical integration, is it not?

Dr Riley: No. I am definitely not here to argue for further vertical integration. I do not want to see any further vertical integration.

Q388 Mr Binley: I assume you are a capitalist and you believe in competition. I assume you believe in serving the consumer. We are both businessmen. We have a sort of basic philosophy and I assume that is yours. How then do you explain a market place where one of the major users of your product has not had a competitive approach in three years? If that is the case, is there not something seriously wrong with that market place that you say is not broken in any sense?

Dr Riley: I cannot answer that question.

Q389 Mr Binley: I think I know the answer. I think it is clear: "Of course it is right but I do not want to say it." Is that not what you are telling me?

Dr Riley: No.

Mr Oaten: You are asking the wrong people.

Mr Binley: I do not think I am asking the wrong people.

Q390 Chairman: I think you are.

Dr Riley: We do not sell gas.

Mr Binley: The point I am making is that the whole market place has closed down dramatically in the last five years to six major players in the generation business and not many more major wholesale sellers. It has closed down sizeably.

Chairman: Mr Armour is the biggest single producer in the country.

Q391 Mr Binley: Vertically integrated companies have aided that particular movement. We have arrived at a situation where the market, we are told, has become massively less competitive. You are involved in that process.

Mr Armour: I was surprised to hear that, partly because we are the supplier currently supplying Mr Tane. I certainly had expected other people to be competing for that business because I know we competed pretty competitively to get it.

Q392 Mr Binley: Does it bother you?

Mr Armour: It is very surprising to me. That comment was not what I expected.

Q393 Chairman: What I am really puzzled about is that new entrants are not building conventional gas and coal fired generator capacity. The big six are. Why?

Mr Foy: We do not see how the spreads can justify a reasonable return on a power station. We are somewhat surprised that the big six are building them.

Mr Armour: You may look at prices now but over the last five years we have been operating in a pretty volatile market which equally has an impact on the ability to take forward projects. Looking forward, there is a degree of uncertainty on the price of carbon. The price of electricity going forward will be volatile. All of that has to be factored into the market which you are trying to invest in.

Dr Riley: There are other reasons why that might be the case in the UK. The vertically integrated players also by their nature are part of bigger European utilities generally with big balance sheets, so they can afford to build new entrants on their balance sheets. An independent power producer's business model again is quite different and we would look to the debt markets to raise a significant amount of project finance to fund that development. Then you are into what you need in place to raise that project finance in the first place, which is a medium to long-term off-take agreement. Again, we go back to when we make those investments in other markets. You are looking to do a deal with an incumbent or with a new entrant to mitigate your risk by taking some of the supply for a period of time. We need that to raise the finance to build vertically integrated players by virtue of the fact that they are parts of companies with big balance sheets, not necessarily just because they are vertically integrated and can finance that in a different way.

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

Q394 Chairman: If I understood Mr Foy's answer correctly, inevitably the spread between fuel costs and wholesale prices is an important determinant of an investment decision. It has to be, by definition. There is an implication that spreads could possibly be wider for the big six.

Mr Foy: Again, this comes back to separation of businesses. If they are operating the business in the same way as we are, they should be seeing exactly the same spreads as us.

Dr Riley: The spreads that they would observe in the market should be exactly the same for everybody. The difference that there might be is that their return requirements or their costs of capital might be different than other players and therefore they might be prepared to build with the same technology and the same spreads but they would see that that would deliver a different return than their competitors.

Q395 Chairman: Should we be requiring them to be separating out their accounts so it is clearer what is happening in the vertically integrated companies?

Mr Foy: That is certainly one way of doing it. You see where the value is. Again, if we have a different cost of capital, it is slightly different. You would also probably expect them to compete amongst each other, not just with the independents. Do they try and take the market share of the other vertically integrated players?

Q396 Mr Bailey: Arising from the comments of Mr Armour about the volatility of the market, in the context of some previous comments, as independent operators you are relatively happy with the market as it has functioned. I hope I am not putting words into your mouth. That is how I understood the comments that you made. What concerns me is that there is a general feeling that it would be beneficial to have more independent operator suppliers within the market but that the existing market volatility ensures that only the big six have the ability to raise investment, to if you like provide more capacity; yet you as independent operators seem quite happy with that situation. I find it rather strange.

Dr Riley: I do not think you can say that it is only the big six who can raise the investment to build new infrastructure.

Q397 Mr Bailey: I am not saying that. I interpreted that from what you said.

Dr Riley: We own five power stations in the UK. Three of those have significant levels of debt on them that we were able to raise in a merchant market without a long term contract, which is normally what is required to allow us to own and operate those power stations going forward. The market will go through various cycles and there will be points in time when we would hope we would be able to raise finance to invest new in the UK. There is also a question I think around what you would class as investment in new capacity. If I take Rugeley, our coal fired power station which is quite an old power station, we are currently investing over £100 million in flue gas desulphurisation equipment there to keep open capacity that otherwise would have closed in

2015. There is investment from independent power generators in capacity in this market under the current rules.

Q398 Mr Bailey: I welcome that. I worked in Rugeley Power Station many years ago.

Mr Foy: You say we are happy with the way things are. When I said I was happy, I was referring to Mr Clapham's point about the mechanism in terms of cash out price. As Dr Riley said, it is a secondary issue in terms of how this market operates. I cannot see any great need to delve into those balancing type rules. In the wider market itself, vertical integration is a potential issue.

Q399 Mr Weir: We have talked a lot about the big six and their place in the market. What do you think the impact of the sale of British Energy to one of these big six would have on market liquidity?

Mr Foy: If all that power got tracked it would have a huge impact on market liquidity. That would take an awfully big piece away and you do need volume. You need a lot of players out there to make a market, to make it worthwhile, brokers being in existence and everyone else. It will be a big issue.

Dr Riley: Liquidity works, clearly.

Q400 Chairman: That would be a bad thing?

Dr Riley: That would be. We were fairly clear in our submission that we would not like to see further vertical integration, further consolidation amongst vertically integrated players.

Q401 Mr Weir: We heard a lot earlier about the situation particularly in the European market where there has not been the level of liberalisation that there has been in the UK. Obviously many of the big European firms, EDF, RWE and E.ON, are operating within the UK. Do you think it would be a bad thing for the market for example if EDF were successful in taking over Iberdrola of Spain and ended up dealing with Scottish Power at the same time, having a further concentration of markets and fewer than six companies in the UK?

Dr Riley: Yes.

Q402 Mr Weir: Very bad?

Dr Riley: Bad enough that it should not be allowed without some conditions being placed on it.

Q403 Mr Weir: Given what you are saying about liquidity, do you think the UK government should be considering selling British Energy to one of these companies perhaps, like EDF?

Dr Riley: It depends on the government's objectives, does it not? If the government is looking for a creditable, reputable company to build new nuclear going forward, a sale to EDF for example would probably achieve that objective, but that should not be to the detriment of the current liquidity and the current market players. It could not just happen without some other conditions being placed on that which might be for example that combined entity auctioning some of its power through the market or

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

possibly even forced divestments, not necessarily of the nuclear plant but of the coal plant that would be in that combined entity.

Q404 Mr Weir: What you are really saying is that the government then has to make a political decision against liquidity in the energy market as opposed to its desire for more nuclear power stations, for whatever bizarre reason they may have for that.

Dr Riley: I think they could achieve both if they put the right conditions on the transaction.

Q405 Mr Weir: What conditions would these be? Would it be simple if EDF were to sell off some of their existing plant in the UK?

Dr Riley: Yes, that would help.

Q406 Mr Weir: Would that be as an independent entity to one of the other big six? By selling off to the other big six are you not just shifting the concentration but still having a greater concentration in the market?

Dr Riley: No. If there were some power stations, either individual or a small portfolio available for sale in the UK, that would get interest from new entrants.

Q407 Chairman: Mr Armour, you are in a difficult position, I appreciate, in order for you to comment on these questions. My prediction is that to sell British Energy to one of the big six without some kind of corrective action, whatever that might be, would not be appropriate because of the effect on market liquidity. What you can and cannot say is a matter for your judgment, I appreciate, in the situation you are in.

Mr Armour: Thank you very much. I am constrained. We did make an announcement on 16 May that we were in discussions with a number of parties. We have scrupulously not said whether those parties are big six or different parties beyond. Logically, the time to look at the implications of any deal is if and when there is a deal proposed which you can then evaluate. Equally, that is something that inevitably the competition authorities would look at if that deal came to fruition. There is no guarantee that it will.

Chairman: I would like to press you quite hard but I think that is probably as much as is reasonable to expect you to say in the circumstances.

Q408 Mr Oaten: Obviously we have heard about an awful lot of the issues that are taking place in the industry. There is a number of investigations and inquiries taking place. There is also talk of a possible Competition Commission looking at this and I just wondered whether you would see that as something which would come in whether people felt it was necessary or not. We just need to clear the air. Would you have concerns that any inquiry like that and indeed some of the other ones that are taking place are going to get in the way of some of the big investment decisions that are having to be taken at the moment?

Dr Riley: It is clear in the current environment of high energy prices that people would want to have a look at the market and assure themselves that it is working properly, or not as the case may be. I have no doubt that when there are a significant number of regulatory reviews going on at the same time in the market that that spooks investors and it does delay investment decisions. Again, sorry to hark back to it but when we look at investment in any market because we have a choice as to where we put our capital, the regulatory environment is one of the considerations we look at when deciding whether to invest in a market. At the moment in the UK we all understand the reasons why we are where we are but there is a lot of regulatory scrutiny going on. I think the answer is clear. That does play a role in people making their investment decisions.

Q409 Mr Oaten: The phrase that you have no doubt: could you harden that up to say you are definitely sure and you have seen examples of people being turned away because they are concerned about the pace of regulation?

Dr Riley: No. I am really saying that it is my view that investment decisions that people are considering at the moment are being delayed while these investigations are going on. They will wait to see the outcome before they make those decisions.

Mr Foy: It is tough. If there are investigations ongoing then, yes, it may well put people off investing. However, from what you have heard today and what you hear everywhere else, there is this problem around vertical integration. Is it a problem or is it not? The way the market is structured and the way we deal in this market I do not think is particularly bad but all that needs to be cleared up is how do the vertically integrated players operate. It is not the market. It is just do they have true separation of businesses; are they operating efficiently or efficiently for the whole market? That should be able to be done fairly quickly.

Mr Armour: If something came out of Ofgem's investigation, perhaps that would justify going to the Competition Commission. Otherwise, I would very much echo what Dr Riley was saying. A prolonged Competition Commission inquiry at a time when we are facing a generation gap is not helpful unless there is some clear evidence as to what we are chasing.

Q410 Mr Oaten: This goes back to the significance of cash out, which I am a bit reluctant to get into. How many times do you have a situation where the company falls short of the contract and how many times do you have a situation where you are spilling over, just so that I can get a sense of how many times this happens and how significant an issue it is?

Mr Foy: Traditionally so far, the market has been what is called long. The suppliers spill a small amount of power. That is how they protect themselves. Obviously, you are never quite certain how a customer is going to take the fluctuation but

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

the situation tends to be long. For us as generators, our big problem is we lose plant instantaneously, so a plant trips. At that point, you are going to be exposed to these cash out prices. If you are lucky, it is just a couple of pounds above the price of the power you have sold so it does not hurt. If you are unlucky, it may be £500 or £600 a megawatt hour, ten times what you have sold it for.

Q411 Mr Oaten: Is it happening lots of times?

Mr Foy: Power stations are falling off and units are falling off all the time. I remember some report by NGC many years ago which was four hours hence, if you look at the plant that is running, 400 megawatts will go missing within that four hours. There are 120 units around the system. A couple go missing every day and a couple come back every day. You will be exposed to imbalance almost immediately when you trip and you go to market immediately and repurchase power.

Q412 Mr Oaten: Is that worse in the UK from mainland Europe?

Mr Foy: We do not trade in mainland Europe. I do not know how that operates.

Dr Riley: The cash out mechanism is just an integral part of the market design at the moment. I would have thought almost at every instance suppliers will be slightly out of balance and generators will be slightly out of balance, so you have to have that mechanism there to ensure that both parties are managing that as tightly as possible to reduce the overall costs.

Mr Armour: This is why the vast majority of trades are in the short term market in the run up to gate closure and people are balancing their portfolio, trying to get themselves in the right position to go into that last period.

Mr Binley: One of our prime objectives is to discover whether the current market structure encourages effective competition in the retail markets for gas and electricity, as you know. My particular concern is business because I think that unless we start thinking much more about wealth producing sector—I am sure you would agree with me—we will be in serious trouble in 30 or 40 years' time. I was pleased to hear you say that you would not want to see more vertically integrated companies in the market but, when I read that the building of non-incentivised generation capacity—ie, large, conventional new builds such as gas and coal—is noticeably dominated by vertically integrated companies or joint ventures involving vertically integrated companies, that brings me back to you. When I also have evidence that tells me that the competitive margin in the sale to industry is 0.5% of total costs, we have a problem. That problem is partly of your making. I just want an understanding of that because you are also involved—

Chairman: That 0.5% was a gas figure, not electricity.

Q413 Mr Binley: Okay, but you are also involved in creating an integrated market. You are happy with the market place as it is. I see really quite distinct contradictions here.

Dr Riley: Just for the record, that was not our submission.

Mr Foy: That was ours.

Q414 Mr Binley: I know but it is true, is it not?

Mr Foy: Yes.

Q415 Mr Binley: That is what counts.

Mr Foy: The passage is that the majority of plant being built is being built by the vertically integrated players. Everything, as far as we know, that is currently being built is by vertically integrated players and not independents.

Mr Binley: I just do not understand why you are not taking more concern from that perspective.

Q416 Chairman: I do not get a sense from you that you are itching to increase your own ability to generate. You are not burning with a passion to put more liquidity into the market yourselves. Dr Riley, you have given some helpful indications as to why that might be the case but I worry why people are not burning with this desire. The small Opuses of this world are complaining that they cannot buy electricity. They buy it from you, Dr Riley, but they are complaining they cannot. Why are they not putting small scale generating plants in themselves? What is preventing them from becoming their own generators? Why is the market looking so rigid from my perspective?

Mr Foy: I do not think it is looking rigid. When you look at the numbers they do not seem to justify building power stations.

Q417 Chairman: What is the smallest power station you can build? CHP systems of course are quite a prospect.

Mr Foy: The CHPs have similar problems in this market. They tend to be relatively small but they tend to be dominated by the heat load rather than the electricity load. Most of the power stations that are probably going to be built are going to be 800 megawatt CCGTs.

Q418 Chairman: What are the capital costs of one of those?

Mr Foy: 500 or 600 million.

Dr Riley: I would say the total installed cost would be over £500 per kilowatt.

Q419 Miss Kirkbride: The price has gone up. Therefore does the price have to go up even more to make it economical? Secondly, how come it would appear that in Europe they can have more independent producers? What is it about England that the barrier to entry is the price of building power stations?

Mr Foy: I do not know about Europe. The price of power has gone up an awfully long way but so have the fuel costs. The international cost of the fuel that Drax buys, coal, from last September to

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

now has doubled from about \$70 a tonne and I think it is now approaching \$160 a tonne, so the margins are staying relatively strapped in a tight band. Most of the commentators in the market are saying they do not meet the new entry costs.

Dr Riley: There is a number of questions there but I think the common theme is, if I put it directly to us at International Power, why are we not considering investing more in generation in the UK? I thought I had answered that partly before by saying that we have invested money in Rugeley to keep that open. If you take a look at what we have done since 2000 when we were created, we have increased our share of the generation capacity from 500 megawatts to over 5,000 megawatts. That has all been through acquisitions so far. We are doing that in partnership with Mitsui & Co which is a big Japanese trading house. There is a strong partnership there which is very interested in increasing its exposure to the UK market and it is then just a case of finding the right opportunity with the right risk profile before we could do that. I do not think again that you should go away with the conclusion that this market is not of interest to independent power generators because that is not the case.

Q420 Chairman: You are beginning to convince me that you are interested in expanding your operations. That is what I wanted to hear. I get a slight sense of complacency from the three of you. It is all okay really. You could live with it.

Mr Foy: We are in this market. Drax has announced that we are going to invest around 80 million. We are going to become the biggest biomass co-firer in the UK. We are also investing £100 million in renewing all our HP and LP turbines to make them more efficient. We are willing to invest. We want to invest, but to invest in the retail business we do not see as particularly possible and to invest in new power stations we do not see an incentive in the market.

Q421 Mr Clapham: As a risk profile for example on an independent investing into new gas stations, has it gone to a degree where it militates against that investment?

Dr Riley: For us, when we look at this investment now, I would probably put my money in other markets rather than the UK in terms of the deals that I can do in building new gas fired stations but I do not necessarily think that is always going to be the case. If I could get a long term offtake contract in other markets and that would present a lower risk profile for me. In any of the markets we look at at the moment, one of the subjects that we have not touched upon at all is just the rising cost of building new power stations. Not just the UK but the whole of Europe and elsewhere around the world is in need of new capacity. If you take a view over the last two or three years, the cost of putting a new power station on the ground has also gone up significantly and we have not even started to see the impact that that is going to have on the returns of investors.

Q422 Mr Clapham: Given that you are in Europe, do you find that for example with regard to a gas fired station you are more encouraged to invest in gas fired stations in Europe than you would be in the UK?

Dr Riley: At this point in time we are investing in two gas fired stations in Europe and none in the UK so I think that answers the question. Referring to a point that Ian made earlier, if you look at the spreads now as the key determinant as to whether you would invest in the UK compared to where they were two or three years ago, the signs are much more encouraging. There is optimism there. Have you the optimism that this market can deliver the returns that are required to burn new CCGT on the ground? The question is then your level of confidence as to whether that is going to be there for the long term or not. That is changing.

Q423 Miss Kirkbride: Having listened to all the evidence this morning, it seems to me that we are in quite a difficult position because North Sea oil is running out very quickly, it would seem. We have a situation where domestic consumers and industrial consumers are being hammered with the potential that our industrial consumers might well withdraw industrial production from the UK, which is extremely grave. We have an unliberalised market in Europe which again, according to our previous guests, suggested that that was meaning that prices could be higher in the UK because companies were able to take advantage of UK consumers without being able to do the same in Europe. We have producers saying, "Look, if you really want us to make these investments which are dead expensive and getting more expensive, if you do hit us with a Competition Commission inquiry, you are not going to get what you want in terms of future capacity." We are really in a very difficult position and yet in 2003 the Energy Minister, Brian Wilson, had a review of energy in the UK and a review of nuclear energy in the UK and said, "There is not a problem. It is all fine. We do not need to worry about this. We will just put it on the shelf for the next four years." Would you like to comment?

Mr Armour: I think that is why there was another energy review in 2006 and a series of papers. Clearly, the gap that is facing the industry in terms of generation capacity either driven by retirements or the Large Combustion Plant Directive and environmental constraints or by low carbon is getting that much closer.

Q424 Miss Kirkbride: Was that not a grossly irresponsible judgment at the time?

Dr Riley: It was at a time when generators were going bust and losing money. Companies were writing off significant amounts of investment that they made in those power stations. We should not lose sight of the fact that back in 2002–03 it was a completely different environment to the one that we are facing now.

3 June 2008 Mr Robert Armour, Dr Steven Riley and Mr Ian Foy

Mr Foy: In 2003 I was at Drax and the American owner walked away. We had in the past year got rid of virtually all the coal stock. There was not a lot left at the station. Part of our argument here is that we do not want these swings. We want to be able to hedge. We want to have the signals out there such that you can see a long way forward and make these big investment decisions. We want a more liquid market. One of the arguments is that vertical integration may be stopping those long term markets.

Mr Armour: All I was saying was investors, credit rating agencies etc., have a long memory. They, like all of us here, got burned in 2001–02. Looking forward at the challenges, regulatory uncertainty is

not a conducive factor to meeting those challenges. I am not necessarily saying, “Do not do anything on the Competition Commission.” It is just that that overall LD Investment environment does not look easy.

Chairman: We could go on all day. I think you have agreed with Julie Kirkbride’s question but in a diplomatic way. Thank you very much, gentlemen. We have been courteous but we have treated you with a degree of robustness sometimes. Thank you very much for rising to the challenge. We are very grateful to you. If you think there is anything we did not say or you want to clarify in further written evidence, please feel free to send it. Thank you very much indeed.

Thursday 5 June 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Mr Brian Binley
Mr Michael Clapham

Mr Mike Weir
Mr Anthony Wright

Witnesses: **Jenny Saunders**, Acting Chief Executive, National Energy Action, and **Lesley Davies**, Chair, National Right to Fuel Campaign, gave evidence.

Q425 Chairman: Ladies, welcome to this third evidence session of our inquiry into fuel prices. We are very grateful to you for coming and for the written memoranda that you provide the Committee with. Although we know who you are, would you tell the rest of the world who you are and where you are from?

Jenny Saunders: I am Jenny Saunders. I am Acting Chief Executive of National Energy Action, a fuel poverty charity.

Lesley Davies: I am Lesley Davies, and I am Chair of the National Right to Fuel Campaign.

Q426 Chairman: Could I start with very factual questions to get your assessment particularly of your current estimate of the levels of fuel poverty?

Jenny Saunders: We are estimating that there are 4.5 million households across the UK who fall into the category of fuel poverty as defined as needing to spend 10% or more of your income to heat the home to an adequate heating regime.

Q427 Chairman: That represents what change on recent history?

Jenny Saunders: That is an increase from about 2.4 million three or four years ago, so there has been a dramatic increase in the numbers; a doubling due to the price increases. The distributional effect has been that we see certain parts of the UK, certain regions in England having much higher percentages of households in fuel poverty, so for example the North East at 20% odd, lower percentages perhaps in the South East.

Q428 Chairman: Can you characterise those households? I know that the debate is always about pensioners and obviously that is a large part of that group, but are there other groups as well that you would identify as being particularly important to remember when we are talking about fuel poverty?

Jenny Saunders: We categorise people as being vulnerable households who are most likely to suffer worse symptoms of fuel poverty as being not only pensioners, but families in receipt of income support and those with special disability allowances as well. It is clearly a problem linked to low income, but it is obviously very clearly linked to the problem of the housing type, the insulation and heating standards and the cost of energy.

Q429 Chairman: If my colleague, Roger Berry, were here—he apologises that he is not because a lot of this is his special interest subjects but he has a debate on the Floor of the House on the Future of Care and Support which he wants to participate in and I understand that—he would emphasise, for example, that young disabled people often get overlooked in a study. Do you think that is a major area of concern?

Jenny Saunders: We have tried to highlight to DWP for a number of years that perhaps some special assistance could be given by extending the winter fuel payment not only to pensioners, but to households who are eligible for the cold weather payments and families with disabled members of the family could fall into that category.

Q430 Chairman: We meet at quite an auspicious time because we have just had Ofgem's statement on the Fuel Poverty Action Programme after the recent summit. One of the big issues announced is sharing data so that the suppliers know who is actually in need and who is not. It seems that it is quite difficult to identify which households are specifically in need. How confident are you in the accuracy of the estimate of 4.5 million that you have given?

Jenny Saunders: I think we can be confident in the accuracy of that number because it is based on statistical data that is collected by the Government through the English House Conditions survey. What we do not know is where exactly those individual households are because it is this complex combination of income, housing type and how many members are in the household. It is not easy to say, unless you get across the doorstep, that this household is definitely in fuel poverty, as we define it. What we can say is, and we can do some mapping, that particular parts of the country down to subward level are more likely to have households suffering fuel poverty.

Q431 Mr Weir : I want to pick up a point about the numbers and you mentioned that it is because of rising prices and of course Ofgem have had the fuel summit speaking to the 'Big 6' generators. I know that your sister organisation in Scotland, Energy Action Scotland, has done good work in respect of off-grid houses, people who rely on fuel oil, calor gas and propane gas, for example. Are these included in your 4.5 million figure or is there any way to differentiate how many people fall into that category outside of the normal suppliers?

5 June 2008 Jenny Saunders and Lesley Davies

Jenny Saunders: They will be included in that category. However, we have different degrees of fuel poverty. You are quite right, people off the gas grid area will be having an average energy bill of somewhere in the region of £1,700 compared to the average £1,000 if you are on the gas grid. It is particularly affecting people in rural areas and there is no protection. Although they may get assistance through their electricity supplier through the CERT scheme, there is no special measure if they are dependent on calor or oil.

Q432 Mr Weir: Most of these are using the oil or the calor for heating as opposed to anything else, so it is vitally important.

Jenny Saunders: Yes. In some work that we have done in some properties off the gas network we have shown that by taking them off bottled gas we can reduce their heating bills by somewhere in the region from £42 a week in the winter to about £14 by giving them an air source heat pump which is a new alternative technology. We would like to see some more innovation in the kind of measures that we offer people who are living in those off gas areas.

Q433 Chairman: We must not labour the point now but I think the Committee is concerned about the lack of regulatory oversight for these fuel types. Theoretically it is a very strong oversight for gas or electricity if you are on the mains, but I have had a letter from the Office of Fair Trading only this week which indicates that there is a serious gap there and that is an issue that the Committee will be looking at. Tell me about energy prices and what role they play in fuel poverty. Obviously insulation is one of the issues we are talking about in energy efficiency and obviously usage. People can, for example, set their own consumption of energy as well. Sometimes one might be aware of the costs that they are incurring. Tell me about the role of energy prices in fuel poverty?

Jenny Saunders: The recent increases in the numbers of households in fuel poverty we would argue, is down solely to the energy price increases. Previously we have tried to map how the different policy instruments have helped us to reduce the levels. We have looked at incomes policy and energy efficiency. Up until 2004, about 60% of the reduction in fuel poverty was attributable to just helping people to increase their incomes, particularly the pension credit, and that has been eroded now. Some households do not understand the complex range of tariffs. They clearly do need better energy advice on how they can save energy in the home, but most people in fuel poverty will not be profligate; they will be sparing, they will not be wasting energy if they cannot afford to do so. That is our view.

Q434 Chairman: Few people make profligate use of energy now given the prices. The Government's projections on fuel poverty made in last year's White Paper, which was the most recent projections, what validity do you think those projections now have in light of the events since the publication of the White Paper?

Jenny Saunders: They suggested three possible energy price scenarios. We are already way beyond the highest possible scenario that was predicted. We would estimate that the target 2010 date for eradicating fuel poverty in vulnerable households cannot be met with current resources. In 2016 we would hope that we could meet them but it will require significantly more resource and some new policies.

Q435 Mr Clapham: In relation to new policies is it possible to say where you would like to see those new policies?

Jenny Saunders: We need to have an expanded range of measures on offer to households. We are not saying that everything that is being done at the moment is wrong. We have had faith in the energy efficiency programmes. We do know that they are delivering a good deal to people. We have to step up and we have to bring in, particularly in the off gas areas, new insulation products, we have to join up rather better at a local level and see how the new performance indicators on local authorities can be constructively implemented. I think we do need to look at a social tariff being a statutory obligation, but we are not saying everything is wrong and we tear up the strategy, but we certainly need more resources to deliver.

Chairman: Towards the end we will come back to the action programme that Ofgem has announced, so there may be an opportunity to explore this issue in slightly more detail at the end, but that is a helpful overview, thank you.

Q436 Mr Bailey: These questions are primarily posed at yourself, Lesley, because they are NRFC's statistics, but obviously if Jenny wishes to make a comment then that would be welcome. First of all, in very broad terms you have claimed that the energy firms have made £2.3 billion more in profit in 2006 than in 2003. Can you tell us what is the basis of your methodology for calculating this?

Lesley Davies: Firstly, I need to say that we may have included an incorrect table. The figure is slightly different to £2.3 billion; it is about £2.07 billion and I will send a corrected table but it does not undermine any of the arguments that we have made in the paper. Please accept my apologies for that error. We were really very concerned when energy prices were rising so substantially and the retailers were saying there is nothing we can do about it, it is all just to do with increases in wholesale prices, and we wanted to put that to the test: could you explain the increase in energy prices by increases in any of the supply chain costs? We commissioned a consultancy—we did not do this ourselves as you would not want to trust me with a calculator with these types of numbers—to look at this so that we could produce something really quite robust, bearing in mind though that we were using only publicly available information and that in itself was quite a challenge. We have always said that this is a starting point for a discussion around these areas. It is also something we had wanted Ofgem to do and Ofgem had been asked to do by different parties over

5 June 2008 Jenny Saunders and Lesley Davies

the period when energy prices have been increasing and they had not undertaken this task and we are hoping that they do do it so that perhaps a bit more robustly than we were able to do it, given their own powers and duties as part of the energy probe. We did something really quite simple. We estimated using BERR data the expenditure that had been made by residential consumers in 2003 and 2006. In 2003 it was £14 billion; in 2006 it was £22 billion, not an insubstantial increase and our evidence suggests that you can explain half of that increase only by increases in wholesale costs. You can explain around 20% of it by an increase in what we have loosely termed “other costs” but there are other costs in the supply chain, for example, increases in distribution and transmission transportation costs, those types of things, and costs to serve and so on, but that you were left with around £2 billion which really could only be accounted for by an increase in profits to, we think, just using our data principally from electricity generation.

Mr Bailey: I am trying to phrase this in a way that ensures that we do not get bogged down in a morass of statistics but there are one or two questions that must involve them. First of all, you have said that the increase in fuel plus other costs is 104% and 18%, ie 122%. The increase in margins is 213%, but you have said that reported expenditure has only increased in 58%. I am a little puzzled how you can only get an increase in expenditure of the public buying this electricity of 58%, but the gap between the costs and the margins is that much greater. How do you run these statistics off against each other?

Q437 Chairman: Reported expenses at the top level—is that the total of the three? What is it? I want to make sure I understand what “reported expenditure” actually means.

Lesley Davies: The reported expenditure is the proportion of total expenditure made by all consumers, including business, but we have then reduced that down to what would be representative of residential consumers. The £14.3 million is the expenditure made by residential gas and electricity consumers.

Q438 Mr Bailey: That clarifies one point. My next question was could these be altered if you took in industrial and other consumers?

Lesley Davies: You would increase it.

Q439 Mr Bailey: Getting back to the point, it would seem on the surface that if costs have risen by 122%, but in effect the percentage change in the amount that the public have purchased only goes up by 58%, the companies must have done something to mitigate the increase in costs.

Lesley Davies: You have to take into account the proportion of the bill that is made up by energy, so an increase as I understand it in terms of the wholesale costs would only impact on around half to three quarters of the bill. It differs between gas and electricity so you are not comparing like with like

with those two percentages. I think perhaps it would be better if I dropped you a note about that particular point rather than trying to answer it here.

Q440 Mr Bailey: I am anxious to avoid getting into too great a detail and then the whole thing becomes incomprehensible. There is, however, one point that I must make, and far be it from me to defend the energy companies but I have to play the devil’s advocate in this. 2003 was a year when wholesale and retail prices were very low. Is it really a fair comparator between 2003 and 2006 to make these observations on?

Lesley Davies: We chose 2003 because it was when energy prices were going up and it was also the point at which fuel poverty numbers were at the lowest, so that was really our starting point. It was not a malicious starting point so that we would get a bigger profit number at the end by making the comparison, because had we only taken 2006 and looked only at the profit levels there, I think the fact that the energy industry can make profit levels of just over £2.3 billion at a time when their costs are going up but their prices are going up even more than their costs and there are now four and a half million consumers in fuel poverty, I think is really quite a telling thing. It seems to me that a market that is able to do that is not a market that is working particularly effectively. Even if you discount and ignore 2003, and you ignore the profit comparison, the levels of profit in 2006 are too high to my mind and not fair.

Q441 Mr Bailey: It is obvious that the research that you initiated only goes up to 2006 and there has been quite a dramatic increase in oil and other prices since then. How would you assess the situation has changed since the publication of these statistics in the 2006 timeline?

Lesley Davies: It is difficult to say without referring back to the data because it is difficult to assess how much expenditure by consumers has gone up and what the profit levels of the generating stations that we use to make this has been declared at, but I do know that when some of the price increases were happening at the beginning of the year all the people that we were talking to were saying that there had not been any particular constraints on capacity, for example, that might generate those price increases.

Jenny Saunders: It might be something that you could ask Ofgem to report on if they are doing the energy probe. That is something that they will perhaps have more information on.

Q442 Mr Bailey: I ask you quite deliberately because if action is to be taken by the Government, it must be based on the up-to-date situation rather than the situation that arose in 2006, bearing in mind that things have changed quite dramatically.

Lesley Davies: Ofgem do have access to far better and far more detailed and far more accurate information than we do. We only used publicly available data for this report.

5 June 2008 Jenny Saunders and Lesley Davies

Q443 Mr Bailey: I come now to my final issue and perhaps the crunch issue. Do you feel that on the basis of the evidence in this particular assessment and your assessment of what has happened since that there is a case for a windfall tax and, if so, at what sort of level should it be levied?

Lesley Davies: I personally think there is a case for a windfall tax, looking backwards between 2003 and 2006. It certainly would not be all of the profit that had been made. That would not be sensible. I really do not have a figure in my head but my starting point would be to think about what is the shortfall that is needed to supplement the fuel poverty programmes like Warm Front and so on, and if a windfall tax was not palatable or was not appropriate, I also think that the Government has taken rather a lot in additional revenues from VAT. I think we have estimated that between 2003 and 2004 at around £400 million. There is also petroleum revenue tax that has added to the Government purse as well which I really have no idea about because that is based on profit levels of gas producers and that is a really difficult place from which to get any information. There is an awful lot of additional money going around here that is really on the back of the most vulnerable people in society. It seems to me that it is fair that some of that should come back and help them deal with the consequences of what is happening in the energy market at the moment.

Q444 Mr Bailey: What you are saying, in essence, is that it should be driven by consumer need rather than the balance sheet or future investment plans of the energy companies.

Lesley Davies: I am not saying it should necessarily be driven but that would be my starting point for working out how much you would want to take from the taxation revenue.

Jenny Saunders: The problem with a windfall tax is with hypothecation because, having called previously for a tax on the upstream producers, it did not necessarily result in the programmes that we had advocated. Once the Treasury has that funding it does not always go where we want, but we do think that government should prioritise additional funding as a matter of urgency and, as Lesley pointed out, having the additional revenue from VAT on fuel receipts is a way in which it could fund some of this work.

Lesley Davies: I agree completely with Jenny on that one about you would only want a windfall tax if you could hypothecate it properly otherwise it is not very effective.

Q445 Chairman: What you are saying is that the Government has had its own windfall tax anyhow which could be used for this purpose.

Lesley Davies: Quite.

Q446 Chairman: How do you estimate the fuel costs? I thought these were commercially confidential? I would love to know what Centrica is paying and British Gas is paying for their gas. In a malfunctioning market we do not even know what the actual price is.

Lesley Davies: Some of the information in for electricity is company specific, so we do need to bear in mind just how little information there is available, as you are saying. For gas we used the declared revenue for gas production so of course there is an element of profit included in that and that was for an indigenous supplier. I think we used the month ahead market for imported supply and again that was revenue. There is an awful lot of hypothecation that we have done ourselves in arriving at this. We were the first to put information like this into the public domain and it is a starting point for Ofgem to actually do a much better job with and they can do better.

Mr Binley: I am slightly worried about what looks to me like a sizeably narrow snapshot of a very big issue.

Chairman: We do have the full report that this is based on, so I think we all ought to look at it quite carefully.

Q447 Mr Binley: I understand that but there is a concern there and I think you would share that concern too.

Lesley Davies: Absolutely.

Q448 Mr Binley: I am particularly concerned about what "estimated other costs" are as well because that covers a very big area of activity.

Lesley Davies: This goes again to the way in which we try to get the data to fit together in some respects because there were some things that we could not explain with the numbers. We have been as transparent as we can with the report. We did not really want to use it to make any claims that could not be substantiated by the report itself because that would be irresponsible. We have put it out to the industry, to Ofgem and to government and, frankly, the only criticism that has come back to us has been about whether or not the £2 billion profit was reasonable or not, not really that there is any fundamental inaccuracy in the way in which we have constructed this, given the data that we have used.

Q449 Mr Binley: You have still not told me what "estimated other costs" covers?

Lesley Davies: It is all there in the report but it will include distribution, metering costs, suppliers' costs to send billing systems, debt recovery, transmission, transportation costs.

Q450 Mr Binley: Does it cover investment?

Lesley Davies: Not necessarily.

Q451 Mr Binley: Why?

Lesley Davies: Just because of the way in which we were able to extract the data but the point that you make is completely fair and had we had access to more data and as well in terms of the organisation if we had had more resources to do a more extensive piece of work we would have done.

Q452 Chairman: You are really offering this as a best guess on Ofgem and the 'Big 6' can challenge this if they want to. The 'Big 6' are all coming in to give

5 June 2008 Jenny Saunders and Lesley Davies

evidence later on in this inquiry and I think we will want to push them quite hard on what they make of these figures.

Lesley Davies: I think that will be a really useful thing to do.

Jenny Saunders: When energy prices were going up so dramatically at the same time company profit levels were being reported at record levels. We just wanted to test out exactly how these things fitted together.

Q453 Mr Wright: We have taken evidence in the past regarding the ability or inability of some people to switch from company to company and quite clearly we have your views on that. The NEA says “incumbent suppliers treat their legacy customers like a cash cow” and obviously there are a number of people tied into the companies from your own table up to December 2005. Do you think that the companies should be allowed to get away with charging different rates and also to encourage new customers in knowing that there is going to be a significant number of customers that will not switch?

Jenny Saunders: When the price controls for supply were abolished we did fear at that point that there would be difficulties in this area. The ways in which the tariff structures have been constructed do reward those people who will switch away and onto the cheapest way in which the companies will be able to service them. That is how markets will work. That is how they will want to be cost-efficient, but there are people who for no fault of their own cannot switch because offerings are not put to them; the companies are not giving them incentives. If they are on particular payment methods such as prepayment they may not be able to switch because they are being blocked. Despite a debt assignment protocol, nobody with debt has been able to switch supplier. People who see the companies just keeping track with each other are fearful that if they do switch they might switch to a worse deal. The information put before them is complex and I think we have to recognise that after this length of time with competition there is a sector of society, principally older people and social categories D and E, that are less inclined to switch and will not. We would like to see some kind of either loyalty scheme or some review so that they are offered a discount for remaining loyal to that company.

Lesley Davies: I see this in more competition terms and I cannot really understand the justification for charging in the former payers area consumers who have not switched higher prices than people who have switched away and then switched back because it seems to me that people who have stayed still and not moved and not done anything to incur costs for the company are actually a lower cost to the company. It seems obvious to me that the people who are moving away incur the cost of switching away, having a final bill, being chased to pay that bill and then switching back have incurred marketing costs to the company. It seems a little odd to me and I think an indication of the sluggishness of the competitive market that in an area consumers pay more than they should.

Q454 Mr Wright: Jenny, you have mentioned the fact that there could be this loyalty scheme. Have you had discussions with the energy companies? Has that been put forward to the energy companies perhaps that they should have a loyalty scheme because quite clearly looking at the groups according to this table again it is the over 65s, it is the people on prepayment meters, those that are on fixed incomes that are going to be less likely to switch are those groups who need more help and quite clearly they are not getting that. Presumably the over 65s because they get the winter fuel allowance and perhaps companies see that as a little bonus that they are going to get additional to the other income.

Jenny Saunders: We did raise it at the fuel poverty summit that Ofgem convened and the chief executives of all of the six companies were there and it is for them to think about and to come forward with their offerings under the new social action plan. Some companies are reviewing and one did say that they would go back to all their customers and check that they are on the best tariff for them, but we think it has taken them a long time to think about this and a real push needs to happen now from Ofgem to get behind this to encourage that action.

Q455 Mr Wright: In terms of the figures that you have published there they are three years old now. The message coming back to us was that there is probably less difference between the prices in the companies now than there was three, four or five years ago. Has there been a change in the figures for people switching significantly in those areas since 2005?

Jenny Saunders: There has been an increase in the number of people switching who were on prepayment meters, yes, but that has been driven by publicity campaigns by trying to encourage trusted third parties and charities and local CABs and there is more work to be done on that. Having done some of that work ourselves, working with advice agencies, we recognise how difficult it is. It is time-consuming. People will not necessarily respond just to a leaflet. They need to be taken through the process. There is not capacity in the existing advice sector to help and adequately support people as they go through that switching process. I also do not think that switching is necessarily the be all and end all. Why not have something that rewards loyalty and links it to an energy efficiency package. Some companies are trying to think their way through this, but not on the scale that is needed. We have 4.5 million people really in desperate need at the moment.

Q456 Mr Weir: We were told by energywatch that the average customer saving is something like £30 a year. Is switching really worth it for your average customer? I can see that from a prepayment meter onto direct debit a lot of saving would be made, but for the average customer is it worthwhile, especially now that the companies are raising their prices one after another very quickly?

5 June 2008 Jenny Saunders and Lesley Davies

Jenny Saunders: £30 is for the direct debit customer now, although going on you could save a bit more, but for prepayment meter customers if you think that the average differential is £200—

Mr Weir: I appreciate that, but everybody is told that they should switch but in fact it seems to me that only those who are on prepayment meters and can get onto a better tariff make any real benefit by switching.

Chairman: It is prepayment meter to prepayment meter is what you are saying. We all know that if you switch from prepayment to direct debit you get a big saving.

Q457 Mr Weir: If you are on your average direct debit tariff, as many of us are, is there much point in actually switching?

Lesley Davies: The other issue to take into account is whether or not you have ever switched before because I think there are probably larger savings to be made if you have never switched before, which goes back to Jenny's point about the loyalty issue. The issue of having switched once and whether you switch again for £30 is more the answer to your point.

Q458 Mr Clapham: My questions are on payment types and they are more directed to the NEA but, Lesley, if you want to come in, please do so. One of the things that you say in your submission is that differentials between prepayment and other payment methods have now increased to an unacceptable level. Could you tell us about why you believe that customers on prepayment level are now having a charge that is at an unacceptable level?

Jenny Saunders: I think the differential has been increasing over the past few years as these new online tariffs have come on stream. There are a number of factors. Traditionally the meters are more expensive; the cost of servicing a prepayment meter customer we recognise may be more. However, we do not know exactly what those costs would be. It has been estimated to be in the region of £85 by Ofgem. We would like to see some analysis as to how we can get some more efficiencies into that bit of the market. Overall, energywatch have estimated that prepayment users are being overcharged in the region of £300-£400 million a year. For the individual household if you are on a low fixed income and there is a differential of £300, £6 a week can go quite a long way if you are surviving on £80-£90 a week. We do not think that that is acceptable. A thousand prepayment meters are going in every day to recover debt. The companies use it as a debt recovery vehicle. Customers quite like the idea of using the meters as a budgeting tool but they are being penalised for that and that is the problem. We do not think that the sensible approach that customers are taking to help manage their household budgets should result in such a high differential, but again we expect in September there to be some action. Scottish Power reduced its prepayment meter level down below direct debits and some of the other companies are having to look

very seriously at their differentials now. If it does not happen voluntarily, we would want the Government to step in on this issue.

Q459 Mr Clapham: The figure given by energywatch is enormous, is it not? £401 million excess charges for prepayment meters.

Jenny Saunders: Yes, it is unacceptable.

Q460 Mr Clapham: Is this something that you have taken up with government at all or taken up with the energy companies?

Jenny Saunders: I am a member of the Government's Fuel Poverty Advisory Group and we have raised this over the past two years. We have asked for action on this but again I think the crunch came just a few months ago when the high profit levels were being reported and energy prices were going up. I think it was just at that point that the energy probe was called. We hope that it does result in some action.

Q461 Mr Clapham: One of the things that you say in your submission that you propose prepayment charges be capped at the level charged to standard credit customers. To some degree that is different to what, for example, Ofgem are saying. Ofgem calculate that equalisation of prepayment tariffs for different debit or standard credit will cost the average household £14 to £6 per year respectively. If you introduced, as you want to do, that capped level of charge to standard credit customers, there would be a spreading of the cost, would there not?

Jenny Saunders: There would and that is why we went for the lower figure. It is £6 a year across every customer and we think that that is a fairer outcome than the existing differential. That is our judgment and we hope that those people who are on standard credit on low incomes would be assisted through a social tariff and that would be the mechanism to mitigate that cost for them. That is what we are hoping that DWP will address in some kind of offering to pensioners.

Lesley Davies: Could I make one point about the differential, and it may be a question for Ofgem again. You can also describe the differential as a margin that is there waiting to be competed away by suppliers in the market. It would be an interesting question to ask of Ofgem why they think that margin, in a market that they think is truly competitive, has not been competed away when they keep talking about suppliers looking for new ways of marketing to consumers because that is the thing that I do not understand why that margin exists in a competitive market.

Q462 Mr Clapham: 4.5 million households are living in fuel poverty, Jenny. Is it possible to say what number of those households would be on prepayment meters?

Jenny Saunders: I cannot remember off the top of my head what the estimate is but I think people on prepayment meters are more likely to be on a low fixed income. They are not all fuel poor, we accept that, but then it is not easy to identify everybody by

5 June 2008 Jenny Saunders and Lesley Davies

their payment methods who are in fuel poverty. They are more likely to be on a low fixed income, they are more likely to be in debt. They are the people who are having these meters fitted now for debt recovery so we think that link can be made.

Q463 Chairman: A lot of people on standard credit terms are also in fuel poverty and on low incomes.

Jenny Saunders: They are but they can be assisted through other mechanisms.

Q464 Mr Weir: In the last budget the Chancellor announced that the leading energy companies had increased expenditure on social tariffs to £150 million per year. Do you think that will make much difference to the fuel poverty figures?

Jenny Saunders: If I can make the connection, a 1% increase in the price of energy results in 40,000 people falling into fuel poverty. Energy prices only have to go up by 2.5% for that initiative to have been eroded because it was estimated that that amount of money could take 100,000 households out of fuel poverty. I would put it in that context, but I would say it is not an unwelcome first gesture and we would see it as something to build on.

Q465 Mr Weir: It does a little bit, not a lot that we are seeing.

Jenny Saunders: Yes.

Q466 Mr Weir: Looking at social tariffs, there is a vast difference between the various companies. Can you tell us who gives the best social tariffs and who gives the worst?

Lesley Davies: The only data that we have access to is an energywatch report which used the criteria that BERR may have adopted for assessing social tariffs and that suggested that British Gas and EDF were the best and RWE and SSE were the worst, but that has to come with a huge caveat, not least because, to defend the suppliers, SSE have sought to hold off their fuel price increases more than many of the others, so I am not sure whether you can actually just baldly say best and worst in that context.

Q467 Mr Weir: Is one of the problems that they are so different? Would you support a standard social tariff?

Jenny Saunders: Yes, that is the reason why because it is so difficult to compare the offerings. Some of them have been made obviously on a voluntary basis and they are welcome initiatives, but we cannot with any surety understand which is the best deal for certain people and also they are not available in great enough numbers. They are capped at the moment and our job is to make sure we get as many people onto those tariffs as possible.

Q468 Mr Weir: A standard tariff would allow everybody throughout the country to know exactly what the social tariff is. What action would you have liked the Government to have taken in the Energy Bill on social tariffs?

Jenny Saunders: It is not too late for them still to take action. Certain Members of the House of Lords were keen to put down an amendment. We would like to see an enabling clause that will require companies to offer a social tariff with a clearly defined objective. We would like it linked to eligibility for cold weather payments. We would like to see it have a package of being the company's lowest offering linked to an energy efficiency offering and referred back to DWP for assistance with additional income maximisation advice. That is a holistic approach. That is what is needed and in terms of new policies they are the kind of progressive initiatives that should be brought forward. Energy prices are going to keep increasing; the companies are telling us that. For a long time they said no, we have extra gas storage, we have long term contracts now and we are certain that things will stabilise. You are scaremongering if you say prices are going to stay high. They are now telling us that they are staying high for security and for carbon reduction. We have to respond to that without annual knee jerk, bring the companies in, what are you going to do? We need to set a framework for this going forward so we are not always just appealing to their better nature, appealing to voluntary initiatives. It should be a statutory duty. This is an essential commodity for the health and wellbeing of every household in this country and we cannot leave it to market forces.

Q469 Mr Weir: We talked earlier about a windfall tax. Is it the case then that we are really looking at a future where energy companies are going to have to invest more of their profits back into helping social customers and energy efficiency and in fact they are going to have to make less profit because of that in the future on an annual basis, not just a one-off windfall tax?

Jenny Saunders: We want the companies to make a reasonable profit because obviously they do need to invest in new generation plant, they do need to make those investments and we are not disputing that, and also the energy companies are not social agents of government and we do not want them to behave as such. We want them to be responsible and take care of their vulnerable customers. The Government has to respond perhaps with some additional income payments and stepping up their action. It is amazing that the Warm Front budget has been cut at this time and that is the Government's contribution to this agenda.

Q470 Mr Wright: Moving straight on to the Warm Front issue, what are your feelings in terms of the performance of Warm Front since its implementation?

Jenny Saunders: There are two elements, I think, to this question. One is around the framework for the scheme set by Defra and one is on the delivery by the installers and the scheme manager. I have recently started to sit on the Scheme Manager's Board so I am trying to get my head round some of these issues because we have a maximum grant for Warm Front in England which is lower than the equivalent

5 June 2008 Jenny Saunders and Lesley Davies

schemes in Scotland, Wales and Northern Ireland. People are being asked to pay a contribution to the work which we think is unacceptable. We would like to see the average grant increased but we have to be pragmatic. The Government has set the budget for the next three years at a lower level. We do not think that the programme should be left to provide the existing measures that it is providing. It is limited and we need to bring in new technologies. There is such an irony that at the time the Government has more revenue from higher increases in energy prices, it has cut the budget for Warm Front.

Lesley Davies: The other thing to bear in mind certainly with the grant maxima is how are the top-ups picked up? Clearly most low income consumers would find £400-£700 completely out with their budgets to take advantage of Warm Front which is a really good scheme in delivering benefits when all of the things fit. We know from things that our members have told us that it is local authorities who pick up the difference. It is the British Legion that picks up the difference, so there is an awful lot of responsibility being met elsewhere. If someone else is picking up the bill why would you feel the need to address the issue of top up, but it can, if those moneys are not available, mean that people who really, really need the benefit of Warm Front do not get it because they do not have access to the funds to make the top up.

Q471 Mr Wright: I think most MPs have been involved in terms of some of the issues surrounding the top ups on this, but one of the issues that has been raised with eaga and with others is this question about the client can actually get the job done cheaper in the locality than by the preferred installer from eaga. This has been flagged up on numerous occasions where perhaps the £2,700 would be sufficient if they were allowed the flexibility of getting a Corgi registered local installer to do exactly the same job as the one that has been given the contract. Is that something that has been raised as an issue?

Jenny Saunders: It certainly has. There was a quality study carried out for the board that made these comparisons on costs that Warm Front were being charged by installers and other companies providing a national scheme for heating and insulation. It appeared that Warm Front was not paying over the odds. It is comparing like with like. Some people, if we were to hand over that grant, would be quite capable of going and arranging the work themselves, but others would not. For a government scheme you have to have monitoring; you have to have some insurance; you have to have health and safety considerations at the forefront. That is my view that it may be done cheaper locally in some instances, but overall I do not think that you would have the quality control and you would have that certainty that you are getting a good quality of work.

Mr Wright: The fact is that with gas installations you have to be Corgi registered. The regulations are very strict in terms of installation for protection and everything else. If that person is a Corgi registered installer and can do the job for £500 cheaper, surely

that should suffice the regulations because that person has to register on an annual basis for his or her Corgi standard?

Q472 Chairman: We are addressing these questions to eaga in a few minutes' time as well. We have technically four minutes left and two areas of questioning left, so we need to be brief on this.

Jenny Saunders: There is certainly more that we can do to bring together the Warm Front and the CERT schemes into a more holistic package. We might get some more cost efficiencies in there as well.

Q473 Mr Wright: Finally, you have put forward a case for an improved hybrid programme with CERT as well as Warm Front. Can you tell us how it would operate?

Jenny Saunders: What we have tried to do through our subsidiary charity that NEA runs—Warm Zones—and in the 11 areas it is operating it tries to bring together the different grants available—Warm Front, the local housing board funding—but they all have slightly different objectives. One is a carbon reduction target, one has a social need. If we are to have something that is more meaningful for the household that we could not have to pay administration costs twice over, we might have some of those efficiencies and you would have a better package offered. It could be then that local authorities identify the need in a local area and they can draw down funding from a central pot. It is that kind of thing we are exploring as we go through into the next stage of obligations on the suppliers from 2011. Let's be a bit more creative and think about the tariffs being built in; a social tariff linked to an energy efficiency package that might look different to just loft insulation or cavity wall.

Lesley Davies: It could then be the focus for a really strategic approach to dealing with fuel poverty which we have discussed already is pretty lacking. The only concern I have with that type of scheme though in my experience is when you hive off the least popular part from the popular scheme it tends to suffer by withering on the vine and not getting the budget that it had previously had. I would have that cynical concern about such a scheme.

Q474 Mr Binley: I have three questions about incomes. You have both been pretty critical of the Government in terms of the way it distributes additional income for the purpose of overcoming fuel poverty. What more could the Government do through the benefit system? Is there anything you would advocate?

Lesley Davies: We certainly want to see the winter fuel payment extended to people who are non-pensioner households that are currently eligible for the cold weather payment because I think that will cover about half of the people who are in fuel poverty. That would certainly be one thing that the Right to Fuel Campaign would advocate.

Q475 Mr Binley: Is it a very inefficient system of dealing with what is a sizeable issue?

5 June 2008 Jenny Saunders and Lesley Davies

Jenny Saunders: The winter fuel payment is going to about 11 million older people and it maybe is not reaching those people who are in fuel poverty.

Q476 Mr Binley: How do we improve it?

Jenny Saunders: One proposal might be that we tax you on the payment that you receive, so for higher tax payers—

Q477 Mr Binley: Is that not more expensive for the taxpayer all this administration? I want a more focused sharper point to what you are trying to do. I agree with what you are trying to do but I want it more focused and sharper.

Jenny Saunders: We recognise that the winter fuel payment is not really a fuel poverty measure. The Government estimates that it takes out about 100,000 people out of fuel poverty as it is defined as an income measure. It is very popular with older people and we do not want to see it taken away. We want to see some additional kind of payment to those who are on pension credit and I think that is something we want to explore with DWP over the next few weeks how we can get an additional payment for them.

Q478 Mr Binley: In truth we have no real answers at the moment about how to spend taxpayers' money more efficiently to achieve the object you want to achieve. That is my concern.

Jenny Saunders: The sustainable way is by putting in more insulation and better heating systems, by improving our housing stock, but we recognise that that takes time. That is where we would best spend taxpayers' money, but we have an immediate crisis where people just cannot afford it because their incomes are too low. An additional payment is what is needed.

Q479 Mr Binley: Will the increased winter fuel payment cover the increased costs of energy this winter?

Jenny Saunders: It depends how much the companies put the bills up by.

Q480 Chairman: Probably not is the implication because you said earlier that you expect further increases in energy prices.

Jenny Saunders: It depends. The over 80s are getting an extra £100 on top of the £300. It is a very significant amount of money but if we look at what

it used to buy, it used to buy about 35% of your fuel bill; it buys about 24% now. It does not have that great an impact.

Q481 Mr Clapham: How useful is Ofgem's *Fuel Poverty Action Programme* in helping to reverse fuel poverty?

Jenny Saunders: It is not going to reverse the fuel poverty trend significantly by its own admission. What it is trying to do is to help people take advantage of what is on offer in the market and to push through some voluntary initiatives. In terms of the overall fuel poverty strategy it is not going to significantly reverse the trend. It will bring forward some very welcome initiatives, and we are not knocking those at all, but we have to be serious about where the funding gap is. It is at about £200-£300 million a year for the next ten years as estimated by FPAG a couple of years ago before prices were where they are, to be invested in energy efficiency programmes and not just in social tariff rebates.

Q482 Mr Clapham: My final question is we have three government departments that are in some way involved with fuel poverty—BERR, the DWP and Defra. Given that there are three government departments with different responsibilities for fuel poverty, does it prove to be a barrier, or is it working reasonably well?

Jenny Saunders: It is a cross-departmental issue, as we know. It is welcome that they all have their own responsibilities and that is fundamental to what we want. We would like to see the inter-ministerial taskforce meet again. It was established but it has not met, so perhaps at a ministerial level it would be helpful to bring them together formally again. I think behind the scenes they are currently trying to join up initiatives. For Defra, their fuel poverty objective is a departmental objective, one of 70-odd now. We would like to see it having greater priority and further up the list because there is a fear that the reason we got the cut in the Warm Front grant was because it was lower ranking than it had been.

Chairman: Ladies, thank you very much indeed. We have slightly over-run, but not by much. I hope you have had an opportunity to say all the things you wished to have said. I think some further information was promised in some respects, but if there is anything you think you would like to have said to us, please feel free to put that in writing. Thank you very much indeed.

Witnesses: **Professor John Chesshire**, OBE, Acting Chairman, Fuel Poverty Advisory Group, and **Mr John Clough**, MBE, Chief Executive, eaga, gave evidence.

Q483 Chairman: Gentlemen, welcome to this second part of today's evidence session. Thank you for your written evidence, which I appreciate. Could you introduce yourselves and your organisations for the record?

Mr Clough: John Clough, Chief Executive of eaga plc.

Professor Chesshire: I am John Chesshire, a member of the Fuel Poverty Advisory Group, currently acting Chairman of that group.

Q484 Chairman: Professor Chesshire, there is one thing that intrigues me about your memorandum. It has some quite critical things to say about the structure of the industry and implicitly some of the behaviour of some of the members of it. I notice that Graham Kirby of E.ON, Ian Peters of Centrica and Eva Eisenschimmel of EDF Energy are all members of the group. Do they not come to the meetings?

Professor Chesshire: They do indeed. They are a broad church, FPAG members. You are quite right, we have government officials there and we have the voluntary sector, we have the housing sector, fuel poverty organisations and the energy suppliers. We can very rarely aim at unanimity, Chairman, but we do aim at the highest common factor most of the time, but where there are a set of views which is shared by a majority where there clearly is a problem affecting fuel poverty we try to express it even though the energy suppliers sometimes would not wholly share our views.

Chairman: That is a helpful clarification.

Q485 Mr Wright: In terms of Warm Front you heard my comments beforehand. What are your views so far as the performance is concerned of Warm Front?

Professor Chesshire: As far as the Fuel Poverty Advisory Group I think we see it as a very successful scheme in itself. It has been evaluated, there have been some difficulties, some of which you raised yourself a little earlier with other witnesses, but where there have been value for money assessments undertaken of the scheme by government and by the Scheme Board of Warm Front (eaga), it is shown to be broadly successful. I am sure lessons have been learnt from those evaluations. I am not being entirely complacent of it. The primary criticisms are the sheer scale of the programme and we can come to that maybe later on. You heard also about the limit on the grant maxima which is becoming a constraint in the programme. Some people would also see a greater focus by joining up some of the alternative delivery programmes such as CERT and Warm Front maybe at an area based level.

Mr Clough: In terms of the scheme itself at a macro level the indicators are that it has never been more successful than it is at the moment. It has assisted getting on for half a million homes in the last two years. The average impact on fuel bills is of the order of £300 per annum. Those people who receive a heating intervention then that saving is considerably more than that but, as John has said, and as you yourself have echoed, there are some challenges in

the programme. Some of those are architectural by the nature of the scheme in terms of its grant maxima, *et cetera*. To give you a feel for that, because I know that that is a matter which particularly interests Members, since 2002 the grant ceiling of £2,700 has risen by 8%. In the same period, RPI is above 20%. That is not to be complacent. We have applied downward pressure to pricing and the supply chain and that has been somewhat successful, but we have moved from a programme which, in 2000, was hailed as effectively free at point of access—whilst the word “free” was not used, that was the implication—to a system where now if you are eligible for a heating intervention, and 65% of those people who we assist do get a heating intervention, about half of them are expected to make a contribution now. The average contribution is over £500 and, as Jenny said in her evidence earlier, that is a significant sum for this client group. It is unsurprising, therefore, with the pressure on this client group that we have because of high energy prices, and the demand has never been higher for the programme, nor its satisfaction levels higher, that we have got this confluence of forces which is bringing to bear a very high demand and with some individuals who are in great need an inability to fund the excess themselves. We work very closely with local authorities, caring agencies and the likes of the British Legion. Indeed, we ourselves have a corporate social responsibility fund and this year we will forego £2 million of contributions as effectively the installer who is the backstop to provide these services if no-one else will. So there is a significant amount of contribution from the supply chain, from local authorities and from caring agencies, but there are still 16,000 people on my waiting list who cannot have a heating system because they cannot afford it.

Q486 Mr Wright: Have any customers been prevented from going ahead with the Warm Front because they could not afford the top up, or has there always been something in place to take into account that amount?

Mr Clough: There are a number of people who basically say “*I can't afford it*”. We try every available route to assist them. They look obviously to see if they can afford it by some other means but there are a number of people who have sadly fallen by the wayside because they just cannot proceed.

Q487 Mr Wright: Do you have numbers?

Mr Clough: There are 16,000 at the moment who are sitting there waiting for more funding. That is not to say all of those will not go further, but all I can do is give you a snapshot in time as to the number of people who are not proceeding through the programme.

Q488 Mr Wright: Is that 16,000 who could not afford the top up, or is it 16,000 waiting for the next tranche of money to come through from government?

5 June 2008 Professor John Chesshire and Mr John Clough

Mr Clough: No, we are not constrained at the moment in the sense that we have not run out of money, but each individual only gets £2,700, so those 16,000 are sitting there with a bill greater than £2,700. We know from the independent assessment—no-one was keener than I to see the result of that appraisal—was that the equivalent service in the, if you like, private sector where you go out and seek your own contracts would be 57% more expensive. If I can just pre-empt one of your questions which you asked previous witnesses—why is it that a local installer can offer a cheaper price—the question is about sustainability of that price offering and there is always a spot market available and that is not to decry that, but a very important point is compliance with the likes of Part L of the Building Regulations. The big difference between the likes of Warm Front and if you or I went to our local installer is that, under Warm Front, we inspect 100% of all of the heating systems independently to ensure that they have been installed to those building regulation and safety standards. If you or I went to a Corgi registered installer, I am afraid we would take that Corgi registered installer's view that he was operating to standard and, to be perfectly frank, as a non-technician I would have to take his word for that.

Q489 Mr Wright: I have raised a concern with a particular constituent of mine with yourselves and I would question that particular statement in that respect, but in terms of the eligible households, how many would you estimate in the UK would be eligible for Warm Front if they were to put their name forward for it?

Mr Clough: I would concur with the earlier figures where we have, in terms of eligibility for Warm Front, around the three million number because they are the vulnerable fuel poor as opposed to the larger cohort of fuel poor households at four and a half million, vulnerability being determined as disability on a means-tested benefit, *et cetera*. Those are the proxy eligibility criteria which enable you to apply for Warm Front.

Q490 Mr Wright: Was there any reason given to you by the Government as to why the spending had been cut in this particular area?

Mr Clough: Government do not need to account to me. The company is there to deliver the programme at the funding levels provided. Clearly the impact is significant.

Q491 Mr Wright: In terms of numbers, even at the level of £2,700, how many are we talking about in reduction on an annual basis?

Mr Clough: On an annual basis the funding has gone from £350 million or so of government funding last year to the order of, and I have yet to have the final number confirmed, £280 million this year, so a £70 million reduction at an average grant spend of about £1500. That gives you an impact on the number of households, but in fact because of the increase in what I would call run rate—the rate of activity month by month—at the end of last year Warm

Front was operating at a level on an annual basis in the last quarter of about £400-£410 million, which is now reduced to £280 million, so the downturn is significantly more.

Q492 Mr Wright: If the Government was to come back and say there are financial difficulties and decisions to be taken, which there always are, how would you suggest that they could actually claw back or raise the extra revenue required to breach that particular gap, but also go a step further to make sure that there is more than enough money in there to take into account the extra costs, but also the number of people that would require this, because quite clearly this impact of Warm Front would have an effect of reducing the number of people who are in fuel poverty.

Mr Clough: It would and it is very effective at alleviating fuel poverty. If we were just looking to restore the budget, then we would be looking for something less than £100 million per year, but the true demand out there is well in excess of £400 million per year. We know that from the demand we get in our contact centre and through our networks each day. In terms of where would those funds come from, there are a number of choices but clearly they are political choices and we just offer some thoughts on that. We have looked at winter fuel payments in terms of every individual gets those, whether they are on a higher tax band or not. The impact of taxing those people on the higher band and recovering that would be, we believe, of the order of £200 million per year, so there is an opportunity there. Increased fuel prices of course, whilst they are the cause of this problem, also bring increased VAT receipts to the Treasury and the estimate there from such as FPAG is of the order of £400 million per year. If you were to look at recycling the “windfall” under EU emissions trading schemes, that also has been estimated at about £400 million a year. I think there are levers which can be pulled if the political will is there to pull them.

Q493 Mr Wright: You highlight nearly a billion pounds of extra income which could be put to good use.

Mr Clough: Indeed.

Q494 Chairman: I think we have covered some of this ground already in your earlier answers and we can take this quite quickly. How successful do you think the Energy Efficiency Commitment was at tackling fuel poverty?

Professor Chesshire: As an energy efficiency programme it was a great success. The provisional evidence from Ofgem, which I received earlier this week, suggests they have overshot the three year target 2005-2008 quite considerably. When I looked specifically at the impact on fuel poverty the only data I could find readily, Chairman, was in the Government's own fuel poverty annual report of last December which said, looking at the last six years of EEC 2002-2008 and the CERT Programme to 2011, that nine year period would lower fuel poverty

5 June 2008 Professor John Chesshire and Mr John Clough

numbers by about 100,000.¹ It is important to bear in mind though that those programmes were not designed as fuel poverty programmes. EEC was designed primarily as an energy efficiency programme and certainly the Carbon Emissions Reduction Target, as its name implies, has placed even greater weight on carbon savings, so in a sense almost by scheme design the fuel poverty reductions are incidental.

Q495 Chairman: Should CERT be about fuel poverty at all?

Professor Chesshire: A big battle certainly in the Fuel Poverty Advisory Group. We argued a case for a significant increase in capital programme resources both from Warm Front, the Government-funded programme for England, but also from the extension of EEC and what became known as CERT. We argued for about a billion pounds a year of capital programmes in England. If Warm Front had been kept at the same level that would have been running at or about £400 million or thereabouts, but as you have heard it was cut. We argued, as public expenditure pressures were mounting undoubtedly last year, that the share that went into the priority group in CERT should remain at 50%. The Government, as you probably know, chose to lower that to 40%, although they have now said that they will include all those over 70 years of age, so there is a bit of a widening. The focus on the priority group is exactly the same as that on fuel poverty—it is a very broad proxy—so our view is that overall the resources for fuel poverty have not increased and certainly in relation to the population now suffering fuel poverty they have diminished.

Q496 Chairman: The best way to reduce carbon dioxide emissions would be to move entirely to renewable energy and nuclear energy supply, would it not? It would not do anything for fuel poverty at all though, would it?

Professor Chesshire: I am not sure that is true, Chairman. In the climate change programme evaluation on which John was talking earlier in a different context, the third most cost-effective carbon reduction programme in the United Kingdom was the Warm Front Programme.

Q497 Chairman: Let's look at the extent to which Warm Front and CERT overlap. You have already mentioned this earlier. How bad do you think that overlap is?

Mr Clough: There are three areas of potential overlap or integration: at the policy level, at the financial level and at the implementation and delivery level. At the policy level clearly they have primary objectives which are separate. Warm Front is a social policy programme. The Energy Efficiency Commitment (CERT) is a carbon reduction programme. There is some overlap which is attempted but they are largely separate. At the financial level we do have a degree of interaction

because what we are delivering is essentially, to a large extent, insulation in homes. Both of those programmes have that target in their sights and therefore to the extent that eaga as Warm Front main contractor can persuade a utility to contract with us to fund the insulation measures that we find as we enter a home so that we will pay for the heating system, and hopefully reduce the level of contribution required of the client whilst the utility pays for the insulation and we do that. To give you an idea of the quantum, last year with a government budget of about £350 million we raised about £25 million from the utilities in addition to that by trading those credits. At an installation level we have an interest in that regard. Where we enter someone's home we will look to fund the measures again by whichever route is possible. That can be confusing for the client because they are not quite sure who is paying for this, what the deal is, it is not a joined up approach. My own preferred solution is that wherever we can do the financial reconciliation and as far as the customer is concerned it is a seamless experience that someone else—an accountant in a back office—does the financial reconciliation and sends the invoices either to Government or the utilities with forward facing contracts to give us assurance in that regard. That is by far the most cost-effective way of doing it and the most seamless and best customer experience for the client.

Q498 Chairman: How does that marry up with the NEA's suggestion of a hybrid scheme?

Mr Clough: I would see the NEA's version of the hybrid scheme to be more a joined up version of what you can do on the ground and we are great supporters of Warm Zones which effectively then spurs the hybrid programme. In that regard where you look at a national programme in Warm Front or a Warm Zones local based initiative or a hybrid base, the key word in this policy agenda is "and", not "or". They each have their place, they each have their function and it is very important that we join those together and we do simply because we know one another in the field and work very closely on these things to reduce confusion as much as possible for the customer.

Professor Chesshire: Warm Front only targets the private sector and primarily focuses on central heating systems as well as insulation. The CERT programme by and large is wider than that. Historically the EEC programmes have been used very heavily by local authorities and residential social landlords and so on because there are clusters of properties that contractors have found attractive to handle. They are running out of those clusters. The only other point I would make is that really neither programme has an objective of eradicating fuel poverty. We have no policy instrument in place to eradicate fuel poverty. I know that sounds an absurd point to make, Chairman, but it is a fact.

Q499 Mr Wright: I have a couple of quick questions because I think they were covered in the previous session and, Mr Clough, you mentioned it very briefly in terms of the winter fuel payment. Do you

¹ *Note by witness:* The source for this data is the Government's 5th Annual Progress Report—The Fuel Poverty Strategy, December 2007, page 19, paragraph 3.27.

5 June 2008 Professor John Chesshire and Mr John Clough

consider it is reaching those most in need and if the increase that has been announced this year is going to actually take more people out of the poverty trap anyway and cover the extra costs?

Professor Chesshire: May I make a number of points in response to that question. In the Fuel Poverty Advisory Group we take the view that the winter fuel payment is not really a winter fuel payment; it is kind of a Christmas payment. There are those of us on the Fuel Poverty Advisory Group on the other hand who would say revenue support is running well over £2 billion a year UK-wide for winter fuel payments. The capital programme is almost a tenth of that through Warm Front and the devolved equivalent. Some of us are concerned over time of incremental changes—the increments of expenditure on Warm Front and increments of expenditure on revenue programmes such as winter heating payments. You have heard others give evidence today arguing for an increase in winter fuel payments. What I would say there is that we do not know in public policy terms where the next £50 million is best spent. Is it on a capital programme, an increment to Warm Front? Is it on revenue support to winter fuel payments, or might it be £50 million to DWP to increase take up of benefits, because we can take up benefits by those who are not claiming them. On average I think the benefit health check increases household income by about £1400 a year. That would make a dramatic effect. I think we need some cross-Whitehall analysis with the constrained resources of where is it best spent. Specifically to your question, as John has said, those paying the 40% marginal rate of tax are receiving approximately £200 million a year of tax free income. They are not a priority group I would have thought. FPAG has argued if resources really are tight you have to tax that back. The other area for revenue is value added tax. We heard earlier this afternoon that the increase in consumers' expenditure in the household sector on energy in the last five years is £8 billion. The Chancellor gets 5% of that through VAT and there is £400 million. There is the windfall tax already, as it were, so there is money there. The question is where do we most cost-effectively spend it? At FPAG we cannot tell you that at the moment.

Q500 Mr Wright: Surely the most cost-effective way, as you have said, is the benefit checks which flag up £28 a week extra income on average which in itself will draw people out of the fuel poverty area. The Warm Front scheme quite clearly reduces the need for energy and conserves the energy and the carbon neutral as well in many respects. Ultimately is the only way out of this problem that we have with high energy prices by increasing the incomes of the individuals, or is this something that we can do extra?

Professor Chesshire: Incomes is clearly an important way to go. Whether we can increase incomes at the rate prices have increased is another matter and with an economy which OECD projects will grow at 1.7% for the next two years, by and large it will be very difficult to increase incomes more than that across the economy and prices are going up, as we know,

between 35–40%. Even incomes have a limit when prices change at that rate. The only sustainable way is to make our dreadful housing stock more energy efficient. If one does take the view that energy prices will rise in real terms, then by definition they will probably also rise faster than incomes. That again caps the extent to which you can rely on increases in incomes. The last thing I would say is that I think looking forward, both for carbon reasons and for fuel poverty reasons, we have to change the nature of competition in the energy market and that competition has been based to date on competition on the price of a kilowatt unit of energy, whereas the problem facing the fuel poor is the size of their energy bill. What we have to do is to aim to minimise the size of the bill and not get quite so exercised about the size of the unit price. Again, it takes us to energy efficiency measures, capital programmes and so on.

Q501 Mr Weir: Do you think the energy companies are making enough progress in reaching the fuel poor through social tariffs?

Professor Chesshire: No, I do not, but if I may speak personally because there is a difference of view amongst our members at FPAG, I really question the weight government is placing, and possibly Parliament, on the role of competitive companies to tackle the social problem. Government has a statutory objective set by Parliament to eradicate fuel poverty by 2010 for the vulnerable and by 2016 for everybody else. It is now setting up much vaunted targets to tackle climate change. When the going gets tough, the tough get going I suppose, and one looks for a wider range of players to be blamed and hence this increased focus on the energy companies. I think the energy companies can do more—we have had examples of that this afternoon—but they are never going to be the lead players in tackling UK fuel poverty, let's face it. At best what they do is tokenistic. What worries me is, with the Ofgem summit and other initiatives taken recently, our eye goes off the ball onto the sticking plaster and not onto the gaping wound. That is the perspective I would come to it as someone advising a group such as this. Do not get carried away with the marginal increase in money here on a social programme by an energy company when the resource requirements are just so much bigger than that, probably in order of magnitude bigger than that.

Q502 Mr Weir: But they are part of the solution to tackling fuel poverty from what you have said yourself. Is part of the problem, and specifically we appreciate there is a wider context regarding social tariffs, in the way that they vary so much from company to company?

Professor Chesshire: They do vary because different companies have a different definition of corporate social responsibilities (CSR). Some sponsor sport, some sponsor NEA conferences or whatever it is and they have that difference of objectives, so I am not surprised that there would be a difference of approach to the specific issue of fuel poverty as well.

5 June 2008 Professor John Chesshire and Mr John Clough

As we have heard, some have claimed to have lower tariff levels than others and so on and it would not be surprising if those which have a larger amount of profits to play with might appear more generous with their social tariff initiative, whereas one might properly ask them why is the tariff so much higher in the first place? There is a fog of war out there on the battlefield but my point is this: can it be more than a sticking plaster? Can we really expect profit-making companies to address the social ills such as fuel poverty? Yes, we can, because of corporate social responsibility—some would be very good at doing it—and we can also ask them to experiment. I think if we did get six companies doing more work in this area we might get more knowledge of best practice. What is the best way of reaching the really hard to reach customers, for example? Which marketing campaigns have worked more successfully? Those kinds of issues—engagement of trusted social partners on the ground, for example, the churches, the faith and community groups and so on, all those kinds of groups we could learn a lot from a higher level of social activity by the companies. I am saying do not rely on this to resolve the problems that confront Parliament and the Government.

Q503 Mr Weir: I do not think anybody is relying on it as solving the problem. What we are trying to get at is, first of all, the Government argue that by not mandating specific social tariffs it allows the companies to innovate. That seems to me to be what you are saying as well. Do you accept that or do you think the Government should have a mandatory clear social tariff that applies equally to all the companies operating in the market?

Professor Chesshire: I think FPAG's judgment will be we want a mandatory minimum floor if we are to go that way, but not a cap.

Q504 Mr Weir: The other side of the argument is if we put a mandatory tariff in, the minimum becomes a maximum because companies will only do what they have to do. Do you accept that?

Professor Chesshire: In the dynamics of competition that is the case. In our earlier debate we did not touch on the dynamics of competition. The issue is that those customers who are most mobile, most socially adept, most technologically fluent in the internet and telephoning call centres are the most mobile and you are left with a rump who are less able to move, less socially confident, less in possession of the information and that will be exploited.

Q505 Mr Weir: There is no competition for these customers.

Professor Chesshire: When I was advising your predecessor, Chairman, one anticipated this very point that the mobile part of the customer base would become mobile and the margins for them would be competed away. When I first switched I saved £142 as a direct debit customer to direct debit. We are now talking about £30. There is no competition in the pre-payment end of the market.

Q506 Mr Weir: To get a meaningful social tariff, accepting all that you say about it, it does not tackle the whole problem. There is going to have to be action by the Government to set a mandatory minimum. Would you accept that?

Professor Chesshire: I think it needs to be examined. We have not formally at FPAG taken the view that that is the way to go because we want to see what the offer is. We want to see some evidence, but it may well be that if capital programmes cannot increase and for the reasons I have given incomes cannot increase at the rate that price increases in this area, then we might need to consider this. The problem is some groups—this is my own personal view—will want the net spread as wide as possible. If you have say eight million households receiving a social tariff being supported in total by 25 million customers, there is an awful lot of cross-subsidy. The nearly fuel poor suddenly find themselves subsidising the fuel poor and become fuel poor as a result. This is why FPAG as yet has not taken a decision yes, that is what we want. We want to see what the offers are. Clearly the wider the number of social groups entitled to this tariff, the bigger the challenge is in its sustainability over time, but it is an option which we need to bring onto the table.

Q507 Mr Weir: Taking it slightly wider, I did raise earlier with the other witnesses those who are off grid and not on the gas supply, for example, have you thought of any way in which they could be helped with the rising prices of fuel oil or bottled gas and suchlike which are not covered apparently by Ofgem's recent fuel summit or any other regulation?

Professor Chesshire: I think all of us have paid insufficient attention to the non-reticulated customers—not the wires, not the pipes in other words. The amount of research time focused on households using coal, oil or LPG has really been quite small. There was a Competition Commission inquiry some two years ago about LPG and so on and who pays for the tanks and whether customers are locked in, but by and large outside Northern Ireland, I think, the amount of policy attention focused on customers using coal or oil has been quite small. Those numbers are quite small and, as Mick Clapham will tell you, Chairman, a number of those are still in receipt of concessionary coal and so on.

Q508 Mr Weir: It is estimated at one and a half million households.

Professor Chesshire: There is a problem there because as you are moving solid or liquid fuels into rural areas the transportation costs are very high as well because the amount you are dropping off at each point is comparatively small compared with a dense urban area. Even if one moves to renewable sources of supply like biomass, unless one can get clusters, rural areas are always going to be disadvantaged because you are moving a low density fuel around quite large distances using oil as the fuel to transport it by and large, so that is a problem. I think programmes such as Warm Front over time, and certainly CERT over time, need to look at a range of renewable micro-generation technologies,

5 June 2008 Professor John Chesshire and Mr John Clough

for example, both at individual household level and, where applicable, because of scale at an integrated level, maybe a local dairy and a farm with a school and houses and so on. Not much field trial data exists on those—it is being accumulated—but we have not spent enough money in my view on soundly-based field trial data to inform public policy and scheme design, but that will be a feature I have no doubt of policy programmes in the next five years or so.

Q509 Mr Weir: There is nothing that gives any immediate solution.

Professor Chesshire: There is no silver bullet I regret to say.

Q510 Chairman: You have heard what I said in response to the last session to the lack of joined up energy regulation. From the Office of Fair Trading letter it is quite clear that they can only do this by launching a full scale inquiry and they say that they must prioritise their work given its limited resources. There is no-one going oversight here in the way there is with gas and electricity.

Professor Chesshire: If I could challenge you, Chairman, there is no ongoing oversight in respect of the gas market. The reason you are having your inquiry and the reason why so many of us are getting rather vexatious is that those who believe in the much vaunted market do not want to evaluate its successes or its failures. FPAG has always argued, and it should be evidence-based—I think Sir John Mogg takes the same view—let's do this, but let's do it regularly, annually and report frankly and let's have it peer-reviewed as well, I would suggest, not just done by the agency responsible for the regulation. That is a personal view but peer review is quite important.

Q511 Chairman: Our next witnesses are Ofgem so I am sure these issues will be put to them. I would like to engage in the philosophical discussion about why—I am intrigued by this debate about social tariffs—it is right for energy companies to offer cheaper prices to some of their customers but not for food supply companies like Tesco's or Sainsbury's. We will not go into that debate now.

Professor Chesshire: That is my next session tomorrow, Chairman!

Q512 Chairman: Let's look at the differential between different forms of payment. Why is the average differential between direct debit customers and prepayment and standard credit customers so large? Why do they increase these differentials?

Professor Chesshire: I do not think we wholly answered the question, Chairman, going back to your colleague. I think lack of competition in some parts of the market—competition for mobile customers on direct debit was intense early on. They were seen to be lucrative customers, they were seen to be trouble-free customers, they paid up on time and did not cause debt or disconnection problems and they were seen as the obvious target market for suppliers operating outside their historic catchment

geographical area. No one found competition for the fuel poor or those on prepayment meters, which are not quite the same, as attractive; in fact, obstacles were often put in their place where they had accumulated debt to prevent them switching suppliers and so differentials widened for that reason—market dynamics. Why they have widened in the last year or two defeats us, Chairman. We have drawn attention in the FPAG annual report now for the last three years to the evidence of this widening differential which cannot be explained by novelty of a newly liberalised market. We have had the liberalised market going for a long time now, so opportunistic companies did take, in my judgment, opportunity to raise margins where they could in the least competitive part of their business. We have argued, and Ofgem knows this, that Ofgem is the only body really fully qualified with access to all the information up and down the energy supply chain to take a look at this. We have said that two or three years running.

Q513 Chairman: You have partially answered all the other questions I wanted to ask you in that helpful answer. If prepayment meter customers who are not identical with fuel poor customers—many fuel poor customers are standard credit—but if they are being ripped off by the energy companies with making more money out of prepayment meter customers, then there should be enhanced competition for them logically. If they are paying they should be attractive customers.

Professor Chesshire: I am an economist and at some point you must be right. The margins get sufficiently fat, as it were, for some innovator to come in and say we will specialise in that part of the market, what others might have regarded as the awkward corner of the market. If that does not happen then there is yet another solution of course which is technological change and we will I hope before too long see the roll out of smart meters and this will squeeze those price differentials. That will take a somewhat longer time.

Q514 Chairman: We have had this discussion before in this Committee and smart metering is often raised as a solution to carbon dioxide emissions. My own personal view is that it is much more likely to help competition in the energy market by highlighting prices and encourage switching.

Professor Chesshire: Yes.

Q515 Chairman: As a direct debit customer myself who feels his energy supplier always overestimates what I owe the company and therefore I think is taking too much money off of me too regularly, is there any prospect that direct debit customers are being ripped off by excessive upfront charges?

Professor Chesshire: This is a periodic one, Chairman, and that is the amount of idle balances carried forward each quarter by the energy companies. Certainly at a time when energy prices were falling that was a problem and people were accumulating large amounts. I think some quarters I had over £100 sitting there idly during the summer months which the companies explained in their

5 June 2008 Professor John Chesshire and Mr John Clough

covering letter would be used to pay off my higher consumption in the winter and by and large that is true. In a rising energy price market of course that is much less likely to be true. In fact, I would think, and we do not have an FPAG position, the majority of customers were rather glad to find that they did have a bit of a carry forward to soften the blow when it came. Ofgem needs to take a look at that but I think it is not quite the issue it was because we are on a rising price curve, not on a falling price curve.

Q516 Mr Weir: The amount taken by direct debit is rising every time prices go up.

Professor Chesshire: That is true.

Chairman: Speaking from my personal experience, I did have large carry-overs when prices were falling and I think on the whole I am doing rather well now when prices are rising.

Q517 Mr Bailey: Energy companies' profits—I gather from your submission that you broadly agree with the figures given by the NRFC in terms of companies' profitability?

Professor Chesshire: Yes. We do not have a big research budget. We do rely on the resources of officials in BERR and Defra and sometimes from Ofgem. Where we placed our own weight in the last two or three years is looking at the resources required for fuel poverty so we have not tracked this area so our submission relies fairly heavily on the work of others, particularly the National Right to Fuel Campaign.

Q518 Mr Bailey: Why do you think energy companies have sought to increase their profit margins and, secondly, who do you think has been the biggest beneficiaries of these increased profit margins?

Professor Chesshire: We argue in our memorandum that the difficulty is arguing what is a reasonable level of profit in this rather complex energy supply chain. Undoubtedly there was a time probably five years ago, maybe a little longer, when margins were being squeezed quite severely and there was concern about a mounting backlog of power station replacement building up over time. If this was likely to be low carbon technology it was possibly at a higher capital cost than combined cycle gas turbines, for example, so there was some public policy concern of the profit margins being made by the industries. I do not want to sound an apologist for them, but clearly they were being squeezed very hard at that time. I think most reasonable analysts would have expected some return to normal profits. The difficulty is defining what that normal profit might be. Clearly the pendulum has gone the other way for various reasons and they are now making very significant profits in view of the National Right to Fuel Campaign and the data we present here, profits which are very high indeed, probably not sustainable again in the long term but they will be nibbled away by pressures. You ask who is benefiting from this and I am scrambling around in the notes I have here to identify who that is and let me try and be as specific as I can in response to your question. Our

judgment is that the bulk will be electricity generators; that would include the independents but certainly the 'Big 6' integrated generators are likely to be the beneficiaries. The difficulty there is they can pass costs and profits up and down the supply chain and they can gain from some transfer pricing. The other beneficiaries in that process will clearly be the traders, the transporters, the shippers, the movers of electrons and gas, and also the storage and distribution networks. Some will have gone upstream to the gas producers themselves who are also the integrated oil companies in some cases. I think there has been quite a lot of crumbs on the table for quite a lot of players is the answer to your question, Mr Bailey.

Mr Bailey: Earlier you seemed slightly unenthusiastic about the role of the industry in alleviating fuel poverty, which seemed slightly at odds from the general thrust.

Chairman: Through social tariffs.

Q519 Mr Bailey: Yes. Do you think that the independent generator as in the gas companies should be included in any scheme to contribute to alleviating fuel poverty?

Professor Chesshire: We do not formally have a view at FPAG on that point. If Ofgem is looking at this market and if the Committee is looking at the market it is something worth looking into. Clearly there are huge transactional costs. There are a lot of players involved who are not familiar with the fuel poverty type of issues, a lot of transformation of information to lots of different places. My judgment is that the share of the market you are going to be capturing, the incremental share of the market is really quite small and I am not briefed on that. If it was an awful lot of effort for 5% more of the market is it worth the candle? I would not want to rule it out if we are going to have a root and branch review, let's have a root and branch review, but do not be carried away that there are lots of riches somewhere out there which are not being captured by the 'Big 6' integrated energy suppliers in the domestic sector. We are talking about the domestic sector in FPAG.

Q520 Mr Bailey: From recollection it was about 23% from the figures we had yesterday.

Professor Chesshire: That is not in my head; I am sorry.

Q521 Chairman: On the question of profits, it strikes me that there is an issue here in that making a profit is one matter, but what you do with the profit is another matter. If you are distributing it to your shareholders or if you are seeing a large cash amount and not using it, then that is one issue. If you are spending it on investment then of course that is quite different. Do you have any assessment of how these increased profits are being used?

Professor Chesshire: A significant source of increased profits certainly for the generators is the operation of the Emissions Trading Scheme and I am sure you have done inquiries galore on this, Chairman. You will know that they were gifted these certificates—they were not auctioned—and as a

5 June 2008 Professor John Chesshire and Mr John Clough

result of that of the order of probably £550 million a year of the profits the companies are making derive purely from that policy design—you might call it error or learning experience—and clearly there is pressure to move to auctioning of emissions and that will happen in 2011 or later, so we have to be patient there. Other elements have come because there has been a bit of a dip in the level of investment by the companies. There have been indecisions about investment on nuclear for reasons you will understand while the policy framework was put in place. There has been hesitation to move down the coal generation route. Will they have to have carbon capture and storage (CCS) or not? Will they have to be CCS compliant or fully fitted or not? There is a large backlog of investment decisions in the offshore wind area, in some of the onshore wind areas and so on, so investment has not been moving at quite the rate the companies initially anticipated when they put in planning applications for some of these schemes. Again, I do not want to be an apologist but I do not think you can look at the wider profit margins and say they are just getting fat. I think there have been some structural reasons for it: one is postponed investment and one is the windfall from the Emissions Trading Scheme, but there are other reasons, I am sure, as well. They will try and get away with what they can do and, let's face it, the structure is now fairly rigid. There is not any new entry.

Chairman: Exactly, which is one of the issues that we will soon be looking at.

Q522 Mr Weir: The recent Ofgem fuel poverty summit—do you think that those range of measures that came out of that will do enough to reverse the current trend of fuel poverty?

Professor Chesshire: We have to welcome Ofgem's initiative, having argued that Ofgem should take a more serious part in this debate I think we cannot be critical when they actually do. I suppose we would argue that it is kind of a little late. The primary responsibility for fuel poverty is mainstream government departments, not Ofgem. Ofgem has a facilitating role particularly in its relation with the companies. There has been a scrambling around, let's face it, to put something on the table as the political concern with fuel poverty increased, let us be honest. I am sure Sir John Mogg and colleagues sitting behind me have been scrambling around for a smorgasbord to interest the fuel poverty lobby and politicians. That may be unfair but it is politically realistic in my long experience. Are the measures enough? As I said earlier, they are tokenistic and some will take some time before they are put in place. If you look at the time line at the back of the action programme, who owns responsibility for each measure—I rather like the way they have set this out—the target date and the fact that there is quite a lot of discussion to be held to put the flesh on the bones, so watch this space, but it is not the solution to the dilemmas that confront us today, but I welcome Ofgem's interest in the field.

Q523 Mr Weir: Given that there are three government departments—BERR, DWP and Defra—involved in this, do you think that that dissipates the way forward? Do you think it would be better if it was under one department?

Professor Chesshire: I wish it were that simple. The biggest problem we face is existing housing stock and the fact that the energy efficiency of it is absolutely lousy. If we are looking 15-20 years, or even longer further forward, that is the primary challenge that we face. The poorest quality housing is occupied by the fuel poor. CLG is of primary importance that I would add to your list and we have talked about taxation and VAT and so on and for obvious reasons I would bring in the Treasury. A very fair point was made earlier when the Fuel Poverty Strategy came out in November 2001, the Government said this is a complex multidisciplinary cross-departmental problem and the only way we are going to tackle this is an inter-department ministerial group and a shadow group of officials. I agree absolutely. That ministerial group has not met for a very long time and I think the drive has gone out of this process.

Q524 Mr Weir: Given that CLG are not involved in this, you are really saying that they are missing the real target.

Professor Chesshire: They set issues such as decent homes, for example, which is very important. There are a lot of areas where CLG will be involved in the wider fuel poverty programme. The primary responsibility for energy efficiency has been with Defra, for pricing strategy and sponsorship of the energy supply sector it has been with BERR and Ofgem's assistance, and DWP has a lot of data on household incomes. What we do not know is, and we were asked this question earlier on, why can we not identify the fuel poor? In our annual report we identify the fuel poor by separating by age, by thermal efficiency of the properties. Our difficulty is identifying the fuel poor by six digit postcodes. That is our problem. We could get our bangs per buck much greater if we could identify down to that level. That means some delicate data sharing about energy use held by the energy suppliers, income levels held by DWP and there are natural sensitivities there, particularly with data discs going missing last year and so on, of which I do not need to remind the Committee, but if we can crack that we could target resources very much more efficiently on those most deserving and we could lower the rising transaction and search of costs which are bedevilling our attempts to tackle fuel poverty. If we are not careful more and more of the money does not go on measures, it goes on trying to find the fuel poor household. That is another reason for being joined up.

Q525 Mr Weir: The proposed eaga initiative coming out of this, will it make any difference given that energywatch's own "Are you missing out?" campaign only persuaded about half of those who could have saved between £451-£600 to switch?

5 June 2008 Professor John Chesshire and Mr John Clough

Mr Clough: I think the key here is we will find out during that pilot. My own concern is that the pilot needs to be larger and I am looking forward to energy companies helping us scale up the pilot from the 400-500 that we proposed—this is a size which is designed to ensure the business processes work and it is a good experience for the customer—up to something which is 3,000 or more where we can get some real findings out of it and we can segment the datasets such that we find out what the moving parts look like. I have a firm belief that if anything can work, that can, given the experience that we have on benefits entitlement checks and that is a very good customer experience with very good confidence and take-up levels that if we can then enlighten people as to the benefits of switching then if we can open that door for them that would be very effective. If I have a concern it is that we then pass them back to their existing supplier, and I understand the sensitivities there, and we are reliant upon the supplier then doing the right thing. From my own point of view I will lose visibility on the customer experience from then on. This is a first step. I would not say it is a solution at all but it is a step in the right direction.

Q526 Chairman: You said that you want to scale it up. I thought the commitment was to scale it up to 3,000?

Mr Clough: We are in that process now and that is what will be delivered.

Q527 Chairman: The Ofgem announcement says that Defra, eaga and energy suppliers will run a pilot programme and check about 3,000 vulnerable customers.

Mr Clough: We are absolutely confirming that and are working with suppliers now to finalise the appropriate business processes.

Q528 Chairman: It has been announced as a policy decision. You are saying that it is actually not yet agreed?

Mr Clough: We have started. The final size of the pilot, once processes have been finalised will be 3,000 plus.

Q529 Chairman: That is what we are being told is already settled. One last question to get a measure of the importance of this data sharing issue. When I spoke to Npower recently, who are almost a constituency company, about their doorstep selling techniques, they put huge store on data sharing as one of the keys to unlocking any problems in fuel poverty. You have implied that as well today, Professor Chesshire.

Professor Chesshire: I think it is absolutely fundamental because the research costs are going to keep rising, if we are not careful—and the bang per buck falls. It is not just DWP, energy companies, intermediates that Ofgem might identify; it occurs at local authority levels as well. Information on benefit recipients held by local authorities cannot be shared with housing officials; a whole lot of things. It is a very clumsy area. We share data on cars but we do not share data on housing.

Q530 Chairman: There is a Parliamentary press announcement to be made shortly. DCLG are not here again of course. It says DWP, BERR, Defra and suppliers on this issue.

Professor Chesshire: At the Ofgem summit I thought the single most enthusiastic and constructive minister was Mike O'Brien from DWP. He had heard this concern and he was astonished at how much of a hurdle it was across the waterfront, not just in this narrow area for local authority levels and so on. He expressed a very strong personal commitment to try and get this moving. I have no brief from him to say that; it is just an observation that he was committed to make some progress.

Mr Clough: It is worth noting the precedent that primary legislation has already been passed for the digital switchover help scheme where DWP provide information. We happen to deliver that programme for the BBC. It can only be used for that sole purpose and that is a restriction but I understand the reasons for that, but the precedent is already there that we can, if the will is there, release that information.

Q531 Chairman: What we are told is that the target date for this is that a Parliamentary and press announcement will be made shortly. Have you any idea what “shortly” means?

Professor Chesshire: It usually means within the calendar year in my experience.

Q532 Chairman: That is my experience too. We will press Ofgem on that, I am sure, in two weeks' time.

Professor Chesshire: That is probably unkind.

Q533 Chairman: Your cynicism I think is not misplaced. Summer extends to about November normally in parliamentary terms. Unless my colleagues have any questions or are there any other points you would like to make and have not so far had an opportunity to make?

Professor Chesshire: An awful lot of numbers have flown across the table this afternoon. If you think we can assist you in any way at all, I will sharpen some of the numbers because they are like ships passing in the night in the fog.

Chairman: Professor Chesshire, you have often been of assistance to this Committee and its predecessor and we are very grateful for that offer. Thank you both very much indeed.

Tuesday 17 June 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Roger Berry
Mr Brian Binley
Mr Michael Clapham
Mr Lindsay Hoyle

Miss Julie Kirkbride
Anne Moffat
Mr Mike Weir
Mr Anthony Wright

Witnesses: Mr Alistair Buchanan, Chief Executive, and *Dr Andrew Wright*, Managing Director, Markets, Ofgem, gave evidence.

Q534 Chairman: Gentlemen, thank you for coming to this important session of evidence of the Committee's inquiry into energy prices. We know who you are. In particular, I have met Alistair Buchanan both formally and informally on a number of occasions, but nonetheless perhaps for the record you would introduce yourselves.

Mr Buchanan: I am Alistair Buchanan, chief executive of the industry regulator Ofgem.

Dr Wright: I am Andrew Wright, managing director of markets at Ofgem.

Q535 Chairman: Thank you for all you have done to assist this inquiry and the informal session we have had with you. We also thank you for your written evidence and further written submissions which have been genuinely helpful. Why did you change your mind? On 16 January you told the Chancellor of the Exchequer that there was absolutely no problem and a few weeks later you launched an inquiry.

Mr Buchanan: On 16 January we went to see the Chancellor following a letter we received in early January inquiring about two things, first as to what was going on with regard to increased prices because Npower had put up its prices in early January; second, we had an invitation to give the Chancellor a range of ideas, which we did, with regard to fuel poverty. At that meeting we basically outlined two issues. First, we believed that the markets were working well with regard to investment coming into the marketplace, innovation both upstream and downstream, choice and quality. We also felt that with regard to the patterns of pricing strategy we had seen in the sector at the end of 2006 and through 2007 when prices were falling the confidence that Ofgem had had in markets remained. We also wanted to respond specifically to the claim made in the *Sunday Times* which we were concerned about on behalf of consumers that there was overt collusion and meetings on motorways by the 'Big 6' so prices were being fixed in that respect. We confirmed that we had no evidence of that, and such evidence still has not been presented to us. In terms of our decision on 23 February at the Board's monthly meeting—these meetings are arranged well ahead—as an executive team the Board confirmed its concern that the pricing pattern as announced effectively by the industry in late January/early February suggested two things and one additional

factor: first, that the pricing strategies we had seen from the companies before with regard to the timing of pricing announcements had changed. If you look at when they dropped prices, effectively there was a period of nearly eight months between the first company announcing its drop and the last company effectively, largely under name and shame from Ofgem, following suit. Equally, the amounts by which they dropped their prices had a range suggesting a product offering to the consumer. This time round the companies went roughly at the same time. There were immediate price increases and on a national average you will see that the charts suggest very little differentiation between them. That is combined with the third factor which is very important and comes back to our statutory duty to represent consumers. There was tremendous consumer concern, including obviously this Committee's, that this needed to be reviewed. Clarity over the word "this" did not matter because there was a lot of concern. We had similar concerns in 2004 when we announced our previous probe in the upstream market. We felt that the combination of those three factors led us with confidence to go to the court and take time out to look at the marketplace particularly with regard to retail pricing, which is what we are doing at the moment.

Q536 Chairman: There are two concerns about the integrity of your inquiry. Let us deal with the first one. The fact that our decision to launch an inquiry was followed two weeks later by yours is also quite interesting. We are pleased that you followed our precedent. What about the fact that you have said effectively there is no problem but you will investigate it anyhow? How can you say there is no problem? You have given part of the answer in response to the previous question in that you have said that prices are moving more closely together, but there is a view out there that really your heart and soul are not in it because you do not believe you will find a problem. By the way, we agree that there is no collusion; we have had no evidence of it, but imperfect markets deliver imperfect outcomes.

Mr Buchanan: Ofgem frequently hears this accusation. If one goes back to 2004 when we conducted a probe, that was an inquiry which arguably stretched outside our normal activity. I know that today you are taking evidence from witnesses from BP, Shell and ExxonMobil. They

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

were not thrilled about a downstream regulator coming into their business. Generally, when we started that probe there was a similar degree of cynicism, which was that it would be a whitewash; it was not because we came out with some very substantial findings with regard to both the Sean field and why it was not running but also the missing £1.4 billion that appeared to be being lost to the British consumer in the very uncomfortable gas/oil indexing contracts on the Continent. I have to say: judge us on what we have done before. I feel confident that when we produce our results you can judge us on the quality of the work we have done.

Q537 Chairman: You will have followed the evidence we have had so far. The other way you seem to prejudge your outcomes is by not looking at the wholesale markets this time. A lot of the evidence we have had so far indicates that the wholesale markets are the real problem and that is one of the reasons we want to talk to the oil and gas companies after you. Why not look at the wholesale markets?

Mr Buchanan: You will see within our terms of reference that we have clearly indicated that will not be excluded. Indeed, within the terms of reference we are looking at the vertically integrated companies and that will be taken into the review.

Q538 Mr Clapham: Mr Buchanan, I want to ask questions regarding the way in which the European gas market impacts on gas prices in the UK. For example, we see that in the summer gas is pushed down the interconnector into Europe. That gas then bears the European price which is increased, but at the same time we see gas going into storage also taking the European price. In winter time we then have higher gas prices because gas has gone into storage at the same price as European gas. What can be done about that?

Mr Buchanan: I think we have come quite a long way. Your Committee and the British Government have helped in terms of the pressure exerted both by DGCOMP and DGTREN in the past two to three years in Europe but also the pressure we have brought to bear individually on companies. Therefore, we have seen substantial advances. You are absolutely right that markets work with quality and transparency of information. In France and Belgium we have had substantial advances in information flow. That has been a big success in the past couple of years. DGCOMP has cracked the whip over some of the companies about which we have been most concerned, the E.ONs and RWEs. In reaction to that they are looking at unbundling voluntarily, but does that get us to the information we need from Germany in particular at the moment? It does not. We need to keep the pressure on DGTREN and, if need be, to do it by DGCOMP cracking the whip over them and threatening them with articles 81 and 82 and serious fines—10% of global turnover—if they do not provide us with this information. You are right that at the moment Germany has the benefit, due largely to historical reason, of 18 BCMs of storage compared with Britain's 4 BCMs. That is due largely to the fact that

Germany has two large umbilical cords, one to Russia and one to Norway. You can see why they needed that storage, but we do not know what is in it, when it is there and what the flow of gas is. You are absolutely right that it leads to great uncertainty in the marketplace and is something on which we need to keep pressure.

Q539 Mr Clapham: But there is greater uncertainty for consumers. It is a real worry when one looks at the oil and gas linkage. We see gas prices linked via the oil contracting indexation system. Talk of oil probably reaching \$200 a barrel by the end of the year means that again consumers will be on the receiving end of hefty price increases. Why can we not break that link? For example, we have heard from energywatch that the link is irrational.

Mr Buchanan: All of us—the British Government, the Committee, the MEUC and Jeremy Nicholson who came to see you on behalf of industrial consumers—are trying to bring pressure on Europe. I know that Philip Lowe of DGTREN is trying to break this down so we get quality information and we can identify what is going on. We can then start to work out how we treat that going forward. I do not downplay what Neelie Kroes is doing at DGCOMP. It is rather like looking at what happened in the UK energy scene in the 1990s when on the one hand the vision side was pushing market and transparency of information and, on the other hand, Steven Littlechild was regularly thumping the companies, forcing divestment and getting action that way. One needs both the soft glove and the hard fist and I believe we have both in Europe at the moment. The key is that with the third directive going to the Council of Ministers this week what we must not do is say, “Phew! Now we can worry about something else”; we have to keep pressure on energy.

Q540 Mr Clapham: I hear what you say about the hard fist, but what we have here are uncompetitive European prices that determine prices in the UK to the great detriment of consumers. You say there is a move in Europe and further proposals will be put to the Commission, but what can we do to make those proposals more robust because there is a clear need to move towards liberalised markets? How long is it likely to be before we see liberalised markets in Europe in your estimation?

Mr Buchanan: I think we will see how the Council of Ministers resolves the third directive this week. Clearly, the European Parliament is quite radical in terms of market liberalisation and forced unbundling. It will be interesting to see how the decisions of the European Parliament align with the Council of Ministers' and it is worth coming back to talk about this in the autumn. I am sure that you will invite me back anyway after we have announced the findings of our probe because we will then know where Europe will go and we will have a much better feel. We shall need to think very carefully about the issues that you rightly raise. It is uncomfortable.

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Q541 Mr Wright: One of the issues briefly touched on was the question of gas storage in the UK and the difference between us and Germany. You talked of BCMs. What we could have in two three years is perhaps 19 days' storage capacity whereas in Germany it works out as 99 to 100 days. Do you think that the market will increase the capacity of gas storage in the UK?

Mr Buchanan: I was looking at my notes when we had a chat about the 2004 probe. It is worth putting it in context. We can take Germany and the UK as quite good examples. Basically, the UK has 4 BCMs of storage for 100 BCMs of gas demand; Germany has about 18 BCMs with a demand of 87 BCMs. Historically, we came from quite different places. You could argue that the UK had 155 ports of call with the various fields on which it could draw, whereas Germany had its umbilical links to Norway and Russia in particular. When we spoke in 2004 we had a genuine hope which was also shared by this Committee that 4 BCMs would rise to 10 BCMs by 2010. Here we are half a year away and we are nowhere near that. When you look at the history, one of the major reasons is planning. A good example has occurred just in the past few weeks. Canatxx is looking to develop a huge salt storage facility in Lancashire and has been denied permission for the second time. I am afraid that an element of history is developing here. One hopes that the new planning Bill proceeding through Parliament will unblock this because it is clear that the market wants to do it. Scottish and Southern and Statoil are developing Oldbury. Some sites are being developed, but as we look at it today planning is something of a curse on storage development. On a more positive note looking forward, it is worth bearing in mind that in the UK, certainly from what I have read of the debate so far, it is not something that has been given very much coverage. When one looks at the 180 BCMs of potential supply that Britain will have next year against 100 BCMs of demand it is worth bearing in mind that 50 to 60 of that come from three new pipelines and 50 to 60 come from five or six LNG facilities, so we have a range of options in terms of security of gas supply which Germany simply does not have. Germany has been planning for as long as I can remember to build an LNG facility at Wilhelmshaven and it still has not done it. It remains very locked into those essential relationships with Russia and Norway. From the point of view of our potential security of supply, looking out to Nigeria, Oman and Qatar, that is an advantage we enjoy as a country.

Q542 Mr Wright: We might have the advantage you describe as a country, but surely we knew 15 or 20 years ago that eventually North Sea gas would run out and our capacity for storage would have an effect. Quite clearly, the industry is now making an awful lot of money by virtue of the fact that we do not have this storage facility within the UK and it is in their best interests for planning to be delayed even further. Is this something that the government

should do perhaps in terms of having strategically placed storage capacity within the UK and taking it away from the market?

Mr Buchanan: I am sure that is something that you will be asking the government, but it would appear to me that to a certain extent the government is trying to approach that by means of unblocking the planning process. Stepping back, one of the concerns is whether it is an art or a science. The oil majors are to talk to you today. I suspect they will argue that how fast one has a run-down of a field is an art rather than a science. One of the complications for potential investors in the market is that, as you remember, until 2002–03, maybe 2003–04, proper information about the market was not provided. Therefore, only with that did one start to get information coming through about the marketplace. One then had MOD006 that Ofgem pushed through about 18 months ago which gave us real time information. If one looks backwards to decide whether we should have been cleverer, maybe we should but I certainly think that for potential investors coming into the marketplace it is a bit like us looking at German storage today. It was quite difficult to see what was going on in the North Sea. If one takes the argument that field depletion is an art, again one does not want to be too hard on decisions taken by people 10 years ago.

Q543 Mr Wright: Looking at the other side of the coin, with regard to LNG it was seen as another avenue that could be used to fill a particular gap, but we hear evidence that the Isle of Grain storage facility has been little used during 2008. Why is that the case?

Mr Buchanan: Jeremy Nicholson raised that point and I asked my team to get the data for me. The LNG facility at Grain has been offered 64 times and because there are pre-emption rights BP Sonatrach has taken that 63 times. Effectively, that is their facility. Perhaps the flavour of the discussion suggested that those rights had not been taken up but that did not appear to be the case from the data I obtained.

Q544 Mr Wright: Do you think that the new Milford Haven and other storage facilities for LNG will stabilise price volatility in the gas market? Do you think it will have any effect?

Mr Buchanan: It will potentially provide a substantial input for us, but it comes back to the market price. Where does LNG fit within the global market? Currently, Japan is paying about 75p to 80p per therm which suggests that arguably on the global market, which is about \$15.5 per NMBTU, it might compete at that kind of price. Therefore, arguably the facility would be used in that environment, but the oil and gas majors who are to come will give you a better flavour of it.

Q545 Chairman: You say that the Isle of Grain has been used during this year or might be used?

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Mr Buchanan: From the data that I received this morning—with the caveat that I will double-check it because I noted that that question was raised—there have been 64 opportunities for delivery and 63 have been taken up by BP Sonatrach.¹

Q546 Mr Hoyle: Possibly we see LNG as the future, but we know that ships have been on the way to the UK and the product has been resold. What guarantee do we have in the market when that happens? Is there further evidence that what we believe to be a secure supply coming to the UK is suddenly sold just before it arrives?

Mr Buchanan: If one looks at the pressures within the marketplace, although current pricing in Japan suggests a figure of about 80p per therm the winter price is about 110p to 120p which is high. Why is that? It appears that Japan is sucking in LNG because it has problems with its nuclear plant. As we have seen on the evening news, Spain which is an LNG user appears to have problems with its hydro reserves; they are down by about 7% or 8% on this time last year. There will be tightness within the LNG market. We know it is tight because the Americans are taking none; they are staying with American natural gas. The American natural gas price has doubled in the past year but it is still below the LNG price. You are absolutely right. Although we have the facilities we are operating in a global marketplace.

Q547 Mr Hoyle: We seem to come back to the question of storage facilities to which my colleague Anthony Wright quite rightly pointed. It is not good enough. We cannot keep hiding behind the issues. The bottom line is that the people who should be providing the storage facilities are failing to do so. My view is that the reason for it is that they make more money by not having storage facilities. I think we will have to drag them screaming all the way to building these facilities. We cannot have another session here where it is not taken seriously. It is not good enough. At the end of the day, whichever way one looks at it the poor old punter—the housewife out there—who wants to turn on the gas cannot afford to do so because these companies will not build storage facilities. We have talked about Germany, but we have not even mentioned France's 122 days' storage. We are giving a poor deal. What are we going to do about it, and when will real action be taken? Are you the toothless tiger that we imagine?

Mr Buchanan: Some substantial storage facilities have been denied on planning grounds, so clearly there is active interest in building them. Let us hope that the planning Bill unlocks that. We operate in a market-based environment and therefore when prices are high we will attract LNG, as we did in the

winter of 2006–07. You will remember that Excelerate literally threw up its LNG facility on Teesside and took its first boatload because the price in the UK was a preferential one. That is what you get from a global market.

Q548 Mr Hoyle: If oil and gas are brought out of the Falklands and are supplied straight to the UK where will we store it?

Mr Buchanan: It depends on whether it becomes LNG. There is plenty of LNG storage.

Mr Hoyle: We will need a lot.

Q549 Mr Binley: I want to ask about wholesale gas contracting and storage. Mr Buchanan, why do you think that oil and gas companies favour off-market contracts for gas over the open forward market?

Mr Buchanan: I believe this question is about lack of liquidity of the market which drives contracts off market. It may be small comfort but in the gas market liquidity in European countries is very low. From the figures I have seen recently, trading in our marketplace has gone up from about 16% to 20% in short-term trading. Based on information from Pöyry Associates, in the gas market you can now trade out to 60 months, so there is liquidity. From that and other information I have received within the industry it appears that there is liquidity in the gas market. The electricity market remains however profoundly illiquid and in that regard you heard comments from a number of independent generators and suppliers.

Q550 Mr Binley: The long-term market is now about gas contracts of five to 25 years, are they not? energywatch has made it clear that this is not a transparent market, does not help us with planning our supplies and is generally one of the factors that force up prices. What should we be doing about that?

Mr Buchanan: I am not entirely sure what energywatch is talking about in that respect. As far as concerns the UK market, it is highly transparent thanks in part to energywatch which supported MOD006 that provides real-time information to all players so industry knows what is going on in the marketplace. I do not quite understand that issue with regard to transparency of information.

Q551 Mr Binley: Let me quote what Allan Asher, chief executive of energywatch, told us: "... we think there ought to be much more disclosure of some of these secret contracts, these long-term contracts, by which gas and power are dealt with. A lot more of that should be brought into the forward market", so he is saying they are not transparent.

Dr Wright: I do not believe it is unusual for a market to have commercially confidential long-term contractual arrangements.

Q552 Mr Binley: Mr Buchanan is saying it is transparent and you are saying it is not.

Dr Wright: We have transparency in terms of the flow of gas. We know where it is coming from and from which fields but we do not necessarily have full

¹ *Note by witness:* Ofgem confirmed in a supplementary memorandum that there have been 127 slots available for the importation of LNG at the Isle of Grain since February 2006. BP/Sonatrach have used 63 of those slots themselves and, in accordance with the rules, they have offered 64 for sale on the open market. None of the slots that have been offered to the secondary market have been bought.

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

transparency of the long-term contractual arrangements between suppliers and companies which are properly commercially confidential. I am not certain I understand what harm that does to consumers. I would say it is normal for a market to have a combination of public exchange trade arrangements along with long-term contracts.

Mr Binley: Mr Wright, I am hearing different answers. Mr Buchanan said earlier in this session that markets worked best with transparent information and yet these long-term markets according to Allan Asher are not transparent; they are secret contracts. I am not quite sure what you are telling us.

Q553 Chairman: About 80% of all gas traded is subject to these long-term contracts. How can you say it is a liquid market when so little is being traded?

Mr Buchanan: With the greatest respect, I am not entirely sure about that. I was looking at the industrial and commercial trading figures. From the figures I have, 40% is spot trading and 44% is based on spot out to a month, so I do not know from where that information has come. Certainly, the information that I have been given by industry appears to indicate that one of the reasons why the large industrial consumers, to whom you spoke last week, are so concerned is because of their spot trade activity and the fact that they go short term for their product. That is the best part of two-thirds of all usage in the UK.

Q554 Mr Binley: We were told by energywatch that about 80% of long dated physical volume is sold on long-term contracts. What concerns me is that you are there to protect the interests of the consumer as you rightly say. Do you not need that information? Do you not need to be more aware of what 80% of the market is doing? If you are not aware how can you possibly do your job on behalf of consumers?

Mr Buchanan: We have to ensure that the market has transparent and open information upon which commercial contracts can be made. I cannot support or otherwise those figures provided by energywatch because they are not ones that I recognise at first glance.

Q555 Mr Binley: There are a lot of people out there who are very concerned about rising prices of energy as you well know. Will you undertake to find out from where energywatch got those figures because, quite frankly, you ought to have them?

Mr Buchanan: I certainly will.

Q556 Mr Binley: Given the low level of liquidity in the forward gas market and the effect of that on price transparency, does it concern Ofgem that industrial consumers tell us that the majority of contracts are linked to forward gas prices? If you find out the truth of this matter what will you do about it?

Dr Wright: The majority of contracts are linked to forward prices. That is not a concern in itself. If a company has been able to secure long-term lower cost sources of gas there is a question as to whether that ought automatically to be passed through to

consumers. Whether or not that is the case is a question in an open market. Companies and suppliers procure gas under a variety of arrangements, some long term and some short term, and some of those arrangements are commercially confidential and some are publicly traded.

Q557 Mr Binley: Should not Ofgem have found that out before it told the government there was no concern about the market?

Mr Buchanan: Perhaps I may pick up something about which we have raised a lot of concerns.

Q558 Mr Binley: Can you first answer my question? You can then go on to tell me what else you want to say.

Mr Buchanan: Do we think that the market has adequate information? We have sought to ensure that it does. We are carrying out a probe, as you know.

Q559 Mr Binley: My question was not that but whether you should have got hold of this information before you complacently told the government in January, I believe, that there was no problem with this market?

Mr Buchanan: I do not believe that our understanding of the market and how commercial contracts are struck within it would affect the advice we gave the government at the time.

Q560 Chairman: This line of questioning goes to the heart of our inquiry. What you have told us is factually at odds with what we have been told by previous witnesses as far as I have understood it. There may be a way of reconciling this because different definitions are being used. We were told by the large users that their contracts were determined by a tiny volume of traded gas which then determined their long-term contract prices, so there is not the liquidity in the market that you claim and that goes to the heart of the problem. You deny that, so it is very puzzling to the Committee.

Mr Buchanan: I am saying there appears to be liquidity in the gas market. Certainly, in the meetings that we have with the large industrial users they make it very clear that they seek to trade short term and do not seek to lock in long-term contracts. I am interested that they have given you an indication otherwise. We certainly need to marry up the information flows.

Q561 Chairman: It is absolutely crucial that we marry it up.

Mr Buchanan: It is absolutely crucial.

Q562 Mr Binley: We were told that forward curve prices were therefore based on limited trading activity and might not be a robust indicator of future costs. That does not equate with what you told the government in January which had a massive impact on how people now feel about energy prices. It is this lack of information of which you are in command that concerns me because you cannot do your job without it.

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Mr Buchanan: We feel that we can be confident about the market with the information flows we have. Should we feel that we need more information in the light of the review we are doing that is something that will have to consider.

Q563 Mr Wright: While we are considering wholesale gas contracting, one of the issues that has been raised is the difference between wholesale prices on mainland Europe and here. Evidence was given to us that a company trying to buy gas from mainland Europe to put through the interconnector was not offered the same price in mainland Europe; the supplier would sell it only on the basis of the UK wholesale price, which is absurd bearing in mind that the company has interests in mainland Europe and can buy it cheaper there, but the same gas would have to be traded in the UK. Does that concern you?

Mr Buchanan: This is very interesting. I give full marks to INEOS Chlor who went public with that information when it visited the Committee. I was privy to that information a little before that. They provided that example to DG TREN and DG COMP. INEOS Chlor has done a very good job in drawing attention to instances of what appears to be bizarre behaviour on the part of some of the large pan-European players in terms of their inability to move gas across Europe and get a suitable price.

Q564 Mr Weir: To develop that, INEOS seems to want continental-style contracts with large suppliers, but in answer to Mr Clapham earlier you talked about the link between oil and gas prices on the continent. You gave the impression that this was a bad thing because it kept prices high, and that is certainly the evidence we have had from others. However, that seems to contradict INEOS's position; they wish to have these contracts as they seem to be of the view that that will give them longer-term security on price. Can you explain the apparent contradiction between the link which keeps prices high and large users wanting to have contracts on that basis?

Mr Buchanan: With a caveat, what INEOS has done has been breakthrough work in trying to assist us to obtain market instruments and to get the marketplace to work in Europe. Where I struggle with some of their discussions is the inference that they could pack up Runcorn and move over to Germany or other countries in Europe. The starting point is the forward price curve. Italy which is an oil and gas market and Holland and Britain have substantially higher prices; for Italy and the UK it is €20 and for Holland it is €10 higher than for Germany. Why is that? Primarily, it arises because Germany is driven by a coal-based market whereas we are driven by an oil and gas-based market. Let us say one up sticks and goes to the Ruhr. One gets that €20 pick-up, which incidentally is no different from where it was when we discussed this three or four years ago in the probe. There are a number of things about which one needs to be quite worried. First, the transportation and network cost within one's overall bill is substantially higher in Germany; it represents over 20% of the bill, whereas in Britain it is below

5%. That wholesale price is therefore not one's final price. If one moves to the Ruhr one has to consider two things that might have an impact. First, there is the oil/gas lag index within Germany. One might still have that impact in the UK, but from figures that I have seen coming from the City there is a belief that the EU trading certificate is trading €10 low. Clearly, in a coal-based market that will have an impact. Therefore, when one looks at the simple statement about moving from Runcorn and going to the Ruhr that is an easy sound bite. One needs to break that down.

Q565 Mr Weir: That was not my point. We are told that the oil/gas link creates higher prices in effect because of the escalating price of oil, but INEOS appears to be saying to us that contracts based on that link are better value than contracts based on the forward gas price as appear to exist in the UK. I cannot quite get my head round the contradiction between these two concepts.

Mr Buchanan: Perhaps we need to go back to them to get additional clarity, but I believe they are saying that the German price is more preferable to them and maybe that is because it is coal-based and they have not felt the full impact of the EUETS which are yet to come. There are other issues within Germany such as local tax breaks from the various *Länder* that may have a benefit. I went to Runcorn and chatted to them about it and they acknowledged that that could be quite a substantial issue within the overall package in Germany.

Q566 Mr Weir: We have heard concerns voiced by some of the small suppliers about lack of liquidity in the electricity market. Is that a concern you share?

Dr Wright: Yes. It is a message that we hear consistently from small suppliers. We have not seen the same increases in liquidity in the electricity market as we have seen in the gas market over the past few years. On some measures we have seen a decline and the increasing vertical integration of the industry may well have contributed to that in addition to the exit from the market of various trading companies such as Exxon and TXU earlier. That is a concern and it is something we are looking at as part of the probe. We are concerned by anything that makes it more difficult for small suppliers to establish themselves in the market.

Q567 Mr Weir: Are you able to tell us what effect this lack of liquidity has on wholesale electricity prices?

Dr Wright: Because the majority of electricity suppliers are vertically integrated to some extent it may make it more difficult for new entrants to come into the market and so it may mean that the competitive environment in electricity supply is less intense than it might be if we had a range of new entrants able to enter the market easily. The management of wholesale market risk is a major challenge for a small supplier.

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Q568 Mr Weir: Given that a major player, British Energy, who produces electricity is not in the retail market would you be concerned if that company was bought up by one of the existing 'Big 6' suppliers and so led to even less liquidity within the market?

Mr Buchanan: Perhaps I may just outline our broad strategy and then answer the question. We do not comment on any potential deals because we do not want to be seen to be affecting capital markets. There is a 10-day window on the back of a major deal that John Fingleton at the OFT as competition authority would offer. We would put out a consultation during that phase. It will not surprise you that we have had substantial representations. I have been out on the road to see a number of companies which have raised issues in this regard to which I will come back. The third element is that whether it is the European Commission or our own Competition Commission we will make a detailed comment. We have had similar comments from you and from both independent generators and suppliers which we take seriously. My colleague mentions that it is being reviewed as part of the problem. As they have said to you, the question is whether there is any way that a certain amount of the trade should be made transparent. Should contracts be made transparent in the marketplace? What will we do about historic information? From companies like British Energy or Drax currently one gets a vast amount of information. Would all of that go or would you get just one line in an EDF group account, if you are lucky? Therefore, how can independents understand what is happening in the marketplace? It is a matter of both liquidity and information. We hear what they are saying and, as my colleague infers, that is something we are looking at within the probe.

Q569 Mr Weir: Another point about lack of liquidity is what is happening on the continent. Despite what you say about unbundling there is evidence that some of the big companies are trying to buy up others to create bigger entities and that could have a knock-on effect in the UK if, for example, EDF was successful in buying Iberdrola of Spain which owns Scottish Power. For example, would you be concerned if there was a contraction from the 'Big 6' to the 'Big 5' in the UK?

Mr Buchanan: In those instances the likelihood is that the OFT would blow the whistle and say it would like to hear from the parties and the usual range of criteria would be looked at: market shares, HH index and regional and national factors. I cannot go further than that, in part because I am not the competition authority but also because I am sure that these issues would be raised with it.

Q570 Mr Weir: It has been suggested to us by some other witnesses that the integrated firms, in effect the 'Big 6', should be forced to trade some of their electricity on the open market. Is that something that you believe has merit?

Mr Buchanan: I want to be very careful here. We have a probe running. You will be our first port of call when we arrive at our views in September.

Q571 Chairman: We are discussing today primarily prices but they are related to everything else, particularly investment. Along with prices availability of electricity and gas is also crucial. We face a particular problem in relation to generating capacity for reasons we all know. What puzzles me is that incentivised generation where there are subsidies, for example renewables, is being undertaken by some smaller companies alongside the 'Big 6', but conventional non-incentivised generation is taking place almost exclusively within the 'Big 6'. Why is that? Is there some market failure there?

Mr Buchanan: I think it is worth standing back. There is a tendency to say that because you have a 'Big 6' in supply you have a 'Big 6' in generation. Clearly, the issue involving British Energy that we have just been talking about highlights that that is not the case. The 'Big 6' in generation have 50% to 60%, so what is the remainder? Drax, British Energy and International Power have grown their market share from about 4% to 9% in the past few years. One also has Teesside Power and Conoco. There is a list of about 13 players in all within the generation market. One starts from that position. If one looks at the new plants in what one might call the traditional end of the marketplace, where are they coming from or what is changing hands? Teesside Power with the largest gas-fired power station in Europe has just been bought by Gaz de France. That is a new entrant into the electricity market in the UK. A very large power station in Aberthaw in South Wales is being built by Welsh Power, an independent. Last week a plant in Redditch was bought by Severn Power, an independent. Hatfield's 900 MW power station is an independent. The two stations that are being built in the traditional sector are Langage by Centrica and Marchwood by Scottish and Southern. Those are the 'Big 6'. Even within the traditional area the knee jerk reaction that it can involve only the large players is not working out like that at the moment. E.ON, RWE *et al* would like to build big power stations at Kingsnorth, Tilbury, Pembroke and Staythorpe. Yes, they would, but clearly there are independents coming into the traditional end of the market. As we discussed last time we were here, if you are looking at the kind of subsidy with which the renewables certificate provides an entrepreneur will seek to go to the renewable end of the market because the returns are quite substantial.

Q572 Chairman: So, they are responding to market signals?

Mr Buchanan: I think they are.

Q573 Chairman: Until recently there was a risk—perhaps it still is—that British Energy would be bought by one of the 'Big 6' with the loss of liquidity that would flow from it as Mr Weir just discussed with you.

Mr Buchanan: Indeed.

Q574 Chairman: A huge slice, give or take 20%, of independent generation would be lost?

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Mr Buchanan: Yes.

Q575 Chairman: Are you really confident that vertical integration of the electricity market is not dulling market signals for new entrants?

Mr Buchanan: You have put your finger on something that we are looking at within the probe.

Q576 Chairman: Did you refer to a plant in Redditch?

Mr Buchanan: Yes. RDI has a small oil-fired open gas plant.

Q577 Chairman: You will know that BizzEnergy is in my constituency and the Committee will be taking evidence from them next week. Why are the smaller electricity companies which say they have a problem buying electricity not investing in generating capacity themselves, albeit incentivised generation?

Mr Buchanan: Some are and some are not. Good Energy whom I saw recently are looking to develop further their windfarm site. Some smaller players are doing so, and BizzEnergy will answer for itself.

Q578 Chairman: You are saying that some make a commercial choice?

Mr Buchanan: Yes.

Q579 Mr Bailey: In a moment I want to ask about the retail markets particularly prepayment meters, standing orders and so on. Before I do so, one matter has been puzzling me. I go back to the issue of continental liquidity in the gas market. Given the fact that both energywatch and the intensive users said in public session that there was illiquidity and you appeared to think there was liquidity, why did you not pick it up and explore the reasons for the difference in perspective?

Mr Buchanan: It does depend on perspective. If they are talking about Europe I do not believe there is liquidity. Within the UK market there is much better liquidity than in European markets and perhaps that was what they were talking about. The best answer I can give is for me to go back to the large users. I will speak to Jeremy and Chris Taylor in INEOS Chlor and come back to you with a written answer.

Q580 Mr Bailey: I am just puzzled why you did not do that before given that this was public information.

Dr Wright: It may simply be a matter of some liquidity being a good thing and more liquidity may be a better thing.

Mr Buchanan: Let us square the circle and give you a written answer to that.

Q581 Mr Bailey: I turn to relative pricing. I suppose that there are two issues: first, why is there such a difference in the annual cost to somebody who has a prepayment meter and somebody who pays by standing order, particularly prepayment?

Dr Wright: The analysis we have made suggests that on average the difference between somebody paying by prepayment and somebody who pays by direct debit is about £125. Our work also suggests that the

difference in cost is about £85. We are doing further work on those cost differences and trying to establish that. On average it appears that the price differential is greater than the cost differential. Within that there is quite significant variation between suppliers, so for some that gap is significantly greater and for others it is close to or even below £85. Therefore, there is a different picture with different suppliers. The differences in the differentials between suppliers may reflect differences in costs. That is not necessarily an excuse. One would expect in a competitive market for cost differences of that size to be competed away. We would be concerned if such cost differences were sustained and those increased costs were passed through to customers in a competitive environment. I believe that is an issue regardless of whether that is cost reflective. You would expect us to say that this is right at the heart of what we are looking at in our probe. Obviously, if there is evidence of discriminatory pricing particularly for groups of vulnerable customers that is something we are concerned about.

Q582 Mr Bailey: The data we have shows that the average is £145, not £125.

Dr Wright: One can cut the data in various ways. It depends on how you average it, whether you extend it beyond the 'Big 6' and how many kilowatt hours or therms of usage one is looking at. Some suppliers argue that to use the standard consumption of 3,500 kilowatt hours is wrong because these consumers tend to use less electricity, for example. There are methodological differences and I am not surprised that it is possible to come up with different numbers of that order.

Q583 Mr Bailey: Is it fair to summarise what you say on that issue that there is a price differential that cannot be accounted for by the increase in cost and therefore there is a *prima facie* case for investigating what appears to be an imperfectly working market?

Dr Wright: We are yet to get to the very bottom of that. We are doing a lot of work on the cost structure of companies and how they allocate costs between different tariff groups and checking whether that cost allocation is appropriate. We shall get to the bottom of the issue. I think there are some bits and pieces of evidence that give us concern. One is that a number of companies charge a significantly higher premium in some areas than others and it is hard to see why the cost in Newcastle should be different in Birmingham, for example. That does make us concerned.

Q584 Mr Bailey: When will you be publishing the results?

Dr Wright: That will be part of the initial findings we publish in late September.

Q585 Mr Bailey: If you look at the prepayment market as being separate from the other, there is a very wide price differential in what people pay in different parts of the country with different deals.

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Dr Wright: Yes.

Q586 Mr Bailey: On the surface that seems to indicate there is not much competition even within this particular market let alone the direct debit market. Would you comment on that?

Dr Wright: That goes back to my previous point. Even if these are cost-reflective differentials we would expect that difference to be competed away. Prepayment customers do participate in the competitive market in quite large numbers, in some areas more frequently than the average customer, but we have some concern that switching decisions are not always good. There is evidence that some prepayment customers move onto higher tariffs. We have written an open letter to try to seek out ways in which we may be able to improve the quality of information provided to prepayment customers at the point of sale to reduce the incidence of prepayment customers moving to more expensive tariffs. We are concerned about the quality, not quantity, of competition and switching in that prepayment market.

Q587 Mr Bailey: I think that your approach should be a little stronger than “some concern”. Given the way prices are rising, the big differential and the fact that a lot of people on prepayment meters are lower income consumers there ought to be huge concern. Do you accept that it was a mistake to remove price controls for prepayment meters?

Mr Buchanan: If I may, perhaps I may hold judgment on that until we have carried out the probe. The question is fair and the areas in which you have sought to interrogate us are all valid and are ones we are picking up. This Committee will be our first port of call once we have carried out the probe.

Q588 Chairman: You have talked about prepayment meters a lot but standard credit customers are also incredibly important and are often overlooked in this debate. A good number of them are also in fuel poverty; a lot are on fixed incomes.

Mr Buchanan: More are on standard credit. Only 20% of the fuel poverty lie within PPM, and one of the areas we are investigating is why the standard credit gap has risen from about £40 to £60. Therefore, that is within our review.

Q589 Anne Moffat: I should like to move to switching which we are very concerned about. There is a major con going on. How can a market where half of the consumers have never switched be described as competitive?

Mr Buchanan: Perhaps I may start with the macro approach. I think it depends on one’s starting point. In relative terms the switching that we have seen in the energy market is quite successful. We see nearly 50% switching in energy. Fixed telecom is about 37%. If you start to get down to mortgages at 20%, pensions at 10% and bank accounts at 2% the switching rate is high relative to other sectors, and it is very high in relation to other markets that have sought to open. In the half of the United States

market that has been opened only 1.5% of consumers have switched; in Germany it has been about 4%. In the Nordic countries it has been 10% to 15%. When you look at the contrast, the UK consumer sees price going up and so does not really care about that. What benefit is there? I will ask my colleague to speak about that. The question is whether the switching proposition is working or whether one is being encouraged to switch to the wrong tariff. When one looks at how well the concept of choice and switching has worked by contrast to other UK sectors and internationally where markets have been introduced, this has worked quite well. Also bear in mind that, based on the various surveys that have been done—again, it may be small comfort—of the 50% who have not switched 15% have self-selected that basically they never will because they just do not want to, or they are lucky enough to have too much money or whatever it is.

Q590 Anne Moffat: When you say “lucky enough to have too much money” it makes me think about the fact that a third of switchers end up paying a higher tariff without realising that is the result.

Dr Wright: If I may make one clarification of what my colleague said, the proportion of people or households who have never switched is more like 20% than 50% because a lot of people have switched gas but not electricity, so in terms of the households that have switched one or other of their suppliers it is closer to 20%. There is a very high level of participation. As I suggested on prepayment tariffs in our probe we are very concerned to look particularly at quality as well as the quantity of switching. A high level of switching is good; it shows that the market is working, there is participation and that consumers are engaged in the market, but it could be because of consumer dissatisfaction and not all those switching decisions necessarily lead to consumers having a better deal. One thing we have noted is that a high proportion of switching is in response to outbound selling as opposed to consumers actively choosing in a proactive way. One thing we are looking at is the quality of switching as a result of outbound selling—doorstep and telephone selling—which may be a concern. It may simply be that consumers are making a choice between two alternatives rather than looking at the whole market, but that is something that is within the scope of the review we are conducting.

Q591 Anne Moffat: Do you think there is fairness among consumers about whether or not it would be a good idea to switch and whether or not they can receive the full information, that is, those who are computer literate and those who have a better standard of living and some who may not? I acted as a daft lassie once when someone came to the door. The con was unbelievable. I was asked who my electricity supplier was. I said I did not know. Immediately they knew they had someone of interest to them. They came into the house and looked at the meter; I let them go through the whole process because I wanted to see it for myself. I am worried

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

about the more vulnerable people who will be conned by switching. Should there be stronger regulations by you particularly about doorstep and phone marketing?

Dr Wright: There is a question about individual fairness in that respect but there is also a question mark about the market working well. Does consumer choice and switching provide adequate price discipline on suppliers? We are looking at it in both directions. There are really two issues. One is to ensure that consumers have good information on which to make choices; the other is to ensure that the benefits of competition are available to all consumers, not just those who are engaging in the market. One feature one would also expect from a well-functioning competitive market is that the benefit is not available just to those who switch.

Mr Buchanan: We will not shy away from using our enforcement powers. Currently, we are inspecting the Npower case which has been compiled by a number of parties including energywatch.

Q592 Anne Moffat: Even if there were some guidelines that people could access very easily that would be an improvement on what we have at the moment.

Mr Buchanan: As to prepayment meters, there are certain licence conditions whereby companies are meant to provide the advantages and disadvantages. Do they, and how do they do it? Is it so difficult to get to? Is it slanted? Those are the things that we are looking at and particularly in this area we would be happy to come back to the Committee to talk about it.

Q593 Chairman: I just want to make clear how your investigation of the doorstep selling scandal interacts with the fuel price inquiry. Is it entirely separate and carried out in different compartments?

Mr Buchanan: It will run along its own enforcement track.

Q594 Chairman: Doorstep selling is hugely important to switching given the proportion of switching that it has achieved. In terms of getting people to change supplier it is important but it must be done very well.

Mr Buchanan: Indeed.

Dr Wright: There is a large grey area between a perfectly functioning market and mis-selling which is in breach of licence. We are potentially also concerned about where the market is not working well but it falls short of something that we can enforce, so we are not just looking at things that are currently a breach of the licence; we are looking at how well the market is working for consumers and how well it is working as a price discipline for the companies.

Q595 Chairman: I think you agree with everyone else that the big gain from the switching is your first switch. When you move away from the incumbent monopoly of the CEGB days to the new competitive world for the first time that is when the big savings come; after that the savings are more marginal?

Dr Wright: Not necessarily. You are right that there is often a big saving to be made when moving away from incumbent suppliers, particularly if you move from standard credit to direct debit at the same time and get the benefit of a dual fuel discount, but there are still significant savings. If you compare dual fuel direct debit you can make significant savings at the moment by moving from a standard billing approach to online billing. There are still substantial savings to be made from participating even if you have switched once. We would encourage people to continue to look around for the best deal because what was the best deal yesterday may not be the best deal today.

Mr Buchanan: The majority of it is on price, but it may be you want to switch to a green supplier like Good Energy or a supplier like First Utility which now offers smart meters within its package. You may be very distressed by service you get from a company and go to JD Power; it may be published in the newspapers and right at the top of the service league you see "I'm getting lousy service."

Q596 Chairman: It may be rational to switch to a higher price?

Mr Buchanan: It may be that you choose to do that. Perhaps a green product is offered at a premium price.

Dr Wright: Some companies have a record of being at or about the bottom of the price range, if they are not absolutely the cheapest at every moment in time. You may choose someone who is on average in the cheaper half of the tariffs.

Q597 Chairman: So, switch is not a surrogate measure of competition because it may be logical to stay with the current supplier because you know that he will become cheaper in due course?

Dr Wright: I think that is right. Switching may be a one-dimensional measure of competition. It is important because it shows participation in the market; it shows that consumers can switch. If switching rates were very low it would be a concern to us, but there are other factors that influence the quality of competition.

Q598 Roger Berry: energywatch say that there is "a huge amount of fraud going on". Are they right?

Dr Wright: "Fraud" would be a very strong word.

Q599 Roger Berry: "Fraud" was what they actually said.

Dr Wright: We are currently engaged in a process to establish some guidelines for green tariffs and central to that those guidelines will be that any green tariff must demonstrate an additional benefit to the environment.

Q600 Roger Berry: Why have you not done this before?

Dr Wright: We are doing it now and it is something of which we have become aware and are addressing. We would expect proposals to be in place before the end of this year. This is a matter that we have been looking at for nine months. We are doing it by way

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

of co-operation with suppliers rather than relying necessarily upon the cumbersome licence approach and we think it will be successful.

Q601 Roger Berry: You acknowledge that at present there is no scheme to verify the claims made in relation to green tariffs. For years all of us as consumers have been offered deals by suppliers in relation to green tariffs. Only now are you getting round to checking to see the extent of the fraud in that market. Is that not a bit slow? A lot of us have signed up for green tariffs in good faith and assumed that what we were told was correct. You are now acknowledging that that may not be the case.

Mr Buchanan: You are absolutely right that in the past two to three years green tariffs have developed. Eighteen months ago the NCC which becomes the new energywatch in a few months' time produced a very good report which flagged up concerns. The Energy Savings Trust was, I believe, the prime movers. Either they were invited to do so or they themselves started to develop green tariffs. You are absolutely right. We believed that this had begun to become such a serious issue that we wanted to bring our own work and brand to it and be involved in it. That was why we became involved in the past year. My colleague is very close to releasing what will be a substantial step up in comfort for consumers. You are absolutely right to point it out. We are onto it.

Dr Wright: Although it is a small part of the market it is important that people do not make the assumption that somehow they can mitigate their environmental impact by signing up to a green tariff and they still keep pressure on reduced energy use through energy efficiency measures at the same time. Unfortunately, sometimes that is the message that gets across at the moment.

Roger Berry: That is absolutely correct but it is a different message. We can all take individual actions to try to reduce our impact on the environment. Interestingly, for years and years many people have signed up to green tariffs in the believe that it is an additional contribution and only now is the regulator getting round to looking into it and the consumer watchdogs say that there is a huge amount of fraud taking place. I suppose the polite response is that it is better late than never.

Q602 Chairman: Mr Buchanan nods in agreement, I think.

Mr Buchanan: No. We are working with it and trying to take industry and energywatch with us as well.

Q603 Mr Weir: National Energy Action told us that consumers who were off the gas grid had an average energy bill in the region of £1,700 per annum compared with about £1,000 for those on the gas grid even with rising price. Many propane/home oil prices are rising faster than domestic and gas electricity prices. Is Ofgem content with the level of regulatory oversight of the domestic heating oil and propane markets?

Mr Buchanan: This issue has been raised with us. Within our remit we have sought to try to approach the off-gas network from the angle of encouraging the networks to be developed. I think we took some substantial steps with the initiatives in our gas price review put through the industry at the end of last year and early part of this year which will run for the next five years. As to regulatory oversight, if they are local gas networks there is an element of oversight by us. If it is off the network I am not entirely sure where we would come into the regulatory oversight.

Q604 Mr Weir: You say that you are encouraging the development of networks, but many rural areas, including my constituency and others, will never have a gas network; it is too far away from the existing networks. It appears from evidence we have heard that there is no regulator whatsoever in either the home oil heating market or propane gas market. Given that there is regulation in a number of parts of the energy market and the importance of this particularly in rural and other areas, it is right that there is no regulation? Should a regulator like you or someone else take on this market?

Mr Buchanan: I wonder whether you have brought this up within the framework of the Energy Bill as well. That may be a framework suitable for that debate.

Q605 Mr Weir: It has been brought up in several fora and nobody seems to be taking it on at the moment. There does not appear to be any consumer interest or any regulation of it at all.

Mr Buchanan: I should like to go back and find out more and then have a bilateral discussion either with you or the Chairman.

Q606 Chairman: This is a matter of considerable concern. I receive letters from my constituents who say that prices are rising significantly faster than for mainstream gas and electricity customers. It is not your fault.

Mr Buchanan: But there is concern about it and we should follow it up.

Chairman: The OFT says that it can do a major inquiry but it is busy with all kinds of other things and it does not have time for it.

Mr Wright: Another reason why regulation is required is that prices have increased to such a level that some people cannot afford the minimum delivery requirements of the companies. It is now so expensive that people do not get deliveries; the suppliers will not supply below a certain amount. That is another problem.

Q607 Chairman: If this Committee were to recommend that your remit should be expanded to include this section of the energy market would you resist it?

Mr Buchanan: I should like to go away and look at it in more detail before I give an answer.

Q608 Mr Clapham: Do you have any idea how many customers use LPG?

17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

Dr Wright: We know approximately how many are off the gas grid; it is somewhat less than 20% of all households. This is also an issue for the supply market probe. We are looking specifically at whether the competition is as effective for customers who are off the gas grid. A lot of the focus of the competition is on dual fuel and often it is harder for door-to-door salesmen to get to these customers because they are in rural areas. These customers may well get some benefit through the CERT and EEC programmes for energy efficiency. This just shows how complicated the issue of fuel poverty is because that is another dimension that feeds into it.

Mr Weir: The point is that these consumers have just fallen off the radar of the regulator. There is no one looking at decent tariffs for them as they do in gas and electricity. In many ways they have been forgotten. To say that you will develop the gas network is impractical in many areas of Scotland and other areas.

Q609 Chairman: The problem is the density of the population. The irony in Worcestershire is that the big gas mains that take gas all round the place roar through the county and people who live almost next door to them cannot get access to piped gas for their own houses, and never will; it is not feasible.

Mr Buchanan: Clearly, the range of concern is substantial, so we shall definitely follow it up.

Q610 Roger Berry: You recently published your fuel poverty action programme. I welcome the attention that you have devoted to this issue. What proportion of those who are currently living in fuel poverty will be taken out of poverty as a result of your action programme, and over what period of time?

Mr Buchanan: There is our programme and what the DWP plans to do which in many ways is much more substantial. As one would expect, they focus on trying to use data management both to access those who are fuel poor and to get benefits to them. The scale of the benefit will be the key. The ability to do this by the winter and the scale of it are questions I would be asking them, as I am sure you would. That will be the main driver. For every 10% increase in price 400,000 people go into the fuel poor league. This is a very big problem now, and we are receiving price warnings from the companies. My answer is that there are three questions aimed at government and DWP. What we are trying to do is to enhance the quality. We have a programme running with the Citizens Advice Bureau called the best advice programme. I think it is working well. We are working with the University of Bristol to ensure we get good research to identify ward by ward across England where the worst areas of fuel poverty might be. We are trying to do what we call our find and fix programme by working with relevant bodies, but I think the real difference will be felt by the scale of the DWP programme and what the Government will do.

Q611 Roger Berry: I am sure you are right. The much proclaimed £225 million of extra social assistance over the next three years—the deal with

the ‘Big 6’ companies—is an increase from £50 million to £150 million annually. I do not say it is not worth a row of beans; it is money, but the increase is from £50 million to £150 million. Clearly, someone somewhere is treble-counting. As I understand what the DWP has said, this is being targeted as extra money to help pensioners in fuel poverty. The obvious question here is: what about the three-quarters of a million children in fuel poverty? What about disabled people who are not pensioners but are in fuel poverty? Where do they fit into this?

Mr Buchanan: That is a very good question. I should like to come back on the slicing and dicing and the way it is going up. Thank you for the information.

Q612 Roger Berry: What does Ofgem think of the Government’s position on social tariffs?

Mr Buchanan: That is an interesting question that is probably best directed to the Government. I believe that the Government is trying to approach fuel poverty through a three-pronged package. The first is the DWP-based package which is linked to what they are trying to do on the Warm Front programme. You will know that that was pulled back a little in terms of financing. It is also focusing on the companies to step forward. We have seen companies develop their plans possibly under additional pressure. Scottish and Southern has now rolled out its energy-plus plan from 20,000 to 100,000 potential customers. It must identify them and get the benefits to them. Ofgem is concerned with information facilitation and driving through the opportunities within the market-place for the fuel poor. I think that is the Government’s three-pronged approach to it. If it wishes to take a step forward and say that it wants to reregulate a form of tariff then that is really a question you must ask Malcolm Wicks or John Hutton.

Q613 Roger Berry: You have come up with some specific proposals. Perhaps the most celebrated one is that some of the £9 billion windfall that UK energy companies are set to receive from the allocation of carbon permits under phase two of the EU emissions trading scheme should go towards helping those in fuel poverty. How much of the £9 billion should it be, and how do the various partners in this exercise feel about your proposal?

Mr Buchanan: This was considerably highlighted when we were invited to see the Chancellor at No.11 and give our views and provide ideas on fuel poverty as an issue and what the Government could do. Our ideas included, amongst other things, that we should get on with smart metering and have a look at the various DWP data issues now being developed. We also referred to one of the ideas that we flagged in April 2006 in an earlier representation to the Government, namely that this pot of money was sitting there. The companies will argue that the pot of money is there for them to be able to reinvest in renewables. I think an interesting question to ask them is: have they invested that money in new technology? It is worth looking at a number of companies. One company that comes to mind is Drax. At the moment the City forecasts that about

 17 June 2008 Mr Alistair Buchanan and Dr Andrew Wright

70% of its EBITDAR over the next four years—£1.6 billion—will effectively come through the EU ETS scheme. How much is it investing in the next few years? On city forecasts it appears that they are investing about £350 million, so there are some interesting issues there. I pick just one company; I am not picking on it, but some interesting questions can be raised. This is a matter for Government because Ofgem is not a lobby group. As with smart meters, we raised these issues with Government and urged them to look at it. It is up to them.

Q614 Chairman: I want to reinforce what Mr Berry said about people other than the elderly who are in fuel poverty. This Committee has been banging on about it for years and nothing seems to happen. As fuel prices rise to eye-watering heights it is becoming a greater problem. I know I am lecturing the wrong people here, but the Committee attaches importance to the inclusion of other groups in fuel poverty measures. You have a difficult task on your hands. I began with some questions which expressed scepticism about your good intentions given that you thought the market already worked perfectly. We know that fuel prices will continue to increase. Look at the oil price. We know that this is a continuing problem that will get worse and worse. Companies are talking of further increases all the time and people are hurting. Every one of us finds his fuel bill an intolerable burden. Therefore, if you do not make a reference to the Competition Commission at the end of this you will look rather weak, will you not? It is the only thing that people think you can do.

Mr Buchanan: We did not make a reference on the back of the 2004–05 probe when prices were very high compared with what they had been previously. We had been looking at prices of about 10p to 20p per therm and they went to about 50p to 60p. There was great concern at the time. We came out with a package of measures which the CC at that time did not feel was necessary, but for you and any other consumer there was a weighty tome of evidence to show why we had come to that conclusion. I know that the board will approach September with an open mind to see what the right course of action will be, but everything will then be published and you will see whether or not we have taken the right course of action. I imagine that we shall be hung from the lamp posts if you say that in producing the information our judgment is missing because our own information tells us to go to the CC and we have not done it.

Q615 Chairman: As a well-educated man you will be familiar with the rock and whirlpool of Scylla and Charybdis. If the rock of Scylla is the expectation that you can do something with that kind of reference failure to push the nuclear button will in some sense ruin your reputation, but the whirlpool of Charybdis means that if you do make such a reference you will disrupt the investment plans of major city companies at the crucial time to keep on the lights. You are damned if you do and damned and you do not, are you not?

Mr Buchanan: It is a difficult job.

Chairman: On that note we shall bring this session to a conclusion. Thank you very much for your evidence. You have promised us at least one matter in writing. If there are other things that you want to give us as you characteristically do we shall welcome them.

Witnesses: **Mr Nigel Wooley**, Supply Director, BP Gas Marketing, **Mr Richard Guerrant**, Director, Europe, ExxonMobil Gas and Power Marketing, and **Mr Paul Trimmer**, Vice President, NW European Business Operations, Shell, gave evidence.

Q616 Chairman: Gentlemen, thank you very much for coming to this very important session of evidence. You have heard some the reasons we want to ask you questions. I know that they have been explained to you beforehand. We are grateful to you for the information which you have already provided to the Committee. I begin by asking you to introduce yourselves for the record for the benefit of those who are listening to our proceedings.

Mr Wooley: I am Nigel Wooley, the supply director of BP Gas Marketing.

Mr Trimmer: My name is Paul Trimmer and I am with Royal Dutch Shell. We produce and buy and sell gas in various countries across Europe.

Mr Guerrant: My name is Richard Guerrant, one of the directors of the ExxonMobil UK group of companies. I am responsible for natural gas marketing across Europe.

Q617 Chairman: This session marks a change of gear for the inquiry in a way. Next week we have a very significant number of the chief executive officers of

the ‘Big 6’ coming in to talk about their work which will be fascinating. Today we are looking at rather more specific issues that affect your companies. The first blindingly obvious question from the chair is: why are oil prices so high? Are they here to stay, and to what extent does speculation contribute to those high prices? That is the million-dollar question.

Mr Trimmer: If one looks at the medium and long-term whilst Shell does not speculate on prices—I shall not give a price forecast; if I did it would almost certainly be wrong—there are certain fundamentals coming together on the demand side which are impossible to deny, that is, growth in demand in India, Indonesia and particularly China with the build-up to the Olympics. That puts immense pressure on the demand side. The populations and industrialisation of these areas are set to grow, so there seems to be a very strong fundamental pressure on the demand side. As to the supply side, the era of easy to find but cheap to produce oil and gas is on the decline. We are not finding the large oil and gas fields that have been around. There are, therefore,

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

two fundamentals coming together which appear to push in the same direction and provide a medium to long-term perspective. Reading the newspapers at the weekend, if you talk about other things that may have an impact on prices, the amount of money that is available to go into the markets has gone up from less than £7 billion in 2004 to over £130 billion this year. Presumably, a lot of that is going into the energy markets. The flows of that money in and out of those markets can have an effect. Certainly, from Shell's perspective we find it difficult to rationalise all of the price movements on the basis of the fundamentals alone, but whether or not that is a long-term effect is difficult to determine.

Q618 Chairman: You do not know or you are not telling us; it is one or the other.

Mr Trimmer: I am saying what I believe to be the fundamentals which are pushing in one direction. If you look at it over time it is pretty clear that prices are heading in one direction.

Q619 Chairman: Gentlemen, I suspect that you agree with the general thrust of that; it is not a very controversial view. To what extent do you believe that speculation plays a part in driving current market prices?

Mr Guerrant: To add just one more comment, ExxonMobil believes that over the long term the fundamentals of supply and demand drive the price. We are surprised about the prices that you see today.

Q620 Chairman: What is the oil price this morning?

Mr Guerrant: I am not sure. Yesterday afternoon I believe that the WTI (West Texas Intermediate) benchmark was in the range of \$137. As to the question of what causes it to be where it is today, clearly there are temporary factors that influence some of these things. There are experts round the world who say that speculation is not the issue. It may be due to the weak dollar and many of the familiar things that we read in the newspapers every day. It is a difficult question. Our costs in finding new supplies are also going up. One of the issues about which we are concerned is that our job of bringing on new supplies to try to moderate this, to get access to new resources and develop them and bring them online is becoming more difficult. We are going into more difficult and higher cost areas.

Mr Wooley: The fundamentals that Shell has described are exactly those that we observe in the market, too.

Q621 Chairman: I understand that in the United States limits are placed on the size of positions taken by traders. I know you have underplayed the importance of speculation, but there is no such rule in the London markets and the FSA certainly has no such provision. Do you think there is a case for capping the size of positions taken by London traders in the same way as happens in the America?

Mr Wooley: In relation to the traded gas markets in the UK one of the benefits we have seen and talked about is the liquidity in those markets. Obviously, the positions which various companies and trading

houses take in bringing forward that liquidity are a benefit to the market. I am not sure what benefit there will be in capping the size of a position that is taken.

Q622 Mr Clapham: When we look at the gas market in Europe, there has been enormous change. For example, in 2003–04 we imported about 2% and by 2008–09 it is likely that the figure will increase to about 40%. When one compares the UK gas market with Europe—you were in the room during the previous session and heard what Ofgem said—it seems as though it is the European relationship that will impact and have an influence upon prices in the UK. Is that your view? Do you see it changing in the near future, or are we in for a long haul whereby prices in the UK will be determined by what happens in the gas market in Europe?

Mr Wooley: What we have seen over a period of time is a transition in the UK market. If you go back to the period prior to 1998 when the interconnector between the UK and continental market was opened the UK was essentially an island economy which benefited from plentiful natural resources around its coast and was predominantly supplied from UK sources. It was able to maintain a reasonable balance in the market. We entered a period of liberalisation which encouraged the bringing forward of lots of new gas supplies to the UK. In the mid-1990s leading up to the opening of the interconnector we saw very low prices and the development of a very competitive market in the UK and we experienced levels of gas on gas competition within the UK market. As the UK has moved away from being a net exporter of gas to an importer of gas the pricing signals which the UK market experiences are much more determined by those that come from continental Europe and the oil indexation and long-term contract nature of that market. Therefore, I think the market has seen a period of transition and as we go forward we expect more and more to be involved in the European market and to take price signals from there. Further, with the development of the LNG terminals which will serve the UK market increasingly LNG trades at least on a regional basis and is connected in a global sense. We see some global price indicators from LNG markets coming to the UK too.

Mr Trimmer: I emphasise the last point. The interesting transition is how quickly the UK is absorbed into pan-European pricing, but how quickly will pan-European pricing be absorbed by global pricing? All of Europe's incremental supplies now come from very long distances. Even the Russians, for example have an opportunity to put gas into LNG or a pipeline; similarly the Algerians and the rest of the North Africans. Therefore, there is another overlay. When does the global market have a very substantial impact on UK prices?

Mr Guerrant: Over the past five years there has been an evolution of liquid markets on the continent. In the Netherlands there is a very active liquid trading hub called TTF. It is very similar to the way in which NBP is being traded and it has a gas index very similar to what you see here in the wholesale market.

 17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

In the past two years we have seen the German system change with a new grid access model that allows the markets there to create these trading hubs. We have seen trading hubs around: there is the E.ON system as well as another hotline system called BEB. In northern France we have seen the evolution of a trading hub. My company is trading on all of those hubs today. All of our gas that is not dedicated to long-term contracts moves to all of these trading hubs. That is not to say that the liberalisation of the continent is moving fast enough, but it has started. We have started to see significant liquidity developing there. We are starting to see that and it is very encouraging.

Q623 Mr Clapham: It appears that there are two factors which will impact on gas prices in the UK in the long term: one is LNG and the other is the situation in Europe. Mr Guerrant, given what you say about the interconnectedness of the hubs in Europe, why is it that gas prices in this country last winter rose so much higher than European gas prices? What was the reason for that?

Mr Guerrant: You see a very close correlation within a few pennies of the prices at these liquid trading hubs on the continent with the NBP because the gas moves from Norway and other places back and forth across those hubs. You have a convergence. You still have demand centres around certain areas that may cause prices to be a little bit higher at a particular point in time, but those usually close back up and you get prices at the liquid hubs to come back into some parity within a few pennies which reflect transportation costs across the hubs between the continent and the UK.

Q624 Mr Clapham: Is that the view of all the witnesses? I am looking at the graph provided to us by BP.

Mr Wooley: Referring to the points that have been made about the connectedness of the European hubs, primarily the issue is that the amount of liquidity available at some of these hubs—we have talked about the French and central European hub, the EGT in Germany—is at very low levels given the current state of the market. We have seen some evolution of traded gas at Zeebrugge and now at the TTF hub which operates in the Netherlands liquidity is growing. It is still a long way behind the traded rates in the UK, but there is some liquidity. The amount of gas traded on the French and German hubs still remains very small and therefore has only a very small effect on the market.

Mr Trimmer: If you look at the German market and what is happening in the spot market, it is picking up very significantly, but the majority of the gas is still sold on the basis of an oil-price indexation which picks up the spikes but smoothes them out. The price still rises but it is not as volatile.

Q625 Mr Clapham: We hear so much about European liberalisation and that is constantly blamed for the gas price increase but given the high

price we saw in winter why did not your companies provide more gas to that market to bring down that price?

Mr Wooley: That is a common misconception which has been referred to at one or two earlier evidence sessions and in some of the remarks by other companies. There is no great residue of excess supply being held back by the companies in the North Sea that they can bring forward to the market. Throughout the year and certainly in the winter time the companies in the UK arena are very focused on producing all the gas that they can from their reserves for delivery to the UK market. We tend to take maintenance periods and production outages during the summer to make sure we do that at periods of lower gas prices, but in the winter time when there is the greatest need for gas we try as best we can within the context of safe operations to run our facilities as hard as we can to bring gas to the market. There is no residue of gas out there which can simply be drawn upon in those circumstances.

Mr Trimmer: Shell did move some gas which was originally destined for continental Europe across to the UK, but there is a limit to what we can do for the reasons that have been identified, plus the fact that we have contractual obligations. We need to be able to comply with our contractual obligations, for example, in Germany or Denmark at the same time.

Mr Guerrant: The LNG facility that ExxonMobil and its partners are building in Milford Haven was based on the ability to be able to move the gas all the time in the marketplace; in other words, having a very liquid market like NBP that we enjoy; otherwise, we would probably have looked at another location somewhere else in the world. The fact that you have a very liquid market here and a producer has the ability to sell all of his gas all the time at a fair market price is very attractive.

Q626 Mr Clapham: One of the big worries we have looking at the gas market is that not only is the domestic consumer paying more than his European counterpart but it is undermining British competitiveness. There is a real fear that given the great increases in gas prices we could see British competitiveness lose out. You were present during the previous session when we discussed the fact that British gas went into Europe when prices were high. That sets a high price for British gas that goes into storage for winter time. Consequently, we have high prices in winter. At no time do we seem to have the same kind of gas prices that our European counterparts have and that is a real blow to British competitiveness. What can be done to deal with the situation which will help British industry?

Mr Trimmer: One of the things that we are doing in joint ventures with other parties or by ourselves is to increase the connectivity of the UK to other sources of gas supply. Now that we have made the switch from self-sufficiency to dependency on imports we feel that this is one of the most critical things we can do. It enhances the choice that the UK has by having access to Norwegian gas and continental gas and LNG but it also enhances the security of supply in case we have a problem with one of those sources of

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

supply. We are very active in trying to increase the number of links that the UK has to all of the possible sources.

Mr Guerrant: The biggest thing we can do is to bring on more suppliers. I point to Milford Haven as a good example. We and our partners are spending \$13 billion to bring that supply into the marketplace. What ExxonMobil and the industry can do is bring on those new supplies and create greater interconnectivity. If over the past few years you look at Vesterled, Langeded, Tampenlink and the BBL, all of those pipeline projects bring more gas from the Netherlands or from the Norwegian sector, which is very important, and, at the same time ensure that we get the most out of UK gas: we are all working very hard to do that, but we have to understand that it is a mature province that is in decline.

Mr Trimmer: We are making investments to upgrade and refresh the existing infrastructure and facilities so they can last longer. We are investing in prolonging the life of the fields. The UK has been astonishingly successful in perpetually pushing out the date at which we drop off the cliff. New fields are still coming on stream. Some of the incentives that have emerged most recently to encourage new investment in existing acreage are good.

Mr Wooley: It is key to emphasise that the role of the upstream industry is to invest and bring forward new supplies to the market. Earlier there was a commentary about the Isle of Grain and the terminal where BP shares contract rights with Sonatrach. We have been able to bring a large number of cargoes to market over recent years through that terminal since its inception in 2005. Obviously, that has made an important contribution to the UK's supply in a period when prices were very tight.

Q627 Mr Clapham: Obviously, connectivity is enormously important, but you guys are involved in the European market as well as the global market. What is your view about the timeline for liberalisation in Europe?

Mr Wooley: I think that those of us who have been observing and participating in the market for some period have noted that the pace of liberalisation in Europe has always been a little slower than anticipated. Europe has been running through gas directives and attempts to liberalise.

Q628 Chairman: I do not want to go too far down this route. We shall ask you about liberalisation. I want to make sure that my colleagues can ask about that in some depth. Sometimes I feel a degree of tension among our three witnesses. We shall not probe you for commercial secrets; sadly, we do not have those powers, much as we would love to have them. But we need to get a feel for the overall environment in which you are operating. Mr Wooley, you have talked about the Isle of Grain but you have not told us a great deal about it. How many gas shipments were landed at the Isle of Grain so far this year? Is it 63 or a handful?

Mr Wooley: I admit that I was somewhat puzzled by the comments of Mr Buchanan when he sat in this chair. In 2008 only one of 13 available slots in the Isle of Grain has been used so far by BP. Our record over the period since the terminal opened is that we have used 32 out of the 80 slots made available to us. Predominantly, those would have been used in the first quarter of the year—the winter quarter. The number we have used in different years has varied. As you would expect, it is used in response to the relative position of the UK market in comparison with global markets for LNG. Overall, we have used just under 50% of the slots that have been available since 2005.

Q629 Chairman: Mr Guerrant, at this point I look to you. A massive investment is being made at Milford Haven. To what extent are we insulated therefore from decisions by those who seek to sell us gas so that supplies presently at sea will not respond to price and go to Japan where the price is higher but will still come to Milford Haven? What security does that give us?

Mr Guerrant: Let me talk a bit about how it is structured which I believe will give you a sense of how it should work. Obviously, we have built this facility with the liquefaction, or supply trains in Qatar and all the ships and the actual import facilities in the UK. All of that is designed to fit together for quality. The specification for gas here is different from other places in the world. All of that is designed to fit the UK market. Having said that, the question is: how do you put together a commercial arrangement to ensure that it works? At the end of the day a supplier like the Qatar Government wants to ensure that it gets the market value for its gas compared with all the other markets in the world. We could have gone down the route that basically said we should find a buyer in the UK that would guarantee to take all the gas at the highest price anywhere in the world. That would not be a very fair thing for the UK consumer; it would not be a good thing for the country. What we did was to put together an arrangement that ensured Qatar got the market price and it would have the option to move those cargoes when other markets were higher. That allows the gas to be here when the market price signals say that it should be sent here relative to other markets in the world. That flexibility is critical. That was the reason I said earlier that it was so critical to maintain the integrity of that wholesale market. You have a base supplier that has the ability to divert to other markets depending on the price in the UK versus other markets.

Q630 Chairman: Therefore, you and the Qataris themselves have put a lot of money in a terminal that may not be used?

Mr Guerrant: When it is not used it is available for third parties to use.

Q631 Chairman: But they also respond to price signals round the globe?

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

Mr Guerrant: That is true. From the perspective of LNG supply/demand over the past year or so we have been in a fairly tight situation. Earlier reference was made to Japan's nuclear problems. In addition, there has been cold weather in Korea. Then new buyers in China and India have come into the marketplace and paid high prices for LNG. That has tightened up the supply/demand balance. We shall see some new suppliers come on. We have not had new LNG supplies come on in the past couple of years. The Qatargas venture will bring on new supplies and there are other ventures in Qatar as well as other supplies. In 2008 and 2009 we will see new supplies of LNG come on around the world. Obviously, depending on weather and how the world economy responds, we believe that that may moderate the situation we see today.

Q632 Mr Bailey: Earlier it was said by Mr Wooley that the price of European gas obviously had an effect on domestic prices. Looking at the continental model where prices are linked to oil prices, what puzzles me is how in a market you can have the price of one commodity, ie gas, determined by the supply and demand model for another commodity, ie oil. What is the rationale for that?

Mr Wooley: Perhaps I may start with the traditional European model, as it were. The history of gas prices in long-term contracts that supply the European market has developed largely on the basis of competing fuels. When the resource owners in perhaps Russia, Norway or Algeria look to develop their gas reserves and sell them into the European markets they will place those volumes with the large-scale, national monopolies within those markets. The companies that would be buying the gas would look to make sure that they would be able to place that gas in their own markets. To go back perhaps 30 years, largely they would be doing that by developing the gas market by successively displacing gasoil and fuel oil from heating services within those markets. Therefore, it was very important for those companies in the national markets to ensure they could acquire the gas at a price that would enable them to compete at the burner tip with fuel oil and gasoil. That was why as a general rule the contracts struck with fuel oil and gasoil indices linked to the base price for gas.

Q633 Mr Bailey: That is an interesting historical explanation, but what is the rationale now?

Mr Wooley: I think the rationale that has underpinned it over 30 or 40 years is one that underpins long-term contracts. The nature of the business which enables those supplies to be brought forward is that very large long-term contracts are put in place to support the development of the resources in remote regions which will then supply the market. The continuation and competitiveness of that pricing structure has been the foundation of the industry. If your question is that there is now a different model available within the UK and a pricing structure which relates more to gas on gas we can imagine that that competition will start to develop and move more into Europe, but given the

sheer quantity of gas in Europe compared with that in the UK increasingly we see the price signals from Europe come to the UK rather than the other way round.

Mr Guerrant: I completely agree with the history, but in considering the traded markets like the UK and other traded markets round the world it goes back to: what is the energy mix or demand in the UK and the percentage of the various fuels that provide that energy mix? For gas to be competitive in that marketplace it will have to compete with those other fuels just as my colleague said, but when you do not have long-term contracts all of that mix of fuels determines how the price in the traded market and the demand for that gas will compete against those other fuels. For instance, at times in a traded market in the UK the ceiling could be around oil and you could have the floor price, because it goes up and down based on supply and demand, down at the coal price. My point is that the fuel mix of a particular country and the extent to which it is connected to global markets really determines how gas will compete and ultimately be priced in that market.

Q634 Mr Bailey: I would have expected the price to determine the mix to a certain extent. Obviously, there are issues to do with capacity and production, but in terms of demand I would have expected the price mechanism to determine the mix, whereas here it seems to be the other way round.

Mr Trimmer: I think there is a transition. We all understand the history of the European gas model and pricing and why it developed that way. If you go forward and ask what it will be like when there is extensive and good liquidity across the energy markets as a whole I suspect you will find that, just as in the States, when one of the main energy forms moves up the others move with it. If you look at coal at the moment, for example, that is also increasing very significantly in price not necessarily on the back of something specific that is happening to the coal market but because it is now much more integrated into the overall global energy mix. The problem we need to face is that energy as a whole is coming under pressure and it is not just one market that is moving; all of them are moving. We tend to talk here about oil and gas but we see the same thing happening with coal. It may not be a message that we like to hear but that is happening.

Q635 Mr Bailey: I could understand that if they were separate markets they would often tend to follow each other, but this is a formalised link between the two markets which I believe is a clear demonstration in effect that there is an illiberal market where normal market mechanisms are not operating.

Mr Guerrant: There is a very liquid and competitive market here in the UK. Just to demonstrate that, it trades at about nine times the physical volume in the UK. If you add together all of the various instruments it can be as high as 14-plus. If you put it on the same terms and compare that to the US, which is a larger market, the volume traded versus the physical volume is about 12½, so it is very close.

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

It is notably the most liquid market in the world. We look at this market as being one of the most liquid in the world.

Q636 Mr Bailey: If my memory serves me right, one of the reasons it is very liquid and price-responsive to demand is because a relatively small proportion of the gas is actually traded on this market, so a small increase in demand has a considerable impact on the price mechanism. I do not deny that the British market is liquid, but to a certain extent the increase in price is due to the illiquidity of the European market. To move on, where is the demand for the link between oil and gas? Is it imposed by producers or demanded by consumers?

Mr Guerrant: If we return to what I said about the fuel mix, the relative consumers of fuel and how they build their facilities and the percentage that ultimately end up determining how gas will compete with those fuels and will penetrate that market and be priced. To answer your question directly, it is driven by consumers and the facilities that consume fuel in the marketplace and that percentage mix.

Q637 Mr Bailey: How can the link be broken?

Mr Guerrant: When you look at supply and energy demand overall until 2030, ours and many other forecasts say that 75% of demand will be met by oil and gas. That said, we will need all of the fuels; we will need nuclear, oil, gas and coal—all of them—to meet our energy challenge in the future. Clearly, one of the things you can look at is your mix of fuels. Do you go more nuclear, coal or one of the other fuels? That mix is the driver for how gas and oil will compete in your marketplace.

Chairman: The view forming in my mind is that the reason you are being quite evasive on the oil and gas question is that it quite suits you in the European markets in which you operate. I am a bit sceptical about the evidence we are hearing so far on this issue. I ask Mike Weir to ask about European market liberalisation, and Mr Bailey can come back if he has further supplementaries.

Q638 Mr Weir: We have touched on the liberalisation of the market already to some extent. How far away do you think a liberalised European market is?

Mr Trimmer: One of the things I consider when I try to answer that question is the motive of different governments. I believe that one of the issues we also have to face is that different people in different constituencies have different objectives. We believe that because of our history and what we have experienced so far the best thing for us is a particular sort of liberalised market. We have mentioned the French and the extraordinary length of storage they have. That is driven by the fact that to all intents and purpose they have no oil or gas and so they have a perspective on security of supply that we have never had. I do not believe liberalisation will take place unless someone has a real go at it and grabs the whole thing by the scruff of the neck; otherwise, it will not lead to a converged single interpretation of that. In terms of the pace of change, that will be

determined by how individual governments react, but from our perspective one of the key things we need, maybe not so much as a fully liberalised market in each location, we would like to be able to move gas around with more freedom than we've been able to do so far. They have every right to have a particular structure, but we would at least like the ability to move the gas around so we can then achieve what we want in the UK.

Q639 Mr Weir: Given energy security about which there is some concern at the moment, is there not evidence that some countries have retreated to looking after national energy security rather than a liberalised European market? In that instance is it likely that there will ever be a fully liberalised European market?

Mr Trimmer: I guess that is why I said I thought people would end up in different situations in different locations, but there is another perspective, namely if that is the way people wish to go—it is not for us but elected people to determine that—at least give us the freedom to move gas around, so we would perhaps focus a bit more on saying that we would like freedom to move gas around rather than be particularly concerned about a particular price.

Q640 Chairman: What is inhibiting your ability to move that gas around?

Mr Trimmer: There are some physical constraints in the system and also different regulatory interpretations can sometimes make it difficult to move gas round, but that is improving and I believe that things like unbundling will help that also.

Mr Guerrant: There are also different specifications of gas across Europe that make it very complicated. All of those technical issues need to be worked out. Therefore, there is a hardware problem which is all about bottlenecks, specifications and so forth to make it fungible, but there is also a software problem which is more to do with contracts, regulations and so forth.

Q641 Mr Weir: We were told in an earlier session by one of the major users of gas, INEOS, that it had time on the interconnector and had sought to buy gas in Europe on the type of contract that exists in Europe but no one would supply on that basis. Presumably, you all deal in gas both on the European mainland and in the UK. Why is it that you or one of your competitors would not supply gas to them from Europe on a European-type contract but only a UK-type contract?

Mr Guerrant: I am puzzled when I hear something like that because it does not make sense. If they were going to be taking delivery of gas in Europe they should be able to get the price.

Q642 Mr Weir: They were going to take it back to the UK through the interconnector.

Mr Guerrant: If my understanding of the question is that he had taken capacity to where he was going to take delivery of the gas in Europe he would be taking

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

title to the product there. It puzzles me because there is gas available to be sold there. I am puzzled that he was not able to do that.

Q643 Mr Weir: So, if he approached you you would sell him gas on that basis if he wanted it?

Mr Guerrant: Yes; I am always looking for new customers.

Q644 Mr Weir: Given the strong link between the UK and the mainland European market, is there any point in the UK having a fully liberalised market if Europe is not following along and doing the same thing?

Mr Wooley: I think that what you are observing at the moment is that the UK has taken a particular path and Europe, if it has followed at all, has followed very slowly. Therefore, some of the issues we are describing are ones where the UK has not benefited from liberalisation in Europe because it simply has not taken place. An example I talked about earlier was security of supply. When security of supply is in discussion, particularly for the winter, there are very large storage reservoirs available in some of the continental European countries. One of the questions often asked is: when you get into a peak period in the winter and there are high prices in the UK why is it that only a limited amount of gas flows from Europe to the UK? That is certainly an area where liberalisation would help and you would expect to see more gas moving around. More liquidity in the European markets would promote greater flows of gas to the UK in those periods.

Q645 Mr Weir: But if Europe does not liberalise to the extent the UK has should the UK for its own security of supply look to de-liberalise some of the market here?

Mr Guerrant: First, based on what I said about the development of trading hubs in Europe it is starting down that path. I would disagree that there is no liberalisation because that is occurring now and we are selling into those markets every day. The fact that the UK has liberalised has allowed us to make the \$13 billion investment to bring in new LNG into the UK. The fact that you had a liberalised market was a key attribute for us to select the UK for that project. It has allowed the UK to get new supplies from the Netherlands also with the BBL. I would say that you have enjoyed more advantages than disadvantages over time. We may be seeing some short-term aberration. On the continent many of the long-term oil-based contracts have lag effects and now we start to see higher oil prices we may see prices on the continent flip the other way and the UK may be cheaper. Usually, these things stay pretty close together over a long period of time and you end up with aberrations over a short period of time.

Q646 Mr Bailey: With oil prices likely to continue to rise obviously irrespective of other factors the price of gas will go up. That is very convenient for the producers. Is that not the real reason why this link is being sustained?

Mr Trimmer: If we talk about the UK there is no link. There are some old contracts

Q647 Mr Bailey: But it impacts upon the price of gas in this country?

Mr Trimmer: Yes, that is also why I say we have a transitional period where there is some influence from the continent. One of the biggest influences which will arise fairly quickly is that of the global market. I personally do not see the link and the motive which says that we would hold on to a particular way of working on the continent if it did not give us the signals we need to make the new investments and to do the sorts of things we want to do around the UK. The nature of the UK market is that it provides us with the confidence to invest a considerable amount of money in the Langede pipeline and the very large Ormen Lange gas field that we have just started to bring on the strength of the UK price base. I do not accept the starting point which says that Shell is particularly aligned to one form of pricing or the other. It is the market pricing in the UK that drives the pretty successful investment programme at the moment.

Q648 Mr Bailey: But one of the intensive-energy users said that it had tried to buy gas and asked for a continental-type contract but could not get it.

Mr Trimmer: I can honestly say that I am astonished at the statement.

Mr Wooley: I can say for BP that at the moment that is not an area of the market that we would serve. We withdrew from that sector of the market some years ago.

Q649 Mr Wright: We know that during the summer months there is always a downturn in gas production in the UK for obvious reasons. Is there any evidence that the interconnector is used more to export gas from the UK rather than import it?

Mr Wooley: The balance of flow through the interconnector over the various periods of the year is obviously a matter of public record, as it were. Historically, when the UK had a large production surplus it was able to export quite significant volumes in the summer months. As the UK has become less self-sufficient the amount of gas it can export in the summer has reduced and is quite small. Correspondingly, the volumes of gas that are imported both through the interconnector and the BBL line have increased to the extent where basically we import about 40% of our gas on an annual basis.

Q650 Mr Wright: Is that directly through the interconnector or BBL?

Mr Wooley: Through a combination of the interconnector, BBL, some LNG imports and connections to the Norwegian systems.

Chairman: There is a lot of jargon in this industry and Anne Moffat will ask you about one example which is relatively new to me.

Q651 Anne Moffat: It began this morning when the Chairman did not understand what the national balancing point was. I do not think any of us knew

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

it. One of the notes we have says that it is the virtual trading location for the sale and purchase of natural gas. It sounds like something out of *Star Trek*. Maybe you can enlighten us.

Mr Guerrant: I will take a stab at it. There are various segments of the market here in the UK. Clearly, there is the domestic sector or retail sector, but the sector in which my company is involved is the wholesale sector which is what is called the NBP, the national balancing point. Essentially, this is all the gas that goes into the national grid system. That gas is traded on various terms but primarily on a short-term basis and I talked about the pricing of that a minute ago. If we look at the absolute volume of gas going into the grid from which UK consumers pull their gas, the buys and sells are multiples of nine to 14 times the physical volume that consumers like ourselves pull off the system. That system of buying and selling is what creates the liquidity and creates the highly competitive market and the transparent market pricing one has.

Mr Trimmer: You may imagine a market. Why is it a virtual and not actual location? You do not have to bring the gas to a particular point in order to make the sale; it is virtual because many different points count as your having put gas into the market. You do not have to bring it physically to Easington or London in order to make the sale; you can do that by putting gas in in the north and someone can take gas out in the south. That does not matter because it is within the national grid system.

Mr Guerrant: What is very important is liquidity. If I had to haul the gas to your meter to serve you there would not be liquidity; there would not be multiple buyers. By creating this virtual point it allows all the buyers and sellers to be on the same basis. There is full liquidity and no one has an advantage.

Q652 Anne Moffat: What proportion of UK gas is traded by this balancing formula?

Mr Guerrant: The NBP is a market, not a formula. Looking at UK demand, nine to 14 times is actually traded, so a lot is traded in multiple times. That creates the extra liquidity, so it is the other way round. Does that make sense? You have the physical volume of molecules that go to the customers. Let us call that 10 units. The number of buys and sells of all the wholesale players' buying and selling is 90 units; in other words, it is nine times the physical volume. You have a lot of buying and selling among all the various traders.

Chairman: But that characterises a lot of markets, such as futures markets and so on; it is not a particularly unusual feature. It does not tell you how much gas is being traded off that market or how prices are being set by the small percentage that is being traded on that market. I will ask Mr Wright to put his questions.

Q653 Mr Wright: This is quite relevant. There was some confusion as a result of the previous session when Alistair Buchanan talked about the amount of gas put on the off-market as opposed to the forward market. energywatch has stated that about 80% of the product is in the off-market contracts, leaving

only 20% in the forward market. Is that a true reflection of the amount or is it somewhat different from that?

Mr Wooley: In this regard I can speak only in respect of BP. The history of contracting in the North Sea is that very often in the early days fields would be contracted to customers, primarily British Gas in the old days. You would sell the production of the field for the field life under a so-called depletion contract. You would commit all the gas from that field over its life. Obviously, in today's market we still continue to sell that gas to the original customer. In the mid-1990s there were lots of what we call supply contracts whereby we would commit to supply reserves from fields for, say, a period of 15 years. Those would still be dedicated to a particular customer. The more recent history is as we have developed more fields or old supply contracts have come to an end is that we put those volumes through the traded market.

Q654 Mr Wright: The traded market is the forward market?

Mr Wooley: Yes. BP puts about 60% of its volume through the traded market and about 40% through the older contracts.

Mr Trimmer: To complement those numbers, we are also active in the industrial and commercial sector and so we market directly to companies. Between the traded market and the industrial and commercial market as we call it we are between 60% to 65%, so 35% to 40% is left under the old-style contracts which are similar field depletion contracts. That was all there was at the time because there was a monopoly buyer.

Mr Guerrant: To put ExxonMobil's numbers in the UK in perspective, about 60% of our gas here is on a traded basis and about 40% comes under the old contracts.

Q655 Mr Wright: So, the figure quoted which shows that 80% of long-dated physical volume is being traded on the off-market is not true. You have told me that the figure is about 40%.

Mr Guerrant: There are two ways in which gas is being traded. I am not sure about the question. We call it the over-the-counter market.

Q656 Mr Wright: What is said is that 80% of the total production is already committed in off-market contracts which are being negotiated behind the scenes in secret, leaving only 20% to be traded, which obviously determines the price. You are telling me that it is approximately 40% on the off-market as opposed to 60% that can be traded on the open market.

Mr Trimmer: I do not know whether this is another example of slightly different definitions or interpretations of a word, but I can tell you that the traded market is definitely at 20% to 25% and the industrial and commercial sector, which is one or two-year contracts, is NBP-linked and that is another 40%. That leaves the last 35% to 40% under the old-style contracts which are described in that way.

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

Mr Guerrant: ExxonMobil is not involved in the industrial sector. We put either all of our gas into the wholesale NBP market or it is subject to existing old-style historic contracts. Our split is about 38% in old-style contracts and the remainder goes to the wholesale market. If he says that 80% is in the long-term market it does not make sense for my company and, from what I have just heard, for others.

Q657 Mr Wright: Is it true that the forward prices are used as a basis for many of the off-market contracts?

Mr Guerrant: We start to get into commercially sensitive matters. Let me talk here in conceptual terms; I will not talk about the specifics of my company. Generally speaking, based on my knowledge of the UK a proportion of the old-style contracts are linked to oil; a proportion are linked to the PPI; and a proportion are linked to electricity and coal. The splits can vary.

Q658 Chairman: We have heard a good deal of evidence that a lot of the contracts of the major users are on a forward price basis; they have to pay whatever the market says at any time. They do not know the price which changes as the wholesale market price changes. They say that a very small proportion of gas is traded and that determines their contract prices.

Mr Trimmer: I guess you are hearing that there are three people who do not quite understand that statement. I have to be careful about competition law here and so I shall not go into detail, but we now have about 12—we are creating up to 22—what we call value propositions, some of which are fixed and some of which are floating. Therefore, the customer can make quite a choice at the time the contract is signed, and there are even arrangements that allow the customer to move from one to the other in the middle of the contract. So this idea that somebody is at the mercy of a particular market—if they choose to have a price which is linked to, say, the day or month ahead gas price that is their choice, but it is not the only thing that is around in the marketplace. Maybe they lament the fact that they did not lock in something earlier. I do not know.

Mr Guerrant: What is interesting and very important information for you is that having a liquid market allows more customised pricing than a market that is not liquid.

Mr Trimmer: Absolutely. We would not be able to offer some of the things we do if there was not a liquid market. At the same time, in our marketing activity we do not feel inhibited by a lack of liquidity in the market-place. Several of the things that we put on offer are linked to transactions that take place in the traded market and we could not do them if there was not liquidity. This question of how much liquidity—certainly if we are talking one or two years—if we are talking about five to 10 years ahead then we get into a different area, but if we are talking about the sort of thing which most industrial and commercial customers talk about from my perspective there is not an issue.

Mr Wooley: To clarify, the reason why the older contracts which do not go through the market are not indexed to gas prices is that when they were struck perhaps 20 years ago there was no gas market indicator to which they could be related. That is why the coal, PPI and fuel oil-type indices were used instead.

Q659 Mr Wright: My last question is related to INEOS Chlor which trades in Europe and the UK. It tried to get the same contract for gas supplies in the UK as it has in mainland Europe. Why do you think there are two sets of rules in terms of contracts for the supply of gas?

Mr Guerrant: I am still puzzled about the comment and the situation. You have to understand a lot more detail about what he was looking for in the marketplace.

Q660 Mr Wright: I quote from the evidence. They went to 19 suppliers many of which had supply points on the continent and only six replies came back. Every one of them offered a price based on the UK rather than the continental price.

Mr Guerrant: If he is taking delivery of the gas on the continent I am puzzled; I do not understand it. I think the example he gave was that he took capacity on the interconnector into the continent so he could buy the gas on the continent and then haul it into the UK. I am puzzled about that, if that is the situation.

Mr Wright: Obviously, we can take this up with suppliers anyway, so it narrows it down a bit.

Chairman: It is something that we shall have to take up with the company again because in a sense it goes to the heart of what this inquiry is about.

Q661 Mr Binley: I want to ask about gas storage because we have a serious problem here which from my perspective has not been dealt with very efficiently or effectively. I recognise that the change from supplier to purchaser in this respect relating to the North Sea is a major factor, but what I do not understand is that that can be seen. We are then told that the planning problems in this country have added to those difficulties. I am sorry but they have been around for a long time, too. I do not understand why the present massive need for gas storage to help us equalise winter and summer prices was not seen a considerable time ago. I should like to know whether the market will deliver increases in gas storage in the UK and in what timeframe. It is a big factor. The information we have received is that we will not get it for perhaps three or four years. What is your view?

Mr Trimmer: Perhaps I should kick off with some of the things that we consider when looking at investing in underground storage, which is something we do. We feel that our skill lies more in underground storage that makes use of, say, depleted reservoirs than in other facilities. That is the business we are in. To stick to that, the sort of thing that will be important is the difference between summer and winter prices. A matter to bear in mind is that that has increased very significantly over the past two or three years. If you go back three or four years, there

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

was no track record of a very large differential. Another element is the availability of reservoirs. We would naturally want to deplete a reservoir before converting it into storage, so it is the geology that determines when fields come up. When they do come up we consider them. The other matters are the fiscal and regulatory regime and the planning aspect that you have talked about. Another factor is prediction of the supply/demand balance. It is only in the past two or three years when the planets have become aligned with a supply/demand balance which really focuses on the fact that the end is coming—because we had false dawns on many occasions—together with a market, not surprisingly, beginning to show an increase in summer/winter price differentials, that the commercial environment means one could go ahead. These things are significant investments and one needs more than a whim and a prayer to make them go. The economic signals come through. Things like planning just do not help; they slow down the whole thing. I believe that with the signals we now have and the fact that more reservoirs are becoming available we can expect to see more projects coming through as we do.

Mr Guerrant: First, I would reiterate that given the market signals the incentives were not there because the market was able to handle that flexibility in the past. Those are now there. Second, we all recognised that a couple of winters ago the country was really relying on one large facility and that was another important signal that we needed to expand. As an investor when you put down your money you want to make sure that you can get it done. I do not underestimate the importance of the two Bills that are currently being considered to ensure that the planning process is streamlined and allows it to go forward so that when investors start to develop these things they have the assurance that they can get a reasonable return.

Q662 Mr Binley: In terms of your investment programmes you were caught out because volatility has become a much more important factor than you ever thought it would be?

Mr Guerrant: First, just now we are seeing the market say that you need it. Second, we need streamlining in the planning process to ensure that it can be economically viable and built.

Q663 Mr Binley: If the market cannot do it is there a case for the government to invest in strategic storage? With 13 days' storage we are vulnerable, are we not?

Mr Wooley: The question may be whether the market has yet received pricing signals of sufficient strength and duration to encourage investment in storage. Clearly, the way the market has evolved over the past two or three years has brought forward a number of companies that are beginning to look at the opportunities in the offshore and onshore environment. Companies such as BP are looking at some opportunities, but in order to bring forward these things in terms of a depleted offshore field one is looking at hundreds of millions of dollars of investment both in the facilities that need to be

developed to extend the field life or put the terminals on the coast but also to provide the cushion gas that is needed to make these reservoirs effective. One may be talking of twice as much again in cushion gas costs. There need to be strong and sustained economic signals. As we saw with the development of the infrastructure and the new capacities in the pipeline networks given the UK's development of the regas terminals, if there are strong market signals over a period of time the track record of the industry is that it will respond.

Q664 Mr Binley: Here we are as consumers in Britain at the mercy of supply. We are in a much more vulnerable position than the continent for historical reasons, which you have gone into. You have not seen that coming and as of today you have not invested enough, and the government has lagged behind as well. Who will take responsibility for the vulnerability of our marketplace and the problems that consumers may face?

Mr Trimmer: Perhaps I may go back to something I said a little earlier. Interconnectivity is important and the significance of the increase in capacity of the interconnector, the creation of the BBL which links us with the Netherlands and the opening of the Langede pipeline in the past 12 months are a very significant response from industry. The investment just behind Langede for example, Langede is the longest offshore pipeline in the world which links one of the most challenging, complex and large fields in the North Sea. That is industry's response. There can be issues to do with whether or not we have enough storage at the minute, but connectivity is becoming much greater and in terms of security of supply and the ability to balance in times of local shortage that connectivity is worth a lot. For the future we must have more storage and the signals will bring it through.

Mr Guerrant: The LNG facilities which have been added over the past few years and will be added are significant new supplies to meet the need.

Q665 Mr Binley: Therefore, you are saying that the price volatility that Britain is experiencing because of shortage and storage problems will be equalised in the foreseeable future. When do you think that will happen bearing in mind that we simply have plans to go up to about 18 or 19 days from 13 whilst Germany is about 99 days and France 120.

Mr Guerrant: As new supplies come in volatility will be dampened.

Mr Binley: Perhaps I may turn to a personal concern of mine: carbon capture and storage. How do you view that bearing in mind that we have 240 years of energy requirements under our feet on this island. If we can solve that problem the North Sea seems to be important in that respect. Can you tell us a little about how that is developing and what the timeframes are? Can you also tell us a little about whether the projection of 15%, maybe 20%, of additional fuel from the North Sea can be forced out perhaps by using that technique?

17 June 2008 Mr Nigel Wooley, Mr Richard Guerrant and Mr Paul Trimmer

Q666 Chairman: If it is off-piste I understand but it is interesting.

Mr Guerrant: I believe that globally industry, governments—all of us—have a lot of work to do to come up with technologies that are economically viable to ensure that when we utilise CCS it is cost-effective for the consumer. We are a long way from that. That said, many of us in the industry are today doing pilots and investing in new breakthrough technology to figure out a way to separate CO₂ from other material and to be able to liquefy it and pump it in a way that is cost-effective. In addition, we will need a regulatory framework that makes sense to be able to do the commercialisation of CCS. If you ask the very simple question how long it will be I cannot give a specific answer, but we have many years to go before we are able to get the results back from pilot projects, get new breakthrough technology and put together a commercial framework that makes sense in order to use CCS.

Mr Trimmer: In that context there needs to be a partnership among industry, regulators and government to make it go as quickly as possible. For example, I know that the Norwegian Government is very active in trying to develop and promote schemes in Norway.

Mr Wooley: BP's experience with the additional scheme at Miller that was touted for some period of time was a disappointment and a setback to us in that regard.

Q667 Chairman: We are getting to the end of our time. I want to put one question to you to summarise what we have heard over the past two sessions. We heard some very loud complaints from customers about the illiquidity of the market and volatility of prices and the position was quite broken. We have heard you say that it is all quite liquid and is going rather well; it is much better than anyone thinks and for some reason the European model works in Europe and the British model works in Britain, so we should not break it. The regulator has said he does not know what is going on, and he even gets his facts

wrong about the level of imports at the Isle of Grain. This leaves us in something of a quandary to say the least. This Committee faces the three worst positions. There is no meeting of minds at all. What are we to do? What would be the consequences of a recommendation by this Committee that the only people who can sort out the wholesale gas market are the Competition Commission? Apart from the huge cost, what would be the consequences?

Mr Wooley: As an upstream company the most important role we can play is to focus our energy on the development of new resources and to apply our technologies to bring forward our investment and new supplies both to the UK and to other markets. That is where we should be focusing our energy.

Mr Trimmer: I totally agree. In the context of the UK we should also make sure that we maximise the benefit we get out of the existing production facilities and infrastructure we have, so other things can be done there.

Q668 Chairman: You should be politicians; you have completely avoided the question. Let us see whether Mr Guerrant can do it.

Mr Guerrant: You know that I will agree with the need to bring in new supplies because that is what we do best and that is what we can do to help the consumer. You need to protect your market and the integrity of your NBP wholesale market. We believe that it is working and it has underpinned huge investments in this marketplace. If you do something to send a chill into that good market or change it there may be consequences which will concern investors who are investing in it.

Chairman: This is an issue with which the Committee must wrestle. Gentlemen, we are grateful to you for your time. It was not too painful; you did not have to give us any great commercial secrets. You have been helpful, if confusing in terms of the conflict with evidence received earlier. If on reflection you believe there is anything else you would have liked to tell us we would welcome it in writing. Thank you very much. I release you from your bonds.

Tuesday 24 June 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Roger Berry
Mr Lindsay Hoyle

Mr Mark Oaten
Mr Mike Weir
Mr Anthony Wright

Witnesses: **Mr Keith Munday**, Commercial Director, BizzEnergy; **Mr Peter Bennell**, Chief Executive, Supply, Welsh Power and **Mr Graham Paul**, Sales and Marketing Director, Electricity4Business, gave evidence.

Q669 Chairman: Gentlemen, welcome to the last but one evidence session of this Committee's investigation into energy prices. We are very grateful to you for your very thorough written submissions. I would like to begin, as I always do, by asking you to introduce yourselves for the record and as you introduce yourselves, your name, your responsibility, your organisation and a brief characterisation of what it does and who owns you would be very helpful as well, please.

Mr Munday: My name is Keith Munday and I am the Commercial Director of BizzEnergy. We are a supplier to small and medium enterprises, started by venture capitalists in May 2000. We are based in Worcester and we employ 150 staff. We are very risk averse. We just want to operate in a very controlled environment. Our principal business proposition is to be a retailer. We want to compete on customer service, innovation and cost to serve.

Q670 Chairman: Thank you very much. I do not want to correct you right at the very beginning but you are not based in Worcester; you are based on the edge of Worcester in my constituency, if we can clear that up for the record! Mr Bennell?

Mr Bennell: Peter Bennell, I am the Chief Executive of Haven Power. We are a small supplier of energy, and electricity in particular, to small businesses. We are part of the Welsh Power Group; 74% owned by Welsh Power, the balance by management. We specialise in supplying electricity to small businesses. Our proposition is that we will treat you as a business rather than as ICI or as a domestic customer. Couple that with some personal service and competitive pricing.

Mr Paul: Good morning, I am Graham Paul and I am Sales and Marketing Director of Electricity4Business. Electricity4Business are a retailer of electricity, meaning that we do not actually own any generation asset, we just supply electricity to smaller businesses. Our target market is about 1.4 million smaller businesses of which we are supplying approximately 40,000. We are based in Milton Keynes and we have 150 employees.

Q671 Chairman: This is an important session for us because there is a lot of media attention, understandably, on the needs of domestic consumers and the big energy users get their voices heard quite a lot and gave some very impressive evidence to this Committee a few weeks ago, but this

is the opportunity for the suppliers to the small and medium business sector, largely anyhow. Can you tell me what the difference is in the market you supply to the domestic market?

Mr Munday: I do not think any of us are actually in the domestic market yet although BizzEnergy is on the edge of going into the domestic market. There are clearly some differences in the nature of contracts in that the SME market is principally a fixed-price, fixed-term contract market whereas domestic customers can leave after 28 days. As regards other differences in the domestic market, I think there is a view held widely within the industry that to be a domestic supplier there are very significant economies of scale. This has led to us having five or six suppliers each with about five million customers. That is something that we are not convinced of by any means. When you think about a domestic supplier, you think about customer service staff. For every dozen or so customer service staff, you need a supervisor and for every dozen supervisors you need a manager. It does not appear like huge economies of scale in operation there. So it must be something to do with IT or systems. Actually in 1996–97 when the domestic market was emerging, there were big economies of scale in IT but as of today, with the advent of new computing systems and new software, we do not believe that there are material economies of scale in the domestic market. Clearly you would not set up to serve one customer but we think there is a plug to be filled between a few customers and the five million, and therefore we would like to have the opportunity as a business to challenge this paradigm that you need five or six players to service the domestic market; we really do not believe that.

Q672 Chairman: We will look at some of the obstacles to that later on. Do either of the other two gentlemen want to add anything to that answer?

Mr Bennell: The only other thing I would add is that in the small business market there is a huge volume of business transacted through brokers which you just do not see in the domestic market at all. They are out to get, on various bases, from the very reputable to bordering on the disreputable, the best deal for their customers.

Q673 Chairman: And their interest is their commission?

24 June 2005 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

Mr Bennell: They get commission or a fee or they get paid by either the supplier or the customer.

Q674 Chairman: Can I just ask about Ofgem and regulatory issues. Do you think that the level of regulatory protection is different in different markets? Do you think Ofgem is giving enough attention to the small business sector in its current inquiry?

Mr Munday: Clearly there are differences between the domestic market and the small business market. There are some very necessary regulatory protections in the domestic market for domestic customers to deal with vulnerable customers, et cetera. The business market is deemed initially to be a buyer beware market; you have got informed buyers and sellers. What we are beginning to see emerging in the market is a series of practices which are certainly making us think twice as to whether the level of regulatory protection for customers is appropriate in that market.

Q675 Chairman: We will deal with those practices in more detail later.

Mr Munday: That is something that we would encourage the regulator very much to take a much more proactive stance in addressing.

Q676 Chairman: So in other words, your view is that Ofgem is probably not giving enough attention to the needs of the small business sector?

Mr Munday: Absolutely.

Q677 Mr Wright: In terms of Ofgem, your company Mr Munday, is an example of there not being a powerful enough regulator in some aspects, certainly in terms of competition. We talk about switching in the domestic market where there is a concern but certainly in the business sector it is probably largely unheard of. What are your concerns there in regard to Ofgem's capabilities in taking this forward?

Mr Munday: Ofgem in the past have really focused their attention on the domestic market. They have paid very little attention to the SMEs. They had hoped that a competitive market will emerge there. To a certain extent for a few years it looked like a good market was going to emerge; unfortunately, it has not. As regards their attention on switching rates as a measure of competition, that is not one that we believe is appropriate to use as the sole measure for switching and we see very few stats available from any source on the nature and level of switching in the business sector, and that is a big cause of concern for us.

Q678 Mr Wright: Are there any figures at all that you are aware of?

Mr Munday: No.

Mr Paul: I think one of the key indicators of the level of switching is published in one of the market leader's annual accounts for 2007 which shows that they renewed 95% of their SME contract customers and that was at the same time as being rated as the

worst supplier for customer service in research carried out by Datamonitor and energywatch in 2007.

Q679 Mr Wright: Mr Bennell?

Mr Bennell: I think this is very interesting. The SME market is worth several billion pounds, quite a bit more this week compared to what it was even two or three months ago. There is just an amazingly low choice in it. In any other non-utility market you can think of that is worth that sort of money, yes, you have got a few big players, yes, you have got middle-sized players and, yes, you have got a horde of small ones. They are not present in this market.

Q680 Mr Wright: What measures do you think Ofgem should be taking to bring more competition into the business market?

Mr Munday: There are issues on the wholesale market in terms of the availability of product for people like ourselves to service customers. That is a major barrier. There are some contracting practices where what I believe is happening in the market is that the established players are, by and large, reasonably comfortable with their market share, they are looking for their bottom-line profits, which is a perfectly natural and rational thing for them to do, and they are coming through to the thinking, again which is right, is it better to retain a customer or win a customer. Clearly it is a no-brainer and the answer is it is better to retain a customer. The only thing we are questioning is some of the techniques that have been used to retain customers over the last—

Q681 Chairman: We will come to that in more detail in a little while. Just before I bring in Lindsay Hoyle, one of our submissions, and I cannot find it now, lists the sorts of things that should be addressed in considering whether a market is competitive or not. If you are critical of switching rates, as many people are, as a measure of competition, what measures of competition do you think Ofgem should be using to assess the competitiveness of the market?

Mr Munday: I do not think there is any one single measure which is fit for purpose. I think the variety of products, the variety of players, the ease and entry of players are all good monitors to use. What we want from a competitive market is to know that the customers are getting good value for money. How can we tell that customers are getting good value for money in this market? A normal indicator would be customer satisfaction, and that is great, you can do that, how a customer is feeling. Clearly in this market customers are not feeling very happy. They have the impression that they are being overcharged. If you get that impression, how would you actually test that? In a normal market you say what sort of returns are the companies making who are providing this service, and you see if that is proportionate to the risk and the business that they are conducting. Unfortunately, in the market structure we have you cannot see from any of the businesses how much money they are making out of their supply businesses in electricity and gas or out of their

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

generation businesses. Without clarity as to how much money is being made in these markets it is difficult to turn round to a customer and say, yes, you are getting good value for money and this is why.

Chairman: You are warming to your theme, Mr Munday. One of my colleagues wants to ask about that particular issue at some length later. The answer is there is no single measure of competition, it is a basket of indicators you must look at and take a value judgment as to what the competition is really like in the market. Mr Hoyle wants a supplementary I think.

Q682 Mr Hoyle: Just quickly on what you said because customers believe that the market works against them and works for the suppliers. Whether we like it or not that is the general impression. What I would say is the evidence we did have was that part of the reason Vauxhall moved production abroad was because energy costs were so high and that the market did not work for them.

Mr Munday: Sorry, I am missing—

Q683 Mr Hoyle: The point being that they felt they were being ripped off; this is rip-off Britain, and you are part of the rip-off. Is that fair or not?

Mr Munday: I do not think we are part of the rip-off; I think we are part of the solution. What we want is a level playing field in the market so that we can access the products—

Q684 Mr Hoyle: So you can make profits.

Mr Munday: —to service customers in a manner which is better than is being done by the incumbents. What we want to see in the market is transparency of the accounts and transparency of the market so that people can actually see, yes, they are getting good value for money and remove this myth of rip-off Britain because we think that is in the customers' and the consumers' best interests.

Mr Hoyle: So the bigger profits is not a rip-off?

Q685 Chairman: I am going to interrupt Mr Hoyle here because I ought to put on the record the fact that you supply between you less than 1% of Britain's energy and the other 99% comes from the 'Big 6', and you aspire to take more and more of that 99% by offering a better deal?

Mr Munday: Yes.

Q686 Mr Oaten: But you cannot guarantee that if you had more of the market you would be able to cut prices.

Mr Munday: Presumably customers will switch to us because there is a better service offering or lower prices and there will some attraction for them to move, otherwise we would not grow market share.

Q687 Chairman: Can you give the Committee an example of the kind of offer that you make that distinguishes you from the 'Big 6's' offer to their customers?

Mr Munday: Certainly from BizzEnergy we are very keen on smart meters. We were one of the first suppliers to move into the market in smart meters back in 2004. That is something that we believe gives the customer not only timely and accurate bills, which people have a right to, but also information about their consumption, against which they can make real savings in their consumption. We have been trying very hard for the last four years to promote this market and get it off but we feel like we are all the time being pulled back by the industry not wanting to change its systems and processes to allow this to happen in a timely and effective manner.

Q688 Mr Hoyle: The truth of the matter is you want a share of the market and you are saying "we are the good guys" but the reality is you have entered this market because you want to make money.

Mr Munday: I do not think there is anything wrong with trying to make a reasonable return. It is whether it is proportionate to what we are doing and the value that we add to the overall mix.

Q689 Mr Hoyle: So the jury is out?

Mr Munday: Give us the opportunity to demonstrate and we will be there.

Mr Paul: From Electricity4Business's point of view we have had a big focus on looking at the operational costs of running a retail business and we have invested a lot of time and money in making those processes as efficient as possible in taking a large chunk of that cost out of our supply side so that we can then offer cheaper prices to our market.

Q690 Mr Bailey: To a certain extent I think the answer to some of my questions has at least been hinted at in what you have said already, but if I can summarise the situation so far. You are small independent producers who feel you can make an offer to SMEs which would be competitive in comparison to the 'Big 6' suppliers. However, you are blocked from entering the market by of a range of practices that they have adopted which makes it very difficult for would-be customers to switch to you. Could you give examples of the sorts of practices that you feel are taking place which are preventing that and perhaps some of the changes that need to be in place to prevent it?

Mr Paul: I think one of the overall challenges that you have as an independent supplier is not only generation but obviously is access to the wholesale market. We need to buy forward on the market and we therefore need a liquid and deep wholesale electricity market. Since NETA the wholesale market has been declining. The aim of NETA was to create a deep and liquid wholesale market and that has not been achieved. The shape of the UK electricity supply market has been moving away from a wholesale market to one of vertical integration.

Chairman: You are anticipating both the next lines of questioning. We are going to ask you about the wholesale electricity market next and then vertical integration consequences, so it more the practices we are interested in.

24 June 2005 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

Q691 Mr Bailey: The working practices and contractual arrangements that are adopted.

Mr Paul: Obviously I am not here to complain about competitors' activities—

Chairman: Go on!

Q692 Mr Bailey: You will not have a better opportunity!

Mr Paul: What would be useful is to explain some of the barriers that we have had to jump over as a new market entrant. One example is the practice of “new customer only” pricing, where there are two prices, a much higher price for your loyal customer base and a reduced price for new customers. The one thing that a new market entrant will not have is a customer base to abuse, so as a new entrant you do not have the ability to subsidise acquisition by charging higher prices to your customers. That sets a very high barrier for entry and requires very, very deep pockets where you may be looking two or three years out before you can get a return from a customer.

Q693 Mr Bailey: If I could summarise what you are saying—and you would not put it as crudely but I will—the ‘Big 6’ can fleece their existing customer base in order to make loss leader offers to would-be new customers?

Mr Paul: Yes, it is not unique in this market, we have seen it in the finance sector, we have seen it in the insurance sector, but where you have dominant players and you are trying to get a market structure where new entrants come in, that does become a huge barrier. We are not looking at small amounts. We are looking at a difference in price of seven pence a unit for a new customer to maybe 14 pence for an existing customer.

Mr Bennell: I think as well there is a regulatory practice (and it has been endorsed by the regulator and put into a licence) that allows an incumbent supplier when they receive notification that they have lost a customer, providing they have got an appropriate contractual provision, to use that fact of a loss to contact that customer to whom they had probably offered a high renewal price, to suddenly offer a much lower “save” price and to encourage those customers to break their contracts with whoever has taken their supply on. It is a very unusual feature of the market and I really cannot see how it is in customers' interests that while that customer may get a better deal, there are hundreds of thousands of others that do not get that opportunity, and it is just peculiar really. There is no other business where your competitors can park their tanks on your front lawn and pick your customers off as they are coming through the front door.

Mr Munday: Just to follow on the theme, there are some what we would call disingenuous contracting practices to customers. For example, at the end of a four-year contract a customer may have to give notice that he wants to leave not before 120 days before the end of the contract and not after 90 days before the end of the contract otherwise he is going to find himself tied in for another period. In a market

of shopkeepers and small offices this seems to be a practice which is not illegal but it does not quite feel comfortable. Another practice which is linked to Peter's point is when a customer's fixed price contract term ends, they will go on to an out-of-contract rate which by its very nature will be higher than the contract rate. The customer will sit there probably quite oblivious to what is going on for several months until suddenly he looks at his accounts and finds, “I seem to be spending a lot on electricity; why is that?” and he goes back and he finds, “Blimey, I am paying over the odds. I will go out and get a competitive quote for my electricity”. So he goes out and gets a quote and finds he can save some money. He then signs up with a new supplier who then turns round and says, “Yes, Mr Customer, you can go and take that deal but if you do I will charge you these higher out-of-contract rates for the period since your contract ended, but if you happen to come with me on this now lower contract rate I will waive those charges”. That does not instil a good sense of customer service into the existing player, does it? He is not strongly incentivised to look after his customer. At the end of the day, nine times out of ten that customer does not go to the new supplier; it is retained by the old supplier. I do not think that is doing the customer any good at all and it is certainly not encouraging people like us to act in the market.

Q694 Mr Bailey: You anticipated my question which was to be on the contractual behaviour of the ‘Big 6’ in retaining their existing customer base and how they could get away with it. Is there anything that the other two would like to add in that sort of area?

Mr Paul: I can give you some examples of some figures to show how prominent this is. We lose up to 36% of our sales, so sales which we have for which we have incurred the cost are then won back by the incumbent supplier. It is a fairly unique market thing, as Peter said, you win a customer but you have to tell the current supplier that you want to transfer it.

Mr Bennell: They then physically block that transfer.

Q695 Mr Bailey: They physically block it?

Mr Bennell: They prevent that transfer. That is a practice that is now allowed under defined conditions by the licence.

Q696 Mr Bailey: Just to finish off, what can be done about it? What would you recommend being done about it?

Mr Munday: I think there needs to be lot tighter regulation on this. We do need to change the rules governing the objections. Where we can demonstrate these practices are going on, the regulator needs to take action very quickly. At the moment it feels like a free option to suppliers to take, although there is some talk of strengthening the regulatory powers. That has not happened effectively as yet and it is still a problem to us.

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

Mr Bennell: There is a lot of competition legislation but it is not clear that it is applicable here. A lot of it refers to dominance. What is dominance? If that were to be clarified and if some bigger players were found to be dominant we might see a marked change in behaviour.

Mr Bailey: Do you think the fact that the 'Big 6' are vertically integrated enables them to offer deals such as lower wholesale prices?

Chairman: I am going to rule that question out of order because we are going to ask about that at some length later otherwise Mark will have nothing to ask.

Q697 Mr Oaten: I understand exactly what you are saying about the existing customer and having the power to retain it but, presumably, if BizzEnergy were trying to win some business off Electricity4Business, you would do exactly the same thing in those circumstances, would you not?

Mr Munday: We need to behave and we want to behave in a manner which does the customer service and suits our reputation. We actually let customers go. We decided a few years ago that we would take the moral high ground on this and we would not employ those practices.

Q698 Mr Oaten: Is that the same for the other companies?

Mr Paul: We do not offer any cheaper prices for a customer to stay with us.

Q699 Chairman: So you value all your customers equally?

Mr Paul: Yes.

Q700 Chairman: Unlike the 'Big 6' who value the people who want to change and not the people they have got as incumbent customers who have not had the wit to seek an alternative supplier? You are being used as a Trojan horse to drive down prices for those people who are clever enough to want to switch?

Mr Paul: Correct.

Mr Munday: Which is not actually a sustainable business model for a new entrant supplier. I think we need to go and examine what we are up to.

Q701 Chairman: It is a miracle you have got 1%!

Mr Paul: There are different prices depending on which channels it is and so a 'Big 6' supplier would have a different pricing level for its direct channel and then a different pricing structure for its agent and broker channel and I think we touched on this earlier where some enticements are offered for the agent and broker not to act in the best customers' interests. Some suppliers have a range of ten tariffs, the bottom tariff, the cheapest one, having a low commission rate; a higher top-end having maybe ten times the same amount of commission payable for the same supply period, so those agents and brokers are not having to declare on what basis they are putting forward this proposed price quote. They are being encouraged to actually get the deal that earns them the most commission.

Chairman: We are going to turn now to the two issues which I think are at the heart of your concerns about the structure of the market—liquidity and vertical integration—and the transparency that accompanies those issues. As we do, can I just remind Welsh Power of their very striking comment: "We believe that the market is fundamentally broken and we need a more radical solution than recent Ofgem initiatives". That is quite a big statement. If you feel we do not in our questions address the fundamental aspects of that broken nature of the market please feel free to add to them. Mike Weir?

Q702 Mr Weir: I take it from the evidence that we have already received that you believe that there is a lack of liquidity in the electricity market?

Mr Bennell: Yes.

Q703 Mr Weir: How does that impact upon smaller suppliers?

Mr Bennell: Quite simply we cannot buy what we need to buy to deliver the power for our customers when we need to. It does not matter whether you are going out two years, or at the moment whether you are talking about last weekend, there is a paucity of power on offer. You would expect in a liquid market there to be lots of transactions which would provide a good reference price for future transactions and for the price that you could expect to pay. There are many days when the main power products simply do not trade. We looked at a six-month period and we found that on half of the days roughly the main power products simply did not trade, so there was no price reference. Then when you look at the days when it did trade most of the time there was no deep and liquid trading. There were perhaps one or two isolated examples, so it is a very marginal thing at the moment, and to say that it is reflective or economically efficient is just wrong. From our perspective, it just has not delivered the objectives that were set out for it when it was introduced first as NETA and then as BETTA, which was a level playing field and a deep and liquid market, and it makes it very difficult for us to run our business.

Q704 Mr Weir: What do you think is the reason for that? Is it purely down to the activities of the 'Big 6' or it is because how the other independents work as well?

Mr Bennell: If you go back to the opening of the market, it actually started out somewhat better than it is at the moment. It was quite promising early on, but early on there were more participants than there are now, there were more generator participants and there were more trading participants, and there was much more flexibility in terms of who was offering what and the terms on which things were offered. What has happened is that there has been a consolidation in generation and a lot of the traders have gone away, some of them for good reasons, others for less obvious reasons, and we have now got a market where most of the power, apparently from our perspective, is not traded through the wholesale

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

markets so it does not touch the sides of it. I think that is down to the growth of vertical integration and the demise of players.

Q705 Mr Weir: But when we asked Ofgem about this, they reeled off a whole list of new generation being built, much of it outwith the ‘Big 6’, and I think it quoted your own company Welsh Power as building a gas-fired station in Wales. Is there independent generation coming into the market? Will that make a difference to liquidity?

Mr Bennell: It is very, very tough to build a new generating plant. We are doing Severn Power because we meant it. As an independent generator/supplier without an approved credit rating we have to put our own cash up to do these things and there are substantial amounts of cash involved. People with credit ratings do not have to use cash, they can do lots of these things, ie progress many projects. If you look at the list of generators there is lots of stuff on there that is not being built and will not get built, so there are lots of people on there keeping their options open. That has another knock-on effect in terms of the transmission capacity. There are some big issues on the process for building new generation as well. We would really like to build another two plants but before we can move that on appreciably I think our experience on the first one shows that there is more certainty that is needed there. It took us two years to get generation consent. We are still waiting for an associated pipeline consent for the Severn Power project. We need the planning—

Q706 Mr Weir: What is causing that delay? Is it Ofgem giving consent? What is the reason?

Mr Bennell: BERR consent, for one thing, and it just seems to be driven by the fact there are no prescribed timetables for dealing with this. There are lots of people who are interested whose opinions are clearly important but these processes seem to drag on and on and on, and without an end stop it is just uncertain. If you want to build a loft extension there is a prescribed time for response. If you want to lay a pipeline or build a power station it takes much longer. Apart from that, one of the projects we would like to build we have been given a date of 2022 from the National Grid for the connection of it. That is after most of our parent board have retired. The strange thing is that there is what we would call “sterilised capacity” in that area so there is capacity that is marked for another future project which is unlikely to start for a considerable number of years which we could use now and build that plant and be generating. There is a Transmission Access Group running, but I think we are seriously concerned that some of the ideas that are being talked about, such as the auctioning of capacity and the removal of existing rights, would just make it impossible to get bank finance for independent generators. I think there is a reasonable list of plant there. Most of that plant is ‘Big 6’-inspired. It would be very good to have more independent generation. For that to happen, more liquidity in the market would be helpful as far as good price references are concerned, more certainty on the consents process and the

planning, and something that is practical and sensible on transmission rights. The National Grid have a licence obligation to provide an effective and efficient transmission service, and not being able to do something until 2022 does not seem to be very consistent with that. I cannot see any urgency behind the steps that are being taken to put that right.

Q707 Mr Weir: But you will get that same complaint from some of the ‘Big 6’ who are trying to do, for example, renewables and wind farms, they cannot get connection to the Grid either. So is getting connection to the Grid a serious problem in creating any new sort of generation capacity?

Mr Bennell: Yes, it is.

Q708 Mr Weir: You mentioned auctioning of generation. Do you think generating companies should be obliged to trade a proportion of their energy in the open wholesale market?

Mr Bennell: Ideally all the output from a generator would be traded in the wholesale market. Unless you have got this steady flow of transactions you are not going to get liquidity. It is certainly something to which the Welsh Power Group would be happy to subscribe.

Q709 Mr Weir: So do you think all generators should be subject to that, not just the ‘Big 6’?

Mr Bennell: I would be quite happy for all generators to be subject to that. I think it would help liquidity and lack of liquidity is the root of many of the problems that we have got at the moment where the price reference that we all refer to refers to a very, very small piece of the power that is actually traded.

Q710 Mr Weir: As a matter of interest, where do you buy your energy from at the moment? Is it mostly from the ‘Big 6’? Is it from independent generators?

Mr Paul: Electricity4Business buys it from the international bank in an arrangement that we have. The challenge that we have with that is that they will give us a forward curve price that we can buy from and buy the futures for that we require. However, we have nothing to reference that price against, so we have no way of judging how competitive it is, and so the requirement in having more players being able to offer prices to the independents means that then you can start choosing where you buy your supply from and actually being able to reference whether it is representing a fair price.

Q711 Mr Weir: Excuse my ignorance but when you say international bank are you effectively buying through a broker then?

Mr Paul: No, an international trading house.

Q712 Mr Weir: What is the difference between that and a broker?

Mr Paul: It is their job to buy all of the components in order to make up that trade.

Q713 Mr Weir: It is effectively a broker if they are buying from the market and selling on to you.

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

Mr Paul: Yes.

Mr Munday: BizzEnergy buy principally from a commodity trader, a major up-stream player in coal and gas. With reference to the ‘Big 6’, what has been very difficult over the last few years is actually that they are, if I said not keen that would be a massive understatement, and to try and get suitable trading terms out of them to trade with us as new entrant players has been exceedingly difficult. In the seven years that Bizz has been going we have only managed to extract terms from one of the ‘Big 6’ players. Some of their offers have been absolutely laughable in terms of the reasons for not wanting to do it. Some of them have been very honest and said, “We do not want to deal with you because all you are going to do is compete against our supply business”.

Q714 Chairman: Hang on, that is quite big what you said, Mr Munday, there.

Mr Munday: It is indeed.

Q715 Chairman: I think that is a bang to rights anti-competitive issue?

Mr Munday: It is and if I could get it in writing or prove it, it would be brilliant, but I cannot.

Q716 Mr Weir: Just going on from that, you are buying from effectively a broker or trading house, or whatever, which presumably take commission on what they sell to you?

Mr Munday: Yes.

Q717 Mr Weir: But presumably they are buying from the ‘Big 6’ or someone else to sell on to you?

Mr Munday: The nature in which the product we buy is constructed probably does come from one of the generators but through a very indirect route, through a complicated mechanism called the “dark spread” where effectively it is a mechanism of swapping coal for power. Yes, ultimately someone will have generated it but it is not in the guise that you are thinking of it as a direct transaction.

Q718 Mr Weir: If you are getting energy within the UK, presumably it is generated within the UK, by and large, so it must be coming from one of the ‘Big 6’?

Mr Munday: Or one of the traders. The electrons must flow that way if you want to think of it in those terms.

Q719 Mr Weir: So effectively what is happening is you are getting it from the ‘Big 6’ in a rather round about possibly expensive way?

Mr Munday: Yes.

Q720 Chairman: Not necessarily from the ‘Big 6’ of course. The ‘Big 6’ hint at the need to increase liquidity in the wholesale liquidity market, to be fair, but Centrica say, “What is the problem? There is 40% generated by independents with no supply base and no contracts so what is the issue?” What is the issue if 40% is independently generated by British Energy—and we could discuss who might own British Energy in the future—by Drax, by others?

Mr Bennell: Drax, for example, will only sell to a rated counter party. That is a counter party with an investment grade credit rating. We are miles off that. Welsh Power Group are miles off that.

Q721 Chairman: So that is a commercial decision by Drax?

Mr Bennell: It is a commercial decision, yes, and it follows waves of problems in the early part of the 2000s where lots of people went out of business, I guess. The fact of the matter is that it is very, very difficult to find people that are prepared to trade with you and to supply you and, when you do, it is very difficult to find any sort of liquidity in the things that you are trying to buy. As far as price reference is concerned, it can go on a transaction that happened yesterday or possibly even the day before. It might be a very different transaction, it might be much smaller, or it might be much bigger.

Mr Paul: I feel quite confused by that statement that has been read out because the preliminary results in 2007 presented by Centrica gave four key objectives that they had as a business and the third one was to reduce risk through increased integration, so perhaps you may want to—

Q722 Chairman: They do actually refer to integration and Mr Oaten is going to ask about integration next because there is a very interesting quote from Centrica on vertical integration.

Mr Munday: There is an aspect of liquidity that is worth touching on and that is the granularity of trade. Peter touched on it with respect to Drax. The wholesale market tends to trade in quite large chunks of power. Small suppliers find that these chunks of power are actually far too big for them to handle and what we want to trade in is one or two megawatts of power rather than what happens where Drax probably wants to sell 20 or 20 megawatts at a time because that is efficient. They have got 4,000 megawatts to sell in total so why are they going to mess around with people like us who just want to buy the odd one or two megawatts? It is not necessarily an efficient transaction for them to trade with us. There is a big issue here not just about the product but about the granularity of the product and the timeliness of when it is available. As a supplier what we need is to be able to sell to a customer and buy from the market or buy from the market and sell to a customer. It is a hand-to-mouth existence. A generator, on the other hand, will decide periodically, “I want to go to market and sell a load of power”. That will be an independent generator. The difference for me with the ‘Big 6’ is that every day they are selling and competing against us with the same customers, so they are actually transferring power internally within their businesses through some mechanism to actually feed it. For me all we want to do is to be able to access the power on non-discriminatory terms so that we can compete with them in terms of cost to serve, innovation, and the things that we are good at; retailing.

24 June 2005 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

Q723 Mr Weir: How are you going to do that? In theory it sounds fine but how are you going to do that. You are talking about Drax selling large amounts and presumably that is where the broker comes in and they will buy the large amounts and split it up into smaller amounts. Is that how it works? I am struggling to understand how you work this market and how you are suggesting you get this energy from the 'Big 6' in the way you suggest.

Mr Bennell: We would like to see some fundamental changes in the market. A requirement to sell your output into the market would be very helpful.

Chairman: We are going to get to Mark's question so I had better bring Mark in because you are itching to talk about vertical integration. Before I come to that, can I just ask you a question which is that some of the 'Big 6' have said to me, "These guys are just whingers, they could invest in their own generating capacity". In fact, Welsh Power is doing that so why do you not just build a few biomass plants and a few CHP plants and get on with it?

Q724 Mr Hoyle: A couple of nuclear plants!

Mr Munday: There is one in my back pocket.

Q725 Chairman: There is a serious point here. One of you does but the other two do not.

Mr Munday: When the market was originally designed, it promised a level playing field in generation and supply. It also promised that you would not have to enter both markets. If you think of the characteristics of entering both markets, they are indeed quite different. For a retailer you need to be good on customer service, computing systems, all that sort of thing. To be a generator you have got to be good at heavy engineering and you need big finance. You can start a supplier with a relatively small amount of money, £1 or £2 million something like that gets you up and running as a supplier. For a generator if you want to build a nuclear plant you can all see the price, it is a completely different type of operation. Under the original market design (which we are still working to because nobody has refuted it) it promised separation of this because that was thought to be to the best value of the consumer.

Mr Paul: This is a very important question. The wish is to have a competitive market but with the structure of the market the way it is at the moment, to enter it you have got to not only build a generation business you have also got to build a retail business. Is that what we mean by a competitive market? Or do we mean something similar to the telecoms market as we have seen with British Telecom where you can have retailers entering the business without having to lay new wiring.

Chairman: In other words, you do want to become vertically integrated. We cannot hold you back any longer; vertical integration, Mark Oaten.

Q726 Mr Oaten: Obviously there are a number of barriers that you have outlined in terms of being able to compete and to buy from the 'Big 6' and to get into the market and one of the key ones that comes across time and time again is the so-called

transparency issue and not actually understanding the breakdown of what is going on. One of the difficulties is with the 'Big 6' having these integrated European accounts. You cannot, as I understand it, break down where they are making profit in relation to generation and where they are making profit in relation to supply. I still do not get this, I do not get why that transparency is going to help you guys. What is it you are after and how is it going to help if that was split out and you could see exactly what was going on?

Mr Munday: Transparency itself is only part of the solution. What we are interested in is getting good value to the consumers. In order to do that, we are sitting here today feeling that there is cross-subsidy going on between generation and supply. We do not have the tools to prove that. We cannot indicate that that is going on because there is no information available in the public domain to support that. For me the first step on understanding what is going on in the market is to get some transparency. If there is cross-subsidy going on then there is European legislation that prohibits cross-subsidy between generation and supply. Presumably the regulator or the Government will actually enforce that legislation and level the playing field so that we can contest the market.

Q727 Mr Oaten: Pause there for a moment. What gives you the sense and suspicion that there could be cross-subsidy taking place then?

Mr Munday: It is our daily lives. We are losing customers left, right and centre to the 'Big 6' at prices which are demonstrably below the current wholesale market prices. This causes us a great deal of concern but coupled to that there is a number of events which give us even greater anxiety. Earlier this year Centrica announced profits of £545 million in their supply business. That is absolutely fine although it caused a bit of a furore. A few weeks later Paul Golby of E.ON stood up and said, "I am losing money in supply and I expect to lose money for the next 12 months". So at the same time as he is losing money in supply he is taking customers off of us, some of whom we have had for years, at below wholesale market prices. That just leaves a very, very nasty taste in my mouth. If you go to the latest news, we strongly believe E.ON now are growing their business very aggressively. They have put on many hundreds of thousands of customers (some of them ours) in the last few months and again we are sensing, because of the feedback we get from brokers every day, that these are prices which are below the current wholesale market price. Tie this in with an admission that he is losing money; what conclusion does it lead you to?

Q728 Mr Oaten: Do you think this is all of the 'Big 6' who are doing this? Do you think to some extent there is an agreement and understanding between the 'Big 6' that this can take place?

Mr Munday: I do not think I have got any evidence to say that there is any degree of collusion going on between the 'Big 6'. At the moment it happens to be E.ON who are doing it. Next month it could be any

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

of the other 'Big 6'. It is not always the same person. It depends on whether they want to grow their market share and what they want to do. They all go through periods where the transactions that we see and we face appear to be demonstrably below the wholesale market.

Q729 Mr Oaten: So the cross-subsidy is not taking place on a steady level, it peaks and troughs where there is a need and a demand and the 'Big 6' move around?

Mr Munday: They do move around. The E.ON one has been particularly sustained for about two years/two and a half years.

Q730 Mr Oaten: So transparency would help expose that and then regulation would come in, in your judgment?

Mr Munday: Yes.

Q731 Mr Oaten: How would you like to see that happen? What are you proposing?

Mr Munday: What I would like to see is clear accounting separation of generation and supply and the enforcement of the non-cross-subsidy regulations on those. I would also like to see that the accounts of these businesses are predicated against open and transparent transactions through the market so that we have got something substantive to underpin the accounts. Unless you have an open market to underpin the accounts, you could make up any prices you want to put in them, so you need the market to make it work.

Q732 Mr Oaten: So just in summary, in part, you see two advantages to this: the first is that it would expose any potential illegal behaviour; the second, picking up a point that Graham Paul made earlier on, it would help you understand when you are trying to enter the market at what price and where it is happening

Mr Paul: What is the true cost of wholesale electricity is a fundamental requirement for us when we are trying to negotiate a contract.

Mr Munday: It would also mean that when we are buying in the market to sell to customers we are buying at the same price as the other players and we can actually compete on the things that we are good at which is the innovation, cost to serve and consumer services.

Q733 Mr Oaten: I have got one final question. The brokers are giving you this anecdotal evidence that this is taking place?

Mr Munday: Brokers and some direct.

Q734 Mr Oaten: There are never any audit trails, never anything that is written down, never any proof that this is happening? There is nothing where tangibly you can say to this Committee, "Here is the evidence"?

Mr Munday: We are in the process of collating the evidence to support this for the Ofgem price probe and to the extent we are comfortable that the evidence we have got is reliable it will be submitted to them, and we can copy it to yourselves.

Q735 Mr Oaten: Can it be submitted to us as well?

Mr Munday: Yes.

Q736 Chairman: The comments you have just made are about the SME sector of course. Scottish Power in their evidence to us said "We judge that domestic supply remains a loss-making activity".

Mr Munday: I would absolutely agree with that. BizzEnergy is, as I said earlier, keen to get into the domestic market. We are sitting there ready to go and at the moment prices are some 30% below where we can actually buy. That is good for the consumer, so we are not going to knock that, but it makes it very difficult for a new entrant to come in and compete.

Mr Bennell: It would depend on when the question is asked of course because wholesale prices have risen 30% or 40% since March.

Q737 Mr Weir: It is a devil's advocate question perhaps. I presume from what you are saying that the cross-subsidy in generation subsidising prices to the consumer business or whatever. If you got your transparency, if this was outlawed, if you like, would it lead to a rise in energy prices, especially as I am sure if we ask the 'Big 6' they will say they are absorbing much of the rising cost and not passing it on to consumers?

Mr Munday: I do not think so. The proposals do nothing to interfere with generation costs. The proposals do nothing to interfere with customer income. It just provides a degree of transparency in the middle and it is part of the judgment as to whether the industry is working well.

Q738 Mr Weir: If I understand it correctly, what you want to do is to stop cross-subsidisation between the two, in your view, to give you equal access into that market at the same price, but that effectively would end the cross-subsidisation surely or would not work, and therefore would lead to some rise in energy prices, would it not?

Mr Munday: I do not think it will lead to a rise in energy prices at all because you are not interfering with generation costs. Why would prices go up?

Mr Bennell: If you stand back from this, you have got a range of prices and the ones at the bottom tend to be supported by the ones at the top, as we have said. What we have got to drive to and what we have got to fix is this broken market. The transparency will be helpful there but an actively trading market where people have to sell what they are producing is likely to lead to lower prices, particularly if there is some prohibition on self-supply put with this as well. Go back to the 1990s, there was a lot of concern about concentration of ownership of generation. Generators wanted to buy suppliers and the

24 June 2015 Mr Keith Munday, Mr Peter Bennell and Mr Graham Paul

regulator at the time put safeguards in place before he would allow that, and there were disposals of plant and there were prohibitions on self supply and that led up to the better situation that we had around the opening of the NETA market in 2002. What we have seen since then is a concentration of that ownership and liquidity and everything else in that market going away. I would struggle to see how a more liquid, a more efficient and a better market would lead to higher prices. It might lead to higher prices for the very small number that are benefitting from this, but for a lot of people it would—and certainly for us—open the competitive opportunities that just are not there at the moment.

Q739 Mr Weir: Again being the devil's advocate, the 'Big 6' will argue, I am sure, that they are keeping down prices to consumers and absorbing some of the cost of the rise in wholesale price. In a fully liquid market are you arguing that competition for that energy will push down prices? Might it not have the opposite effect?

Mr Bennell: If you are a supplier to the domestic market you are unlikely to buy on the market today for today or for next week. I think you are going to have a portfolio of purchases that would take you through because of the nature of that business. If you have got a properly liquid market I believe the average level of those costs is likely to be lower and that will lead to lower over time average prices. What we have got at the moment is a situation where we have seen a very steep rise in wholesale costs, particularly since the end of March this year on this wholesale market, and I think that is the position that you are referring to where people are saying that this increase is not being passed on. Absolutely that has not been passed on yet, but this is not a six-month business. If you win a domestic customer you hope to service them for some years, you are going to have customers coming and going and you will build up your purchases accordingly.

Mr Weir: That is fair enough but at the same time I do not know anybody who is suggesting that prices are going to come down in the near future on the wholesale market.

Chairman: Take that as a comment and I will bring in Adrian Bailey who has a supplementary to ask.

Q740 Mr Bailey: Picking up this issue of transparency and accounting processes, I can well understand, if you like, disaggregating the current system which is integrated European accounting, but given what has been said earlier about the fact that the 'Big 6' may effectively just have a marketing ploy over a short period of time, I am not quite sure how annual accounts, even if they were made more transparent, could pick that up. Is the real answer not preventing the suppliers from having contracts with the transmitters, if you like, and being forced to put all their production into an open market so that you would have a really competitive and transparent system?

Mr Bennell: I agree with that and a prohibition on self-supply.

Q741 Chairman: That would be a total prohibition on self-supply?

Mr Bennell: I think that would be the ideal outcome.

Mr Paul: It is a fairly radical—

Q742 Chairman: Of course the 'Big 6' argue that their vertical integration gives them an ability to protect their customers from volatility and changes so they argue there that this self-supply business is beneficial for consumers; you say the opposite?

Mr Bennell: I say the opposite.

Chairman: I think on that note, unless there is anything else you want to say, you have made your major points, or at least I hope you have. If you find there is something you have not said you would like to have said, please drop us a note. Thank you very much indeed for coming; we really appreciate your time.

Witnesses: **Mr Sam Laidlaw**, Chief Executive, Centrica; **Mr Ian Marchant**, Chief Executive, Scottish & Southern Energy and **Mr Rupert Steele**, Chief Executive, E.ON UK, gave evidence.

Q743 Chairman: Gentlemen, thank you very much indeed for coming in today. It is a slightly awkward arrangement with the 'Big 6'. We decided six at a time was too many so we have split you into three and three, using such logic as we could muster for the process. Thank you also for your written memorandum which I appreciate. What I would particularly like to ask you to do, as I always do, is to introduce yourselves for the record and the companies you represent.

Mr Marchant: I am Ian Marchant, I am Chief Executive of Scottish & Southern Energy.

Mr Steele: Rupert Steele, Director of Regulation, Scottish Power.

Mr Laidlaw: Sam Laidlaw, Chief Executive of Centrica plc.

Q744 Chairman: Mr Steele, we appreciate why your Chief Executive was not able to turn up and we are very grateful to you for standing in, thank you very much. You must be about as popular as politicians I suppose really, you three and your three colleagues later! Give us the bad news first: the BBC tells us that power prices/gas prices will be up 40% later this year. What do you reckon the increase is going to be?

Mr Laidlaw: Firstly, if I may just make a couple of introductory observations about the context because I think it is very important here. The UK after 200 years of self-sufficiency, first in coal, then oil, and then gas, is now over a ten-year period moving very rapidly into import dependency so we are buying our gas on international markets. Unfortunately, this is coinciding at a time clearly

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

when oil prices, coal prices and gas prices internationally are moving up very sharply. It is also coinciding unfortunately at a time when there is a far greater realisation of the impact of climate change and the need to meet a low-carbon economy. It is also occurring unfortunately at a time of a global credit crunch and possible recession, and that makes it very tough for families with fixed income in particular when we have got food prices moving up and we have got interest rates of course of moving up, so we have a difficult period. The reality is when you look forward, the wholesale prices for gas move directly as a result of oil because that is the way gas is sold on the international market. We have not made a decision yet, but it is clear that the current prices, where we are buying our gas at over £1 a therm, that at some point in the future gas prices are going to have to move up.

Q745 Chairman: And by?

Mr Laidlaw: This is a competitive market and it is very important, I think you would all recognise, to keep it a competitive market and therefore until we actually announce to all our customers what our price moves are, whether they be up or down, you would not expect us to comment.

Q746 Chairman: And to be fair, in your supplementary evidence to this Committee you have pointed out that you are not always the first mover so it is unfair to ask you to make the first comment anyhow. Do any of you want to hazard a guess that the BBC's 40% figure is right, a bit high, a bit low, or are you all with Mr Laidlaw on commercial confidentiality?

Mr Marchant: It is not commercial confidentiality. Pricing in our market is effectively driven by two forces: input costs and competition. We can see tremendous pressure on input costs and if you run simple models of input costs plus margin you can get the sorts of numbers the BBC will have come up with. It is not difficult to see how you can do the maths but that is not how you will make a final decision on pricing; you look at what the competitive landscape is. That is why I suspect you will find that none of the six of us will be prepared to comment specifically. We do not have plans yet. Unless something drastic happens, I can see that prices in the whole industry will have to go up significantly because of the rise in input costs.

Q747 Chairman: I think that is a reasonable answer and all we can expect in the circumstances. What this Committee is most concerned about is that Britain should be on a level playing field with the rest of the world, and certainly with Europe, so looking at Mr Steele particularly because theoretically you are at least as well if not better informed than your colleagues, what about the rest of Europe? Will increases in Britain be ahead of, behind or keep pace with the rest of Europe?

Mr Steele: Much of Europe has a rather different and much less competitive structure to the energy markets, and that tends to cause movements to operate in different ways. In some parts of Europe

there are price controls which may slow down movements both upwards and downwards. It really is very difficult to compare precisely what will happen there. It is certainly a problem that the markets on the main part of Continental Europe are not as competitive as we would like to see them.

Q748 Chairman: We will look at that a little bit later. To be fair to you, Mr Laidlaw, I should give you the opportunity to say what you said to us in writing as well about the absolute price levels in the UK.

Mr Laidlaw: Thank you for raising it, Chairman. The absolute price levels in the UK, compared to certainly the EU15 gas prices, are currently—and there was a BERR report on this that was published in March—the lowest in Europe, some 45% below the median and electricity prices are 30% lower than the median at the time that the report was published. Obviously this is a moving feast. Some European countries have since put up their prices; some UK prices have gone up, but I think if you look over a period of the last four or five years, there is no doubt that UK prices have been below the rest of Continental Europe. The difficulty we have now is as we import more gas from Continental Europe we are having to pay the imported price, which is an oil price for piped gas, and for LNG we are having to pay a price that actually is competitive with not just the Atlantic Basin consumers—the US and Europe—but also the Asian consumers, and their prices have been very high.

Q749 Chairman: So you are not saying that the reason our prices in the UK are lower is entirely due to the nature of our markets, there are also fundamentals underlying this issue, for example perhaps the investment that our colleagues have made in gas storage, generating capacity, addressing green issues, greater investment in renewable technologies, those kinds of things can also influence the price differential?

Mr Laidlaw: The investments have certainly helped and in the UK there has been over £10 billion of investment going into gas importing infrastructure, whether it has been pipelines or whether it has been regasification tunnels, in a competitive market. The other thing that has helped historically is there has been gas-on-gas competition because there have been a number of independent North Sea producers who have been competing to sell their gas into the UK. As we move forward, there are fewer large exporters and the gas-on-gas competition is being replaced with the sort of contracts that the rest of Europe buys their gas on which are oil-linked contracts.

Chairman: I think that brings in Mr Hoyle.

Q750 Mr Hoyle: I think the British public's view of it all is that you are the fat cats of the energy market or the fat cats of British industry; is that fair?

Mr Laidlaw: No, I certainly do not think it is fair. If we look at the numbers, they are very clear. We are probably the only company that actually separates the supply margin, the retail margin if you like, and over the last four years the average margin that we

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

have had before tax in this business is 3.6%. I think by any standards that is not a high margin. We need to make a return in this business because we need to invest in new sources of gas for the UK and we need to invest in replacing our power generation fleet in the UK. Over 25% of our power generation fleet in the UK is going to have to be replaced over the next ten years. That is clearly going to have a very significant cost. We will also of course have additional cost if we are going to replace it with renewables and low-carbon technologies, so there needs to be a return in this business. I think by any standards the returns in the supply business have been, as they say, modest.

Q751 Mr Hoyle: I think most people would describe them as obscene profits, but there we are. Can I just take you on to how you actually buy the gas. How do you do it? Is it the spot market or are you using the forward market or long-term contracts?

Mr Marchant: Perhaps I could give Sam a break and pick up that one if that is okay.

Q752 Mr Hoyle: Whatever; share it round.

Mr Marchant: We have no access to upstream gas. We do differ from most of our competitors.

Q753 Mr Hoyle: Is that all of you?

Mr Marchant: That is us.

Q754 Mr Hoyle: Who wants to own up then to being up-stream as well?

Mr Laidlaw: We have some up-stream gas production. About 20% of the gas that we have to buy for our customers comes from our own up-stream gas production. Our up-stream gas production is taxed. It has a windfall profits tax on it and it is taxed at 75%, so the reality is that in a higher gas price environment, the amount of additional revenue that we are making on the up-stream by no means compensates for the amount of additional cost. We will be spending this year over £1 billion more to buy our gas for the UK consumers.

Q755 Mr Hoyle: So it is heads you win, tails the customers lose? It is one of those?

Mr Laidlaw: I think you misunderstood me. In a rising market we are actually in a situation where margins get squeezed. The reality is we are at the moment for the next winter buying gas at £1 a therm and after transportation and distribution costs we are selling it at 60p a therm. That is not a sustainable business model.

Q756 Mr Hoyle: So what you lose in the upstream market you will gain in the downstream market?

Mr Laidlaw: No.

Q757 Mr Hoyle: So you are losing at both ends?

Mr Laidlaw: At the moment we are losing in the downstream business.

Q758 Mr Hoyle: But you are making upstream?

Mr Laidlaw: We are making a bit more upstream but the upstream piece is taxed at 75% and is a very small part of our business.

Mr Marchant: We buy all of our gas on the open market. We buy a mixture of short, medium and we have some long-term contracts. The market is liquid in the short to medium-term end. However, it is very illiquid at ten-year plus and all of our long-term contracts will expire by 2011-12. They are generally indexed to oil as well. Basically for our residential customer demand we have to buy all of that gas on the market. We are a pure gas retailer.

Mr Steele: We are in the same position. We are a gas retailer so we are facing this input cost of buying gas at £1 a therm for new acquisitions of gas at the moment. We do not have any of our own production.

Q759 Mr Hoyle: So are you more exposed than Mr Laidlaw?

Mr Marchant: We do not have the hedge that you were describing.

Q760 Mr Hoyle: We are getting to where I wanted to be now.

Mr Laidlaw: It is a different—

Q761 Mr Hoyle: Hang on, Mr Marchant is answering this, Mr Laidlaw. We will come back to what your disadvantages and advantages are.

Mr Marchant: In the gas business we do not have the hedge that you would expect to see of better profits out of an upstream business. We are a pure retailer.

Q762 Mr Hoyle: So you are more exposed?

Mr Marchant: On gas we are more exposed.

Mr Laidlaw: On power we are more exposed. We do not have the structural hedge on power. It is a competitive market; we start with different asset positions; some have more cover on power; some have some cover on gas but, as I said before, the percentage cover we have on gas is very small.

Q763 Mr Hoyle: What were your total profits this year?

Mr Laidlaw: Last year?

Q764 Mr Hoyle: Latest recorded profits?

Mr Laidlaw: Latest recorded profits for the group worldwide after tax were £1.2 billion.

Q765 Mr Hoyle: 1.2 billion?

Mr Laidlaw: After tax.

Q766 Mr Hoyle: After tax, okay. Right. The other argument is that, quite rightly, people believe that the UK is becoming a gas lender of last resort to Europe. I wonder outside European liberalisation what can Ofgem do—and we talk about Ofgem as the “toothless tiger”—to reduce the wholesale price volatility? Is it possible or is it not?

Mr Marchant: It is very difficult for anyone within the UK environment, regulator or company, to influence effectively what is a global market. I do not

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

think it is fair to characterise the UK as a gas lender of last resort. We will have to import around 20% of our gas requirements this year from somewhere. In the summer we tend to be marginal exporters and in the winter we tend to be heavier importers. The reality is the way the UK plays. It is where the global market volatility tends to play out most because we have effectively three sources of gas: we have Continental Shelf gas, we have Norwegian gas and we have LNG. It is one of the very few markets where these three sources can play out a gas price which then tends to echo around the world and then back. Coming back to the very specific question about what Ofgem can do apart from focus on Europe, which is absolutely fundamental, I think there is one thing they could do which is about making sure that it is easy for gas storage facilities to be built. I am thinking particularly about access arrangements to the gas grids where the regime is very, very complicated and it is based upon an auctioning regime. I think that they could help gas storage facilities be built in the UK. Gas storage is naturally a dampener on volatility wherever it is built.

Q767 Mr Hoyle: Last year—and tell me if I have got it wrong—the figure we got was that it went as low as 13 pence per therm and then went right up to 60 pence per therm as we got near winter as demand went up. The argument we keep having and you keep claiming about what investment you have put in, about LNG facilities, wonderful, marvellous, but that is about getting gas in so you can sell it, but why is it you are not investing on the part that will keep the prices down and take the volatility out (and that is what the Germans concentrated on) which is storage? That is where you are failing the customers.
Mr Marchant: We are investing.

Q768 Mr Hoyle: How many days can you store for?
Mr Marchant: You asked whether we were investing. We are investing in Aldbrough which is the biggest storage facility being constructed in the UK at the moment—

Q769 Mr Hoyle: At the moment.
Mr Marchant: —So we are investing.

Q770 Mr Hoyle: Okay, you are investing at the moment but it has taken you years to come to it. How many days of storage after this wonderful investment has taken place will you have?
Mr Marchant: You can define storage in a number of different ways.

Q771 Mr Hoyle: However you want to define it.
Mr Marchant: If you take average UK demand versus storage we have currently got 18 days in the UK. That will go up by another 31 when all the facilities we expect to get built—

Q772 Mr Hoyle: What timescale is that?
Mr Marchant: That is within the next five years

Q773 Mr Hoyle: After all that wonderful investment do you not still think you are failing your customers when we talk about France at 122 days or Germany at 90 days? We are exporting cheap gas in summer; they store it for the winter; and what we do is buy at the spike and rip our customers off.
Mr Marchant: Absolutely that is not the case. I believe that the UK has had the most flexible gas market—

Q774 Mr Hoyle: Had?
Mr Marchant: That is on the decline. However, we will still have flexible fields producing for many years. The market has responded by delivering new gas storage facilities as fast as both regulation and physics allow. It takes some time to develop gas storage facilities, up to five years, because basically creating salt cabins takes time to dissolve things.

Q775 Mr Hoyle: Absolutely no argument with you—it takes time, but you have had time. Why is it that France has got 122 days, Germany has got 90 days—
Mr Marchant: They did not have the North Sea.

Q776 Mr Hoyle: It did not have the North Sea, so therefore we should have been in a better position to see what was happening.
Mr Laidlaw: If I may come in here just to build on Mr Marchant's point. In looking at number of days' storage and making those comparisons we have just been making, the flexibility that currently exists in the North Sea fields has been excluded. What has historically happened is that a number of fields have been operated at low production in the summer and high production in the winter. That is not included in that storage definition. That has historically provided the cushion. As those fields are decommissioned and dismantled in the next few years then there will be clearly an increasing need for storage. Like Scottish and Southern, Centrica is very much involved in moving forward new storage projects. One of our big challenges has been the planning applications for those projects; and we are delighted to see the progress that the Government is making on the planning bill. I think that is very important if we are actually going to get new storage facilities built.

Q777 Mr Hoyle: Okay, so we can match Germany in France in, what, eight years?
Mr Marchant: I am not sure that is the right thing to do. We could significantly overbuild storage if we mandate it. You need to get the right level of storage. Storage is not a cheap option. It costs significant sums of capital to develop these things. The fact is, you need a flexible gas system which would have a range of different storage facilities and a range of different import facilities, and a range of different contractual support for it.

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

Q778 Chairman: We will have a chance to revisit this issue with the next set of witnesses. There is a concern about inadequate gas storage, and there is a concern about the adequacy of the forward gas market. That is what we take from this session?

Mr Marchant: The thing which causes me most concern is the inability to contract long-term for gas molecules, whether I am going to put them in the storage in the summer and bring them out in the winter, or float them throughout the year. Up to three or four years is fine—beyond that the market is very, very illiquid.

Q779 Mr Weir: Moving on to the liquidity of the electricity market, we have heard a lot from the smaller suppliers who say there is a lack of liquidity within the market and that dulls the price signal for investors. What are your comments on that? Do you agree there is a lack of liquidity in the electricity market?

Mr Laidlaw: Our experience would be that there is less liquidity than there is in the gas market but, nevertheless, for up to two years out there is reasonable liquidity. It is not obvious to me that actually a process of releases and mandated sales would help here, because we would be in the situation of selling out but having to buy back; and buying back might actually increase the cost to our customers.

Mr Marchant: We have tried to get some data on the volume of trading in the electricity market versus annual demand, and we think it trades around between four and eight times—there are different data sources. Four times the UK's annual demand is trade—whereas gas it is ten to 15. Clearly the gas market is more liquid; there is more trading going on; but it is still four to eight. For our own company, to give you a flavour, last year we generated around 45 terawatt hours but we traded over 200. You can see we are active in the market, balancing our position and trading our position in short, medium and long-term markets. The other thing is, you say: is there a barrier to new entry in generation; of the four gas projects that started last year, two of them have non-Big 6 participants. One, Caron Energy is being done completely by a new entrant; and Marchwood is a project we are involved in where 50% is owned by ESB the Irish utility. New entrant is still happening in generation.

Q780 Mr Weir: You talked about the amount that you traded—how do you trade that energy? Do you trade it directly with small suppliers; is it traded into a market?

Mr Marchant: It is generally traded through brokers, through screen activities.

Q781 Mr Weir: Have you traded directly with any of the small suppliers? Is there any bar to doing that?

Mr Marchant: There is no bar to doing that. We would and do trade with them. It is relatively small but we do trade with them. There are no counterparty restrictions that we place on anybody, apart from on a credit basis.

Q782 Mr Weir: What restriction on a credit basis? That was one of the complaints. If I understood them correctly, they can only buy energy from the Big 6 suppliers if they had some gold-plated credit rating.

Mr Marchant: You do not need a gold-plated credit rating, but you do need to have a credit rating. One of the biggest issues I have faced in my time as Chief Executive was a large loss when TXU effectively went bust late in 2002. That sharpened everybody's focus on credit in the traded markets. The practices at energy are no different than in general financial services. It is basically credit-rating dependent.

Mr Laidlaw: If I may just add to that too. 40% of the generation capacity comes from independent generators, so they do not have to buy from the Big 6 suppliers.

Q783 Mr Weir: One of the things being put forward is that you should be forced to report more information about where you make your profits—be it in supply or generation. How do you feel about that? The argument being, the more transparency there is then the easier it is for them to get into the market. Do you agree with that?

Mr Marchant: I think there is a higher level point. I feel at the moment ourselves and Centrica have to disclose more than the other four because we are UK quoted companies and have restrictions placed on us and demands of shareholders that directly come to us, rather than the other four that are subsidiary companies. The risk when you demand increased transparency is it disproportionately affects two out of the six players. That is the first point. The second point I would make is we do not run our profit and loss account on a generation business and a supply business. We run an integrated basis. I do not see monthly splits of profits, so why should I create something that I do not use for management purposes? We report to the City, as we are required to, on the basis on which we run the business. You will be creating an artificial construct between two businesses, and that is not how we run it.

Q784 Mr Weir: The argument is, if I understand it correctly, that the Big 6 because of the vertical integration are cross-subsidising between generation and selling to the public and undercutting independent suppliers. Do you accept that is happening?

Mr Marchant: I seem to be accused simultaneously of making too much money in supply and cross-subsidising it in supply; so I am not quite certain what the crime is.

Q785 Mr Weir: They are not mutually contradictory!

Mr Marchant: Actually I think they are. If you are saying new suppliers cannot make enough profit then I am, by definition, charging too little for supply. The reality, sitting here today—that is exactly what is going on. Supply is loss-making under any definition with the increase in wholesale prices. At present for this period of time supply is

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

loss-making. If it was not for the fact that all of the six are vertically integrated, prices to customers would already be higher than they are now.

Q786 Mr Weir: I think the point we were making was, there was a small proportion of potential switchers that were being targeted with lower prices when particularly business customers tried to switch away from the Big 6 to the smaller suppliers. I take it you are denying that?

Mr Marchant: We have grown our supply business by 90% over the last six and a half years, and we have taken on every single customer we could find. Are we targeting people who have not switched—absolutely.

Q787 Mr Weir: That is a separate issue. What they were saying was, if they had a customer who was coming from you to them then you would target the customer who was leaving you with a lower price subsidised, if you like, on the generation side to keep the customer.

Mr Marchant: If that is their case they should produce the evidence to the regulator because they have a prima facie case for predatory pricing. They should put up or shut up. I do not mind if they try to put up!

Q788 Mr Weir: The other point being put forward was the idea that the Big 6 generators should be forced to trade a proportion of their electricity on the open market. What do you think of that? What do you think the effect would be if that was to happen?

Mr Marchant: We already do. We do naturally.

Mr Steele: We trade three times our generation volume on the open market. Mr Marchant has said that he trades four times his generation volume on the open market. What exactly is being asked for?

Q789 Mr Weir: What has been asked for is that a proportion of all generation should be on the open market; but you are saying you already do that?

Mr Steele: Yes.

Q790 Mr Weir: Do you accept Ofgem's argument that you are making windfall gains from the free allocation of allowances under the European Union's Emission Trading Scheme?

Mr Steele: No, very simply. There are at least two reasons for that. The first reason is that it is not enough simply to take the value of the allowances and multiply it by the number of the allowances, because the allowances have had a major effect on investment patterns because they encourage people to make further investments in situations when otherwise they would not happen. This effect was studied in a report written for BERR as part of the Energy White Paper. That report concluded that 90% of the benefit of the free allowances in Phase 3, if there were any, would end up with consumers and not with generators, because they would enhance investment and reduce power station closures and, therefore, leave the market less tight. On that basis we think that the windfall barely exists. In addition,

such income as remains from the free allowances is undoubtedly one of the things that is enabling us to shield our customers from the very substantial input cost rises we are currently facing.

Q791 Mr Weir: Your argument is that you have used the money both for investment and to keep down prices in the short-term. That again presupposes then if not the ETS, we are looking at very large increases in the future. Is that correct?

Mr Marchant: That is quite likely. If there are no free allocations in 2013 I would expect you would see a further adjustment upwards in retail electricity prices—absent everything else that will be going on at that point in time, absolutely, yes.

Q792 Mr Weir: You say that it has not affected it, but each of the companies has shown fairly substantial profit rises over the last few years. It is alleged that a lot of that is due to ETS; you are saying that is not. How do you explain, if you are keeping down prices, that you are still having such rises in profits?

Mr Marchant: In the last five years we have more than doubled our generation capacity; added 90% to our supply customers; and the reality is 2002 one of my competitors, who you will be seeing in the next session, described the generation market as “bust”. The reality is generation prices at that point were below cash cost; and we have seen a recovery of generation profits; they are still below new entrant levels; they are still below any assessment of what would be needed to remunerate investment, but there has been a recovery. In our case it is a basic rise in profits driven by two things: growth in the business; and a recovery in generation profits. Actually the supply margins have been in number of years negative, and between 2002 and 2008 they are net down.

Mr Laidlaw: We have a slightly different perspective on carbon allowances. Clearly our position as a generator with gas and renewables is that we have much smaller carbon allowances. We do think that they have actually created some distortions in the market, and encouraged clearly coal-fired generation; and also the opportunities, as we have heard, to cross-subsidise. We have been consistently arguing for full auctioning; and we would certainly, even in Phase 2, advocate that the Government should take advantage of the opportunity to auction up to 10% of the allowances rather than 7%, and use that money to assist the vulnerable customers.

Q793 Roger Berry: We have had answers to different questions, in a sense. The question was: have there been windfall profits, as Ofgem has alleged? The answer has been: maybe; or, it is not as big as that; or we used the money for a good purpose. All of which are actually related. The straight question: are you saying that Ofgem, the regulator, does not know a windfall profit when they see it?

Mr Steele: We think that on this particular issue they have not considered all the factors generally.

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

Q794 Roger Berry: Is it that there has been no windfall profit, or it is not £9 billion?

Mr Steele: What we are saying is that £9 billion is certainly the wrong number because of these other factors that I have mentioned.

Q795 Roger Berry: There has been a windfall profit but it is not £9 billion. What do you estimate it at?

Mr Steele: It is very difficult to estimate whether there is a windfall profit at all and, if so, at what level it might be, because you are dealing with some imponderables. It is very clear to us that the £9 billion assessment, simply multiplying the value of the allowances by the number of allowances, misses both the investment effect and the impact on domestic prices.

Q796 Roger Berry: You are seriously saying that the organisation that has this statutory responsibility for regulating this industry cannot spot a windfall profit accurately, and cannot estimate the value of that accurately? If they cannot do that how on earth can they regulate the industry?

Mr Marchant: All I can say is, for my company there has not been a windfall. I cannot comment on other people's decisions. I particularly cannot comment on generator-only companies, rather than generator and supply companies because the question should be directed to them too. All I can say is, for my company there has not been a windfall profit. Therefore the £9 billion is wrong.

Chairman: We have had one or two of the other companies in to whom we addressed this question in the past as well. I think we will refresh our memories about their evidence in that respect—bearing in mind something you have just said. We have to move on because of time.

Q797 Mr Oaten: These are all massive figures we have been talking about—can I home it right in now to individual people and the suffering and difficulties they are having at the moment, because as politicians that is what we are here to represent, and particularly to focus on the issue of prepaid meters. I wonder if you could try and explain to me why it is that, on average, if you are on a prepaid meter you are actually paying around £145 a year, 17% more, than if you are a customer who is paying by direct debit. There does not strike me as being a level playing field there.

Mr Laidlaw: Let me have a go at that, and let me start by saying I think it has now been well established and certainly Ofgem's statistics and the Government's statistics are that only 20-25% of those people on prepayment meters are in fuel poverty. Nevertheless we clearly need to do everything we can to keep the costs down for everybody on prepayment meters—which is one of the reasons that earlier this week we actually announced a new tariff for internet prepayment customers which will reduce their bills. The reason prepayment meters are more expensive is that they are more expensive to serve. Typically the average call volume on a prepayment meter—in other words, the number of times a prepayment customer calls us

in—is about 70% higher than the average call volume that we get for our normal cash, credit and direct debit customers. We also have a large number of outlets across the country from which we have to go and collect the cash and service; and British Gas has 35% more outlets per customer than anybody else; so it is a very extensive network that has to be supported. We also have a 24-hour call-out capability, so that we can go on wind-on meters in emergency situations and that has a cost. What we are doing is also working on a new piece of technology called “the energy point technology” where people through a phone modem will basically be able to add money onto their meter. That energy point meter, we are rolling out 10,000 of them this year, that will reduce costs and we have separated out the prepayment business so that we can service those customers better, reduce the costs of that business; and we very much believe in a competitive market you have to have cost-reflected pricing, so we expect over time that differential to come down.

Q798 Mr Oaten: I understand your point about extra cost, but it is not a view which is shared entirely by Ofgem. They say, yes, there are additional costs, but the costs if you like would be around £85 difference; whereas the figures are coming out at around £145 difference. Are you telling me that the actual cost involved in managing the prepaid meters are actually the total amounts taken up with the additional costs? At the moment it is around 17% higher. Can you say absolutely hand on heart that it is 17% more to actually administer these?

Mr Laidlaw: I am pleased to say that what we are working on is actually reducing the costs and also reducing the tariff differential.

Q799 Mr Oaten: It is at the moment I am interested in. It is now. It is not where you may be heading, it is now. Is it the case that it is 17% more for you to administer a prepaid meter over a direct debit scheme, because that is the additional amount you are charging? If it is not the case the only conclusion I can draw is that you are making some additional profit out of this.

Mr Laidlaw: It is not as simple as that, because we have gas meters, we have electricity meters and, do not forget, we also have a large number of prepayment customers who are on our essentials tariff. We were the first to launch a social tariff that actually equalises everybody so there is no premium for them over not just cash and credit but over the direct debit discount number. We have 350,000 customers; we would like to have more customers; and we are hoping to target more with the help of the DWP to actually increase that to 750,000. You cannot just look at an average here; you actually need to look at the individual components.

Mr Marchant: We have a slightly different perspective. Our differential is lower than that and Mr Steele will point out that his is lower still. Within the competitive market the six suppliers have taken different attitudes to prepayment meters. Scottish Power have abolished a surcharge for both gas and power; I believe EDF have abolished it for

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

electricity; the other three have not. From our point of view, because we seek for our tariffs to be as cost-reflective as we can make them, we make less money on a prepayment meter customer—deliberately less money on a prepayment meter customer—than a monthly direct debit. Our differential of about 12% (just doing the maths here) is less than what we believe the costs are. I am not saying they would be 17%, but they are more than 12%.

Q800 Mr Oaten: So it can be done? If you take the political decision to do it, it can be achieved?

Mr Marchant: It can be. We took the view two years ago, there as a great outcry about prepayment meter surcharges; we all received letters from a number of charities and a number of MPs; we took the view then that that was what was required to help to make our contribution to fuel poverty. The sad thing is that in Ofgem's current view that abolition of prepayment meter surcharges will not count as our action towards social tariffs; therefore you might find that the three of us who have done something move in the opposite direction.

Q801 Mr Oaten: We are going to come on to social tariffs in a minute. Mr Laidlaw, would you say you have got a little bit of catching-up to do compared with some of your competitors?

Mr Laidlaw: We are the only one that has the essentials tariff; and we do also have the most comprehensive network; and we have the largest number of prepayment customers. We have different demographics in a broader network so it is higher cost. What I have said to you, and I repeat, is that we are committed to reducing this differential.

Q802 Mr Oaten: In what kind of timescale do you think we are looking at? If we were to look at this figures in a year's time—

Mr Laidlaw:—they will look better.

Q803 Mr Oaten: They will definitely look better?

Mr Laidlaw: Yes. Just to give you context here, we have taken 25% of the cost out of our residential supply business over the last two years, so we are on a very clear mission to reduce costs wherever we can but continue to provide service and provide value for money to our customers.

Q804 Mr Oaten: Just on the costs, presumably with prepaid there is no real credit risk involved; there is no real collection risk involved on prepayments. I am still not 100% clear why it costs so much to manage it; because I would have thought it would have almost been cheaper given those factors?

Mr Laidlaw: The meters themselves cost more to rent as well. You have actually got a piece of technology that is more expensive to rent and to service.

Mr Marchant: You would be surprised at the level of transactions, the degree of care of maintenance with these customers, the number of phone calls per account, the number of call-out visits; and actually there still are credit issues.

Q805 Mr Oaten: If it is not effective for you and it is not being particularly effective for them, why is it so difficult for some of these customers to actually get away from meters and to switch to direct debit; because the barriers are in place for doing that?

Mr Laidlaw: No, the switching rates amongst prepayment customers are amongst the highest in the industry. If you look at different channels of trade, whether it is direct debit, whether it is cash and credit, or whether it is prepayment, the switching rates on prepayment are some 30% higher than general switching rates. Contrary to a general perception that they are locked into prepayment meters, all the evidence and history (and I am happy to share a paper with you on this point) is that actually the prepayment customers have switched more than the average customer.

Q806 Chairman: The evidence you have given as a supplementary shows that is more of a problem for those on standard credit terms?

Mr Laidlaw: Correct.

Chairman: Where the fuel poverty is actually concentrated we do not spend enough time talking about. I know I am going to frustrate Mark, but I am going to move on to Tony because he is asking about switching particularly, and this is the time to pick up extra issues.

Q807 Mr Wright: It is recognised that probably 50% of customers in the market regularly switch between companies. What are you actually doing as companies to be more proactive in pursuing the other 50% and encouraging them to switch?

Mr Steele: We would love to find them and get them to switch to Scottish Power. We have every opportunity to find these customers—the difficulty is finding them and getting them to take our products.

Q808 Mr Wright: Surely a lot of the products are sold on the doorstep, by telephone, on the internet, and indeed energywatch have got a specific site which will tell people in a particular area which company will sell the best electricity. On that basis surely some people come to you; and you would also go out into the market to find them?

Mr Marchant: Absolutely. You have identified the three key routes to market: doorstep; telephone; and internet. There are other ways through to market affinity arrangements. For instance, we have a deal with the British Heart Foundation where, if people who support that charity sign up to us, we make a donation, which has already totalled three-quarters of a million pounds which we have given. It is a competitive market and we are all trying different things to reach those customers who have not switched. You have to recognise that there are a significant number of customers who have made a conscious decision not to switch. I would like to feel that the customers who have not switched from me think that the package of service, product and price that I offer them is sufficiently attractive that it is not worth them switching. That is not to say I am not

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

being competitive. We are trying everything we can. I think our results show that we are being pretty successful at that.

Q809 Mr Wright: Is not one of the problems though when it comes down to some of the selling techniques, when you sell on the price, that in reality the majority of customers do not really understand how much they are actually going to save by switching companies? The evidence suggests that a third of those who switch actually switch unknowingly to a higher tariff in any case. What would you do in that particular case? How do you sell your product and prove to your customer it is cheaper?

Mr Marchant: Generally, because we have typically been the cheapest supplier—certainly on the doorstep we have been the cheapest supplier—we have had the least of those sorts of problems. In fact we worry about our losses on the same basis; because unless someone is signing up for a particular internet tariff or special deal most of our losses are probably going to end up paying more. I share your concern. What we do is we have an independent verification system where the salesmen will call our office and they will speak to someone who has no incentive whatsoever on sales to check that the customer has understood what the process is doing, and that they are comfortable that the package of price, service and product they have selected is right for them. If those people identify particularly a vulnerable customer who was paying more they will tell them. They would make sure that that was clear. That is our position.

Mr Laidlaw: We have a similar process. We actually launched the industry code on this to ensure best practice, and to ensure that there was an independent audit. I think you have to put this in context, in that there are currently around 100,000 customers switching a week; this is one of the highest churn rates in the energy business, certainly in the world the highest rate. It is a higher rate of switching than you see in telephony, than you see in financial services, insurances and a whole lot of other products. There is switching. I think I have seen numbers that suggest up to 70% of people have switched, rather than 50%, on a single fuel. Some people are just switching on one fuel, rather than switching on both, and it is probably 55% on dual fuel; but we still need to try and catch the remaining 30% or 45%, whatever the number is. We are doing our best to do that through similar channels of sale. I think everybody here is seeing the advertising that we all do to make everybody aware that this is a competitive market, and we will continue to do that and capture customers off other people.

Mr Steele: As far as our practices are concerned, our doorstep sales agents are provided with sales aids that show the comparison in pricing between suppliers and identify the cases where people would not make a saving. We expect our sales agents to provide customers with a fair overview of the situation, and we take disciplinary action against those who do not.

Q810 Mr Wright: One of the evidence sessions we have had before suggests, for instance, that Scottish and Southern have cornered the market because they delay the increase in the price of the fuel but after, say, five or six months they catch up, so the saving is only a six-month basis, on a short-term. Is that policy specifically on the basis of trying to capture the customer base, on the basis of something cheaper?

Mr Marchant: We have what we call a “responsible pricing policy” which says that we will be one of the last to increase prices if we have to, and one of the first to reduce them if we can. Over the last four years we have scored very well against that policy. Yes, that is part of our deliberate policy to grow our business. We are trying to strike a balance between customers and shareholders; that is what underpins our responsible pricing policy. We have grown by 90% over six years; 10% over the last year. A typical customer joining us would have saved £400 over the last four years; but that is not equally the same over every month—some months you save more and some months you save less, depending upon the particular profile of prices. What we are aiming to do is to offer customers a long-term branded price promise that means that they will over time see good value out of the being an SSE customer.

Q811 Mr Wright: In reality, over a period of time, the savings now are minimal. It may well be up to £30 unless, of course, you switch on a dual fuel basis and go to direct debit. Really the margins are very, very minimal now, are they not?

Mr Marchant: You can save between £30 and £60. Assuming you have already switched fuels, you could save between £30 and £60, but that has been over £100 on an annualised basis. It just depends upon the period which you are looking at. We tend to take an annual view of this, because people tend to regard their power, their gas bills, on an annual basis. Going back over the last years, those savings have averaged £100 a year for the last four years: us versus a sort of market leader.

Chairman: I want to move on to the social tariff questions and will try and come back if there is time, because they are all related issues.

Q812 Roger Berry: The Government recently announced an agreement with the Big 6 companies to increase spending on social tariffs, social assistance. I think the figure for this year is an extra £50 million. As I understand it, all that has been said about the use of that money is that it will be targeted at the poorest pensioners. Has it yet been decided how that £50 million is in fact to be spent?

Mr Marchant: Each company makes its own decisions. From our point, we have pledged to quadruple the number of people on our energyplus care social tariff, which is 20% below market price. We are busy working on targeting for those. That is the principal vehicle that we are using. Others will have to tell you what they are doing with their share of the money.

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

Mr Steele: We are very supportive of the approach that the Government discussed with us, and we all agree we think it provides a really effective way for social action to work in the market, working with the grain of the market. We are still actually developing the precise package of arrangements that we will be doing. It will involve the rollout of our Carefree Plus social tariff; almost certainly a great deal of activity through the ScottishPower Energy People Trust which has already helped 221,000 people in 91,000 households. We will be putting together a package of measures within this framework.

Mr Laidlaw: We were the first company to launch a social tariff last year. We currently have about 350,000 customers on that social tariff. It costs us £32 million. We want to do more; we were very clear about that. Last year we had a target of getting to over three-quarters of a million customers by 2011 on that. One of the issues has been actually working with the DWP on getting good data; because the eligibility for social tariffs is those who are on various different forms of Income Support. What we have been keen to do with DWP is match our computer systems with their computer systems, to ensure that we really have good targeting. One of the concerns has been that actually there are some £4.5 billion of unclaimed benefits at the moment because we do not have adequate targeting. One of the things we have been very keen to ensure is that the targeting is good and really goes to the most vulnerable customers. In addition to our social tariff we also spend £21 million on our Energy Trust which helps those who are really having difficulties with their fuel bill. We are also of course doing a lot through the Carbon Efficiency Reduction programme, the CERT programme, to actually ensure that our vulnerable customers and the fuel poor achieve energy efficiency measures, loft insulation and energy savings.

Q813 Roger Berry: I absolutely appreciate that in the medium and longer term those kinds of measures are more effective rather than simply increasing benefits. In relation to this £50 million, Age Concern and Help the Aged have said there is a very simple way of helping the poorest pensioners, which is what the Government has said this money is for, and that is simply to give a £50 fuel voucher, effectively a rebate, to pensioners over 70 on Pension Credit. With the winter fuel allowance the Government knows exactly who these people, over 70 on Pension Credit, are. A £50 rebate would spend the £50 million; it would be targeted at some of the poorest pensioners. Why not do something as simple as that? Why are we still waiting to know how this money will in fact be spent?

Mr Marchant: In the discussions with the Government we have talked about those sorts of ideas. The Government knows who the people who most need this help are—we do not. We know a fraction of them and we generally know by accident, maybe because they have written to an MP, an MSP or a local councillor we have become aware of them. The Government knows that, and we have said the Government will be best able to target the help.

Q814 Roger Berry: Earlier you said each company was doing their own thing?

Mr Marchant: That is the agreement that was reached.

Q815 Roger Berry: How confusing for people. How thoroughly confusing for customers.

Mr Steele: It is beneficial I think that there is scope for innovation. For example, we have a programme about benefit entitlement checks where, for every pound we spend on that programme, some £20 of additional benefits are found for the customers concerned. That programme is a valuable programme that might be giving better value for money than the programme you suggest. The programme you suggest may be the right programme. We are certainly going to consider the proposal from Help the Aged; but we have to remember that pensioners are not the only people having difficulty with their fuel bills; there are families and lots of other people as well. That is why we are trying to have a balanced programme, rather than necessarily spend all the funds available on one group.

Q816 Roger Berry: I agree with you. There are disabled people under 60; there are 750,000 children who live in fuel poverty, you are absolutely right; but the Minister's statement said specifically that the extra £50 million was to help the poorest pensioners. I would have thought in these circumstances this £50 million is not a lot of money—whatever one thinks about the windfall profits or not, £50 million is not a vast sum of money—but we were told it was to go to the poorest pensioners. Surely Help the Aged and Age Concern are right in saying a very simple way of doing it, and telling people now what is going to happen rather than the continuing uncertainty, is to do something like this: to say to people, “Over 70 on Pension Credit, you get £50 a year each”. Is that not the simplest way of doing it? Why spend more time debating an issue like that? Yes, I would like to ask in a moment about non-pensioners.

Mr Marchant: I do not believe we are the right people to be asking that question of.

Q817 Roger Berry: Why did you agree that it would be left to you? Why did you not just say to the Government, “Look, £50 million we can afford it. No problem. You tell us how to spend it”? Why did you not say that?

Mr Marchant: We said, and each company is different, “We can support a voucher scheme”. We said, “We're not just going to write Government a cheque, but we can support a voucher scheme”. We said that. It is not easy to do. It is easier to say to do; but we said we felt a voucher scheme could have been ready for this coming winter. You are talking about a mass mail-out. Things like fraud and all sorts of things need to be dealt with. It is easy to say—less easy to do. We said back in February that it could be done for the winter. For various reasons a different route was chosen. Therefore, we will play our part in that.

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

Q818 Roger Berry: The route was that it would be left to each of the six, was it?

Mr Marchant: Yes.

Mr Steele: We said we would support a voucher scheme as well in the discussions with the Government; but, again, they eventually decided to go for a route of leaving it to us to use our initiative. In many ways that is a good result because it will set lots of other ideas free; but we would have supported the voucher scheme if that is what they had chosen. I think it is quite tight to change horses at this stage and do it in a way that is resistant to fraud and works properly.

Q819 Roger Berry: Given the time, I think that is a very simple, straightforward thing to do. I am amazed it is still unclear what is going to happen, apart from anything else. One final question because I know we are pressed for time. Mr Laidlaw mentioned that Centrica had 350,000 customers benefiting from social tariffs, with plans to increase. Could each of you quickly tell me how many of your customers are currently fuel poor and what proportion of those currently receive social tariffs?

Mr Marchant: The answer to the first question is that we have absolutely no idea, because we do not know our customers' income, we do not know our customers' housing situation or family circumstances. We do not know how many of our customers are fuel poor. All we can do is the same statistical analysis that the Government does. That is the first point. The second point—how many people do we help? Absolutely a fundamental question is: what is a social tariff? This is where I fundamentally disagree with Centrica's position. We believe passionately that a social tariff should be the lowest tariff you offer. British Gas's Essentials tariff on that score would not count. We have, on our energyplus, 30,000 customers where we are charging 20% less than the standard rate, so it is significantly below any internet or special offer that we see. We think it makes a genuine difference. If I take British Gas's definition of a social tariff, 667,000 of my customers I am deliberately cross-subsidising. For three months this year every single one of my customers was on a social tariff, because they were paying less than British Gas's Essentials tariff. Fundamentally we are completely at odds on what a social tariff is. For those members of the Committee who have not signed the Early Day Motion on this, I would encourage them to go and think about it! As you can tell, I passionately believe if we are going to help people who are fuel poor we should be helping them properly.

Q820 Chairman: Mr Laidlaw has got to come in now!

Mr Laidlaw: As Mr Marchant has already said, it depends what snapshot in time you are looking at. If you look back to last year when we were the first to reduce our prices, our prices for that group would have been lower than anybody else's. The reality is that the internet tariff that Mr Marchant is referring to is a tariff that very few customers are on. The real basis of comparison is our cash and credit

customers, who are some six million accounts, and our direct debit customers who enjoy a discount. Our Essentials tariff actually enables all our people who qualify for that tariff to participate in the direct debit discount tariff. That is the lowest significant tariff that we have. The outlier is an internet tariff that we have very few customers on.

Q821 Roger Berry: Finally, does this not suggest therefore that there should be a clearly defined social tariff, and that it should be mandatory so that everyone knows precisely what the minimum amount of support you should be providing is, and how that minimum is actually measured? A bit like the minimum wage—we know what it is; we know how it is defined; and it is mandatory. Why should there not be a mandatory social tariff?

Mr Marchant: I do not believe there should be a mandatory social tariff, because that will stifle innovation; but I do believe there should be a mandatory definition of what qualifies as a social tariff, which is a different point.

Q822 Roger Berry: How does it stifle innovation? It will help it.

Mr Marchant: No, because if you say a standard internet tariff is X pence per unit, everybody has to charge X pence per unit. It stifles competition and it stifles innovation.

Q823 Roger Berry: The minimum wage does not stifle competition. You have competition for the things that are not mandatory?

Mr Marchant: If you mandated that a social tariff had to be the lowest that you offered, I can support that because that allows the market to innovate on exactly what the social tariffs are, how they are targeted, how they are structured; and it does not distort competition in the main market. If you fix a mandatory social tariff you will absolutely stifle innovation in the vulnerable customer sector.

Mr Steele: Not only that, the way the Government has agreed this with the industry in terms of a fixed target of money that we, if you like, have a commitment to spend, that gives us an incentive to be innovative and effective in our marketing to go and find the people who can benefit from these tariffs. A mandatory social tariff which said we basically had to sell at a loss to a particular group of people would reverse those incentives, and actually give us an incentive not to find those people.

Q824 Mr Bailey: I just want to talk about the consolidation of the industry, particularly with the European dimension. Centrica in its evidence to us said that it was very concerned with consolidation in Europe. The question I have got is: why is consolidation of the industry okay in the UK but not in Europe?

Mr Steele: Which consolidation do you mean? Do you mean the consolidation that happened around 2002 when lots of companies went bankrupt, or some other consolidation?

24 June 2008 Mr Sam Laidlaw, Mr Ian Marchant and Mr Rupert Steele

Q825 Mr Bailey: Perhaps it would be easier if the representative of Centrica could answer because it was them who made the point in the submission?

Mr Laidlaw: The point we were making in the submission is a function of the fact that the European competitive landscape is very different. Switching rates in Europe are still very low. To give you the most stark example—there are 20 million customers in the UK who are supplied by French and German suppliers in the UK; Centrica is still not able to sell to a single retail customer in France or Germany. You have situations where the markets have not liberalised, and clearly continued consolidation and the capture of monopoly rates by those business enables them to build very strong positions in which to penetrate the UK. The UK market is very different. The UK market has liberalised; 40% of the generation is outside the Big 6. There are multiple different suppliers and, therefore, I think it is a different landscape.

Mr Marchant: I think that the structure of the industry in Europe is largely regional geographic monopolies, and consolidation effectively is a land grab to those regional monopolies over a larger area. That is the first thing. Effectively it freezes more of the market if you see consolidation in Europe. The second half of your question—what about the UK—you said consolidation would not be (inaudible); I would challenge that. I believe that our current generation supply markets are fully competitive. If there was any move to consolidate either of those markets through any transaction we absolutely need to understand what the impacts on the issues we have been talking about this morning are. I do not think it is a slam-dunk that any consolidation would get off scot-free. I think there are some serious issues that would need to be asked. That is why we have a merger control process. That is why we have regulatory investigators both at the UK and EU

level. Absolutely right, because we need to make sure that both our generation supply markets remain competitive. I am not sure it is right to say that consolidation in the UK would be okay. I think it would absolutely need to be addressed.

Q826 Mr Bailey: You have partly anticipated my other question, which was: would you favour any further consolidation in the UK market? I would gather that you would not?

Mr Marchant: I am not saying I am against it. I am saying that each particular sort of consolidation raises different questions. Some might be acceptable; some would not be acceptable. You need to look at the specific circumstances at the time. I think any consolidation would require those questions to be asked.

Mr Laidlaw: I would agree with that. I think you have to look at the circumstances at the time. I think the OFT in the past has studied the competitive dynamics both in generation and in supply very carefully and would scrutinise it very carefully. I think the mechanisms are in place in this country to ensure that there remains good competition.

Q827 Chairman: Gentlemen, it is frustrating because there is so much more I would like to ask. I would like to question you particularly about physical generation because I think you trade to balance your positions not what the market really needs, for example, an issue we might discuss subsequently. We are where we are, and we are over time already for our next three witnesses. Thank you very much indeed. If there are other issues you feel we have not addressed, or issues which have arisen you would like to clarify, further written notes are welcome but urgently, please; we aim to get our report out quite early in the summer.

Mr Laidlaw: I am gratefully for the time. Thank you very much.

Witnesses: **Mr Andrew Duff**, Chief Executive, RWE npower, **Mr Vincent de Rivaz**, Chief Executive, EDF Energy and **Dr Paul Golby**, Chief Executive, E.ON UK, gave evidence.

Q828 Chairman: Gentlemen, we are running just a little later than I had hoped so we will need to crack straight on. Can I begin by thanking you for coming to the Committee and thanking you for your written evidence. Can I ask you to introduce yourselves, perhaps starting with you, Mr Duff.

Mr Duff: My name is Andrew Duff. I am Chief Executive of RWE npower.

Mr de Rivaz: My name is Vincent de Rivaz. I am Chief Executive of EDF Energy.

Dr Golby: Paul Golby, Chief Executive of E.ON UK.

Q829 Chairman: Gentlemen, I am going to begin with a question I asked our last witnesses, I do not expect to get a very different answer from the answer I got last time. To be honest, I rather expected their answers. What is going to happen to energy prices

for the rest of the year, here and in Europe? Apart from the fact they are going to go up, can you be more specific?

Dr Golby: Let me start—I think it is very difficult to be more specific. We are facing a seismic shift quite frankly, I think, in commodity prices. Since I came into this industry in 1998–9 we have had a 14-fold increase in the oil price; it has doubled over the last 12 months. We have seen other commodity prices—oil, gas and coal—increase by about 60% over the last four months. So it is not difficult to see that the pressure is upwards. I think what will happen will very much depend on what happens to the forward price over the next weeks and months. I do not think I can be more specific than that.

Chairman: I think this Committee accepts, as we all do, that energy prices are rising. We cannot deny that reality and one of the fundamental reasons for

 24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

it is other markets in the world, particularly in places like India and China. We understand that. Our concern is to make sure that the different sectors of the market are getting the best possible deal they can in the circumstance—domestic customers, particularly those in fuel poverty, small and medium sized business and the large industrial users, because there are different issues for each of them—to sustain a standard and quality of life or sustain your business and sustain competitors in the UK. We understand that. I think it is probably best we move on to the one of the key determinants of that issue—the wholesale gas market,

Q830 Mr Hoyle: There was a report done by the DTI back in 2005 and it suggested that 70% of the physical volume in the UK is sold on long-term contracts. There are other arguments that say it is 40%. It tells us that most of it is done on secretive long-term contracts. To what extent do you buy your gas on contract, as opposed to by the open market?

Mr Duff: The physical gas market in the UK two or three years out is very liquid, and trades at about ten times the underlying size of the physical market. My company purchases about 30% of its total gas requirements through long-term contracts. There are commercially confidential aspects of that, but not really very much. There is not much that is not known about long-term contracts, because most of them were negotiated in the expansion of gas production in the North Sea back in the 1980s; and many of them have been in the public domain as companies have divested assets and divested contracts in the years since. We buy a small proportion of the gas, and my company is very comfortable living for the vast majority of its requirements in the open wholesale markets. They are very liquid; delivery is secure; and there is a rich diversity of major upstream suppliers from which we can procure.

Mr de Rivaz: I confirm that as far as EDF Energy is concerned we are buying nearly all of our gas on the open market.

Q831 Mr Hoyle: That is 99%?

Mr de Rivaz: Yes, it is important for the committee to recognise the simple fact that, since the beginning of 2007, the gas price on the wholesale market has increased by 270%. It is a real challenge for companies like ours to mitigate the impact of these costs on our customers, which we are trying to do.

Q832 Mr Hoyle: So you have no long-term contracts in reality?

Mr de Rivaz: No.

Dr Golby: In the situation of E.ON, we purchase about 70% of our gas requirements from the market at market related prices; the balance of 30% do come from fixed-price long-term contracts; and those long-term contracts have a combination of factors inflating the prices: RPI; gas oil; heavy fuel oil; crude or electricity prices. The long-term contracts which are clearly a diminishing proportion of our portfolio

are linked to a whole series of indexes in terms of their prices; but 70% comes from the short-term market.

Q833 Mr Hoyle: It is interesting—and I do not know what you would like to make of this—Allan Asher, Chief Executive of energywatch, told us that in his opinion it was 70% of all gas coming from mysterious contracts and he would regard them as highly anti-competitive and needing to be exposed and broken up. What would you like to say to that?

Dr Golby: I am not sure where he gets that information. It is certainly not something that he has shared with me. Certainly from my point of view the majority of our gas is bought in the market at market prices. I think Allan Asher actually identified that the current levels of churn in the market at ten times physical actually is an indication of a very liquid market. I think that market is working.

Mr de Rivaz: We would not agree with the idea that the wholesale gas market or the electricity market in the UK are “opaque” as some say. It is clear there are some ways to improve their liquidity. I think the industry is working on that on the electricity side, which is slightly less liquid than the gas market. It is certainly not possible for us to accept the idea that these markets are opaque and there are some secretive deals which are made—this is not the reality.

Q834 Mr Hoyle: I just wonder whether you will be able to agree that gas producers are the same for the UK operations as they are for the European operations and why they do not purchase gas on the open forward market. Have you any views on that? If you look at the UK operations and the European operations, how does that work? Is there a differential between the two, between the UK and European in the way the gas is bought?

Dr Golby: Take my sister company in Europe, we probably buy more of our gas through international sources from Russia, for example, and those contracts I think again are reasonably transparent. They are linked to crude oil prices, but so are the majority of Russian gas prices; and increasingly the nationalised gas companies around the world link their gas prices to crude oil; it is a fact of life, I am afraid.

Q835 Mr Hoyle: Do you think it should be broken?

Dr Golby: I do not know how it could be broken, because increasingly it is the oil companies or the gas companies owned by sovereign states. Whilst we might try to persuade them that that is not any longer valid, I think it is very difficult for us to say to the Russians, for example, “You must change the way in which you decide to sell your gas”. I would like to see it but I do not think it is very credible.

Q836 Mr Hoyle: So it is there to stay?

Dr Golby: I think so.

Mr Duff: I think it is important to say that in the UK we are actually very fortunate in terms of the diversity of access to gas that we do have. It feels uncomfortable at the moment because as an

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

importing nation we are vulnerable to global price effects in a way that we have not been for many years. The UK North Sea still produces over 60% of the gas that we need. The Norwegian sector of the North Sea produces 40% of the gas that we need in the UK. Pipeline capacity coming into the UK is another 80%-odd. By this winter we should have 30-35% capacity for LNG imports into the UK. None of that protects us from price affects, which I think you are referring to; but it does ensure that we have some negotiating leverage in our ability to source gas from a variety of sources.

Q837 Mr Hoyle: What about storage capacity?

Mr Duff: Storage capacity is something that needs to be increased ideally. It is not as simple as a matter of comparing UK storage capacity with, for example, European storage capacity. We have a number of things that make the UK more robust. For example, the amount of gas that comes from the North Sea which is a flexible sort of source, through contracts which in many cases, and particularly our own, give flexibility that allow us to capitalise on the supply flexibility as a virtual kind of storage. One of the things that would help a lot in the UK would be greater transparency of production, not just from our own sector in the North Sea but the Norwegian side and pipeline transports. There have been times in previous years, and particularly last year, when for example supplies through the Norwegian pipelines were very hard to predict and had quite a significant impact on prices in the UK.

Q838 Mr Hoyle: It would be fair to say that UK customers are the losers by not having more capacity. Presumably at peak times we are vulnerable and we are paying the spike on the market; yet some are exporting North Sea gas which could go into storage in Europe and then be exported back to us at a higher profit. Does that not seem ridiculous?

Dr Golby: Let me pick that up. Firstly, historically we have not needed storage because of the North Sea. I echo the points made about transparency if production is important. I think at the moment we have about 15 days' storage in the UK. I think that certainly has to double. My company is currently investing up to a billion pounds into gas storage facilities. One has started in Cheshire, and one we hope to see planning consent for in East Yorkshire, but these take time to bring on-stream. I might just add, it is very pertinent at the moment that one billion cubic metres of storage has already been turned down at the planning stage; so it is not so easy to get planning permission for gas storage. In terms of your question about storage of gas in Europe, I do not want to be provocative but that actually is a market that is working; because 50% of the gas fields in the North Sea are associated fields; and that means that they produce oil and gas. At the time the oil companies are trying to produce maximum oil—which I think we all would like them to do at the moment—they are producing gas during the summer, which currently we cannot store in the UK and yet that is sold to Europe and the European

companies sell it back at higher prices in the winter. That I am afraid, whether you like it or not, is a competitive market that is working.

Q839 Mr Hoyle: At the disadvantage of UK customers where they see something they believe is sovereign being exported and then being ripped-off when they buy it at a higher price because companies have not invested in storage and they have let down the people of the United Kingdom?

Dr Golby: Firstly, of course, the gas is sold by the oil companies, so in that regard it is not sovereign. The market did not respond to the gas storage situation as quickly as I think any of us would have liked. The pricing signals were not there, and that is where improved transparency of production would be helpful. I think that investment is going in now, but we do need to see the planning consents coming through so we can get ahead and build that storage.

Q840 Mr Hoyle: So we have got it right: the market has failed the United Kingdom, and the bottom line is they did not react quickly enough, and now what we are trying to say is, "It's down to planning issues". We should have been planning this ten years ago when we could see what was going to happen?

Dr Golby: I do not think the market has failed. The market is not perfect. The pricing signals were not there at an early enough point in time, but the market is now responding.

Q841 Chairman: What this Committee and its predecessor said in 2001 was that the Government should look at strategic gas storage, because it identified this problem coming down the track to meet us. That was a recommendation of this Committee that was not acted on. In fact in the 2003 Energy White Paper again gas storage was not pushed right up the agenda by the Government either, so there has been a collective failure, has there not? It was blindingly obvious to this Committee's predecessor that there was a problem emerging and no-one managed to address it.

Dr Golby: We are addressing it. We have been investing; we have been building a new gas facility for the past two and a half years and we have another one in the pipeline.

Q842 Mr Hoyle: Is the reality not that you can make more profits by the way you deal with it, rather than storing gas? There are bigger profits to be made by not creating storage?

Dr Golby: No, I do not believe that is the case. My company does not have a lot of storage in the UK at the moment, but companies which do have storage I think they are quite transparent in their profit and loss accounts and which profit they make from storage. It is a profitable business to be in.

Mr de Rivaz: I think globally the more you are mitigating your risks as a company, the more your customers are benefiting from such a risk policy. Gas storage is part of mitigating our risks. We are certainly better off with gas storage than we would be without; that is why we are all investing in gas storage.

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

Mr Hoyle: I do not think we quite see that, but I suppose we all have different opinions.

Q843 Chairman: Mr de Rivaz, may I just ask you, this is quite a difficult inquiry for the Committee because we are hearing such contradictory and different things from different people. Some people told us the wholesale gas market is fundamentally broken; there is no effective forward trading. The forward prices are determined by a very small volume of trading gas, if any. Others say that actually it is all hunky-dory, it is working perfectly; it is marvellously competitive and we have not got a thing to worry about. Others, like you, fall somewhere in between, because I think it was your evidence to us which said, "While the wholesale market in the UK is competitive, there is still room for improvement . . ." What improvements would you like to see in the wholesale gas market?

Mr de Rivaz: I think it is a fair comment to say that this market is not perfect and can be improved. I think we have to be realistic, modest and recognise the strengths and the weaknesses that we are all facing in Europe in general and in the UK market in particular. Certainly more visibility on the physical flows, for instance, would support a better market. We have been promoting modification to the unified network code to make more information available, and are doing everything to make information more available, more reliable, more transparent and this is going to improve this market. I think in the gas wholesale market we are in a slightly better position than in the electricity wholesale market, where we are still, despite the fact liquidity has increased over the last few years, hoping some improvement will be made. We are also working on having some better spot market indicators commonly shared for that market to work even better.

Chairman: The wholesale gas market is of huge fundamental importance to everything we are talking about today, but we also want some of the wholesale electricity market. I will move on now to Adrian Bailey.

Q844 Mr Bailey: Ofgem estimated that in 2006-07 the value of the over-the-counter electricity market was just £31 million, which is a tiny fraction of the total generated. My question is: firstly, what proportion of your purchases are made from the open market; and, secondly, why is this market appearing to become more illiberal in the UK but more liberal in countries such as Germany and the Netherlands?

Mr de Rivaz: I can only answer as far as the electricity market is concerned. Basically we all have the same objective, to be better vertically integrated—maybe we can discuss that further. In our situation with our own generation we are producing ourselves about half of what we are selling on the market; but globally it covers our residential retail market. Having said that, everything we are producing is sold on the wholesale market. The generators are contributing, even if they are vertically integrated, to the liquidity of the market. My view is that we should be even more

vertically integrated. To have more integration is a good thing in this market, simply because I believe that in doing that we are mitigating our risks, and in mitigating our risks we are protecting our customers.

Q845 Mr Bailey: I am sorry, are you saying that the electricity that you generate is all sold on the open market?

Mr de Rivaz: Yes.

Mr Duff: The electricity markets are not as liquid as the gas markets. I would just like to re-emphasise the transparency and liquidity are absolutely aspects of this market that our company would like to see and encourage. One of the problems is that during the failure of a number of major companies in electricity generation and supply in 2002-03, some liquidity was lost to the power markets markets in the UK, and perhaps there was also a collective loss of confidence there which did not help. I am referring to the restructuring of British Energy, to the failure of TXU, to the failure of Enron and so on; all of whom were very helpful in stimulating liquidity particularly in the power markets in the UK on which we all depend. This company is very, very supportive of trying to continue to build liquidity back and it is doing so and has been improving for the last two or three years; but perhaps one of the barriers to improving liquidity, in the power markets particularly, is the ability for companies to exit positions close to real time without being left with untradable physical positions. For that reason, Npower is leading an industry group looking at trying to create an exchange traded mechanism that would allow a more diverse range of participants in the market to enter the market safe in the knowledge that positions could be cashed out effectively, close to real time, which would bring in banks, trading houses and other independent players as well. As it happens, the generating market is extremely fragmented and the result is that a very large proportion of the energy generated in the UK is traded openly in the wholesale markets. In terms of our position, we have to purchase from the open market at least as much again as the energy that we generate, and we run our generation businesses and our retail businesses quite independently, and they both trade independently with the market too, therefore further stimulating liquidity. So, yes, I feel less comfortable about power than about the gas market, but all the signs are that liquidity is moving into that market in the way that we would like it to do, and it is certainly far better than any other similar market that I know.

Q846 Chairman: Adrian, can I interrupt one second? Mr de Rivaz, you said, I think, just now that all the electricity generated is sold on the open market. Is that the case?

Mr de Rivaz: Yes. We are not selling directly from our plants to our customers; we are going through the wholesale market.

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

Q847 Chairman: Your written evidence says: “By using a proportion of electricity that we generate in order to meet part of our own demand, we are reducing our customers’ exposure . . .” There seems to be a contradiction there.

Mr de Rivaz: It is not a contradiction, it is a fact that globally in having half of our needs covered by our own generation we are mitigating our financial risks, and that is a benefit to our customers. Every day we are trading on the wholesale market what we are producing.

Q848 Mr Bailey: In 2006–07 the total wholesale market, which is £31 million—how much electricity did you generate in 2006 and 2007, in financial terms?

Mr de Rivaz: Can you say that again?

Q849 Mr Bailey: How much electricity did you generate in 2006–07, because you have said it was all traded on the wholesale market? We are told by Ofgem that the total value of the wholesale market is £31 million.

Mr de Rivaz: We have sold on the wholesale market all the electricity we have produced, which is to the tune of 25 terawatt hours, I think.

Q850 Mr Bailey: I am sorry?

Mr de Rivaz: Twenty-five terawatts, which we are producing every day.

Q851 Chairman: This is very confusing. Adrian, I do not want to take over your questioning, but your written evidence says, again: “Generators, including those who are part of vertically integrated companies, must compete to minimise the cost of the electricity they generate—essential to ensure their supply business is able to sell competitively priced electricity”. You are saying there is no point in being vertically integrated; you run the businesses entirely separately and your generation capacity flogs it to the wholesale market and the supply business buys it back from the wholesale markets. I do not understand that.

Mr de Rivaz: I am sorry, Chairman. I am saying that vertical integration does not mean that we sell only to ourselves; we sell into the market and we buy from the market. That is what is happening every day. Having said that, as a company, when we look at the risks which exist in the retail market, or the generation market, we are better off in having a business which is in both elements of the buying chain, because in doing that we are limiting our risks, our exposures, and in limiting our risks we are limiting our costs, and that is beneficial for our customers. It is why in every country vertical integration is a better solution than non-vertical integration. It has been the case in the UK since the beginning of the opening of the markets with more and more vertically integrated companies, and it is the case in other countries. You have, in Germany, vertically integrated companies and a high level of liquidity in the market. There is no contradiction between vertical integration and liquidity on the market. That is the point.

Q852 Mr Bailey: Surely, the issue is how many of those vertically integrated companies have what are effectively “off market” contracts between the generators and the suppliers?

Dr Golby: Can I, maybe, tell you what we do in the UK? That would help. Firstly, we are also participating in the design project that Mr Duff referred to in terms of trying to devise instruments and systems to increase the liquidity of the UK market. I think it is fair to say that the UK market is not perfect, it trades at about three-times physical; European markets trade at between six and seven-times physical, so they are more liquid, and because they have those instruments in place in NordPool and EEX, for example, that means they get more financial players and people who do not have physical positions trading in the market place. So the market is not perfect and we need to make some changes to increase the liquidity. However liquidity is increasing, I think it was independently confirmed by the Financial Services Authority just recently that it increased by 52% in 2006–07, so it is moving in the right direction, but it is not perfect. In the case of my own company, in the year to March 2008 we generated 41 million megawatt hours and we bought in the market 92—so we are trading in the market twice what we are producing.

Q853 Mr Bailey: Can I turn it round—and you have touched on this. What needs to be done in the British market to make it more liquid? Possibly it is being done in the German and Dutch markets, but what is the lesson you have learnt for the British market?

Mr de Rivaz: As I think all three of us have said, we are working to find a sensible spot market index providing a reference price that could be used as a base for the financial forward contract for the UK market, and it is something which will improve further existing liquidity. So it is all about having tools which exist in other countries which provide a higher level of liquidity. It is not a question of vertical integration, it is a mechanism by which the market is more efficient—the wholesale market is more efficient.

Dr Golby: Could I say I think it is a very good and detailed question. I am not an expert in this area but perhaps I could come back with a note to actually set out precisely what we need to look at here, if that would be helpful, Chairman.

Q854 Chairman: That is quite urgent.

Dr Golby: We can respond very quickly.

Q855 Mr Bailey: I think, Chairman, that would be helpful and is necessary. To a simple layman such as me, it seems to me that if you want a perfectly liquid market all that you have to do is insist that generators put all their production on the open market for the suppliers to purchase from. What is your opinion on that?

Mr Duff: From my experience—and I cannot say for other companies—we are seeing that happening. We have to buy, every year, 30 terawatt hours—that is,

 24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

at least, between 5 and 10% of the UK market—from the markets in order to cover our sales. So I do not think there is, in the short term (by that I mean one to two years forward) a major problem in liquidity, although it can be enhanced, and we want to see it enhanced. Beyond that, there is probably no more to be said than to look at the specific reasons why the market may be difficult for certain players. One of the issues is the ability to exit financial positions close to closure without being left with an untradable physical position.

Q856 Mr Bailey: I have to say there is a significant body of disagreement with that. Can I move on in terms of new entrants to building large-scale generating capacity? It would appear that something like 13 gigawatts of the 17 gigawatts of approved projects are being built by existing vertically integrated companies. What do you think needs to be done to encourage new entrants into that?

Mr Duff: The biggest challenge for new build is just the basic economics, at the moment. You are talking about very large plant, with very long paybacks and returns looking forward in the market that are not very attractive. In fact, for the first time in four or five years we are starting to see, on a going forward basis, returns that just about cover the cost of capital for new entry for new build. So this is an issue for all potential or would-be investors in this market. Actually, the UK power generation market is pretty fragmented and there are very healthy signs of significant amounts of new investment not just in fossil plant but in renewables as well, from independent non-integrated organisations.

Q857 Chairman: Where is the subsidy? It seems to be there where new build comes from the independent sector but where there is not, there is not.

Mr Duff: No, the evidence, I do not think, supports that. We see Severn Power and ConocoPhillips building KG plants on the east coast; we see Gas France entering the market as a new entrant as well, and many other new entrants looking at building plant as well as existing generators in the UK.

Dr Golby: Could I add to that, Chairman? I think there is a legacy issue here. It was only back in 2003 when this market was bust; the Government had to rescue British Energy, TXU went bust (and my company bought it) and other power stations ended up with the banks. So there is a legacy of people losing their shirts in this marketplace. I am afraid the recent credit crunch has not helped there; it is increasingly difficult for companies to raise finance for these investments. Yes, vertical integration helps—it helps manage the risk—but the fact of life in this big ticket industry is that it is the bigger companies that are more robust and able to invest during these very difficult financial times. I have got no suggestion as to how we help other parties also invest—that is up to them—but I am sure that you would want the large companies to invest because we are facing an energy crunch if we do not.

Q858 Mr Bailey: The cynic would say that it is only the current vertically integrated companies and their ability to rig the market and to guarantee the market that gives them the financial capacity to produce the new generating capacity. What would your response be to that?

Mr De Rivaz: First of all, I think the structure of the market itself does not prevent new entrants from building large-scale generating capacity, and today more than 40% of the electricity generated in this country is generated from outside the alleged ‘Big 6’. I think it is very important that large companies like ours are in a position to invest the billions that this country desperately needs to have the lights on, tackle climate change and, at the end of the day, have more affordable prices for all. I think the priority is to be in a country which is encouraging investors to invest in the long term, and if it is a new entrant, fine; if it is one of the existing large generators, fine as well. What is important is that new investment flows in this country.

Mr Duff: I think diversity is the key word when we talk about energy supply and, particularly, generation. I mean diversity not just in fuel type but ownership as well, and a healthy, competitive environment. The scale of the investment required in this industry over the next ten years is absolutely staggering, as a result of the age of much of our infrastructure and the need to build climate-friendly capacity in place of much of the old dirty capacity we have got. It is absolutely staggering. We simply cannot afford to discourage any investor in the generation infrastructure in this country. I cannot imagine that any group of participants or individual participant could possibly have any concern about the extent of the openness of the market to investment. The concerns are about access to finance and the scale of the investment that is needed. It needs everything that we have got—in the short term, in gas-fired generation, because it is really only the quick solution in the short-term, but in the longer term, in renewables, in nuclear plant, in carbon capture and storage technologies—to get this country to still be in a secure energy marketplace and still competitive in 10 years’ time, as it is today.

Q859 Mr Bailey: So you do not think that “dulling market signals” (a quote from Drax) is disincentivising new entrants into the industry?

Mr Duff: No, absolutely not. I do believe that we are in a very difficult transitional phase where the forward returns visible currently barely cover the cost of new investment but at a time when we know that over the next five to ten years a significant amount of capacity is going to retire and is going to be withdrawn from the market, and therefore one has to take quite courageous decisions in order to initiate new build projects, not least because the returns are marginal in the current view but, also, because the paybacks are so long. I really do not understand the basis of the question; I think that this country needs all the investment it can muster in new infrastructure, particularly in climate-friendly generation, and it needs to be encouraging it from whatever source.

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

Mr Bailey: The basis of the question is that the ‘Big 6’ vertically integrated companies are acting in such a way as they rig the market, which effectively prevents any other would-be entrant into the generating—

Chairman: I think that has been comprehensively denied by the witnesses.

Q860 Mr Bailey: With respect, the witness said he did not understand the question, so I am just trying to make it a little clearer. It is the allegation being made by the industry and you are denying it.

Mr De Rivaz: We understand that people think that the market is not competitive when all the evidence is showing that it is an extremely competitive market and, at the same time, there is a need for huge investment which I think will be achieved both by large, vertically integrated companies which have the financial strength to do it and, also, by new entrants. There is nothing in the market which prevents it.

Q861 Chairman: I was going to end with some questions on your investment, and I will drop off those, but I have to say that I fondly imagined that rising oil prices would make investment in renewable energy and nuclear much more attractive as a proposition, and actually you would be quite bullish about your investment. All you have said about margins—and indeed EDF’s evidence makes the point about very low margins on existing capacity—is very bearish about the investment. So this Committee’s concern in this inquiry is about prices, and we are about to move to some of the pertinent questions about our individual constituents and the pain they are experiencing at present, but keeping the lights on is actually very important, too. These are two balancing issues we have to bear in mind throughout this inquiry. I am getting rather mixed messages today. Will we keep the lights on? Will the investment be made? What could frustrate that investment being made?

Dr Golby: Let me echo the point made earlier: we are looking at billions of pounds of investment. We have to replace a third of our generation capacity in the next decade, and that probably doubles to 60% over the next 20 years plus the investment to reduce carbon. So this is a massive investment programme in the UK—almost without precedent. We need everybody who is able and wants to invest in the United Kingdom to be part of that programme. So I would welcome investment from new entrants. I have got no concern there. I think your general point is correct that if oil prices stay high or go even higher investments in nuclear, renewables and other non-oil related fuels become that much more attractive.

Mr Duff: This company is closing two of its three coal-fired power stations in the near future under existing climate and environmental conditions—that is about a third of our generation—and the investment that we are going to be making to replace that and to build what we believe the country will need in the next decade to maintain security of electricity supply means that we are looking at, in every year for the next ten years, significantly

negative cash flows from our business and an investment programme that is well over £10 billion over that period of time. The challenges are large. Part of the problem is that the UK is not alone in needing to reinvest in its energy infrastructure currently. Much of the rest of Europe is in the same position, and access to turbines, to equipment, to contractors and to machinery—we are in real competition now and we are seeing the costs and prices of procurement going up as a result as well, all of which is making this a tough environment in which to invest.

Chairman: So it is a challenge. I think we had better leave it there because this is not an investigation into investment, especially into prices, and people are hurting out there and we need to discuss their problems.

Q862 Mr Oaten: One of the groups that are hurting are those customers that are on pre-paid meters. I can be pretty brief here in terms of the questions. First of all, could you all confirm it is the case that with your individual companies you are charging prepaid meter customers around 17% more than those that pay by direct debit? A “Yes”, presumably, will suffice on that, from each of you, if that is the case.

Mr De Rivaz: I think the answer is probably not the same for all the companies. As you probably know, we have been the first supplier to align electricity prepayment to existing credit prices. There are, and Ofgem recognises it, clear additional costs for a supplier to a prepayment meter payment option rather than the standard kind of option. The actual cost is to the tune of £65. As far as we are concerned, for dual fuel prepayment customers, the prices have just a gap of £29 per year. So there are differences between the suppliers, and we have been, as I said, the first one to align our prepayment to credit electricity prices.

Q863 Mr Oaten: So you are saying to me that although it costs more to collect under prepaid you are actually charging less than those additional costs that you incur?

Mr De Rivaz: We did that for electricity prepayment in the context of our overall policy for the most vulnerable customers. We thought it was the right thing to do.

Dr Golby: If I can add to that, firstly, just for clarity of fact, prepayment and fuel poverty are different issues.

Q864 Mr Oaten: I am not asking about fuel poverty. We are all suffering here; it is not just the fuel-poor who are suffering alone.

Dr Golby: Okay. Let me answer your specific question. For the vast majority of our customers on electricity prepayment it costs us an additional £45 for that service compared to monthly direct debit, and we actually charge £35. So we are charging our customers less than the additional cost of that metering.

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

Mr Duff: We charge, on a dual fuel prepayment basis, almost exactly the cost for us to serve both prepayment—

Q865 Mr Oaten: So someone is not telling us the truth, in fact, because the figures from the Government data are telling us that, in fact, it is costing 17% but all of you guys are saying: “No, no, it’s not that high, in fact, we are really just covering our costs with this additional amount”. I am confused. Who is telling us the truth here, or have you changed practice in the last six months or so?

Mr De Rivaz: I am not qualified to comment about what the others are doing. I think prepayment, at the moment, is part of this inquiry looking at this question, and hopefully it will help us to have the answer to your specific question as to who is doing what. What I can say is that, as far as EDF Energy is concerned, on average we have the lowest price differentials of the ‘Big 6’ energy suppliers between prepayment and monthly direct debit prices for gas and electricity. We have the lowest differential.

Q866 Mr Oaten: Then just accept this: despite the fact that you are trying to narrow the gap there is still a gap and it is the case that those on prepay meters are paying more than other schemes.

Mr Duff: This is the real issue: that it costs significantly more to serve prepayment meters in their current technology, and that is a problem for a significant proportion of our customers. The solution, I think, is a technological one, predominantly. I do not think you can ever eliminate the differential cost to serving the two segments, but I do think it is possible to significantly reduce the cost of prepayment through implementing, for example, smarter meters—something that this company has always promoted.

Q867 Mr Oaten: Here is a challenge. We got a commitment from Centrica in the last session; when asked the question: “Are you going to do more about this?” they said: “Yes, we are going to do more about this”, and when I asked the question: “Can you come back here in a year’s time and say that that differential will have been reduced?” the commitment from Centrica was: “Yes, we will attempt to do that”. Can you each also make that commitment to try and reduce this gap, whether it is through new technology or a pricing scheme?

Mr Duff: The problem is how fast you do it, and I have to say here is an area where a stronger political and regulatory lead would be very, very helpful, not just in prepayment meters but, actually, in smart metering across the entire UK estate. We have seen, in other countries like Italy with a very, very strong regulatory drive to mandate, the roll-out of smart meters. I think they delivered it across the whole country in about five years. If we really want to make a difference to the quality of data, to the way customers are served and to the accessibility to competition, then a much, much more rigorous approach to rolling out smart metering, I believe is the right approach.

Dr Golby: Could I just add that the answer to your first question is yes, and I will just build on what you have just heard. Quite frankly, the industry, the department and Ofgem have just been talking about the roll-out of smart metering for too long, and if there was one thing I would really like to see from your Committee report it is a very clear direction that we should get on with this, because, quite frankly, we are using Stone Age technology here; we know we can do better; we just need to agree the process by which we roll it out.

Mr De Rivaz: If you ask me what I am going to do, I have answered what I have already done, which means that today we are, among the six big suppliers, the company which has the lowest price differential. So we have already done what you are suggesting us to do.

Q868 Mr Oaten: So a mixed response: some of you, in fact, will make a commitment to come back and challenge us in a year but what you are also saying is it is not just down to you; you are looking for some government direction, and smart meters would be the key to working with you to achieve that.

Dr Golby: Yes.

Q869 Mr Wright: Just moving across to people who switch, which we recognise is about half of consumers, Scottish and Southern have been very successful in persuading people to switch to them; I think, in 2002-07 8% of the customers who switched switched to Scottish and Southern, and 5% in the electricity market as well. You have not been so successful in that area, so are you not really after the people who switch, or have Scottish and Southern got something that you have not?

Dr Golby: Maybe I will pick up on that one. We took a decision some two or three years ago to remove people from doorstep selling because we did not feel that was the right way to sell this product. As a result of that change we started to lose a significant number of customers. We since have reverted and built quite a strong sales force in that area, and we are now growing customers. So I think it is a response to that type of situation. The market is very competitive out there; people will switch, and you have to contact them to switch. Having an active sales force along with other channels—much as I personally dislike that type of selling—is what, clearly, works in this UK market.

Mr De Rivaz: The first thing we have to say is that according to Ofgem’s last statement, 9 million accounts have been switched in 2007, which means approximately 5.1 million households have switched. So this market is dynamic, is highly competitive, and each company is making its own choice in terms of market share, reduced margins, depending on their own ability and own strategy. If a company, for instance (in this case, EDF Energy), has a more strong organic growth strategy than a very huge increase of its customer numbers it means that in this context of churn rates, which are, let us say, on average, 20%, to maintain or to slightly increase our market share we need to be extremely active to win new customers because we are, as all

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

our competitors are doing, losing customers. The simple fact that the churn rate is 20% means if you have five million customers, to remain with the same number at the end of the year, you need to win one million customers. So each company is making its own choice in this respect. This market is extraordinarily dynamic and highly competitive. The churn rates are very high and I think it is one of the reasons we are saying that in the reality of this market, because it is very competitive, the margins are pretty slim.

Mr Duff: I would echo those comments. In 2002/03 we lost a significant proportion of our customer base while we were focusing on building systems and consolidating platforms and getting our service proposition rights so that we could sell effectively. Since then we have been fairly successful in increasing our own market share through a combination of the right proposition, product, brand, promotion and the use of channels. The challenge for any company is to get the right combination of those things: brand, value, proposition price and sales channel to grow one's own customer base at the expense of one's competitors, and I am pleased to say that we have been successful in that in recent years.

Mr Wright: Dr Golby, you said you did not like that type of selling, so you went away from it and you have gone back to it again. What would you say—and this would be to all three of you—in terms of the allegation in the Sunday paper where they said that customers signed forms without revealing it was a contract, exploiting people with poor English, lied about standing charges and pretended to be from the Electricity Board, leading to an investigation by Ofgem? Is that what you are afraid of? Is that something that you would dislike—that you have not got control over people who actually sell a product?

Q870 Chairman: I think Mr Duff should answer that question because it is his company that caused the difficulties, and his company that is being investigated. He must be pretty ashamed of what happened.

Mr Duff: Let me say, yes, that this company very much regrets the incident that was reported on then. It is one of the great difficulties with managing effectively a direct sales channel, and in that incident we were found to be caught short. That is why this company has reacted very, very aggressively: internal inquiries, changes of processes and very much stronger controls to ensure that, to the best of our possible ability, it cannot happen again. The difficulty for us—not just us as a company but as an industry—is that direct selling is perhaps the most effective mechanism of bringing the benefits of competition to the widest range of customers and, particularly, those who do not, for example, have access to internet tools, computers and so on. So it is a very powerful force for competition and one that has delivered over the years significant benefits to customers in the UK. It does present very serious challenges to us, in terms of controls, and we are determined, through things like 100% verification of

every sale, mystery shopping and controls of the way that teams and customers are trained, to ensure it does not happen again.

Q871 Mr Wright: In terms of the people that switch then, it is proven fact that a third of those that switch actually switched to a higher tariff than the one that they left. Surely, that practice itself should be quashed. What would you do, as a company, to prevent that happening?

Dr Golby: Let me tell you what we are doing, because when we re-established and rebuilt our direct sales force we made sure that every single sales person has a Pen Tablet—that is a small, hand-held computer. Into that is programmed all of the available tariff information, and so if we are not able to offer a customer a saving it is very clear and we say so, and we move on to somebody else. So I would certainly recommend across the industry that we ought to adopt similar techniques and make sure we are very, very transparent and probably even follow that up with a formal written quotation, so people are absolutely clear about what they are getting.

Mr de Rivaz: I agree with that. In 2002 we led the industry in establishing a code of conduct in terms of sales activity, and we are firmly sticking to this code of conduct, which I think is the only way to behave in this industry. There are many products available; I think there are almost 50 products available on the market for customers to be able to choose from. Typically, I think, each of the suppliers has between seven to nine different products. Price is one of the elements, and within price there are various products possible—fixed price, cut price—and there are other products which are offered to customers. We, for instance, have been very successful in offering a product which we call Read, Reduce, Reward, which is a strong signal given to customers to encourage them to reduce energy. So the choices to the customers are largely driven by prices, and we are very open and transparent about it, but they are able also to consider other aspects. That is the beauty of the market—the customers have the choice.

Mr Duff: I would say that it is absolutely essential that customers understand precisely what it is that they are signing up for, and that is why in our case 100% verification of sale is the best way to ensure they understand precisely the nature of the agreement that they are entering into. It also gives a strong control against any possible allegations of mis-selling. However, I think it is also very important to say that the industry has responded to customer demands for a variety of products which are not necessarily as you describe. For example, we sell boiler maintenance as an offer alongside an energy contract. We have 350,000 customers who pay a premium, quite consciously, for a green tariff product. We have 160,000 customers who are in the process of registering for long-term, fixed-price deals at a premium to the existing market price for long-term security. So the market is responding, I think, quite dynamically to the needs and demands of customers in a variety of different ways, and the products that are being sold are not a simple

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

homogenous product that you can only differentiate on price; there are other issues that go into the decision.

Q872 Mr Wright: Finally, one of the reasons Scottish and Southern suggest that they are leaders in the market to get new competition is the fact that they have got a fair pricing policy. By implication this would suggest that all of the other companies have an unfair pricing policy. What would you say to that?

Mr de Rivaz: My company, EDF Energy, has a fair pricing policy, and I have not heard Mr Marchant saying that the others were unfair.

Mr Duff: I certainly hope he has not. We have a fair pricing, responsible pricing policy and a competitive pricing policy.

Dr Golby: I cannot add to the comments that have just been made.

Q873 Chairman: Before I move on to the last section of questioning I want to come back to this question of doorstep selling, because I was very struck by Dr Golby saying he did not like it, and you lost control of it completely at Npower. Is it really possible that this vital tool to achieve switching can be done ethically? You had a major management failure at Npower, and it was a meltdown for your corporate reputation as well. Can we be confident that the measures you have put in place now, which have been great for a year, will not be chipped away again by enterprising salesmen after a quick commission and we will be revisiting these problems again in a year's time?

Mr Duff: I think the answer is we have to be. Just some context: complaints on selling have reduced, in our company, by something like 90% since 2002. This industry, I believe, bears favourable comparison with any other industry that utilises direct selling to access customers in this way. However, it really does carry risk. As you said, this was an illustration of the control challenges that it presents and ones that we must adequately respond to, to ensure that, as I said, the benefits of competition are available to everybody.

Q874 Chairman: I do not want to labour the point as we are not inquiring into this subject, but I know Lindsay wants to come in. Dr Golby, why do you not like it?

Dr Golby: I think, with a product as critical to life as the products that we sell, it just does not feel an easy thing to knock on people's doors or ring them over the telephone to sell. That is just a personal, intuitive view. That is the way, however, the industry works, and that has proven to be the most effective way of persuading customers to switch. Therefore, we have to be absolutely rigorous in the controls we put in place and why we spend a lot of money with hand-held computers so we can see exactly what our salesmen are quoting to customers, and therefore can make as sure as possible that mis-selling does not take place.

Q875 Chairman: The simple thing is a telephone call can be recorded but a doorstep conversation cannot. Are not telephone sales preferable to doorstep sales?

Dr Golby: A doorstep conversation, if it is recorded on electronic devices, as I have just said, where the customer has a copy and we have a copy of exactly what is being sold, I think, is equally as valid as a recorded telephone conversation.

Q876 Mr Hoyle: You are absolutely right; it is about transparency. I think the biggest problem is that you turn up on the door, you knock on the door and you give them the Christmas present—which seems to be all tinsel, all balls and all the latest wrapping paper—but the problem is they are very disappointed when they get the present because they really do not understand what they have signed up to. So the assurance has to be that that is not going to be the case any more; it is going to be transparent and they are going to understand the price. Is that right?

Mr Duff: Correct.

Q877 Mr Hoyle: So, in 12 months' time, if you have got it wrong, what do you do? Resign?

Mr Duff: I do not expect to get it wrong.

Chairman: Good question, Mr Hoyle. Is it a resigning issue if you get it wrong again? There is no answer to that. The silence speaks volumes. This is an issue on which, if it goes wrong, we will be back to visit again, I can assure you. We certainly will.

Q878 Roger Berry: May we turn to the significant problem of fuel poverty and social tariffs? Much was made of the announcement that the 'Big 6' would contribute an extra £50 million this year to spend on social assistance. Fifty million, as you pointed out in the context of this industry, is hardly a vast sum of money. Has it been decided that the individual companies will decide how to spend their share of the fifty million? Do you know now what you are going to do? I do not want the details of what you are going to do, but is it a uniform policy across the 'Big 6' or not?

Mr Duff: This company is committed to spending around £52 million over the next three years. We have already announced the simplest possible way of targeting that aid to those most in need. It is a social tariff, it is £125 discount per fuel on whatever tariff the particular customer is on—£250 discount for dual fuel, obviously—and we will target it at those who most need it. That, we think, is the best solution.

Q879 Roger Berry: How do you identify those?

Mr Duff: We identify those through our call centres—people who contact us with difficulty paying. We encourage people to contact us if they are in debt and struggling to pay. We make it very much part and parcel of the training programmes that we put our call centres through and we obviously publicise the availability. Further, we are willing to take references not just from individuals but, also, close family members and other representatives to initiate contact.

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

Q880 Roger Berry: Given that you cannot, for obvious reasons, know who amongst your customers are fuel poor and, therefore, you have to respond to people, perhaps, phoning up and saying: “Do I qualify for the social tariff?” do you not think it might be better, as suggested by Help the Aged and Age Concern, that the £50 million could be allocated to the poorest pensioners, very simply, by a £50 voucher to pensioners on Pension Credit over 70, for example?

Dr Golby: Let me respond to that. Our main vehicle is part of a tariff which we call Stay Warm, which we had already expanded three-fold before we agreed to the additional funding with the Government. We focused that at people we believe are the most seriously affected here (so people who probably are spending up to 20% of their income on fuel rather than the cut-off of 10%), and that is, predominantly, older people on benefits and mentally or physically frail. We have a tariff there which is quite deep and targeted and that, probably, costs about £400 for each of those customers. So whilst the Age Concern comment, I think, is useful, if we are really going to tackle this problem we have to do more than £50.

Q881 Roger Berry: Possibly more than £50 million extra this year. In some statements we have been told it is £225 million over three years, which is classic treble-counting—whether it is on the part of the Department for Work or Pensions or yourselves I do not know, but £50 million extra this year. I take the point that there are indeed others than pensioners who are suffering very seriously, and you mentioned disabled people under 60, for example, and the three-quarters of a million children who live in fuel-poor households. So I accept the case that there is an important argument for giving them support as well, but I am left with two questions. The first question is: the Government said this money was to be used for the poorest pensioners. So my first question is: is that true or false?

Dr Golby: That is certainly the way we intend to spend it.

Q882 Roger Berry: So you are focusing entirely on the poorest pensioners?

Dr Golby: We are focusing predominantly.

Q883 Roger Berry: Predominantly.

Dr Golby: Predominantly.

Q884 Roger Berry: I have to say, I genuinely do not know how customers can make sense of this. How do customers find out if they might be entitled to something from this £50 million? You do not know who the fuel-poor are. One of you relies, to some extent, on people phoning up and saying: “I think I might qualify”. You cannot have the information to identify who are the poorest of your customers. I do not know how you are working out who gets this money. Can you help me on this?

Mr de Rivaz: Can I try to say something, because I have been the last one to say something about fuel poverty. My company has been the first one a few years ago to implement a social tariff, which is a

simple one, which is a 15% discount off their energy bills. I am pleased to see that others have been following in our footsteps.

Q885 Roger Berry: May I ask for whom? Forgive me interrupting, but 15% off their bills sounds very good. For whom?

Mr de Rivaz: We have been targeting, through various channels with the help of social organisations, people who have the responsibility in society to—

Q886 Roger Berry: Welfare organisations like Age Concern, and so on, do you mean?

Mr de Rivaz: Yes, absolutely. The combination of all these actions plus our own fuel poverty propensity model to assess the likelihood of customers across a customer base to be in fuel poverty has helped us to target. I am not saying that we have reached all those who are in need among our customers, by far, but we have made this first step, which is, I think, an important one. The final remark I would like to say is that there has been a summit a few weeks ago with the Government, the energy industry—a lot of organisations—about this fuel poverty issue on the back of the Government’s decision to increase the suppliers’ contribution to it. I think we should rely on this process, to look at all the options to define before next winter what will be the practical ways to spend efficiently this additional money. Beyond all that, there is always the burning question in this country about the benefits of having a kind of mandatory social tariff. I know that it is a point on which I have a position which is different from many of the suppliers. I do not think a mandatory social tariff will prevent competition or would prevent innovation. It will be the basic requirement for all; it does not prevent anyone going further to offer innovative products in addition to that. This debate has been here for years and years but fuel poverty has not decreased in this country. So it may give everyone the right signal to address this issue on a level playing field and discussed in the most open way, I think it might be helpful.

Mr Duff: The approach to fuel poverty, currently, was designed at the end of the 1990s in a world where energy costs were relatively low and declining in the UK, and I think was an entirely sensible approach to delivering better lives to those most in need in the community. We are going through an energy price shock globally the like of which we have not seen since the 1970s. I think it is right to question whether that model is any longer sufficient to support that particular group of vulnerable people in our society, faced with the very, very real pressures that all of us face going forward. I wonder whether a fresh policy look at the whole approach is the right answer, so that the necessary effects of these very high energy prices that we are seeing will drive the right signals in behaviour in the way people who can afford to change the way they live their lives can do so while protecting those in community who are least able to respond to the challenges that this presents. Far

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

from disagreeing with my colleague, I would support a fresh policy look at this and consider whether the piecemeal approach is any longer sufficient.

Q887 Roger Berry: So you think it is worth looking at a different tariff?

Mr Duff: Yes, I think so.

Q888 Roger Berry: That is two out of the six so far. I have never understood the argument that says that having a mandatory social tariff destroys innovation and competition, any more than a National Minimum Wage destroys innovation and competition. Dr Golby, are you open-minded on this as well? Let us try and get three out of six!

Dr Golby: I am open-minded in the sense that, as I said at the beginning, we have had a 14-fold increase in the oil price since this policy was put into place. It is not surprising that it is not working, and we really need to have a fundamental look at it. The Government periodically asking us to put some more money into it, I think, is not the right way forward. We need to stand back and have a real look. However, this is difficult to do in a competitive market, and that is what you politicians have set up here—a competitive market for gas and electricity. If we are going to treat this problem seriously this is a major redistribution of wealth, and we ought to be open, honest and clear about it and get some very clear direction from government, because government are the people who actually have the information that can target this. Whatever we do as an industry, and we want to do something because none of us feel comfortable being in this position, they have the levers to pull here; we find it more difficult to pull those levers.

Q889 Roger Berry: How major it will be will, clearly, depend on the sums of money involved, but in principle—as with the National Minimum Wage—this could either have an effect or it could not have an effect, depending on where you set the level. As with the National Minimum Wage, you have the enormous advantages (a) that people know what the policy is and (b) they know what it includes. So just as we know what we include in the National Minimum Wage, in a social tariff we would know what that would actually mean, and, thirdly, it would be a level playing field for everybody. Given that, Dr Golby, do you not think there is a powerful argument for making it clear to consumers, and having a level playing field and transparency, so that instead of lots of different social tariff schemes people knew what the minimum requirement was? Does that not appeal to you, to make progress from a situation you have very adequately described as being confusing?

Dr Golby: Clarity certainly appeals to me, particularly if we are going to tackle this on a long-term sustainable basis. Yes, I can subscribe to that if that is the direction that government wants to go. Can I make one further point here? Let us not run away with the view that social tariffs are the only thing we should be doing here. Yes, we must alleviate this problem because it is just totally

unacceptable, but the real issue is the disgraceful energy inefficiency of most of the housing stock in this country. So rather than subsidising people to waste energy we ought to be solving that problem.

Roger Berry: I entirely agree. Indeed, I echo every part of that sentence, but we are talking about social tariffs because you have got them, you are all saying how good they are, you have signed up for another £50 million, and so forth, and therefore it is a public policy area that needs clarification. Obviously we cannot, Chairman, but given that we have now got three out of the six supporting the principle of a mandatory social tariff, it is a shame we cannot get the other three back on again.

Chairman: One was not against it last time.

Roger Berry: Fine—four out of six! This has to be a major recommendation in our report, I think, Chairman. I will rest my questions there.

Chairman: I am very grateful. There is just one factual question Mark Oaten wanted to ask.

Q890 Mr Oaten: Very finally, a good indicator of what kind of a messy situation we are in at the moment would be just how many of your customers are defaulting on their bills. What kind of percentage increase have you seen in the last year for people who just cannot pay?

Dr Golby: I will come back with a written response. This is an intuitive response. I think we have probably seen our bad debts double in the last 12 months.

Mr de Rivaz: I will give you more precise answers. We are doing two things. One is recognising that there is a current challenge due to this difficult context, but we are trying to improve our bad debt achievements in the company, so it is difficult for us to differentiate between what is the result of our efforts to reduce bad debt and what is the consequence of the context which increased the bad debt. I will give you more details in written evidence.

Q891 Mr Oaten: So bad debt is up?

Mr de Rivaz: Well, in our company I will not say bad debt is up globally because we are acting—

Q892 Mr Oaten: In the UK market, are more people struggling now to pay their bills than they were a year ago? Yes or no?

Mr de Rivaz: The answer is yes.

Q893 Mr Oaten: Fine. Next one.

Mr Duff: The answer is yes, and the response in our case is to put in place some very, very targeted debt relief measures for people who are struggling to pay their bills and to encourage them to come and talk to us.

Q894 Mr Oaten: Has it doubled as well for you?

Mr Duff: No, but I will have to come back to you with a factual response to that question.

Mr de Rivaz: What is true is that our EDF Energy Trust Fund, which has been given £7 million of

24 June 2008 Mr Andrew Duff, Mr Vincent de Rivaz and Dr Paul Golby

funding for customers who are under the huge impact of having high debt, is highly successful, and there are more and more requests from customers to use the possibilities of the fund we are funding.

Chairman: What all six of you have been highly successful at is using this opportunity to promote your own particular competitive advantage in the market. I am impressed by that. Sadly, I have not had the opportunity to ask Dr Golby whether I should take his fixed price tariff to lure me away

from you, Mr de Rivaz, having left Mr Duff a couple of years ago! We might explore that later, afterwards. There are a million things we would like more detail about but this has been a fascinating session. We are grateful to you. I think you have demonstrated a sensitiveness and awareness of the challenge, and we look forward to seeing what you report. We have one more session with the European Commission on Thursday. Thank you very much indeed.

Thursday 26 June 2008

Members present

Peter Luff, in the Chair

Mr Adrian Bailey
Mr Brian Binley

Mr Anthony Wright

Witnesses: **Mr Heinz Hilbrecht**, Director, Security of Supply and Energy Markets, DG Transport and Energy, **Mr Philippe Chauve**, Deputy Head, Energy and Environment Unit, DG Competition, **Mr Ricardo Cardoso**, Antitrust Energy and Environment Unit, DG Competition and **Mr Jan Gerrit Westerhof**, Electricity and Gas, DG Transport and Energy, gave evidence via a videolink.

Q895 Chairman: Good morning, gentlemen, and thank you very much indeed for giving up your time to talk to the Committee. I think I would like to introduce my colleagues to you, first of all, so that you understand who we are in the room, and I will ask you to do the same thing. My colleague here is Brian Binley and he will be asking you questions towards the end, over there is Tony Wright who will be asking you the first questions after mine, and Adrian Bailey is over here. My two colleagues here are Clerks to the Committee, who are responsible for the working of the Committee and writing our Report, and you will not, I expect, be hearing from them. Gentlemen, can I ask you to introduce yourselves.

Mr Hilbrecht: Thank you very much for having us. My name is Heinz Hilbrecht and I am the Director for Energy Markets and Security of Supply in the Directorate General for Transport and Energy of the European Commission. I have to apologise for Eric Van Ginderachter, who was scheduled to be here from DG Competition, but he had a tragedy, his mother died yesterday, so he apologises that he cannot be here today. In his place, I am happy that Philippe Chauve, to my right, is here and also Ricardo Cardoso from DG Competition, and I have with me from my Directorate, on my left, Matti Supponen, working on electricity and Jan Gerrit Westerhof, who is also working on electricity and gas, in particular.

Q896 Chairman: Thank you very much indeed. I think you understand what we are doing as a committee; we are looking at fuel prices, in particular, in the UK, though obviously that has a relationship to every other issue affecting fuel, including security of supply and investment, but I thought you would probably want to begin by explaining to us progress on the third package, where you think things are at and, in particular, what the prospect of getting that package is before the end of the Parliament.

Mr Hilbrecht: Yes, we are quite happy that both the Council and the Parliament have taken up the discussion on the third package on energy with the view of achieving a final decision still within this mandate of the European Parliament, in other words, before the Parliament will go into recess next summer for the elections. We had, particularly under the Slovenian Presidency, very intense discussions in the Council and the Parliament and the rapporteurs

have been very active. We have now come to some propositions in Council on which the Energy Council has found broad agreement. In the last meeting earlier this month, there was a lot of discussion, as you know, about ownership unbundling where, from the Commission side of course, we always underlined that our strong preference would be full ownership unbundling. But our proposal also included a second-best option, the independent System Operator, because we knew from the beginning that it would be very difficult to find complete agreement with all Member States on ownership unbundling. In the end, we managed to have consensus in the Council which includes a third option, the Independent Transmission Operator (ITO), where the mother company can still be the owner of the transmission, but will have to fulfil our strict requirements with regard to the independence of the management and very strict control by the regulator involved. This of course is not the ideal solution, we have to accept that, but at a certain point in time, I think, in the busy discussions, we were faced with the question whether we cut off there, so to speak, or have an agreement now. Because, if we did not have agreement, (the countries opposing it had a blocking minority) before the Parliament goes into recess and it would have taken the discussion probably to 2010 and 2011 and we would have easily lost four or five years. Therefore, we preferred to have a second-best solution, but which, nevertheless, is, I think, an enormous step forward. It makes the independent operation of the transmission system operator, even under the ITO solution or the third option, much clearer than it is now and it will add also another important element, in particular, with regard to the co-operation across the board of the transmission system operators and also with regard to the better co-operation of the regulators. Many regulators today are not strong enough, so we have asked that there will be strict minimum requirements with regard to the powers and the independence of the national regulators. The package will create also a mechanism where the national regulators can better co-operate at the European level to close the regulatory gap which exists today and for which all the regulators, in particular, deplore. The Parliament has achieved already a vote on the electricity part 10 days ago and they will vote on the gas part next week. On the electricity side, the Parliament has opted for full

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

ownership unbundling. This is, in some aspects, different from the Counter-compromise, also as regards to the powers of the Agency, that is the new mechanisms for the national regulators to cooperate at the European level. The Parliament wants to give more decision-making powers to the Agency, in particular, the Agency would be empowered to take binding decisions on the establishment of a European Grid Code, something on which the legal services of the Commission and the Council are much more hesitant. Under the present institutional arrangements, we cannot delegate such powers to an Agency, but such decisions must be taken by the Commission under the so-called “comitology procedures”. The Parliament is also opting for more stringent consumer protection. They want to have better rules, in particular, with regard to a customer charter in order to make it binding, whereas we, for the time being, think that this sort of charter should be a recommendation to Member States, and should be left more to the subsidiarity level. I think these are the major areas for the second reading. It remains to be seen how the Parliament will vote next week on ownership unbundling for gas. It is too early to say exactly whether they will also go for full ownership unbundling, but the chances are that they will accept, or that they can accept, possibly a third option for gas, which will not be as demanding for gas as for electricity. We will then go into second reading and we hope that we will have a final package adopted, if everything goes well, if not fully by the end of the year, perhaps in the first quarter of next year.

Q897 Chairman: Thank you for that comprehensive answer, and that is clearly very encouraging. What further liberalisation would you ideally like to see in a properly liberalised European energy market?

Mr Hilbrecht: I think we will have made quite an important step forward with the third package which will cover the ground to a large extent, and it remains to be seen then later whether that package is sufficient as a framework for the European market. I am sure that we will have to look into the functioning of the ITO-model/third option and to have an analysis done in four or five years’ time of the package, in particular, as those countries who are pro unbundling want the Commission to analyse whether the third option really is sufficient or not. We will also see whether the co-operation of the regulators is working sufficiently well and whether the co-operation of the transmission system operators is really efficient. But, for the time being, I think we would rather have quite a sound package and we will be looking forward to seek advice from all the stakeholders over the next years. It is however too early to say whether we need to go in some years time for a fourth package, I would not say this today, that remains to be seen.

Q898 Chairman: So this is going to be the most significant development and we are likely to see further changes in the next four or five years?

Mr Hilbrecht: Yes, possibly.

Q899 Chairman: You would probably say this is a question for British ministers rather than the Commission, but what benefits, do you think, will flow to the United Kingdom from the third package?

Mr Hilbrecht: I think, and hope, that we will come back to this a little bit later today, but we are now in a situation where, from a point of energy security, we realise that individual Member States are in a situation where they have difficulties in reacting in an appropriate and fast manner if the markets are separated along national lines. To have a common energy market provides an additional level of security for all Member States, including the United Kingdom. If you have problems with the supply of gas or electricity, all Member States benefit and have an additional security level if they can rely also on a quick reaction by the delivery of gas and electricity from other Member States. If we want to increase energy security, I think we all have an interest in having a common market which is functioning across the 27 member countries. Of course I think the United Kingdom has always been an advocate of ownership unbundling and of having a functioning market. The United Kingdom and also other Member States should therefore welcome that we go in this direction. Ownership unbundling is not a panacea, but it is a necessary condition, not the only condition, but a necessary condition for a functioning common market, and the UK should therefore welcome the third package even though this step is perhaps not as fast and as big as one would have wanted from the beginning.

Chairman: Well, that is a very helpful opening, for which I am grateful, thank you. I am now going to hand over to my colleague, Tony Wright, who will ask you questions on the oil-gas price link and gas trading.

Q900 Mr Wright: Could I just, first of all, mention the energy sector inquiry that you held last year, and one of the respondents estimated that the annual costs to the EU of gas prices remaining linked to the price of oil could, under certain assumptions, be extremely high, and a value of around €50 billion was mentioned. It considered that this indicates that the price benefits to the EU consumers of introducing gas to gas competition would be likely to be significant, so what is the rationale for linking the price of oil and gas in the European contracts?

Mr Chauve: Good morning. First of all, I would like to come back to the history of this. Why did we have it in the first place? You have to remember that at the beginning, when gas started to be on the market, it was seen first as an alternative to oil and there was very little offered on the market, very few producers and very few buyers, and, in the lack of a market, they agreed on the mechanics of the price which was as achievable to them as possible, looking at the references in the supply contracts, which were fuel oil and other oil product prices. Now, these have evolved to some extent, but evolved only in a few markets, in the UK market, and there have been for quite a number of years a large number of producers

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

and buyers, but in most other markets there is a limited number of suppliers upstream with a limited number of wholesale buyers upstream, and between them there is a consensus that, in the lack of a global worldwide market, they would prefer to stick to an oil-gas price link using fuel oil and other oil product prices to price their contracts which are rather long-term contracts. It is not the case in the UK. Whereas the oil-gas indexation is 80% on the Continental European market, in the UK it is more like 30%. Why is it so? It is because in the UK there is a liquid gas market to some extent, very clearly liquid in the short term, a bit less maybe on the forward market, and this allows market participants to have other indices to price their contracts against, and the reason thus for this oil-gas pricing is mainly historical, to put it in a nutshell, and mainly because there is a lack of liquidity in most markets, except maybe in the UK.

Q901 Mr Wright: So that is one of the reasons why our prices of fuel have gone up significantly in the UK. Does the demand for this linkage come from the producers or is it demanded by the consumers or the governments?

Mr Chauve: The answer is that basically the wholesalers and the producers prefer this oil-gas price link because of, they argue, the need to have some long-term certainty and some stability, but the other participants in our sector inquiry were usually not in agreement. Most of the regulators and the traders usually argued that this was a sign of a lack of competition and some other regulators and customers were arguing that there should be a price link to the gas market fundamentally. Now, given what I said earlier, it is a bit of a chicken and egg situation because, so long as you do not have a liquid market, you will not have an index which people can use, but, when you do not have an index, then you use this oil-gas price link. The bottom line, I think, is that you need a sufficient number of suppliers to have liquidity and to create an independent gas market with the relevant price and then gradually the gas price will be used as the reference in the supply contracts, even if they are somewhat long-term.

Mr Hilbrecht: If I may add a sentence, I think what Philippe has said is absolutely right. The problem is that on the upstream side the producers and wholesale suppliers have an interest in long-term contracts and, traditionally, the price is placed in relation to oil. Now we see globally that this is shifting as we have more and more suppliers coming in and as we have a more diverse situation from the supply side. If you only have gas traded under long-term contracts, for example, then of course you cannot expect that you will have a lot of liquidity in the market. If you have also LNG, Algerian gas and so on, then you have more sources and you will have also more liquidity in the market and then you get a more reliable spot price also. For the time being, you cannot really blame people that they use other indices than a gas to gas price and say, "Well, we do not have much gas traded and, therefore, there is a lot of volatility in the market and we do not know

whether the gas price is a reliable indicator". But we see movements that this is slowly changing, and the UK indeed is probably a leading factor. It will be interesting to see whether the NBP price will, and can, develop and be generally considered by the market as more reliable for setting the price. We have seen that some Norwegian gas contracts just recently, I think, take the NBP price as the reference and are no longer only related to the oil price. So there is movement in the market, but again more liquidity is needed. The more liquidity in gas, the more reliable that people will feel the gas to gas price can be.

Mr Cardoso: I just wanted to add two further points to this oil indexation question. Firstly, I think that there is one fundamental aspect which must be kept in mind, that oil indexation is inherently linked to the long-termness of contracts. It is only because you have long-term contracts that you then need oil indexation because, if you had a short-term one or a two-year contract, you could conceivably always fix the price, so it is only when you have producers who need the certainty in a 30-year contract to justify their investment and to get bank funding that you then go on to say, "Yes, we need a long-term contract and, secondly, it needs to be indexed to oil because that is the only conceivable way we could price it", or at least in half that was the case. Secondly, what we found in the sector inquiry was that oil price indexation is not uniform across Europe, so it is not entirely correct to say that every single long-term contract in Europe is indexed to oil, no, because you get the indexation to oil, and yes, it is the majority, but you also get a high proportion, up to, say, 20–30%, which can be indexed to things like coal, to electricity, to general inflation rates or even, in some cases and I believe this is a growing case, they are starting to be indexed even to hubs in the European market, although that probably can only be for Zeebrugge, which is a Belgian hub linked to the NBP, or for the TTF, which is a Dutch hub which is also growing and evolving.

Q902 Mr Wright: Did I hear you correctly earlier on when you said that in the European market only 30% is on fixed-term contracts as opposed to 80% in the UK market?

Mr Chauve: No, what I said is that in the Continental market 80% is very much linked to oil and oil product indices, whereas in the UK market indexation is only 30% to fuel oil and oil-related products, the rest being NBP and sometimes other indices, maybe sometimes even coal indices, so the figure I gave was 80% for the Continental market, but 30% for the UK market.

Q903 Mr Wright: Just explain then, in terms of the oil-gas linkage, does that actually have an effect on the security of supply, and could the link be broken, in your opinion, between the oil and gas prices?

Mr Hilbrecht: It depends really from what point of view you look at security of supply, and the picture is not totally black and white there. If I am a buyer of gas and I have a reliable supplier, of course I could say that it is an advantage for my security of supply

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

situation if I know that I will get my gas on a long-term contractual basis indexed to oil. So far so good, but what happens if I have a supply disruption, if something happens when the demand increases then I have a problem, as has happened in the UK, for example, a couple of years ago? The market is not able to respond quickly enough if you do not have sufficient liquidity in the market. If you have a market, as we have seen it in the past, which is, to a large degree, dominated by those long-term contracts indexed to oil, you lose the flexibility of the market to respond quickly to supply disruptions or any other problem which may occur. Then you have a security of supply problem. Under normal circumstances, the security of supply problem is not so evident, but in times of change it becomes clear that the market, as we have seen in the past, is not sufficiently secure. Therefore, you need over time to provide more and more liquidity in the market. I think that is also the reply to your question about what can we do to do it better. We need to develop the hubs in Europe, and Mr Chauve already mentioned that there are a number of other hubs now emerging in Europe, for example in France, in Austria, in Germany, in the Netherlands. The more diversity of supply and the more liquidity we have, the more flexible we will be to react in times of crisis and in times of disruption and the more energy security we will get.

Q904 Mr Wright: You have actually pre-empted my next question which is on the gas trading and obviously in terms of the hubs, so you have answered that in terms of the progress that there has been, but how does the UK's national balancing point hub compare to the other countries and how can gas producers be encouraged to trade a greater proportion of their output in the open market rather than on contracts?

Mr Chauve: First of all, the UK is very good at analysing itself and it is always wondering whether it is good enough, at least in this field, and there is a huge difference between the UK market and other markets. As we have shown already in the sector inquiry, the liquidity and the size of the trade in the UK market is so much bigger, more than eight times bigger, than in the second-largest trading markets in Europe that it cannot be compared even to the others; it is in a completely different league. Despite the development of the other markets which are rapidly growing, but from a much smaller state, the UK remains by far the largest traded market in the EU.

Mr Cardoso: Just in terms of the size that we are talking about, when we did the sector inquiry, we looked at the size of the different hubs and at the time the TTF, which is the Dutch hub, over the period 2003 to the end of 2004, traded a total volume of six billion cubic metres. Now, just to show you how this market is growing, this year every single month, it has traded a volume of over four billion cubic metres per month, whereas the other six billion were over two years. However, just so that you see how small this is compared to the NBP, in 2006, the

NBP had a volume of 650 billion cubic metres, so yes, the European hubs are growing, but they are still pygmies next to the NBP.

Chairman: Thank you very much indeed for that very helpful answer. I am now going to hand over to my colleague, Adrian Bailey, who is going to ask you about the link between European and British energy prices and about the working of wholesale electricity markets.

Q905 Mr Bailey: We have had evidence given to us by industry that during the summer, when demand is lower in Britain, we export gas to the Continental market because the price is higher. However, in the winter, when demand exceeds supply, the price rises, but we do not get a corresponding inflow of gas from the Continent to bring the price down. Now, on the surface, it would appear that the price mechanisms are not working properly. Would you agree with that and, if you do, why do you think gas producers in the rest of Europe are not taking advantage of higher UK prices?

Mr Chauve: This was also referenced during our debate with the UK authorities and we too have actually been investigating it during the course of the sector inquiry at the end of 2005 because the issue became, over the last five or six years, most acute in the winter of 2005–06 when there were really very high gas prices in the UK, much higher than on the Continent. We investigated the reasons why, as you said, there were not as many flows of gas from the Continent to the UK as could have been expected. The first reason that must be discarded is that it is not the interconnector itself which is at stake, and this is shown by the price of the Belgian Zeebrugge hub, which has followed, during the whole period, the UK gas prices, so the gas price in Europe would be exactly as high as the UK price in that period, so the issue is not the interconnector itself. The issue is more on the Continent itself where we found out that there were quite a number of physical, contractual and capacity limitations on the network, on the transport network of gas on the Continent, which prevented some gas from flowing into the UK. This is an issue which does not only affect the UK, but it is a more broad issue that we are trying to tackle in the whole of the Continent in many different markets. There is a problem of a lack of sufficient capacity, constraints either through physical limits that can only be changed by investment, but also sometimes through contractual limits which have prevented the gas from flowing. As you have seen, we have a number of cases which are targeting such possible capacity hoarding situations. Now, this is not the only issue, we have found out, that was holding back flows. There is another issue, that the spectrum of the quality of gas which is allowed to get on to the UK market is smaller than the spectrum of the quality of gas which it is possible to have on the Continent, and it is not an issue of the same size as the previous one, but this is an issue which could be solved possibly by having a blending station which would allow some other sources of gas to also go through the pipeline and get into the UK. One other possible issue which we have investigated, and

 26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

clearly is it not an issue of the companies not wanting to take advantage of a business opportunity, in this case an arbitrage opportunity, but actually our investigation revealed that there were business constraints, so it is not that they did not want to do it, it is that they did not have enough interest to do it, and they actually might have expected to need the gas for other reasons, and I will give you a very concrete example. When the price of the gas rises, including in the UK, it is mainly because the market participants expect the winter to be very cold, the coming winter. Now, when they expect the winter to become very cold in the UK, it is rarely the case that only the UK remains cold during that winter and it will be also the case that it will be cold on the Continent, at least nearby, and that means that the operators in those regions will have exactly the same expectations as the UK operators and will say, "Maybe I can seize this short-term opportunity now, but, as we need the gas during that winter and I don't have enough to do this plus have the gas later in the winter for my own needs, then, rather than pay dearly during the winter for getting additional gas, I will keep it now in my storage".

Mr Hilbrecht: It has something to do, I think, again with the problem which we raised earlier about the liquidity of the market. A lot of gas is bound by longer-term contracts. If I may add a sentence also on gas quality for your information. We have now started to discuss the issue of gas quality standards with the European standardisation body, CEN. CEN has created a working group already to see whether a European gas quality standard can be worked out to avoid the problems particularly related to a narrower band of gas quality in the UK compared to the Continent. This work will take several years to come to fruition, provided that it can really be implemented on a cost-efficient basis.

Mr Chauve: If I can add one point also, there are other factors which affect also these possible flows between the Continent and the UK, especially the Norwegian producers who have now a pipeline Langede linking to the UK and they still have these pipelines linking to France and Belgium. In effect, they are the best arbitrators between the two markets and they can decide to send their gas to one or the other market, depending on the prices. We witnessed that even yesterday when more influx of Norwegian gas had a dampening effect on prices in the UK, so there are a number of positive elements to this, but there is more to be done.

Mr Cardoso: I just wanted to add one more remark regarding your question because you made the specific reference to the winter of 2005–06 which is also the winter we looked at in the sector inquiry. I think it is important to note that this was a very cold winter and, if I remember correctly, it was one of the ten coldest winters in France since 1950, so the whole of Europe was a bit short on gas and, furthermore, there were several cold snaps, particularly late in the winter, which was unexpected and by then there was not that much gas left in storage. Finally, and this was probably one of the worse things for the UK in terms of pricing, there was a fire at the Rough storage, which is the main UK storage site, which

knocked it out at the end of the winter. If you compare that to the winter of 2006–07, there, on the contrary, you would say that both the UK and the Continent were over-supplied, so there was gas available and there were lower prices and, if you look on a historical price basis, the average traded price for gas in March 2007 was at about the same level as the average price for gas in March 1996. Therefore, clearly the weather has an effect, but there are congestions in the pipelines which may also prevent it, and then there are also the secondary issues in terms of whether companies are able to for strategic reasons and sometimes for legal reasons, because in France, for example, suppliers must maintain the gas in storage for a one-in-50 winter by law, so there are several constraints on suppliers where they may want to supply gas, but they are unable to.

Q906 Mr Bailey: Thank you, you have given a very comprehensive reply. Given that the European gas prices tended to set a floor for UK gas prices, but not necessarily a ceiling, and that the UK draws a large proportion of its gas supply from the UK Continental Shelf, you would reasonably expect gas prices to be lower in the UK than in Europe, but this is not so. Now, I think I would summarise, I hope fairly, what you have said, that there are capacity and infrastructure reasons, contractual reasons and also quality of gas reasons why we have not had quite the inflow that you might expect. Would you expect this pattern to continue in the future, even though the measures you have taken are designed, at least in part, to address that?

Mr Chauve: If you are looking for advice for a business proposition, I am not sure we are the best-placed people for that, but it is a fair question. In addition to the reasons that we have mentioned, there is a very fundamental evolutionary aspect of the UK market that will be looked at, which is when the UK market has turned from a gas-exporting market only a few years ago, a very large gas exporter, to when it may become a very large gas importer. When you get to this position the pipelines can flow in two ways, although sometimes they are not in the right place, but there the big difference is also that when you are also a producer, you store it where you produce. When you are an importer you are so afraid not to have your gas you have a lot of storage capacity, and there is a huge difference between UK markets and other markets, and when you look at the percentage of storage capacity and then the consumption, in the UK it is about 4%. In similar size markets like France, Germany or Italy, it is 20%, so there is a big gap to be closed in the UK in order to meet certain changes, such as changes which occur seasonally, and that would make a significant difference in terms of prices. In that respect we see positive development. A lot of companies are starting to build storage facilities in the UK but, as I said, the size of the investment to be made is quite significant. Another important aspect is to look again at the evolution of prices. What will be the effect of LNG prices, because as the UK becomes a net importer it involves also more LNG,

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

and that means that the price of LNG on world markets will have an impact on the UK prices? Also, if you look at the prices of the different sources of gas, the cheapest are on the Continental Shelf for the UK, then you have the Continental Europe prices, then the LNG and then the storage off-shore, and, obviously, the more you need gas the further up the ladder you will go and the higher the prices, and the prices will also be higher if the world energy markets become tight. As we have seen very recently, it was difficult for the UK to import more energy because there was a lot of demand on the Asian side.

Mr Cardoso: Let me just add something. In terms of understanding how important global LNG has become, in July of last year there was a major earthquake in Japan which knocked out the Kashiwazaki Nuclear Power Station, which was one of the biggest nuclear power stations in the world. Consequently, the Japanese had to dramatically increase the amount of LNG they had to purchase on world markets, and this pushed up Asian and world LNG prices, moved some of the free LNG ships back onto the Asian market rather than the European or the American, and I think one of the results, which we see in the UK even today, is that over the past year there have been very few companies bringing LNG to the UK market, for example, and this is because the prices of LNG are at around in Asia between \$15 to \$19 per million British Thermal Unit, which is equivalent, I might add, to more or less where the Winter 2008 forward NBP prices are right now.

Q907 Mr Bailey: Could we move on to the wholesale electricity markets? Again, evidence that we have received so far would indicate that the UK market is becoming illiquid, largely because of off-market contracts by the vertically integrated suppliers and transmitters. Why do you think liquidity in the UK electricity market is falling, whereas in Germany and the Netherlands it is rising and, supplementary to that, what do you think are the best ways of increasing liquidity in the wholesale electricity market?

Mr Hilbrecht: I do not know whether DG TREN has a good view on that, because we have actually not really analysed it in much detail. I think it is a fact that, unlike in gas, there is not a high level of electricity trading in the UK. On the Continent, particularly in Germany but also now going over to France with the merger of the power exchanges, also in the Netherlands and the Nordic countries, the power exchanges are getting stronger and stronger. The influence of the power exchanges is getting bigger and, therefore, you have more mobility in the market, whereas spot trading in the UK is very small.

Mr Chauve: If I can add a few words, we looked at the issue during the sector inquiry because we were a bit puzzled. Basically, the trading multiples or the relation between consumption and electricity traded forward was 1.5 in the UK, it was 5.5 in Germany and the Netherlands—so a very big gap between the two—and we looked at vertical integration—the fact that the big generators were usually teaming up

with large retail businesses that would have used their energy directly for retail instead of using it in the wholesale market—whether that was not a reason, and we could not assume that it was really a determining factor. It was probably contributing but maybe not significantly enough to be sure that it was the main driver. We can ask ourselves today, three years down the road. It is still the same situation and the operators have still been able to compete rather fiercely on the retail market in the UK, so it probably comes from the fact that the operators themselves prefer to deal bilaterally. If they prefer to deal bilaterally, I would encourage you to ask them why they prefer to deal bilaterally instead of trying to deal with standard contracts. Maybe it is because of the structure of the UK market where there is very limited possible trading on the spot market, and that is a very important element for operators to be able to cover their needs at the last moment; whereas, as was just said, on the Continental market there is a sufficiently large spot market in order to cover your needs.

Q908 Mr Bailey: Based on your experience on the Continent, what do you think we could do here in the UK to rectify this?

Mr Hilbrecht: I think there are two issues. First of all, I think the UK should try to promote a liquid day-ahead market. You are very short on the liquidity side. The success we have seen in the Nordic market, and in Germany in particular, shows that it is really important to provide more liquidity in electricity. Secondly (and this is the other aspect of the package we talked about in the beginning), one needs to improve interconnections between the Member States. The UK is not a particularly good point in case. We have within the EU an informal objective of a 10% interconnection rate—the interconnection rate giving the relation between import capacity and installed domestic generation capacity. For the UK it is about 3% only. That means you are not sufficiently interlinked with the Continent to make it possible to have a better exchange of electricity which would increase the liquidity in the UK market otherwise and also improve your security situation. I think it is a legitimate point.

Chairman: Thank you very much. I now move for the last two questions to my colleague Brian Binley, who will ask you about the EU Emission Trading Scheme and the so-called windfalls to generators and then about European market consolidation in the energy sector.

Q909 Mr Binley: Good morning, gentlemen. I had the privilege to share a meeting with a number of colleagues on Monday and Tuesday in both the Parliaments and the Commission, so it is nice to talk to you again on these subjects. You may know that Ofgem has raised concerns that the large energy companies are making windfall profits from the free allocation of permits under Phase II of the EUETS (the European Union ETS project). Can I ask

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

whether you believe that is true and, if you do, whether you think there is any action that should be taken and, if you do not, tell me why not?

Mr Hilbrecht: There is no doubt that there are windfall profits, and from a commercial point of view I think it is pretty much defensible that a company which receives an ETS certificates for free treats them as opportunity costs and prices them in. That is quite normal. From a competition point of view, the only question is whether the “pricing in” is acceptable at a 100% level or whether pricing in at such high level reflects a dominant position. The German competition authority has done some work on that. As far as I know nobody there disputes that these certificates which have been given for free have been priced in. The Commission has proposed that in the next stage of the ETS system (as of 2013) those certificates should be auctioned and not be given for free any more to the energy generation sector and we hope that the Council and Parliaments will accept these proposals.

Q910 Mr Binley: Thank you very much for that.

Mr Chauve: I would not comment on the competition aspect. As has been said, it is, unfortunately, cost. It is rational business behaviour. The bottom line of the problem is that they were given for free—that is what is at the root of windfall profits. There have been a number of measures taken by a number of Member States. For example, some Member States have granted much less to their electricity companies in the second phase than they granted previously, so these operators are short and can have so-called windfall profits only for the few that they have obtained for free; some of them have also introduced some levy mechanisms. It remains to be seen how acceptable or efficient these are, but there are a number of ways to look at these things and I would advise you to look at what other Member States are doing.

Mr Hilbrecht: Can I add another sentence? The Commission has also proposed that 20% of the auction revenues should be used to support renewable energies or addressing social aspects of vulnerable consumers, and also we hope that some amount of money will be used to realise a number of carbon capture and storage demonstration projects. In some countries, like in Germany, for example, they have now taken the position that because of the windfall profits the companies should give back some of that windfall and realise these demonstration projects without any additional funding support. This position is not shared by many of the companies. It remains to be seen whether we are going to use the ETS system also to enhance alternative energy sources and CCS.

Mr Chauve: I think what is important is also to make consumers understand that the purpose of this is to make electricity more expensive, to first, if possible, switch to less expensive sources, but, equally, they should actually use less electricity, and that is one of the key aspects of the Commission, that you have more efficiency in the use of electricity.

Q911 Mr Binley: Thank you. Some might call that social engineering, but I will leave that at this moment! My concern, however, is that you are telling me that some Member States are, in fact, adding to the market by their own actions, and that is interesting. You will know that the total windfall is reckoned to be nine billion sterling. I know that you will not want to interfere in our local domestic scene, but there is a view that we should be taxing windfall profits. Do you have anything to say about that?

Mr Hilbrecht: No, I think it is a matter of subsidiarity.

Mr Binley: I thought you would say that. Quite right.

Q912 Chairman: Entirely right. Thank you very much!

Mr Hilbrecht: Of course, as Philippe said, the whole objective of having an ETS system is to have an effect on the market, and you are having an effect on the market if the prices reflect the costs of the ETS specifically. Whether you have a windfall depends on how you attribute the ETS certificates in the first place: we think they should be auctioned. In the meantime, what do you do with the windfall profits is a matter which, I think, is solely up to you.

Q913 Mr Binley: It is an answer I expected, Sir. Thank you. Can we move on to the question of market consolidation? I do not need to tell you of the consolidation which we have all seen over recent years. Can I ask you whether you believe the level of market concentration across Europe is impeding progress towards further liberalisation?

Mr Chauve: First of all, one of the key conclusions of our inquiry was to show that concentration was one of the biggest hurdles to competition, but we have to accept that the very first reason for concentration is legacy. We have started, especially in gas, with quasi monopolies. So it is not because of consolidation that we have concentration in many markets, and even monopolies in some markets, it is because of the legacy and the fact that competition was introduced without having several operators, as was done, for example, in the UK with CEGB and what happened as a follow-up, particularly in IT. The only country to have done something similar, but not even to the same scale, is Italy. There is now consolidation. The good news is that some of it takes place across borders, like what we have seen in the E.ON case buying Endesa or Iberdrola and Scottish Power where the operators are linking across borders. Where there is a worry is when consolidation is taking place within a market, especially an EU Member State, and we have been addressing these cases in a very determined manner. In some cases we have forced divestitures. For example when E.ON was created a number of subsidiaries were divested, but in some cases when it is simply not possible to accept a merger, we have even prohibited. That was the case. When EDP and GDP the electricity and gas incumbents in Portugal wanted to merge. So we are looking very closely at the consolidation process. When it creates a

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

problem, we are addressing it, including, if prohibition is needed. And, last but not least, I would like to mention the fact that if operators are too big and if they abuse their power, we are determined to face it. This is what we are doing in the E.ON case currently in Germany, the operator being dominant and where we have concerns that they have abused their dominant position to raise electricity prices, we are in the process to accept commitment by E.ON to divest, for the first time in European history, a significant part of its assets, between one-fifth and one quarter of its generation assets, including a key base load and very flexible plants, so that it cannot any more use its market power to the detriment of consumers. So we are looking at the consolidation process, and even if operators are dominant, we are determined to address this and deconcentrate, if need be, in order to avoid the problems recurring.

Mr Hilbrecht: May I add a sentence on a more general level to what Philippe has correctly said. We think that competition in the Common EU Market will develop on two levels, and those developments should now come through. First of all, the big companies will discover, and they are already discovering it more and more, the European dimension of the market. They go across the national borders into other markets which will enhance competition at that level. As long as it does not reinforce their position in their home market, I think it is a development which is welcome. The second level of competition which we see is at the level of niche players, smaller companies, coming up on the renewable side, for example, developing new markets, benefiting also from the better and more liberal market conditions which we create through a European framework. Whether this will in the end again lead to a further wave of consolidation of these smaller companies, whether they will be picked up by the bigger ones remains to be seen. Hopefully our competition colleagues will look at that and watch it very carefully. Nevertheless, there are for the time being two developments at two different levels which, I think, show that increased competition is a real possibility in Europe.

Q914 Mr Binley: So what you are telling me is that, in the main, you consider consolidation to be not a bad thing at this moment, depending on the type of consolidation, but you are keeping your eye on the situation. However, you do talk about small players coming into the market. We have had evidence to suggest that, in fact, it is becoming more and more difficult for small players to come into the market. Would that be your concern on a European level, or should it just be a concern about the British market?

Mr Chauve: I am not sure what exactly you mean by the small players. If you mean small players on generation at a wholesale level, or on the gas side if there is no room for small players, but on the electricity side there are smaller players on the generation market, on the generation wholesale market. Even after consolidation in the UK, there are still quite a number of smaller players.

Q915 Chairman: Can I just clarify. We have evidence of new energy suppliers vertically in the market place. They cannot access power supplies to sell to customers.

Mr Chauve: That is retail then. Okay; sorry. Clearly it depends on each market. The issue on the retail market is access to the energy sales, but it is not only in the UK that you have problems. There are much worse situations, I can tell you, for example, in Germany, where in order to enter the retail market you have to face hundreds and hundreds of different distribution operators with different rules, different tariffs, different delays, different procedures, and that makes it a nightmare when you are not one of the really big operators because it requires huge entry costs to start up a retail business. So it happens not only in the UK, and in the UK the situation in that respect is much better. Lastly, what we have to face is that the retail markets are not markets where there is a huge margin, unlike in other network sectors like telecom where innovation has provided new products, created the scope for more services, higher priced services. At this stage they have limited innovation and that creates a more limited scope of competition. So we are aware that at the retail level there are problems for competition, but, in general, this is better addressed at national level because the markets are mostly national and usually even much smaller than national. These should be addressed by the national regulators and competition authorities because sometimes also the practices of the authorities are creating hurdles for the smaller operators.

Q916 Mr Binley: Thank you. Just a final point. Is there a case for requiring European companies to disaggregate their accounts by country so that potential new entrants can see where the profit-making opportunities lie?

Mr Chauve: I do not see how we could request this at this stage. If there is a real case of extension of dominance, meaning leveraging a dominant position on a given market to ensure one's place on another market, maybe we would look at this, but that is not what we have heard, and any new entrant, to be frank, in retail markets usually at the beginning makes losses, even the big ones and the small ones, everyone entering makes losses, because, as I said, you have entry costs to start with. So I am not sure that if you had a loss-making business of a big operator entering a new market we would ever be able to say this is bad behaviour. It is the nature of this business. Only after some point you can break even. So I do not see as we could go that far. There are also accounting rules which may allow you to disaggregate certain businesses, and then when the companies are publicly listed it is up to the shareholders to make their rights respected.

Mr Cardoso: Can I add one thing to that? That is not the way that companies that decide to enter a market do it. Most of the time a new entrant will look at where he is going to get gas or electricity, what the final retail price is, whether there are regulated prices which might impeach and influence selling on the market and make a profit, and based on that he

26 June 2008 Mr Heinz Hilbrecht, Mr Philippe Chauve, Mr Ricardo Cardoso and Mr Jan Gerrit Westerhof

makes a qualified decision on whether he wants to go forward with it or not. I will not give you the idea that they are looking at the retail margins country by country and then deciding; it is more a case of, “Where do I have gas? Can I transport it? Can I sell it?”

Q917 Chairman: Can I pursue that one last time for the Chairman. Put at its crudest, there is a suspicion among some parts of the emerging small and medium-sized enterprise supply sector, the people who want to supply small businesses in the UK—we are not typically talking about the domestic sector—that the vertically integrated companies allow their generators to make large profits, sell their interests too expensively to their supply companies and, therefore, those who wish to operate as retailers are denied the opportunity to make a profit out of the retail operation. That is putting it rather crudely. Do you share that concern?

Mr Chauve: It is difficult to reply to this without looking at each and every individual operator. What we can say in general is that, clearly, the most profitable business in this sector is on wholesale markets, not on retail markets. As I said earlier, retail markets have usually smaller margins and even the bigger operators are usually organised with different profit centre for wholesale and retail. I suppose, it is true in the UK as well as on the Continent, including for electricity where they have their own generation, unlike in gas where sometimes

they have to buy the gas. Even if they have a lot of generation, they just sell at arms’ length to their retail business what they have as generation, because they have a different profit centre for the wholesale market compared to the profit centre for the retail market. Indeed, they have made, in many cases, significant amounts of money, but usually it comes from the wholesale market, not from the retail market. That is in general terms what I can answer. I cannot answer to you on the prospects for individual companies.

Q918 Chairman: That has been very helpful. That concludes the questions we wanted to ask you. Is there anything you feel you have not had the opportunity to say or you feel we should have asked you before we terminate the session?

Mr Hilbrecht: Thank you very much. We have said what we wanted to say and wish you good success for your work.

Q919 Chairman: Thank you very much. We really are grateful for your trouble. There will be a transcript prepared of these proceedings. The line has been very clear, by the standards of these things. Nevertheless, I suspect our ladies who have been responsible for maintaining the transcript have found it more difficult than usual, so I hope you will be able to check it with particular care when we send you a copy of the draft. Gentlemen, thank you very much indeed. Your help has been invaluable.

Mr Hilbrecht: Thank you very much. Goodbye.

Written evidence

Letter by the Department for Business, Enterprise and Regulatory Reform (BERR)

I am writing to provide the Committee with further information on certain points which were raised when I attended your meeting on 31 January.

ELECTRICITY TRADED

According to estimates made by the Financial Services Authority, between 1 August 2006 and 31 July 2007 984.8 GWh of electricity were traded.

GAS STORAGE

There are currently nine gas and LNG storage projects that have already gained consent and are awaiting, or are in the process of, construction. Completion of these facilities would lead to an additional 920 Mcm (Million cubic metres) of gas equivalent of LNG in tank storage, and 1,850 Mcm of underground gas storage.

With one exception (which is targeting full capacity in 2018), if these projects proceed according to their commercial plans they will come online between 2008 and 2015. This would constitute a 57% increase in UK gas storage by 2015.

There are also a number of projects, some at a confidential stage prior to public application for planning permission and some already in the planning system, with the potential to increase total storage capacity well in excess of this.

DELAYS AT LNG IMPORT TERMINALS

As the Committee knows, commissioning of both the Milford Haven LNG import terminals has been delayed into 2008. As I said to the Committee, my Department's assessment is that the delays have not had a major impact on our gas supplies and prices this winter.

EFFECT OF PRICE RISES ON NUMBERS IN FUEL POVERTY

Energy price rises witnessed in 2008 to date will clearly result in upward pressure on numbers in fuel poverty. My department takes this issue very seriously and we recognise that we need to know the real impact of price movements, taking into account all significant variables and the distribution of fuel poor at any one time. My department is revising and improving its forecasting method for estimating the effect of the most recent price changes on fuel poverty and will complete this work shortly. This will enable us to make more confident estimates until we receive the full results of surveys that allow us to calculate the authoritative numbers. Given this, I do not want to make any guesses now about the effects of recent price changes.

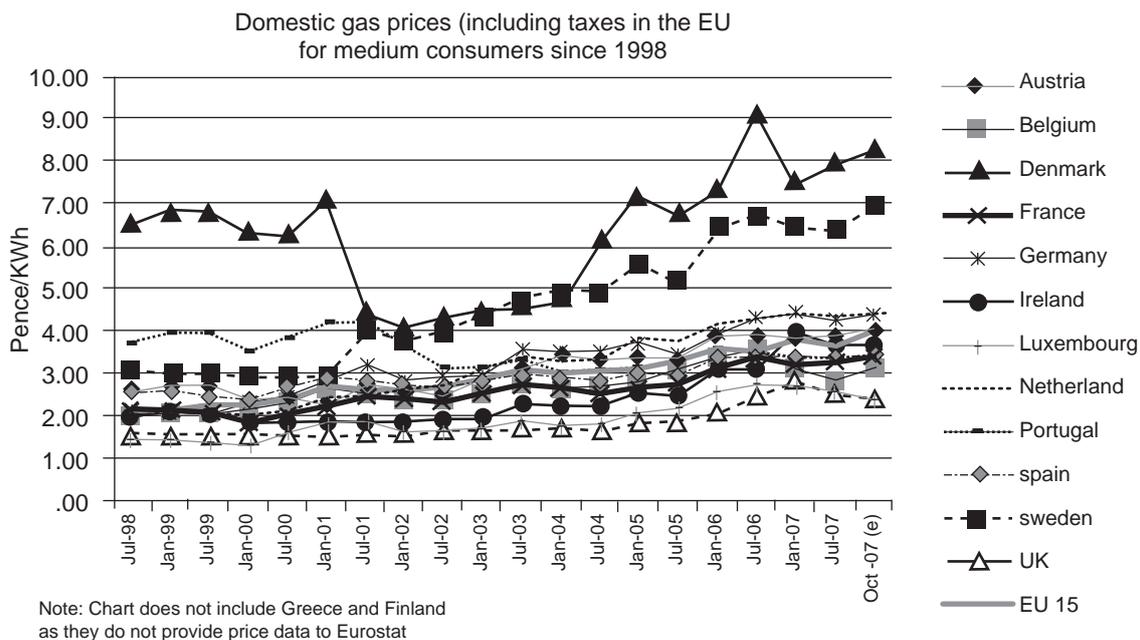
FUEL POVERTY AND DISABILITY

In 2005 there were estimated to be 97,800 households in England including a disabled person under the age of 60 and living in fuel poverty.

EU COMPARISONS

Committee members pointed out that a graph which I presented to was titled inaccurately with respect to its content. I attach another version of the graph with a detailed breakdown on domestic retail gas prices across the EU, which gives a clearer illustration of the point.

I hope this letter provides the information that you require. I have noted the announcement of your enquiry into possible anti-competitive behaviour in the UK's energy market. I and my department are of course ready to assist in any way.



15 February 2008

Memorandum submitted by BERR

SUMMARY

This memorandum responds to the Committee's call for evidence.

Section 1 gives an overview of current domestic market conditions including pressures on prices, and other relevant issues.

Section 2 addresses EU and international markets and action to improve levels of competition in them.

Section 3 addresses regulatory issues and notes current Ofgem reviews on aspects of the markets.

Section 4 provides an update on action to reduce and alleviate fuel poverty.

INTRODUCTION

1. As set out in last year's Energy White Paper, we face two principal long term challenges in energy policy:

- tackling climate change by reducing carbon dioxide emissions within the UK and abroad; and
- ensuring secure, clean and affordable energy as we become increasingly dependent on imported fuel.

2. Global competition for energy resources is growing, and so is the UK's reliance on international resources. We cannot isolate ourselves from international markets; rather we need to work to improve the competitiveness and transparency of those markets, to increase the diversity of our energy sources, and to encourage the investment needed to bring those sources into play.

3. Within the domestic markets we need to ensure that competition continues to deliver benefits for all consumers. We need to maintain, and where appropriate develop, the frameworks within which our competitive markets operate, to ensure that we meet all of our energy policy goals.

4. This memorandum summarises BERR's views on the UK energy markets in their global context, the regulatory framework in the UK, and fuel poverty, noting ongoing Government activity where relevant.

SECTION 1: COMPETITIVE ENERGY SUPPLY MARKETS

5. We believe that energy supply is best delivered through competitive markets. By giving clear price signals to market players, and promoting activities that reduce costs and risks, competitive markets are the best way of maintaining secure and sustainable energy supplies, increasing efficiency and improving services for customers.

6. Ofgem is responsible for the regulation of the GB energy markets. Ofgem's principal objective is to protect the interests of consumers, by promoting effective competition wherever appropriate.

7. Since liberalisation, the UK's competitive energy markets have delivered highly reliable, affordable supply, improvements in efficiency and productivity, and large investments in infrastructure to build up a diversity of supply sources. While the UK's exposure to movements in global energy prices has increased as its self-sufficiency in fossil fuels has declined, competition continues to work in the interests of UK energy consumers.

8. In January 2008 the Oxford Economic Research Associates (OXERA) published research confirming that the UK's energy market remains the most competitive in the EU and G7. OXERA monitors the competitiveness of the energy market by assessing a range of factors, including the market shares in generation and supply, the separation of transmission from generation and supply, and the availability of regulated third party access to gas and electricity transmission and distribution networks.

9. However, rising prices for consumers have recently given rise to concern about how well the markets are working. In response to this, Ofgem announced on 22 February 2008 that it had launched a probe into the gas and electricity supply markets, including whether competition is working well for all energy customers.

10. We welcome this action by the independent regulator in response to public concern. It is important that all appropriate measures are used to monitor and promote competition in the markets. Ministers have recently met with Ofgem to discuss these issues, and will continue to do so. In particular we welcome Ofgem's concern with ensuring that the benefits of competition are available to all consumers.

11. We are deeply concerned by the impact of higher energy prices on people on low incomes. Ongoing measures to reduce and alleviate fuel poverty are described in Section 4 of this Memorandum.

12. Ofgem has previously reviewed the wholesale markets, for instance in the Gas probe 2004–06, which identified some imperfections, and has worked with the European Commission to find remedies. Ofgem undertakes regular analyses of the operation of the domestic markets, and publishes Domestic Retail Market Reports (the last in June 2007).

13. The same six vertically integrated companies compete in the domestic gas and electricity markets. A number of parties exited the domestic electricity supply market in 2002; there has been no further significant consolidation in that market since then. Indeed, companies that previously held a monopoly position in specific regions (or, in British Gas's case, the whole country) have tended to lose overall market share. In comparison, the industrial and commercial supply sectors are characterised by larger numbers of competing companies.

<i>Company</i> ¹	<i>Gas market share</i> %	<i>Electricity market share</i> %
BGT	47	22
Eon	13	19
SSE	13	18
RWE npower	12	16
Scottish Power	9	12
EDF Energy	7	14

14. Different suppliers will employ different purchasing and pricing strategies but operate within many of the same external conditions. Overall, competitive pressures in the market mean that companies that charge higher prices compared to other players lose market share. Many consumers have switched supplier and their ability to do so, even if they choose not to, has helped to create competitive pressure on suppliers to improve the price and service they offer to customers. Even with the latest price increases, there will be opportunities for customers to save by switching suppliers. However, not all consumers (particularly those on low incomes) are in a position to switch easily or at all—and this issue is returned to in paragraph 67 of this Memorandum.

15. In the non-domestic supply markets energy suppliers offer several products to help customers manage the risk of increasing and more volatile wholesale prices, including interruptible contracts. Products are also being offered providing improved energy management.

16. To protect consumers we need competitive energy supply markets, but it is also essential that energy companies can operate successfully and profitably, rewarding investors and making further major investments year on year to renew and extend infrastructure. The current trading environment can be challenging, with rising wholesale prices, environmental obligations, and volatile margins. These markets are by their nature cyclical, with periodic strategic decisions needed on investment. We need companies in this sector to take these decisions with confidence.

¹ Table figures are taken from Ofgem's Domestic Retail Market Report, June 2007 (% of customers as of March 2007).

17. We note below that energy companies are already making large investments in major infrastructure developments for gas import and storage, to meet demand and provide greater protection against price shocks and delivery interruptions. In addition, about a third of the United Kingdom's electricity generation is due to be retired over the next two decades, and we will need new generation to replace it. Network infrastructure needs to be maintained and renewed, and to develop alongside the generation mix.

18. The Government is committed to maintaining and developing the good environment for energy investment that we have established. Ofgem is reviewing regulation of networks to ensure that conditions are right to encourage necessary investment. We are also introducing fundamental changes to the planning system, affecting major energy infrastructure developments among other projects, to ensure that proper scrutiny is undertaken within a timescale which does not deter investment unnecessarily.

Energy prices

19. Ofgem's analysis has identified underlying cost pressures as the biggest factor in recent increases in retail energy prices. Global energy demand continues to rise, particularly demand from developing countries. Global fossil fuel prices have been on an upward trend over the last 12 months, reaching record levels, driven mainly by strong demand growth and tight production and refining capacity.

20. In the UK, wholesale gas year-forward prices have increased by more than 50% and coal prices by more than 85% since January 2007. These increases in fuel prices have put pressure on electricity wholesale prices which have increased by 85% in the same period. Environmental regulation, commercial decisions by suppliers, and transportation charges also impact on prices.

21. High fossil fuel prices impact on retail energy prices, though the relation between them is complicated by long term contracts and suppliers' individual buying and pricing policies. BERR's internal analysis suggests that wholesale prices make up, respectively, around 50% and 45% of retail prices for domestic gas and electricity customers, and around 70% and 91% of prices for (average sized) industrial gas and electricity consumers. It is therefore not surprising that large increases in the underlying costs can also translate to substantial increases in end-user prices.

22. Domestic competition alone cannot protect UK consumers from all the effects of the rising global demand for energy resources. Because the UK is interconnected with the Continent and the global market through pipelines and LNG trade, UK gas prices are increasingly linked to those in the rest of Europe and the world. Daily variations in UK gas prices depend significantly on many other variables, but the long term trend in UK wholesale gas prices is similar to that on the Continent.

23. EU wholesale gas markets are currently working imperfectly, with a strong link to the price of oil and oil products, bundled and non-transparent gas transportation and supply, and a predominance of rigid long-term supply contracts. This means that arbitrage is not working as it should: European gas flows do not always respond to price signals. Action to improve the competitive functioning of EU and other international markets, and the UK's access to them, is described in Section 2 below.

24. Electricity generation in the UK is more reliant on fossil fuels than in some other EU states. Therefore, our electricity prices can be more sensitive to rises in their global prices. In 2007, electricity produced from coal-fired generation was 37% of total electricity supplied.

25. Some network costs have also increased, adding to prices. Charges for gas transportation have risen in 2007–08. These reflect higher pension management costs, higher costs of gas lost in transportation (because of the higher value of gas), and necessary investment in the maintenance and development of the networks (specifically the mains gas network). However UK network costs remain relatively low in comparison with those in other EU states.

26. As we noted initially, affordable prices and security of supply are not the only goals of our energy policy. This Government has taken the lead in the EU and globally in developing cost-effective policies to move towards a lower-carbon economy. Our environmental policies within the energy markets—the EU Emissions Trading Scheme, the Carbon Emissions Reduction Target (CERT), and the Renewables Obligation (RO)—all have an impact on prices, and the overall impact has risen this year.

27. The Government is committed to the EU 2020 Renewables Target, which requires the EU to obtain 20% of its energy consumption from renewables sources. In the summer, the Government will launch a full consultation on what more the UK should do to increase renewable energy use and meet its share of the EU target. We will work hard to ensure that we take the most cost-effective approach to meeting our targets.

SECTION 2: UK AND INTERNATIONAL MARKETS

Global markets

28. For many years, the UK has benefited from its indigenous reserves of oil and gas. As the North Sea matures and UK oil and gas production both decline, we will become increasingly dependent on imported energy. By 2010, net gas imports could be meeting around a third of UK annual gas demand, potentially rising to around 80% by 2020. To adapt to new conditions and ensure continuing secure and affordable supplies, we need new import and storage infrastructure, and we need improvements in the way the international markets function.

29. Our competitive markets have previously delivered investment in networks and supply routes, giving the UK access to resources and an enviable record of reliability. This continues: in response to developing import demand, there are now nine gas and LNG storage projects in the UK that have already gained consent and are under construction or awaiting it. Completion of these facilities will lead to an additional 920 Million cubic metres (Mcm) of gas equivalent of LNG in tank storage, and 1,850 Mcm of underground gas storage. These projects could constitute a 57% increase in UK gas storage by 2015.

30. This investment will put the UK gas market in a stronger position to deal with present and future risks to different international supply sources. Access to the LNG market in particular will allow for greater flexibility to respond to shocks. It is important that this record of positive investment continues to meet our developing energy needs in the future.

31. We must also make further progress in establishing fully competitive and transparent international markets. This will enable companies to get fair access to the energy resources we need. Effective markets will ensure that the world's finite resources are used in the most efficient way and ensure that we make the transition to a low carbon economy at least cost. Further liberalisation of EU energy markets is an important part of this.

32. UK and Continental gas prices and flows are increasingly affected by the wider international energy market. As noted above, gas prices are influenced by global oil prices, both directly through oil price-linked contracts and also indirectly where oil and gas are substitute fuels (eg electricity generation and heating). In the future, it is likely that gas prices will also be influenced by coal prices, which is a key substitute in the power generation and industrial sectors.

33. Trade in Liquefied Natural Gas (LNG) is forecast to increase internationally. The UK participates in this market through the import facilities at the Isle of Grain and at Teesside and, looking forward, through the LNG import terminals at Milford Haven, which are expected to commission this year. Supplies of LNG to the UK are currently sourced from Algeria, Qatar, Egypt and Trinidad & Tobago. At present LNG prices are high, in part due to high demand in Japan (following problems with their nuclear power fleet) and Turkey (due to low volumes of piped gas imports). Over time the more global and liquid the traded LNG market becomes, the greater the access for the UK to more diverse sources of supply.

34. Russia dominates gas supplies into Europe, currently accounting for some 25%. Whilst the UK is not directly dependent on Russian gas and has a diverse range of supply sources and import routes, tightness in the Continental gas market can affect the UK flows and prices. There are some concerns about the level of investment in Russian gas production given the decline of their existing large gas fields and forecast growth in European and world demand. We are working with the EU to launch the Partnership and Cooperation Agreement which we can use to encourage a more stable regulatory environment for overseas investment in the Russian energy sector.

35. Similar concerns also exist around investment in the Middle East and North Africa. The UK is working with the International Energy Forum to investigate barriers to investment and encourage their reduction. We are also working with the International Energy Agency and the EU, in particular the EU Gas Coordination Group, to consider cross-border security of supply issues and the state of the global gas market.

36. Further, we are promoting diversification as a key component of an effective EU external energy policy. As part of this we are working to create conditions in Turkey and the Caspian states that will favour the construction of the Nabucco pipeline, to carry gas from the Caspian to Europe.

EU markets

37. As noted above, EU wholesale gas markets are currently working imperfectly. The Government is committed to working for transparent, liberalised energy markets in the EU. Transparent markets would ensure that gas prices better reflect market fundamentals and respond more flexibly to the supply/demand balance, and would make a substantial contribution to ensuring security of supply, both in the short and the long term.

38. Completing liberalisation of the internal energy market is one of the key objectives of the Lisbon Economic Reform Agenda, which focuses on making the EU more competitive. The Commission published the results of a sectoral inquiry in January 2007 stating that:

- (a) further unbundling of transmission businesses from non-network activities would remove any incentive to discriminate in favour of particular supply businesses;
- (b) regulators did not always have the powers or independence to ensure competition. The solution suggested was to give them the necessary powers and independence, along with a duty to promote the internal market. It was noted that there was a lack of coordination of activities on cross-border issues and it was suggested that there should be an Agency to ensure such cooperation;
- (c) the markets displayed a lack of transparency. New obligations to make public some types of operational information were proposed.

39. In September 2007 the Commission brought forward their proposals for legislation, and these are now being considered by the Council and European Parliament. It was agreed at the Energy Council on 28 Feb that efforts would be made to reach agreement on the package at the June Energy Council. The relevant issues for competition and regulation are summarised here.

40. **Unbundling:** This is the proposed separation of transmission businesses from other businesses in companies that are currently vertically integrated. It is needed to prevent vertically integrated companies from discriminating in favour of their own supply and production/generation businesses, to the disadvantage of competitors. While there is already a degree of separation required by EU legislation, more has been judged necessary.

41. The Commission is proposing that the same company should either no longer be able to own both transmission network assets and businesses in the competitive arena (“ownership unbundling”); or, alternatively, that the operation of transmission networks so owned should be carried out by an entity independent of the network owner (this is the “Independent System Operator” or “ISO” model). Ownership unbundling would be significantly more effective in preventing discrimination than even the strongest ISO, as it would remove all commercial incentive for network companies to favour particular supply or generation businesses.

42. France and Germany, along with some other Member States, oppose the Commission’s proposals and have put forward an alternative form of unbundling. This consists of a number of measures to strengthen current requirements for legal unbundling (ie unbundling that would allow transmission businesses to remain within a vertically integrated group). The Government believes this falls short of the Commission’s stipulation that any such alternative must provide a similar level of protection against discrimination by vertically integrated companies as its own proposals and should involve structural measures.

43. **National regulators:** National energy regulators independent of the industry were established by the 2003 EU energy liberalisation package. However the limited remit given to many regulators by national governments has restricted their effectiveness. Intervention by national governments in regulatory decisions increases the risk that market rules are not applied equally and transparently, so frustrating effective competition. The Commission has therefore proposed widening regulators’ duties (including for the first time a duty to cooperate in developing the internal energy market) and increasing their independence from governments.

44. The Government welcomes the Commission’s proposals. Regulators should be independent of Government and have wide-ranging duties and powers and sufficient resources to carry out their duties. This is important to ensure regulation is stable, transparent and predictable so that market players have the confidence they need to invest. We also support the regulators having a duty to promote the internal market, in addition to their national duties.

45. **Agency for the coordination of energy regulators (ACER):** The Commission has proposed the establishment of an Agency to oversee the coordination of efforts to encourage the investments needed to establish an integrated European grid in electricity and gas and to simplify and enhance cross-border trading.

46. While the Government welcomes the proposals for this Agency for greater cooperation between national regulators, particularly on cross-border issues, we would want to see the powers of regulators strengthened in the Agency model proposed so that they can collectively take binding decisions on defined cross-border issues. This is essential for the transparent, predictable and stable regulatory framework needed to encourage investment in an integrated European grid in electricity and gas.

SECTION 3: REGULATORY OVERSIGHT OF THE UK ENERGY SUPPLY MARKETS

47. Healthy competition is essential to protect consumers and drive innovation. The recent report of the House of Lords *ad hoc* Committee on the Regulators noted that most witnesses agreed that Ofgem and its predecessor regulators had helped to achieve a successful transition to fully competitive gas and electricity markets and brought significant benefits to consumers.

48. BERR and Ofgem are in close contact with regard to energy prices and the competitiveness of the retail energy markets. However it is important that the Regulator is independent of Government, and seen to be so, to ensure that the regulatory process is free from political interference, and to avoid creating unacceptable levels of uncertainty in the markets.

49. We have full confidence that Ofgem would respond to any evidence of anti-competitive behaviour by taking strong and effective action. Ofgem has a record of using its competition powers, for instance in its recent decision to impose a large fine for a breach of competition law that restricted the development of competition in the domestic gas meter market.

50. Ofgem announced on 22 February 2008 that it has launched a probe into the energy markets in electricity and gas for households and small businesses, in response to public concern about whether the market is working effectively, stating that customer confidence is vital for a well-functioning market. Ofgem also cited its own concern about the increased volatility of wholesale prices the impact of European and other global energy market developments. However Ofgem states it has not to date seen clear evidence that the market is failing.

51. This detailed probe will investigate whether the market is working well for all customers, not just groups using particular payment methods. The probe will be carried out under Ofgem's Enterprise Act powers. The European Commission will collaborate with Ofgem in the probe to ensure Ofgem has full information on other European energy markets. As noted above, we welcome this action by Ofgem.

52. Ofgem will also continue ongoing work on tariffs for pre-payment and standard credit customers, among other areas. Ofgem will discuss findings at a Fuel Poverty summit in April, which Ministers will attend.

53. In addition, we welcome Ofgem's inquiry into the regulatory regime for energy networks (announced on 6 March 2008). This will examine how best to provide reliable, well-run networks with good service at reasonable prices amid growing investment challenges. Ofgem has stated that this should not be considered as a statement that the current framework is not working, but that the markets now face new challenges and these should be addressed. Issues considered in the review will include: how to adapt the regulatory framework in line with government proposals for 2020, proposals for greater power network interconnection in Europe, a greater emphasis on small-scale distributed generation, and growth in gas imports. Ofgem has stated that there can be no change to the regulatory regime without full consultation.

54. Ofgem has also launched a code governance review to determine whether there are weaknesses in the way the codes are governed, preventing industry and consumers from gaining full value from the arrangements.

55. We are satisfied that Ofgem's primary duty is appropriate for the independent regulator of the competitive energy markets, and we do not believe there is a compelling case to amend or add to it. However we recognise that national and global conditions in the energy sector continue to develop, and we believe that it may be appropriate to update Ofgem's statutory social and environmental guidance. We plan to publish a public consultation on this shortly. It will reflect our expectations for Ofgem's role in ensuring that the benefits of the competitive markets are available to low income and vulnerable consumers, in facilitating switching among those groups, and in meeting overall sustainability goals.

SECTION 4: FUEL POVERTY

56. The Government has a statutory target that, so far as reasonably practicable, it should seek an end to fuel poverty for vulnerable households by 2010 and for all households by 2016. We continue to work towards these goals.

57. Fuel poverty is influenced by a range of factors. The most prominent drivers are fuel prices, level of household income and the energy efficiency of a dwelling. The Government's strategy for alleviating fuel poverty is centred around:

- Programmes to improve household energy efficiency measures and efficient heating systems.
- Maintaining a competitive energy market, ensuring the market works for the less well off, and encouraging industry initiatives to combat fuel poverty.
- Continuing action to tackle poverty and increase incomes through the take-up of all benefits.

58. Since 2000 the Government has spent around £20 billion on tackling fuel poverty across the UK. These measures have helped to ensure that the number of households in fuel poverty in 2005 was significantly below the number in 1996.

59. However, more recent rises in fuel prices have had a significant impact, offsetting to some extent the success of these measures. The latest estimates produced by BRE for the Fuel Poverty Advisory Group Annual Report show that in 2007 approximately 2.9 million households were in fuel poverty in England (of whom 2.3 million were defined as vulnerable). However it should be noted that this projection does not take into account energy efficiency improvements to dwellings since 2005, an area extremely difficult to model statistically, and thus is likely to represent an upper bound of the actual level.

60. In the light of the effects of higher fuel prices, we have decided on further actions, which were announced in Budget 2008. A summary of ongoing and new initiatives to alleviate fuel poverty is provided below.

Warm Front

61. Since its inception in June 2000, 1.6 million households have received assistance through Warm Front, which offers a range of insulation, heating improvements and energy advice. Between 2000 and 2008 the Government will have committed £1.6 billion to Warm Front, providing support to vulnerable households across England. Similar schemes operate in Scotland, Wales and Northern Ireland. Looking ahead, the Government has announced an ongoing commitment to the Warm Front Scheme of just over £800 million during the next Comprehensive Spending Review period.

Carbon Emissions Reduction Target (CERT)

62. The Carbon Emissions Reduction Target (CERT) will have a focus on low-income and elderly customers through a priority group obligation. The targets for overall lifetime carbon dioxide savings under CERT will be roughly double that of the Energy Efficiency Commitment (EEC, which ran between 2005 and 2008). Energy suppliers will be required to meet 40% of their carbon saving target by installing free of charge energy efficiency measures to a priority group of low-income and elderly customers (aged 70 and over). The effect of this increased activity together with the Warm Front funding announced means that spending on energy efficiency and other measures in low-income, elderly and disabled households is expected to rise, by £680 million to around £2.3 billion compared to the previous spending period.

Decent Homes Programme

63. The Decent Homes Standard is a minimum standard below which homes should not fall in England and the Government aims to have 70% of vulnerable households in decent homes by 2010. The majority of local authorities and registered social landlords are carrying out work well in excess of the thermal comfort standard, with 90% planning to install both cavity wall insulation and loft insulation even where the standard only requires only one of those. Progress on thermal comfort means that the number of social sector homes in England failing on this criterion has more than halved since 1996.

Area based approaches

64. Warm Front and the Energy Efficiency Commitment are also supported on a local basis. This has enabled us in 2007–08 to award funding of over £6 million to 50 projects across England under the auspices of the Community Energy Efficiency Fund. The projects being supported are designed to promote innovation and look at a whole house approach, with the aim of providing a cost effective way of delivering measures to households on a local basis, drawing together support from the Warm Front and energy suppliers' activity through the Energy Efficiency Commitment/Carbon Emissions Reduction Target. The projects supported are expected to help assistance to be delivered to around 600,000 households in England over the next three years.

Access to the gas network and alternative technologies

65. We have also been exploring the role of alternative technologies in alleviating fuel poverty and looking at ways to encourage gas distribution network companies to provide connections to deprived communities off the gas network, as gas is the cheapest form of heating. As part of the post-2008 Gas Distribution Price Control, Ofgem consulted on measures that would incentivise companies to provide connections to deprived communities currently off the gas network. This is likely to benefit up to 360 communities in Great Britain.

66. The Design and Demonstration Unit within BERR has successfully developed a model for the provision of gas connections to deprived communities by independent gas transporters. The Unit has also developed models to provide lower-cost household energy from renewable and other new technologies for those deprived communities where gas connections are not economically viable. These approaches are currently being piloted in deprived communities in the North-East and Yorkshire.

Ensuring access to the competitive market

67. The Government has been working with Ofgem to enable the fuel poor to use the competitive energy market to their advantage by switching to suppliers offering the lowest tariffs. Ofgem is currently working with the Citizens Advice Bureaux to help vulnerable customers to switch to a better tariff and is conducting research into barriers that might prevent the fuel poor from switching supplier. Looking ahead the

Government will also be joining Ofgem at the Fuel Poverty summit in April that will bring together key players to consider what steps can be taken to deliver support to vulnerable households to help them take advantage of the offers the market may offer.

Energy supplier social programmes

68. In the Energy White Paper, published May 2007, the Government challenged energy suppliers to deliver a proportionate programme of assistance to their vulnerable customers. The energy companies responded by increasing the level of assistance provided to vulnerable customers from £40 million to £56 million benefiting around 700,000 households. These measures were estimated to take 70,000 households out of fuel poverty across Great Britain.

69. We welcome these steps but, given recent rises in energy prices, vulnerable households need further help. Together with the energy companies and Ofgem we will draw up an action plan to achieve a fair programme of assistance for vulnerable households. Our aim is to increase the level assistance from £56 million a year to a £150 million a year. The Government is prepared to legislate as necessary to require energy companies to make a fair contribution.

Tackling tariff differentials

70. Households that use prepayment meters and typically pay around £55 more a year for their energy than customers paying by standard credit and £144 more than those who pay by direct debit. It is not clear that these differentials simply reflect the extra cost to companies of servicing prepayment meter customers, nor is it clear whether prepayment customers are being given enough information about other cheaper payment methods. We have therefore asked Ofgem and suppliers to develop proposals to ensure prepayment meter users are treated more fairly. If sufficient progress is not made by next winter the Secretary of State for Business Enterprise and Regulatory Reform is prepared to use his statutory powers to reduce the differential between prepayment meters and other forms of payment.

Increasing incomes

71. A wide range of action has been taken across Government in tackling poverty through improved incomes. Significant progress has been made in tackling pensioner poverty and work is ongoing to tackle the challenge of child poverty. Key actions include the introduction of Pension Credit and the introduction of Tax Credits for families.

Winter Fuel Payments

72. The Government introduced the Winter Fuel Payment in 1997, specifically to help older people, who are particularly vulnerable to the effects of cold weather, with their winter fuel bills. The Winter Fuel Payment helped to keep 11.7 million households in the UK warm in the winter of 2006/07. If counted against fuel bills this would remove one million households from fuel poverty in the UK. In addition to our commitment to paying Winter Fuel Payments at their current rates (£200 for households with someone over 60, £300 if over 80) for the lifetime of this Parliament, in Budget 2008 we have announced an additional one-off payment of £100 to over-80s households and £50 to over-60s households in winter 2008–09.

Benefit Entitlement Checks

73. Improving the income of households has a major role to play in reducing fuel poverty. There is a commitment across Government to encourage people to claim all of the benefits to which they are entitled. Since 2003 we have offered benefit entitlement checks to those households who contact Warm Front for assistance but at the time of doing so are not in receipt of one of the qualifying benefits. This assistance was extended in 2005 to offer benefit entitlement checks to all under Warm Front, whether or not they are in receipt of a qualifying benefit when they apply for the Scheme. These checks result in an average increase in potential income of around £1300 a year for those found to qualify for additional support.

Memorandum submitted by Association of Electricity Producers

1. The Association represents a wide range of electricity generating interests embracing well over 90% of the UK's electricity production. The membership includes all the major electricity companies and a wide range of other enterprises from PLCs to small family-owned businesses. Virtually every generating technology used commercially in the UK—from coal, gas and nuclear power to a wide range of renewable energies—is represented in the Association.

GENERAL COMMENTS

2. The Association has supported strongly the development of markets for the production and sale of electricity and for gas, which is an important fuel in the power generation sector. Since it was formed in 1987,² it has seen the introduction of the Electricity Pool of England and Wales and the abolition of the Pool in favour of the New Electricity Trading Arrangements (“NETA”) and later the extension of NETA from England and Wales to Great Britain (“BETTA”). The electricity wholesale market is now mature and even detailed modifications to market mechanisms are less frequently proposed than was once the case. The available evidence on market competitiveness does not support changes to the existing market frameworks.

3. It is vitally important that investors in the electricity generating industry should have confidence in the electricity and gas markets. This is a prerequisite for securing the massive new investment which is necessary to replace ageing power stations and thereby maintain security of supply and deliver the low carbon power generation that the climate change agenda requires. Confidence is derived from a market framework that is seen to work and from clear and stable public policy which minimises political and regulatory uncertainty and hence risk.

4. Clarity and stability, however, have not been strong features of energy policy in the last 10 years. During that time, there have been three fundamental reviews of energy policy, each with a different emphasis in terms of its outcome:

- Review of fuel sources for electricity generation 1998;
- Energy Policy Review 2003; and
- Energy Policy Review 2006.

5. There has been an extensive programme of environmental legislation relating to clean air measures (largely EU-driven) and to the climate change agenda and recently, rumours of a “windfall tax” to fund measures to alleviate fuel poverty. In addition, there has been a constant stream of regulatory measures and proposals.

6. The Association hopes that this review (and the parallel investigation by Ofgem) does not lead to proposals for fundamental change. The industry is poised to make very large investments in new power stations and it could be very damaging if potential investors were to be confronted with new political and regulatory risk.

RESPONSE TO SPECIFIC ISSUES RAISED BY THE COMMITTEE

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

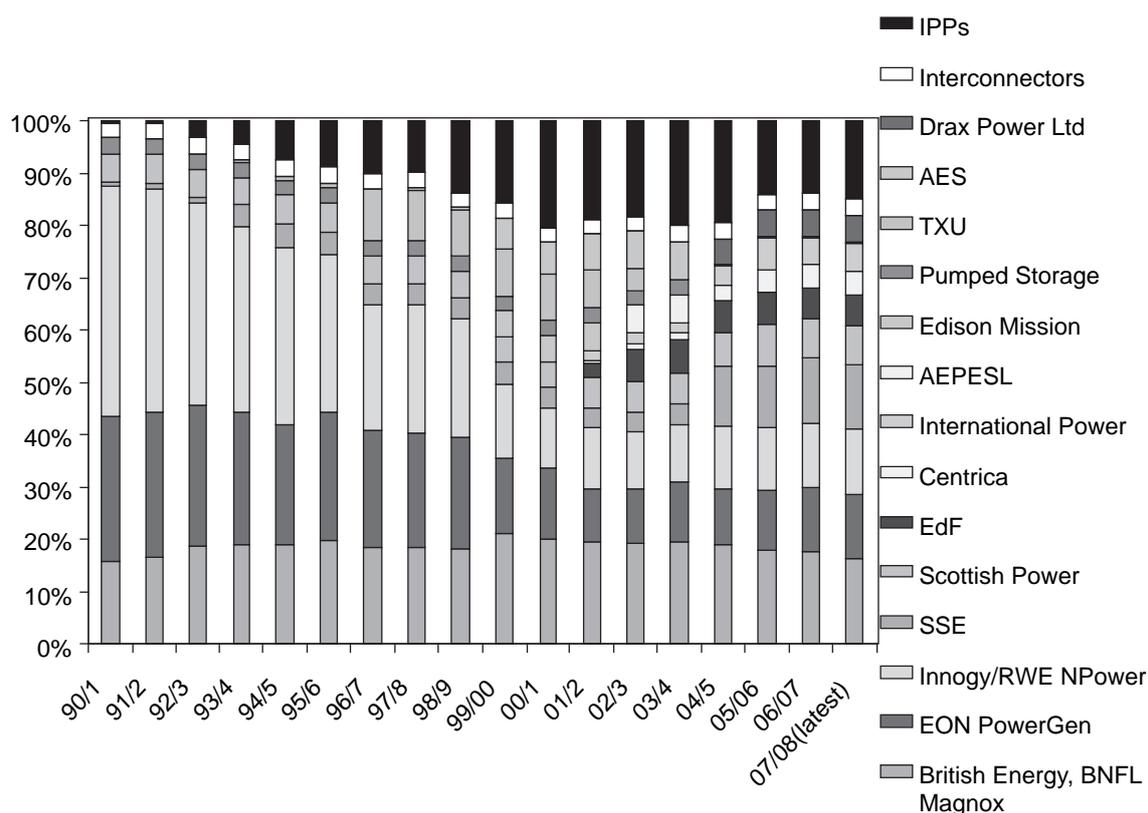
7. The Association does not feel competent to comment on the retail market.

Whether there is effective competition in the wholesale markets for gas and electricity

8. Competition in the wholesale electricity market is highly effective. There are no barriers to entry other than cost. Risk, however, is real and in recent years, when wholesale prices fell dramatically, companies went out of business in the generating sector. Despite this, it is still possible to build a business in this market and there are examples of that within the membership of the Association.

9. The chart below shows the percentage share of generation capacity owned by specific companies or types of company in Great Britain. It clearly illustrates the general growth in diversity (and hence competition) in the wholesale electricity market since the original market liberalisation and the large number of significant and distinct entities currently in active competition with each other.

² It was formed as Association of Independent Electricity Producers in 1987 and changed its name to Association of Electricity Producers in 1995, by which time there was very little state ownership from which to be “independent”.



Source: MMC Pacificorp and the Energy Group plc, Pool Statistical Digests, NG Seven-Year Statement & Pury Energy Consulting estimates. All years are calendar years ending December, capacity shown as at 1 January at start of calendar year.

10. The government has itself commented on the effectiveness of competition in the UK market. The 2007 Energy White Paper remarked that “To date, the UK has benefited from one of the most competitive and reliable electricity markets in Europe with “cost-reflective” prices” (para 5.1.5, p126).³ In addition to BERR and Ofgem, a range of other bodies have described the UK wholesale electricity market as competitive:

- Oxera’s Energy market competition in the EU and G7: preliminary 2006 rankings (October 2007, prepared for BERR) places the UK first with a score of 8.3 for the electricity market with the UK electricity wholesale market ranking among the leading markets.⁴
- The European Commission in its decision exempting electricity generators in Great Britain from the Utilities Procurement Directive (2004/17/EC) with effect from 8 March 2006, following advice from Ofgem, determined that generation “is directly exposed to competition on markets to which access is not restricted”.⁵
- DG Energy and Transport’s report on the implementation of the internal market in each Member State (SEC(2006) 1709), issued as part of the 10 January 2007 Energy Package, comments that in Great Britain “for electricity, there would appear to be a sufficient range of companies to suggest that the market is both competitive as well as being open to new entrants”.⁶
- DG Competition’s Energy Sector Inquiry Final Report (SEC(2006) 1724, 10 January 2007) presents a range of indicators pointing to the competitiveness of the UK market. For example, it comments that “It can be seen from Table 32 that the markets in which most information is published (eg Nord Pool and the UK) are generally perceived as more competitive than those where little information is published” (para 575, p 190), although the UK has the top score of 38 out of 49 issues on which information is published compared to the highest Nord Pool member Denmark with a score of 31.⁷
- As the International Energy Agency’s Energy Policies of IEA Countries. The United Kingdom 2006 Review states (p 117): “Overall the UK electricity market appears to be competitive and there are numerous market players ready to respond by investing in new generating capacity according to the needs of the market”.⁸

³ See <http://www.berr.gov.uk/files/file39569.pdf>

⁴ See <http://www.berr.gov.uk/files/file44272.pdf>

⁵ See http://europa.eu.int/eur-lex/lex/LexUriServ/site/en/oj/2006/l_076/l_07620060315en00060008.pdf

⁶ See http://ec.europa.eu/energy/energy—policy/doc/10_internal_market_country_reviews_en.pdf

⁷ See http://ec.europa.eu/comm/competition/sectors/energy/inquiry/full_report_part2.pdf

⁸ See <http://www.iea.org/textbase/nppdf/free/2006/unitedkingdom2006.pdf>

11. Prices, of course, have fallen and risen. Price increases have been in response to rising fuel costs (gas prices increased by 83% and coal prices by 97% between February 2007 and February 2008) and environmental legislation has played a part, too. It would not be surprising if prices rose further in response to fuel costs, investment costs in power stations and network charges and generating businesses' response to ever-tightening environmental legislation.

The implications of growing consolidation in the energy market

12. The market remains open and competitive and to date, the Office of Fair Trading has been content to clear mergers between companies. Consolidation can reduce the risks for the players affected and it can result in cost savings.

The relationship between the wholesale and retail markets for electricity and gas

13. The Association is not directly concerned in the retail market, but it would expect to see retail prices driven up by wholesale market price increases given the proportion of wholesale costs in retail prices (see Ofgem factsheet 66,⁹ 15 January 2008), albeit tempered by the competition in both sectors. As noted in Paragraph 11 above, wholesale electricity price increases have, to a large extent, been determined by fuel price increases and the costs of environmental legislation.

The interaction between the UK and European energy markets

14. The Association continues to support the opening of European energy markets as something that will help to sustain the competitiveness and security of the UK industry and is engaged in the discussions that arise from that—regulation, cross-border trading, environmental issues, etc. However, the UK cannot expect the benefits of increased linkage to the single European market (for example, in terms of security of supply) without also being affected by the prices which prevail upon that market. In fact, the interaction today goes farther than the relationship between the UK markets and the wider European energy markets. Many fuel prices are set globally.

The effectiveness of regulatory oversight of the energy market

15. The Association is not always in agreement with the decisions and positions taken by the industry regulator as Ofgem has a tendency to micro manage issues. That said, Ofgem is generally supportive of market-orientated solutions to problems, which tends to make regulation more predictable and which stance aligns with the policy of the Association. We should be concerned if there were to be radical changes to the regulator's remit. Ofgem's remit, of course, is already much wider than the oversight of the competitive wholesale market. It regulates the monopoly networks for example and its decisions in that area have an effect on the competitive market—in operating costs generally and in opportunities for investment.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

16. The Association is aware of the government's concern about this issue and of the engagement of some member companies with energy retail interests in the debate about what to do about it. It does not have a view on this matter except that the issue appears to be primarily a matter of social policy, rather than energy policy.

7 April 2008

Memorandum submitted by Alan Barton

THE PRICE OF OIL

As long ago as 1997 worrying trends in oil pricing began to show themselves. Since the start of the oil business in the late 19th century the natural law of supply and demand had determined the value of this extraordinary hydrocarbon at any moment in time and this appeared not to be the case any longer.

With the advent of new technologies in the early 80s it became possible to establish oil futures exchanges and transmit electronically live prices for months ahead from the exchange to screens in offices worldwide. The earliest and most significant of these was the Mercantile Exchange in New York, closely followed by what became its satellite, the International Petroleum Exchange in London.

⁹ <http://www.ofgem.gov.uk/Media/FactSheets/Documents1/energy%20prices%20jan08.pdf>

The effect on the oil business itself was dramatic in that the price on the screen more or less set the price in the physical market but with it came another more destabilising development. Computer programmes had been written to use past market data to define market trends and to use this “sign language” to develop trading strategies. The finance houses concerned saw this technology as being applied to the new commodity—oil. This meant that the oil price could be set without any reference to the situation in the physical oil business itself.

These trading strategies became known as Technical Analysis and the conditions existing in the real world as the Fundamentals. So diverse were the two that the editor of the house magazine of the IPE, the Pipeline, decided that it would be appropriate to publish a piece on Technical Analysis versus Fundamentals. I wrote the section on Fundamentals but at my request it did not bear my name because of the possible conflict of interest with my employers.

My item, copy of which is attached, set out a brief history of oil pricing with particular reference to OPEC, of course, and the perils of Technical Analysis. My final paragraph prophetically expressed concerns about the effects these changes would have and my view that the possible result could be “unjustifiable price increases for consumers”. This, of course, is exactly what happened.

Over the last few years there has not been any problem with the availability of oil and this cannot be why we have seen such an exorbitant increase. Prices of around 100 dollars per barrel are symptomatic of a crisis in supply that has simply not existed. The main reason for this unnatural paradox has been that large international financial institutions came to see in the oil futures markets the possibility of big profits by trading in this new and largest “commodity” in the world. There was no need to have any knowledge whatsoever of a barrel of oil itself, the main game being to profit from price movements, up or down, the objective being to buy and sell, or the other way round, in order to gain from the difference. The absolute price was not really relevant. Furthermore, additional change (“volatility” is the technical description) could be generated by building into the price the possible effect of events which may or may not take place in the future such as military actions, strikes, adverse weather, etc. Hence the going price, ultimately paid by the consumer, includes a differential for the possible effect on supplies which have not taken place and might never occur. On top of this there has been an explosion in the growth of derivatives for all types of oil deals that are freely available in the unregulated OTC (over the counter) market.

A house of cards has been created.

Meanwhile, today OPEC sits on the fence. When asked about the huge increase in price they say it is due to “speculators”. In fact they are telling the truth in that the OPEC power on pricing has been overtaken by the forces of the futures market. Most members are happy to receive the greatly enhanced income although the largest ones, especially Saudi Arabia, are probably concerned about the long term effect of the resulting damper on demand, the boost it provides to renewable alternatives and the way it scrambles the economics on long-term investments. It is possible that the bigger OPEC countries would be willing to accept a price around 30 dollars.

The wave spreads to other forms of energy especially natural gas where prices are linked to oil by formulae contained in the contracts. The oil and gas companies reap staggering profits and when questioned simply point to the “market”. For most of the oil companies this is hiding behind a falsehood. They know that the “market” is not the real market at all and that the price is set by a few financial “traders” pushing buttons in New York but they are happy to quietly make their billions without any blame. Some of them assist in the process using futures in a big way for hedging, thereby providing liquidity, the lifeblood of the futures market. One huge oil company does not use futures at all preferring to ride the waves while another speculates in it and has received many fines for price fixing. For the gas companies these immense profits are truly windfalls. While not part of the primary reason for the price inflation they are well aware of it and how they benefit by association with a pricing system they know to be unreal. In a letter published in the *Daily Telegraph* a year or so ago the author who I happen to know is a highly experienced gas man, pointed out that the true landed cost of gas in the UK was between 10 to 20p per therm versus a wholesale price at the time of 67p.

The political effect is even more disturbing. The massive flow of petrodollars has revitalised Russia and given countries, many unfriendly to the west, increased financial muscle to use as they see fit. One of the reasons the US attacked Iraq was not about oil itself (Iraq never interfered with the flow of oil to the US and other western markets) but the money it generated for Saddam. The imposition of sanctions did not stop this and huge sums continued to be transferred illegally back to Iraq by oil traders, mostly American, some of whom were unmasked after the invasion and prosecuted with at least one jail sentence passed.

Iran, a long standing price hawk in OPEC, which is currently at odds with the west over nuclear matters, and the backing of terrorists has been gifted for years huge increases in oil revenues.

It is so ironic that the country where the damage is the greatest, the USA, has its source at home on its doorstep—the “Merc” in New York.

Action can and must be taken to change the situation if only for the sake of national and global economies. Furthermore, unless steps are taken an escalation of conflict in one form or another appears inevitable.

March 2008

Letter by BizzEnergy

INTRODUCTION

Set up in 2000, BizzEnergy is the largest independent energy supplier in the UK. The company is aiming to make a complex market sector simple by challenging the industry norm and developing innovative, flexible and efficient ways to serve customers across the UK.

The company's aim is to deliver the highest quality service to small and large customers, and to lead market innovation. Examples of this innovation include BizzEnergy aiming to become the first electricity supplier to allow its customers to fully serve and control their accounts online, and BizzEnergy being the market leader in implementing Smart Meters as part of our supply contract.

BizzEnergy welcomes the opportunity to submit a briefing paper on energy prices to the Business Enterprise and Regulatory Reform Select Committee prior to the evidence session with Malcolm Wicks, Minister of State for energy, and looks forward to further engaging with the Committee on this important issue in the future.

ENERGY MARKET OVERVIEW

As the Committee will be well aware, the UK energy market is dominated by British Gas, Npower, E.ON, Scottish and Southern, Scottish Power and EDF, with few opportunities for new market entrants. The "Big 6" share about 99% of the energy market and current low levels of fragmentation in the energy marketplace give these large utilities great power to dominate market developments and to prevent new entrants from gaining a foothold. Independent energy suppliers in the UK have approximately only 1% of the UK's energy market share. BizzEnergy believes that this figure must grow in order for the UK's energy market to develop and customers to benefit.

The current lack of competition and regulation has not escaped the observation of industry watchdogs. In September 2006, for example, energywatch demanded a full inquiry into energy market competition stating:

"Major problems with electricity generation and upstream gas supply mean the UK energy market is anything but competitive . . . There needs to be increased competition in Gas and Electricity markets. A licence obligation, backed by effective regulatory monitoring and enforcement could achieve this".

While industry watchdogs have clearly outlined the situation, there has thus far been little action to either address the lack of competition in the marketplace or increase Ofgem's regulatory powers.

ENERGY PRICES

BizzEnergy is very concerned about the level of price rises in the wholesale market, especially at a time when it appears that there is a significant element of 'super profit' being made by the generators as a result of Carbon Allocations.

BizzEnergy, at present, only supplies SME customers under term contracts. The prices included in these contracts are set against the wholesale market prices at the time of the contract being agreed. This is the case because BizzEnergy sources its energy wholesale from the market. Therefore, the recent price rises in the UK are embedded within BizzEnergy's contracts.

One of the biggest concerns facing companies like BizzEnergy is that with the "Big 6" having their own power stations, with direct access to energy sources (electricity or gas), this leads to market inconsistencies and aids the anti-competitive structure of the market. By restricting access to these supplies, the wholesale prices of energy on the market can be massively affected. The liquidity of the wholesale market is currently very poor and sporadic due, in part, to this level of vertical integration. As a matter of practice, vertically integrated suppliers are likely to contract with their own generation before trading in the market, thus removing vital liquidity from the energy market. This has a direct impact on independent energy suppliers such as BizzEnergy and its potential new customers.

The Government's recent announcement in support of an increase in the use of nuclear power is an important development ensuring greater diversity of supply. However, unless the problems in the wholesale market caused by the dominance of vertically integrated energy companies, are addressed, then the opportunity to diversify may be lost as new entrants will be reluctant to come into a market which does not have a fully-functioning wholesale market for their product. This in turn may delay the development of new-build nuclear facilities as the incumbents will be under no competitive pressure to bring on stream new nuclear supply in a timely fashion.

The global demand for nuclear power means that new companies are emerging to meet this demand. It is important that the UK market is not foreclosed to these companies because of market entrance difficulties and inherent anti-competitive market structures. New energy generators will have to use existing suppliers to get product to market. However, large suppliers will probably rather build their own generation facility, but in their own time.

In the current energy market, a consequence of the current distortion of wholesale pricing is the absence of a reliable price benchmark. Without this, and with the nature of financial reporting of energy companies, it is difficult to determine what profits are being made and by whom. If this lack of transparency continues, how can the public—or indeed regulators—have confidence that UK energy customers are getting a fair deal?

Liberalisation of the retail markets was intended to address the issues arising from vertical integration by increasing competition in the generation and the supply of energy. However, the combination of liberalisation and changing the trading arrangements has, in fact, favoured the development of large, vertically integrated suppliers. As a result, barriers to market entry either stop entry altogether or require a new entrant to ally itself with one of the existing players.

While there is some choice, it must be stated that most offerings are “similar shades of grey, not vibrantly different”. Some observers state that electricity markets are working well because 1 in 5 customers (mainly domestic) switch suppliers in the UK. However, just because customers switch does not indicate that there is the right level of healthy competition. While there may be some retail competition, there is not sufficient wholesale competition. Additionally, although the UK gas and electricity markets still measure highly for competitiveness against other EU Member States, as prices have increased dramatically the significant financial advantages for consumers of switching suppliers are steadily being eroded.

BizzEnergy calls for:

- Clear and effective regulation from Government that will limit the negative impact of vertical integration in the UK energy market. In the current environment where no one seems willing to challenge the prevailing wisdom that markets are better than regulation, one of the unintended consequences of liberalisation is that the market is taking the easy option and passing the higher costs on to consumers.
- New rules on market transparency. The problem of concentration is undeniably made worse when dominant companies are not required to reveal basic supply information to smaller market players.
- Licencing separation. This would increase market transparency and increase market confidence.

CONCLUSION

Clearly, competition benefits not only suppliers but also consumers. Increased competition and an end to the privileged position held by certain suppliers would offer higher quality and more varied services to energy users at lower prices. This would lead to a well functioning competitive market, which would ensure sufficient investments in power plants and transmission networks thereby helping to avoid interruptions in power supplies and protecting security of supply. An increased degree of transparency would, additionally, minimise distortions in the market, and thus, the market would be more robust, and ultimately, the customer would be better served.

BizzEnergy thanks the Chair of the Committee for the opportunity to provide this briefing paper to the Business Enterprise and Regulatory Reform Select Committee, and would welcome any further enquiries from members on the issues raised.

23 January 2008

Memorandum submitted by BizzEnergy

POSSIBLE ANTI-COMPETITIVE BEHAVIOUR IN THE UK'S ENERGY MARKET

BIZZENERGY

1. Set up in 2000, BizzEnergy is the largest independent energy supplier in the UK. The company is aiming to make a complex market sector simple by challenging the industry norm and developing innovative, flexible and efficient ways to serve customers across the UK.

2. The company's aim is to deliver the highest quality service to small and large customers, and to lead market innovation. Examples of this innovation include BizzEnergy aiming to become the first electricity supplier to allow its customers to fully serve and control their accounts online, and BizzEnergy being the market leader in implementing Smart Meters as part of our supply contract.

3. BizzEnergy welcomes the opportunity to submit written evidence to the Business and Enterprise Select Committee Inquiry into Possible Anti-Competitive Behaviour in the UK's Energy Market, and looks forward to further engaging with the Committee on this Inquiry as it progresses. BizzEnergy is available to provide supplementary written evidence to the Committee, and would welcome the opportunity to provide oral evidence in due course.

INTRODUCTION

4. As the Committee will be well aware, the UK energy market is dominated by British Gas, Npower, E.ON, Scottish and Southern, Scottish Power and EDF, with few opportunities for new market entrants. The "Big 6" share about 99% of the Domestic and smaller end of the SME energy market and current low levels of fragmentation in the energy marketplace give these large utilities great power to dominate market developments and to prevent new entrants from gaining a foothold. Independent suppliers of energy in the UK have approximately only 1% of the UK's energy market share. BizzEnergy believes that this is an unnaturally low share and that figure must grow in order for the UK's energy market to develop and achieve meaningful diversity and for customers to benefit.

5. The current lack of competition and regulation has not escaped the observation of industry watchdogs. In September 2006, for example, energywatch demanded a full inquiry into energy market competition stating:

"Major problems with electricity generation and upstream gas supply mean the UK energy market is anything but competitive . . . There needs to be increased competition in Gas and Electricity markets. A licence obligation, backed by effective regulatory monitoring and enforcement could achieve this".

6. While industry watchdogs have clearly outlined the situation, there has thus far been little action to either address the lack of competition in the marketplace or increase Ofgem's regulatory powers.

7. The UK energy market was originally designed around the separation of generation and supply; with the primary premise that parties could enter the market as either generators or suppliers and not necessarily both. Current trading arrangements have, however, given rise to vertical integration, which those who are vertically integrated argue makes for efficient and effective risk management and lower costs to the customer. However, the cost of this is the loss of liquidity, transparency and competition in the market—major conditions required in order to ensure a robust, liberalised and efficient market.

8. In addition to this, while profits within some sections of the energy industry appear to be excessive, it is very difficult to judge whether this is the case. Company accounts normally provide a strong, reassuring and robust commentary to all stakeholders but this is not possible in the UK due to the international nature of two thirds of the "Big 6".

9. This paper provides details of BizzEnergy's position and its response to the terms of reference for the Business and Enterprise Select Committee Inquiry into the UK energy market.

ANSWERS TO INQUIRY QUESTIONS

1. *Whether the current market structure encourages effective competition in the retail markets for gas and electricity*

10. Whilst BizzEnergy believes that the basic UK energy market design is sound, the natural outcome of the drivers from such a design is consolidation and vertical integration. As a result of this, the market then looks to find an equilibrium and, as such, the existence of five or six players each with approximately 20% market share all similarly structured, tends to reduce the stimulus for competition.

11. These large players therefore, by necessity, adopt a systems-based approach to customer service and products—fitting customers to standardised products rather than bespoke solutions. Smaller suppliers are more commercially flexible and should be able to service customers’ requirements more precisely. This offsets the benefits of scale and sustains the competitive market.

12. A further tendency for markets in this position is to:

- Increase barriers to entry.
- Develop sophisticated customer retention strategies restricting the ability of customers to switch.
- Introduce increasingly complex trading arrangements.

13. An effective market design needs to have transparent costs and prices in order to stimulate and encourage both competition and new entry. Unfortunately, the current design does not have the required level of transparency and therefore does not stimulate effective competition for either generation or supply from a new entry perspective.

14. Two thirds of the market players have integrated European financial accounts and it is therefore impossible to identify what profits are being made from the UK. Further, these accounts do not reliably or effectively separate generation or supply profits, so even if UK accounts were to be published a new entrant would need to enter both sides of the market to access any available margin with confidence.

15. The current market design was supposed to facilitate entry into generation or supply separately and not require parties to enter both. Bizz is, therefore, concerned that the current structure does not encourage effective competition as per the original market design.

16. An obligation to report segmented gas and electricity supply business accounts will further remove the ability of larger players to cross-subsidise their activities.

17. We are also mindful that security of supply is a big issue and that alternative market arrangements as laid out in Appendix 3 may be worth some consideration.

2. *Whether there is effective competition in the wholesale markets for gas and electricity*

18. Vertical integration, as it exists in the UK, reduces the need for the vertically integrated players to use the wholesale market. Each company has sufficient generation to supply their domestic and SME customer base. Larger I&C customers are generally supplied on market related shorter term, index type transactions.

19. Companies, therefore, naturally tend to hedge their sales from their own generation first and then to the extent that there is a need to trade in the market. Thus, liquidity in the wholesale market is focused on the first season. Liquidity beyond this point is poor and declining (See Appendix 2).

20. To give a specific example of this, BizzEnergy seeks to benefit customers by offering them a choice of contract length of up to four years. We are risk averse and wish to hedge out any liability incurred in the wholesale markets. The best products for us to use are a combination of baseload power (24 hours a day) and peak power (7.00 am to 7.00 pm weekdays). These products do not, however, trade reliably in the market. Peak power does not trade out beyond the first year, and contracts for two and three year baseload rarely trade. Bids and offers are always available in the market, but the spreads are usually large and the prices on offer usually significantly more than the retail margin, and the prices at which trades can be transacted frequently bear little or no relation to the offers that are being made to customers by the vertically integrated players.

21. The issue for new entrant generation is that in the absence of a reliable, deep and liquid market they will be forced to sell their output to one of the vertically integrated players on a long term contract, thus further depriving the market of any new liquidity.

22. A further issue with the current wholesale arrangements is “cashout”. This is the mechanism by which any imbalance in a player’s contractual position is settled. The mechanism for “cashout” is extremely complex, and is recognised as such by the regulator. The prices are supposed to represent the energy costs of settling the imbalances, but these are widely acknowledged to be polluted with other costs such as system operation costs. The impact of this pollution is increased costs on smaller parties and non-vertically integrated parties which has the effect of distorting competition. OFGEM is carrying out a review of this, but has been doing so on and off for some years, and the industry awaits its findings.

3. *The implications of growing consolidation in the energy market*

23. BizzEnergy is frequently concerned by vertically integrated players making offers to customers below the (apparent) wholesale market level, making it exceedingly difficult to compete. Proving the existence of predatory pricing is difficult and complex. However, we did note a statement from EON in the FT in March, “the company had lost money on its retail business last year and expected to do so again this year”. This was an effective admission of cross subsidy and underlines the difficulties faced by smaller players trying to enter the market who cannot subsidise their accounts in this fashion.

24. The main issue—from BizzEnergy’s perspective—is the lack of transparency of energy suppliers’ accounts and the loss of a common reference price against which to judge and measure the performance of the generation and supply arms of the vertically integrated businesses. This inhibits the opportunities to enter the market for new entrants, which we believe should be a concern to regulators, the Government and most importantly public confidence.

4. *The relationship between the wholesale and retail markets for electricity and gas*

25. Whilst BizzEnergy cannot comment in detail as we are not active in the gas market, there can be seen a lag between price movement in the wholesale market and published tariffs (see Appendix 5).

5. *The interaction between the UK and European energy markets*

26. BizzEnergy has found the barriers to entry in most European countries insurmountable. However, the recent passing of an anti cross-subsidy law in Holland makes the Netherlands market attractive and we are actively considering setting up in that country in the next year.

6. *The effectiveness of regulatory oversight of the energy market*

27. As a natural outcome, when a market matures into a position of considerable integration and consolidation, we would expect to see the need for increased regulatory scrutiny and advocacy of consumer positions. The current trend, however, appears to be the reverse, with light touch regulation and the abolition of the consumer advocate energywatch being prime examples.

28. BizzEnergy believes that OFGEM is a generally effective body, but that it has areas where its activities are restricted. For example, it appears to take a literal interpretation of the highly complex industry rules rather than a general and purposeful interpretation. Thus, parties may be carrying out operations that have the effect of inhibiting competition, but are still compliant with poorly drafted industry rules.

29. In order to change, OFGEM must compete with companies who, due to the nature of their size, have considerable resources. The presence of the Competition Commission and the appeals process creates an additional hurdle for OFGEM to clear if any substantive changes are to be made against the views and interests of the incumbents. This, by its nature, slows down the speed and effectiveness of the Regulator.

30. To date, OFGEM has used relatively simple measures of competition to assess the effectiveness of the market, for example numbers of customers switching. We believe that this is too simple for a mature market and that other more effective measures should be developed. It rarely issues any information on competition in the business markets, and it seems to make information available on domestic markets no more frequently than once a year, which is inadequate.

7. *Progress in reducing fuel poverty and the appropriate policy instruments for doing so*

31. BizzEnergy is not an active supplier of domestic customers, although we are looking to enter the market later this year. Fuel poverty is a serious concern and we do not believe that the current definition adequately captures the extent of the issue in the UK.

32. For example, in its annual report published in March 2008, the Fuel Poverty Advisory Group said more than 2.3 million of the most vulnerable households in England alone are now forced to spend at least 10% of their income to heat and light their homes.

33. We, therefore, believe that some urgent work is required to identify those who need assistance and fall within the real fuel poverty bracket. Fuel poverty, in our view, is not just related to pre-payment meters nor to the level of disposable income spent on fuel.

34. Energy prices will be minimized, and therefore fuel poverty reduced, in the longer term by ensuring competitive energy supply markets prevail. Specific market segments may require innovative products and service arrangements, and these are most likely to emerge when there are no barriers to market entry or prohibitive requirements upon continued market operation. Ultimately fuel poverty is a social issue that requires a political solution; it should not be tackled primarily through legitimising more cross-subsidy in a market that already manifests insufficient transparency.

CONCLUSION

35. Vertically integrated parties (with more than 10% market share in supply) should be obliged to transact through an open market any volumes that they transfer between their generation and supply businesses. They should be obliged, by licence, to separate their generation and supply business accounts and operate them in a sensible manner, as if they were a standalone business [Market in Financial Instrument Directive].

36. In addition, they should be obliged to separate UK licensed activity accounts and make them independently available as if they were a standalone business. Segmenting accounts between supply and generation may not be sufficient for the introduction of due visibility within the “Big 6”. It may be necessary to go further and separately account supply activities between:

- Gas and Electricity.
- I&C and smaller customer markets.
- For smaller customers, those activities where they have been historically dominant and otherwise.

37. This approach allows vertical integration and economies of scale, but establishes an openness and viability of the underlying nature of transactions. OFGEM has indicated that they believe I&C and gas markets are national whilst the supply of electricity to smaller customers is still a regional market and so this approach will reinforce their market overview.

38. BizzEnergy calls for:

- Clear and effective regulation from Government that will limit the negative impact of vertical integration in the UK energy market. In the current environment where no one seems willing to challenge the prevailing wisdom that markets are better than regulation, one of the unintended consequences of liberalisation is that the market is taking the easy option and passing the higher costs on to consumers.
- New rules on market transparency. The problem of concentration is undeniably made worse when dominant companies are not required to reveal basic supply information to smaller market players.
- Licensing separation. This would increase market transparency and increase market confidence.

39. Competition does benefit consumers. However increased competition and an end to the privileged position held by certain suppliers would offer higher quality and more varied services to energy users at lower prices. This would lead to a better functioning competitive market, which would ensure sufficient investments in power plants and transmission networks thereby helping to avoid interruptions in power supplies and protecting security of supply. An increased degree of transparency would, additionally, minimise distortions in the market, and thus, the market would be more robust, and ultimately, the customer would be better served.

40. BizzEnergy thanks the Chair of the Committee for the opportunity to provide this written evidence to the Business and Enterprise Select Committee, and would welcome any further enquiries from members on the issues raised. Additionally, Bizz would happily provide oral evidence to the Committee as part of the ongoing Inquiry.

APPENDIX 1

STATEMENT PREPARED BY DEEPAK LAL OF ECLIPSE ENERGY FOR BIZZENERGY

The below is an excerpt from a BizzEnergy-commissioned article by Eclipse Energy.

What is wrong with the power market?

The market is dominated by six big players. Such market concentration is anti-competitive and it is deterring new entry into the market. It is also making the market opaque to the detriment of independent players and customers. We need to borrow ideas from other markets to address the short-comings of the power market.

Conventional wisdom?

The changes that we would like to see in the power market are based on conventional wisdom. Some of this wisdom has appeared in the principles underpinning the Market in Financial Instrument Directive 2004/39/EC (MIFID) regulations. The objective of MIFID was to create an open competitive market in the financial services industry to safeguard the interests of stakeholders and consumers. The impact of MIFID is to enhance the:

- competitive landscape;
- transparency of the market;
- market liquidity; and
- protection of customers.

Whilst the details of MIFID are specific to the financial services market, the objectives are common to many markets. Indeed, the wholesalers in the energy market are not dissimilar to the brokers in the financial services market in terms of meeting the needs of their customers through the traded market. Many power market commentators will be making similar points because the underlying objectives are broadly the same.

What needs to change in the power market?

The competitive landscape is such that the power market is dominated by six vertically integrated players. The Hirschmann-Herfindal Index (HHI) is a commonly used index that provides a measure by which it is possible to judge whether there is effective competition in a market. The HHI for retailing power in the UK shows that the market is far too concentrated. An Ofgem report on the domestic retail market put the HHI at about 1765 in March 2007¹⁰ and this level of concentration is undermining competition. New entrants find it hard to challenge the dominance of the incumbents. Further market consolidation (such as the takeover of Scottish Power by EDF) is not in the interests of the end-consumer. The question is whether specific action should be taken to reduce market shares of the big six.

The concentration of market shares in retail is inevitably going to have an impact upstream in both trading and generation activities. This is evident by the poor level of liquidity in the wholesale market.

The big six players are ensuring that the market is opaque by doing bilateral deals. Such deals are not visible to the rest of the market. The most insidious deals are those done between the different divisions of the same company, particularly between the generation and retail divisions. The lack of transparency here means that independent players, particularly in the retail market, are at a serious disadvantage because they do not know whether they can procure energy on the same terms as the retail divisions of the big six. The current arrangements also allow the existing players to arbitrarily move profit margins between the two divisions to the disadvantage of competitors.¹¹ Enhanced reporting through a separation between the accounts of the retail and generation divisions and an obligation to treat all trading counter parties equally is likely to make a significant difference to the creation of a fair competitive environment.

MIFID has shown the way by expecting better reporting on deals to safeguard the market and the interests of the stakeholders in the market. Further, a “best execution” obligation under MIFID has put an onus on the service provider to demonstrate that the service provider is getting the best prices for its clients which implicitly requires audit trails to demonstrate compliance with the obligation. In addition, under MIFID, a Systematic Internaliser is a firm that may execute orders from its clients against its own book. Such players are required to meet the requirements for trading transparency.

The bilateral deals between the big six players and also between the various divisions of the big six players are having a major impact on the lack of trading liquidity. The lack of liquidity and transparency is deterring new entrants into the market which is compounding the impact of market concentration. Vertical integration in-itself may not be a bad attribute of the market. Indeed, vertical integration might be encouraged, but only if it is coupled with transparency and liquidity. The alternative is the break-up of vertical integration companies as a means to force transparency and liquidity into the market.

Enhancements to the competitive environment in the power market would have a major impact on customer protection. We believe that the interests of the customers are best served by transparent and fair competition between suppliers backed up by the supply licence conditions to ensure that suppliers meet their reasonable social obligations.

It has been a long-standing goal that there should be light-touch regulation in the power market and that the accepted view was that regulation was a poor substitute for robust competition. Light-touch regulation can only follow when there is confidence that the competitive market is working. The lack of transparency undermines the confidence in the workings of the market amongst the customers, the industry players, the regulator and the government.

¹⁰ The HHI has been consistently above this level since 2002.

¹¹ Some commentators have challenged the profits made by industry players as excessive and detrimental to the end-consumer. We do not believe that making profits in a competitive market is acting against the interest of the consumer. What we are concerned about is making profits in a non-transparent way.

APPENDIX 2 STATISTICS

The following tables use market data to provide evidence that current markets:

- do not bring forward the products required to service long-term supply contracts (see table 1);
- when appropriate wholesale products are available, they are only liquid close to delivery ie a very short-term perspective (see table 2); and
- do not provide sufficient depth of liquidity to facilitate a normal wholesale market environment (see table 3).

TOTAL NUMBER OF TRADES OCCURRING IN EACH YEAR FOR ANNUAL PRODUCTS

<i>Count</i>	2004	2005	2006	2007
Base 1 Yr	1,369	513	1,279	1,691
Base 2 Yr	199	26	321	325
Base 3 Yr	16	0	31	0
Peak 1 Yr	77	20	48	31
Peak 2 Yr	2	0	1	0
Peak 3 Yr	0	0	0	0
LS44 1 Yr	62	15	44	30
LS44 2 Yr	2	0	1	0
LS44 3 Yr	0	0	0	0

These figures shown that peak products for periods longer than a year simply do not exist, and that even baseload products of longer than a year are rare. The tools to back out a customer contract of longer than a year on the day it is signed therefore do not exist.

Necessary products do not exist

<i>MWh</i>	<i>Total Volume Traded</i>	<i>Total System Demand</i>	<i>%</i>
S04	158,163,408	142,816,565	111
S05	157,960,920	157,760,747	100
S06	88,452,624	157,207,037	56
S07	147,806,256	152,095,637	97
W04	275,739,360	177,108,878	156
W05	205,233,600	191,580,945	107
W06	138,756,072	183,080,678	76
W07	232,180,104	184,735,447	126

(Total traded volume calculated as a sum of all baseload and peak trades reported for a given season)

The number of times each individual unit required is traded has been decreasing steadily over the past few years, although has enjoyed a slight upswing on the recent couple of seasons. During the low point in 2006 it was not possible to trade sufficient volume to cover the demands of the national customer base. Even at the high point of trading in Winter 2004 the average unit of demand was only traded 1 and a half times which is much lower than the figure expected of a liquid market.

CUMULATIVE PROPORTION OF TOTAL TRADE COUNT OF SEASONAL BASELOAD TRADE AS

%	S06	M06	S07	M07
M-50				0%
M-49				0%
M-48				0%
M-47				0%
M-46				0%
M-45				0%
M-44			0%	0%
M-43			0%	0%
M-42			0%	0%
M-41			0%	0%
M-40			0%	0%
M-39			0%	0%
M-38		0%	1%	0%
M-37		0%	2%	0%
M-36		0%	2%	0%
M-35		0%	3%	0%
M-34		0%	3%	0%
M-33		0%	3%	0%
M-32	0%	2%	3%	1%
M-31	0%	3%	3%	1%
M-30	0%	3%	3%	1%
M-29	0%	3%	3%	1%
M-28	3%	3%	3%	1%
M-27	4%	4%	3%	1%
M-26	8%	5%	3%	1%
M-25	11%	5%	4%	1%
M-24	14%	6%	4%	2%
M-23	15%	6%	4%	2%
M-22	16%	7%	4%	3%
M-21	20%	8%	4%	4%
M-20	22%	9%	4%	5%
M-19	24%	11%	4%	6%
M-18	25%	14%	6%	8%
M-17	27%	18%	7%	10%
M-16	28%	22%	9%	12%
M-15	30%	22%	13%	14%
M-14	31%	22%	15%	17%
M-13	32%	22%	18%	20%
M-12	37%	30%	21%	23%
M-11	43%	35%	24%	26%
M-10	54%	39%	27%	29%
M-9	55%	46%	32%	38%
M-8	55%	52%	36%	49%
M-7	55%	60%	46%	61%
M-6	63%	66%	50%	66%
M-5	72%	73%	57%	72%
M-4	76%	80%	62%	76%
M-3	84%	90%	79%	86%
M-2	93%	95%	90%	94%
M-1	100%	100%	100%	100%

(Here M-x indicates the period x months before deliver)
See also Graph "Trade Proportions"

From this table it can be seen that 75-80% of trades in a seasonal product occur in the 12 months prior to delivery, with as much as 30% of the total trades that occur not taking place until the three month period prior to delivery. So even where a product does exist within the market the window where it is available is frequently short and not open for regular backing out of customer contracts.

Existing products are not available when the would be useful

APPENDIX 3

ALTERNATIVE MARKET FOR NEW PLANT

There is now an urgent requirement to commence construction of a new generation of low carbon power stations to replace the current coal and ageing nuclear stations retiring between 2015 and 2020. The only two realistic options available to provide sufficient electricity to meet the nations needs are nuclear or fossil fuel plant with carbon capture and storage. Both these solutions are highly capital intensive compared to CCGTs and developers are understandably looking for government assurance and guarantees on market prices before risking the capital investment required. Unfortunately such assurances tend to reinforce the current oligopoly and make competition from new entrants more difficult.

BizzEnergy is very anxious that no plant shortage develops as plant shortages will only contribute to higher retail prices. Our position is simple, we need a market based solution which kicks start the construction of new plant whilst maintaining liquidity in the whole sale markets and increasing opportunity for new entrants in both supply and generation.

Such criteria could be easily met by the introduction of capacity tickets to be auctioned by NGC for the first 5000MW of new low carbon plant. Tickets would be open to developers with sites capable of achieving planning permission and auctions held regularly in tranches up to the 5000MW limit. It might be fair to exclude companies from European countries where access to energy markets remains restricted.

Once commissioned, NGC would trade the output from the new stations via the exchanges. If the output receipts exceed the price of the capacity tickets the surplus would go toward reducing the BSUOS cost. If below the sum of ticket and marginal costs, BSUOS would be increased to cover the total cost. It is envisaged these capacity tickets would last between 8 to 12 years to provide developers with confidence to commence construction.

The requirement to trade all the output from the new stations (around 30TWh) would improve the liquidity in the wholesales market and give a clearer indication of future market prices to allow new low carbon plant to be constructed.

APPENDIX 4

FOR INFORMATION ONLY

THE HHI

Effective competitive markets are predicated on having sufficient competing actors. The risk of market dominance is a major issue in most competitive markets. A commonly used index for measuring market dominance is the Hirschmann-Herfindal Index (HHI). The market share (%) of each market participant is squared and summed to produce a score on the index.

- 100,000 is a monopoly.
- 1,800 and above is a highly concentrated market and in the USA, a merger leading to a score greater than 2000 would probably be challenged.
- A score of 500 to 1,000 is deemed a highly competitive industry.

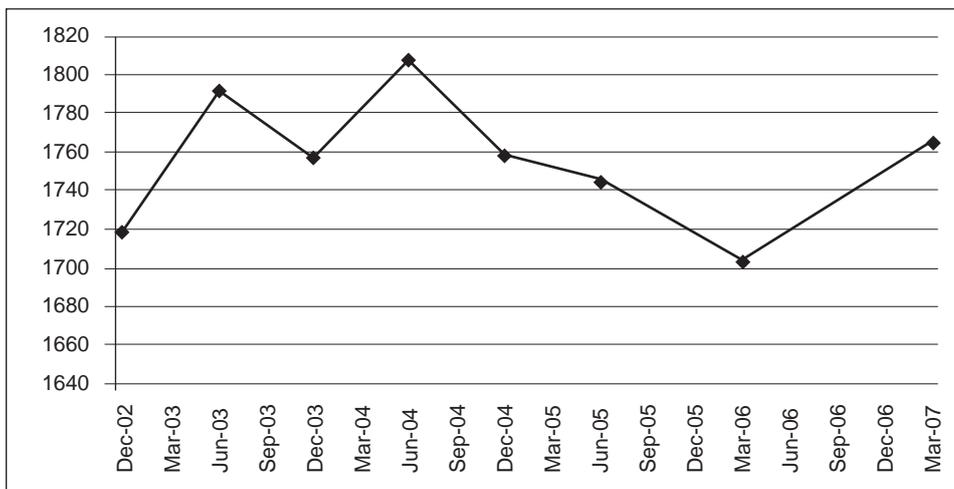
RETAIL POWER HHI

Ofgem carried out a review of the HHI for the non-domestic retail market in November 2005. The HHI score in the electricity market decreased from 1695 in November 2003 to 1575 by the end of 2004. The implication is that the market was not as competitive as the regulator may have wished.

Figure 1 charts the changing HHI scores for the domestic market. The data were taken from an Ofgem report on domestic retail competition in June 2007. The ultimate source of the data was the Distribution Network Operators.

Figure 1

HHI NATIONAL MARKET SHARES IN DOMESTIC ELECTRICITY MARKET



Source: Ofgem report

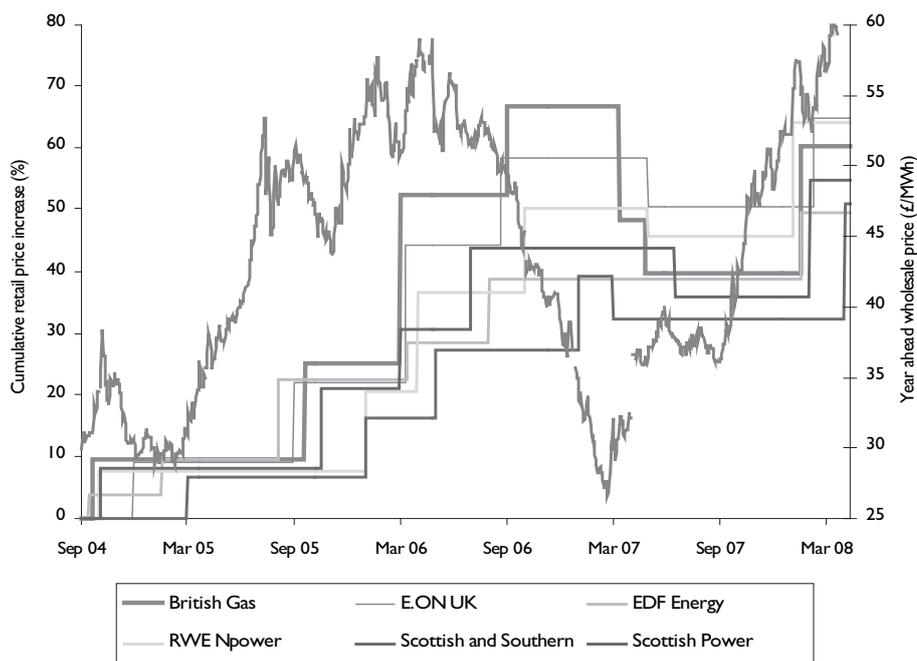
The process of market consolidation has led to an increase in the HHI score in electricity as the big players take over more businesses. The HHI is high and it has been reasonably stable in the 1,700 to 1,800 range for some time. A reduction in the value of the index is desirable and any increase would be a significant cause for concern. Over the period from December 2002, the market share of the independents outside of “Big Six” retailers has hovered between 0 and 1.5%. It shows that over a sustained period of time, the market is not conducive to new entry.

Based on the HHI scores, it seems that the retail market in electricity supply is too concentrated and new entry into the market might be desirable.

APPENDIX 5

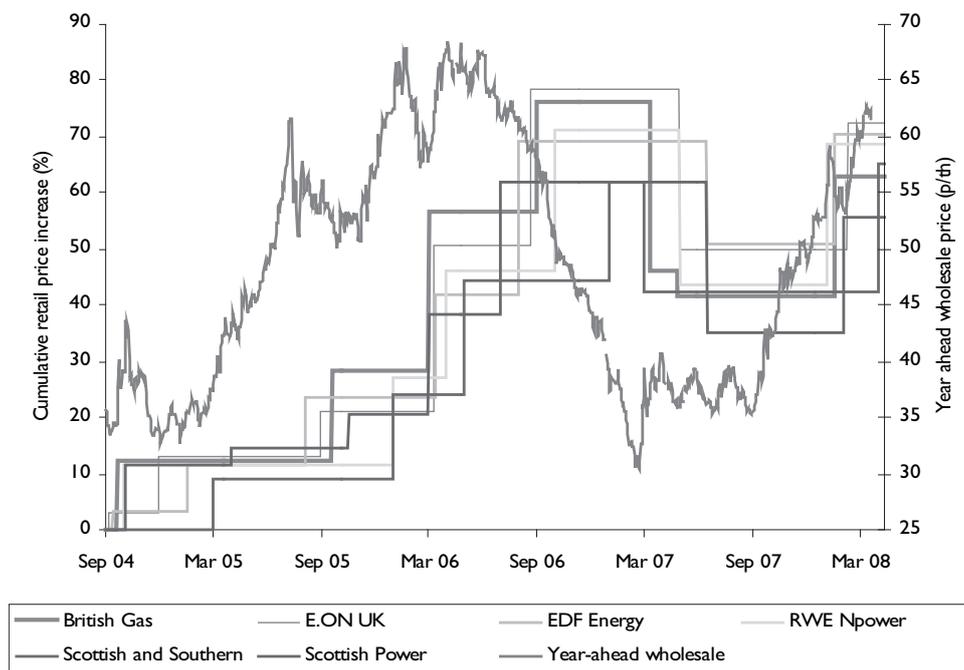
WHOLESALE VERSUS RETAIL PRICES

Trends in baseload (year ahead) wholesale gas prices and household price increases since September 2004 are demonstrated below:



Source: Cornwall Energy Associates

Trends in baseload (year ahead) wholesale electricity prices and household price increases since September 2004 are demonstrated below:



Memorandum submitted by BP

INTRODUCTION

1. Many of the issues covered by this Inquiry—such as those appertaining to the retail gas and power markets—are beyond the scope of BP’s activities. Accordingly, we limit the majority of our comments to the wholesale market, and in particular the area of gas supply.

2. In addition, many of the comments made by BP in its memorandum of 9 December 2004 to the Trade and Industry Committee are still relevant and applicable in our view; and the Committee may wish to refer to this document in their deliberations. This memorandum updates and qualifies the points made previously where necessary.

UK GAS PRICES

3. The fact that gas and electricity prices have risen significantly in recent years has led to understandable concern, with many consumers claiming that they are both unjustifiably high as well as a reflection of a failure in the operation of the market. However, we would maintain that the UK wholesale gas market continues to operate efficiently, and that the price increases we have witnessed are consistent with the known internal and external influences.

4. Such influences can be grouped under two key themes, namely:

- the decline in UKCS production and concerns over security of supply which are both key drivers for UK gas price movements; and
- the pace of European liberalization, and the continuation of oil price linkage in European gas prices with its impact on the UK market.

5. In the last five years, the share of UK gas which is imported has risen from 2% in 2003–04 to what is predicted to be around 39% in 2008–09 ie increasing by a factor of twenty. The proportion of imports will continue to rise at around 5% per annum as UKCS supplies decline (see Appendix). This increased reliance on imports creates both concern over security of supply and means that the UK must compete for supplies with European and other world markets where gas prices are linked to oil prices.

6. Other points discussed in our previous submission are still relevant. For example, and in brief,
- suppliers of gas to the residential market, driven by the need to obtain certainty of prices over time (in contrast to constant spot price fluctuations) have had an impact on the forward market;
 - when there is increased concern over security of supply in forward winter periods, the consequent change in forward purchasing behaviour will have a disproportionate effect upon future price movements;
 - in terms of “prompt” prices (ie where gas is delivered on or immediately after the specific day of an agreement), a strong correlation exists between supply and demand fundamentals and the prices agreed for the day or day ahead. This is supported by a deep and liquid market, and does not reflect either market manipulation or market failures; and
 - the lack of gas-to-gas competition in Continental Europe, linked to the indexation of gas contracts to the price of oil, has led to further volatility and has contributed to a general lack of confidence in the gas market’s ability to both register and react to reliable supply/demand signals.

7. We continue to maintain, therefore, that taken as a whole the UK market has been working effectively. And as we highlighted in 2004, additional comfort is provided by the very significant number of material investment projects planned or under construction. These include:

- Interconnector expansion, thus increasing the UK’s import capacity;
- Isle of Grain LNG import terminal;
- Milford Haven (Qatar Petroleum/ExxonMobil) LNG import terminal;
- Milford Haven (Petrol’s) LNG import terminal;
- Langede pipeline;
- Ormen Lange gas; and
- BBL pipeline—Netherlands to the UK.

8. The number and complexity of these projects is very difficult to reconcile with allegedly inaccurate market signals. What is even clearer than four years ago, however, is the need to differentiate between capacity and commodity. Whilst new facilities bring additional capacity, it is a separate issue as to whether additional commodity (gas) will flow into the GB market.

THE EUROPEAN GAS MARKET

9. It has been apparent since 2000 that Continental Europe is a major driver for the movement of UK gas prices. Most long-term contracts in Europe remain indexed to oil, and high oil prices provide incentives to capitalise on the arbitrage opportunities associated with selling UK gas into Europe, and from European buyers seeking cheaper UK gas to meet their demand needs (see Appendix).

10. Whilst liberalisation of continental arrangements began some while ago, these developments remain ongoing. The emerging spot markets at Zeebrugge encourage a gradually deepening liquidity, but the reality of an inter-connected network of continental trading hubs remains a distant goal, and significant barriers to liquidity remain, including difficulties in securing economic access to continental storage facilities; gas quality specification issues; and issues associated with access to transportation.

11. But while lack of progress in this area remains a source of regret, it is still doubtful whether it is having the effect on UK competitiveness which is sometimes alleged. There are perceptions that UK consumers are at a disadvantage to their continental European competitors regarding their gas price. There is some difficulty in obtaining like for like comparisons but both Gas Strategies data (see Appendix) and BERR’s Energy Trends and Quarterly Energy Prices show that the UK is reasonably well placed in comparison to continental Europe.

12. One of the benefits of a liberalised market is that there is greater transparency in pricing. That is one of the reasons why consumers will benefit from full implementation of the Second Gas Directive in all EU Member States and from the development of the EU Third Package.

13. We reiterate the improvements which BP advocated in our previous memorandum:
- full legal unbundling of transportation and supply businesses, with customers enjoying the freedom to select service provision for supply independent of the provider of transmission and distribution services;
 - the equivalence of transmission and distribution services, when provided by a regulated entity to a third party; and
 - the freedom of Parties to source supplies from any other party and sell services to any other party.

14. But it has become necessary now to add that the pace of European liberalisation remains slow. The second Gas Directive is still not fully implemented in all Member States almost five years after its introduction. Furthermore the EU’s Third Package of energy measures is still under development and even once implemented it is unlikely that it would be before 2010 that any of the resulting Directives would actually take effect in Member States.

15. Thus, the benefits of liberalisation remain in terms of greater transparency. But other realities remain, which is why liberalisation does not, *per se*, lead to lower prices. Rather it gives consumers the freedom to choose suppliers, encourage the development of new products and services while allowing the market react more quickly to changes in supply/demand fundamentals.

CONCLUSIONS

16. It has been clear for many years that the UK supply demand balance has been changing fundamentally. The transition from supply surplus to a greater reliance on imports of gas is bound to necessitate higher consumer prices, despite the various infrastructure enhancements coming on stream. Moreover, it must be remembered constantly that an enhanced infrastructure does not of itself guarantee that additional gas will arrive in the UK market.

17. BP continues to believe there is no fundamental flaw in the UK market, nor any manipulation. Prices have been responding as might be expected. The effect of greater gas import dependence will be to increase supply diversity which in turn can enhance security of supply.

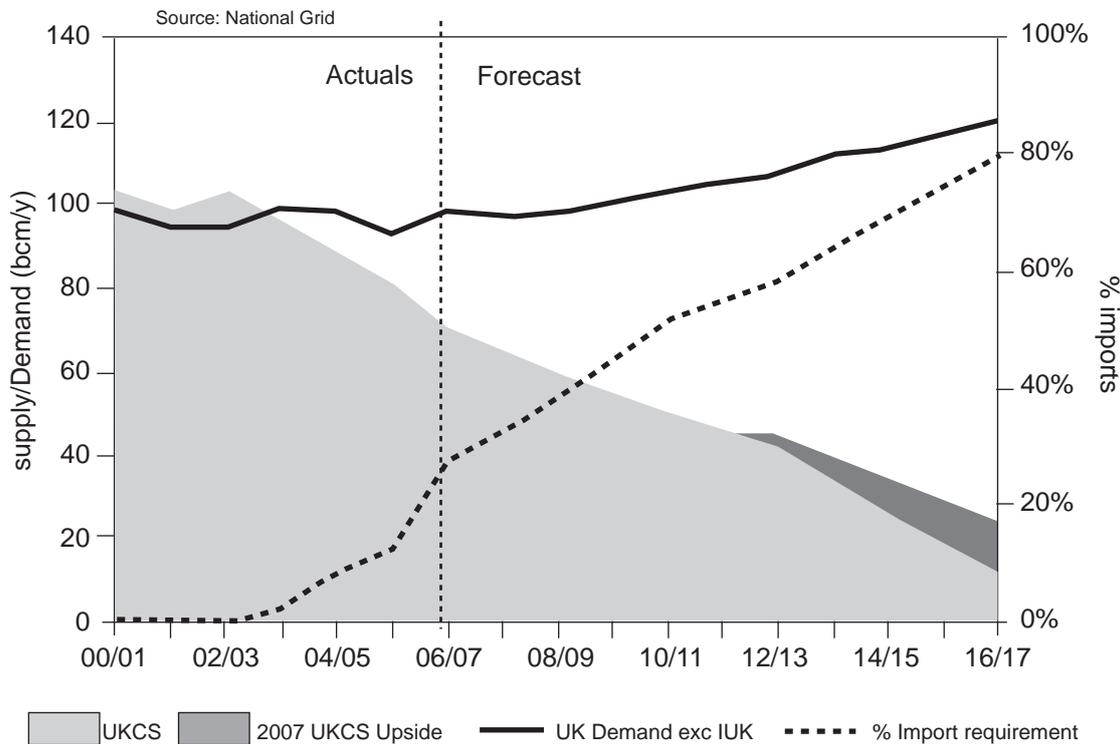
18. There remains some nervousness, reflected in forward prices. However, attention should be given to the growing linkages in world gas prices which have become more pronounced in recent years. In particular, LNG—which now forms an important part of the UK gas supply mix—is influenced by world LNG market signals as evidenced over recent months by Asia attracting LNG cargoes which might otherwise have arrived in the UK. Within the EU, the Spanish market has also been prepared to pay a premium to attract LNG cargoes. In a world in which LNG is currently in relatively tight supply, the willingness of other competing markets to pay a premium for LNG naturally puts upward pressure on GB gas market prices. Looking into the future, growth in world LNG production is predicted to be steady and no step change is predicted.

19. Additionally one observes in the worldwide arena growing concerns about securing sufficient supply from producer countries, with anecdotal reports of some producer countries applying a longer term strategic view to how they intend to permit production of gas resources. Such sentiments are likely to put upward pressure on market gas prices.

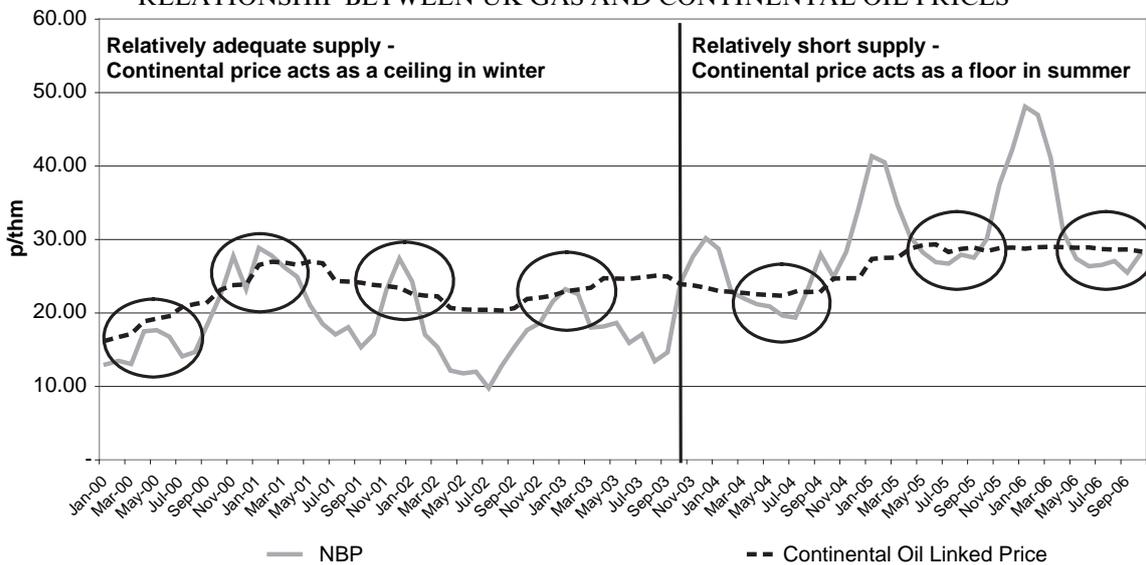
20. The UK is seen as an attractive market for investment as evidenced by the significant capital projects either mooted or in progress. However, the UK can no longer exist in “splendid isolation”; and a fully liberalised Europe is necessary to ensure ongoing security of supply. We remain supportive of OFGEM’s determination to discuss these issues with the European Commission.

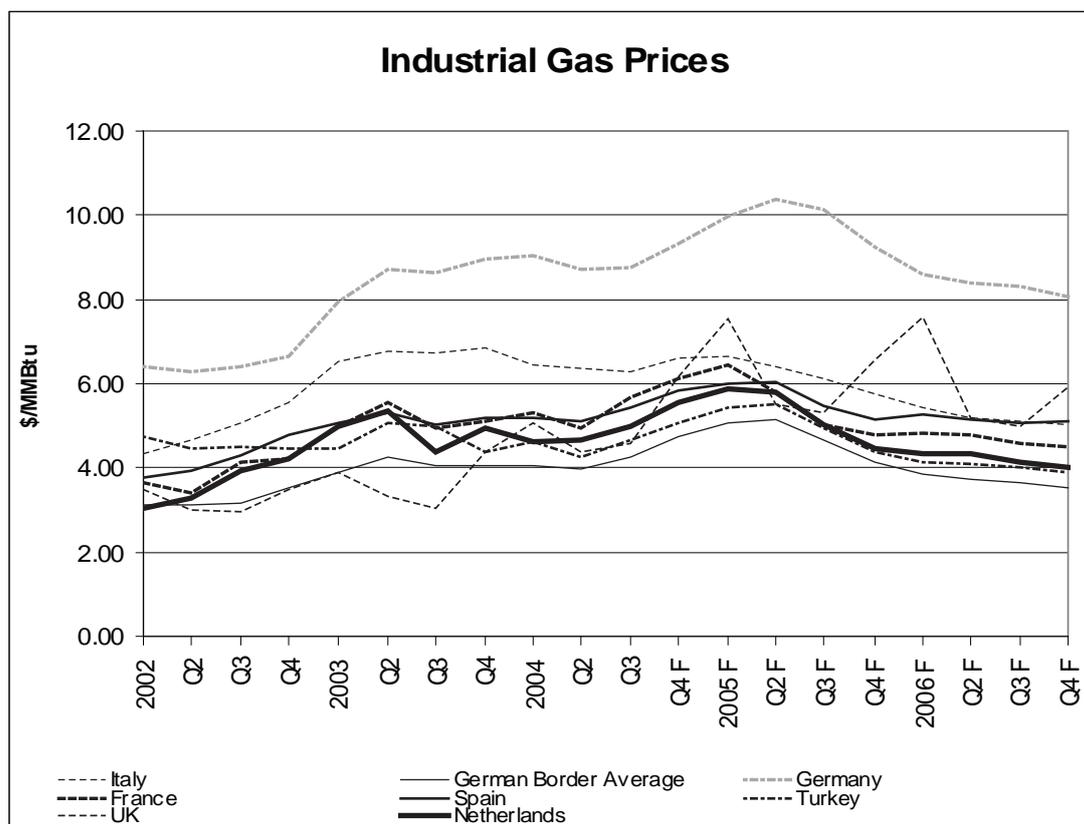
APPENDIX

Figure 4.2B - UKCS Annual Forecast & Import Requirement



RELATIONSHIP BETWEEN UK GAS AND CONTINENTAL OIL PRICES





Source: Gas Strategies

14 April 2008

Memorandum submitted by Dr Gail Bradbrook

I would like to raise the issue of the increased prices for “green energy consumers”— I get my electricity from Good Energy company and previously from Ecotricity. I have been prepared to pay higher prices to support a growing renewables market. However we have recently been subject to higher prices with the reason given being “increased wholesale prices.

I quizzed Good Energy a few times and read their FAQs before being confident this wasn’t profiteering on their part—however the first point I would like to make is that it does lead to mistrust of the green companies and could be a reason why people leave or don’t join.

I now believe that the major energy suppliers are not really making a distinction between the renewables and fossil fuels and this leads me to conclude that:

- the renewables market is not a “real” market;
- that people already paying higher prices for fossil fuels are subject to further increases at the whim of the fossil fuel suppliers;
- that the opportunities for growth and distinction for the renewables market are being lost; and
- that these are extremely significant points in the face of climate change.

I don’t have the ability to investigate and prove the above, and also believe that is a role for Ofgem.

A BRIEF INTRODUCTION ABOUT YOU

I am a consumer and have no other affiliations that are significant here.

FACTUAL INFORMATION YOU WOULD LIKE THE COMMITTEE TO BE AWARE OF

As above and as stated believes rather than concrete knowledge.

ANY RECOMMENDATIONS THAT YOU WOULD LIKE THE COMMITTEE TO CONSIDER INCLUDING IN ITS REPORT

Actions are taken to ensure the renewables energy market is vibrant and protected from fossil fuel increases investigation and consultation into the pricing of renewables, particularly ensuring that smaller, green energy companies cannot be bullied by bigger suppliers or that renewable products owned by larger suppliers are genuinely that and not a front end mostly for profiteering.

March 2008

Memorandum from British Energy

SUMMARY

- The UK requires a stable energy policy and regulatory framework that balances security, diversity and care of the environment with competitive markets and price stability. This in turn will encourage the much needed industry investment required to underpin security of supply. In light of this we do not consider there to be a need to significantly amend the regulator's remit through changes to its statutory duties.
- Since the introduction of NETA the wholesale electricity market has seen relatively lower liquidity with trading largely focussed on the fine tuning of short-term positions. This has contributed to a more volatile wholesale market where relatively low levels of trading activity can result in significant swings in market prices.
- Liquidity issues are widely recognised by the industry and there are a number of initiatives currently underway which are looking to address them. BE welcomes these initiatives and continues to actively participate in the development of proposals that have the potential to introduce more liquidity into the market.
- One of the key themes the UK's energy policy is attempting to address is to improve the environmental performance of the overall energy system. Whilst we fully support this theme there is a need for an increased emphasis on reducing the regulatory compliance costs in respect of environmental measures. We consider there is scope for simplifying the regulatory provisions without undermining the effectiveness of dealing with the environmental issues. There also needs to be better focus on ensuring that measure introduced are consistent and both cost-effective and affordable.
- We actively support the opening of the European market and believe the development of genuine competitive European gas and electricity markets will help to sustain the competitiveness and security of the UK industry. However, real progress is slow and potentially hindering the development of more competitive wholesale markets across the EU.
- In the context of fostering a competitive single European energy market, it would be neither appropriate nor efficient for there to be significantly different, more complex or more burdensome arrangements in the UK. Regulatory decisions need to be closely co-ordinated with neighbouring jurisdictions. Consequently, when proposals are presented to modify the existing UK market arrangements it is important that consideration is given to the effect such changes will have on the integration of the UK market with other European markets.

INTRODUCTION

1. A FTSE 100 company, British Energy Group plc is the UK's largest producer of electricity and the lowest carbon emitter of all the major UK electricity generators. We produce around one sixth of the UK's electricity requirements and employ about 6,000 staff. British Energy owns and operates eight nuclear power stations and one coal-fired power station in the UK. Of British Energy's nuclear power stations, seven are AGR power stations and one is a PWR power station with a combined capacity of about 9600MW. Eggborough Power Station, our coal-fired power station in Yorkshire, has a capacity of about 2,000MW. During the year ended 31st March 2007, British Energy's power stations produced total output of 58.4TWh.

2. Our electricity production is sold via a number of routes to market, including through structured trades, through the electricity wholesale market, and through the company's direct supply business, British Energy Direct Limited (BEDL). BEDL only supplies industrial and commercial electricity customers in Great Britain, and it is one of the largest suppliers of electricity in that sector, supplying around 29TWh to over 1650 customers across 9,365 sites in 2006-07. The Group also has a trading division that is responsible for arranging the wholesale sale of the Group's electricity output as well as providing trading risk management and balancing services to the Group.

3. British Energy plays a major role in helping the UK meet its emissions targets. In 2006–07 our nuclear stations avoided the emission of 33.7 million tonnes of CO₂ (MtCO₂) that would otherwise have been emitted had the same output been generated by fossil fuel stations. This is equivalent to removing around half of the cars from the UK's roads.

OVERVIEW

4. The electricity industry is a capital intensive industry characterised by long-term investment and planning horizons. There is currently a requirement for a significant and sustained investment programme in the UK infrastructure including new generating capacity to ensure on-going security of supply. With this in mind there is clear need for a stable political and regulatory framework in order to encourage the investment required to deliver this.

5. Ofgem has recently announced a parallel investigation into the electricity and gas markets following expressions of consumer and public concern over the competitiveness of the markets. We welcome this announcement and will be actively participating in its investigations. There is clearly some considerable overlap between the issues that fall within Ofgem's investigation and this inquiry. Consequently, we recommend that the BERR Committee should review the findings of Ofgem's investigations before finalising its own conclusions and recommendations. To do otherwise would be potentially inefficient and counter-productive.

6. As our primary operations are within the GB electricity market the views expressed below predominantly relate to this market.

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

7. BE does not operate directly within the retail markets for domestic customers in either gas or electricity and is not therefore well placed to comment on this issue.

8. The Group is however licensed to supply electricity to any non-domestic customers within Great Britain through its subsidiary BEDL. The top end of the industrial and commercial sector of the electricity supply market where we predominantly focus our direct supply activities is a highly competitive, low margin market sector. It is characterised by generally well informed customers who are highly price sensitive and overall has high levels of customer switching. This degree of competition has brought real benefits to consumers in terms of vigorous competition on price, quality of service and responsiveness and innovation on contract forms and terms.

9. It is acknowledged that the UK has one of the most developed liberalised energy markets in Europe with energy prices relatively competitive with many EU markets. The European Commission ("EC") as part of its recent energy sector inquiry and the development of the 3rd Energy Package has been investigating national market structure issues and their potential to restrict competition. However, in the main the EC did not identify any significant concerns with the existing UK energy market structure. In particular, the EC has greatly focused on the issue of network ownership unbundling with a view to promoting effective competition in generation and supply markets. However, unlike in most European countries, this is not a significant issue in Great Britain since National Grid, its transmission system operator, is fully unbundled from generation, distribution and supply activities. Although some electricity distribution companies are part of vertically integrated groups consisting of both generation and supply activities these businesses have been ring-fenced and are subject to regulatory conditions designed to promote effective competition. These regulatory provisions appear to be working effectively as we are not aware of any evidence of discriminatory behaviour having been identified.

10. Notwithstanding the above, we do have concerns with the development of competition in the provision of metering services across the whole electricity supply market. It is clear that competition in this section of the market has not developed as Ofgem anticipated when deciding to open up this sector of the market. Indeed, many incumbent metering service providers are now starting to withdraw from offering their services to BE and other independent suppliers. This may have an adverse effect on supply competition. This situation could be exacerbated by some of the current proposals on Smart Metering. In particular we do not support the ERA's proposals to create regional franchises to implement the roll-out. Instead, we have been advocating a solution for the mass introduction of smart metering which works within the current competitive market framework and which, amongst other benefits, would remove these competition concerns.

Whether there is effective competition in the wholesale markets for gas and electricity

11. Since the introduction of the new electricity trading arrangements (“NETA”) in England & Wales in 2001 (extended to Great Britain in 2005—“BETTA”) the wholesale electricity market has seen relatively low liquidity. This was confirmed in the EC’s interim sector report from 2006. The wholesale generation market is increasingly confined to the role of a secondary balancing mechanism where trading is largely focused on the fine tuning of short-term (within day/day ahead) positions as opposed to the trading of longer term positions. This has contributed to a more volatile wholesale market where relatively low levels of trading activity on the longer-term forward curve, (both in terms of the number of and volume covered by trades executed), can result in significant swings in market prices. These factors, combined with the continued absence of any meaningful traded derivatives market, make it more difficult for independent power producers or suppliers to trade their output or requirements and manage market risk effectively.

12. Vertical integration has been a natural reaction of the major market participants to the inherent risks they face following the introduction of NETA. Under the trading arrangements prior to the introduction of NETA (the Pool) market participants and even pure financial traders were better able to mitigate wholesale electricity price risk by signing contracts-for-differences that used a single wholesale price as a reference price. Under these arrangements, generators generally sold their output at the reference price and retailers bought their requirements at a separate selling price in which the reference price was the main element. Both parties could hedge their risks by signing contracts to hedge themselves against variation in the reference price.

13. Such contracts are no longer available to manage risk. Under NETA market participants no longer have a single reference price but instead sell their forecast output through bilateral contracts. Their physical exposure is limited to the risk associated with the (dual) prices assigned to “imbalances”, ie to the differences between contracted sales (or purchases) and actual output (or consumption). This complex (and deliberately punitive) dual cash out pricing regime makes it difficult for participants to be sure of their price exposure and hard to devise effective hedging against a variation in two separate imbalance prices.

14. The level of market liquidity is also affected by the significant demands for credit. Under the Pool, credit risk was effectively spread across the whole market. Under NETA, the uncertain risks faced by market participants through contract default tend to drive contract counterparties to require high levels of security from sellers in the form of collateral/bank guarantees etc. The combination of the lack of financial hedging products and credit arrangements provides strong drivers for market participants to become vertically integrated in order to better manage these risks.

15. The issues highlighted above are widely recognised in the industry and there are a number of initiatives currently underway which are looking to address them. For example, the Power Trading Forum of the Futures and Options Association is looking to establish a reliable day-ahead index which may encourage more liquidity and the development of a range of financial products for hedging and trading purposes. Also Ofgem is currently undertaking a review of the balancing market cash-out regime with a view to potentially amending the rules used to set prices on imbalances. We welcome both these developments and will continue to participate actively in the development of proposals that have the potential to introduce more liquidity into the market.

The implications of growing consolidation in the energy market

16. As highlighted above, vertical integration is largely a response to the market structure and the risks faced by market participants under NETA/BETTA. Similarly, horizontal consolidation can lead to “netting out” of imbalances, and thus also potentially improve the ability to manage the risks faced under NETA/BETTA. Of course, high market concentration can have adverse effects on competition, which need to be balanced against efficiencies. The UK merger control regime relies on the OFT and the Competition Commission to perform this balancing exercise.

The relationship between wholesale and retail markets for electricity and gas

17. As highlighted above, we currently are not directly involved in the retail supply to domestic customers and therefore have little experience to base any views on the relationship between the wholesale and retail markets. With respect to the industrial and commercial sector of the supply market in which we operate there is traditionally a strong and increasingly direct relationship between end user and wholesale market prices. Customer prices in this market sector are well correlated to wholesale prices—indeed many more customers are actively choosing to enter in to contracts where prices are indexed to market prices thereby directly exposing them to wholesale price fluctuations.

The interaction between the UK and European energy markets

18. It is recognised that the UK has one of the most developed liberalised energy markets in Europe. However, European energy markets together with EU regulatory and competition policy is having an increasingly important impact on the UK's energy markets and consumers. There is therefore a clear need for the UK to participate in the development of European policy in energy markets in order to influence the way in which this develops.

19. We continue to support actively the opening of the European market and believe the development of genuinely competitive European gas and electricity markets will help to sustain the competitiveness and security of the UK industry. In particular, we are playing an active role in discussions on regulation, cross-border trading and environmental policy issues. Further, we fully support Ofgem in its role in Europe in particular through its participation in CEER/ERGEG¹² where it is clearly engaged in promoting and developing competitive energy markets and effective network regulation across the EU.

20. Although some developments have occurred in Europe (eg increased transparency in gas market information in some European markets), real progress is slow. This is hindering the development of more competitive wholesale markets across the EU. For example, as part of the ultimate move to a competitive single European energy market, proposals to develop well functioning regional markets are being discussed. However, real progress on a number of significant issues in respect of the UK, France and the Republic of Ireland (FUI) regional market has been difficult. If an effective FUI regional market is to be developed and UK competitiveness is to be maintained, a number of barriers to trade need to be addressed such as the compatibility or consistency of trading/balancing arrangements, differences in transmission charging, transparency of market information and the removal of the potential for discrimination from all market sectors.

21. In the context of fostering a competitive single European energy market, it would be neither appropriate nor efficient for there to be significantly different, more complex or more burdensome arrangements in the UK. The EC in a report in early 2007 on the internal market commented that "Britain can no longer be regarded as an isolated, self sufficient market for electricity and gas. Regulatory decisions need to be strongly co-ordinated with neighbouring jurisdictions. If not there is a continuing risk that inconsistent regulatory frameworks will create perverse incentives for energy companies". Consequently, when proposals are presented to modify the existing UK market arrangements it is important that consideration is given to the effect such changes will have on the integration of the UK market with other European markets.

The effectiveness of regulatory oversight of the energy market

22. Experience with electricity markets is still evolving and conditions in the British electricity market are changing all the time. Some regulatory oversight may be desirable to ensure that changing market conditions do not harm consumers' interests. However, competition might also be hampered by inappropriate regulation. For example, although lower prices can be in the interests of consumers and could potentially increase the competitiveness of UK businesses in the short-term, simply lowering prices should not become an aim in itself. Significant interventions in the market should therefore only be contemplated when the regulatory authorities have demonstrated a clear benefit to consumers. Given the specific features of the electricity market, the demonstration of clear benefits requires objective empirical analysis and cannot be justified merely by reference to abstract theories of the market and of competition. Such ideologically motivated interventions would lead to uncertainty about future regulation, undermine investor confidence in the market and hence hinder the delivery of the required investment in new generating capacity needed to underpin security of supply.

23. Government quite rightly takes no role in the day-to-day operations of Ofgem. However, whilst we fully support this independence it is vital that the decisions of Ofgem do not fundamentally conflict with overriding Government policy—particularly given the important role Ofgem plays in helping to deliver the Government's energy, social and environmental objectives. There is therefore a question of how best to ensure there is a coherent policy and regulatory framework against which market participants can make business decisions, whilst maintaining Ofgem's independence from Government. At the very least, effective scrutiny of how and to what extent Ofgem's policies are consistent with and complement the framework of energy policy set by Government is required.

24. One of the key themes the UK's energy policy is attempting to address is to improve the environmental performance of the energy system. Whilst we fully support this theme there is a need for an increased emphasis on reducing the regulatory compliance costs in respect of environmental measures. We consider there is scope for simplifying the regulatory provisions without undermining the effectiveness of dealing with the environmental issues. For example, the prevailing Emission Trading Scheme (ETS) addresses environmental damage from CO₂ emissions by way of a cap-and-trade system. Such a system allows the authorities to set the optimal level of emissions whilst also creating market-based incentives to minimise the cost of achieving that level. By contrast, some other arrangements are very complex and, in BE's view, unnecessarily complicated and costly. For example, the Renewable Obligation (RO) aims to

¹² CEER—Council of European Energy Regulators; ERGEG—European Regulators' Group for Electricity & Gas.

reduce CO₂ emissions from electricity generation, even though they are already capped by the EU ETS. Moreover, it mandates a method for emissions reductions (renewable energy) which carries a significantly higher cost per tonne of CO₂ abated than current and forecast prices in the ETS.

25. Similarly, many energy efficiency policies, such as the EEC/CERT and CRC, amount to “double regulation” of emissions and impose a regulatory rather than market-based choice of methods for emissions reductions. Finally, interactions between policies can create unintended consequences contrary to cost-effective reduction of CO₂ emissions. For example, the separate targets for renewables and energy efficiency risk creating uncertainty about future prices for CO₂ emissions and energy production. We consider that the compliance costs of the EU ETS and similar market-based systems are likely, in the long run at least, to be lower than for more complex regulatory solutions.

26. Notwithstanding the above, we do not consider there to be a need to significantly amend the regulator’s remit through changes to its statutory duties. Britain requires both an energy policy and a regulatory framework that balances security, diversity and care of the environment with competitive markets and price stability. The continuing challenge for Ofgem is to develop an energy regulatory framework that satisfies the public interest test by striking the right balance between these priorities whilst operating in accordance with best regulatory practice. As part of this, it is important that the regulatory authorities explain in full how they intend to balance their (potentially conflicting) priorities when making regulatory decisions, in order to create a stable and more predictable environment for new investment.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

27. As we have already indicated we are not directly involved in the supply of electricity or gas to domestic consumers and do not therefore have any direct relationship with customers that are affected by fuel poverty. Our primary activity is the generation and trading of electricity where we contribute to and actively promote a fully competitive electricity wholesale market. Competition is the best form of constraint on electricity prices. Consequently, we make a positive, albeit indirect, contribution to addressing fuel poverty through competition.

28. Notwithstanding the above, we do acknowledge that fuel poverty is a major issue that requires careful consideration. However, we believe fuel poverty is a public policy/government social policy issue rather than a market/regulatory one. As such this issue should be addressed via appropriate and properly targeted social policy instruments such as the benefits/taxation regime as opposed to interventions in the electricity and gas markets. Any attempts to do the latter will potentially distort the energy markets and thus have an adverse effect on investor confidence at a time when there is a need for a large scale investment programme in infrastructure including new generating capacity to address a looming capacity gap. This in turn could lead to customers and tax payers paying more in the long run.

29. If the Government wishes to use energy policy or the liberalised energy markets to deliver its social policy objectives then this is a different model than the one that is currently in place and understood by market participants and investors. Consequently, any significant change such as this should be made explicit so that the additional implications faced by market participants can be fully assessed.

April 2008

Memorandum submitted by Roger Brocklehurst

1. EXECUTIVE SUMMARY

My recommendation is for the setting up of a new “not-for-profit” national energy Distribution company, which would act as a consolidator for locally-based Combined Heat and Power (CHP) and renewable energy schemes operated by the public sector, local authorities, registered social landlords (RSLs) and social enterprises.

2. MY BACKGROUND

For more than 10 years I have been involved at Board level with social housing and am currently an independent Board member of Downland Housing Association and of BHT, two RSLs within the Affinity Sutton Group (52,000 residents).

Prior to that, I had run an England-wide charity for seven years following on from 30 years in banking and corporate finance.

The views expressed in this paper are essentially personal and should not be taken as representing those of any organisation, with which I am, or have been, connected.

3. FACTUAL INFORMATION

- (a) The current debate on climate change is leading to the promotion of CHP where there is an economic demand at local level for heat and power, in order to save energy and reduce CO₂ emissions. (CHP also reduces the “transmission” loss-of-energy effect from which electricity supplied via the National Grid suffers).
- (b) The Government with EU encouragement has put in place a number of measures to support and encourage the development of CHP.
- (c) There are already 1500 CHP Units in the UK and it is estimated that by 2010 over 10% of total electricity will come from CHP schemes. (I have not been able to ascertain the breakdown by sector of ownership of CHP plants currently in operation).
- (d) Local authorities are becoming increasingly involved in the promotion of CHP both as operators for their own needs and through planning conditions attached new housing, industrial estates etc. Notable examples of local authority involvement here include London and Aberdeen.
- (e) Housing Associations, ie RSLs, are becoming involved as planning consents for the development of larger estates of affordable or mixed tenure homes will often include the provision of CHP.
- (f) Currently a major barrier to the installation of CHP units is the gap between the “export” price obtainable for generating surpluses that are sold on to the Grid and the “import” price paid for supplies bought in via the Grid.
- (g) CHP operators individually are essentially small players in terms of potential supply of surplus energy to the Grid: a more collective approach would strengthen their ability to negotiate on price.
- (h) In an era of escalating energy prices, RSLs are only too well aware of the problems of fuel poverty facing many of their tenants. Recent estimates indicate that fuel poverty (ie households where over 10% of income goes to meet energy costs) affects 3.5M homes in the UK, and every 1% increase in domestic fuel prices forces another 40,000 households into fuel poverty. RSLs therefore already have a very real interest in better energy conservation in the design and refurbishment of their housing stock, but also now in the direct supply of energy to those tenants where CHP units are being installed.

4. RECOMMENDATION

My recommendation is for the creation of a new not-for-profit energy distribution company operating across the UK, whose role would be to:

1. act as an aggregator/consolidator for all locally-based CHP schemes and/or renewable energy projects operated by its members from amongst:
 - (a) the public sector;
 - (b) local authorities;
 - (c) RSLs; and
 - (d) Social enterprises.
2. establish a Distribution Network organisation, so that it can sell back to those members temporarily “in deficit” the surplus energy produced by other members.
3. explore the possibility of block energy agreements to supply RSL tenants on better terms than currently available to them as retail consumers. (Many tenants are stuck on pre-payment meter tariffs).

The company would be set up as a “social” business with the intention that surpluses would be returned to members or reflected in lower “import” and/or higher “export” prices than would be obtainable by operator members going to the market on an individual basis.

This recommendation has been put to Ofgem as a submission under their recent review (“Review of the regulatory regime for energy markets: Distributed Energy Ref:295/07—March 2008), as changes will be needed to reduce/remove the barriers to the creation of a new mechanism along the lines suggested above.

The purpose in establishing such an organisation is as follows:

- to increase significantly the rate of investment in CHP and renewable energy schemes;
- to encourage such schemes to invest in surplus capacity, and in higher efficiency units, reducing reliance on the national grid and the demand for new power station capacity;
- to achieve a better balance between the export and import prices currently obtainable by CHP operators;
- to create a new credible force within the current marketplace, that is dominated by six major privately-owned utility companies;
- to ensure that any profits are returned to members or reflected in lower import prices, for the benefit of RSL tenants/residents;

- to secure economies of scale and other efficiencies across the CHP sector; and
- to reduce fuel poverty amongst social housing residents.

If the Government is serious in its commitment to a competitive energy market, to the provision of a secure and environmentally-sustainable supply, and to its drive to tackle fuel poverty, then it should give the proposal outlined above its full consideration.

March 2008

Letter submitted by Centrica

Thank you for your letter of 11 January regarding information you are gathering for the evidence session with the Energy Minister on 31 January.

As you will be aware, British Gas recently announced that it would be increasing gas and electricity prices by 15%. We are firmly committed to supporting our vulnerable customers especially during times of rising energy prices and as evidence of this we have deferred the price increase for 340,000 customers on the Essentials social tariff until 1 March meaning that none of these customers will see a price increase until after the winter period. Essentials offers up to 750,000 of our most vulnerable customers the equivalent to our monthly direct debit rates—our lowest standard offline gas and electricity tariff—irrespective of payment method. It represents a financial commitment from British Gas of £32 million per annum.

To offer further help for up to 25,000 of our most vulnerable customers, British Gas has also launched a Winter Protection Package, Winter Warmer, which includes a credit of up to £90 and free insulation. We are also investing a further £13.45 million in the British Gas Energy Trust over the next four year, which helps consumers with debt problems, taking the total committed by British Gas to the Trust to £21.3 million since 2004.

A new report from energywatch last week found that *“British Gas has and will have made the most significant voluntary commitment to measures to reduce the impact of fuel bills on its vulnerable customers”*. The report concluded that British Gas’s financial commitment to helping its vulnerable customers was *“nearing double the level that would be expected from its market share.”*

It is important to recognise that as the UK becomes increasingly dependent on international and more expensive sources of energy we can no longer rely on cheap energy prices. The increasing environmental costs arising from the Renewables Obligation and the Carbon Emissions Reduction Commitment are also placing an upward pressure on domestic prices.

Since British Gas reduced its retail gas prices by 20% in the spring of 2007, wholesale energy prices have risen sharply and the forward gas price for 2008 has increased by 51% and the forward electricity price by 61%. In addition the price charged to British Gas to transport and distribute energy will rise by 7% whilst CERT and RO costs are expected to add around £31 and £12 respectively to an annual customer’s bill.

Unfortunately we had no choice but to pass on these costs in part to our customers. The last time British Gas tried to absorb all of the increase in wholesale energy prices it made an operating loss of around £200 million over a 12 month period. In the last six months of 2007, higher wholesale gas prices have reduced British Gas operating margins to just 1% after tax.

It is important that British Gas generates sound profits in order to fund future investment in securing future gas and power supplies for our customers. We invested around £900 million in 2007 alone and we will invest around £2 billion between now and 2009. We have also invested in our customer service, with a £430 million commitment in a new billing system which will enhance the customers’ experience and lower our operating costs to make us more competitive. Our internal costs reduced by £140 million in 2007 and we are committed to a further £60 million reduction in 2008. We are also committed to roll out smart meters providing the Government creates the right market conditions for the roll out to happen. Smart meters offer the opportunity for energy suppliers to make a step change in the services we offer customers, for example in the provision of accurate bills and the availability of real time consumption information. We would be happy to brief the Committee on this issue at a later stage.

Even with the recent price rises, our customers’ bills will still be below 2006 levels. UK prices also remain competitive compared with most other European countries. Average UK electricity prices including taxes are the fifth lowest amongst the EU 15. Britain’s gas bills are also still amongst the cheapest with the UK average gas price the second lowest in the EU 15. Belgium gas prices have recently risen by 25%.

Going forward, we continue to call for faster progress on liberalising energy markets in Continental Europe which is important in helping break the link between gas prices and high oil prices and which feed through to UK prices as we import more gas from the Continent. Within the energy sector, the Government estimates suggest that insufficient liberalisation of EU gas markets will cost European energy consumers an estimated £40 billion in 2007. A recent study by Copenhagen Economics estimated that market opening in electricity could reduce prices in the EU 15 by 13%. We welcome the third package of energy legislation brought forward by the European Commission and we are calling for full ownership unbundling as part of the package to improve transparency and access to networks.

You also invited us to comment on the Government's decision on nuclear power. We welcomed the Secretary of State's announcement on 10 January which gave the go ahead to the construction of a new fleet of nuclear power stations. We believe that new nuclear will play an important role due to its low carbon intensity and its contribution to the diversity of fuel sources in the UK generation fleet. Centrica is already considering the economic case for new nuclear power, reflecting the value we have gained from sourcing nuclear generated electricity in recent years. We will also continue to invest in other forms of low carbon technology such as offshore wind and we remain committed to our role in the gas market which could see further gas exploration and storage.

23 January 2008

Memorandum submitted by Centrica

**CENTRICA'S SUBMISSION TO THE BUSINESS AND ENTERPRISE SELECT COMMITTEE
INQUIRY INTO THE UK'S ENERGY MARKET**

Centrica plc (Centrica) was formed in February 1997 when the former British Gas plc was demerged to form BG Group plc and Centrica. In Great Britain, Centrica trades under its brand names, British Gas, Scottish Gas and Nwy Prydain. It is the UK's largest energy supplier, supplying around 10 million gas and 6 million electricity customers in the domestic sector and has around 950,000 supply points in the non-domestic sector. It also owns upstream gas production and power generation assets to support its supply businesses.

Centrica is pleased to submit written evidence to the Business and Enterprise Select Committee inquiry into the UK's energy market. We trust that both this inquiry and the investigation into the energy markets announced by Ofgem on 21st February will reassure and satisfy consumers and opinion formers that the UK energy market is working in the best interests of customers.

Our submission covers the areas outlined in the Business and Enterprise Select Committee press release of 5 February 2008, principally:

1. Whether the current market structure encourages effective competition in the retail markets for gas and electricity;
2. Whether there is effective competition in the wholesale markets for gas and electricity;
3. The implications of growing consolidation in the energy market;
4. The relationship between the wholesale and retail markets for electricity and gas;
5. The interaction between the UK and European energy markets;
6. The effectiveness of regulatory oversight of the energy market; and
7. Progress in reducing fuel poverty and the appropriate policy instruments for doing so.

1. COMPETITION IN THE UK RETAIL ENERGY MARKET

1.1 The UK gas and electricity supply markets are characterised by the presence of six large retail suppliers to the domestic market, British Gas, Scottish and Southern Energy, Eon, Scottish Power (Iberdola), EdF Energy and npower (RWE) and a number of smaller niche players (for example, suppliers offering electricity from renewable sources eg Good Energy). Centrica is the smallest of the six companies by market capitalisation with four of the competitors being part of very large integrated European utilities.

1.2 In the non-domestic market, where competition was introduced much earlier than in the domestic market, there are more players. In this market, we have seen some new players independently enter the energy market in the last three years such as Utilita, Smartest and Bizz Energy.

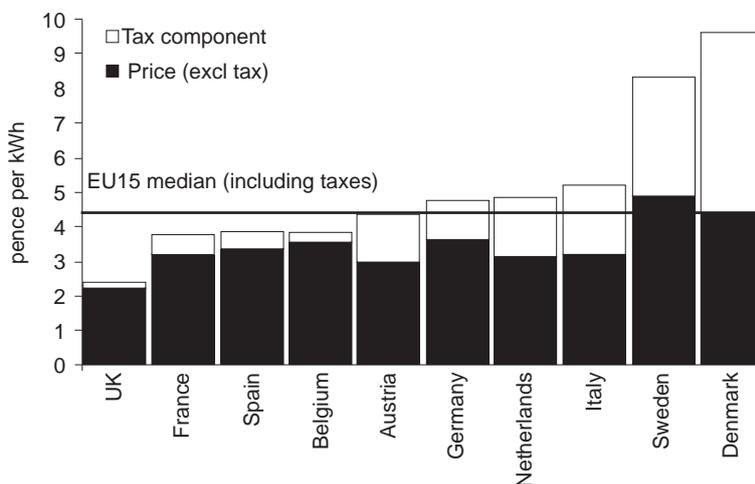
1.3 The presence of six major competitors in the domestic market is capable of supporting effective competition. All these suppliers operate in a highly competitive market. When measured against the usual indicators of competitiveness, namely pricing, product innovation and switching, the UK's energy retail market emerges well. Indeed, as recently as 30th January 2008, research by independent energy consultancy Oxera for the Government concluded that: "the UK energy market is the most competitive in the EU and G7", and that "creating an open and competitive energy market has meant that UK consumers have consistently benefited from amongst the lowest energy prices in Europe."¹³

¹³ The BERR press release can be found at:
<http://www.gnn.gov.uk/environment/fullDetail.asp?ReleaseID=348951&NewsAreaID=2&NavigatedFromDepartment=True>

Pricing and product innovation

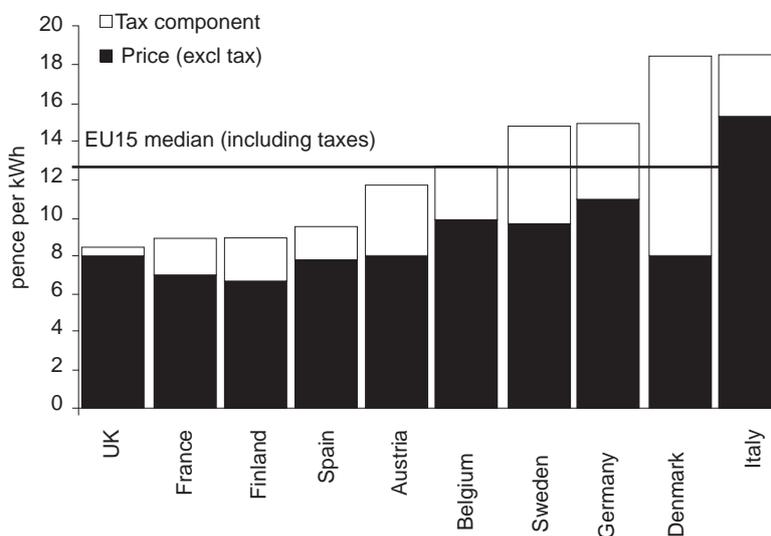
1.4 UK energy prices are still cheaper than prices in many EU Member States that have been slow to liberalise their markets. The graph below shows that the UK domestic gas price (excluding taxes) for medium consumers was the lowest in the EU 15 and 30.1% lower than the median price.¹⁴

ESTIMATED AVERAGE DOMESTIC GAS PRICES FOR MEDIUM CONSUMERS¹⁵
IN THE EU AS AT 1 JANUARY 2008



1.5 In electricity, the UK price, excluding taxes, was the seventh lowest in the EU 15 and 17.0% below the median price as shown in the graph below.

ESTIMATED AVERAGE DOMESTIC ELECTRICITY PRICES FOR MEDIUM CONSUMERS¹⁶
IN THE EU AS AT 1 JANUARY 2008



1.6 Competition in the retail energy market has also delivered an increasing range of new and innovative products and services as suppliers compete to keep customers by offering products such as fixed/capped prices and green offerings. Around 4.2 million UK households have chosen new ways to buy their energy which range from on-line, fixed and capped rate products to green energy and low-price protection packages for fuel poor customers. For example, 2.4 million customers on fixed term, fixed price contracts were protected from British Gas' most recent price increase.

1.7 Most suppliers are coming forward with green tariffs for customers who want to cut carbon emissions and this is also an area which has attracted entry from specialist green suppliers in response to growing consumer awareness of the need to cut carbon emissions. Nearly 350,000 customers in Britain have chosen a green tariff.

¹⁴ BERR, Quarterly Energy Prices, March 2008

¹⁵ Medium consumers for gas are defined in the BERR report as having an annual consumption of 23,260 kWh per annum

¹⁶ Medium consumers are defined in the BERR report as having an annual consumption of 3,500kWh per annum of which 1,300 kWh is at night.

1.8 British Gas offers its customers two green tariffs, Future Energy and Zero Carbon, both backed by electricity from renewable sources and with a contribution into the non-profit British Gas green fund, which supports UK schools in reducing their CO₂ emissions and development of new renewable technologies and resources. Additionally, Zero Carbon contains carbon offsetting.

1.9 On-line tariffs have also been introduced, originally as a niche product, and now offer the lowest prices and by doing away with paper bills, on-line tariffs also bring environmental benefits.

1.10 Suppliers are also being increasingly innovative with energy efficiency packages. British Gas, for example, introduced an Energy Savers Report to help customers save money when energy bills were rising in February 2006. Over 1.7 million customers have completed a report which gives an energy rating for the home and offers simple advice as to how to improve the energy efficiency of the home (eg by installing energy efficiency measures or by behavioural changes) which could lead to savings of £175 per annum on the average energy bill.

1.11 Additionally, suppliers are also seeking to extend and improve on existing service to the benefit of consumers. For example, British Gas has separated out its prepayment meter customer segment to become a separate unit so we can focus on the needs of that customer segment and better tailor our processes and costs. One of our first steps has been to trial the new EnergyPOINT device. This device which is easy to install and use allows customers to top up their prepayment credits at any time from their own homes saving them a trip to retail payment outlets (such as the Post Office). 10,000 EnergyPOINT units are to be trialled in customers' homes and should be made more widely available from May 2008.

Switching rates

1.12 As a consequence of this innovation and competition in the market, annual rates of switching are high. In excess of 100,000 domestic consumers are switching supplier each week, with over 4 million (some 20% of customers) switching in 2006 alone.¹⁷ This is in comparison with only 9.2% domestic electricity customers who have switched in Germany and only 1.3% of total gas volumes (no customer figures published)¹⁸.

1.13 Contrary to the perception that prepayment customers do not switch as much as other segments, prepayment meter switching has been growing since 2005 and is now the most active switching segment. Our own research shows us that for the three month period up to January 2008, customer defection levels for our gas prepayment business were 79% higher than for our overall gas customer base. This is 30% higher than for the same period last year. Our research also shows that for the three month period up to January 2008, customer defection levels for our electricity prepayment business were 77% higher than for our overall electricity customer base. These figures are 45% higher than for the same period last year.

1.14 This consumer appetite for switching has led to the growth in the number of switching internet sites in recent years, which now stands at 12. Sites such as uSwitch advise customers on the best deals and offer customers significant savings on energy bills if they switch to a cheaper supplier.

1.15 The exceptionally high switching rates that we have seen in the UK since the market opened are reflected in the changes in market share. In the ten years since competition was introduced, British Gas has seen its market share for gas reduce from 100% pre competition, to around 46% currently as other companies have built market share. Conversely, the introduction of competition in electricity has meant that British Gas has been able to build an electricity base from zero to a current market share of around 21%.

1.16 In our view, the levels of switching and the range of new and innovative products and services available in the market place from a range of suppliers, indicate effective competition at the retail level.

2. COMPETITION IN THE WHOLESALE GAS AND ELECTRICITY MARKET

Wholesale gas market

2.1 In the last five years, there have been significant changes in the UK's energy markets with the decline of North Sea gas reserves and an increased dependency on gas imports. By 2015, the UK market will be importing as much gas as it produced in 2007.

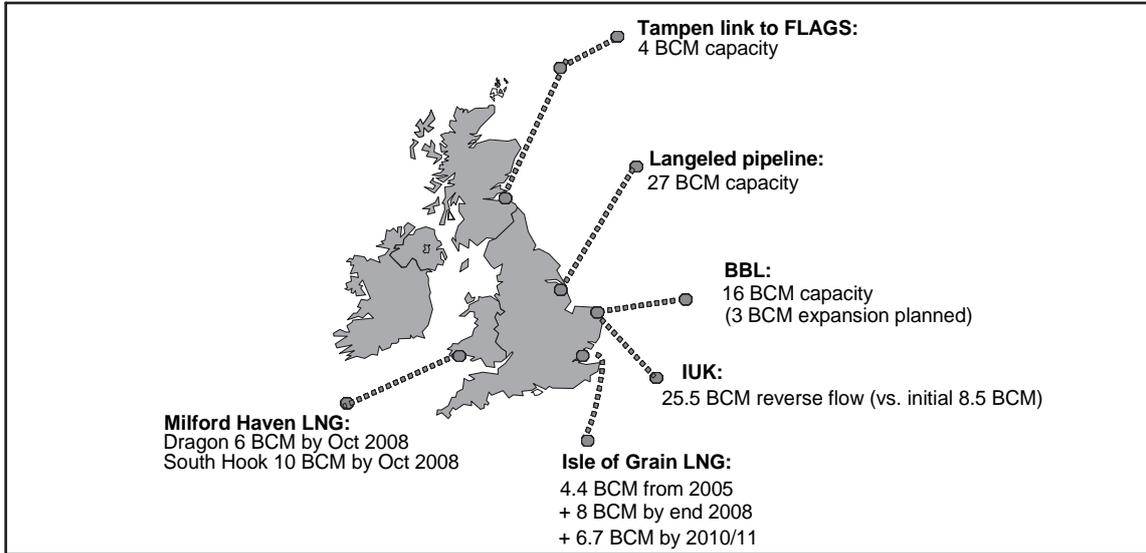
2.2 The UK competitive market has responded well by bringing on significant new investment with 24 companies from 11 countries currently investing over £10bn in the UK energy market. New capacity has taken the form of new pipelines (eg Langeled capable of bringing nearly a quarter of UK peak requirements from Norway), enhancements to existing interconnectors with continental Europe (eg Interconnector UK)

¹⁷ Ofgem Domestic Retail Market Report June 2007

¹⁸ Monitoring Report 2007 published by the Federal Network Agency, November 2007

and new LNG facilities built (eg Isle of Grain). Centrica's own gas purchase contracts with Statoil and Gasunie have helped underpin the investment case for new infrastructure, especially Langeled and BBL. The major new gas import facilities in the UK are illustrated below.

MAJOR NEW GAS IMPORT FACILITIES¹⁹

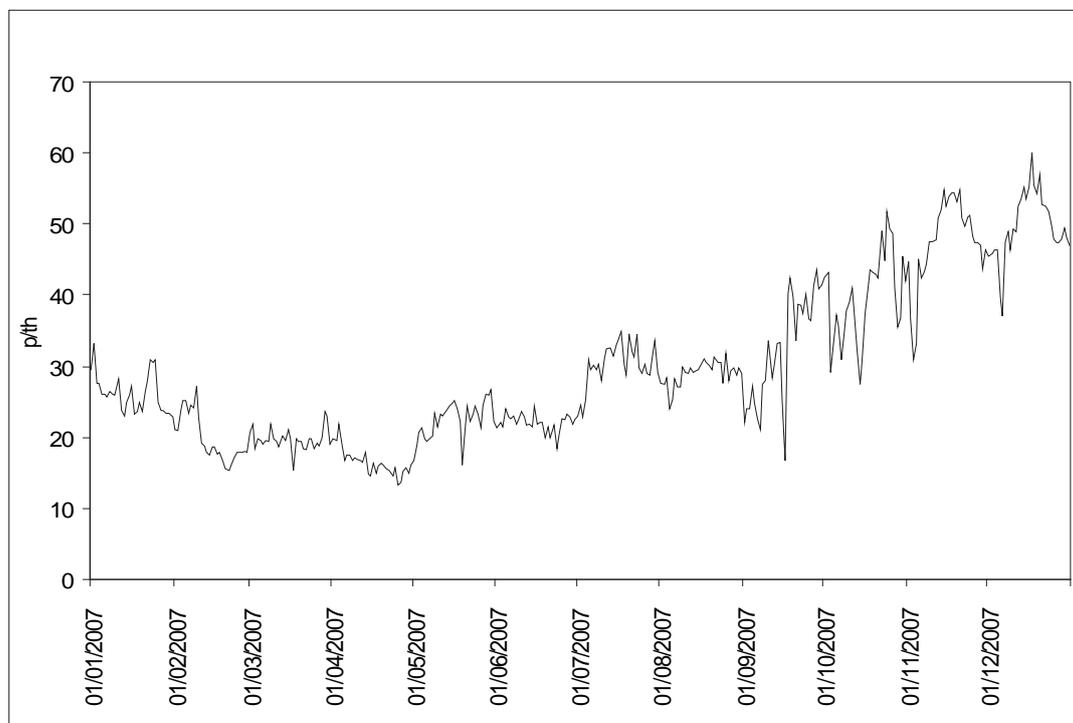


2.3 Importantly though, this new capacity has not necessarily translated into the same volumes of gas flowing into the UK. LNG is becoming a global gas market with increasing arbitrage opportunities between the European, American and Asian markets and the Asians are presently paying the highest prices for spot LNG. These market conditions have meant that UK LNG terminals have often been left idle this winter. The addition of Langeled and the Tampen Link Spur to add to Vesterled has led to the UK being exposed to much greater producer arbitrage. Total and individual flows from these supply sources into the UK are highly variable and difficult to predict given the lack of transparency in continental European markets. Of particular concern though has been the absence of gas flowing through the Interconnector from continental Europe, even when gas price differentials between the UK and Europe would indicate that gas should flow.

¹⁹ Slide produced by Centrica

2.4 This unpredictability of flow of physical gas to the UK has led to significant volatility in the wholesale gas market and has contributed to rising wholesale gas prices. For example, prices in early 2007 fell to a low of 13 pence per therm and then rose by 47 pence to a high of 60 pence per therm at the end of the year with huge intra day volatility.

2007 UK DAILY WHOLESAL GAS PRICES²⁰



2.5 The dwindling North Sea reserves and the current supply constraints and volatility are compounded by the fact that the UK has the lowest level of gas storage capacity of any major EU economies, at around 5% of its annual demand. Even with the current planning reform proposals, the situation will take several years to improve. There are a number of storage projects in the pipeline including the recently announced plan by Centrica and its partners to look at the feasibility of converting the Bains gas field into the UK's first new offshore storage facility for over 25 years.

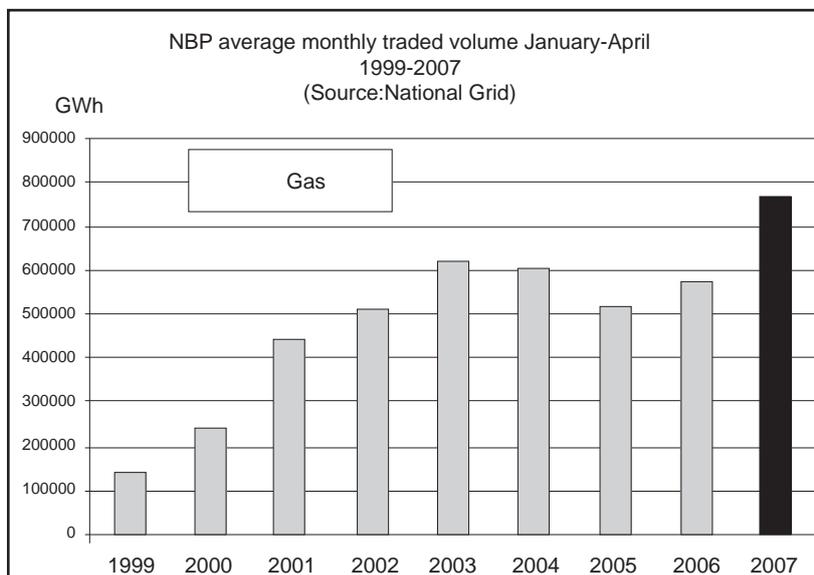
2.6 There is no indication or suggestion that the increase in UK wholesale market prices has been driven by anti-competitive behaviour. On the contrary, there have been numerous independent inquiries into the UK's energy market since 2001 including by the EU Commission, BERR (formerly DTI) and Ofgem and all have concluded that the UK market is fully competitive²¹. However, there are problems deriving from the largely unliberalised European energy markets which have a distorting effect on the UK market. This subject is discussed in more detail in section 5 of our submission.

2.7 We believe the UK wholesale gas market is generally operating effectively. There is good transparency of information with regular and timely notifications of UK field outages and gas flows. By contrast, we have concerns about the limited transparency in continental European gas flows and transparency could also be improved for the volumes of Norwegian gas flowing into the European market.

²⁰ Slide produced by Centrica

²¹ These include: DTI November 2001—Consultation into concerns about gas prices and possible improvements to market efficiency; March 2002 European Commission Investigation into the operation of the IUK gas pipeline; Nov 2003 Ofgem investigation into wholesale gas price rises; Nov 2003—FSA investigation into price fluctuations; November 2004—Gas Probe into flows of gas from Sean fields; June 2005 EU Competition Directorate sectoral inquiry into EU's gas and electricity markets

2.8 Liquidity of the market has also improved after a period of decline when a number of traders exited the market. Recent signs of improvement include award of 10 new supply licences and 20 new shipper licences to banks and other new entrants in the last 12 months.²² As the graph below shows, liquidity for the early part of the year in 2007, January—April, was at its highest level to date.



Source: Heren Energy

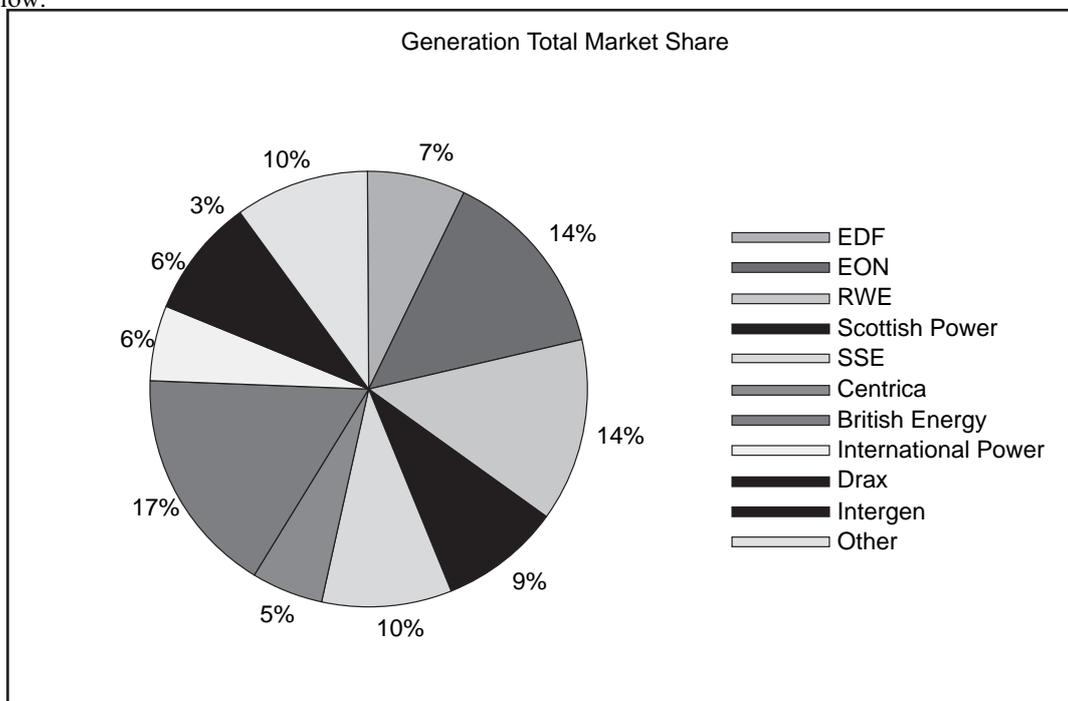
2.9 We have, however, observed that there is a lack of long-term liquidity. This could relate to the relatively recent reduction in reliability in some of the assets in the North Sea due to age with outages and uncertainties around when flows will resume. We believe that this uncertainty, together with the significantly greater price volatility in the UK has contributed to producers’ (physical players) reluctance to sell further out. In addition, the nature of trades has also changed with much of the current traded gas relating to financial positions/spark spreads (ie arbitrage between different fuels) rather than physical positions.

2.10 However, even non-physical players are reluctant to trade out much into the future. This reluctance could be eased if the uncertainty and hence risk was reduced by increased transparency and thus predictability of European and Norwegian gas flows. This in turn could reduce volatility in the wholesale market, easing producers’ concerns about similar trades and thereby creating a virtuous circle. This point is expended upon in more detail in section 5 of our submission.

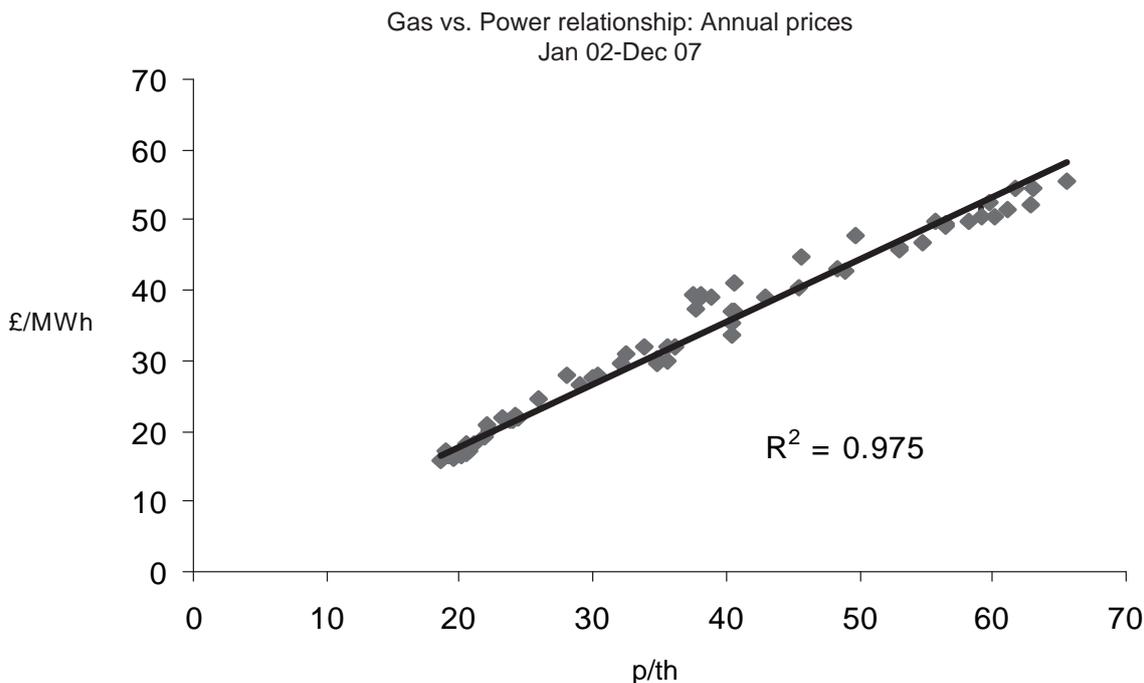
²² Ofgem

Wholesale power market

2.11 The wholesale power market differs from the wholesale gas market in that the power market has limited interconnection. It is also characterised by a greater degree of vertical integration where a company participates through the entire value chain from generation to supply. Despite this degree of vertical integration, it is important to note that over 40% of the generation market is held by independent generators without significant residential market positions. The generation market shares are shown in the chart below.²³



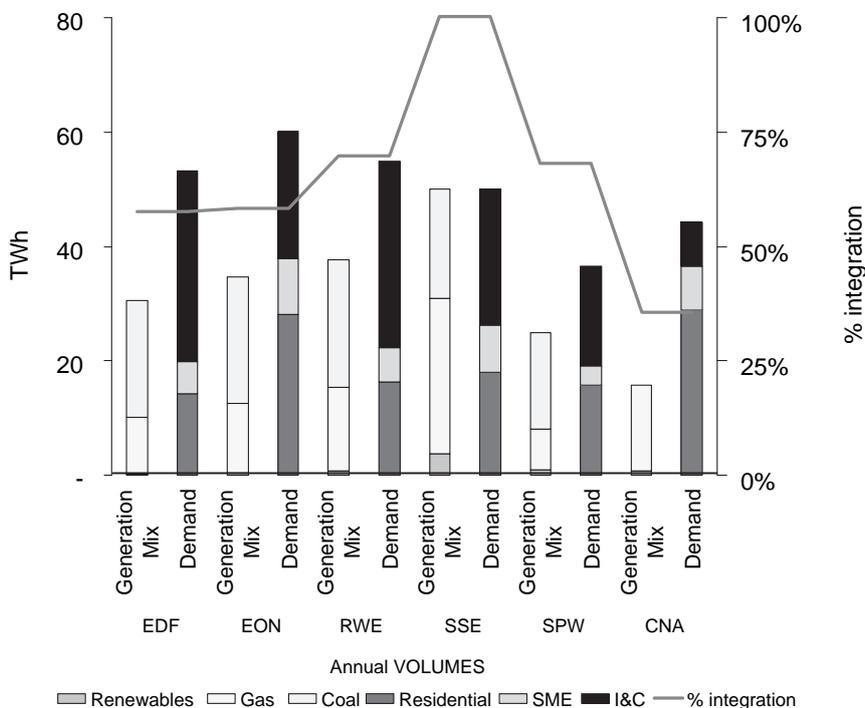
2.12 The market is also characterised by a close linkage between gas wholesale prices and electricity prices. This is because gas-fired generation accounts for 40% of UK electricity supplies and with gas-fired generation at the margin for significant periods of time, electricity prices are driven in large part by UK gas prices and therefore are affected by the increases in wholesale gas prices. This is illustrated in the graph below.²⁴



²³ Slide produced by Centrica

²⁴ Slide produced by Centrica

2.13 Vertical integration through asset ownership and/or by contract is a natural reaction to power price volatility as it helps companies to manage wholesale price volatility and provides greater certainty in customer prices. As a result, all the six major energy retailers are vertically integrated to a certain degree, though as the chart below shows, Centrica is the least vertically integrated of all suppliers. In fact, the level of “internal” generation cover varies between about 40% and 100% with the average at around 60%–70%.²⁵



2.14 This means that the majority of the six must source additional generation from the market. This is done through trading on the BETTA market as well as other bilateral trades and contracts. Centrica welcomed the introduction of the BETTA electricity reforms in 2005 as it created a competitive wholesale market with a common set of trading rules, so that electricity could be traded across Great Britain. We believe that BETTA has played an important role in creating a level playing field for all generators and reduced barriers to entry.

2.15 A key indicator of healthy state of the UK market is the extent to which there is significant new investment including by Centrica (at Langage) and independent power generator Welsh Power (with their 800+ MW gas-fired power station at Uskmouth). There is also significant plant at the planning/permitting stages such as Barking Power’s 400MW plant extension and in addition, companies have plans for future build including Eon (at Grain, Kingsnorth). Of course, this is in addition to the numerous renewables developments to build onshore and offshore wind farms including Centrica’s own investments (eg Lynn and Inner Dowsing which are at the final stages of construction).

2.16 It is vital that investors in the electricity generating industry should have confidence in the electricity and gas markets. For this to happen they need clear and stable public policy which minimises political and regulatory risk. The industry is poised to make very large investments in new power stations in the very near future and it could be very damaging if potential investors were to be confronted with new political and regulatory risk.

2.17 We hope that this review (and the parallel investigation by Ofgem) does not lead to proposals for fundamental change. However, if the Committee were looking for one area where improvements could be made, it would be around the free allocation of carbon emission allowances to the power generation sector under the EU Emissions Trading Scheme. Centrica has lobbied both the Government and the EU for the past four years to fully auction allowances on the grounds that this free allocation of allowances distorts the market in favour of polluting incumbents and raises the barrier to new entrants. Whilst the Government decision to auction 7% of the allowances under Phase 2 of the scheme which began this year, is a step in the right direction, we would have preferred that the Government had opted for the 10% limit allowed under the EU rules and ultimately full 100% auctioning. As long as free allowances exist, gas fired generators like Centrica are placed at a competitive disadvantage compared to coal producers such as Drax and SSE.

²⁵ Slide produced by Centrica

3. IMPLICATIONS OF GROWING CONSOLIDATION IN THE MARKET

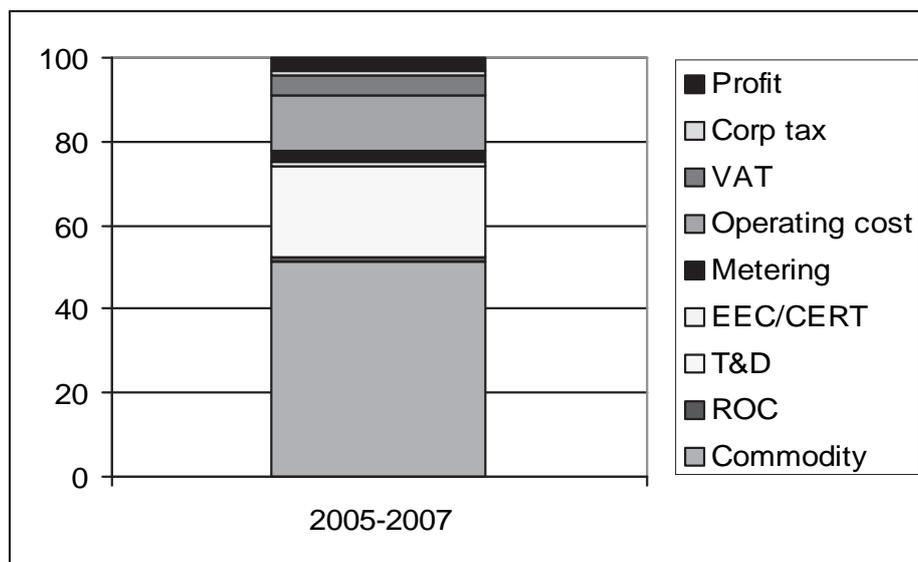
3.1 In the UK, there has not been much consolidation in recent years since the wave of changes of ownership in the electricity sector which gave rise to the present structure. Such consolidation as has happened was subject to UK merger control and was only cleared once a thorough competition analysis had been carried out. Centrica itself experienced the thoroughness of this process upon its acquisition of the Rough gas storage facility from Dynegy which was considered by the OFT and then by the Competition Commission.

3.2 To our mind, it is not the consolidation which has taken place within the UK to date which should be a cause for concern but instead the continuing consolidation across Europe within markets where competition is still extremely weak and where such consolidation reduces the number of potential competitors in other European countries. It is also of concern that such consolidations may not necessarily be subject to the same level of detailed scrutiny by other national competition authorities as we have experienced in the UK.

4. THE RELATIONSHIP BETWEEN THE WHOLESALE AND RETAIL MARKETS IN GAS AND ELECTRICITY

4.1 Wholesale price volatility has an inevitable and profound effect on UK retail prices given that around 50% of the customer's bill is the cost of the commodity. The remainder is largely fixed costs such as transportation and distribution costs which have risen by 7% or £14 alone this year and metering costs. Increasingly Government levies are an important component of the bill with the costs of the Renewables Obligation and the Carbon Emissions Reduction Target adding around £10 and £38 per annum respectively.

4.2 The chart below demonstrates how much of the retail gas price is made of the wholesale price and transportation and transmission costs. In our experience, the net margins made by the retail supply business for gas are at best a few pence per therm but the commodity price is over 40 pence per therm. What therefore really drives gas prices in our view is not retail margins, which have been consistently modest, but wholesale price movements²⁶.



4.3 By way of example, British Gas's average net margins over the last 6 years have only been 3.6% which is much lower than in many other industries.

4.4 We have responded to significant movements in wholesale gas prices and last March and April (2007) we announced two price reductions totalling 20%. However, very sharp increases in the wholesale cost of gas from spring onwards reduced British Gas's margins to just 1% and with wholesale prices at their current level British Gas would have been loss making in 2008 without our January tariff increase.

4.5 It is vital that Centrica as a group remains profitable in order to fund the billions of pounds we need to spend to secure vital sources of gas and power for our customers and to remain competitive in the future. By 2015, the UK will be importing around 75% of its gas from overseas²⁷. We have to be able to fund the acquisition of new assets and contracts to ensure that gas is available to our customers in the years ahead.

4.6 Acquiring and building more upstream gas and power capacity to reduce exposure to volatile markets is a key strategic priority for Centrica. We already have plans in place to invest £2-3 billion upstream from 2007-2010, but it is clear we will need to invest billions more in low carbon power generation by 2020 on

²⁶ Slide produced by Centrica

²⁷ Gas Transportation ten year statement 2007, National Grid p.37

top of this. This will include more renewables and more storage capacity and possibly new nuclear and clean coal power plants with carbon capture and storage, all of which can cost up to 3 or 4 times as much to build as gas fired generation.

5. THE INTERACTION BETWEEN THE UK AND EU MARKET

5.1 As mentioned in section 2 of our submission, the UK market is increasingly linked to the energy markets in continental Europe.

5.2 Since the construction of the Bacton-Zeebrugge interconnector, the UK gas market has effectively become more linked to a wider North West European gas market. As a result higher oil prices which typically set the gas price in Europe have fed into UK market prices as more gas is imported from Europe.

5.3 A report by Global Insight in August 2005 explained the implications of the oil-gas linkage as follows:

“The lack of effective liberalisation in continental gas markets and the predominance of long-term supply contracts have maintained the pricing of gas on an oil indexed basis across Europe. The persistence of this pricing link, which has meant that the level of European gas prices are generally isolated from underlying supply and demand dynamics, is the primary source of costs to the UK from its interaction with a less liberalised market. We have estimated that for the coming year (2006), this could cost end users of gas as much as £10 billion”.²⁸

5.4 Moreover, gas flows from the continent to the UK have been highly variable and difficult to predict given lack of transparency of information in EU markets. For example, gas flows information is currently published at less than 40% of the pipeline interconnection points in Belgium, Germany and the Netherlands. Contrast this with the UK National Transmission System, where inflows at the various terminals and sub-terminals are now made available every twelve minutes.

5.5 This unpredictability of flow has contributed towards a UK anxiety premium. For example, in Winter 2005/6 despite UK spot prices being as high as 200 pence per therm within day, we could not rely on European gas to flow into the UK. As recently as quarter four of 2007, Interconnector UK imports remained low despite high gas price differentials.

5.6 A recent example of this was Saturday 29 March, when there were relatively low levels of demand of around 300 mcm and prices peaked at 60.5 p/th on the OCM within day balancing market. Despite the within day market trading at more than a 5p premium to the forward month there were still no increase in flows from Europe coming through the Interconnector.

5.7 We believe that major continental suppliers have secured gas under long-term contracts at oil-linked prices, which effectively take precedence over gas being made available to the UK. The UK then becomes the swing destination for Norwegian gas with this supply acting like a supplier nomination contract. Our increasing import dependence means that the traditional gas on gas competition enjoyed in the UK as a result of a diversity of upstream gas suppliers is being superseded by oil-linked contracts from national oil companies within which the final destination of the gas can be varied.

5.8 In the last 100 days since 1 October, the Interconnector has exported more gas to Europe than it has imported, despite the wholesale price on occasions being over 3p/therm higher here than on the continent. Indeed, despite there being a + 3p/therm difference in the wholesale gas price in the UK compared to Europe at times, the Interconnector has not flowed into the UK at any higher than 26% capacity. In comparison, its highest export flow was around 66% on 16th October.

5.9 Until there is a well-functioning competitive wholesale gas market in North West Europe, players on the continent will use the UK as a gas supplier of last resort at short notice but may not be able or willing to provide the reciprocal service to the UK in response to price signals. In this way, the UK suffers from being the gas bank for North West Europe.

5.10 This situation is caused by physical and contractual congestion on the continent, limited co-ordination of “open season” processes, secondary continental markets that are hardly functioning as well as varying security of supply standards in continental Europe.

5.11 In this context we acknowledge the efforts of the European Commission who have been vigorously pressing for competitive energy markets in the form of ownership unbundling. This is opposed by some European Governments who are reluctant to accept this critical step in the transition to more competitive markets.

5.12 We have seen some encouraging signs such as the decision by Eon to divest their electricity transmission business in Germany which should give greater transparency and potentially improve access by third parties to key infrastructure. However, there remains strong opposition, led by France and Germany, to enforced ownership unbundling, and numerous obstacles to the realisation of the internal gas market in particular.

²⁸ “The UK Gas market—impacts of interactions with the wider European gas market”, Global Insight, August 2005

5.13 The French and Germans have pushed for a so-called “Third Way”. This is inadequate as it does nothing to address the serious concerns highlighted by the European Commission’s lengthy recent investigation into the energy market. These proposals even fall far short of how the European regulators group, ERGEG, recently suggested that the existing second package legislation should be implemented.

5.14 Effective unbundling of transmission, with ownership unbundling being the cleanest and most effective solution, is key to unlocking many of the current problems but it will not be enough. Unless there are strong and independent energy regulators whose powers extend to promoting competition in the wholesale and retail markets, there will not be sufficient confidence to ensure a properly competitive retail market.

5.15 Centrica warmly welcomes the package of reforms proposed by the European Commission late last year. We agree with the Commission that the necessary reforms also include increased market transparency to bring European information up to the very high levels found in the UK market, adequate access to gas storage and effective separation of distribution from supply, the latter not having had the attention it deserves.

5.16 Whilst it is important to implement these changes in electricity, it is even more critical in gas, particularly for the UK. A country can, if required, increase its own generation using a diversity of technologies. However, as gas import dependency grows, most countries are increasingly dependent on cross-border flows to access the significant volumes of gas just outside Europe’s borders. The best guarantee of adequate gas supplies from Europe into the UK is ownership unbundling of the gas transmission networks on the continent.

6. THE EFFECTIVENESS OF REGULATORY OVERSIGHT

6.1 Economic theory demonstrates, and competition authorities regard, competition as providing the best protection for consumers leading to better service, lower prices and/or a wider range of products or services. In the energy sector, given the monopoly nature of networks this must be coupled with soundly based price controls of network infrastructure, which accounts for a major proportion of the retail price. On network regulation in general, Ofgem has fulfilled its responsibilities in a broadly satisfactory and rigorous manner. It continues to develop a strong incentives based regime in this area as a proxy for competition. Whilst additional efforts are required in some areas, for example, cost of capital and gas quality, overall we support Ofgem’s approach in this area.

6.2 In the retail energy market, Ofgem’s regular reviews of the domestic market in the UK (for which all suppliers are required to provide information to Ofgem) continue to find competition in the retail energy market to be effective. This has been the case since Ofgem undertook analysis of the market which resulted in total removal of retail price controls over six years ago. Those price controls were removed because competition was found to be effective and capable of protecting consumers.

6.3 Since then the Competition Act has acted as the deterrent to anti-competitive behaviour underpinned by its strong information request powers coupled with the threat of significant penalties. Ofgem has exercised those powers in relation to a number of matters within the energy market.

6.4 Additionally, on each occasion that there has been consolidation in the energy market, this has been subject to analysis of the effect on competition at the time as part of the merger control process. Having been through the process itself, Centrica regards that process as robust and thorough. However, a separate consequence of the acquisition of UK energy retailers by European companies is that Centrica is now unique among the six major suppliers to the UK market in the level of segmental detail disclosed in its published accounts. To varying degrees, our competitors aggregate their operating performance by regions, market sectors and across the value chain with the result that it is not readily possible to determine their downstream supply margins in the UK market.

6.5 A number of activities within the energy market are licensed—with licence conditions supplementing competition law by setting out requirements relating to, amongst others, standards of service and customer protection. As with competition law, compliance with these licences is underpinned by the threat of investigation and penalties for non-compliance. The recent review by Ofgem of the supply licences to simplify them and make them more relevant to today’s market conditions was an exercise we welcomed and supported. The review was a natural one to undertake given the nature of established competition in the market.

6.6 In addition to competition law and the licence framework, there are a number of industry arrangements which support the competitive market—these are subject to separate governance arrangements and/or self regulation. In our view, some of the industry arrangements supporting the UK energy markets are complex and can be costly to operate for existing suppliers as well as potential new market entrants. Ofgem is currently reviewing the nature of industry governance in this area and we believe that is an appropriate exercise of its regulatory oversight. In this area, it is our view that aspects of the industry arrangements have become overly complicated especially in the electricity market, where for example 25 separate data flows are required to complete a customer transfer. However, we believe it is important to also recognise that whilst complex, some aspects of the arrangements reflect the complexities of market design rather than any undue or intentional barrier. The governance processes themselves are

becoming suffocated by the burden of maintaining over 10,000 pages of documentation and as a result parties may be deterred from initiating change proposals that would be of benefit to the market. Governance arrangements also differ sharply between codes, principally as a product of history rather than design.

6.7 Increased levels of self governance would be a positive step forward, particularly in areas where there is lower materiality, risk or contention. However, the issues of access and transparency would need to be properly addressed first. In addition, an enduring right of appeal to Ofgem must be in place for all matters that relate to industry arrangements.

6.8 In this area, we believe that the regulatory oversight should assist in ensuring that industry arrangements are proportionate and not over-complex. Given the presence of effective competition in the market, we believe that this is an appropriate focus for Ofgem.

7. PROGRESS IN REDUCING FUEL POVERTY

7.1 Much progress has been made in reducing the numbers in fuel poverty from 1996 when numbers stood at around 5.1 million²⁹. However, with higher energy prices and lower disposable income, the number of households in fuel poverty has been rising with the Fuel Poverty Advisory Group estimating that around 2.9 million people in England are in fuel poverty in 2007 of which 2.3 were vulnerable.³⁰ The Government's target to eradicate fuel poverty amongst vulnerable households by 2010 looks increasingly challenging.

7.2 Fuel poverty is part of a wider problem of poverty and social exclusion which has been exacerbated by above inflation increases in the prices of many foodstuffs and other essentials. Poverty is an issue for government and requires a focus on increasing the incomes of those most critically affected and improving housing. However, energy suppliers play their part through Government schemes such as the Carbon Emission Reduction Commitment (CERT), and through suppliers' own corporate social responsibility (CSR) activity.

CERT

7.3 Energy suppliers currently offer a range of programmes through the Carbon Emissions Reduction Target (CERT) programme to support the fuel poor. Under CERT, vulnerable households are eligible for free insulation and energy efficiency advice from their energy suppliers. The Government is anticipating that 2.5 million insulation measures will be installed in vulnerable households during the CERT period from 2008–2011 under a doubling of the previous programme. This could potentially save householders up to £200 per year on their fuel bills, a significant saving for a vulnerable household.

British Gas voluntary initiatives

7.4 British Gas is firmly committed to playing its part by helping its more vulnerable customers through voluntary programmes as part of our corporate social responsibility agenda and since 2002 we have helped over 1.3 million fuel poor customers. We contribute the most of all the energy suppliers towards fuel poverty measures. In fact, around £7 in every £10 spent by energy suppliers on vulnerable customers initiatives is spent by British Gas.

7.5 A recent report from energywatch reviewing the six main energy suppliers' voluntary initiatives for vulnerable and fuel poor customers found that "British Gas has and will have made the most significant voluntary commitment to measures to reduce the impact of fuel bills on its vulnerable customers". In addition, the report found that at 0.49%, British Gas already contributes the largest proportion of turnover of all suppliers with the next highest, EdF at 0.16% and npower and SSE at 0.07%.³¹

7.6 Energywatch has calculated that if all other energy suppliers matched British Gas' spend as a percentage of turnover, another £72.3million would be spent on fuel poverty.

7.7 British Gas' Essentials social tariff is the largest on the energy market and offers up to 750,000 of our most vulnerable customers access to our lowest standard rates which is monthly direct debit. We also delayed our recent price rise for 350,000 of our Essentials customers until after the worst of the winter months.

7.8 In addition, we have also extended our financial commitment to the British Gas Energy Trust for a further four years, bringing our total investment in the Trust to £21.3 million. The Trust provides grants and advice on energy efficiency to help customers in debt pay their utility bills.

7.9 This winter we have also offered 25,000 of our most vulnerable elderly customers an additional support package. This initiative includes free loft and cavity wall insulation, a credit of up to £90 and advice for customers on how to manage their energy use and finances.

²⁹ Fuel Poverty Advisory Group, Sixth Annual report for England, published March 2008

³⁰ The figures quoted are for England only and are estimated. The latest year for which actual figures are available is 2005. According to the Government's UK fuel poverty strategy, fifth annual progress report numbers in fuel poverty in 2005 were 2.5 million overall of which 2 million were vulnerable.

³¹ "Proportionality of social tariffs and rebates paper for energywatch", Cornwall Energy Associates (Jan 2008)

7.10 This commitment is in addition to an extensive programme of activity with our charity partners which include Help the Aged and Save the Children. For example, British Gas and Help the Aged are now in their eighth year of their strategic partnership to support the elderly and address winter deaths. More than £7 million has been invested in improving the lives of 1.9 million people.

2008 Budget proposals

7.11 In the Budget statement of the 12th March, the Chancellor announced that he wants suppliers to increase their spend on social tariffs from £50million to £150million per annum. He also stated that 5 million customers on prepayment meters should be given “a fairer deal.”

7.12 This announcement reflects a worrying tendency towards short-term fiscal interventions or now even the suggestion of price controls for certain groups of customers in what is held to be a competitive market. Such intervention is contrary to the spirit of liberalised markets and could undermine investor confidence and even risk jeopardising construction of the critical generation and gas supply infrastructure we need. The announcement also comes at a time when the Government has recently reduced its spending on fuel poverty by cutting the budget for Warm Front which it acknowledges to be its main weapon for tackling fuel poverty by 20%.

7.13 We remain opposed in principle to any form of social tariff mandation; however, if legislation is brought forward and social tariffs are introduced in the Energy Bill we believe that our Essentials social tariff, referred to above, should be used as the industry standard. At the time of writing, discussions are ongoing between Government, Ofgem and energy suppliers in an attempt to reach a voluntary solution.

Prepayment meter equalisation

7.14 With regard to prepayment meters it is important to note that prepayment is not synonymous with fuel poverty, as only 25% of customers on prepayment meters are deemed to be fuel poor. Prepayment meter customers incur a higher cost to serve for suppliers through higher rental charges for the meters themselves, collecting cash payments, providing a 24/7 contact service and managing higher call volumes. According to Ofgem figures, there can be as much as a £85 cost to serve differential for prepayment meter customers compared to direct debit and around £65 difference for standard credit.³² We believe this additional cost does not include the higher switching rates and therefore cost to serve of prepayment customers above.

7.15 Since the majority of fuel poor customers do not use prepayment meters, equalising prepayment meter tariffs to monthly direct debit would actually mean that the majority of the fuel poor customers—those not on prepayment meters—would end up paying more for their energy. This is because it would become more costly for energy suppliers to offer such low direct debit and standard credit prices as they currently do if they were forced to offer the same price to prepayment customers also (given the higher costs of serving prepayment meter customers).

7.16 Ofgem has raised this as a concern and has estimated that equalisation would make the 3 million monthly direct debit and standard credit customers who are fuel poor worse off, while only benefiting the small proportion of fuel poor customers that are on prepayment meters better. We would also give serious consideration to curtailing our targeting of prepayment meter customers for new business as these would simply drive higher losses.

7.17 In addition we believe that equalisation of prepayment prices to on-line direct debit is the wrong benchmark as our on-line product is a niche product with only 120,000 customers. If British Gas was compelled to equalise prepayment meter prices in this way, it is likely that we would stop providing the on-line tariff, which, if other suppliers followed, would threaten the business model for switching sites.

7.18 As mentioned above, British Gas’s Essentials social tariff already equalises tariffs for vulnerable customers on pre payment or cash/cheque payments to our lowest offline direct debit tariff. We have 350,000 Essentials accounts to date and are committed to increase this to 750,000 by 2010. We are happy to have further discussion on the potential to rollout Essentials as a model for the industry standard.

7.19 Ofgem is currently conducting a review of price differentials and we are feeding into this process. They are also holding a summit on fuel poverty in April to which we will be contributing. We believe that this is the most appropriate forum for a proper and considered dialogue around the best and most appropriate way to help the fuel poor so that suppliers and Government resources can be targeted at those who need it most.

³² Ofgem, Domestic Retail Market Report, June 2007, pg: 28-29

Role of Government

7.20 Identifying vulnerable and fuel poor customers has always been a challenge for the industry and it is keen to share more data with Government Departments to help improve targeting. Currently there is huge wasted effort and cost associated with searching for these customers and without access to benefits data to more accurately target eligible households these costs will escalate substantially. We have been attempting to work with the Department for Work and Pensions to achieve a greater level of access to its benefits data to enable us to better target the fuel poor. If successful, this will help to ensure that a greater proportion of the money invested in addressing fuel poverty goes to providing financial assistance rather than to funding targeting and marketing initiatives by suppliers which are currently inefficient.

7.21 Government aid could also be more efficient if better targeted. A recent study undertaken by the London School of Economics on behalf of the British Gas Help the Aged Partnership shows that individual pensioners could be losing up to £50,000 on benefits over a lifetime by not claiming their entitlement. These benefits currently sit in the Government's pot of £4.5 billion unclaimed benefits for older people, but 1 in 3 pensioners are not aware of who to turn to for help and advice on how to access these entitlements which could amount to between £5,000 and £50,000 per individual over a lifetime.

7.22 Currently everyone over the age of 65 receives an annual payment of £200 increasing to £300 for the over 80s, irrespective of income. This contribution goes some way to cover the annual cost of energy bills but often is not used to pay energy bills. We believe that winter fuel allowance should be paid directly to suppliers so that we can offset this against their energy bills.

CONCLUSION

Centrica believes that both the UK's retail and wholesale markets are operating competitively and are working in the best interests of customers. With amongst the cheapest energy prices in the EU, high rates of switching and suppliers offering a wide range of innovative products and services, the presence of six major competitors in the retail market is more than sufficient to sustain effective competition.

The UK's competitive market has responded to declining North Sea gas reserves by bringing on significant investment in new sources of gas. However this new capacity has not translated into equivalent gas volumes, leading to significant volatility in the market and rising wholesale gas prices. This has been compounded by the relatively low levels of gas storage in the UK. Increases in wholesale gas prices have also contributed to high electricity prices.

Wholesale costs account for around 50% of the customer's bill; therefore volatile wholesale markets have had an inevitable impact on consumer prices. Centrica has been quick to pass on reductions in wholesale costs to consumers. However it is vital that the company remains profitable in order to fund the billions of pounds needed to secure vital sources of gas and power for our customers.

We do, however, have continued concerns about the limited transparency in continental gas flows. The UK's market is increasingly linked to continental energy markets and a lack of transparency about continental gas flows has added to an anxiety premium in the UK market. In addition, lower than expected flows from Norway has exacerbated the problem.

Although we welcome the progress the European Commission has made to date in pressing for competitive EU energy markets, effective ownership unbundling with strong and independent energy regulators remains crucial to ensure competitive retail markets in the UK. The limited consolidation in the UK's energy market has been subject to rigorous scrutiny by the competition authorities, which is in stark contrast with the continent, where entry into the market remains difficult.

In these difficult times for the energy market, we remain firmly committed to playing our part in helping the Government meet its increasingly challenging fuel poverty targets. British Gas contributes the most of any supplier to voluntary initiatives and our *Essentials* social tariff is the largest on the energy market.

We remain opposed to any moves by Government to mandate social tariffs and believe that any short-term fiscal intervention in the market is contrary to the spirit of liberalised markets. We also believe that any move to equalise prepayment tariffs rates could have an adverse impact on fuel poverty as only 25% of prepayment meter customers are fuel poor.

Going forward some form of data-sharing with Government remains crucial to ensure that those eligible can access the help available to them in the most cost-effective way.

Supplementary evidence submitted by Centrica

1. *British Gas typically moves first when prices increase*

It is not true to say that the first mover is typically British Gas. In the last four years, the only time when we have “moved first” was in 2007 when we were the first to reduce prices and the only supplier to reduce them twice—by a total of 20%.

Recent evidence shows that we have not led on price increases. For example:

- 2008: npower announced first on 4 January, then Edf 15 January, then British Gas.
- 2006 half 2: Scottish Power led 22 June, Edf followed on 24 July; British Gas were third to move.
- 2006 half 1; Scottish Power led 9 February; Edf followed 15 Feb; British Gas were again third to move.
- 2005; Powergen moved first 21 July, Edf followed 29 July, British Gas moved third.
- 2004; Powergen and Edf again both announced before British Gas.

2. *UK liquidity compared to Europe*

According to Gaselys (a French owned energy trading company) around 90% of European gas liquidity comes from the UK. We have, however, observed that there is lack of long-term liquidity. This may be due to the fact that significantly greater price volatility in the UK has contributed to producers’ reluctance to sell further out.

The UK power market is not as liquid as gas but it is still amongst the most liquid. Though on some measures it is likely that the German market might appear more liquid than the UK, the markets are not directly comparable. In the UK, the only link to other countries is through the France-GB Interconnector, which is 2,000MW (the GB-Ireland Interconnector could be considered an additional 400MW). Contrast this with Germany which has over 17,500MW of interconnection with eight different countries.

In order to get a fair comparison of liquidity between UK and German markets these significant structural differences would need to be considered and would certainly make the UK power liquidity picture look much more favourable than the initial numbers would suggest.

3. *We are increasingly becoming dependent on global sources of gas*

In 2007, approximately 27% of UK gas had to be imported to meet demand. This year, we expect it to be nearer 40%. The UK is no longer a “gas island”. We are increasingly interconnected via pipeline and LNG so that the UK wholesale market gas price (and the pricing of gas supplies contracted on a market index base linked to oil) is more and more influenced by the wider European/global supply, demand and pricing position. We would support the decoupling of oil and gas in European contracts which is adversely affecting UK wholesale prices and leading to higher prices.

4. *Benefits of vertical integration*

Vertical integration through asset ownership and/or by contract is a natural reaction to power price volatility as it helps companies to manage wholesale price volatility and provides greater certainty in customer prices. As a result, all the six major energy retailers are vertically integrated to a certain degree, though Centrica is the least vertically integrated of all suppliers. Despite this degree of vertical integration, it is important to note that over 40% of the generation market is held by independent generators without significant residential market positions.

5. *Switching amongst prepayment meter customers*

Contrary to the perception that prepayment meter customers do not switch, recent evidence from Ofgem indicates that in 2007 prepayment meters customers switched at least as much as those that pay by direct debit, while standard credit customers switched less frequently. The figures are as follows:

	<i>Gas</i>	<i>Electricity</i>
Direct Debit	21%	21%
Prepayment	23%	20%
Standard Credit	13%	12%

This trend of prepayment meter customers actually switching more than others is entirely backed up by our own data.

6. *Prices in Great Britain are systematically rising much more quickly than in Europe*

According to the BERR's latest Quarterly Statistics, the estimated average domestic gas prices including taxes in the UK for medium customers as at 1 January 2008 were the lowest in the EU 15 and were 45.3% lower than the median.

Similarly, the estimated average domestic electricity price including taxes in the UK for medium consumers as at 1 January 2008 was the second lowest in the EU 15 and was 33.6% lower than the median price.

Whilst these figures do not take account of the retail price increases earlier this year, neither does it include European price increases. In Germany, where energy bills are already amongst the highest in Europe, gas prices are set to rise 20% this year whilst the electricity price is expected to grow by a minimum of 10%.

24 June 2008

Supplementary evidence from Centrica

1. UK/EU PRICE COMPARISONS

In our original written submission to the Select Committee, we referred to BERR's Quarterly Energy Statistics published in March 2008. Quarterly Energy Statistics covers estimated gas and electricity prices to UK and EU domestic and industrial consumers. BERR have recently updated this document to include estimates of prices between January and June 2008. This can be summarised as follows:

- For gas, BERR Quarterly Energy Prices (published 26 June 2008) show that estimated average domestic gas prices, including taxes, in the UK for medium consumers from January to June 2008 were the lowest in the EU 15 and were 45.1% lower than the median.
- For electricity, BERR Quarterly Energy Prices (published 26 June 2008) show the estimated average domestic electricity price including taxes in the UK for medium consumers for January to June 2008 was the 5th lowest in the EU 15 and was 12.5% below the median price.

2. ACTION TO ADDRESS PREPAYMENT METER DIFFERENTIALS

- British Gas is the only supplier to have created a standalone business to focus on prepayment customers and we fully intend to pass improvements in our operating costs through to our customers to allow us to close the differential between cash/cheque and prepayment.
- British Gas currently has 2.3 million prepayment meter customers. Our priority is to offer these customers improved service in a number of different and unique ways. For example, British Gas operates its own 24 hour contact centre service for customer emergencies with dedicated, trained customer service advisors to ensure continuity of our prepayment customers' supply. No other energy supplier currently offers this service.
- We have up to 35% more pay outlets than our competitors—for many customers convenience/access to outlets is important.
- We are innovating and we have launched the first online prepayment tariff which will see prepayment dual fuel prices fall by 6% compared to off line prepayment prices. For customers moving to this online tariff will see an average dual fuel bill fall from £1,143 to £1,073, a saving of £70.
- Our Essentials tariff is the largest social tariff in the UK and allows eligible customers to equalise their prepayment prices with our lowest standard tariff—Monthly Direct Debit. This equates to an average saving of around £161.
- Centrica also believes that prepayment meter customers will benefit from the introduction of smart meters and that the improved functionality of smart meters will remove prepayment differentials.
- We expect that smart metering and the introduction of new e-payment and website technology should sweep away high cost to serve practices such as cash collection costs, payments to retail outlets within today's high prepayment meter model.
- British Gas is uniquely trialling 115 electricity prepayment meters in Manchester using e-payment technology. Results from this trial show consumers prefer e-payment facility and a reduction in cost to serve.
- We want to use our experience from this trial for our general smart meter programme.
- However, we believe more work needs to be done to perfect and improve on the technology and systems and we see the roll out to prepayment meter customers as an integrated part of a wider universal roll out.

- Ultimately we want our meters to be switchable between prepayment and credit which we believe will grow the prepayment meter market with customers choosing to take a range of value added offerings.

3. EU EMISSIONS TRADING SCHEME AND WINDFALL PROFITS

- The table below shows the total allocation of free allowances that each of the six energy suppliers are scheduled to receive over Phase II of the EU ETS which runs from Jan 2008 to December 2012. It clearly shows that Centrica benefits least from the allocation of free allowances. It is also important to note a couple of key points:
- “Profit” is only made for Phase II as we are expecting full auctioning from phase III for generation sector—Centrica has been calling for full auctioning for a number of years. We were also calling for the auctioning of the maximum 10% of allowances allowed under Phase II of the scheme. The Government has stated only 7% will be auctioned.
- Centrica would support the revenues from the 7% auctioning of allowances under Phase II and from the 100% from Phase III being recycled to support low carbon and fuel poverty objectives. The CBI estimate the sale of the 7% auctioned EU ETS allowances would raise £1.6 billion.

FREE ALLOWANCES UNDER EU ETS

	<i>Value of Free Allowances (£m)</i>		
	<i>Ph II allocation (kt/yr)</i>	<i>Annual average phII</i>	<i>Total phase II</i>
Centrica	4,765	98	492
E.on	13,434	277	1,386
EdF	10,956	226	1,130
RWE	12,321	254	1,271
Scottish Power	10,029	207	1,035
SSE	13,795	285	1,423
Total for big 6	65,300	1,347	6,737
Total in Power sector	104,000	2,146	10,730

Note: calculations are based on current carbon price of €25/t and an exchange rate of 1.25.

- Centrica receives comparatively low allowances as a result of its ownership of clean sources of power generation. These are supported by its gas-production assets. Centrica experiences a high incidence of additional “windfall” taxes on the value of gas produced by its principal fields which are subject to a higher tax rate of 75%. Its clean power generation therefore comes at an additional tax price not shared by the rest of the industry.

“WINDFALL” TAXES SUFFERED (£’M) 2008–12

	<i>PRT</i>	<i>SCT</i>	<i>Total</i>	<i>%</i>
Centrica	1,271	501	1,772	89
E.on	8	111	119	6
EdF	0	0	0	0
RWE	13	76	89	5
Scottish Power	0	0	0	0
SSE	0	0	0	0
Total for big6	1,292	688	1,980	100
Total in Power sector				

Note: Figures for windfall taxes (ie those in excess of the UK statutory corporation tax rates for large companies) have been obtained from published Wood Mackenzie data and estimates.

- We believe that it is important that talk about windfall taxes on profits is seen in the context outlined above. Centrica will be investing £1 billion per annum in new gas and power assets in the next three years and it is vital that this investment is not undermined especially at a time when the UK is facing a generation gap as a result of the closure of coal and nuclear fleets.

Memorandum submitted by Chemical Industries Association

SUMMARY

The Chemical Industries Association is pleased to have the opportunity to make a submission to the Committee and highlight our continuing concern over the high and volatile prices prevailing in UK wholesale energy markets.

We represent around 150 of the mostly larger producers in the chemicals sector, which in 2006 had a total turnover of around £57 billion and a trade surplus of £7 billion. Further details are in the Appendix at the end of this submission.

Below we provide a background section explaining the main features of UK energy markets, and then go on to consider specific issues of concern to our members.

In summary, we conclude that fundamental market characteristics provide scope for anti-competitive behaviour in UK energy markets. These include the fragmented nature of supply, lack of storage capacity and lack of transparency in some key import sources, all of which add to market nervousness and volatility, which in turn encourages speculation. Suppliers have little motivation to secure extra physical supplies of gas on a long term basis, since they may lose contracts with customers; conversely customers feel they are offered little choice of contract. There is an uneasy stalemate and most contracts are tied to the spot price. Vertically integrated suppliers have a vested interest in maintaining high prices. Longer term contracts could benefit both sides.

The proximity to a Continental market run on very different principles is costing the UK dear. While the Continent has a large element of long term contracts and some price predictability thanks to a system of retrospective adjustment to an index based on a basket of oil product prices, the UK works on a short term basis and industrial customers are forced to rely mainly on spot buying. The same vertically integrated suppliers largely control flows of gas between the UK and Continental markets. While the UK is open to Continental buyers, the Continent is largely closed to the UK.

Our members are finding instances of less competitive behaviour: there is a tendency for fewer competing tenders at contract renewal, and these vary little. They sense the market may be being manipulated at certain times—instances appear in paragraph 15 below. They cannot directly access cheaper Continental gas to ship back themselves.

BACKGROUND

1. We first outline in paragraphs 2–10 below why the question of energy prices and security is so important to the chemical industry, why gas in particular is a focus of concern, and why we believe features of the present market arrangements lead to less than satisfactory competition and can leave customers less than well served.

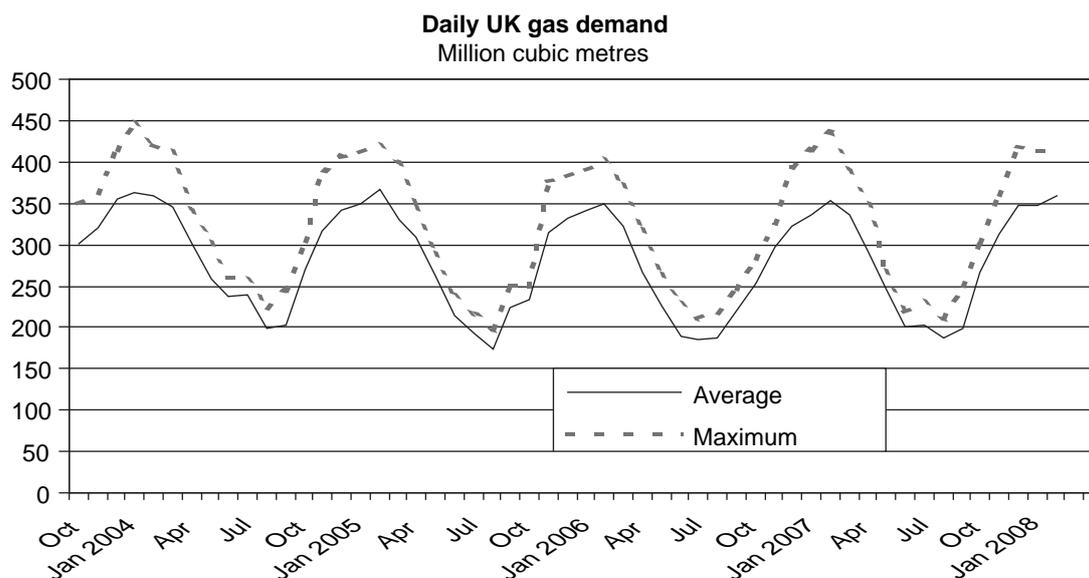
2. The UK chemical industry operates in fiercely competitive global markets. The industry is also global in ownership, with over 65% of CIA's membership being foreign "headquartered". Investment decisions are therefore mostly made overseas. Any significant imbalance between the UK business climate and other markets can lead to the loss of UK trade and investment.

3. Key "building block" products are made using raw materials purchased at global prices and are sold as commodities likewise at global prices. Companies compete on the efficiency of the conversion processes, which are frequently energy intensive. Gas also serves as a raw material for fertiliser manufacture. Intermediate products are widely used by downstream speciality chemical companies, who thus indirectly feel the effects of high energy prices, even if their own operations are less energy intensive. Finished products of the industry are used as industrial components, for example in automotive manufacture, as process enablers, for example in textiles and paper manufacture, and as consumer products such as detergents, paints and pharmaceuticals. Access to internationally competitively priced energy and gas as a feedstock is therefore vital to the viability of the UK chemical industry. Consequently the members of this association take an exceptionally keen interest in energy markets and employ skilled manpower and devote considerable senior management time to energy purchasing.

4. Crude oil and refined products are easily transported. There is a true global market and essentially common prices apply (disregarding local taxation differences.) The same is not true of gas, whose delivery depends on expensive pipeline infrastructure or liquefaction facilities at source (LNG—liquefied natural gas) and specialised ships to transport LNG to purpose built receiving terminals. Globally, significant price differences occur, and access to the transport infrastructure is vital if competition is to be given full rein. In the UK a large proportion, around 40%, of electricity generation is also dependent on gas, underlining the importance of a competitive gas market.

5. As North Sea reserves are slowly being exhausted, the UK market is becoming increasingly dependent on imported gas. The main import routes are pipelines from Norway (Langeled and Vesterled), the Netherlands (BBL), and Belgium (Interconnector). LNG can be imported at Isle of Grain; additional facilities at Milford Haven are nearing completion. Existence of import capacity does not, however, guarantee a flow of gas. While Langeled, Vesterled and BBL have flowed consistently, almost no LNG has come through Isle of Grain in 2008, and net inflows along the Interconnector have been negligible—from 1 October to mid-March they averaged only 1.1 million cubic metres (mcm) per day, compared to UK demand of about 325 mcm. It has been a long standing concern that gas has not flowed to the UK from the Continent via the Interconnector when market prices suggested it should. Conversely, the Interconnector has sometimes exported gas from the UK even while gas was being taken from storage to meet UK demand.

6. UK gas demand has a strong seasonal component, as demonstrated by the following chart³³:



There is a large variation in summer and winter demand, almost entirely due to changing heating requirements for domestic and commercial premises. Industrial process use, in contrast, is quite stable. Unfortunately the UK is not well supplied with storage capacity—the main “long term” storage facility, Rough, can provide only 45 mcm per day (less than 15% of average winter daily demand) for 70 days. Drawing on “medium term” storage can double this daily flow, but for fewer than 20 days, since Rough represents around 80% of storage by volume. Consequently the UK needs a large seasonal increase in imports just when the rest of Europe has maximum demand. Our storage capacity is manifestly inadequate given our present and expected increasing future dependence on imports.

7. Suppliers are not required to hold any physical gas in store; all assume they can “go to the market” if needed. If contracts with users are linked to the “spot” price, the shipper runs no risk. Supply and demand will ultimately balance as demand is choked off by higher prices—and with disastrous consequences for industrial customers, who help to provide the euphemistically named “demand side response”. Forward contracts are either unavailable or have such a large risk premium that chemical industry users cannot afford to buy/use gas at that price, and of necessity rely largely on spot-linked contracts. When prices spike they are forced to reduce or even cease production.

8. Many suppliers are part of a larger vertically integrated energy company. Despite “Chinese walls” the shippers do not always have an obvious interest in trying to win market share if this involves increasing supplies to the market and thereby reducing the price of the commodity their parent produces.

9. All in all the combination of uncertain supplies from the Continent and of LNG, and the UK’s limited storage capacity, create a sense of nervousness in the wholesale gas market which is reflected in high forward price premiums and frequent spikes in spot prices whenever the UK is hit by a spell of severe weather, or if there is reported or rumoured interruption to supplies, for example damage to pipelines. Against such a background it becomes easier to create perceptions of shortage which lead to higher prices to the benefit of integrated suppliers.

10. Because of the high proportion of gas fired generating capacity, any increase in the wholesale gas price feeds directly through to electricity prices.

³³ Data from National Grid Monthly Reports.

SPECIFIC ISSUES OF CONCERN TO OUR MEMBERS

11. *Market transparency*

Despite improvements in recent years, transparency in markets remains less than ideal. This applies in particular to conditions in Norway, and the reasons for flow variations along the Langed and Vesterled pipelines are not clear. Much of the Continental European system remains opaque; volumes of gas in storage are not readily obtainable, certainly not on a timely basis. Flow capacity constraints within Europe are not always known. This serves to increase uncertainty and volatility in the UK market.

12. *Impact of interface with Europe*

The principal link with the UK market, the Interconnector, does not always behave in a manner consistent with price differentials in the markets. There is an uneasy meshing of the UK's liberalised market with the much less free market on the Continent. Gas prices there are often linked to an index based on a basket of oil products, and adjusted every six months in arrears. Many suppliers on the Continent operate in the UK market too, but their relative priorities are unclear. In practice they determine flows of gas—in both directions—through the Interconnector. Their motivations for not taking advantage of the opportunity to sell gas at a higher price in the UK are likewise unclear, since the precise forms of contract with Continental customers are not known. There may be penalties for failure to supply; stocks in storage appear to be guarded until later in the winter. However, they are free to take gas from the UK market, and frequently do, even in our winter, as our own stored gas is being drawn down.

Views recently expressed by Centrica's chief executive, Sam Laidlaw, reflect these concerns. Speaking at a conference in Amsterdam on 5 March, he commented that the UK was in danger of becoming a "gas lender of last resort". He observed that some governments in Europe were reluctant to open up their energy markets, which had led to insufficient gas flows to Britain. Without further liberalization of European markets, "Europe will continue to use the UK as a main source of gas at short notice, but may not be willing to provide gas to the UK when the UK needs it".³⁴

Major gas consumers are further frustrated by being unable to use spare import capacity through the Interconnector if they attempt to buy gas on the Continent to use in the UK. Many have manufacturing operations in Europe and know they can buy gas more cheaply there, but find that the charge to bring such gas back to the UK precisely offsets any gain from the price differential, despite the marginal cost of transporting gas through the Interconnector being very low (around 1p/therm.).

13. *Contracts available*

Lack of choice in contracts is a major issue. Members report that when they put up their supply contracts for renewal, the number of replies has tended to fall in recent years. For major industrial users the wholesale price of gas represents around 95% of the delivered cost, and suppliers differentiate themselves only on the remaining 5%. Even here variations are small.

14. *Low utilisation of import capacity*

It is frustrating for consumers to see import facilities not being used even when UK prices are high. OFGEM is aware of concerns over the lack of use of the Isle of Grain facility, which as observed above, has essentially been unused so far in 2008. Third parties find access extremely difficult to arrange, and OFGEM appear so far to have been thwarted in their efforts to secure better access.

15. *Members' examples of unsatisfactory market features*

In response to a CIA questionnaire undertaken to assist the formulation of this submission, responses included:

- "Lack of storage, and high level of speculation around supply problems, be they real or perceived, or possibilities that may or may not occur, result in the price being far too sensitive in the UK. This inevitably results in inflated higher market prices and unstable conditions. Traders/Market reactions to these 'problems' seem quite disproportionate to the reality and there is a real sense of 'playing the system' at the expense of the end consumer".
- "No competition between suppliers (even when several offers are received), since differentiating factors between suppliers operate on less than 5% of the total contract cost, thus resulting in no motivation for changing supplier. No long term offers means no visibility either for industry or for the supplier and thus impossibility for long term investments".
- "It's broken—too volatile, too much speculator involvement, too influenced by non-UK energy companies who exploit our market freedom, whilst defending their home market rigidity".

³⁴ As reported by Bloomberg news agency, 5 March 2008.

-
- “There are too many players who can manipulate market prices without having to suffer the consequences of buying daily energy. Why does the Bacton pipeline [*from Belgium*] frequently flow counter intuitively (why when Rough fell over did Germany & France accelerate filling already adequate storage and prevent gas flowing to the UK)? Why do within-day Norwegian flows to Easington change suddenly at sensitive trading slots? How many bull runs on the gas market are triggered by speculators? How few gas trades are made by industrial buyers? How frequently does electricity generation switching fuels to/from gas accelerate market swings? How often does the UK’s lead in energy/carbon markets reform disadvantage UK manufacturing eg electricity generators were able to pass through all their EU ETS exposure (leading to a step increase in costs by 7%³⁵)”

16. Ranking of issues

When asked to rank the order of importance of various factors influencing UK market competitiveness, this was the result:

- 1 = Lack of UK storage
Lack of access to Continental markets
- 3 = Lack of pre-contracted LNG
Inadequate transparency of Norwegian gas flows
Access arrangements at LNG terminal

These are the issues we would ask the Government to address.

17. Damage to UK industry caused by present state of UK energy market

CIA asked members what steps they were taking to mitigate the impact of high energy prices. All are endeavouring to be more efficient in their energy usage, but other more worrying measures were mentioned too. Responses included:

- “Greater focus and effort on gas/electricity purchasing activity (we have no choice and this is an additional cost to our business), continuous energy efficiency, production shift overseas”.
- “Not only have we shifted manufacture from UK and mainland EU to Asia, we are losing significant parts of our US & Australian markets to Asian manufacturers with higher carbon footprints”.
- “Our company has clearly been shifting production and investment overseas, becoming every day a smaller and smaller industrial and energy player in the UK”.

We could add here that climate change measures which disproportionately affect UK (and possibly other EU) manufacturers, for example being forced to buy allowances at auction, rather than receiving a free initial allocation under the Emissions Trading System, can only accelerate the exodus. Moreover, auctioning has no impact on the incentive to reduce emissions: however allowances are acquired, their value at the margin remains the same when the cap is fixed.

CONCLUSIONS

18. Any anti-competitive behaviour taking place in UK energy markets is being facilitated by fundamental market characteristics. These include the fragmented nature of supply, lack of storage capacity and lack of transparency in some key import sources, all of which add to market nervousness and volatility. This in turn encourages speculation. Suppliers have little motivation to secure extra physical supplies of gas on a long term basis, since they may lose contracts with customers; conversely customers feel they are offered little choice of contract. There is an uneasy stalemate and most contracts are tied to the spot price. Longer term contracts could benefit both sides. Vertically integrated suppliers have a vested interest in maintaining high prices.

The proximity to a market run on very different principles on the Continent is costing the UK dear. While the Continental market has a large element of long term contracts and predictable price levels (at least over six months, given the retrospective adjustments), the UK works on a short term basis and industrial customers are forced to rely mainly on spot buying. The same vertically integrated suppliers largely control flows of gas between the UK and Continental markets. While the UK is open to Continental buyers, the Continent is largely closed to the UK.

³⁵ One member’s direct experience. The impact in percentage terms will vary according to the carbon price, the extent to which this is passed on (and evidence so far suggests usually in its entirety) and the “base” level wholesale electricity price. At a recent presentation to a BERR/DEFRA meeting, another member estimated that EUETS Phase 3 could add as much as €20–€25/MWh to UK electricity prices.

APPENDIX

CIA CREDENTIALS

The CIA is the leading representative and employers' body for the UK chemical industry, with 150 members at over 200 manufacturing sites. Some sites produce bulk chemicals by energy intensive processes; others make smaller volumes of speciality chemicals. Almost all depend upon energy inputs at some stage of their operations.

Turnover of the UK chemicals sector in 2006 was £57 billion (including merchant goods). It accounted for 1.5% of UK GDP and almost 12% of manufacturing's gross value added. [*Source: Office for National Statistics (ONS), Annual Business Inquiry.*] It employs some 185,000 highly skilled people directly and supports several hundred thousand jobs throughout the broader economy. The chemical industry typically contributes an annual surplus of £5 billion to the UK's balance of payments [*Source: ONS*]. The industry is global both in terms of markets and ownership, with over 65% of CIA's membership being foreign "headquartered". Any significant imbalance between the UK business climate and other markets can therefore lead to the loss of UK trade and investment.

The industry is one of the most energy intensive sectors of the economy, and accounts for 22%³⁶ of total industrial energy consumption. Gas is also used as a feedstock for making many chemical products, including fertilizers. The industry's annual combined energy and feedstock bill amounts to an estimated £2.5 billion.³⁷ The industry has an excellent record of improving energy efficiency. As part of its ongoing commitment to energy efficiency, the CIA is part of a negotiated Climate Change Agreement with UK Government to deliver an aggregate improvement in efficiency of 34% between 1990 and 2010. A significant proportion of these improvements have already come from additional Combined Heat and Power (CHP) plants and the chemical industry now generates over 30% of its own electricity requirements, most of which is from CHP.³⁸

27 March 2008

Memorandum submitted by the Citizens Advice Bureau

EXECUTIVE SUMMARY

1. Citizens Advice is very pleased to be able to contribute to the select committee's timely inquiry into the uncompetitive character of the energy market and energy prices. Our comments focus predominantly on part of the inquiry which deals with "progress in reducing fuel poverty and the appropriate policy instruments for doing so." In particular, we consider the impact that rising energy prices have had on CAB clients, who are often among the most vulnerable members of society, and the consequent growth in the level of fuel debts.

2. The recent announcements made in the 2008 Budget statement were very welcome since they heralded a determination to secure a narrowing of the differential between fuel prepayment meters and other prices, an increase in the Winter Fuel Allowance, and plans for a significant increase in fuel suppliers' social programmes. The three-fold increase in the amount spent on social programmes by suppliers—from £50 million a year at present to at least £150 million per year over the period ahead—offers the potential to make major progress in tackling fuel poverty. Yet to truly make a difference it will be imperative that this increase in spending is overseen to ensure that it is spent in the most effective ways.

3. In our view the interventions announced in the Budget statement are overdue and very much required. Citizens Advice has for some time called for more action to help those on low incomes who are struggling to cope with rising fuel bills, for example by calling on fuel companies to equalise the difference in tariffs between prepayment users and direct debit customers.

4. CAB evidence shows that many people are struggling to heat their homes and that a broad and sustained programme of remedial measures is taken to tackle this problem and supplement the announcements made in the recent Budget. This should comprise:

- extension of the Winter Fuel Payment to other vulnerable groups who currently are excluded from the scheme;
- a comprehensive benefit take-up campaign be launched—this approach has a proven track record in delivering significant benefits to large numbers of people in fuel poverty in the most cost-efficient manner; and

³⁶ Source: BERR "Energy Consumption in the United Kingdom", as updated July 2007, Chart 4.2.

³⁷ Extrapolated from 2004 input-output data from the Office of National Statistics.

³⁸ Source: BERR, Digest of UK Energy Statistics, Chart 5.2 (electricity usage) and Table 6.8 (CHP output).

- an increase in the funding of the Warm Front programme, plus resolution, as a matter of urgency, of the significant problem of funding shortfalls for Warm Front and the consequent need for top-ups from eligible consumers, which currently undermines the impact of the programme.

INTRODUCTION

5. The Citizens Advice service provides free, independent, confidential and impartial advice to everyone on their rights and responsibilities. It values diversity, promotes equality and challenges discrimination. The service aims: to provide the advice people need for the problems they face; and to improve the policies and practices that affect people's lives.

6. The Citizens Advice Bureaux (CAB) network is the largest independent network of free advice centres in Europe, providing advice from over 3,200 outlets throughout Wales, England and Northern Ireland. We provide advice from a range of outlets, including GPs' surgeries, hospitals, community centres, county courts and magistrates' courts, and mobile services both in rural areas and to serve particular dispersed groups.

7. In 2006/7, the CAB service dealt with 5.7 million enquiries on the whole range of issues bureaux give advice on, including 1.7 million on debt.

8. The CAB service has seen a significant increase in inquiries on fuel issues over recent years. In 2006/07 we received 60,000 new enquiries specifically about fuel debts—an increase of 33% on the previous year. In addition, the service dealt with 47,000 enquiries about a range of other fuel matters, a 74% increase on 2005/06.

THE IMPACT OF RISING PRICES ON CONSUMERS

9. The recent spate of large price rises announced by all the major fuel suppliers means that consumers have seen massive rises in their annual energy bills, with energy prices currently about 50% above their 2003 levels in real terms. Such hefty price rises are hitting vulnerable people and those on low incomes particularly hard, especially since they have been accompanied by rises in other essential expenditure—rises which show no sign of slowing, for example water and sewerage bills are set to rise by an average of 5.8% for the average household from April 2008 while council tax bills will increase on average by 4.0% in England in 2008–09.³⁹

10. Benefit income and wages have failed to keep pace with such increases and their impact can be seen in the significant rise in the number of enquiries relating to fuel debt and disconnection dealt with by Citizens Advice Bureaux. Annual statistics released by Citizens Advice for 2006-7 reveal that many hundreds of thousands of people are increasingly struggling to meet their day-to-day living expenses, with problems relating to gas and electricity debt shooting up by 33% on the previous year. More recently, new figures released by Citizens Advice about debt problems dealt with in the first two months of 2008 reveal continuing increases in problems relating to basic essentials such as gas and electricity, water, telephone and council tax debts.⁴⁰

11. In addition, energywatch found that a comparison of the same three-month period in 2004 and 2007 shows there has been a 64% rise in consumers owing more than £600 on their electricity bills and an 19% rise in consumers owing more than £600 on their gas bills.⁴¹

12. Large price rises have reversed some of the progress previously made in eradicating fuel poverty, with the Fuel Poverty Advisory Group's (FPAG) annual report 2007 stating that "it is likely that in 2007 there were about 2.9m households and 2.3m vulnerable households in fuel poverty in England—the highest levels for nearly a decade."⁴²

13. The increased flow of individual cases reported by CABx describing how clients are struggling to make ends meet demonstrates the difficulties faced by people on low fixed incomes in attempting to cope with massive rises to their fuel bills:

A CAB in Buckinghamshire reported that their client, a man with long term physical and mental health problems, came to the CAB for money advice since he had a number of priority debts to sort out. The client is in receipt of short term, lower rate incapacity benefit of £59.20 per week but his ongoing payments for gas, electricity and water account for approximately half his weekly income. Since it is difficult for him to meet essential expenditure and have sufficient available income to offer creditors, he has made the decision to not use his gas heating as he says he cannot afford to pay this and his other priority commitments.

A Lincolnshire CAB reported a case in which their clients, a young couple in their twenties in rented accommodation with good jobs and a 2-year-old child, had been managing to repay debts which they had previously accumulated. However, the spate of recent household fuel rises have

³⁹ Oral Statement by John Healey MP, Minister of State for Local Government, Department for Communities and Local Government, 27 March 2008

⁴⁰ Many more seek help with mortgage arrears—new Citizens Advice figures, Citizens Advice, Press Release, 18 March 2008

⁴¹ Serious energy debt taking toll of consumers, energywatch, Press Release, 25 January 2008

⁴² Fuel Poverty Advisory Group—Sixth Annual Report, 2007, p.4

tipped the balance of their precarious finances and pushed them into a state where they cannot afford to maintain their repayments at current level. As a consequence they are sinking deeper into debt.

A Leicestershire CAB client, a disabled man in his fifties, came to the bureau for assistance because he was extremely worried about paying his electricity bill. His electricity supplier had increased their prices by 34% in the last year, meaning that the client was now unable to afford regular electricity payments and was faced with the prospect of getting into debt or self-disconnecting from his electricity supply.

A CAB in Buckinghamshire reported that their client, a man with long term physical and mental health problems, came to the CAB for money advice since he had a number of priority debts to sort out. The client is in receipt of short term, lower rate incapacity benefit of £59.20 per week but his ongoing payments for gas, electricity and water account for approximately half his weekly income. Since it is difficult for him to meet essential expenditure and have sufficient available income to offer creditors, he has made the decision to not use his gas heating as he says he cannot afford to pay this and his other priority commitments.

A CAB in the East of England saw a disabled client who was living in fuel poverty. The client was in receipt of Disability Living Allowance (DLA) and Income Support and relies on storage heaters to heat her home. Her total cash income is approximately £70 per week. Out of this she is paying throughout the year in excess of £30 per week on her electricity. If she did not have DLA she would find it difficult to afford any heating to speak of at all. The client felt that she had to choose between being cold and being hungry.

POLICY RESPONSES TO FUEL POVERTY AND RISING PRICES

14. The government has set itself the extremely challenging target of abolishing fuel poverty for vulnerable households by 2010 and for all households by 2016—we would argue that it needs to give itself the tools to give it a fighting chance of meeting this target.

15. As we state above, we welcome the measures contained in the recent Budget statement including the rises in the Winter Fuel Payment, the commitment to reduce the differential between prepayment meters and other means of payment and plans for a significant increase in fuel suppliers' social programmes.

16. We recommend a number of complementary measures: extending eligibility for the Winter Fuel Payment; launching a comprehensive and sustained benefits take-up campaign; and increasing the funding for Warm Front and reviewing the way it currently works in order to overcome present shortcomings.

EXTENDING ELIGIBILITY FOR THE WINTER FUEL PAYMENT

17. Citizens Advice welcomed the increases in the Winter Fuel Payment, as announced in the 2008 Budget Statement. These increases will certainly be welcomed by pensioners. However, it is important to note that while the Winter Fuel Payment is highly valued by many pensioners it is a very poorly targeted benefit, with all pensioners—regardless of income—entitled to it. It is therefore understandable that proposals for more targeted use of this money to alleviate fuel poverty has been advanced, for example the Fuel Poverty Advisory Group (FPAG) has suggested discontinuing Winter Fuel Payments for higher rate tax payers, which would free up over £200m pa which could be used to fund increases in the Warm Front programme.⁴³ In our view, this proposal has much to recommend it provided that such a change to a system based on means-testing does not adversely affect levels of take-up among eligible pensioners.

18. We also recommend that consideration is given to extending eligibility to winter fuel payments to other groups who may live on low benefit incomes and struggle to afford their fuel bills. Such groups might include people under 60 years of age including disabled people, people with a long-term illness, and households with young or disabled children. This measure would provide help to such groups in the short-term. Over the longer term it would be preferable to look at raising levels of benefit income, or perhaps consider uprating benefit levels more closely to fuel prices.

LAUNCHING A COMPREHENSIVE BENEFITS CHECKING SERVICE

19. The government should consider proper funding for holistic benefits advice, which would allow people to claim benefits currently unclaimed as well as providing information about getting a better energy deal, helping with energy efficiency measures etc. Government research has shown that “income improvements were the most important factor in reducing fuel poverty”, with 61 per cent of the reduction in fuel poverty since 1996 attributable to improvements in incomes.⁴⁴ Funding holistic benefits advice is therefore the most efficient way of tackling fuel poverty and this exercise would go a long way towards putting extra money in people's pockets and enabling them to pay their bills with dignity.

⁴³ Fuel Poverty Advisory Group—Sixth Annual Report, 2007

⁴⁴ The UK Fuel Poverty Strategy—3rd Annual Progress Report 2005, Defra and DTI, p.27

20. Citizens Advice Bureaux already provide a great deal of advice to clients when helping them to resolve their problems. In 2006–07 bureaux dealt with more than 5.7m problems, helping approximately two million clients. Additional funding for holistic benefits advice would enable bureaux to supplement this with proactive benefit take-up campaigns, targeting people who may not visit bureaux and who may be unaware they are missing out on benefit income that they are entitled to. Information about the impact that such campaigns can have and the key factors necessary for successful campaigns is provided in *Serious benefits—the success of CAB take-up campaigns*, (Citizens Advice, April 2003).

21. Such efforts are very much needed, with official estimates suggesting that up to four in 10 pensioners entitled to pension credit are not getting the extra cash they are due, and that as much as £2.5 billion went unclaimed in the financial year 2005/06, the most recent year for which figures are available.⁴⁵ The amount of Housing Benefit and Council Tax Benefit not being claimed is also large, and take-up of these benefits has actually declined in recent years.

22. Recently three Citizens Advice Bureaux have started to work in partnership with Ofgem, the energy regulator, to pilot a campaign to (i) make sure people are getting the best deal for their energy and; (ii) to provide information about what help is available from the energy industry and government for people struggling to pay gas and electricity bills. This work is particularly focussed on encouraging people with prepayment meters to exercise their ability to switch supplier to get a better deal. The pilots are targeted at frontline workers (eg CAB advisers and housing association advisers) who can spread the message to people they deal with as part of their everyday work, as well as to customers themselves.

23. Learning from these small-scale pilots is likely to be invaluable in coordinating efforts to target a range of help and assistance with affordability of fuel to third-parties and customers.

INCREASED FUNDING FOR WARM FRONT PROGRAMME PLUS REVIEW OF CURRENT OPERATION

24. In the Comprehensive Spending Review it was decided to cut the annual Warm Front budget by nearly 25% for the period 2008-2011. The decision to cut one of the government's principal means of tackling fuel poverty in England was deeply regrettable at a time when rising fuel prices have pushed the numbers of people living in fuel poverty to their highest for almost a decade.

25. Warm Front annual expenditure should, in the 2008–11 period, be restored to at least its 2007–08 level of £350m per annum. The Fuel Poverty Advisory Group (FPAG) has suggested a number of sources where funding for this expenditure, and we would encourage government to look closely at the options outlined.

26. Although very supportive of the Warm Front programme in principle, many Citizens Advice Bureaux have reported difficulties experienced in the operation of the scheme. This issue was debated in Parliament on 3 March 2008 and the problems highlighted mirror many of those experienced by CAB clients. In general, the problems with Warm Front relate to the costs quoted by authorised contractors for carrying out work, the failure of the Warm Front grant to cover the cost of work required and the consequent need for applicants to find substantial sums to 'top-up' the grant. The following cases highlight these difficulties:

A CAB in the West Midlands reported that their client, aged 69, came to the bureau as his boiler stopped working in December 2007 and he had no hot water or heating during the coldest months of the year. The client had received independent estimates for a replacement boiler and was advised that the cost would be between £1,300—£1,700. He was then told by a friend that he might be entitled to a Warm Front Grant to assist with payment. The client therefore made an application to Warm Front and was informed that he had qualified for a Grant of £2,700. Given that he expected the grant to easily cover the cost of the new boiler, the client also asked for replacement radiators as his were over 20 years old. The client was sent a letter from Warm Front, stating that the total cost of the work recommended would be £3,821.81, meaning that the client needed to pay £1,255.36 towards this figure.

A CAB in County Durham reported a case in which their client, aged 63 and in receipt of pension credit, received a Warm Front grant for the cost of installing oil-fired central heating worth £4,000. However, the total cost of the work was £6,960.67 so the client was expected to find the excess of £2,960.67 before the work could be carried out. The client could not afford to pay nearly £3,000 and so had to continue living in an inadequately heated home. The client contacted a local heating company that informed her that in their estimation the work should cost approximately £4,000.

A Middlesex CAB's client reported a distinct difference between the prices quoted by local heating engineers and the Warm Front approved contractor. The client, a widowed female, aged 79 and in receipt of Pension Credit, was awarded a Warm Front grant of £2,700 but the cost of the work was £3,460.63, with the balance to be paid by client. The client was unhappy with this quote as she had also obtained quotations from local companies, the highest of which was £3,100. The client was also understandably concerned that the Warm Front approved contractor was based almost 300 miles away in Sunderland, and she might therefore experience problems contacting them if anything were to go wrong with the new boiler.

⁴⁵ Source: Department for Work and Pensions Income Related Benefits Take-Up Estimates 05/06

27. Along with other consumer organizations, Citizens Advice has highlighted the inadequacy of the grant and the consequent need for eligible customers to find large sums of money before the work can be carried out, for some considerable time. Improvements have not yet materialized and a number of Citizens Advice Bureaux now report that they may soon start to think twice before referring clients to apply to the Warm Front programme. Citizens Advice recommends that a solution is found as a matter of urgency to the significant problem of funding shortfalls for Warm Front, and the consequent need for top-ups from eligible consumers, which currently undermines the impact of the programme.

April 2008

Memorandum submitted by Corona Energy

Corona Energy (Corona) welcomes the opportunity to comment to the Business, Enterprise and Regulatory Reform Committee on possible anti-competitive behavior in the UK's energy market. Corona is a shipper and supplier in the UK Industrial and Commercial gas market and also offers a range of energy services including an industry leading AMR service.

Corona relies on liquid wholesale markets to ensure the prices it can offer its customers are as competitive as possible and therefore welcomes the Business, Enterprise and Regulatory Reform Committee's interest in this area.

Corona also welcomes the investigation into possible anti-competitive behaviour in the UK's supply markets. While Corona does not have any evidence of anti-competitive behaviour it recognises the importance of effective competition to ensure consumers have access to fair prices and to be an incentive for good service.

Following a number of recent appeals of GEMA decisions, Corona are interested in the views of the Business, Enterprise and Regulatory Reform Committee on the effectiveness of regulatory oversight of the energy market. Corona are particularly interested to know whether the Business, Enterprise and Regulatory Reform Committee believe the level and complexity of regulation has inadvertently become a significant barrier to entry to the energy markets.

If the committee would like to discuss the issues raised in this response in greater detail then please contact Richard Street (details above) who will be happy to help you.

26 March 2008

Memorandum submitted by Drax Power Limited

SUMMARY

1. Observations of the operation of the electricity wholesale market suggest that the hedging behaviour of the vertically integrated companies operating in the electricity market may be dulling or masking market price signals leading to market inefficiency. Such inefficiency has the potential to have an impact on investment decisions, which holds implications for security of supply. Analysis of the proposed generation capacity new build would appear to support the suggestion of market inefficiency.

2. Power prices are driven by a number of factors, however, the more recent price increases witnessed in the electricity wholesale market are a reflection of the increases in the input costs of power generation. It is worth noting that generators do not achieve the spot prices in the market; generation businesses are hedged over a period of time and therefore achieve a variety of prices.

3. In a market characterised by vertically integrated companies there may be a tendency for businesses not to compete aggressively, but instead to maintain relatively stable market shares. Analysis of the relative market shares of the six largest vertically integrated companies appears to uphold this theory on behaviour.

INTRODUCTION

4. Drax Power Limited ("Drax") is the operating subsidiary of Drax Group plc and the owner and operator of Drax Power Station, the largest, cleanest and most efficient coal-fired power station in the UK. With a capacity of some 4,000MW, Drax Power Station is nearly twice the size of the next largest power station in the UK. Drax sells its electricity through the electricity wholesale market of Great Britain, and at current output levels meets some 7% of the UK's electricity needs.

5. Drax is pleased to have the opportunity to participate in the Committee's inquiry into energy prices. As a generation-only business operating solely in the wholesale market, Drax should like to provide some context to the inquiry by offering observations on the general functioning or efficiency of the electricity wholesale market, the price increases witnessed in that market and the implications for competition in the electricity supply market.

EFFICIENCY OF THE ELECTRICITY WHOLESALE MARKET

6. In determining whether the wholesale market operates efficiently and testing that electricity prices are a true reflection of the costs of both fuel and capacity, it is necessary to understand the functioning of the market and this necessarily demands some consideration of the industry structure.

7. The electricity market is characterised by six large vertically integrated players, who between them account for some 58% of the total generation capacity on the system or 69% of the price-setting plant (gas, coal and oil) (with a controlling interest, through full ownership, part ownership or tolling contracts in 74% of the price setting plant) and together these companies supply some 85% of the total demand. In the early years of the privatised electricity sector, vertical integration was recognised by both the regulator and the Government as a potential source of concern and at odds to the rationale for the restructuring the electricity market. Indeed, policy decisions were taken during this time which prevented the then two major generating companies from owning supply businesses.

8. The “anti-vertical integration” policy was relaxed following the forced divestment of coal-fired plant owned by the same two generating companies. However, the existence of Standard Licence Condition 12b, which essentially prohibits cross subsidy between licensed activities, for example the activities of generation and supply, is evidence that the concern surrounding vertical integration remains today.

9. Observations from the electricity wholesale market are that the vertically integrated companies tend to hedge their supply positions by allocating their own generation to the smaller commercial and domestic customer market. Given this natural hedge, the vertically integrated companies do not have to go to the market to contract for power other than in spot and short-term markets. Therefore, volumes of power traded in the market in the medium and long-term are reduced, so reducing liquidity in the wholesale market.

10. Locking out both generation and supply volume from the contested market carries the risk that the true value of generation is never revealed leading to inefficient operation of the market as a whole. By allocating their own generation to their supply businesses, the vertically integrated companies may not be putting these power transactions in the most efficient place and the costs of this inefficiency are, in effect, passed on to the end customer.

THE IMPACT OF MARKET INEFFICIENCY ON INVESTMENT DECISIONS

11. Investment decisions rely on the medium and long-term markets for price signals. A further potential consequence of an inefficient market, therefore, is the impact on investment decisions in the generation market, which ultimately holds consequences for security of supply.

12. Analysis⁴⁶ of the proposed new generation capacity in Great Britain reveals that 13GW of the 17GW of approved projects are being built by the vertically integrated companies. More interestingly is that “incentivised generation capacity”, such as renewable and CHP generation, is being built by a mixture of the vertically integrated companies and a number of smaller companies. Whereas, the building of “non-incentivised generation capacity”, that is the large conventional new builds, is noticeably dominated by the vertically integrated companies or joint ventures involving the vertically integrated companies.

13. It is the “non-incentivised generation capacity” which one would expect to be driven by market price signals, therefore, there is a suggestion that vertical integration is dulling market signals. If this were not the case wider market entry/new build would surely be observed.

14. If greater volumes of power were to be traded in the market, liquidity in the market would improve and so the market would tend towards finding the true value of generation. A market with high and regular liquidity should be encouraged, only then will the price signals become efficient and only then will the market see prices truly reflect the fundamentals of supply and demand.

ELECTRICITY WHOLESALE MARKET PRICES

15. Power prices are driven by a number of factors: the underlying commodity prices, for example, gas and coal prices; the margin on the system, that is, the relative level of generation to demand; market sentiment, that is, the market’s reaction to information (which is more pronounced in less liquid or thin markets); and the physical positions taken by the individual market players.

16. Recent power price movements, however, are clearly linked to gas price movements and so the increases experienced in gas prices have fed directly through to power prices. The price of coal has also risen dramatically over the last year—some 90% from the start of 2007 to the end of the year. It should also be noted that the price of carbon allowances for delivery in Phase II of the EU Emissions Trading Scheme has risen by 45% on last year. These, amongst other factors, were responsible for the reported lower earnings of Drax Group plc in 2007 compared to the previous year.

⁴⁶ Power Station Tracker, Power UK, pp 5–39, 29 January 2008

17. From the highs of early Summer 2006, power prices in the wholesale market fell until Spring 2007, since when they have been steadily increasing. It should be noted, however, that although power prices have been increasing not all power over the period would have been traded at these higher levels. Generators do not achieve the spot prices in the market; generation businesses are hedged over a period of time and therefore achieve a variety of prices.

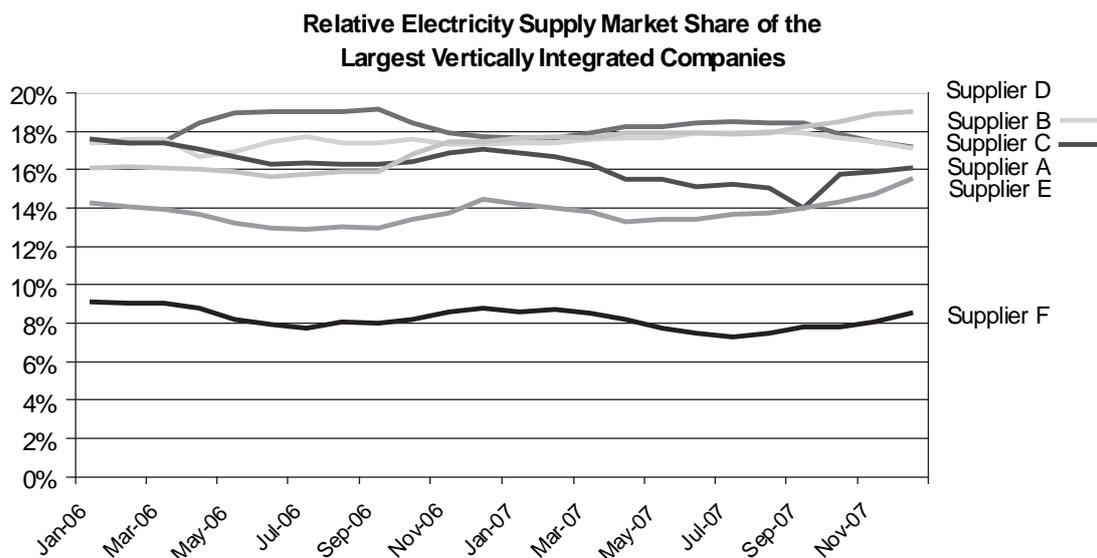
IMPLICATIONS FOR COMPETITION IN THE ELECTRICITY SUPPLY MARKET

18. With electricity prices being a function of fuel and capacity margin, any business owning generation capacity would only do so if the market covered its long-term fixed costs, as determined by the margin over and above its fuel costs that it can achieve in the wholesale market.

19. With vertical integration there is a danger that the margin may appear in another part of the supply chain suggesting generation capacity has reduced value; equally true is that the margin attributable from supplying retail customers could appear in another part of the supply chain making it appear that the supply business is not profitable.

20. The obvious danger for any business in a market which displays such characteristics is that it becomes out of step with the rest of the market, losing or gaining market share quickly without the ability to hedge itself which in turn leads to less predictable revenues and costs.

21. As a consequence, in order to avoid financial unpredictability, there may be a tendency for businesses not to compete aggressively, but instead maintain relatively stable market shares. Although it is claimed by some that the electricity supply market of Great Britain is competitive, it is surprising that no single supplier has broken out of the pack and taken a larger market share than the others. To illustrate this point, the chart below shows the market shares held by the six largest vertically integrated suppliers.



CONCLUSION

22. In conclusion:

- (a) It is suggested that the hedging behaviour of the vertically integrated companies effectively locks out both generation and supply volume from the contested market carrying with it the risk that the true value of generation is never revealed. This in turn leads to inefficient operation of the market as a whole, the costs of which are passed on to the end customer.
- (b) A potential consequence of an inefficient market is the impact on investment decisions in the generation market, which ultimately holds consequences for security of supply.
- (c) Analysis of the proposed new generation capacity reveals that “non-incentivised generation capacity” build, that is the large conventional new builds, is noticeably dominated by the vertically integrated companies or joint ventures involving the vertically integrated companies. If the market was operating efficiently and prices reflected the fundamentals of supply and demand, one would expect to see wider market entry/new build.
- (d) Price increases witnessed in the electricity wholesale market are a reflection of the increases in the input costs of power generation. Although it should be noted that generation businesses are hedged over a period of time and therefore achieve a variety of prices.

- (e) Analysis of the relative market shares of the six largest vertically integrated companies appears to suggest that there may be a tendency for businesses not to compete aggressively, but instead to maintain relatively stable market shares.

March 2008

Supplementary memorandum submitted by Drax Power Ltd

INTRODUCTION

1. Through its operating subsidiary Drax Power Limited, Drax Group plc (“Drax”) owns and operates Drax Power Station, the largest, cleanest and most efficient coal-fired power station in the UK. We are a generation-only company, with no business interests in the end user supply market. With a capacity of some 4,000MW, Drax Power Station is nearly twice the size of the next largest power station in the UK and we sell all our output through the electricity wholesale market of Great Britain, and at current output levels meet some 7% of the UK’s electricity needs.

2. As a power generation business operating in commodity markets, we are exposed to the prices of power, coal and carbon. There are many factors that drive the prices of these commodities, including the weather. Forward power and gas prices are highly correlated, with gas strongly influenced by and indexed to oil which has seen dramatic price increases over the last 18 months. Coal prices too have hit record highs, driven by tight markets for both coal and freight, especially in the Pacific Basin caused by strong demand from China and India, combined with some production and logistical issues in Australia and Indonesia. It is important to note that the effects we are seeing, in terms of increasing UK power prices, are being driven by long term global growth and demand factors. Drax sits at the end of this long and interrelated commodity market chain.

3. Further to giving oral evidence to the Committee on 3 June, Drax should like to submit the following clarification on its answers to the questions raised during the session concerning market structure effects.

VERTICAL INTEGRATION

4. Drax believes the current market rules and arrangements for trading power place the right incentives on market participants to deliver an efficient wholesale market. However, price transparency is critical. In the absence of price transparency market price and price signals are dulled.

5. Whilst we are not against vertical integration per se, our concern is that the hedging behaviour of the vertically integrated companies limits participation in the wholesale market as significant volumes of power are transacted between the generation and supply businesses of each of the vertically integrated companies. The effect is that these trades are not visible to the wholesale market, which essentially forecloses competition in the contested part of the wholesale market. It is our contention that this brings inefficiency to the wholesale market.

6. It is imperative that there is clear separation between the generation and supply businesses and price transparency for all power trades to ensure that the true value of generation is revealed.

VERTICAL INTEGRATION AND LIQUIDITY

7. As an independent, generation-only company selling its entire output into the traded power market we are an important market participant. Through our activity in the wholesale market, we provide a clean indicator of price which assists in the discovery of the value of generation. If the vertically integrated players were also to trade all their generation output through the wholesale market and satisfy their supply requirements in the same way we would have a much deeper, more efficient and more liquid market.

8. Again, it is our view that vertical integration per se is not the problem, and therefore forced divestment as a remedy is not necessarily required. A potential solution would be to require all vertically integrated companies to take all their physical requirements to the open market and/or offer the same terms to counterparties that they offer themselves internally.

VERTICAL INTEGRATION INVESTMENT EFFECTS

9. It is the market spreads, that is, the difference between the price of power and the cost of fuel (or cost of generation) that signal new entry. The current spreads are too low to signal new entry and with no long term hedges available in the market, for example, through long term power purchase agreements, there is little incentive to invest in major, capital intensive new build projects.

10. Given that there are power plants currently being built there must be some other driver at play. Analysis of the approved projects reveals that it is the vertically integrated companies that dominate the new build sector. It is interesting to note that companies would be expected to come to the market seeking long term contracts before taking the risk of building. We have not seen this activity which again suggests other factors are at play.

11. New entrants or independents are unable to put in place long term hedges due to market illiquidity. The vertically integrated companies, however, have the additional long term hedge through the inertia of their domestic customer base.

MARKET CONSOLIDATION

12. It is Drax's view that the sale of British Energy to one or more of the vertically integrated players would have a significant detrimental impact on wholesale market liquidity if no conditions were attached.

13. British Energy produces around 17% of UK electricity, a large proportion of which underpins volumes for the wholesale market. Removing volumes from the wholesale market would lead to a critical decline in market liquidity and in the extreme would place at risk the ability of the independent players to sell output. In short, the reported wholesale market would diminish and price signals would be even less reliable.

CONCLUSION

14. In conclusion:

- a. the current market rules and trading arrangements provide the appropriate incentives to deliver an efficient electricity wholesale market;
- b. whilst not against vertical integration per se, there is concern that the hedging behaviour of the vertically integrated companies limits participation in the wholesale market, forecloses competition and brings inefficiency to the electricity wholesale market;
- c. clear separation between the generation and supply businesses of the vertically integrated players and price transparency is critical to ensuring that the true value of generation is revealed;
- d. forcing all the power trades of the vertically integrated players through the wholesale market would deliver a much deeper, more efficient and more liquid market;
- e. the hedging behaviour of the vertically integrated players masks price signals and deters new entry into the independent sector of the generation market; and
- f. further consolidation in the market resulting in the removal of power trades from the wholesale market would lead to a critical decline in market liquidity and in the extreme would place at risk the ability of the independent players to sell output.

23 June 2008

Memorandum submitted by eaga plc

RESPONSE TO THE BUSINESS ENTERPRISE AND REGULATORY REFORM COMMITTEE TO INVESTIGATE POSSIBLE ANTI-COMPETITIVE BEHAVIOUR IN THE UK'S ENERGY MARKET

SPECIFIC QUESTIONS FOR CONSIDERATION

Below is eaga's response to the question raised by the enquiry. Where a question is asked in the call for evidence and not listed below, eaga has no views.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

In considering the usefulness of Government policy instruments for reducing fuel poverty eaga's response will focus on the following:

- Warm Front;
- Local area based initiatives;
- Carbon Emissions Reduction Target (CERT);
- Energy Performance Certificates;
- Decent Homes Standard;
- Winter Fuel Payments; and
- Energy company voluntary schemes and initiatives.

Warm Front

eaga has delivered the current phase of the Warm Front Scheme across England since 2005, and has been at the heart of the Scheme's development, implementation and delivery since its inception in June 2000.

The Scheme is the Government's primary tool for tackling fuel poverty at a national level. Help provided by Warm Front means the most vulnerable households in England can stay warm, through the installation of efficient central heating and energy efficiency measures such as loft and cavity wall insulation. The improvements lift families out of fuel poverty due to average bill savings of almost £300 per year. These measures also mean householders need no longer risk ill health because their homes are cold and damp.

Warm Front is a central part of the Government's pledge to eradicate fuel poverty in vulnerable households in England by 2010. By significantly reducing the carbon footprint of the homes we improve, it is also helping deliver the UK's climate change commitments.

We strongly believe that, in an era of rising energy prices, there should be greater coordination of Warm Front, CERT, Trust Funds, Local Authority discretionary funds and other sources of help to ensure that the most comprehensive range of services are delivered in each low-income home treated.

Warm Front has been a very successful scheme in a number of ways:

- It has reduced fuel bills for low income customers by an average of almost £300 every year or 30%. Of course, this is an average figure, meaning a substantial amount of people save far more.
- The Scheme currently fits or repairs a heating system every minute of every working day.
- It has reduced CO₂ emissions in a very cost effective way, indeed the Scheme was independently ranked as Defra's third most cost-effective carbon saving instrument in the domestic sector.
- The Scheme has helped more than half a million homes in the last two years alone.

As the Fuel Poverty Advisory Group, of which eaga is a member, have already raised, the question of resources for fuel poverty programmes is important. In light of this, there is a concern that the 2010 and 2016 statutory targets for reducing and eradicating fuel poverty will now be missed. On the subject of resources for fuel poverty, we note the Fuel Poverty Advisory Group's most recent annual report said:

“The cut in Warm Front is, to put it mildly, difficult to understand—given the programme's success and given the still more pressing need, in the wake of the price increases, to improve the energy efficiency of homes and heating systems. The programme has been cut when fuel poverty is at its highest level for nearly a decade”.⁴⁷

Warm Front's Benefit Entitlement Check service is another extremely important tool in moving households out of fuel poverty. By improving benefit take-up while delivering energy efficiency measures we reduce fuel bills in conjunction with improving income, making a real difference to the lives of people on low incomes. Last year some 55,000 people received Benefit Entitlement Checks, and in 2006–07, 22,761 Benefit Entitlement Checks were carried out under the Scheme (39% were subsequently found eligible for Warm Front). The average increase in income was thus increased weekly by £26.51 and annually by £1,378 per client.⁴⁸

The Warm Front Scheme has been extremely successful in reducing fuel poverty through installing traditional measures. This success could be underlined if the Scheme was opened up to other technologies and energy efficiency options, such as external cladding, that would better enable it to assist residents of “hard to treat” homes.

A key area for consideration in the inquiry should be the next step for fuel poverty programmes, the most logical of which is the introduction of renewable technologies, such as air source heat pumps and solar thermal heating. This could facilitate market transformation in the renewables sector through guaranteed volumes, supply and economies of scale.

In addition, these options have potentially greater potential for carbon savings, and would be important for Government climate change targets. They would also provide solutions to lack of heating in hard-to-heat homes off the gas network. Of course, the associated question of how the introduction of said technologies might impact on resource requirements should also be considered.

Local Area Based Initiatives

The most widely known local area based initiatives for tackling fuel poverty are Warm Zones.

Warm Zones are a targeted programme that are intended to provide appropriate assistance to householders in privately owned, rented or social housing. The Warm Zones broker funds and grants from a wide range of sources to deliver benefits such as energy efficiency, carbon savings, fuel poverty reductions, benefits advice, health improvements, fire and home security, employment skills and training.⁴⁹

⁴⁷ FPAG Annual Report 2007, p 12.

⁴⁸ The UK Fuel Poverty Strategy 5th Annual Progress Report 2007, p 15.

⁴⁹ <http://www.cse.org.uk/pdf/pub1028.pdf>, http://www.warmzones.co.uk/c_what_is_warmzones.html

eaga continues to work in partnership with Warm Zones and is exploring other local area based solutions to fuel poverty, including work on projects under the 'Community Energy Efficiency Fund' (CEEF) banner. We believe many of these projects will play a valuable role in continued efforts to reduce fuel poverty levels, while recognising that they serve in an ancillary role to a national programme like Warm Front.

Carbon Emissions Reduction Target (CERT)

While we recognise the vital nature of ensuring energy suppliers play a large and active role in improving domestic energy efficiency, we have some concerns with the apparent increased reliance on CERT from Government.

There has been a shift from Government-funded programmes such as Warm Front to the benefits provided under CERT through energy supplier programmes. This means customers, including those on low incomes, consequently bear a greater share of the costs as a result of this reliance on the CERT mechanism. This is potentially detrimental for those in or near to fuel poverty.⁵⁰ eaga would question the growing reliance on CERT to provide energy efficiency measures when these instruments are primarily intended to reduce carbon consumption, as opposed to cutting fuel poverty.

Government suggestions that expenditure on energy efficiency will increase over the next four years, while accurate, do not acknowledge that the cost of some elements of this equation will fall on consumers. Additionally, it is hugely important that the measures provided by CERT are not as comprehensive as those delivered by Warm Front and do not include heating options, the most meaningful in tackling fuel poverty.

Nonetheless, the obligation on energy suppliers to focus a significant amount of energy savings in low income, vulnerable householder groups will also remain. This means that, as well as funding continued growth within the "able to pay" market, significant opportunities for further interaction with schemes such as Warm Front will continue to develop and expand.

In addition, the Government has confirmed that innovative measures such as external wall insulation will receive substantially greater incentives under CERT than was the case with EEC. This further underlines the importance of companies like eaga being able to provide the volume of improvements necessary if the Government's 2010 target is to be achieved. The size, scale and structure of the CERT obligation provides significant opportunities for eaga to use its experience to ensure maximum benefits for householders.

Energy Performance Certificates

Energy Performance Certificates will identify issues in existing housing stock for new purchasers and should over time drive up energy saving initiatives by house owners to help sell their property. This behavioural shift is to be welcomed and eaga are positioned at the heart of driving this initiative forward, with considerable resource delivering EPCs on the ground.

However, this will be a slow process and will not impact where it is most needed: those private homes held by the more elderly in our society with little capital saved to invest in energy efficiency.

An appropriate focus must be maintained on improving existing housing stock. Even by 2050 it is estimated that over 60% of all UK buildings will pre-date 2006 regulations.⁵¹ Their standards must be improved—they are the key to meeting Government carbon emissions targets. The emissions of these homes can be substantially reduced by improving the thermal efficiency of the building itself, alongside improving the efficiency of heating systems.

Providing energy efficiency measures to existing housing is an extremely cost-effective method for lifting people out of fuel poverty, and for making substantial carbon savings. Existing homes account for a clear majority of the 150 million tonnes (a 27% share) of the UK's carbon emissions that housing is responsible for.⁵²

The Decent Homes Standard

The Decent Homes Standard has been extremely successful in delivering energy efficiency improvements to social housing. However, more remains to be done in ensuring that thermal comfort standards set under Decent Homes are properly aligned with mainstream programmes. It is important to remember that despite only 20% of housing stock being social housing, it includes over one third of those in fuel poverty.

⁵⁰ FPAG Annual Report 2007, p 14.

⁵¹ "Transforming Existing Buildings: The Green Challenge", Royal Institute of Chartered Surveyors, 2007.

⁵² *Stock Take*, Sustainable Development Commission July 2006; *Review of Sustainability of Existing Buildings* DCLG 2006.

Winter Fuel Payments

We acknowledge the importance and usefulness of the annual Winter Fuel Payment in alleviating seasonal pressures on the fuel costs of pensioners.

However, it is critical in tackling fuel poverty that an appropriate balance is struck between capital investment and revenue expenditure, with a view to implementing the most sustainable policy solutions.

Whilst we recognise there may be apparent political difficulties in doing so, we would suggest that targeting the payment to those in greatest need would be a more effective use of resources. The funding this would save could more than restore funding to key fuel poverty programmes.

Energy company schemes and initiatives

The Government has recently announced a voluntary agreement with energy suppliers to move a theoretical 100,000 homes out of fuel poverty. While this is to be welcomed, it is a small step when recent fuel price increases have already pushed far in excess of that number into fuel poverty.

we would welcome a mandatory scheme requiring suppliers to meet agreed targets for assisting their most customers using the most appropriate means—primarily through robust (mandatory and regulated if necessary) social tariffs, and real energy efficiency improvements, delivered through measures not currently catered for in mainstream programmes (eg solid wall insulation).

May 2008

Letter by EDF Energy

Thank you for your letter of 11 January and your invitation to submit evidence ahead of the Business, Enterprise and Regulatory Reform Committee session on January 31 with the Minister for Energy, Malcolm Wicks MP.

As one of the UK's largest energy companies, EDF Energy is keen to engage in this process. In response to your specific questions, I am pleased to provide the following evidence.

1. *If you have increased prices what steps you have taken to mitigate the impact on vulnerable groups and if you have not raised prices, whether you expect to raise prices for your retail customers in 2008?*

EDF Energy has worked hard to mitigate the effect of rising costs for our most vulnerable customers. We were the first energy supplier in 2006 to introduce a social tariff, Energy Assist, which currently offers our fuel poor customers a 15% discount on their bill. 50,000 customers in receipt of that tariff will therefore continue to pay us discounted prices. We also offer those customers free benefit entitlement checks to ensure that they are receiving all the income assistance for which they are eligible, in order to help them meet their energy bills.

We were also the first energy supplier to set up an independent trust fund, the EDF Energy Trust, to which we have already donated nearly £7 million and which has made awards to around 8,000 households experiencing problems with energy and other household debt. This has been very effective and we have found that 12 months or more after receiving a grant, over 70% of households have remained free of debt.

Although only a small proportion of our customers using prepayment meters are fuel poor, they do tend to be lower income households. We have developed a responsible approach to these customers and we were the first energy supplier to align our electricity prepayment prices to those of our standard tariff and were also the first to offer those prepayment customers the peace of mind of a fixed price tariff.

EDF Energy's Fixed Price 2010 tariff will enable customers to fix their prices until 31 July 2010. This offers protection and security in a volatile market. EDF Energy is alone in the industry in making this available to prepayment customers. There is no cancellation fee or penalty should the customer want to come off this product at a later date.

EDF Energy has also helped to establish a London Warm Zone with Newham Borough Council in 2001. This delivers intensive door-to-door assessments of households to identify vulnerable households where energy efficiency can be improved and provides support for customers to claim benefits for which they are eligible. The success of this scheme has seen it extended across East and West London so that more than 40% of London Boroughs are now covered.

In addition to our voluntary initiatives, energy suppliers also have a mandatory social obligation from Government: an obligation to deliver 40% of the supplier energy efficiency obligation, CERT, to households in a priority group. However, the blurring of this social obligation with a carbon reduction target creates inefficiencies for both objectives, and we believe that a separation of the carbon and social obligations would have a greater impact on both. Whilst the opportunity to achieve this for CERT has now passed, we are keen to see this separation in place for 2011.

2. *If you have increased or plan to increase prices, what is the scale of the increases you have announced or anticipate and what are the underlying reasons for your strategy?*

With effect from the 18 January, EDF Energy has announced an increase in our gas and electricity prices, with electricity rising by 7.9% and gas by 12.9%. This will impact a typical dual fuel customer by just over £1.92 per week.

Raising our prices is one of the biggest decisions that we have to make and is not taken lightly. However, we have had to increase our prices because of three factors. Firstly, the wholesale price of energy has doubled over the last year. Secondly, the distribution costs of transporting and metering energy have also risen.

Finally, there have been significant cost increases from meeting our environmental obligations, including a major expansion of the Government's Energy Efficiency obligation on suppliers (CERT), which we fully support, but which has doubled from 2008. Even so, in arriving at our decision, we are very mindful of the competitive nature of the market; there is no automatic entitlement to recover the extra costs that we incur.

Our price increase is applied in an equitable way to all our tariffs and we have been careful to ensure that this does not penalise our prepayment customers.

3. *The Government's decision on nuclear power*

You also requested comments on the Government's decision on nuclear power and on the likely implications for investment in a new generation of nuclear power stations, and on investment in other conventional and renewable generation capacity.

EDF Energy welcomes the Government's announcement as a major step in opening a new era of energy policy. It will enable nuclear power, as part of a diverse energy mix including renewables, gas, clean coal, and greater energy efficiency, to continue in the future to make a major contribution to the three key challenges of security of supply, climate change and affordability of UK energy supplies.

Most of the current nuclear and coal capacity will close over the next 15 years, leaving a prospective capacity gap of at least 15GW by the end of 2015 and at least 33GW by 2025. At the same time the challenge of climate change will continue and increase.

The Government's decision following its extensive consultation is therefore timely. We are pleased that the Government recognises the need for facilitative action in respect of a number of issues. These include assessment of current new reactor designs, the availability of suitable sites, the need for a robust long term carbon price signal and the streamlining of the planning system. There is also a need, which is being addressed by the Energy Bill, for clear arrangements for the operators of new nuclear power stations to set aside funds to pay for the cost of decommissioning and of managing the waste produced by these plants. We will be working with the Government and other interested parties to ensure that these issues are resolved in a timely way, so that the right framework for investment can be put in place.

EDF Energy has announced that it is keen to take part in building up to four new nuclear stations. Contingent on the Government's decision we have been working for nearly two years on plans to commission the first of these by 2017, using the EPR design. Following the Government announcement we are stepping up our plans to deliver.

We expect to achieve this in partnership with others. This will be a UK project and it will be delivered with British skills and companies. It will be a project to meet the needs of energy users in this country. In implementing these plans, EDF Energy will also draw on the experience of EDF Group, the world's largest nuclear operator with 58 plants. By drawing on this experience and working in partnership with others we are confident that new plants can be built and run safely and economically without subsidy—covering all the costs associated with construction, operation, decommissioning and waste disposal.

Throughout this new phase we are committed to maintaining openness and transparency both now and in the future. At the heart of this is our unreserved commitment to safety, already proven by our track record.

EDF Energy has committed to reduce the carbon intensity of our electricity generation activities by 60% by 2020. Based on the current generation of our fleet, that represents almost 12 million tonnes annually by 2020. This measure formed part of EDF Energy's "Climate Commitments", which represent the biggest package of environmental initiatives launched by any major UK company.

As part of our commitment to a diverse mix, EDF Energy and our affiliates will be investing in 1,000MW of UK renewable energy production by 2012. In this regard, we have recently received consent for a 90MW offshore wind farm at Redcaron Teesside.

We have also recently received consent for a new 1300MW gas CCGT plant at West Burton. This is due to be commissioned in 2011 and will make an important contribution to meeting the needs of our customers.

I hope this information is helpful to the process of your inquiry. We will of course be very happy to provide any further detail you require. If we can be of any further assistance, now or in the future, please do contact my colleague Kaa Holmes on 020 7752 2179 who will be able to assist.

24 January 2008

Memorandum submitted by EDF Energy

ANTI-COMPETITIVE BEHAVIOUR IN THE UK'S ENERGY MARKET

SUMMARY OF EDF ENERGY'S POSITION ON COMPETITION IN THE UK ENERGY MARKET

1. Many studies have found the UK energy market to be competitive and an independent study on behalf of BERR has found the UK energy market to be more competitive than those in the rest of Europe. As a result, customers benefit from prices that are lower than the European average. They also have the opportunity to easily switch supplier or products, demonstrated by the fact that more than 13 million electricity and 11million gas customers (half of the total) have taken advantage of this opportunity since market opening in 1998, and a range of new products from existing and new suppliers in the market such as green tariffs.

2. The vertical integration of the market, where companies operate generation and sell direct to customers, has brought many benefits to customers. Energy suppliers have become vertically integrated to manage the risk associated with price volatility in the wholesale markets and customers therefore benefit by paying prices that are much less volatile at the retail level. High levels of competition between these suppliers ensure that margins remain slim and prices competitive.

3. The interests of the companies are closely aligned with those of customers. Both want low carbon, diversified, affordable and secure energy sources. Contraction in the credit market has highlighted the value of having companies with strong balance sheets to make the substantial investment required to renew the UK's energy infrastructure and secure low carbon and affordable energy supplies over forthcoming years.

We build on these positions in response to each of the questions posed by the Committee.

1. Whether the current market structure encourages effective competition in the retail markets for gas and electricity

The current market structure is encouraging a very high level of competition for customers between the large energy suppliers and also between the larger suppliers and smaller suppliers, particularly in the area of new product offerings to the market.

The National Audit Office ("NAO") report of 26 March 2008, entitled *Protecting consumers? Removing retail price controls* ("the NAO Report"), found that conditions for competition have developed in the gas and electricity supply markets and that Ofgem has taken action to help consumers take advantage of competition, for example, by ensuring that they can switch easily between suppliers.⁵³ The overwhelming majority of consumers now have the power to exert competitive pressure on suppliers.⁵⁴ The evidence for the level of competition can be seen in the high level of customers switching supplier (demonstrated in section 1.1 below) and the numbers of customers switching to new products (demonstrated in section 1.2 below).

Suppliers who have been able to keep their prices low have gained significant market share in recent years (demonstrated in section 1.3 below). All suppliers are also seeking to compete on more than just price alone, making significant efforts to improve levels of customer service, which has resulted in a fall in complaint levels (as demonstrated in section 1.4 below).

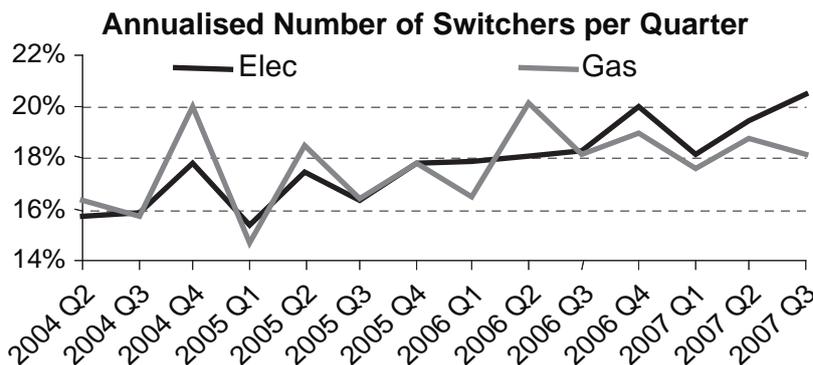
This high level of competition has meant that energy suppliers have not been able to pass on the full cost of wholesale price increases and other costs to customers. Margins in the market are very slim and this is reflected in UK prices being lower than the European average (demonstrated in section 1.5 below).

1.1 Customer Switching

There is a high level of awareness among customers that they are can switch supplier. The level of churn, the proportion of existing customers who change suppliers, in a year, has been growing in recent years and has reached a very high level by comparison with other industries.

⁵³ Summary, Conclusion, section 3, page 5.

⁵⁴ Summary, Conclusion, section 4, page 6.

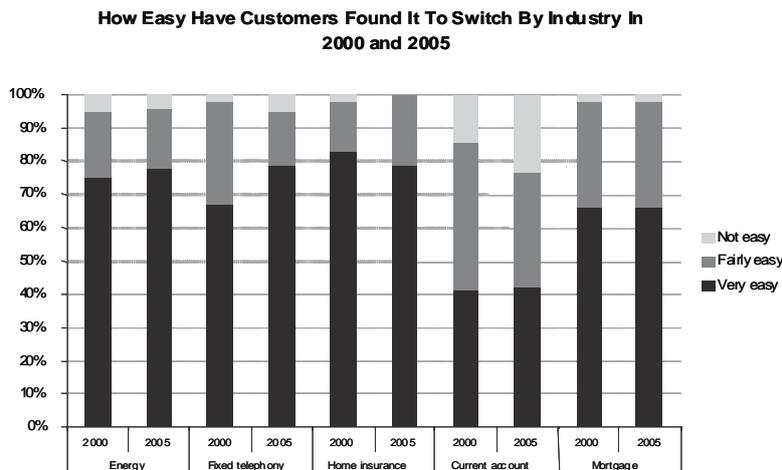


Source: BERR January 2008

While the proportion of gas customers switching supplier has increased from around 16% to 18% in the last three years, the proportion of electricity customers switching has increased even further, from around 16% to over 20% in the same period. BERR reported that 1.34 million electricity accounts changed supplier in Q3 2007.

Customers say that they find it very easy to switch their supplier. This is supported in the NAO report, which refers⁵⁵ to research by the National Consumer Council in 2005 reported in Switched on to Switching, as demonstrating that 95% of energy consumers who switched supplier found it easy to do so.

Research by Mori illustrated in the chart below demonstrates that switching energy supplier is thought to be easier than switching some other service providers and only a small number of customers found the process difficult.



Source: MORI

Energywatch has facilitated the process of switching energy supplier by accrediting companies that offer price comparison services. Currently 12 companies are accredited by energywatch to provide these services under their “confidence code” scheme.

Ofgem has also recently begun a campaign with the Citizens’ Advice Bureau to raise awareness amongst its advice workers of the ability to save costs by switching energy supplier and of how to obtain the best deal.⁵⁶

1.2 Innovative Products

The NAO Report recognises⁵⁷ that the main area of innovation in the retail energy markets has been the introduction of a range of new tariffs. EDF Energy has participated actively in the introduction of innovative tariffs, introducing its own range of fixed price, green, and online tariffs.

Customers are now being given new options when choosing tariffs from a wide range of new products being offered in the market.

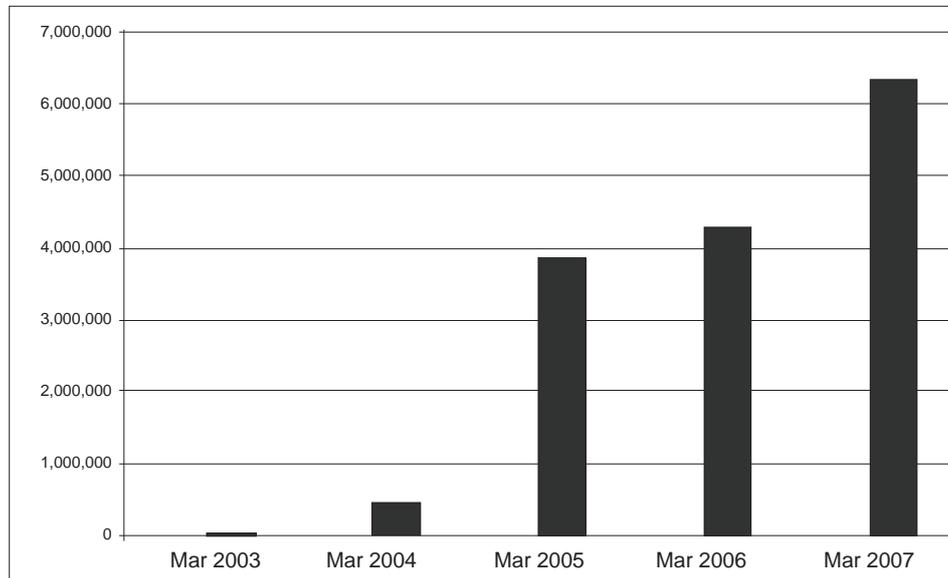
⁵⁵ Summary, Detailed findings, section 5.d, page 7.

⁵⁶ Referred to in the NAO Report, Part Three, section 3.27, page 26.

⁵⁷ Part Two, section 2.16, page 18.

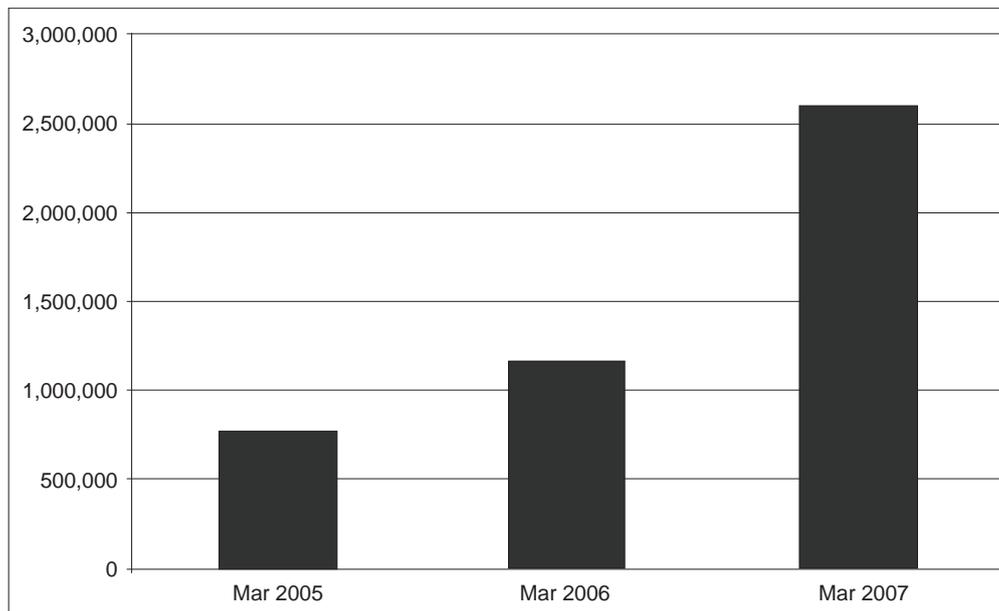
New tariffs include internet based tariffs and price guarantee products, such as fixed or capped price tariffs. Both of these new types of product have become popular with customers, as illustrated in the charts below.

NUMBER OF PRODUCT ACCOUNTS SIGNED UP TO PRICE GUARANTEE TARIFFS IN MARCH OF EACH YEAR



Source: Ofgem

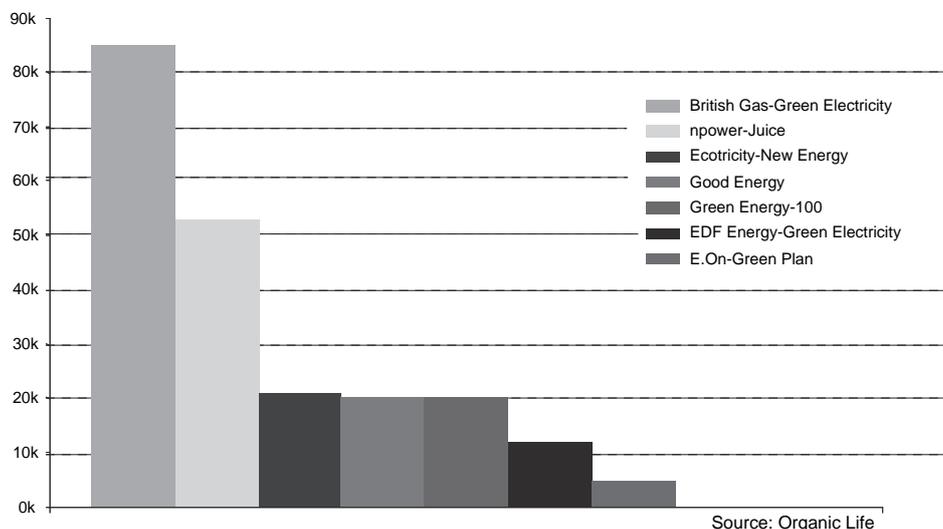
NUMBER OF CUSTOMER ACCOUNTS SIGNED UP TO ONLINE TARIFFS IN MARCH OF EACH YEAR



Source: Ofgem

Green products have been growing in popularity in recent years, and as at April 2007, around 215,000 customers were registered on these tariffs. While at present this only represents a small proportion of the electricity supply market, we are seeing steady growth in demand and expect it to increase significantly in the future.

Number of Green Energy Supplied Customers April 2007



Source: Organic Life

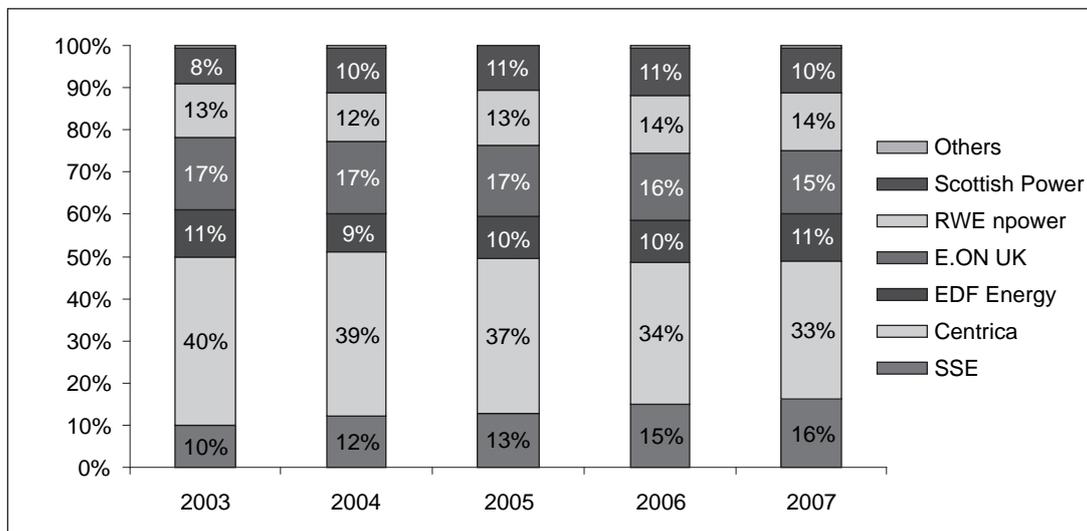
Smaller suppliers have shown themselves to be very competitive in the market for green products, having captured a significant share of this new market.

EDF Energy was also the first energy company to offer a new tariff to our customers that rewards them for using less energy. Our Read Reduce Reward tariff launched in May 2005 currently has 276,000 customers who are rewarded in loyalty points through the Nectar scheme for reading their own meter on a quarterly basis. Energy usage can be tracked online and if energy use reduces from one year to the next bonus points are earned.

1.3 Changes in Market Share

The chart below shows how active competition in the domestic supply market has led to significant changes in several companies' market shares. Centrica in particular has lost energy market share, as customers have switched to other suppliers to take advantage of lower prices and higher standards of customer service.

PERCENTAGE OF DOMESTIC ENERGY (ELECTRICITY AND GAS) ACCOUNTS BY SUPPLIER 2001-07



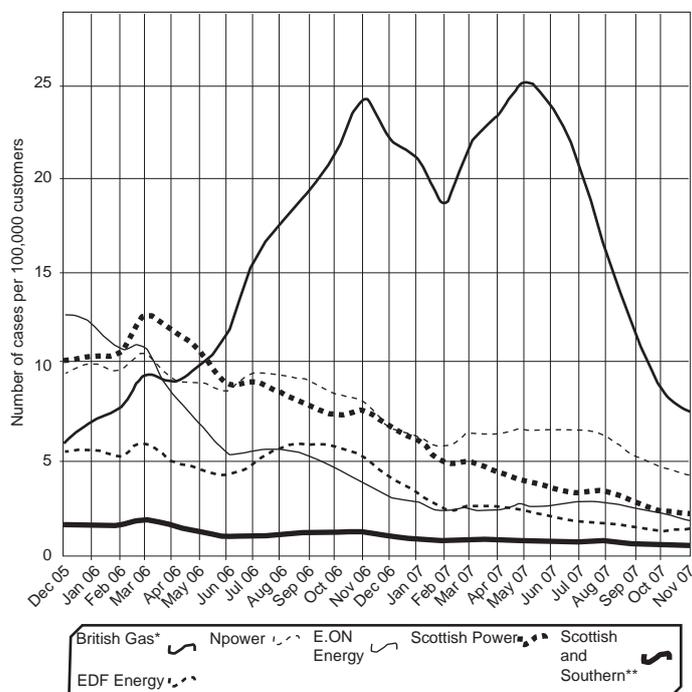
Source: EDF Energy and Cornwall Associates

1.4 Customer Service

Price and innovation are not the only differentiating feature of energy services, however, and all companies are seeking to improve their quality of service.

The chart below produced by energywatch shows that suppliers have been improving quality of service, reflected in the reduction in complaints received, although, as is publicly known, British Gas has suffered particular problems relating to a new IT system in the last two years.

MONTHLY COMPLAINTS BY SUPPLIER (DECEMBER 2005 TO NOVEMBER 2007)



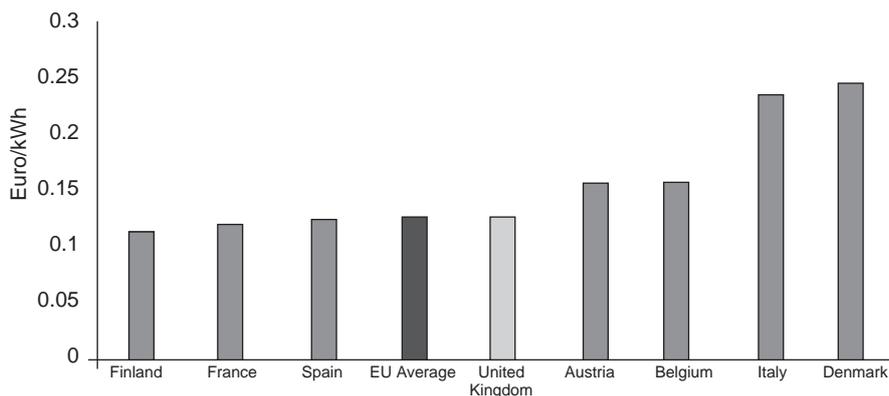
Source: Energywatch

1.5 Prices and comparison with European Energy Prices

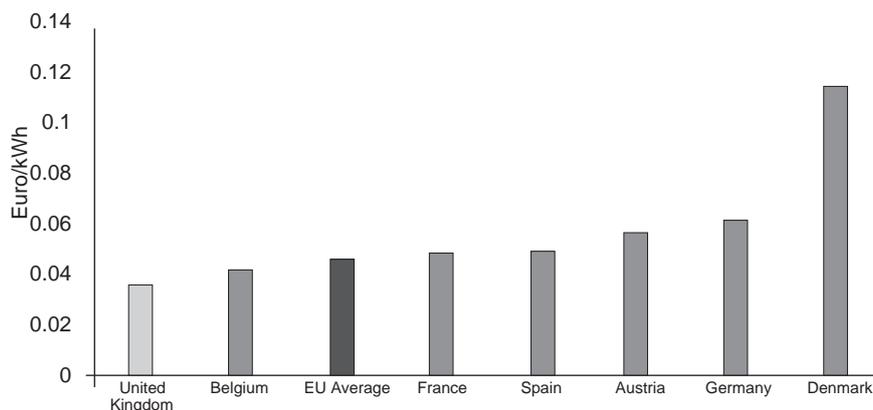
Despite the increases in costs experienced by the energy industry within the UK (see answer to Question 4), the high level of competition has ensured that domestic prices have remained competitive. Downward pressure on EDF Energy’s prices caused by customer switching has had an impact on its prices to all customers, including those customers not actively engaged in the market. EDF Energy’s approach to smoothing prices to protect customers from volatile wholesale prices has resulted in prices that are competitive, and it has in fact made lower profits in an attempt to provide this protection—see below, section 4.

The following charts created by Ofgem illustrate that UK energy prices remain low compared to many parts of Europe.

European electricity prices (including all taxes) in euros per kilowatt hour (kWh) based on annual consumption of 3500 kWh per year



European gas prices (including all taxes) in euros per kilowatt hour (kWh) based on annual consumption of 23250 kWh per year



Source: Ofgem fact sheet based on Eurostat data second half of 2007. Shows domestic tariffs.

1.6 Conclusion to question 1

In conclusion, it is clear that the current market structure encourages effective competition in the retail markets. In addition to competitive prices customers are being offered improved quality of service and new products more suited to their own needs. The success of the market is reflected in the high numbers of customers that are actively engaged in it by changing their energy supplier, a process that customers find easy to undertake.

2. Whether there is effective competition in the wholesale markets for gas and electricity

A number of investigations, including those conducted by BERR and the European Commission, into the wholesale energy market within the UK have found it to be competitive, and significantly more competitive than many other wholesale energy markets in Europe.

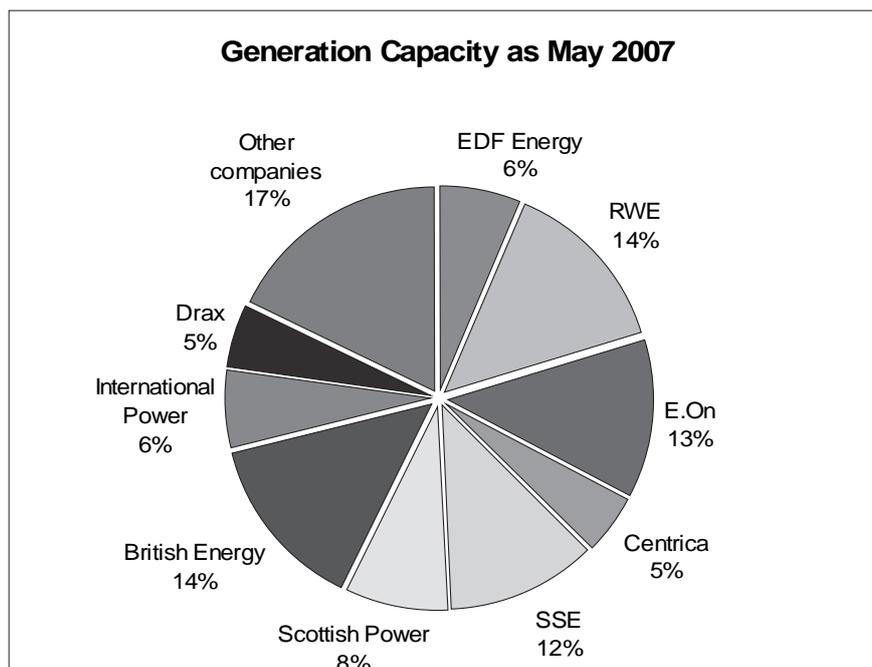
The electricity and gas wholesale markets have a large number of participants and liquidity remains high in the gas market, and is improving in the electricity market (demonstrated in section 2.1 and 2.2 below).

Significant increases in the cost of gas and coal, and the introduction of a price for carbon (demonstrated in section 2.3 below) have driven increases in wholesale electricity prices since 2005.

While the six vertically integrated suppliers do each operate electricity generation portfolios, they also purchase electricity from the wholesale market. In addition, vertically integrated players compete to minimise production costs, so that they can offer competitive retail prices to customers (demonstrated in section 2.4 below).

2.1 Participants in the market

There are a large number of participants in the wholesale electricity market; we estimate that there are 42 currently active players, comprising a number of generators, smaller suppliers, upstream energy companies (such as the large oil companies), dedicated traders and financial institutions. Around half of the electricity generated in the UK is generated by the six vertically integrated suppliers and many of the other generators directly supply industrial and commercial customers and some smaller suppliers also generated their own electricity. In its factsheet on the UK energy market the European Commission states that "Ownership of generation is rather diverse, with the UK having the lowest generation sector concentration in the EU".



Source: Digest of UK Energy Statistics, BERR

In gas there is even greater participation of parties in the wholesale market. The European Commission UK energy factsheet states “The wholesale market is highly competitive consisting of many offshore producers and importers.” EDF Energy, EON, SSE, Scottish Power, Centrica and RWE purchase the majority of their gas from the wholesale market in which there are 245 licensed shippers.

2.2 Market Liquidity

In its most general sense, liquidity is a measure of the number of times a given volume of a commodity or contract for a specified delivery date is traded between parties. It is sometimes argued that high levels of liquidity demonstrate that a market is competitive.

The UK gas wholesale market is often considered as a highly liquid market, with the same physical gas traded many times over. Liquidity has increased significantly since the market was liberalised in 1996.

In the electricity market, liquidity grew steadily in the first five years after liberalisation to 2001 but then decreased significantly after 2002 as a result of the market makers such as El Paso, Dynegy, and Aquila etc leaving the market and with the demise of Enron and TXU holdings. However, since 2007 we are now seeing a marked increase in liquidity in the market.

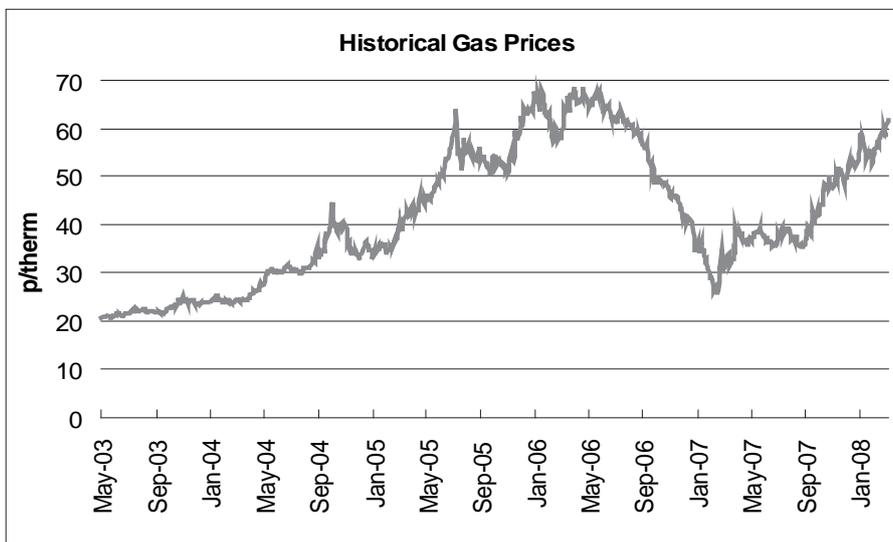
EDF Energy believes that the market would benefit from greater liquidity and we support the development of the Futures and Options Association “Market Design Project” which EDF Energy expects to promote power market liquidity. The first stages of this project will be the development of a central clearing service for the trading of prompt power (which is power traded close to the time of demand) and a robust spot market index. A spot market index should make it much more possible to develop a power futures market, and may lead to the development of a day-ahead auction.

This recent improvement in liquidity is highlighted in the findings of BERR’s annual review, conducted by Oxera, of the competitiveness of the UK energy market compared with other European markets. The latest report, which gives preliminary results for 2006 states, that: “the UK remains the most competitive of the electricity markets evaluated. The competitiveness of the UK electricity market has in general remained unchanged (with a score of 8.3/10), other than an increase in wholesale market liquidity”. On gas the report also states “A series of factors have been in play driving increases in the UK’s gas market competitiveness from 8.2 to 8.5. In particular, the wholesale liquidity figure has increased from 100% to 240%.

2.3 High Wholesale Prices

Since 2004 wholesale gas prices have become highly volatile and have increased significantly relative to pre 2004 levels. This has been driven primarily by high and volatile international oil prices. Electricity wholesale prices have also increased significantly since 2004. This is primarily a result of the high volatile wholesale gas price, and more recently as a result of rising international coal prices. In addition, since 2005, the introduction of the European Union Emissions Trading Scheme (EU-ETS) has meant that the cost of carbon is now included within the electricity wholesale price.

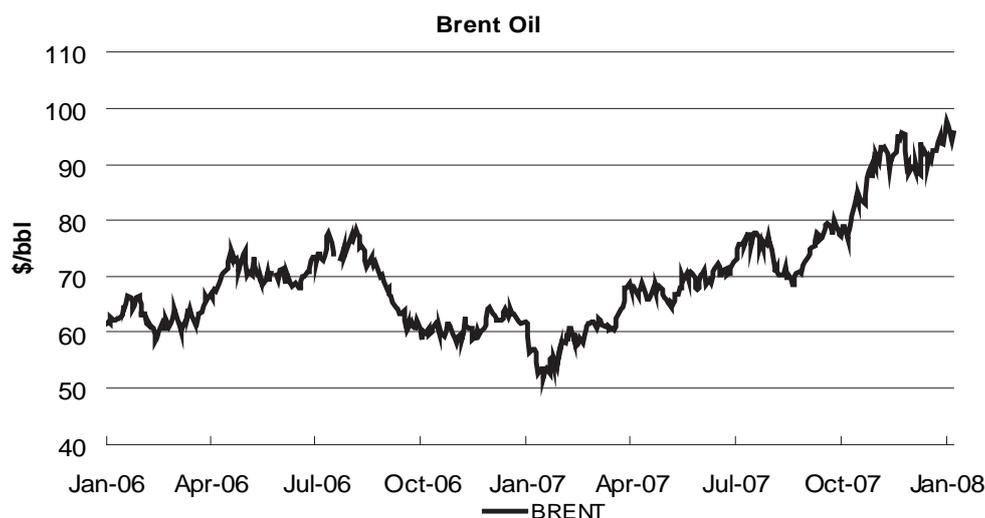
The graphs below show the changes in wholesale coal and gas prices between 2003 and 2008. Gas prices increased significantly between 2003 and 2005, with prices falling at the end of 2006 but then rebounding strongly from September 2007 and remaining high. Coal prices remained relatively stable until the middle of 2007, but have since increased significantly.



Source: EDF Energy analysis. Each data point shows the average price of gas for delivery in the next two seasons. For example, the May 2005 data point shows the average price of gas for delivery in Winter 2005 and Summer 2006. This approach is used to reflect the fact that generators will buy fuel in advance.



Source: EDF Energy analysis. Each data point shows the average price of coal for delivery in the next two seasons. For example, the April 2005 data point shows the average price of coal for delivery in Winter 2005 and Summer 2006. This approach is used to reflect the fact that generators will buy fuel in advance.



Source: EDF Energy analysis

There has also been a significant and prolonged increase in the price of oil since 2005. Even though the UK does not maintain an oil related pricing system for wholesale gas traded at the National Balancing Point (NBP), gas prices here are not decoupled from oil. This is because the UK gas market is increasingly linked to those in Europe, where traded gas prices are generally still directly oil indexed in some way (due to the absence of liquid and competitive gas markets). This means that as we import more gas (as continental shelf reserves fall) gas prices in the UK will still tend to move in line with the price of oil.

2.4 Wholesale Market Exposure of the Six Vertically Integrated Companies

GAS MARKET

EDF Energy like four of the other major UK suppliers has very limited gas reserves of our own. To meet our customers' demand we buy gas in the wholesale market through a mixture of long, medium and shorter-term contracts struck with upstream companies. We are very much a "price taker", and must compete with other suppliers to secure supplies.

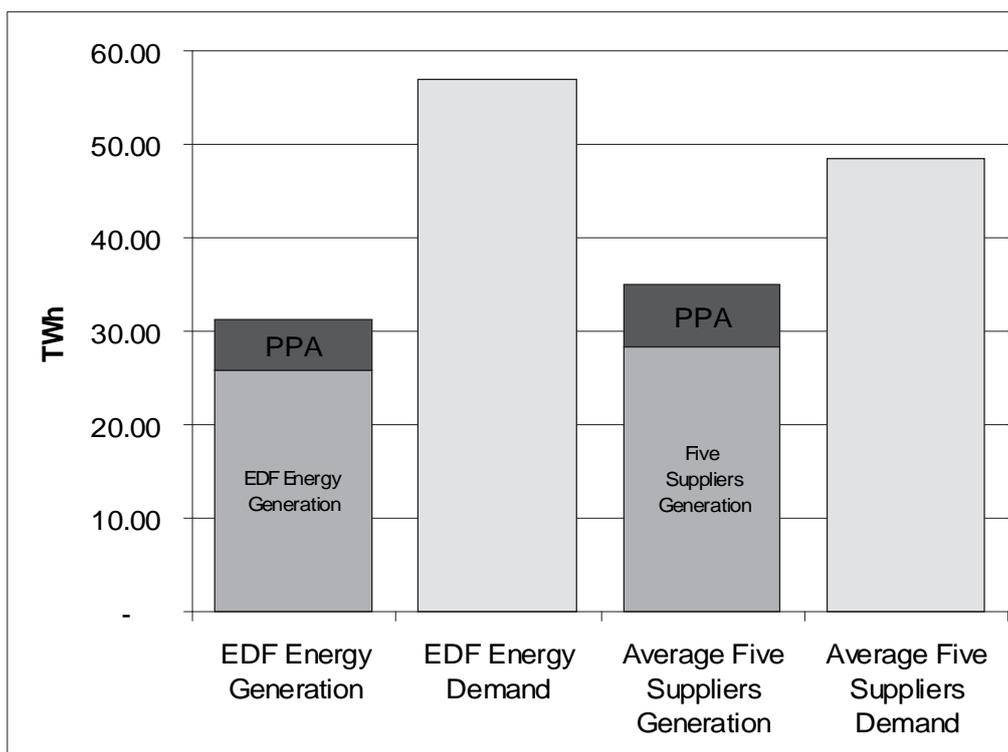
As an energy supplier to the domestic market we have to absorb considerable day to day volatility in wholesale gas prices so that it does not fall on our customers in the prices they pay.

ELECTRICITY MARKET

The six vertically integrated suppliers all have their own electricity generation, but are all also active in the wholesale market. Around half of GB electricity generated is by generators other than the six vertically integrated suppliers, and we believe all of the six have greater electricity demand than they are able to meet from their own generation.

The chart below highlights the level of demand compared with own generation and Power Purchase Agreements (PPAs) which are longer-term contracts to secure generation from other companies. The figures for EDF Energy are compared with an estimated average for the five other suppliers.

COMPANIES' OWN ELECTRICITY GENERATION AGAINST DEMAND



Source: EDF Energy analysis based on publicly available data for 2006

Purchasing from the Wholesale Electricity Market

All of the six vertically integrated companies are therefore exposed to wholesale market prices, and compete with other suppliers to purchase electricity. Each supplier will have a different strategy for purchasing electricity from the wholesale market, based on its view of future energy prices and the level of risk they are willing to accept. This is known as a “hedging strategy”, which a supplier will keep confidential as it seeks to gain advantage in the market.

Own Generation

By using a proportion of electricity that we generate in order to meet part of our own demand, we are reducing our customers’ exposure to the electricity wholesale market.

This market structure does not reflect a lack of competition between generators. Generators, including those who are part of vertically integrated companies must compete to minimise the cost of the electricity they generate—essential to ensure their supply business is able to sell competitively priced electricity.

As discussed in section 2.3, electricity generators are exposed to gas and coal wholesale price markets—we do not have significant reserves of gas or coal. Changes in fuel prices will affect the six vertically integrated energy companies in different ways, depending on the mix of generating plant that companies operate and their fuel hedging strategy. Companies are competing with each other on these factors.

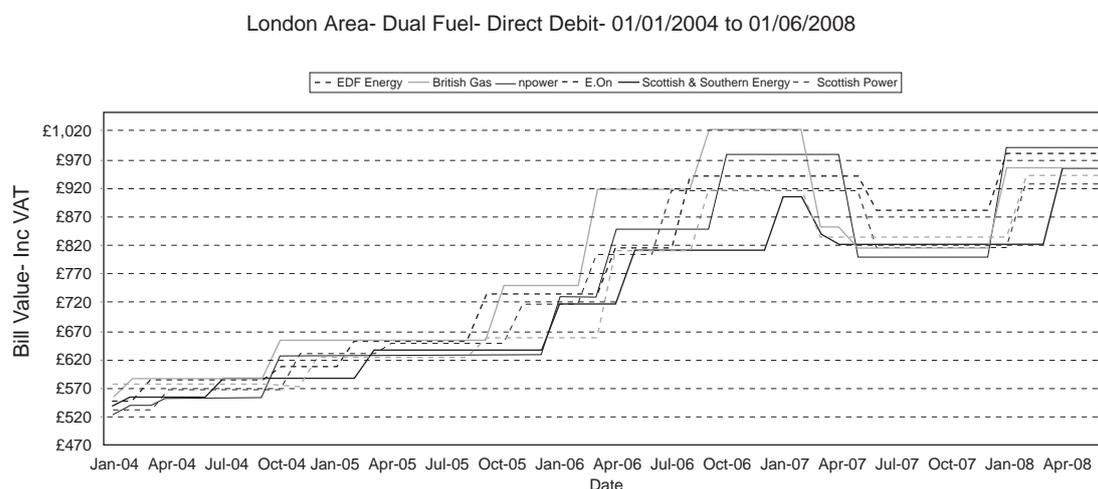
The six large suppliers all have significant generation portfolios, but the type of plants they operate vary. EDF Energy for example, operates two large coal fired power stations and one smaller gas fired station, whereas Centrica’s portfolio consists entirely of gas fired power stations. Therefore when coal prices are very high relative to gas prices, EDF Energy’s overall cost of generation is likely to be higher than Centrica’s.

In addition, as mentioned previously, costs will also be influenced by when the companies purchased in the wholesale markets the fuel they need to run the power station (hedging strategy). In a rising price market, a company that has locked in a fixed price contract for delivery of coal in the following year will benefit in comparison to a company that has not secured sufficient reserves and is now exposed to the latest coal prices.

The competitive market structure described above means that individual vertically integrated companies will incur very different average costs when securing electricity for their customers. This is known as their weighted average cost of power (WACP).

Each company's WACP will have a direct impact on its need and ability to increase or decrease prices, with some suppliers needing to change prices at a different time to other suppliers, albeit driven by the same underlying trends in coal and gas prices. As noted in section 1, the extent to which they can actually vary prices is limited by the competition in the market. This means that profitability can fall even when retail prices are rising.

The graph below shows the suppliers' different pricing strategies showing the broad trends in fuel costs but very different timings and size of price changes, depending on their own generation portfolio and hedging strategy.



Source: EDF Energy analysis based on publicly available data

Potential Improvements to the Wholesale Market

While the wholesale market in the UK is competitive, there is still room for improvement, and EDF Energy has been active in arguing for a number of measures that would make it easier for smaller suppliers and generators to be active in the market. We have introduced a change proposal⁵⁸ to the electricity Balancing and Settlement Code. The change aims to encourage parties to contract ahead of the delivery date to cover customer volumes, thus helping the system reduce any imbalance between supply and demand. The proposal has been widely supported by smaller suppliers and generators, and is awaiting a decision from Ofgem. In gas we have pushed for greater transparency in the gas market. We proposed a change that forced the gas network operator to publish after the day gas flows to large users of gas.⁵⁹ We as a company are therefore fully committed to improving the UK's wholesale energy markets.

2.5 Conclusion to question 2

The UK wholesale markets for electricity and gas are regarded as among the most competitive in Europe. There are many participants in these markets in addition to the large six suppliers, and all six suppliers need to purchase electricity and gas in addition to their own generation, to meet the customer demand. There are indications that the wholesale markets are becoming more liquid, but improvements can still be made to make it easier to trade in the market. EDF Energy has been leading efforts in the industry to make these improvements.

While the six vertically integrated suppliers do operate large electricity generation portfolios, they also purchase electricity from the wholesale market. In addition, vertically integrated players must compete to minimise production costs, so that they can offer competitive retail prices to customers.

3. *The implications of growing consolidation in the energy market*

Consolidation has been the natural result of companies responding to pressures in the market, and the emergence of a truly national market for electricity and gas (demonstrated below in section 3.1).

The exposure to volatile wholesale costs and the high level of competition in the retail market (demonstrated in sections 1 and 2) has driven companies to seek to grow in order to absorb these risks.

At the same time, the level of investment needed to replace the UK's energy infrastructure has grown rapidly (discussed below in section 3.2). Large companies that are able to manage the risks in the market are better placed to make these investments themselves, and can also support investment from others through Power Purchase Agreements (longer term contracts). Independent investors who have such

⁵⁸ BSC Modification 211.

⁵⁹ See Uniform Network Code Modification 121.

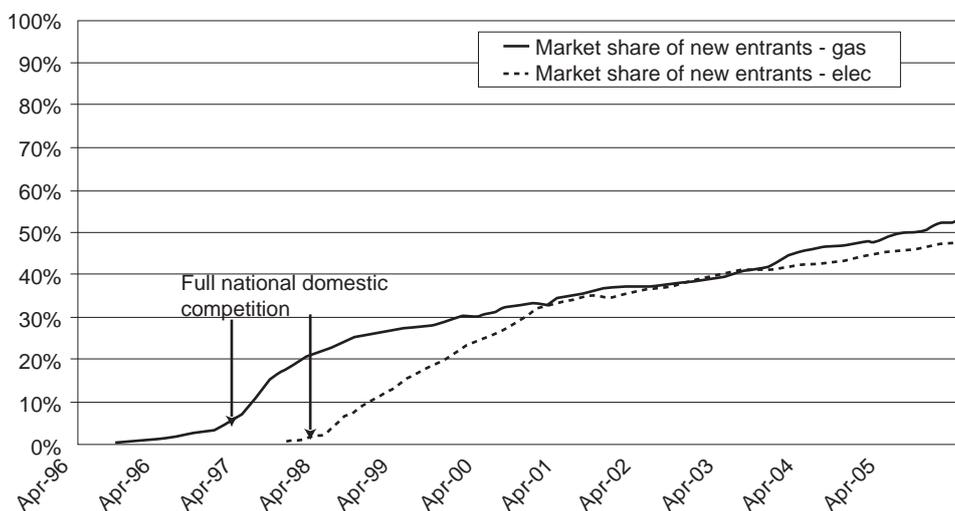
agreements with large companies are better placed to secure financing for their investments. The UK is not alone in seeking to renew its energy infrastructure. The IEA forecasts that \$20 trillion of investment will be needed worldwide by 2030. The European Commission estimates that nearly a trillion Euros of investment will be needed in Europe alone and this estimate was made before the new stretching targets for renewable energy were agreed. The UK will be competing with other countries for the financing of energy infrastructure and the resources to build that infrastructure. Large companies with a dedicated presence in the UK will strengthen the country’s ability to secure the required investment and resources.

3.1 Creating a national market

The consolidation in the market has transformed what were once regional electricity supply companies and one national gas company into a number of electricity and gas supply companies that compete nationally for customers. As illustrated in answer to question 1, these companies compete fiercely with each other and have the structure and size to provide their customers with protection from the volatility experienced in the wholesale markets for gas and electricity, a protection considered by the NAO to be important.⁶⁰

The creation of the national market is reflected in the growing market share of entrants and in the declining market share that energy suppliers have in what would historically have been their regional bases.

MARKET SHARE OF NEW ENTRANT SUPPLIERS (MARCH 2007)



Source: Ofgem

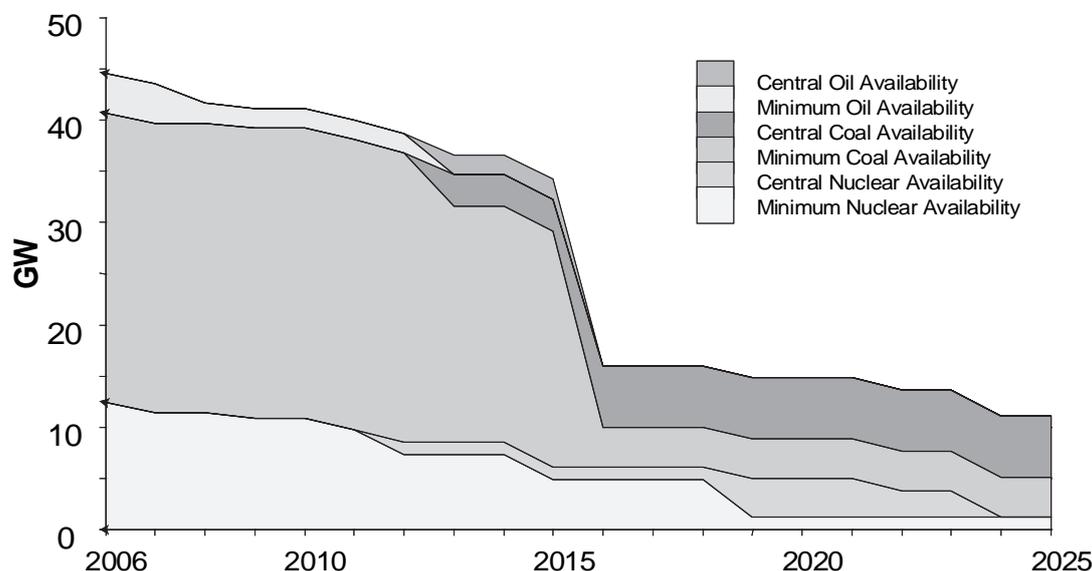
3.2 Investment in Energy Infrastructure

Much of the UK’s energy infrastructure will need to be replaced over the next twenty years. Many power stations will be reaching the end of their lives and will need to be replaced. Changes to our sources of gas, as the UK continental shelf reserves decline, create new challenges to ensure import facilities and storage is sufficient for our needs. In transmission and distribution networks older equipment needs to be replaced and the nature of the networks is evolving to meet new patterns of demand and to connect different types of generating technologies.

⁶⁰ NAO Report, Part One, section 1.4, page 11.

The chart below shows the likely closure scenarios for existing coal, oil and nuclear power stations within the UK.

UK OIL, COAL AND NUCLEAR POWER STATION MINIMUM AND CENTRAL CLOSURE SCENARIOS



This challenge is also an opportunity. By replacing the older high carbon emitting infrastructure with new low carbon technologies the UK has the opportunity to reduce our carbon emissions quite rapidly. However, this opportunity will require very large amounts of investment and resources over timescales that are short in energy infrastructure terms. And this is needed in the UK at the same time as much of the rest of the world.

EDF Group has announced that its investment plans for 2008 to 2010 have increased to €35 billion. Within the UK EDF Energy plans to invest nearly £500 million in each of next two years—10% of annual turnover—on a new gas-fired power station CCGT, renewables, improving existing plant and customer service. As the largest electricity distribution network operator we are also investing more than £300 million a year on improving and expanding the network. We are furthermore planning to invest in four new nuclear power stations to be commissioned from 2017—a £10 billion programme. Other companies are also planning energy infrastructure investment.

This level of investment requires a large company with a strong balance sheet that is able to negotiate effectively with the providers of essential equipment and services, who are experiencing unprecedented global demand. Consolidation has created companies with the ability to deliver the energy infrastructure the UK needs for the future, without compromising expansion by other players.

4. The relationship between the wholesale and retail markets for electricity and gas

Vertically integrated companies look to achieve their profit margin across both the difference between supply costs and retail prices (the retail margin) and the difference between generation costs or upstream gas costs and wholesale gas or electricity prices (the generation margin). In order to deliver the required investment in new UK electricity generation capacity, and in gas infrastructure, vertically integrated companies need to make sufficient margin to justify this investment. However, looking at the profit margins made across both of these areas we can see that the level of profit has been low in recent years.

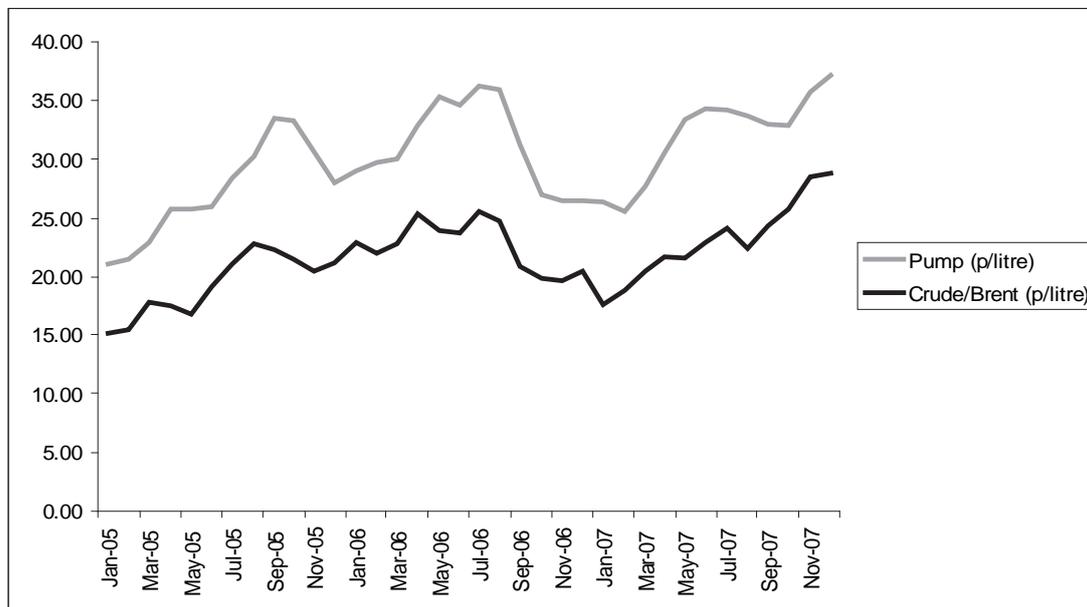
In section 2, we highlighted the level and volatility of costs in the wholesale markets. In addition to this increase in energy costs, energy companies have also incurred increases in other costs, such as network charges, metering costs, and the cost of Government environmental policies. However, the competitive nature of the market means that suppliers are unable to pass the full impact of these cost increases on to customers (demonstrated below in section 4.1), leading to very low and sometimes negative retail margins.

Therefore, energy companies are looking at margins in the generation business to decide whether or not to invest in new plant. EDF Energy has undertaken analysis based on publicly available information that demonstrates that while margins have risen they are still too low to justify the level of investment in new generation that is needed within the UK (demonstrated in section 4.2 below).

4.1 Increasing costs

Unlike certain industries, including the petrol retail industry, electricity and gas suppliers do not change prices on a weekly or even daily basis in order to reflect underlying energy input costs.

The graph below shows how, in the petrol retail industry, monthly average prices at the petrol pump closely follow crude oil prices and petrol spot prices.



Source: UK Petroleum Industry Association, based on data from WoodMac

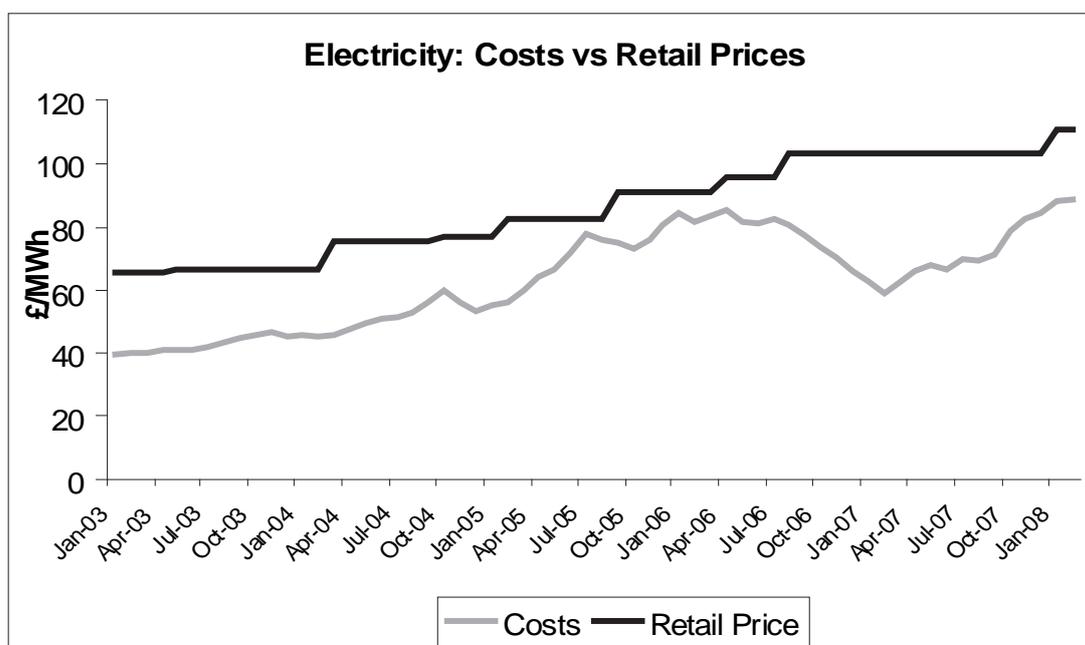
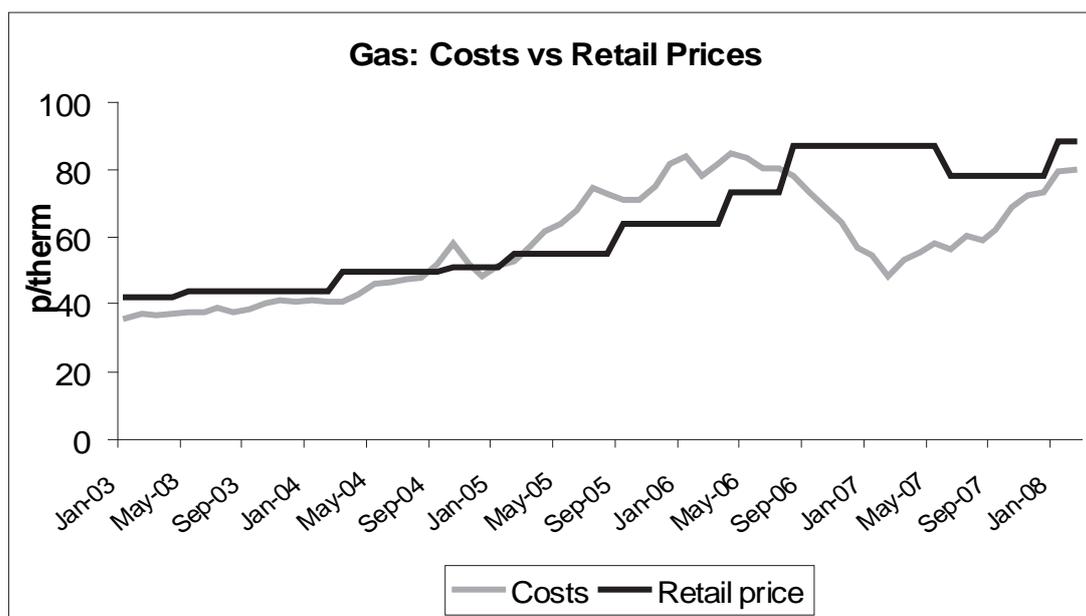
By contrast, in the energy industry, suppliers absorb volatility and smooth prices to domestic customers as far as possible. The industry has been criticised for being quick to raise prices when wholesale costs rise but slow to reduce prices when costs fall. The analysis below shows this to be incorrect, and demonstrates that by smoothing retail energy prices, the companies have actually saved their customers significant amounts of money.

The graphs below compare EDF Energy's standard credit tariff (exclusive of VAT) for gas and electricity against the cost increases experienced within the market between Jan 2003 and Feb 2008.

While the fact that energy costs have increased is well known, it should also be noted that the other costs listed have also increased over the period. In fact, in February 2008 costs associated with using gas transmission and distribution networks and metering were 30% higher than they were in January 2003. The costs included in the total are:

- Energy costs.
- Industry Costs: Network costs, Metering costs.
- Regulatory Costs: The cost of complying with the Government environmental initiatives.
- Renewable Obligation (RO) and the Carbon Emissions Reduction Target (CERT).

The analysis in the charts below includes these costs but does not include our own operational costs. The charts also do not incorporate a likely hedging strategy whereby gas would have been bought more than four quarters in advance. In this way the charts actually present a more positive picture than was experienced by suppliers during, for example, late 2007 and early 2008 when some suppliers were publicly reporting substantial losses in their retail businesses.



Source: EDF Energy analysis. Electricity and gas costs for each month are calculated by taking the average price of gas for delivery in the next four quarters. This approach is taken because suppliers purchase gas and electricity in advance.

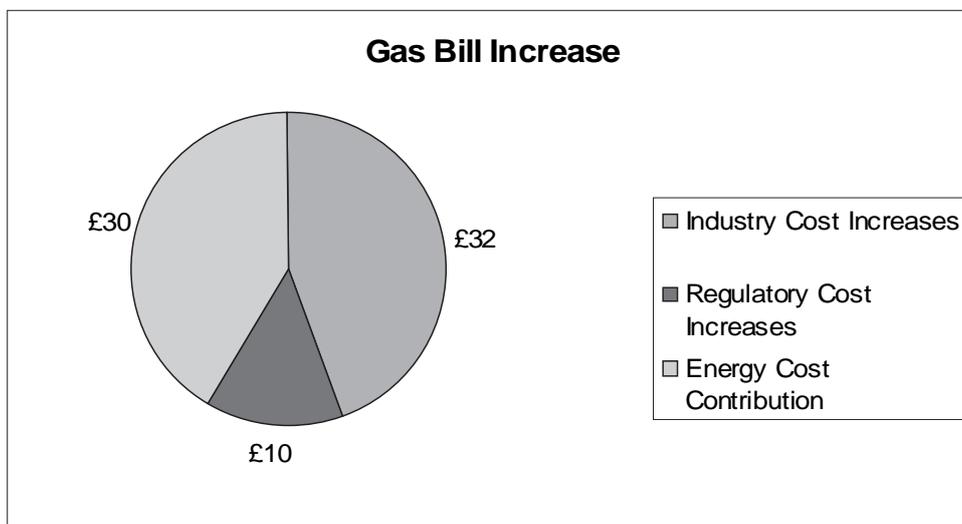
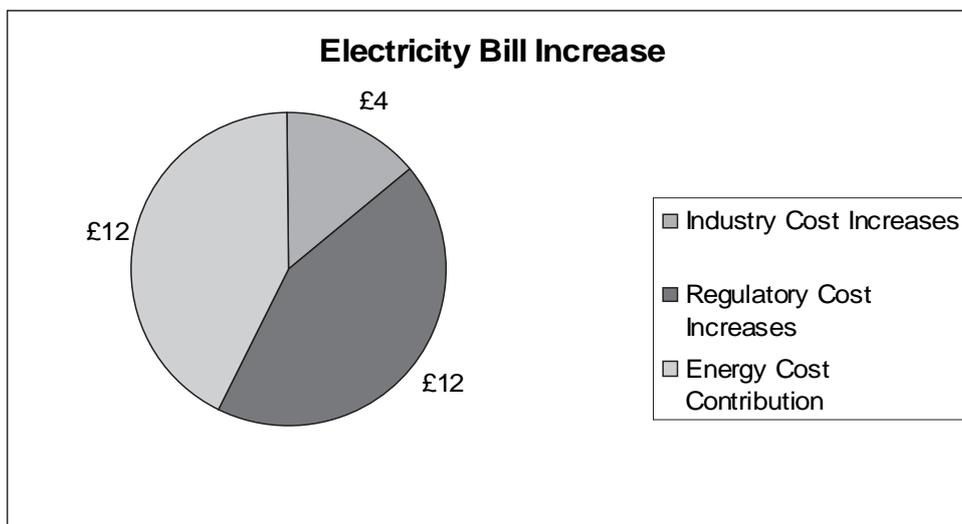
The graphs clearly demonstrate that suppliers' costs have increased significantly over the period. EDF Energy and, according to Ofgem analysis, other suppliers, have not passed through the full level of cost increases to customers and profit margins have been squeezed. In fact, our analysis shows that for a typical EDF Energy customer taking both electricity and gas over this period, we passed on in excess of £150 less than would have been justified by the underlying cost increases. This demonstrates the pressure of competition in the retail markets and that EDF Energy's approach to smoothing volatile prices has resulted in fair prices to its consumers.

This analysis is supported by the conclusions drawn by Ofgem in their Domestic Retail Market Report (June 2007) which looked just at the increase in wholesale costs and stated that with regard to the period Jan 2003 to June 2007 " . . . on average, suppliers passed through less than the full increase in the wholesale costs to domestic customers over the period. This saved the average [dual fuel] customer £116".

EDF Energy's Recent Price Increase

EDF Energy's recent tariff increase was partly a response to an increase in wholesale costs, but also due to a significant increase in "other costs", as discussed earlier.

Electricity prices for an average EDF Energy customer increased by £28 per annum and gas prices by £72 per annum. The graphs below show how this is broken down between the various cost elements. It should also be noted that the bill increase did not cover the full actual increase in energy costs which rose by more than 50% in 2007.



Source: EDF Energy analysis.

4.2 Margin Needed for New Investment

One of the margins on which energy companies can potentially earn a profit is from the sale in the wholesale markets of the power they generate.

The gap between wholesale prices and the costs of generation (fuel and carbon costs) is called the generation spread. There is trading in the wholesale markets at different time horizons:

- the prompt spread refers to same-day trading; and
- the forward spread refers to trading at longer time horizons, up to three years ahead.

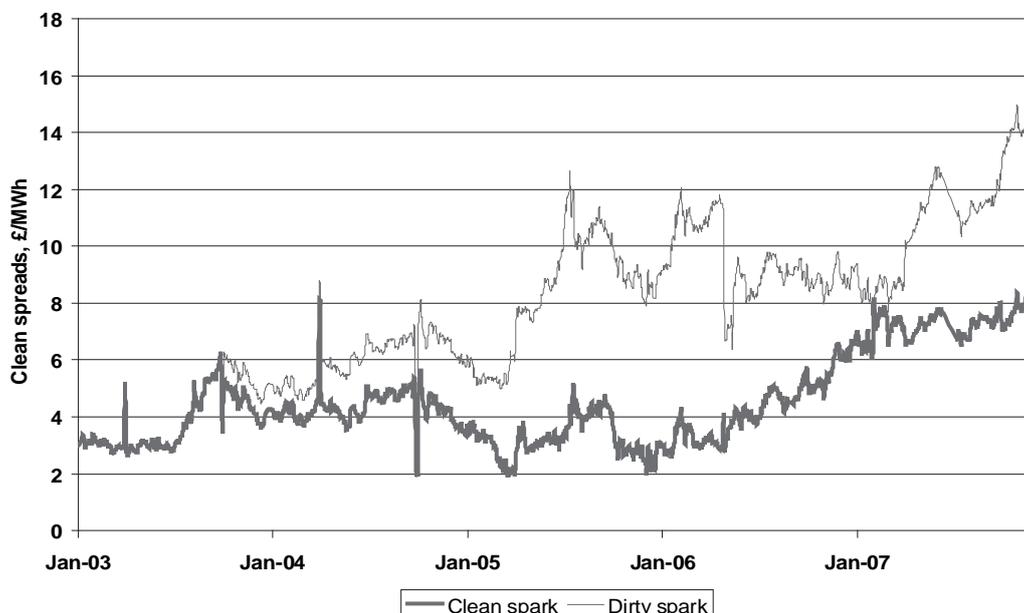
Companies themselves will trade in wholesale markets, in order to keep their costs low and compete effectively on retail prices. Their exact strategy for trading is commercially confidential.

There are different names for the generation spreads for coal ("dark") and gas ("spark"). In either case, the spread can be measured as either the gap between wholesale prices and energy costs only (the "dirty" spread) or energy plus carbon costs (the "clean" spread). This distinction has been relevant since the introduction of the requirement on generators to buy some carbon allowances (the European Union

Emissions Trading Scheme (EU ETS). The Phase 1 allocation of allowances covered only a proportion of historic capacity, amounting to 80% for gas and 70% for coal in the case of EDF Energy, so purchasing of additional carbon allowances has added to generation costs.

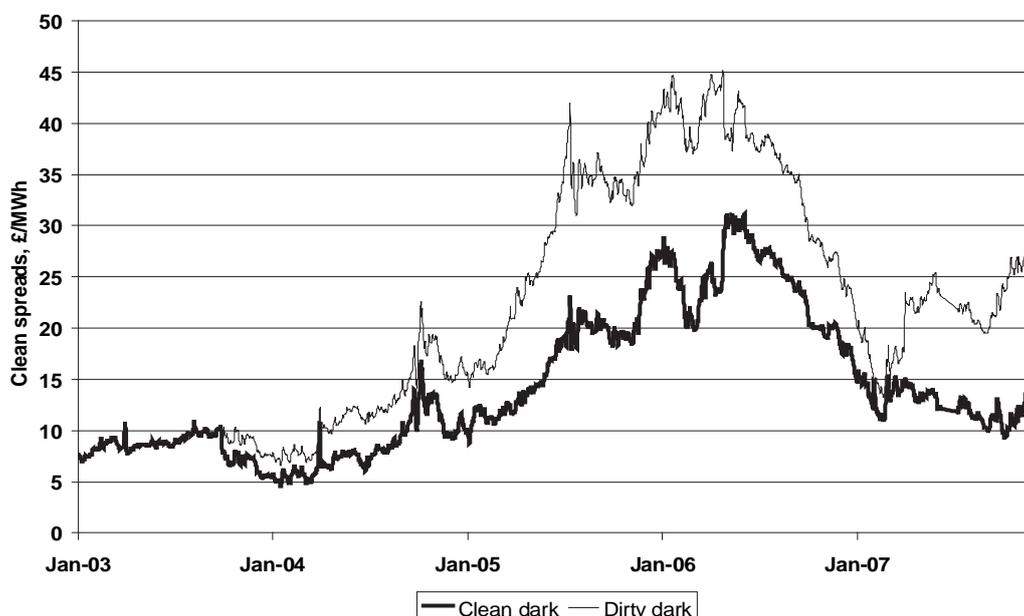
The charts below show both clean and dirty spreads for gas and coal respectively.

GAS (SPARK) SPREADS



Source: EDF Energy Analysis

COAL (DARK) SPREADS



Source: EDF Energy Analysis

The generation spread needs to be sufficiently high to provide a return on investment in higher environmental standards for existing capacity, and even higher for investment in new capacity, where there also needs to be a contribution for depreciation.

In the case of coal, we estimate the break even return even before covering depreciation and providing an incentive for new investment is more than £10/MWh and, depending upon future depreciation and investment, the requirement is around £20/MWh. The chart shows that before 2005 many coal plants were effectively not worth keeping open for much longer. Clean spreads rose to a peak in 2006 but have since fallen sharply, to a level barely above the minimum required for further investment.

In the case of gas, a smaller margin is required as the capital investment and operating costs are lower in a gas power station than for coal. However, gas generators too have consistently earned a margin too low to justify investment (below £10MWh).

In practice the picture is slightly less stark because all generators would seek to use hedging strategies—trading in the wholesale markets on different timescales—to ensure they were not exposed to the full impact of increases in gas and coal costs. However, far from making an excess margin on generation, spreads have been too low for generators to earn a reasonable return on investment.

4.3 Conclusions to question 4

The analysis in this section has indicated that while wholesale costs have risen, the full cost of these rises have not been passed on to customers by the six large suppliers. Competition in the retail market has ensured that prices are kept low even in the face of increased costs.

It is not just fuel costs but also carbon costs which have risen. The EU ETS introduced the requirement to purchase carbon emission permits. The scheme gave a proportion of the allowances to emit carbon free to generators provided that the stations stayed open. These permits have a market value, but without free allowances it would otherwise have been difficult for a number of power stations to have sustained the level of investment required to meet statutory and environmental requirements and remained open. A reduction in generation capacity would have resulted in a less competitive generation market and the potential for higher prices. This shows that the vertically integrated energy companies have not been earning high margins as a result of the free carbon permits that have been given to them under the EU ETS, and margins are still below the level that would justify new investment in these technologies.

Generation spreads overall remain too low, despite recent increases, to justify the significant new investment in capacity required in the UK.

5. *The interaction between the UK and European energy markets*

The level of interaction between the UK and European gas markets has increased in recent years, predominantly as a result of the decline in gas supplies from the UK continental shelf. It is gas where the impact of European energy markets is greatest, but the gas market also has an impact on the electricity market, as gas is one of the fuels used to generate electricity.

In electricity there is a 2GW interconnector (about the size of a coal-fired power station) with France which gives a limited interconnection with the European energy market, although more interconnection is in the planning stage.

Historically the UK has been self sufficient in gas owing to the UK Continental Shelf, and until 2005 the UK was a net exporter of gas. As the UKCS has declined the UK has turned to alternative gas sources to meet its demand, with the UK now importing gas from sources such as Norway, Holland and Algeria.

The key infrastructure linking the UK with other gas markets are:

- Langedled/Vesterled: Connecting St Fergus in the UK to Norway, the Vesterled pipeline was connected into the Norwegian system in 2001.
- UK: Interconnector UK. Completed in 1998 linking Bacton in the UK to Zeebrugge in Belgium.
- BBL: Linking Bacton in the UK with Balgzand in the Netherlands, this pipeline was completed in December 2006.
- Isle Of Grain: A converted LNG storage facility, capable of importing 13mcm/day of gas into the UK. Capacity is held by BP and Sonatrach—Algerian. Currently a second phase of capacity is being constructed, with a third phase due to come on line in 2011.
- Excelerate Energy: Excelerate developed a facility for the supply of LNG gas direct from a ship, with connections at Teeside.
- Milford Haven: Currently there are two LNG terminals under construction at Milford Haven at Dragon and South Hook which are due to come on line in either 2008 or 2009.

The UK market will increasingly be more integrated with the European and world gas markets as the UK continental shelf reserves decline. This will continue to increase the extent to which the UK gas market interacts with markets elsewhere. Prices will continue to be influenced by what happens not just in Europe but also in the rest of world as LNG imports increase.

The UK market is therefore inextricably linked to the rest of Europe—and this interaction will increase in the future. This means that the creation of a single, competitive European market is crucial to how the UK market will develop. EDF Energy and the wider EDF Group supports the European Commission's efforts to create an integrated liberalised market. The “third package” of legislation proposed by the European Commission is an important step towards achieving more competitive energy markets elsewhere in Europe. There are a number of conditions that are needed:

- effective unbundling of transmission companies;

- clear, strong and predictable regulation at both the national and EU level to provide the right framework for investment, supplemented by effective coordination of regulators through the proposed Agency to deal with regional and cross-border issues;
- greater coordination between the transmission companies in the way they operate their networks and plan investments; and
- incentives for transmission companies to maximise the amount of capacity that is made available to the market.

An agreement on the third package in the coming months is crucial for the future development of the UK market.

The UK wholesale energy market is also affected by what happens in the global commodity markets for coal and oil. As explained in section 2.3, coal and oil prices influence what happens in the UK wholesale energy market, which means we are not isolated from price rises elsewhere.

6. *The effectiveness of regulatory oversight of the energy market*

The UK energy market has been closely monitored and regulated by the independent regulator, Ofgem. In addition to this constant oversight many other organisations regularly review the operation of the market, including BERR and the European Commission. The independence of the regulator is seen by the European Commission as a strength of the UK energy market. It said “the Office for Gas and Electricity Markets (Ofgem) has a high level of powers and independence from both the industry and the relevant Ministry” in ‘Prospects for the internal electricity and gas market’ (published January 2007).

Ofgem

Ofgem reviews the operation of the domestic market annually in its Domestic Retail Market Report, which reviews all aspects of competition including cost and price increases and interactions between the wholesale and retail markets.

Ofgem also investigates complaints of anti-competitive behaviour under its Competition Act powers, and has conducted a number of investigations in recent years.

It is also worth noting that Ofgem has consistently reported a steady increase in the development of competition in the gas and electricity retail markets. In fact the retail market was thought competitive enough to remove price controls even when only 36–37% of customers had switched. Ofgem has consistently concluded that the market is competitive.⁶¹ In their most recent survey in 2007 Ofgem concluded:

“Our analysis shows that all segments of the market remain highly competitive and not just for customers who pay by direct debit or online. The key findings are:

- Vigorous price competition between the big six suppliers for all customers—the spread between prices has shrunk and the most expensive suppliers have been forced to become more competitive to stem customers losses
- Suppliers are innovating to retain and win customers—there has been rapid growth in: fixed and capped price deals that shield customers from rising wholesale prices; cheaper online deals; and green tariffs. They now account for roughly 20% of the market.
- Customer service is improving: suppliers are investing huge sums to improve their systems and five suppliers have cut the number of unresolved complaints.
- Annual customer switching rates are at the highest in four years”.

(Domestic Retail Market Report Ofgem 169/07 2007 p1)

BERR Reviews

BERR also reviews the level of competition annually and has a Public Service Agreement target to: “Ensure the UK ranks in the top three most competitive energy markets in the EU and G7 in each year”. A report is produced annually by OXERA on behalf of BERR, the latest version of which confirms that the UK is the most competitive energy market in the EU and the G7.

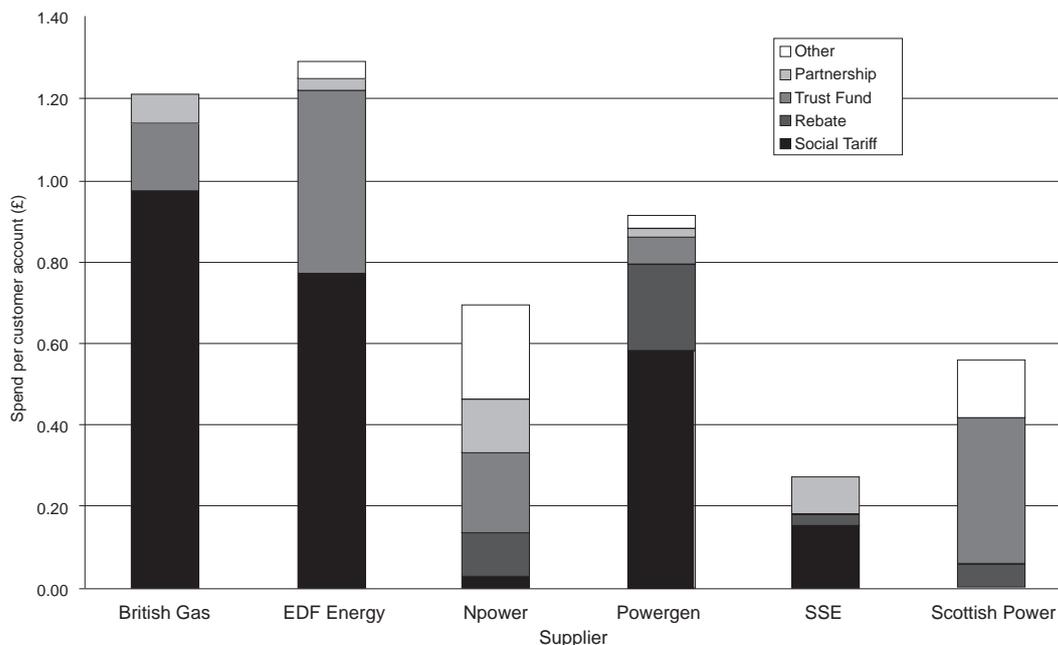
We think this ongoing scrutiny of competition over the lifetime of the market has been strong, and regulatory oversight has been detailed and constant.

⁶¹ Domestic Retail Market Report—March 2006, July 2006 (Ref No 110/06) Domestic Retail Market Report—September 2005; February 2006 (Ref No 23/06); Domestic Retail Market Report—June 2005, February 2006 (Ref No 24/06).

7. Progress in reducing fuel poverty and the appropriate policy instruments for doing so

EDF Energy has led the industry in responding to fuel poverty, as was recognised by Ofgem in its analysis of industry social responsibility initiatives represented in the chart below. But the energy industry alone cannot solve fuel poverty. Government has an essential role to play as fuel poverty is at heart a poverty issue that needs to be tackled from an income perspective as well as an energy cost perspective. It is also Government that has the information with which to identify who is fuel poor. Energy companies do not have the information with which to target vulnerable customers and must rely on imperfect estimations and self identification by customers.

SOCIAL RESPONSIBILITY SPENDING BY THE SIX LARGE ENERGY SUPPLIERS



Source: Ofgem

In February 2008 EDF Energy enhanced our activities in this area yet further with the launch of our Social Commitments. We committed to the following:

1. Provide a long term social tariff for our most vulnerable customers through to 2012 by extend our existing Energy Assist Tariff which gives a 15% discount to its 55,000 most vulnerable customers for a further year—until 31 March 2009. This social tariff has already been recognised by Energywatch as the most generous in the industry.
2. Customers on the company's social tariff also continue to receive free energy efficiency advice and practical measures to reduce their energy usage, as well as access to the EDF Energy Trust Fund and a free Benefits Entitlement Check.
3. By 2012, EDF Energy is also planning to help educate 2.5 million young people in the UK on the sustainable use of energy. As the first Sustainability Partner of London 2012, EDF Energy will support London 2012's education programme and will help schools understand and address their own use of energy, to reduce their climate change impact and reduce their running costs. The education programme will be supported by the EDF Energy Green Fund to deliver renewable technology projects for schools together with available public funds.
4. Manage the supply chain to help ensure that our suppliers meet agreed ethical standards and, in particular, comply with the UN Global Compact.
5. Lead the industry in protecting vulnerable customers from the adverse affects of power cuts.
6. Build on our ambition to achieve Zero Harm in our workforce by promoting health and safety awareness for children, community groups and our customers.
7. For our employees, attaining the gold standard for our approach to diversity and inclusion and increasing training opportunities to develop a range of new skills.

These commitments represent the one of the biggest packages of social initiatives launched by any major British company.

We are happy to work with the government in detailed consultations in coming months to understand what can be implemented on a longer-term basis to meet the government's target of eradicating fuel poverty. Everyone wishes to see fuel poverty eradicated, and to do this in a sustainable, robust and fair way we

support a mandatory requirement on energy companies to provide a form of social tariff. This must be accompanied by firm commitments from Government to provide the information required to identify the fuel poor as well as tackling the wider social and income aspects of fuel poverty.

1 April 2008

Supplementary evidence from EDF Energy

During the oral evidence I gave to your Committee last week I promised to provide a note giving more details about bad debt. I would in addition like to clarify some of the evidence I gave in relation to vertical integration and risk.

On the first point, it is obviously not a surprise that bad debt increases when prices rise. EDF Energy has nevertheless been working hard to reduce bad debt levels, and to mitigate the impact of price rises. We were the first company to introduce a trust fund, overseen by independent trustees, to help customers most in need: to date the trust has awarded £7 million to some of our most vulnerable customers. However, we have still seen an increase of 7.6% in the amount of customer indebtedness over the last twelve months, and we currently predict around a 10% increase in bad debt this year compared to 2007.

On the second point, relating to vertical integration, some of the confusion stems from written evidence given to the Committee by Ofgem, which stated that the value of trades in the wholesale market was only £31 million in 2007. This figure was cited in questioning by Adrian Bailey MP. Unfortunately this appears to be a typographical error on the part of Ofgem, whose evidence is quoting from an FSA report that in fact estimates the market value of such trades to be £31 billion.

As we have said to the Committee, vertical integration is a way of reducing risk, and thereby reducing our customers' exposure to volatility in the wholesale gas and electricity markets. As members of the Committee highlighted, it is for example beneficial to the UK to have more vertical integration in gas through the building of gas storage. Similar benefits arise from vertical integration in electricity, by reducing financial risks. We do not have to sell directly from our electricity generating plants to customers to realise this benefit.

It is important to be clear, however, about the difference between the physical supply of electricity from a generator to a customer and the volume of electricity traded in the wholesale market. When I was asked whether all of the electricity that EDF Energy generates is sold on the wholesale market, I said yes. I wish to clarify this by making clear that we trade the equivalent of all of electricity we generate, and in fact much more besides: in 2007 we generated 26TWh in 2007 and traded 124TWh.

We trade to source electricity for our larger industrial and commercial customers, to hedge our generation position, balance and "shape" the mismatch between the electricity we generate and our customer demand, and to adjust for volume changes arising from events such as abnormal weather. It is this traded volume which determines liquidity in the market, not the extent to which there is a transaction between our plants and our customers or other customers.

The benefit to customers of vertical integration is that vertically integrated companies are able to manage the volatility between the wholesale and retail markets, thereby reducing the cost to our customers. Of course, when the primary costs of fuels rise as they have done over the past few months, the margins in both wholesale and retail markets are squeezed and retail price increases are inevitable—but companies will all try to avoid raising prices for as long as possible to maintain a competitive offering in the market.

I said to the committee that this market is not perfect and can be improved and that we have to be realistic and modest and to recognise the strengths and weaknesses that we are all facing in Europe in general and the UK market in particular.

There are a number of factors that can explain why trading multiples in the UK are not as high as in the Nordpool and in Germany. A key factor is the existence of an exchange that can facilitate financial trading in futures, allowing market participants the flexibility to trade non-physical positions. These exchanges also offer a clearing service for Over The Counter (OTC) trades which reduces the counter party risk for market participants. As I said to the Committee, EDF Energy is supporting efforts to create such an exchange within the UK. The experience of Germany and the Nordpool holds valuable lessons for the UK and demonstrates that more vertical integration does not reduce liquidity. In the German market there are only four major vertically integrated players, but considerably more liquidity than in the UK.

1 July 2008

Memorandum submitted by Electricity4Business
INTRODUCTION

Electricity4Business is a UK-based firm and the only energy supplier in the UK that is dedicated to the SME (Small and Medium Enterprise) sector. The company was set up to take advantage of the deregulated energy market and currently has around 34,000 customers.

Despite being a fast growing and innovative company, we believe that much more can be done to ensure genuine competition in the energy market and the best possible deals for SMEs. Many of our senior staff have moved across from the “Big Six” firms to take on and address some of the criticisms currently being leveled at these companies including cost, transparency and customer service. With 60 years of combined experience in the utilities industry between them, we can therefore provide a great deal of insight and understanding of the issues and challenges of operating successfully in the UK energy market.

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

It is well documented that all six big energy suppliers have announced significant price rises since the start of the year. In early January, Npower put prices up for its electricity customers by 12.7%, while its gas price rose by 17.2%. That same month, EDF put up electricity tariffs by 7.9% and gas prices by 12.9%. British Gas increased gas and electricity prices by 15%. Scottish Power increased gas bills by 15% and electricity bills by 14%, and E.ON put up gas bills by 15% and electricity tariffs by 9.7%. Scottish and Southern Energy was the last to make the move with an average 14.2% increase in electricity bills, and a 15.8% lift in gas charges for domestic customers coming into force on 1 April.

In justifying these increases, British Gas, EDF and Npower highlighted the fact that wholesale prices have increased significantly in the last year. EDF states that gas prices rose by 117% and electricity prices by 90% between February 2007 and February 2008.

However, this ignores the fact that Britain’s energy companies are producers or generators as well as being retailers. As producers they profit when wholesale prices are high, as retailers they profit when wholesale prices are low. This helps to explain how British Gas was able to report annual profits of £571 million at its residential arm in February 2008, up from £95 million in 2006.

Ofgem regards the numbers of consumers switching supplier as the key measure of competition in the market. It suggests that four million out of 36 million energy account holders switched supplier in 2007⁶². This may be true, but the fact remains that half of consumers and 65% of pensioners have never switched supplier⁶³. In addition, almost six million people on prepayment meters cannot switch using an online comparison site and two million people cannot switch because they are in debt to their supplier. With so many consumers unable to switch supplier it is therefore wrong to suggest that levels of switching amounts to effective competition.

There are additionally specific reasons why our target customers, SMEs, are not automatically switching away from big six energy suppliers in response to these significant price increases. Small businesses often have a lower level of knowledge of the opportunities open to them from energy supply competition, especially when the use of different brands by some of the major suppliers can confuse, leaving them with the perception that there is more competition in the market than is actually the case. They also have difficulties obtaining and evaluating offers from competing suppliers, given a perceived non-comparability of terms and a general lack of transparency. This means that their awareness and understanding of a recent shift to fixed price, fixed term contracts is low, leading to a greater tendency to contract disputes around invalid transfers.

Small businesses that do want to switch away are also sometimes confused by the varying cancellation requirements of the major energy suppliers (examples of which are outlined below).⁶⁴

<i>Supplier</i>	<i>Cancellation Notice Requirements</i>
British Gas (British Gas Business/Scottish Gas/Electricity Direct/Enron/Scottish Gas Business)	Written notice at least 90 days prior to the end of the initial contract.
EDF Energy (SWEB Energy/Seeboard Energy/London Energy)	Written notice at least 28 days prior to the end of the initial contract.
Npower (Midlands Electricity/Yorkshire Electricity/Northern Electric)	Written notice at least 90 days prior to the end of the initial contract.
E.ON “Powergen” (Economy Power/Norweb, Eastern Electricity/East Midlands Electricity/Independent Energy)	Notification of cancellation can be given during the “Review Period”. The Review Period is defined by E.ON as:

⁶² Source: energywatch press release, 5 February 2008
http://www.energywatch.org.uk/media/news/show_release.asp?article_id=1084

⁶³ Ibid

⁶⁴ Source: Electricity4Business competitor market research.

<i>Supplier</i>	<i>Cancellation Notice Requirements</i>
	<p>“The Review Period is a period of not less than 14 days from the date of our written notification. Written notification will be not less than 30 days before the end of the Fixed Price Period”</p> <p>Notification can be given by:</p> <p>Letter Fax E-mail</p>
Scottish & Southern Energy (Swalec/Southern Electric/Scottish Hydro Electric/Atlantic Gas & Electricity)	Written notice not less than one calendar month before the end of the initial contract.
Scottish Power (SP Manweb/South of Scotland Electricity)	Written notice at least 60 days prior to the end of the initial contract.

Electricity4Business would also like to bring to the Committee’s attention:

- The loss leader pricing strategies being adopted by the big six energy suppliers as they seek to retain and win back SME customers.
- Delaying tactics being employed in order to enable Win Back activity.
- The manipulation of the role of third party intermediaries.

Loss leader pricing strategies

Research conducted by the business intelligence company Datamonitor shows that the major energy suppliers are offering significantly lower rates to existing customers than new customers. This strategy relies on a high number of existing customers choosing not to switch away from a current supplier, even when the price increases sharply. When customers are responding negatively to the price increases, suppliers are providing a “save” offer designed to keep them from switching as demonstrates⁶⁵ in the table below. Whilst Electricity4Business support the principles of the table below actually “save” offers encountered are considerable lower than those in the table. Indeed, the large energy suppliers are offering rates to new customers at below cost price, on the basis that this revenue can be recuperated in the medium to long term. The supplier has little risk in setting massive uplifts at renewal—knowing they have the protection of “win back” and “price match” should the customer decide not to accept the increase. “Win back” is subsidised by the high renewal prices of the majority of the suppliers’ customer base.

	<i>Low use</i>	<i>Medium use</i>	<i>High use</i>
<i>Existing customer</i>			
Default offer	32%	15%	8%
“Save” offer	16%	8%	4%
<i>New customer</i>			
1st year		– 5%	
2nd year		5%	
3rd year		10%	

Delaying tactics

Electricity4Business is aware that some of the big six energy suppliers are abusing clearly defined rules and using delaying tactics in order to win back customers who have decided to switch to Electricity4Business. Examples include: informing customers wishing to switch away that their transfer date is too early (when correct); preventing customers from moving due to outstanding debt owed to the existing supplier (even when there is no debt) and claiming not to have received termination notices, even though this is deemed to be received on posting by the customer.

The below tables provide additional insight into these activities. The first table is a break down of the percentage of Electricity4Business transfer requests blocked by existing suppliers. Supplier 1 prevents 36% of all Electricity4Business transfer requests. When this information is compared with the second table, it is apparent that Supplier 1 also scored the lowest customer satisfaction rating in a recent industry comparison survey.

⁶⁵ Source: Data Monitor research January 2007.

ELECTRICITY4BUSINESS TRANSFER REQUESTED % BLOCKED BY SUPPLIER⁶⁶
SOURCE: E4B

<i>Supplier</i>	<i>% Blocked</i>
Supplier 1	36%
Supplier 2	13%
Supplier 3	12%
Supplier 4	8%
Supplier 5	8%
Supplier 6	6%

SME POWER CUSTOMER SATISFACTION LEAGUE TABLE, 2007⁶⁷

	<i>Rank</i>	<i>Billing</i>	<i>Service</i>	<i>Price</i>	<i>Average</i>
Supplier—6	1	82%	81%	82%	82%
Supplier—4	2	78%	78%	78%	78%
Supplier—2	2	78%	76%	79%	78%
Supplier—3	4	78%	77%	76%	77%
Supplier—5	5	76%	77%	76%	76%
Supplier—1	6	76%	72%	74%	74%

The manipulation of the role of third party intermediaries

Third Party Intermediaries (eg agents, brokers and comparison sites) hold great influence within the energy industry and are estimated to be responsible for 50% of all switches. This is largely due to the fact that they have access to Contract Renewal Dates and so can target their communication with customers accordingly. Rewards available to Third Party Intermediaries can be substantial—up to £700 on a single sale of £3,500.⁶⁸ They operate in an industry that is completely unregulated and, as such, there is no safeguard against unscrupulous behaviour.

This lack of accountability results in some Third Party Intermediaries being incentivised by suppliers not to act in the best interests of customers. This is typically achieved through the use of Market Up Tariff Products and Commission Based Tariffs. Market Up Tariff Products are those for which the Third Party Intermediary is given a base unit price from the Supplier and can add their own cut on top. Commission Based Tariffs apply when the Supplier presents the Third Party Intermediary with a product but will increase the commission payable depending on the price paid by the customer. This provides a clear disincentive for Third Party Intermediaries to achieve the lowest possible price for the customer and can be demonstrated by the information below, which shows three differing commissions offered by Npower to its Third Party Intermediaries. The bulk of the first year's additional revenue secured by the Third Party Intermediary from the customer is passed back to the intermediary in commission. Note also that the amount of energy being purchased by the customer remains constant on each table.

In Table 1, if the amount paid by the customer is £3,069 per annum the commission for the Third Party Intermediary will be £45.⁶⁹

In Table 2, if the amount to be paid by the customer is £3,291 per annum the commission for the Third Party Intermediary will be £226.

In Table 3, if the amount to be paid by the customer is £3,570 per annum the commission for the Third Party Intermediary will be £452

⁶⁶ Source: Electricity4Business internal analysis of transfers blocked 2007.

⁶⁷ Source: Data Monitor research 2007

⁶⁸ Source: Electricity4Business internal competitor market research.

⁶⁹ Source: Electricity4Business internal market research.

Electricity Quick Quote



Customer Information ▶

EAC	30,000
Direct Debit? (Y/N)	Yes
Contract Length (yrs)	3

PES	10
PC	3
MTC	801
LLF	201

Pricing Level ▶

Select Price Level

Customer Quote ▶

Tariff Code	5Q1F1
All Units (p/kWh)	9.99
Standing Charge	17.89
Annual Spend (£)	£3,069

Your Commission ▶

£45

Questions using this tool? Please contact your npower Client Manager

Electricity Quick Quote



Customer Information ▶

EAC	30,000
Direct Debit? (Y/N)	Yes
Contract Length (yrs)	3

PES	10
PC	3
MTC	801
LLF	201

Pricing Level ▶

Select Price Level

Customer Quote ▶

Tariff Code	5Q1F1
All Units (p/kWh)	10.73
Standing Charge	17.89
Annual Spend (£)	£3,291

Your Commission ▶

£226

Questions using this tool? Please contact your npower Client Manager

Electricity Quick Quote



Customer Information ▶

EAC	30,000	PES	10
Direct Debit? (Y/N)	Yes	PC	3
Contract Length (yrs)	3	MTC	801
		LLF	201

Pricing Level ▶

Select Price Level

Customer Quote ▶

Tariff Code	5Q1F1
All Units (p/kWh)	11.66
Standing Charge	17.89
Annual Spend (£)	£3,570

Your Commission ▶

£452

Questions using this tool? Please contact your npower Client Manager

Whether there is effective competition in the wholesale markets for gas and electricity

Electricity4Business refers the Committee to text we endorse contained within the discussion paper produced in March 2007 by energywatch, entitled “How energy markets are failing consumers”⁷⁰ Page 16, paragraph 3.1.1

Liquid wholesale markets are important to supply competition as they allow suppliers and, in some cases, customers to source bulk energy. After a surge in the late 1990s, wholesale market activity in Britain has declined as the major players have bought their way to scale. Key factors behind this have been: the exit of independent trading and supply companies; the decline of merchant plant models; and vertical integration. Vertical integration through asset acquisition is effectively being used as a trading strategy by major market participants.

Electricity trading volumes have declined since 2003, as the commission’s reports have highlighted. (*Energywatch is referring here to the European Commission’s preliminary report of its Sector Inquiry under Art 17 Regulation 1/2003 on the gas and electricity markets issued on 16 February 2006 and repeated in its final report on 10 January 2007*).

In evidence to the House of Lords in 2004, a representative of Centrica commented on wholesale gas trading, saying that “physical trading . . . is a small, 15–20% portion of the total physical volume being delivered into the UK at the moment; and then there is paper trading, where the gas is traded many times, and that is perhaps 5–10 times the total physical volume.”

Since then, in its “Ensuring effective and efficient forward gas markets” report for the DTI in March 2005, Global Insight suggested that 70% of the gas landed in Britain was subject to long-term contracts. The balance, 30%, was available for forward trading. Its analysis also suggested that the majority of this gas was traded in the immediate run up to its delivery, rather than months or seasons ahead. Therefore, forward curve prices are posted based on very limited trading activity to the extent that while it characterised the spot gas market as “functionally liquid” it believed the forward market to “suffer from a lack of liquidity by global standards”. Its arguments suggest that the forward curve is not a robust indicator of future wholesale costs for gas suppliers—and electricity market liquidity is even lower. But Ofgem has not challenged the appropriateness of forward curves that are not fit for purpose.

⁷⁰ http://www.energywatch.org.uk/uploads/How_energy_markets_are_failing_consumers_March_2007.pdf

The implications of growing consolidation in the energy market

In August 2007, energywatch released a Small Business Electricity Consumers Satisfaction Survey Report⁷¹ which highlighted many of the problems that affected this group of customers.

The report finds that small business customers:

- Do not understand the complexities and risks of associated with being a non-domestic energy customer as their understanding is likely to be modelled on being a domestic consumer;
- By contrast, do not benefit from many of the protections afforded to domestic consumers such as price comparison services, cooling off periods, industry codes of practice on selling, supply transfers and 28-day contracts;
- Are frequently unhappy with respect to inaccurate billing tied to estimate reading; issues with information provision; slow responsiveness; pressure from suppliers in a range of areas and contact issues when dissatisfied.

Electricity4Business is concerned that further consolidation in the energy market would only serve to exacerbate these existing problems for small businesses which are caused by a lack of genuine retail and wholesale competition in the energy market.

Furthermore, the DTI's 2006 Energy Review indicated that by 2025 energy demand in the UK may exceed the available supply by 30%, but research by LogicaCMG has subsequently suggested that a decade earlier the energy gap could already be 23% at peak times⁷². This highlights that the gap is widening far quicker than anticipated, and will have a significant impact on UK business and households. Based on the research LogicaCMG has estimated that by 2015, the impact on GDP could be £108 billion or £3,700 a year for every working adult in the country. The report also shows that it is not just the winter months that will be affected. If the effects (or assumed effects) of climatic change continue, longer hotter summers will mean that electricity consumption through the hottest months will increase as more air conditioning and cooling systems are used.

Electricity4Business believes that these challenges will only be overcome by a competitive and dynamic market for energy in the UK and that increased consolidation will hinder our collective efforts in this regard.

It is also worth noting that indicators of impending market consolidation:

- the interest in Centrica from the Russian energy giant Gazprom;
- market speculation regarding EDF acquisition of Iberdrola (owners of Scottish Power);
- British Energy—acquisition by one of the big six

This could leave UK business energy supply in the hands of a few foreign businesses with the potential to operate as a cosy oligopoly—this is not the free market that businesses should have access to.

The relationship between the wholesale and retail markets for electricity and gas

Electricity4Business would like to draw the Committee's attention to this paragraph on page 17 of the energywatch discussion paper, "How energy markets are failing consumers".

Feedback from independent market participants suggests that this fall in traded market liquidity is making it more difficult for suppliers to source wholesale energy for onward sale to customers. They claim it is not only more difficult to buy wholesale energy but the markets have become more unpredictable as the exit of operators with a trading background has led to a decline in the quality and volume of market activity. This, they argue, makes wholesale markets inherently more volatile.

Our experience at Electricity4Business confirms these fears expressed by energywatch and we regard this wholesale market volatility as a significant commercial barrier to our company and to genuine retail competition in the sector of the market in which we operate.

The interaction between the UK and European energy markets

Electricity4Business refers the Committee to the "five main barriers to a fully functioning internal energy market" outlined by the European Commission in its preliminary report of its Sector Inquiry under Art 17 Regulation 1/2003 on the gas and electricity markets issued on 16 February 2006 and in its final report on 10 January 2007.

It is our belief that each of these five barriers—market concentration, vertical foreclosure, market integration, (lack of) transparency and (complexity of) price formation—is now clearly present in the UK energy market.

⁷¹ http://www.energywatch.org.uk/uploads/satisfaction_report.pdf

⁷² <http://www.logica.co.uk/mind+the+gap+-+white+paper/400008094>

Below, for information, is additional detail on how and when the European Commission believes these barriers can prevent an internal energy market from operating as it should:

— Market Concentration

At the wholesale level, markets generally maintain the high level of concentration of the pre-liberalisation period.

— Vertical Foreclosure

Lack of liquidity and limited access to infrastructure prevent new entrant suppliers from offering their services to the consumer.

— Market integration

Cross-border sales do not presently exert any significant competitive pressure.

— Transparency

There is a lack of reliable and timely information on the markets—normally the lifeblood of healthy competition.

— Price formation

More effective and transparent price formation is needed in order to deliver the full advantages of market opening to consumers.

The effectiveness of regulatory oversight of the energy market

It should be clear from the remainder of this submission that Electricity4Business regards the existing regulatory oversight of the UK energy market as inadequate. In January, Ofgem asserted that the UK energy market is sound⁷³ and reported to the Chancellor that there was no evidence of collusion or price fixing. However, Electricity4Business agrees with a range of other stakeholders including British Energy (the largest independent electricity generator), energywatch, other small independent energy suppliers, academics, Unison and the National Right to Fuel Campaign that there are structural features of the market which constrain the extent of effective competition. The focus on collusion is a red herring, as even if it can be proven that there is no collusion, that alone does not dictate that the existing regulatory regime is sufficiently robust.

Electricity4Business joins energywatch and others in calling for the energy market to be the subject of an inquiry by the Competition Commission who could consider:

- Whether the reduction from more than 20 suppliers to six, or less, concentrates the market in too few hands.
- Whether suppliers with electricity generation or gas production interests, or with long term contracts with independent generators, have excessive information and control over the market.
- Why £10 billion investment in gas infrastructure failed to smooth out volatility in gas supply?
- Why small suppliers have either been forced out of the market or struggle to survive?
- Why new entry is regarded as nigh on impossible?
- Whether the above issues create a comfort zone for the Big Six suppliers which limits effective competition and consumer benefits.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

Electricity4Business is aware that the Government is currently considering levying a windfall tax on large energy suppliers to combat growing fuel poverty amongst vulnerable people following the latest energy price rises. We would endorse such a plan. The latest figures show that more than four million people are fuel poor⁷⁴—spending more than 10% of their income on energy bills. We would also urge the Committee to consider that many small businesses do not generate substantial profits for their owners and that fuel poverty can be the result of an increase in the costs of fuel for an individual's business, as equally as if these costs were related to domestic consumption.

March 2008

⁷³ Source: Ofgem press release, 16 January 2008
<http://www.ofgem.gov.uk/Media/PressRel/Documents1/Ofgem%202.pdf>

⁷⁴ Source: energywatch press release, 15 January 2008
http://www.energywatch.org.uk/media/news/show_release.asp?article_id=1078

Memorandum submitted by Energy Action Scotland

INTRODUCTION

Energy Action Scotland (EAS) is the Scottish charity with the remit of ending fuel poverty. EAS has been working with this remit since its inception in 1983 and has campaigned on the issue of fuel poverty and delivered many practical and research projects to tackle the problems of cold, damp homes. EAS has worked with both the Scottish Government and the UK Government on energy efficiency programme design and implementation.

EAS welcomes the opportunity to submit written evidence to the Business, Enterprise & Regulatory Reform Committee Inquiry into possible anti-competitive behaviour in the UK's energy market. EAS is primarily concerned with the impact of energy regulation policy on the fuel poor, low income and other vulnerable consumers and this response concentrate mainly on aspects of the inquiry which are likely to have an impact on these customers in Scotland.

FUEL POVERTY IN SCOTLAND

The Scottish Government is required by the Housing (Scotland) Act 2001 to end fuel poverty, as far as is practicable, by 2016 and plans to do this are set out in the Scottish Fuel Poverty Statement. The number of Scottish households living in fuel poverty dropped from 738,000 (35%) in 1996 to 286,000 (13%) in 2002. Half the reduction was due to increases in household income, 35% to reduced fuel prices and 15% to improved energy efficiency of housing.⁷⁵ The most recent figures from the Scottish House Condition Survey Key Findings 2005/06 Report show an increase to 543,000 households living in fuel poverty in Scotland in 2005/06, representing 23% of the total.

According to figures produced by Communities Scotland,⁷⁶ for every 1% rise in fuel prices an estimated 8,000 more households would go into fuel poverty. EAS estimates that there are currently 700,000 households, almost one in three, in fuel poverty in Scotland. This significant increase in fuel poverty is widely accepted to be due to the dramatic increases in domestic energy prices and the additional price rises announced recently will exacerbate this situation.

EAS believes that the Scottish Government's target on the eradication of fuel poverty can be met but only if significant additional resources are directed into fuel poverty initiatives and therefore EAS is calling on the Chancellor of the Exchequer and Scottish Ministers to use the extra VAT revenue generated by energy price rises to boost programmes aimed at ending fuel poverty.

SPECIFIC ISSUES THAT EAS WOULD LIKE THE COMMITTEE TO CONSIDER:

Whether there is effective competition in the wholesale market for gas and electricity

EAS does not accept that the competitive market is operating effectively, particularly for vulnerable customers, and is pleased to note that Ofgem has said that it is considering ways to help address this issue. In the consultation document on its Corporate Strategy for 2008–13 Ofgem stated that Britain's energy market is the most competitive in Europe, but EAS does not believe that this is a relevant comparison given that the European energy market is not yet fully open to competition. Indeed it would appear that the impact of the European energy market on British energy consumers is mainly negative. EAS does not believe that the market can provide all the answers for vulnerable and fuel poor consumers particularly at a time when high energy prices are pushing more consumers into fuel poverty.

EAS recognises Ofgem's primary duty is to protect the interests of consumers by promoting competition and its secondary duty is to pay particular attention to the needs of vulnerable consumers. Many vulnerable consumers are either unable or unwilling to take advantage of the benefits of competition; it is therefore essential for Ofgem to continue to use regulation in order to safeguard the interests of these consumers. EAS is pleased to note that this issue has been acknowledged by Ofgem in its Sustainable Development Report for 2006. EAS would like the committee to consider whether the current duties of Ofgem should be changed to ensure that there is a stronger focus on the needs of vulnerable consumers, until such time as fuel poverty targets have been met. Indeed EAS suggests that this should become Ofgem's primary duty.

The conventional wisdom is that customers who receive poor service will switch to another supplier but EAS does not accept this assumption, particularly as many vulnerable energy consumers in Scotland are unable to switch suppliers irrespective of the level of service they receive. Figures⁷⁷ produced by energywatch state that there are 228,000 households with dynamic teleswitching meters in Scotland. Consumers with these meters find it difficult to switch suppliers as most suppliers' systems are not able to incorporate data from these meters. In addition to this, research⁷⁸ carried out by Ofgem shows that pre-payment meter customers are less likely to switch suppliers than consumers who pay by other methods and acknowledges that the competitive market has not worked for these customers.

⁷⁵ Fuel Poverty in Scotland: Further Analysis of the Scottish House Condition Survey 2002

⁷⁶ Fuel Poverty in Scotland: Further Analysis of the Scottish House Condition Survey 2002

⁷⁷ "Working for Scottish Consumers" Factsheet—energywatch

⁷⁸ Ofgem Factsheet 67: "Prepayment meter customers and Fuel Poverty" 27 June 2007

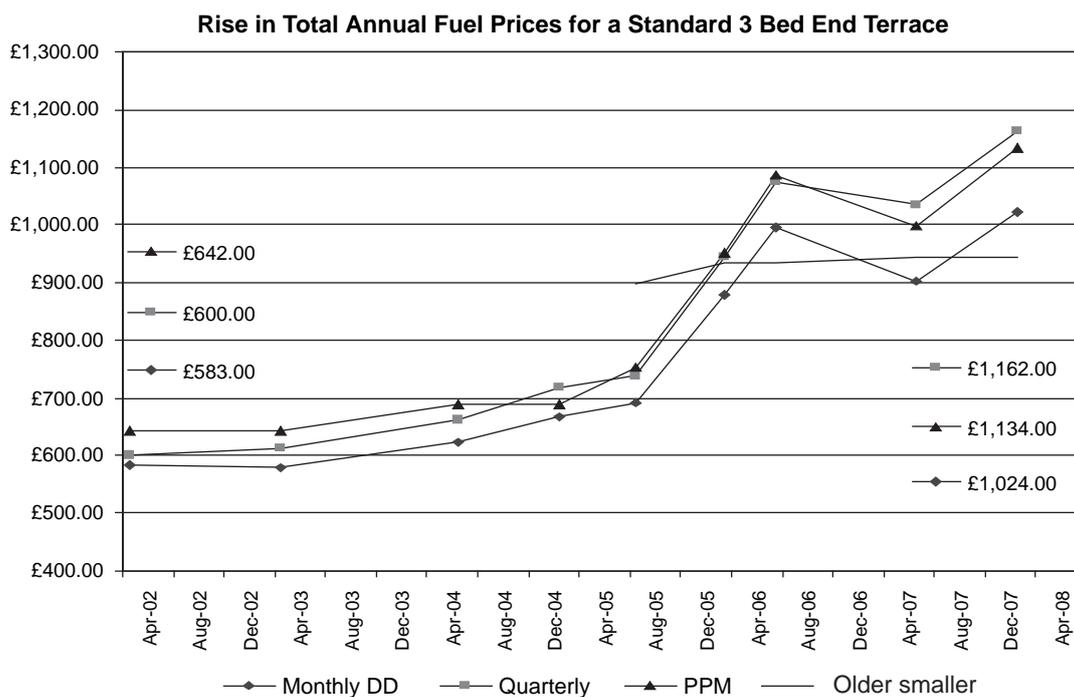
Fuel poor customers, particularly those who have pre-payment meters or who are in debt, have not been able to take full advantage of the benefits of competition and EAS is pleased to note that Ofgem will monitor switching levels amongst disadvantaged groups. The National Audit Office (NAO) Review stated that there is a lack of easily accessible, trustworthy, relevant, understandable and comparable information for customers wanting to switch suppliers. Tim Burr, head of NAO said “Ofcom, Ofgem and Postcom need to be vigilant, and be prepared to use their powers when necessary, to ensure genuine competition is present and that it is working to serve consumers”.

RESPONSE TO SPECIFIC QUESTIONS FROM BERR COMMITTEE:

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

EAS is concerned that fuel poverty targets, which had originally appeared to be realistic, will not be met, mainly because of the unexpected rise in energy prices over recent years. Ofgem has a key responsibility in relation to ensuring that fuel prices are no higher than necessary. In addition to this raising household income and improving the energy efficiency of housing has an important role to play in the eradication of fuel poverty. The Carbon Emissions Reduction Target, which comes into effect in April 2008, will also be an important instrument for the improvement of energy efficiency in housing.

The following graph shows that the rise in fuel prices has pushed all pensioner households (2 adults of pensionable age with no children) living in a standard 3 bedroom end terrace house, and in receipt of Pension Credit, into fuel poverty irrespective of payment method for fuel. Only those households paying by monthly direct debit are not in fuel poverty, but only if their annual fuel bill is less than £950.



SOCIAL TARIFFS:

EAS recognises that energy companies have introduced various products in an effort to assist vulnerable, low income, and fuel poor customers but it is often difficult to distinguish some of these products as social tariffs, particularly if they are more expensive than other products which are available from the same supplier. EAS believes that social tariffs should be lower than any other tariffs available from the company and targeted specifically at low income and vulnerable customers. Some utilities have set up trust funds but these vary enormously in eligibility criteria and are poorly targeted at the fuel poor. EAS considers that in the short term Ofgem should focus primarily on putting pressure on energy suppliers to introduce products to assist vulnerable, low income and fuel poor customers who may be struggling to pay their energy bills.

EAS recommends that Ofgem continues to put pressure on suppliers to develop social tariffs and other Corporate Social Responsibility (CSR) initiatives until such time as fuel prices have returned to 2002 levels. In addition to this Ofgem should audit suppliers’ CSR initiatives and social tariffs to ensure that they are indeed effective.

WINTER FUEL PAYMENTS:

EAS recommends that eligibility for the Winter Fuel Payment should be extended to include other vulnerable groups who may be in fuel poverty such as low income families with young children or household members who are disabled or chronically sick. There should also be a regional weighting for the Winter Fuel Payment the further north households are located, to reflect the longer heating season and therefore higher heating costs for households in Scotland.

PRE-PAYMENT METERS:

Pre-payment meter tariffs offered by power suppliers should not be set at a higher rate than the other tariffs offered; the fuel poor, vulnerable and those on low incomes should not be penalised for not having access to cheaper payment methods such as Direct Debit.

TARGETTING FUEL POOR HOUSEHOLDS:

EAS supports the “find and fix” approach advocated by Ofgem for targeting help to fuel poor customers and the partnership initiative which is bringing suppliers, voluntary agencies and the Pension Service together.

Suppliers should be required to communicate with their customers much more proactively and effectively than they do at present. There are various services available which have been designed to assist vulnerable customers, such as the Priority Services Register and Fuel Direct, and these should be publicised more widely. Many customers with pre-payment meters are often unaware of the amount of debt they are repaying and there is a need for improved communication between suppliers and customers about their ability to repay fuel debts. Any debts that have accrued as a result of delays by the supplier in recalibrating pre-payment meters should be written off.

CONCLUSIONS:

EAS recommends that pre-payment meter tariffs should not be set higher than other tariffs offered by the supplier, that a minimum standard should be set for social tariffs, that the eligibility for Winter Fuel Payments should be extended to include other vulnerable groups and that fuel suppliers should improve their efforts to target fuel poor customers.

EAS believes that improving energy efficiency provides the most sustainable solution to fuel poverty while also helping to meet Government’s targets on reducing carbon; therefore EAS recommends that Government should significantly increase investment in energy efficiency measures. It is estimated that the recent across-the-board energy price increases could bring the UK Treasury an additional £175 million through VAT. This extra VAT revenue should be used exclusively to tackle fuel poverty in the four UK countries.

April 2008

Memorandum submitted by Energy Information Centre Ltd

As the UK’s leading independent consultancy to industrial, commercial and public sector energy users, EIC was established in 1975 and was purchased by Broadfern in 2007. Both companies have considerable experience in the energy sector, representing approximately 1,300 clients with a combined annual energy procurement spend of £1,250 million in 2007.

As such, we welcome the opportunity to comment on the issues raised insofar as the above investigation is concerned.

OVERVIEW

Many of our clients have been in repeated contact with us over the last few days and weeks to express their concern following the extent of gas and power price increases. In addition as the immediate term impact of the prevailing situation on the energy market, the recently published Energy Bill has set out the medium to long-term roadmap for the UK’s energy mix, which will have major implications for the future of the UK economy and its businesses.

Recent weeks and months have seen energy price increases back in the spotlight of the mainstream media, as suppliers have sought to increase gas and power tariffs for their domestic users. While such customers will keenly feel the impact of these increases, they are well below those experienced by their industrial and commercial counterparts.

As well as being subject to greater movement in terms of absolute price direction, business customers have also faced considerable underlying market volatility and—while some customers have the ability, by choice or by circumstance, to deal with this variation in prices—others are not in a position to do so.

While a proportion of this volatility is due to market fundamentals and the need to guarantee that the supply-demand balance is met, some is due to uncertainty and technical trading in the market, while the long-standing inefficiencies of the energy sector as a whole continue to add further potential for price variation.

1. Whether the current market structure encourages effective competition in the retail markets for gas and electricity

The process of consolidation—that has been seen in the UK energy sector over the last decade has effectively reversed the process of privatisation and deregulation, at least as far as energy supply is concerned. The introduction and development of vertical separation and ownership unbundling has proven successful in terms of network operation, although even here consolidation has emerged with the integration of the post-privatisation National Grid and Transco into the current transmission network operator.

However, there is an argument that such a consolidation of gas and electricity network operators has brought with it economies of scale and advantages in terms of planning and system management that more than outweigh any negative consequences. In the case of energy supply, such natural monopoly benefits do not exist, and the question is whether the evolution of the sector has been to the benefit of customers.

From a situation of vertical separation in the wake of privatisation with a wide range of companies undertaking roles as generators, suppliers, local network operators, etc, the mergers and takeovers seen in the past decade have resulted in a small number of companies that have differing levels of vertical integration.

This has led to the dominance of the so-called “Big Six” within the domestic supply market (British Gas, E.ON, EDF Energy, npower, Scottish and Southern Energy and ScottishPower), with industrial and commercial customers and public sector organisations more able to draw on suppliers beyond this group (eg Gazprom, Corona, Bizz Energy).

From a theoretical standpoint, this represents a shift away from an imperfectly competitive energy supply market in the latter part of the 1990s to one that more closely represents an oligopoly with a competitive fringe. This fringe in turn comprises companies of differing sizes that are seeking to establish themselves within that oligopoly.

Therefore, there is the question of competition within—the oligopoly and that within the fringe. While competition within the fringe would appear to be well established, the extent of competition within the oligopoly is less apparent. Furthermore, competition within the oligopoly appears to be based more on non-price factors, while that of the fringe is more focused on price (see Question 3).

2. Whether there is effective competition in the wholesale markets for gas and electricity

As stated in the response to Question 1, the process of vertical integration in the energy sector has meant that there are fewer participants, and this has in turn had—major adverse consequences for the depth of liquidity in the wholesale market. This has resulted in a situation whereby the majority of trading seen for both gas and electricity is in the prompt and near curve contracts, with little activity seen in the more distant periods. As such, this raises the question of how reflective trading prices are of actual market interest and the underlying value of the commodities involved.

The presence of companies across the value chain—either as upstream gas producers and shippers/suppliers, or as electricity generators and suppliers—means that there is inevitably a large degree of internal trading within a company and across the different operational entities, albeit governed by accounting separation. However, this means that a large proportion of the gas and electricity that is produced for consumption within the UK market is not traded openly on the wholesale market, and hence remains opaque to the majority of participants.

As such, the wholesale market is only a small subset of the total traded energy market, but the prices that are set in that market govern the prices paid by virtually all consumers within the UK. Against this backdrop, there is the need to ensure greater wholesale market liquidity in a bid to ensure that prices are both transparent and representative of the underlying supply-demand balance for the commodities traded.

Instances of deliberate market manipulation are thankfully rare in the UK energy sector, but there will always be the suspicion that a highly concentrated and vertically integrated energy sector has the potential for such behaviour.

The issue of effective competition within the wholesale and retail energy markets is also governed by the relationships between the two. While EIC’s view to this is covered in the response to Question 4, it should also be pointed out that there are still high levels of informational asymmetries across the respective markets.

This has been improved considerably in recent years—notably in the case of gas through the implementation of Uniform Network Code Modification 006—although there is still a considerable advantage held by gas producers and generators.

This level of asymmetry is also reflected in terms of market behaviour and the extent of any demand side response. While this has also been encouraged in recent years through new and innovative product offerings by suppliers, this has been relatively slow and has in some cases only emerged after repeated pressure from customers and their representatives. It is unclear whether, in the case of gas, the planned reform to the interruptible supply regime from 2011 will improve this situation, although initial indications from customers are ambiguous.

3. *The implications of growing consolidation in the energy market*

Based upon the assessment that economies of scale are such that a minimum of five million accounts is needed to effectively compete within the domestic supply market, the argument is whether there has been competition to assume dominance having already achieved what is seen as a “satisfactory” customer base.

In recent years, there has been greater focus on retention of existing accounts by suppliers rather than an aggressive pursuit of expansion, with efforts to increase service and non-price factors the objectives. Competition on price has been focused more on ensuring appropriate financial performance rather than aggressive price cuts in a bid to bolster market share, although this is due in part to the repeated escalation in wholesale market prices.

In essence, the competitive strategy adopted by suppliers—certainly in terms of their domestic supply businesses—has been more defensive than offensive. The situation in the non-domestic supply business has been more varied, notably with regard to product innovation and contractual pricing, with competition more evident due to the greater number of potential suppliers.

It is the experience of EIC that the approach of suppliers to contracting with end users varies across suppliers and on a case-by-case basis depending upon the customer in question. Inevitably, there are clients that are attractive to suppliers in terms of their volume or load profile, or potentially through some other non-market specific factor such as the prestige of being associated with that client. However, as with the domestic market, there has been an increasing focus on non-price factors with a more defensive strategy of retention frequently being the primary objective of suppliers, rather than growth.

One of the primary criteria used by suppliers in the wake of the collapse of Enron and Worldcom and its associated fallout has been credit compliance. In this climate, suppliers have refused to quote for sites with which they have previously had a long-standing and successful relationship on the grounds that they do not meet their revised credit criteria. As such, recently implemented risk management practices have also affected a willingness to compete for the business of certain end users.

To conclude, the general decrease in the number of suppliers has inevitably meant that there is less competition in the energy supply market, and while a more concentrated structure is certainly more conducive to collusion, such an outcome is not a forgone conclusion. The nature of the energy sector in recent years has also meant that the larger suppliers (ie those in the oligopoly group rather than the fringe) have adopted a more defensive business strategy, reflecting rising wholesale costs and the need to defend margins.

As detailed in the response to Question 3, similar challenges exist in the wholesale market, where a structure has emerged that does not promote either competition or transparency. However, it does promote investment certainty and long-term commitments to infrastructure and supply projects, resulting in a delicate balancing act in order to preserve energy supply security.

4. *The relationship between the wholesale and retail markets for electricity and gas*

The response by most consultees to this particular issue will inevitably focus on the domestic market, and whether companies fully pass on the increases and decreases seen in the wholesale market to their consumer base. In summary, domestic customers will experience the underlying wholesale market movement, but this will be on a lagged basis of between three and six months and will not reflect the full extent of the change in wholesale prices.

By contrast, non-domestic customers are subjected to greater wholesale price volatility and do not always have the benefit of the mass media or elected officials to champion their cause. In the case of the recently announced domestic tariff increases at the start of 2008, this followed months of continued difficulties for industrial customers and the UK economy in general.

Clearly non-domestic customers have greater options open to them in terms of managing their energy price risk compared to their domestic counterparts, but the risk itself is exponentially greater for non-domestic customers and necessitates a high level of time, skill and resources.

As such, while suppliers will continue to stress the need to make a profit on their domestic supply businesses, households should continue to think themselves fortunate that—despite the increases that will be seen in their gas and electricity bills in 2008—they have not been forced to ensure the rollercoaster ride of their industrial and commercial counterparts.

5. *The interaction between the UK and European energy markets*

This is assessed on a commodity-specific basis as follows.

Gas

The main problem faced by the UK gas market is its deregulated standing next to its peers of Continental Europe, which remain largely uncompetitive despite the requirements of European Union legislation requiring market opening by the start of July 2007. This mismatch of market structures means that deliveries of gas through the UK's import infrastructure—deliveries on which the country has become increasingly reliant since 2004—do not always respond to prices.

This is primarily as a result of the contractual and regulatory structures that exist—for example, those related to the access to pipeline infrastructure needed to transport gas. This is just one of the issues that have been highlighted in recent years by the European Commission, and while we are glad to see that it is an area that the government is keen to champion—both directly and indirectly—the extent of progress in this area has been disappointing at best.

While the Commission is hopeful of addressing this problem by 2009, a longer-term problem facing the UK gas market in its relationship with those of Continental Europe is the practice of oil indexation of gas supply contracts. This is a practice that the UK successfully moved away from in the early years of gas market deregulation, transitioning to a system whereby gas prices were determined by gas market fundamentals. However, the use of such pricing clauses on the Continent remains a long-standing arrangement that incumbents in the sector have little interest in changing, frequently with the implicit or explicit backing of the relevant government.

As such, the increasing reliance of imports from the Continent has meant that the UK has effectively reverted back to this method of charging for wholesale gas, meaning that gas prices are effectively not based upon market fundamentals, but are instead dependent upon the ebb and flow of the global commodity markets. With oil prices at close to record nominal high levels, the issue of oil indexed pricing needs to be addressed as a matter of urgency to ensure that gas prices do indeed reflect fundamentals.

Electricity

The greater push towards low carbon energy sources and renewable generation is a key facet of the broader objective of reducing greenhouse gas emissions in order to mitigate the effects of climate change. As such, this should be a key objective of responsible government and policy making, but the challenge for the UK and the European Union is to ensure that businesses are not punished for the actions of their leaders in this regard given the potential absence of a similar commitment from other nations.

One of the main challenges to the expansion of renewable generation is the delays associated with their development. In the case of onshore wind, these include connection agreements, the negotiation of planning agreements and compliance with planning conditions. Against this backdrop, it is the responsibility of government to ensure that the planning regime works to the benefit of companies and does not subject them to undue and unnecessary delay—problems that have prompted some developers to abandon their plans for the projects.

However, it should be remembered that renewables are not in a position to fully service the country's energy needs, although the potential for such a development is a possibility for the future. In this light, governments should remain reasonable and prudent in ensuring their nation's energy needs are met, and should make decisions on their generating mix accordingly and in a manner that ensures security and diversity of supply.

Ultimately, there is a cost to ensuring that energy needs are met—both in the immediate term and in the long-term—and also a price to be paid if the energy mix does not have an adequate degree of flexibility and contingencies associated with it.

Emissions trading

Overall, the cheapest unit of energy that one can have is that saved through greater efficiency. As such, this is a key area that needs to be pushed at all levels of the economy—notably the domestic sector. Businesses have too long shouldered the burden—and cost—of reducing greenhouse gas emissions while the contribution from domestic customers has failed to match expectations. This is an inequity that must be addressed as a matter of urgency.

The European Commission's "20 20 by 2020" emission reduction and renewable energy plan represents a major challenge for the member states of the European Union, notably given the obligations on biofuels and road transport. For their merit, the expansion of biofuels needs to be undertaken in a socially responsible manner, and it will be a core obligation of the European Commission to ensure that such fuels are indeed sustainable and do not ultimately cause greater long-term problems.

While political responsibility and a desire for strong leadership on emission reduction is important, targets on emissions and renewables must be undertaken in a manner that is achievable and do not compromise the needs of businesses and consumers.

The plan to have the lion's share of emissions come from the EU Emissions Trading Scheme (EU ETS) is a welcome move, provided that the reforms to the scheme are undertaken in a clear and coherent manner. The prospect of a single EU-wide cap on emissions from 2013–20 provides long-term stability for business (as do the provisional details of the scheme beyond 2020), but the planned use of allowances as a means by which to redistribute income among nations must not result in implicit state aid to certain nations, nor should it unduly penalise certain member states at the expense of others.

On the issue of penalties, the proposals requiring non-EU trading partners to purchase allowances in order to sell their products within the EU—assuming that a long-term global emission reduction policy is not agreed—must be implemented in a transparent manner and in full accordance with international trade law. European business needs to compete on a fair global playing field and not be dragged into a trade war and arguments on protectionism—regardless of the best intentions of the EU.

6. *The effectiveness of regulatory oversight of the energy market*

The early years of the post-privatisation era for both gas and electricity were characterised by an increasingly hostile and adversarial relationship between energy companies and their respective regulators. In the case of the gas sector, this saw British Gas face scrutiny from both the Office of Fair Trading (OFT) and the Monopolies and Mergers Commission (MMC), while the electricity sector saw National Power and Powergen criticised by sectoral regulator Offer over their conduct and be repeatedly threatened with a referral to the MMC.

In recent years, the relationship between the regulatory authorities and energy companies has become more conciliatory in tone, although this has not stopped investigations being undertaken by groups including Ofgem, the Financial Services Authority (FSA) and the (then) Trade and Industry Select Committee (TISC) into the operation of the energy sector.

The main question that should be considered is whether regulatory action and its consequences is a credible threat for energy companies, as opposed to how effective regulation has been. Regulators should serve as guardians of the market and customers, rather than reactive entities that are called into action, and they should also have appropriate tools and resources at their command.

For example, the challenge that existed in the early years of post-privatisation within the UK electricity sector was that the market structure itself was conducive to behaviour that was not always in the interest of consumers. This resulted in a situation whereby Offer made repeated threats of an MMC referral to the two primary competing generators (National Power and Powergen) but did not carry this threat out. As such, and as has been subsequently demonstrated by academic research into this period, the credibility of this threat declined over time as it was made and not actioned.

Therefore, the first criteria of any regulator is that it must be ready to act decisively against any potential anti-competitive behaviour, and that the companies under its remit must be faced with the potential for substantial and wide-ranging penalties as a consequence of this behaviour.

The second criteria is that it must be wholly independent of the companies that it monitors in order to avoid regulatory capture, ie when the regulator—intentionally or otherwise—becomes the advocate of the relevant companies. This is far from evident in the UK, although there have been questions over the independence of regulators in some of the markets of Continental Europe, where companies—directly or through state involvement—are essentially protected by the regulator in order to preserve the status quo.

This is an area that must be addressed as part of the process of market deregulation within the EU (see Question 6).

7. *Progress in reducing fuel poverty and the appropriate policy instruments for doing so*

EIC does not have a comment to make on this matter insofar as the domestic sector is concerned, although it should be pointed out that non-domestic customers have increasingly faced their own equivalent of fuel poverty in response to rising energy costs and the inability to fully pass these on to their customers.

As such, the percentage of total costs contributed by energy spend must be considered as a priority for all consumers—not just domestic. This is particularly the case for those industrial customers that face international competition for their goods and services, with some of their peers—even those within the EU—still subject to regulated energy rates below the corresponding market rate.

CONCLUSION

In conclusion therefore, the main challenges facing business customers relate as much to the broader energy sector as to specific industries and their end users.

Firstly, the need for a coherent energy policy, which it is hoped that the Energy Bill will provide. However, with much of the Bill being of the “hurry up and wait” stance of further consultations, these must be concluded in a swift and efficient manner such that the uncertainty that has dogged the energy sector for some time is addressed. Overall, the Energy Bill is a welcome step, but its policy measures need to be adhered to—after all, the 2007 White Paper on energy was the third such document from the UK government in less than 10 years.

Secondly, and on a related point, the need for a coherent energy policy must sit alongside the requirement that it is also consistent. There has been a tendency in recent years for energy policy to become reactive rather than proactive, to the extent that some policies have descended into knee-jerk reactions to prevailing market conditions or attempts to grab headlines. The recent example of windfall taxes on oil companies and power generators illustrate this—private companies are in the business of making profits and it should not be the business of government to determine what is an “acceptable” level of profit. The role of government should be to create a framework within which these businesses can re-invest their profits in infrastructure, not seek a short-term gain and one that may adversely affect the long-term health of the sector.

Thirdly, in terms of ensuring an appropriate framework within which energy supply companies can operate, there is an urgent need for a balance to be struck between the UK’s deregulated structure and the comparatively uncompetitive structure of most of Continental Europe. The two main consequences of this for the UK are the absence of a fully traded gas market on the Continent—due to the traditional retention of oil-linked gas supply contracts—and a lack of complete third party access to network infrastructure. Both of these serve as a barrier to entry and a route by which to maintain the status quo, and while the European Commission’s commitment to address both is welcomed, this rhetoric needs to be backed up by policy.

Finally, business customers have been seen in recent years as a source of greenhouse gas emission reductions while simultaneously shouldering a heavier burden in terms of higher energy bills. Against this backdrop, domestic customers have faced comparatively less pressure in terms of environmental policy obligations while also having more vocal support from politicians and the media when energy prices increase. As such, it could be argued that domestic customers have had a “free ride” at the expense of their business counterparts, and although industry is not averse to meeting its obligations in terms of emission reduction or paying justified energy price increases, there is a need for a more equitable distribution of the burdens resulting from national and international policy commitments.

Given EIC’s long-standing presence in the UK energy sector, we trust that you will consider these comments appropriately, and we would welcome the opportunity to discuss them further with you at your convenience at a future date.

March 2008

Memorandum submitted by Energy Intensive Users Group

1. EIUG represents the energy intensive sectors of UK manufacturing industry (steel, chemicals, paper, cement, glass, ceramics, aluminium, industrial gases, etc.) that compete in international markets and depend on secure, competitive energy supplies to remain in business.

2. Energy supplies represent a high proportion of our members’ operating costs—especially the variable costs. Energy purchases account for around 25% of production costs for steel and paper manufacturing, 40% for aluminium smelting and certain chemical processes and up to 70% for the production of industrial gases. These industries share a strong commercial interest in the efficient use of energy in order to remain competitive, and in most cases are also subject to Climate Change Agreements that require continuing attention to be given to energy efficiency.

3. Energy intensive industries in the UK currently purchase around £2.4 billion gas and £5.2 billion electricity per annum. Around 70%–80% of the cost of industrial energy supply is typically attributable to the wholesale cost of gas and electricity.

4. Energy intensive industries are highly exposed to international competition and increasingly operate under international ownership. The continuing presence of these industries in the UK depends on the faith of international investors that UK energy supplies will, in the long run at least, remain internationally competitive. Our members are therefore much more concerned about *relative* energy costs (ie the extent to which UK energy prices differ from those of our competitors) than the *absolute* cost of energy (rightly a concern for others, with regard to fuel poverty).

5. UK energy prices have risen substantially in recent years, as they have worldwide—though the increases in UK wholesale prices have been particularly dramatic (see charts 1 and 2 appended to this memorandum). There has clearly been a step change in the price of oil, gas and coal on the international

markets (and carbon, within the EU) which has unavoidable implications for the price at which gas and electricity can be sold in the UK. But this development does not explain why the wholesale prices of gas, and especially electricity, have become so much higher in the UK than in most of the rest of Europe.

6. Wholesale energy prices are dynamic and volatile, so quoting a single figure to describe the extent of the UK/EU competitiveness gap is not straightforward. Account needs to be taken of seasonal factors, as UK gas prices tend to trade at a premium to continental prices in winter (when the UK is import dependent) and a discount in summer (when exporting and continental prices effectively put a floor on UK summer prices). There is no obvious reason why UK prices be expected to trade a premium on an annual basis, however, especially considering the liberalised nature of the UK market and the price-supporting influence of oil indexation elsewhere. This last factor is important—sales of gas to industry remain indexed to oil products in continental markets, so comparisons with hub price data (equivalent to the UK NBP) may not accurately reflect the competitiveness position as far as industrial users are concerned.

7. EIUG disagrees with BERR's assertion, as recently as January this year, that the UK energy markets are the most competitive in the G7/EU. This can only be true in a most narrow of senses, eg the extent to which the market is theoretically open to new entrants, or that consumers are able to switch suppliers. Important though these factors are, the test that really matters to consumers is whether prices are competitive—and on this test, for industrial consumers at least, the market is failing. We also urge caution in interpreting BERR data on energy supply prices, which is by its nature historic and so (unlike market data) more useful in painting a picture of what things might have looked like up to six months ago than what they actually look like now, or are expected to look like a year or more ahead. Industry contracts ahead for its energy supplies and is therefore relatively well placed to see what is coming—and the current pricing situation, unfortunately, looks worryingly similar to that of two years ago. We recognise however that it is perhaps unrealistic to expect official UK or EU price survey data to adequately reflect the competitive position for the very largest of industrial consumers, where pricing arrangements tend to be more individual in nature and transparency is often lacking.

8. EIUG recommends that the Committee pays particular attention to forward year-ahead wholesale prices, which tend to be the price base suppliers refer to when quoting for typical annual industrial supply contracts. On this basis, as of April 2008, UK gas prices are around 5% above those in continental Europe (and higher still than in the USA) and UK electricity prices are around 30% higher than those in France or Germany (see charts 1 and 2 appended to this memorandum).

9. In an attempt to avoid locking in costs at potentially uncompetitive levels, some industrial consumers opt to receive gas supplies at a floating rate indexed to day-ahead prices, or with the option to fix at the market price at any point during the contract period. Such supply contracts tend to provide lower costs on average compared with fixed price deals, but with the downside of significant additional risk to the consumer, and are not therefore suitable for all businesses. Indexed supply prices are inherently more volatile and, as events two years ago confirmed, may turn out to be higher than would have been available under a fixed price deal.

10. It is worth recalling what occurred during the last occasion when the UK faced a sustained competitiveness gap, somewhat larger than at present, in the run up to winter 2005-06. Day-ahead gas prices rose to record levels on the wholesale market as gas supplies ran perilously low, forcing a number of energy intensive manufacturers to cut or suspend production on cost grounds (for three months, in the case of one major feedstock user). By the end of that winter, with storage stocks already low, a fire broke out at the Rough gas storage facility and National Grid issued its first ever "Gas Balancing Alert", warning the market to reduce demand as the UK came within 24 hours of having to ration gas to industry. ONS data later confirmed that around 100,000 manufacturing jobs were lost in the 12 months to the following autumn, with energy prices cited as a key factor—ie "demand destruction" had occurred. Wholesale prices fell the following year, perhaps leading some to conclude that problems in the UK's energy market were largely over, having arisen as a result of an temporary coincidence—namely that the UK found itself still completing essential import infrastructure just at the time it started becoming a net importer of gas, and was unlucky enough to do so when EU energy markets, then still assumed to be moving towards full liberalisation, remained largely unreformed.

11. EIUG believes there is an inadequate level of competition within the UK energy markets, which has come about for a number of reasons, listed in the paragraphs below. We suspect that a combination of inadequate competition, high worldwide fuel prices and energy interventions arising from government action (or inaction, in the case of past prevarication about nuclear power) is sufficient to explain why current price levels have become uncompetitive by international standards. We are sceptical that recent price increases can be blamed on anti competitive behaviour but if others have evidence to the contrary, or it is thought necessary in order to restore public confidence in the markets, we would support a referral to the Competition Commission to settle the matter.

12. The current structure of the electricity market discourages effective competition. There has been a persistent trend in recent years towards further consolidation and vertically integration—there are few independent players left, especially retailers. The extent of internal contracting is the primary reason for the very low liquidity in the forward power markets. Money is largely being made at the wholesale end of the market, especially by generators that have been handed an opportunity to make windfall profits, at the expense of consumers, as a result of free allocation of allowances under the EU emissions trading scheme.

We note that “green” spark spreads (allowing for the price of carbon) have also widened considerably, above continental levels, but that this may be consistent with the acknowledged need for new build in the near and medium term to replace considerable capacity of nuclear and non-LCPD-compliant coal plant scheduled for retirement. Consolidation has partly been driven by credit issues and the increasing regulatory burden, both economic and environmental, all of which have tended to disadvantage smaller players. The complexity and overhead costs associated with code structures (BSC, CUSC) is now a major barrier to new entrants and smaller players, including auto-generators and demand side participants, and we believe it should be a clear objective for Ofgem and others to make these simpler and more accessible. We also believe that, absent compensatory reforms elsewhere, any attempt to reduce competition by merger among the “big six” producers should be most strongly resisted.

13. EIUG has had longstanding concerns about the operation of the wholesale gas market. The UK is increasingly dependent on imported supplies, including now LNG which is already a key marginal source of supply. If National Grid forecasts are correct, LNG may need to provide 40% of our supplies within the next ten years. We believe it was a mistake to grant exemption from regulated third party access arrangements at LNG terminals. The lack of adequate arrangements at the existing Isle of Grain Terminal—and those in the process of being constructed at Milford Haven—is a barrier to their use that has worrying implications both for the price of gas in the UK and security of supply. We are not aware that a third party has yet managed to make use of spare capacity at the Isle of Grain terminal (which has remained largely unused this winter) and, given the current limited notice period for spare berthing slots, it is doubtful whether this can be expected to occur. The UK remains also at a disadvantage in being able to make use of attractively priced LNG or other imported gas during periods of low demand periods due to our relatively low levels of gas storage. The lack of storage capacity is one reason why UK wholesale prices are so volatile, and also appears to be a partial explanation for the extent of the risk premium in forward prices, which seems set to remain an issue for the foreseeable future. There has however been an improvement in market transparency as a result of Mod 006 (publishing close to real time information on sub-terminal flows) improving information access to the benefit of market efficiency.

14. The interaction between UK and EU energy markets remains a matter of concern. Despite encouraging proposals from the Commission last year, and significant movement by a number of member states, we remain unconvinced that continental energy markets will be fully liberalised within the near future. Continuing political resistance from a small but significant group of member states to the full unbundling of their energy grids from production and supply is a matter of record, so it is still far from clear that the majority view in support of the Commission’s proposals will prevail. Absent substantial reforms on unbundling, combined with strong independent energy market regulation at both national and EU level, prices are likely to remain divergent. The continued lack of common contractual terms with respect to continental gas supplies—in particular the complete lack of an oil-indexed option in the UK, or the alternative to it elsewhere in Europe, even when supplied by the same company—also remains a concern. The brutal truth is that there is no immediate prospect of UK companies or energy consumers enjoying reciprocal access to continental supplies of the sort we have already granted to our continental competitors. This leaves the UK in a vulnerable position—increasingly import dependent, subject to external shocks through physical interconnection to continental markets, but unable to access continental gas storage or network infrastructure to help secure our own supplies.

15. EIUG does not support the imposition of a windfall tax on energy suppliers, generators or gas producers. If problems are thought to have arisen because of market failure, then that is the issue which needs to be addressed, ideally by referral to the Competition Commission. If problems have arisen because of government failure (windfall profits arising from free allocation of power sector emissions allowances, overly generous subsidies to onshore wind generators, etc.) then the relevant policy failures themselves need to be addressed. Taxing energy producers or suppliers would do nothing to address the problem of uncompetitive industrial energy prices. The imposition of a windfall tax, or even the threat of it, raises the cost of capital for investment in UK energy supply—and the cost of this, ultimately, would fall on consumers.

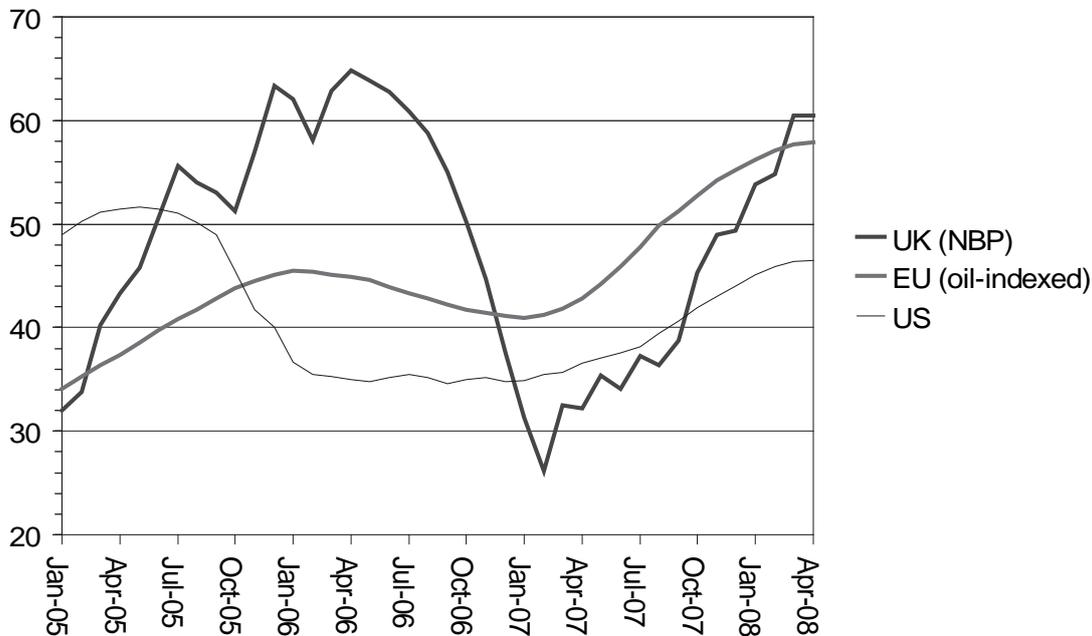
16. EIUG submitted evidence to the Trade & Industry Committee’s 2004–05 inquiry into fuel prices, concluding: “Industrial consumers in the UK are therefore facing a substantial competitiveness gap in the cost of both their gas and electricity supplies. Energy intensive industries are most at risk if this competitiveness gap is allowed to persist.” Regrettably, this statement does not require updating.

APPENDIX

ENERGY PRICE CHARTS

Chart 1

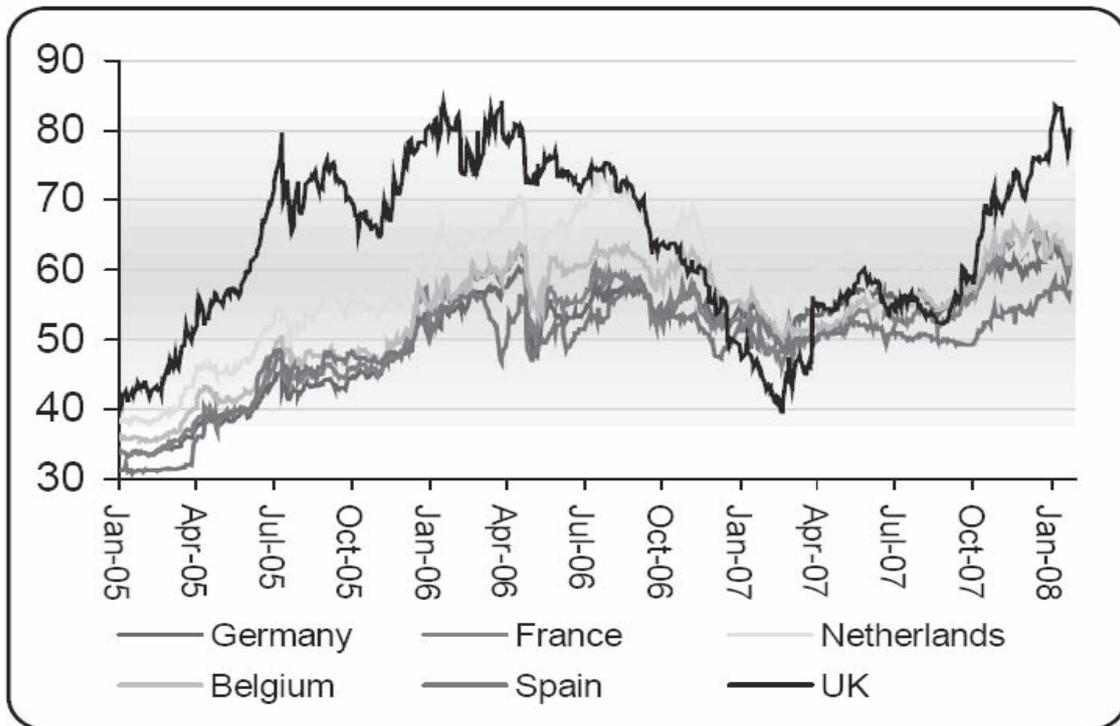
GAS PRICES—WHOLESALE, YEAR-AHEAD (p/therm)



Source: EIUG

Chart 2

ELECTRICITY PRICES—WHOLESALE, BASELOAD, YEAR-AHEAD (€/MWh)



Source: EnergyQuote

1 April 2008

Supplementary evidence from the Energy Intensive Users Group

1. The comments below and attached charts should be read in conjunction with the written memorandum from the EIUG submitted in April 2008.

2. UK energy prices have risen significantly in the last three months, largely in response to the worldwide increase in the price of oil and coal. However, the differential between UK and European gas and electricity prices has also increased, and hence also the level of competitive disadvantage faced by UK industrial energy users. As of July 2008, UK gas prices are around 16% above those in continental Europe and UK electricity prices are around 38% higher than those in Germany on a year-ahead basis.

3. The level of competitive disadvantage in gas is greatest during the winter periods, and in percentage terms has now reached levels comparable with those experienced during the problematic winter of 2005–06. Forward market data for the next two years shows this is not a transient phenomenon (see charts 1 & 2 appended to this memorandum).

4. It was suggested in oral evidence from Ofgem that forward gas prices should not be of great concern to large industrial users since a relatively large proportion of their gas is bought under indexed contracts, typically linked to day-ahead or month-ahead prices, and hence they are relatively unexposed to market prices a year or more ahead. As we stated in our original evidence, it is the fact that forward prices are persistently uncompetitive that has left large industrial users with little option but to purchase much of their gas in this comparatively risky way. The Committee should be aware that this form of purchasing is not an option for all large users, and is much less prevalent in electricity supply (where the competitive disadvantage for large consumer is currently even greater than it is for gas).

5. We question whether high global LNG prices are an adequate explanation for the current high level of UK gas prices. The US is at least as dependent on LNG imports as the UK, yet US forward market prices are substantially below those in the UK (see Chart 1). LNG continues to be delivered to the US—yet little if any is coming to the UK. We remain concerned to understand why UK suppliers do not appear able to deliver to the UK market in a similar manner and at similar prices to the US. In particular, we believe that Third Party Access arrangements at Isle of Grain require independent investigation.

APPENDIX

ENERGY PRICE CHARTS

Chart 1

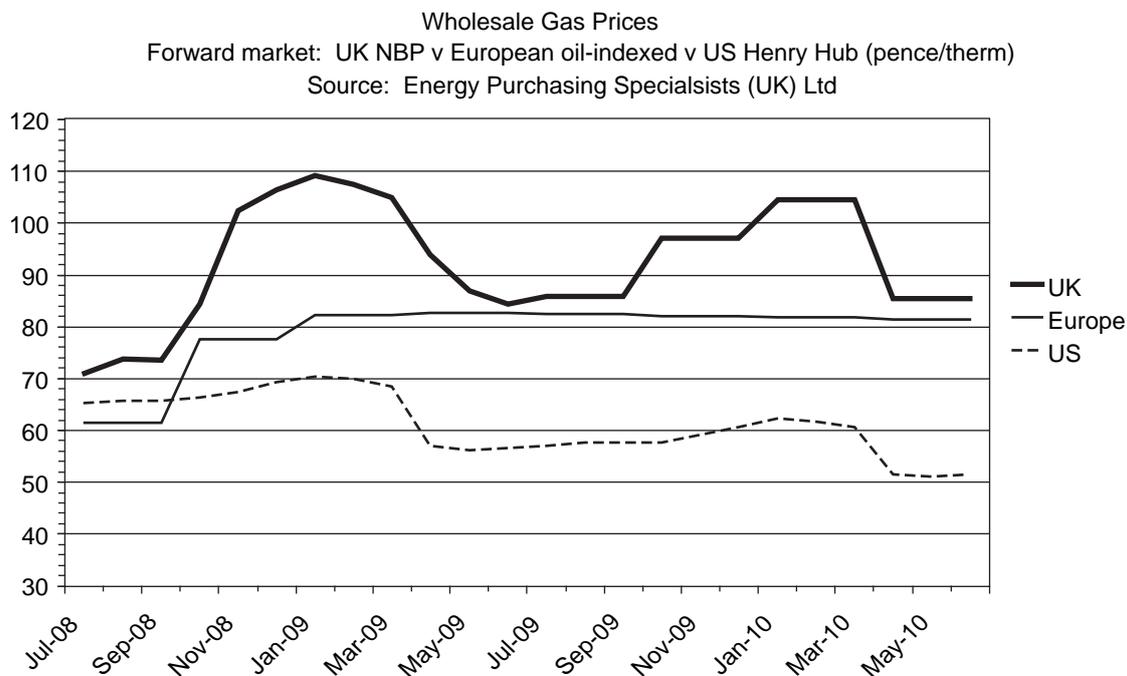
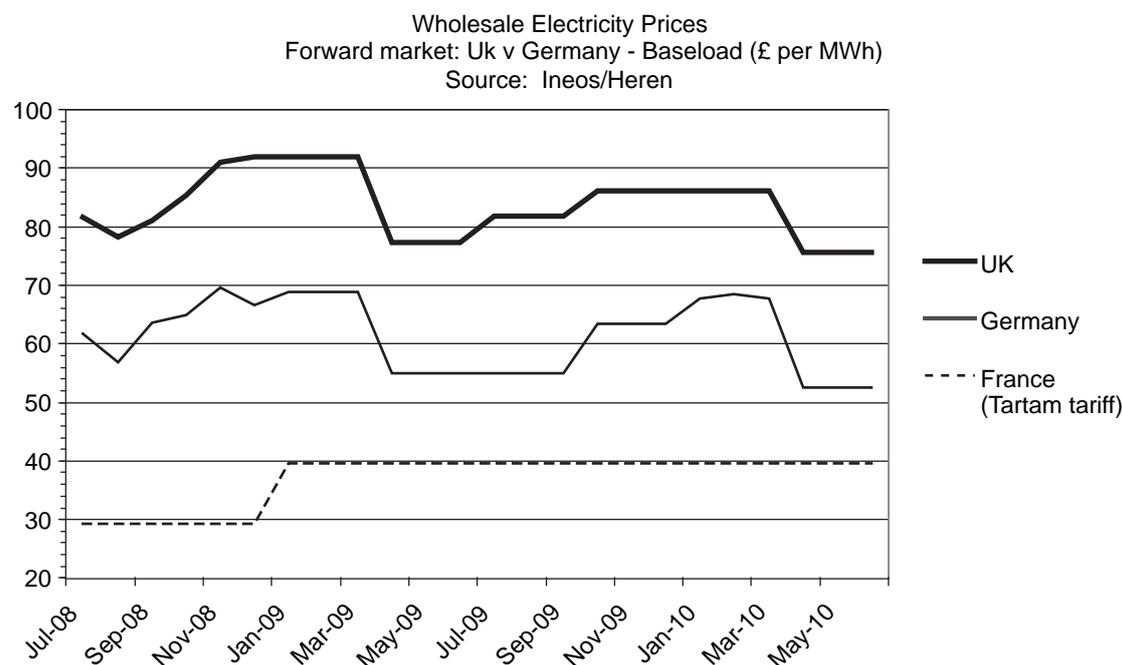


Chart 2



10 July 2008

Memorandum submitted by Energy Networks Association (ENA)

Energy Networks Association (ENA) is the trade association for UK energy transmission and distribution licence holders. It acts in the interest of the energy 'wires and pipes' sectors to achieve excellence in both its internal services and relationships with stakeholders. It is funded by the UK's electricity and gas transmission and distribution companies. Its Members and Associates are asset owners and operators including CE Electric, Central Networks, Chubu Electric, EDF Energy, ESB, Guernsey Electricity, Independent Power Networks, Jersey Electricity, Manx Electricity, National Grid, Network Rail, Northern Gas Networks, Northern Ireland Electricity, Scottish & Southern Energy, Scotia Gas Networks, Scottish Power, Tepeco, Wales & West Utilities and Western Power Distribution.

We are grateful to the Committee for the opportunity to provide a brief outline of how the provision of gas and electricity network infrastructure essential in delivering energy to the public is met within the overall costs of the customer energy bill. We hope that our submission can put in context how different factors come together to determine the final cost of this infrastructure. We believe that by providing this information members will be more ideally placed to better understand the full process that leads to final the energy bill that is delivered through the nation's letter boxes.

GENERAL CONTEXT

How much of a typical household's energy bill is attributable to transmission and distribution?

	<i>Transmission</i>	<i>Distribution</i>
Electricity	4%	17%
Gas	2%	20%

Source: Ofgem Fact Sheet 66: 15.01.08 Updated Household Energy Bills Explained

What is the money spent on?

The money raised from the consumer is spent to ensure a safe, secure, reliable and efficient system. Examples of the type of operational and capital expenditure are those made to ensure the resilience and reliability of the network. These can range from replacing cast iron piping and other components of old networks to vegetation management to minimise the potential disruption to energy supplies during storms.

Who makes the decision on how much is spent by the companies?

Over the course of setting a new five year price control package, there are bilateral discussions between the network companies and the regulator, Ofgem, (and its consultants) to make an assessment of the necessary level of efficient investment. Ofgem will ultimately set an overall allowed revenue for each company based on assumptions about efficient levels of capital and operational expenditure. It is then for the companies to decide how best to utilise those allowances to deliver the necessary network performance over the five year price control period.

The Regulatory framework that has been in place since 1990 (based on the 'RPI-X' approach) has been very successful in encouraging efficiency, thereby reducing charges substantially in real terms, whilst at the same time delivering significant improvements in supply reliability.

CUSTOMERS' BILLS DOWN

In real terms the reduction in network charges have been:

- Electricity distribution – 50% since 1990.
- Electricity transmission – 41% since 1990.
- Gas transportation – 41% since 1994

Source: OFGEM

QUALITY UP

Meanwhile the quality of service delivered by the electricity distribution companies has risen significantly since 2001:

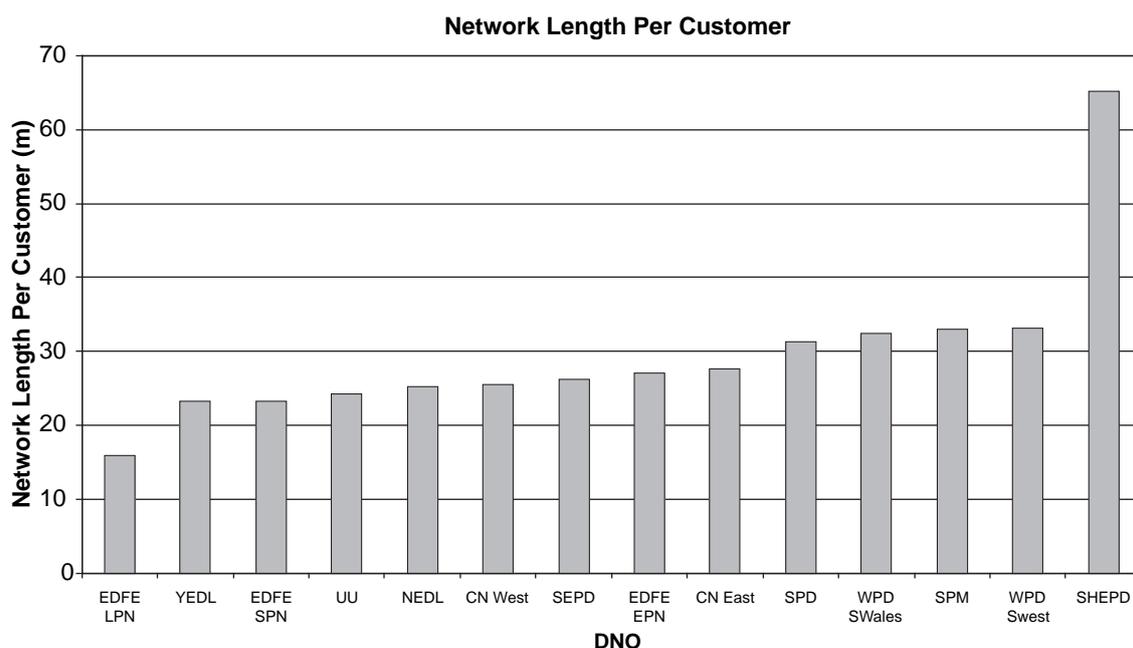
- 15% reduction in number of customer interruptions
- 19% reduction in the average duration of interruptions

Source: OFGEM—Figures exclude severe weather events

Why does regional variation in the cost of transmission and distribution exist?

Regional variations in electricity and gas distribution charges occur throughout the whole of the UK. Differences in distribution costs reflect the cost of maintaining the gas and electricity networks in different areas. This can be due to the different mix of customers in each area, the historical development of the networks and the topography they cover.

For example, there is a need for a higher number of assets per customer to supply customers in some regions with a strong concentration of rural areas (see Figure 1 below). This will tend to increase the costs to the company and hence network prices. The graph below shows that network length per customer is higher for WPD's and SSE's north of Scotland area. Network investment is ultimately funded through use of system charges. Hence customers in these areas are paying a higher proportion of the network cost than customers in densely populated areas. Conversely, for EDF's London network the ratio is at its highest and therefore the amount of network per head is smallest, ie the cost is spread over more customers. However, this will not necessarily mean that London's prices are the cheapest as there will also be other important cost considerations, not least the need to underground a substantial proportion of the network in such urban areas.



In other areas changes in the economic landscape have altered patterns of demand to which the networks have to adapt. In the West Midlands for example the network was originally designed to meet the demands of the large engineering industry which has now virtually disappeared.

Transmission charges also vary by location. Locational charging in electricity is designed to incentivise generation to locate near demand and demand to locate near generation. This is judged to be more economically efficient as it reduces transmission losses and hence the transportation cost of energy (financially and environmentally),

Differences in regional gas and electricity distribution costs as reflected in a typical household customer's bill

<i>Gas</i>	<i>Electricity</i>	
	<i>Annual Distribution Component</i>	<i>Annual Distribution Component</i>
NGG East Midlands	£92.90	SPN £44.54
WWU North Wales	£93.25	CN E £48.20
NGN North East	£94.91	CN W £51.39
SGN Scotland	£95.04	LPN £51.70
NGG East	£98.51	EON £52.11
SGN southeast	£98.79	YEDL £59.46
WWU South Wales	£99.66	SEPD £60.56
NGG North West	£99.78	UU £60.64
NGN North	£100.47	Manweb £63.18
WWU South West	£103.06	NEDL £67.99
NGG West Midlands	£105.06	South West £69.30
SGN Southern	£110.95	South Wales £71.61
NGG London	£114.57	SPD £79.43
<i>GB Average</i>	<i>£100.53</i>	SHEPD £87.81
		GB Average £61.99

Assumptions

Applicable to domestic electricity (gas) customers from April (October) 2007

Electricity consumption 3300 kwh pa on a domestic unrestricted tariff

Gas consumption 18000 kwh pa as an EUC1 customer (73200 kwh pa)

How do you explain discrepancies between the regional variations in gas and electricity distribution costs and the regional pricing policies of some energy retailers?

The process by which regional variations in the cost of distributing gas and electricity is arrived at is transparent and open to scrutiny.

Some of the recent regional price rises by energy retailers have been attributed to the variation in costs of gas and electricity distribution and transmission.

ENA can only comment on the element of regional price variation directly related to gas and electricity distribution and transmission. Any differential beyond these stemming from the retail offering is beyond our scope to explain.

April 2008

Letter by the Energy Retail Association

EVIDENCE SESSION WITH MINISTER FOR ENERGY, 31 JANUARY

The Energy Retail Association (ERA), formed in 2003, represents the electricity and gas suppliers in the domestic market in Great Britain. The ERA works closely with government, NGOs, charities and other organisations in England, Scotland and Wales to ensure a coordinated approach to dealing with the key issues affecting our industry and the British consumer. The main energy suppliers operating in the residential market in Great Britain are members of the association—British Gas, EDF Energy, RWE npower, E.on, ScottishPower, and Scottish and Southern Energy. Our members represent over 99% of the domestic market; the remainder is comprised of niche suppliers such as green energy and internet-based providers.

The ERA's aim is to improve continually customers' experiences with their electricity and gas suppliers. This means that when we meet with our members, we lead on high level policy issues such as tackling fuel poverty and protecting vulnerable customers; delivering energy efficiency schemes; developing standards on operational matters eg billing and doorstep sales.

Since its inception, the ERA has improved industry performance when dealing with customers in the areas of customer transfers, doorstep sales (leading to the establishment of the EnergySure accreditation scheme) and billing (with the creation of the Code of Practice for Accurate Bills and the Energy Ombudsman).

The ERA operates within strict guidelines. Our activity is not related to matters affecting competition between our members, and the ERA is not a forum for discussions as to energy prices or other commercially sensitive matters. Nor are ERA members of staff privy to any information of this nature. As a responsible trade association representing a highly competitive industry we take legal guidance to ensure that our activities do not breach competition law or any other regulations.

22 January 2008

Memorandum submitted by Energy Retail Association

The Energy Retail Association (ERA), formed in 2003, represents domestic electricity and gas suppliers in Great Britain. All the main energy suppliers operating in the residential market in Great Britain are members of the association—British Gas, EDF Energy, npower, E.ON, ScottishPower, and Scottish and Southern Energy.

The ERA is pleased to submit written evidence to the BE Select Committee inquiry into the UK energy market. We have limited our responses to the following areas of the Committee's inquiry:

- whether the current market structure encourages effective competition in the retail markets for gas and electricity;
- the effectiveness of regulatory oversight of the energy market; and
- progress in reducing fuel poverty and the appropriate policy instruments for doing so.

In this response we aim to present a comprehensive picture of the retail market with a level of detail that demonstrates the diversity of offers and range of consumers that are catered for. We will support this with independent evidence sourced through desk research. In order to represent the retail energy market in context we have provided some background information on the dynamics of the market.

The ERA evidence submitted here is intended to be factual and a comprehensive report on all the areas of the inquiry in which we are qualified to comment. For completeness we have included some additional comments, which due to their topical nature are likely to be raised in other submissions.

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

1. Background to Changes in the Market

Key points:

- We are no longer an energy island with domestic UK Continental Shelf gas and oil reserves. Therefore, the price we pay is aligning itself with our EU neighbours whose Governments face similar pressures to control rising prices.
- Britain continues to have some of the cheapest gas and electricity in Europe.
- All energy retailers purchase from the same wholesale and primary fuel market and are, therefore, affected by the same wholesale price volatility. This means they face similar movements upwards or downwards in their costs at broadly the same time. However, actual price movements will also be influenced by suppliers' individual strategies.
- Purchasing strategies are based on securing future national supply and meeting current and projected future demand.
- Britain's dependence on gas-fired generation makes our need for competitive gas supply even greater.

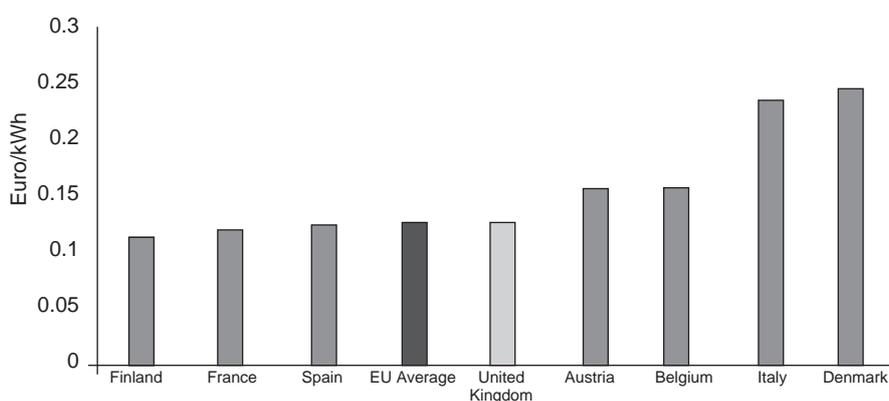
1.1 Since the gas and electricity industries were opened to competition over ten years ago Britain's energy retailers have operated in an increasingly globalised marketplace. This has begun to present some significant challenges. A series of global events have led to record wholesale gas prices; these include:

- Increased demand in China and India.
- High wholesale European gas prices, which are linked to the global oil market.
- Instability in oil producing nations leading to record prices.

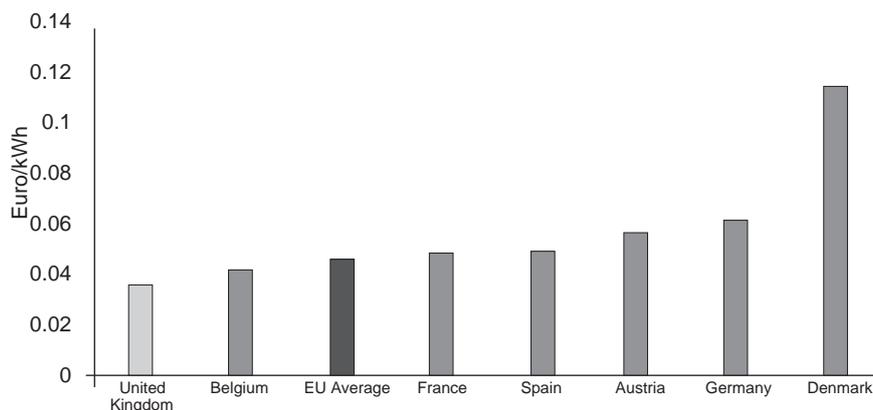
These increases have, in part, been passed on to UK consumers through the retail price.

1.2 We are no longer an energy island with domestic North Sea gas and oil reserves. The price we pay is aligning itself with our EU neighbours whose governments face similar pressures to control rising prices. There remains a challenge to create a more competitive market in many EU countries and to improve the transparency of the market operations. Nevertheless, the result of having the most competitive market in the world (see Section 3.1 below) is that Britain continues to have some of the cheapest gas and electricity in Europe.

European electricity prices (including all taxes) in euros per kilowatt hour (kWh)
based on annual consumption of 3500 kWh per year



European gas prices (including all taxes) in euros per kilowatt hour (kWh) based on annual consumption of 23250 kWh per year



1.3 Against this volatile background, the UK energy marketplace is adapting and changing. In order to cushion consumers from volatility in high wholesale prices energy retailers have hedged their costs. However, efforts to hold back from passing on some costs are becoming unsustainable due to external market pressures. For the first time the UK has become a net importer of natural gas; in future gas will come from areas such as North Africa, the former Soviet Union and the Middle East, as well as from Norway and Holland. The costs of imported gas and other fuels are determined by world markets and these factors will influence the costs of all suppliers.

1.4 The fall in UK gas production, coupled with rising demand for gas, has been an additional factor behind rapidly increasing wholesale gas prices. Over the past 18 months, all UK gas retailers have been forced to increase their prices to customers as a result of the higher commodity costs set on the open global market. The higher cost of gas and coal has also influenced the wholesale price of electricity.

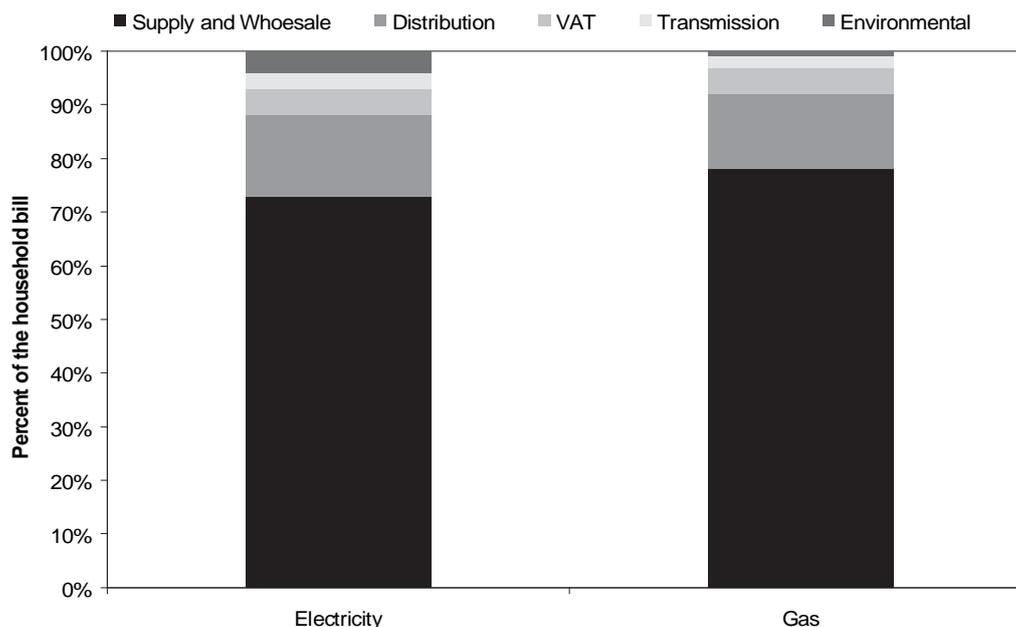
1.5 The situation is not exclusive to Britain. There have been price rises in many other EU states as the impact of world markets has been felt. In Germany, according to a poll by the Financial Times on 7 January 2008, rising electricity prices are topping the list of concerns for German consumers this year where electricity bills have increased by 50% since 2000.

2. Wholesale versus Retail

Key points:

- Energy is not the only commodity affected by a global economic downturn.
- Other products eg food, transport and water are facing similar price pressures.
- Volatility in the wholesale oil markets is due to political and economic factors beyond the control of any one nation.
- Energy suppliers have, to varying degrees, been able to delay the impact of high wholesale prices by adjusting their energy purchasing strategies and making efficiencies elsewhere in their businesses.
- Retail prices have come down as well as gone up.

2.1 Around half of a typical domestic energy bill is made up from wholesale costs and over the last five years consumers have seen double digit rises in both gas and electricity. The juggling act performed by energy retailers between cushioning wholesale price increases to protect retail prices will be made all the more difficult by the cost impact of a raft of environmental regulations due to be implemented in the UK. This is in addition to the requirement for large scale investment in energy infrastructure and the increased cost of the Carbon Emissions Reduction Target, which is estimated to be at least £38 per fuel. The graph below from Ofgem shows the factors that make up a domestic energy bill and the increasing cost of environmental levies.

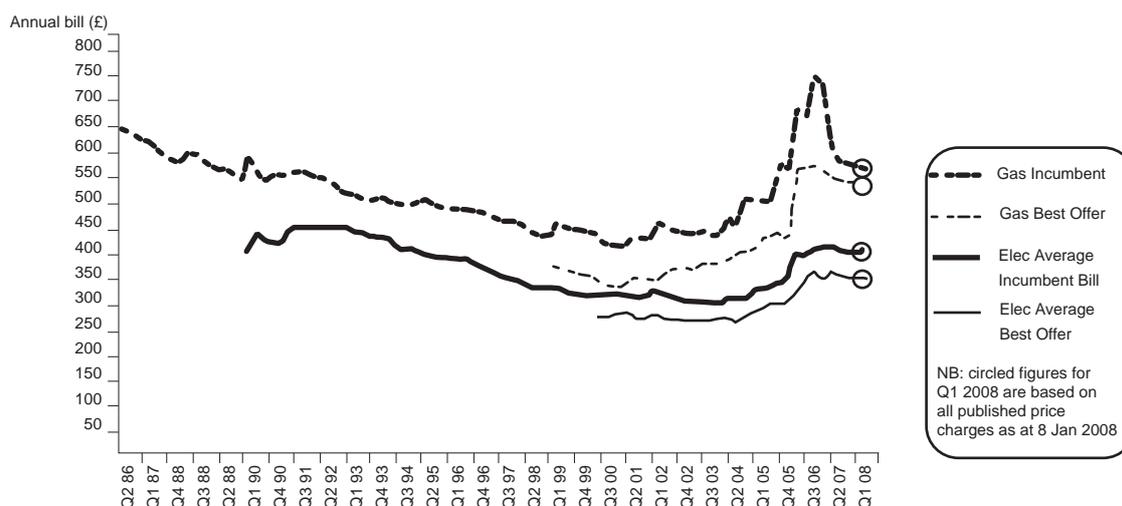


2.2 Unlike petrol pump prices, our energy prices do not fluctuate frequently because energy retailers attempt to smooth the peak and troughs. It can be some months, depending on individual circumstances, before retail prices are caught by the wash of the volatile upstream prices. Similarly, as and when wholesale prices have retreated from these record levels, there has been a delay before those ripples reach retail prices.

2.3 A further criticism raised by some observers is that energy suppliers appear to raise their prices in line with each other. All energy retailers purchase from the same wholesale and primary fuels market and are, therefore, affected by the same wholesale price volatility. While there is some variation in timing and amount of any price adjustments, depending on companies' positions and strategies, the broad commonality of any movements reflects the strength of competition and the consequences in terms of customer losses for any company charging significantly more than its rivals.

2.4 The energy retail market in Britain continues to be defined by highly competitive and dynamic service providers who continue to innovate to increase their market share. In real terms, the competitive market is keeping prices lower for British consumers: the prices they pay for energy remain lower than before market deregulation.

Domestic gas and electricity bills in real terms



Source: Ofgem factsheet 66 Jan 2008

3. Indicators of competition

Key points:

- Britain has the most competitive market in Europe (Oxera, January 2008) in which 55% of gas and electricity consumers have switched supplier.
- Only 25% of consumers have never switched either gas or electricity supplier.

- 400,000 consumers are active and switch each month. Of the remainder, some will have switched and switched back, some changed one fuel, but not the other and some will have changed tariffs.
- Energy consumers have access to the widest range of products provided by energy retailers to meet the requirements of an increasingly engaged market.
- Suppliers are developing markets to promote energy services packages.
- Smart meters will prompt innovation that will shift consumer buying habits from being based purely on price.

3.1 The principal feature of Britain's energy market is consumer choice. A report by Oxera in January this year heralded Britain as having by far the most competitive energy market in the EU and G7 countries over the period 2004 to 2008.

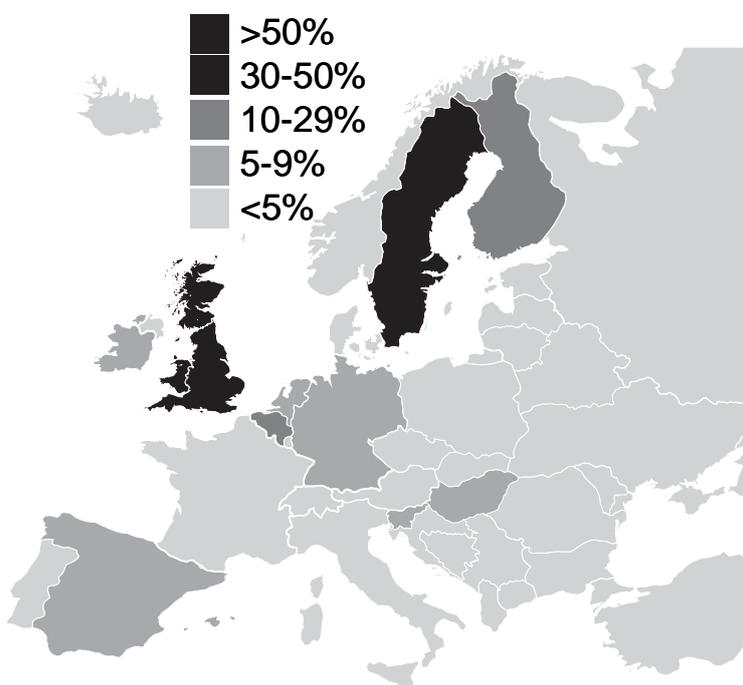
3.2 One indicator is the switching rate of 55%, which is far higher than Sweden at 32%; the second most competitive market in Europe. Ofgem records state that 100,000 consumers switch supplier each week. However, it is likely that the actual switching rate is even higher in Britain because many consumers switch tariffs without changing supplier. This is not just an indication of a dynamic market, but also that many consumers are happy to stay with their existing supplier and choose instead to change tariff or payment method to get the best deal for their individual circumstances. According to MoneyExpert.com's switching index for household products in Q1 2007 the energy market was more dynamic in terms of switching levels than markets in:

- broadband;
- home insurance;
- landline and mobile telephone services;
- credit cards;
- car insurance;
- bank accounts; or
- mortgage providers.

3.3 Research by BroadbandChoices.com, a price comparison site, showed that the figures for consumers switching providers for their broadband services was just 13% in 2007, prompting the comment that broadband service providers had "something to learn from the energy industry".

3.4 The UK (with the exception of the smaller system in Northern Ireland) and Scandinavian countries are the only European states that can claim to have achieved intense competition, as demonstrated by switching rates that far exceed the other EU members. Austria, Denmark, Germany, Netherlands and Spain offer switching opportunities to some degree and Belgium, Ireland, Italy, Luxembourg and Portugal have also already met the EU's market opening requirements. However, it is crucial to note that in other countries the opportunities to switch are not always reflected by the numbers of consumers actually switching. For example, Germany and Austria have a switching rate of 6%. The Netherlands is one of the better performers with around 12% of the population switching energy provider.

The UK has Europe's most competitive energy retail market: electricity switching penetration by market



3.5 British consumers exercise much more power over the market than in many other EU states and this also impacts on the prices that companies are able to charge. Price is a key factor dictating the flexibility of the market and decisions by companies to increase retail energy prices have to be balanced against the potential loss of market share.

3.6 Competition for consumers has driven innovation and better customer service. A variety of different offers are available to consumers indicating a degree of product differentiation. Energy retailers offer price caps, bills without a standing charge, dual fuel discount, and many non-price related benefits, such as a single bill or electronic billing. A number of energy retailers have diversified into other services and offer bundled services, including the supply of energy and telecoms with an option of paying just one bill, for example.

3.7 Affinity partnerships with large retail brands in other sectors continue to be an important feature of the market. Customers are rewarded through bundled offers of products by loyalty points. Energy companies on the other hand benefit from better customer retention and a means of attracting new customers. The introduction of capped and fixed price products by energy suppliers as wholesale prices rose protected many customers from increased prices. Moreover, consumers can now choose to have their retail price indexed to the wholesale market which may provide good value over the long term.

3.8 However, price remains the primary differentiator. This means that any new product must be cost effective to produce and competitively priced to attract consumers. No matter how good the product if consumers consider the price in anyway excessive the product will not sell. A current example is the niche market in microgeneration technology which, due to its high cost has not achieved the critical mass required to enable economies of scale.

The effectiveness of regulatory oversight of the energy market

4. Effectiveness of Regulation

Key points:

- Doorstep sales complaints have fallen by 97% since the EnergySure Code was put in place by industry.
- Switching complaints dropped by 60% after the completion of the Customer Transfer Programme led by the ERA.
- Energywatch has recorded a 70% reduction in overall complaints in the last five years.
- The Billing Code and Energy Supply Ombudsman are voluntary schemes established by industry.
- Self regulatory schemes are independently audited and enforced.
- The Debt and Disconnection Safety Net was reviewed by Ofgem in 2006.

- Ofgem reduced the number of supply licence conditions as a response to confidence in the industry to self-regulate.
- Existing regulation must be proportionate to risk eg consumer protection, health and safety.

4.1 The ERA's members operate in a regulated and customer-facing environment, which naturally leads to close monitoring of the industry by Government and the regulator, which have a responsibility to protect the interests of consumers. Regulation must be proportionate in order to allow the competitive market to function effectively and to enable suppliers to innovate.

4.2 As an example of the ability of the industry to self regulate where appropriate, in 2003 the ERA took ownership of the Code of Practice on Face to Face Marketing of Energy Supply. The voluntary Code, now known as the EnergySure Code, sets standards by which energy suppliers can be judged. Persistent failure to observe this EnergySure Code will lead to a withdrawal of using the EnergySure "badge". The Code aims at the same time to help customers understand the service and behaviour they can expect from EnergySure Code Members. The Code is independently audited on an annual basis by KPMG. Whilst it has no legal force, it provides a means for self-regulation in the competitive energy market and aims to assist the realisation of the benefits of competition. Annually, Code members approach approximately 35 million people about switching their energy supplier, and fewer than 1 in 100,000 approaches results in an energywatch complaint about direct selling. Since its launch complaints to energywatch about doorstep sales practice have fallen by 97%.

4.3 The ERA aims to work with the industry on issues where consumers can benefit from suppliers working for the common good where there is no competitive advantage. The establishment of a "safety net" for debt and disconnections set out a framework for debt recovery and protects vulnerable households from disconnection. In January 2008 Ofgem published an independent review of the operation of energy suppliers debt recovery processes. It concluded:

"Disconnections are down significantly from the record levels seen in 2001. It is reassuring to see supplier's progress in improving debt and disconnection procedures overall since Ofgem's last industry-wide review in 2005".

(Debt and Disconnection Review 07/08, 25 Jan 2008)

4.4 In July 2006, in response to recommendations following a supercomplaint against the industry, the ERA established the Energy Supply Ombudsman to offer a redress scheme for consumers unable to resolve billing disputes with their energy supplier. The scheme is entirely industry funded and since its launch has been extended to include all types of complaints. In accordance with the Consumer, Estate Agents and Redress Act 2007 the Energy Supply Ombudsman will become the Energy Ombudsman with effect from 1 April 2008 and its remit will be extended to networks businesses.

4.5 Since the introduction of competition in the gas and electricity supply markets, the industry has matured and developed significantly. Customers now have a wide choice of supplier and/or supply offers, indicating a high level of product innovation and differentiation within the market. In Ofgem's Domestic Retail Market Report (June 2007) they highlight that their research has shown that less than 3% of customers think switching is too difficult or say they are unaware that it is possible to switch. A National Consumer Council report *Switched on to Switching* (2005) found that 95% of energy consumers found the switching process "very easy or fairly easy".

4.6 We believe that it is vital that the supply licence provides a level playing field on regulatory obligations for all suppliers, regardless of size or whether a new entrant or not. Such differentiation would simply serve to distort competition. We support the view that all regulation must be non-prescriptive, proportionate and developed with a clear and realistic strategy for implementation. Ofgem recognises that regulations that are drafted without due regard to the impact on business will be ineffective and lead to compliance problems.

4.7 As an industry, we acknowledge Ofgem's right to enforcement through energy and competition legislation. However, as the market matures a key advantage to offering added value to consumers will be retailers' ability to innovate. It is important that burdensome and disproportionate regulation is avoided so that there continues to be innovation in the market.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

5. Fuel poverty and social programmes

Key points:

- Fuel poverty is an effect of three factors colliding—low income, poor housing and the price of fuel. Energy suppliers have nothing to do with the first two, and the third is largely driven by world energy markets.
- Nevertheless, energy suppliers have engaged in a number of initiatives aimed at relieving fuel poverty. These have included the significant spend on improving insulation standards for the priority group in EEC/CERT, as well as other voluntary programmes assessed by Ofgem at £56 million a year.

- The Government has challenged suppliers to raise this contribution towards £150m a year over the survey period.
- Social tariffs form part of a package of measures and cannot be viewed in isolation where the issue of fuel poverty is multi-faceted.
- The increased CERT charges present a significant challenge and Government must help suppliers to identify and target low income households.

5.1 Energy suppliers are not the architects of “fuel poverty”. People in fuel poverty often have multiple debts and there is a challenge for the Government to offer joined-up services to address all of the problems vulnerable people face managing their energy bills and keeping their homes warm. This requires long term, sustainable strategy.

5.2 An underlying cause of increasing fuel poverty is higher primary fuel costs and investment requirements in generation and gas import capacity, leading to higher wholesale costs. Such rises greatly exceed margins in energy supply and have to be passed through to consumers. Energy suppliers are intermediaries, and their part in alleviating fuel poverty is focussed on a number of special schemes including the CERT programme (which is improving energy efficiency, especially of potentially fuel poor households) and social initiatives. This is a substantial area of work, which is making a real difference.

5.3 According to Ofgem the price of fuel makes up 15–20% of the overall effect. In supporting the Government in eliminating fuel poverty the main contribution that energy companies can make is to maintain pressure on fuel prices, to promote energy efficiency improvements, and to ensure that there is flexibility in a competitive market to enable vulnerable customers to benefit from competition and the special services and tariffs available to them.

5.4 A social tariff should be seen as one part of a toolkit of measures that suppliers can deliver according to the needs of their customers and according to what provides the most help. Other measures include winter rebates, price freezes, trust funds, boiler upgrades, free insulation, benefits entitlement checks, partnership schemes with charities, local authorities and health services and energy efficiency advice. All these schemes offer flexibility in how they are implemented by suppliers.

5.5 Legislating for a social tariff could become a complex intervention in the market, restricting rather than promoting innovative and sustainable schemes. On the other hand a contribution per customer from each supplier (as set by Government) would enable assistance to be provided in an equitable manner. If the Government chooses this option it must be specific about what it expects suppliers to achieve and that its expectations are realistic. It should also be recognised that taking the social tariff option may remove a segment of society, albeit temporarily, from access to choices in the market. This degree of financial exclusion may be appropriate for some, but there is currently no guidance on who should qualify.

5.6 Identification remains a huge challenge for energy companies and Government, whether it is offering free insulation or targeting welfare support. Means-testing is fraught with difficulty because people do not self-diagnose. Many people in need do not identify themselves and energy suppliers rightly have only the minimum details about their customers’ personal circumstances. This needs to be resolved with Government before any further schemes are launched. The Government must interrogate its data and devise a means of sharing this and overcoming any data protection issues.

For example, this winter 250,000 elderly gas and electricity customers are benefiting from offers of free insulation and heating systems under a joint government/industry scheme that is being funded by energy suppliers. This is the second year that energy suppliers have funded a winter initiative to provide free insulation to 250,000 pensioners on benefits in England, Scotland and Wales. Over a five week period a coupon was sent to targeted households identified using benefits data held by Government. This was a joint initiative involving energy suppliers, Eaga the Department of Business Enterprise and Regulatory Reform and Department of Work and Pensions. Customers responding to a freephone helpline or completing a coupon were offered tariff advice and information about their energy supplier’s social welfare schemes that range from trust fund payments to winter rebates. Households in England were also offered Warm Front grants to improve their heating systems. The scheme is branded under the Government’s winter Keep Warm Keep Well campaign. The scheme will measure the extent that energy efficiency measures can be accurately targeted using data on benefits claimants held by the government. Industry experience is that on average £1,500 is under claimed by each household every year.

5.7 Energy suppliers offer more practical help to low income families than any other business sector. This raises the question of accountability when external factors drive adverse outcomes, as in the case of tackling fuel poverty. Energy companies are not qualified to develop and deliver social welfare programmes and should not have to substitute for public services.

6. Pre-payment meters

Key points:

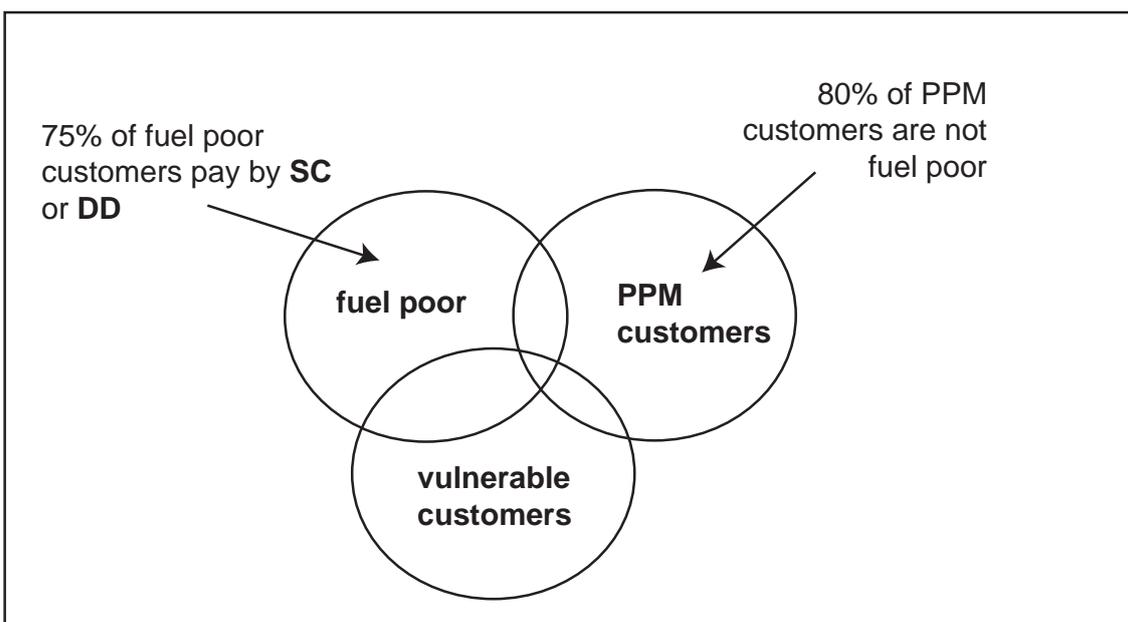
- Prepayment meters (PPMs) operate on a similar principle as “pay as you go” mobile phones.
- This enables customers to manage their energy spend more efficiently.

- The majority of PPM customers are low income, but not fuel poor.
- Of the customers who pay for their energy with a PPM, a minority of 20% are fuel poor.
- Ofgem state that 75% of fuel poor customers pay by standard credit or direct debit and only 5% of pensioners (who account for 50% of Britain’s fuel poor) use PPMs.
- Most customers who use PPMs do so because it enables households on low incomes to budget their energy use.
- Ofgem research (factsheet 67) published in June showed that the majority of PPM customers are happy to pay in this way.
- PPMs are also often used in rented accommodation or holiday lets.
- Some PPMs are installed by energy suppliers when a customer has difficulty paying their bills, to help them manage their spend.
- In 2007 Ofgem research indicated that the proportion of prepayment customers who had switched was below the average for the market as a whole. However, switching rates for prepayment customers were slightly above those for standard credit customers.
- The majority of pre-payment customers are not in debt.
- Suppliers use PPMs as an alternative to disconnections.

6.1 There has been much attention focused on prepayment (PPM) energy customers over the last few years and this has led to some misunderstandings. Prepayment meters operate on a similar principle as “pay as you go” mobile phones and enable customers to manage their energy spend more efficiently. A feature of a pay as you go option is that the cost is often higher than an online offer. In the same way mobile phone calls and texts are more expensive for pay as you go offers and there is a sometimes a minimum monthly top up requirement. In energy most PPMs work with a swipe card or key, which customers use to buy their energy in advance at a local corner shop, garage or Post Office, and then charge their meter.

6.2 Suppliers incur additional charges from meter provision and maintenance, and prepayment meter infrastructure. As with pay as you go mobile telephones, the cost of servicing PPMs is higher, and historically, users’ tariffs have often reflected this. Ofgem indicates that on average each PPM costs an additional £60 compared to standard credit customers and £85 compared to direct debit customers.

6.3 Of the total of 26 million electricity meters and 20 million gas meters in the UK, there are currently 3.5 million electricity PPMs and 2.2 million gas PPMs. The majority of PPM customers are not fuel poor. In fact Ofgem figures state that of the customers who pay for their energy with a PPM, a minority of 20% are fuel poor. Furthermore, 75% of fuel poor customers pay by standard credit or direct debit and only 5% of pensioners (who account for 50% of Britain’s fuel poor) use PPMs. We are concerned about any proposal to intervene on prepayment tariff rates, without a clear principle of seeking to focus help on those in greatest need. Aside from the cost to all consumers, including the majority of fuel poor who do not use PPMs, the proposed intervention will benefit those who use prepayment meters in second homes, holiday cottages, rented property and student accommodation.



Source: Ofgem Domestic Retail Market report, 2005

6.4 A feature of a competitive market is the ability of suppliers to vary their service offers. Every supplier’s customer base differs, and companies have decided on an individual basis how to charge their customers. Companies ensure in a variety of ways that they are offering appropriate products for customers on PPMs.

Some energy suppliers have chosen to reduce or equalise their tariffs with standard credit tariffs. However, others consider that equalising tariffs would disproportionately affect the 3 million fuel poor customers who do not use PPMs. According to Ofgem's Domestic Retail Market published in June 2007 if the cost of servicing PPMs was recouped across all customers, every bill would go up by approximately £14 per year.

6.5 In response to concerns about disconnection levels the ERA established a new protocol in 2004 under what is known as 'safety net' procedures. The scheme has been successful in ensuring that no households identified as vulnerable have been disconnected in over three years. The number of disconnections last year was 5000. This is down from 17,000 four years ago. However, the commitment to reduce disconnections has led to suppliers recovering debt in other ways. Consequently the number of prepayment meter installations has increased.

6.6 PPMs are used to recover debt accrued where this is the best option for the customer. For those customers who are repaying debt, most repay it at less than £3 a week. The rates at which they can repay debt are tailored to the customer's needs. For example, a customer need only pay £2.85 week of debt on a PPM if they are on benefits. However, a significant number agree to a higher repayment rate in order to be clear of a debt. Provided a PPM is not carrying a debt of more than £100 a consumer could switch to a supplier with a better deal. Anecdotally, suppliers have indicated that prepayment users are currently amongst the most active switchers compared to other forms of payment. This confirms figures in Ofgem's 2007 retail market report that show PPM user switching levels are higher than those on standard credit tariffs.

6.7 There is particular concern about old style token meters because they cannot be adjusted remotely, so require a home visit to recalibrate them when prices change. Suppliers are complying with the new license conditions concerning the timely recalibration of token PPMs, and are making significant progress. This style of meter will be phased out by 2009 when the current replacement programme is complete. Suppliers are taking measures to ensure that the number of token PPMs accruing debt is falling. In June the number of token PPMs accruing debt was around 115,000—down from 409,000 when Ofgem first took action in December 2006.

6.8 All suppliers who reduced PPM prices following recent price cuts confirmed that the decreases will be backdated on meters when they are recalibrated and that customers will benefit from lower prices from the date on which they were introduced.

6.9 Despite the poor image PPMs score consistently high marks in customer satisfaction surveys. This was supported by a survey of consumers carried out by Ofgem last June. Some people prefer the pay as you go option as it means that they can budget precisely their energy use.

Additional comments

7. A future low carbon economy

Key points:

- Energy suppliers have accepted that a business model based on selling a finite resource, such as gas, in ever-growing quantities is not sustainable.
- The supplier obligation challenge for energy companies is to reduce carbon emissions from upstream generation and increase energy efficiency downstream.
- There is a cost associated with developing a low carbon economy.
- The next 20 years could see a new era of energy generation.
- Government has a significant role to play in helping energy suppliers to promote new attitudes to energy use.
- The success of new technology depends on creating consumer demand. This is currently undermined by perpetual negative messaging based on misinformation and misunderstanding.

7.1 In the Energy Review in 2006, the Government signalled an ambition for a low carbon economy. Energy suppliers support this ambition and have committed to a major reform of the energy market. The supplier obligation beyond 2011 will mean that suppliers need to diversify their product offers and reduce carbon emissions upstream and increase energy efficiency downstream based on sustainable business model. Companies agree that there is more that can and should be done through traditional approaches (such as the insulation measures supported by CERT) and believe that future policies could continue to encourage these opportunities.

7.2 The suspension of the 28-day rule, allows suppliers to sign longer term contracts with their customers. This will enable energy suppliers to invest in higher cost products, such as new technology, advanced appliances and microgeneration etc, because they can recover the cost over a longer period and have the certainty that their capital investment is not lost by the consumer switching away. If more consumers opt for a longer contract with their supplier switching rates may slow, but the competitive environment will be defined by an even wider range of innovative products being brought to market.

7.3 An essential feature of this new market structure will be the advent of smart meter technology to 26 million homes throughout Britain. Smart meters are two-way communication devices that have the potential to revolutionise the way that consumers manage the amount of energy they use, the cost of their energy and their impact on the environment. They are the next generation of electricity and gas meters. A national roll out of smart meters could bring about the end of estimated bills and meter readings, and provide customers and energy suppliers with accurate information on the amount of electricity and gas being used. They will also provide the platform for the development of a much greater choice in energy tariffs and services for homes across the country. Smart meters will empower customers to make choices on how much energy they use.

7.4 Suppliers will install two-way communication systems that display accurate real-time information on energy use in the home to the consumer and back to the energy supplier. In addition, Smart meters enable:

- Automatic and actual meter readings that will bring an end to estimated bills.
- Flexible tariffs that measure consumption over set time periods.
- Capability for selling energy back to the supplier which will facilitate microgeneration technology (eg solar panels or wind turbines).
- The same meter for electricity (and gas, subject to cost) will be used for all customers, whether they are pre-payment or credit, and regardless of supplier.
- Suppliers could differentiate their tariffs and services through offering alternative means of displaying energy consumption—eg through handheld devices, mobile phones, the internet or via digital TV.
- Improved accuracy of forecasting energy demand at different times of the day.

7.5 The Energy Retail Association is calling on the Government to provide a clear mandate to roll-out Smart Meters across Britain. This mandate is essential if this huge project to replace 45 million meters across every home in the country is to be completed within 10 years at a reasonable cost. Without the mandate it would be impossible to ensure that every energy customer in the country has a smart meter fitted. The industry would also be unable to take their current discussions further and to work together to buy and install smart meters, which would result in a significant increase in both cost and time.

31 March 2008

Letter submitted by energywatch

1. A SOUND MARKET?

BERR and Ofgem have asserted that the GB energy market is not only sound but is the most competitive market in Europe. In fact they only recently dropped the “most competitive market in the world” boast when the Australian State of Victoria achieved a higher proportion of consumers switching supplier.

Ofgem has protested to the Chancellor that there is no evidence of collusion or price fixing and that they invited anyone with information to the contrary to come forward.

However, the focus on collusion is a red herring. Only the *Sunday Times* has raised that possibility. However a broad range of other bodies—British Energy (the largest independent electricity generator), energywatch, small independent energy suppliers, academics, Unison, the National Right to Fuel Campaign and others—have maintained that there are structural features of the market which constrain the extent of effective competition. No accusation of collusion, but observations that:

- In the 10 years since competition was introduced the number of active suppliers has dropped from 20 + to only 6. **Market Concentration.**
- In that 10 years the big six suppliers have re-established interests in electricity generation and gas production. This degree of **Vertical Integration** and the existence of long term contracts with electricity generators effectively **forecloses** the market to new entry and therefore stifles real competitive pressure.
- It is argued that these **market structure** issues mean that suppliers don’t need to compete vigorously on low prices because they do not need to fear the price competition that a new entrant would provide. Given that all the big six are in this **comfort zone** they know that it is none of their interest to buck the trend and cut prices dramatically. Collusion is just not needed in the energy market.

British Energy are quoted in the *Sunday Times* as saying that the control of the big six suppliers over energy trading “increasingly forecloses the market to new entrants”.

What's the point?

The very characteristics that led to a competition investigation by DG Competition in Brussels exist here (although in a lesser form). The market has changed out of all recognition over the decade of competition. Consumers have less choice, there is no new entry, vertical integration ties up all electricity generation in long term contracts, there is very little transparency in the market.

2. FEAR OF THE COMPETITION COMMISSION

energywatch has called for a reference to the Competition Commission to enable it to carry out a Market Investigation into the GB energy market. A Market investigation is a tool available to regulators and government where there is evidence that features within the structure of a market is inhibiting active competition. Peter Freeman the Chair of the CC has made the following points in speeches over the past couple of years.

*The purpose of market investigations [from comp commission] is to enable the competition authorities to take an in-depth look at markets **where competition is thought to be not working well, but where the problem does not at first sight appear to emanate from the dominant position of a single firm or the existence of hard core cartels.** They are meant to be detailed and thorough and to apply a **cure rather than a punishment.** In their deployment of decision-making and remedy imposing powers they are probably unique to the UK.*

Despite the CC's powerful armoury of regulatory and competition enforcement powers, its involvement in regulated sectors in recent years has been minimal. Whatever the justification . . . the fact is that regulators are not making references to the CC for market investigations nor are they or regulated companies using the CC to resolve licensing or price control issues.

September 2006. Bath

"This relative dearth of regulatory cases has caused us some concern (we query if the threat of a Competition Commission reference from a regulator can act as a 'credible threat' if that reference power is very rarely—if at all—used) . . ."

May 2007. Edinburgh

What's the point?

The CC is a critical element in BERR's aspiration to have the best competition and consumer policy in the world. They are the experts in market structure and competitive forces. Ofgem openly acknowledges that it spends 75% of its time and energy on the monopoly network industry (ref its evidence to the House of Lords inquiry into economic regulators). It either cannot or will not apply itself to fundamental questions about market structure. Given that there is a body set up to do exactly that, why will Ofgem or BERR not make a reference to the CC? Has the Minister discussed the energy market with the Competition Commission?

3. SWITCHING NOT A SUFFICIENT MEASURE

Ofgem regard the numbers of consumers switching supplier as the key measure of competition in the market. Last year they claim that 4 million out of 36 million energy account holders switched supplier.

However, half of consumers have never switched supplier, 65% of pensioners have never switched supplier, 6 million people on pre payment meters cannot switch using an online comparison site, 2 million people cannot switch because they are in debt to their supplier, hundreds of thousands of consumers are on radio controlled meters and cannot switch for technical reasons (dynamic teleswitching meters).

Switching is not only more limited than some maintain, research from the University of East Anglia have established that around one third of all consumers who have switched, did so to a worse tariff. Of course, every consumer who has switched in recent years has done so to escape punishing price rises not to make meaningful savings.

What's the point?

The numbers not as healthy as they appear at first and they hide real barriers to switching and actual detriment for those who do switched. There is contestability in this market. But it's hard to claim that it amounts to effective competition for all. Is the minister content that a glance at the latest switching figures is sufficient scrutiny over a market that delivers essential services to consumers and where that service is being priced out of the reach of many low-income consumers.

4. GOVERNMENT FUEL POVERTY STRATEGY

Government will not meet its 2010 target for eradicating fuel poverty from vulnerable households. Around **4 million households** across the UK are considered to be in fuel poverty, where they are required to spend 10% or more of their income to heat their home. The price of energy has the biggest impact on the level of fuel poverty, and price rises seen since 2003 to date of **74% for gas and 55% for electricity** have seen the number of fuel poor households double.

The pillar of the UK Fuel Poverty Strategy dedicated to, “*continuing action to maintain the downward pressure on fuel bills*” seems to have been abandoned. Government said that it would use the Energy Bill to give itself a power to require companies to provide social tariffs if they didn’t act themselves. It has not done so. It has said in the 2nd reading of the energy bill that it prefers to see companies bring forward voluntary and innovative solutions.

In stark contrast, the company that has done the least on social tariffs has itself argued for a mandatory scheme. Npower wrote to Ofgem on 24 September last year and said:

“At present, government is encouraging the delivery of a social action solution within a voluntary framework. It is doubtful whether this is the most efficient approach and it is also seemingly inconsistent with a market framework. We believe that the interest of the fuel poor is best served by a mandatory social tariff and this is the only means by which the Government’s 2010 and 2016 objectives can be achieved. There is no obvious reason why these targets will be delivered within a competitive retail market”.

A recent energywatch report shows that suppliers are currently spending **0.11%** of their combined **£24 billion** turnover on social tariffs and bill rebates—the measures that offer direct assistance with the cost of energy to fuel poor households. The measures currently available only reach the equivalent of 1 in 15 fuel poor energy accounts. If energy suppliers fulfil their White Paper commitments the proportion of industry turnover invested in social tariffs and rebates will increase to 0.25%.

What’s the point?

BERR has identified one lever to dampen price rises for those in or at risk of fuel poverty—the power to require social tariffs. It has chosen not to use that lever. Since government challenged suppliers, through the Energy White Paper, to do more to help their low income consumers, one company has declared that it will launch a social tariff. Little else has happened. On what evidence has BERR based its decision not to take the power to require companies to develop social tariffs? What percentage reduction to the price of energy needs to be made for the 2010 target to be met?

22 January 2008

Memorandum submitted by energywatch

BUSINESS AND ENTERPRISE COMMITTEE: INQUIRY INTO POSSIBLE ANTI-COMPETITIVE BEHAVIOUR IN THE ENERGY MARKETS

EXECUTIVE SUMMARY

1. energywatch welcomes the Business and Enterprise Committee inquiry into possible anti-competitive behaviour of the energy markets. Our response focuses on the fuel poverty and competition elements of the terms of reference.

Fuel poverty

2. To mitigate the impact of punitive prices on fuel poor households, Government must take the powers necessary to oblige suppliers to offer social tariffs in accordance with minimum standards. Standards should include a stipulation that a supplier’s social tariff represents a rate lower than any other rate available to its other customers, regardless of the eligible customer’s payment method.

3. To address the inequities faced by prepayment meter consumers:

- BERR to take steps to abolish prepayment premiums that are shown to be non-legitimate and inefficient.
- Ofgem to reinstate obligation on suppliers to provide annual statements to prepayment meter consumers and to specify that these provide pricing transparency, including: comparison of cost with other payment methods offered by supplier and breakdown of component costs that underpin the differential. The statement should also offer a comparison with competitors’ prepayment meter terms.

- “Health warning” on till receipts at charging points such as shops and post offices, which state that prepayment meter is most expensive payment method, unless supplier can demonstrate otherwise.
- A condition of doorstep acquisition of prepayment meter consumers should be that the acquiring supplier guarantees in the contract a better per unit deal at time of acquisition than their current supplier offers.
- Priority given to prepayment meter consumers in smart meter roll out.
- Provide greater access for prepayment meter consumers to switch through price comparison services.

Competition

4. energywatch believes there are reasonable grounds for suspecting that a feature, or combination of features, prevents, restricts or distorts competition in the GB energy market. We believe the threshold set under the Enterprise Act 2002 for the Secretary of State for Business, Enterprise and Regulatory Reform or Ofgem to refer the GB energy market to the Competition Commission (CC) has been met.

5. energywatch recommends that the GB energy market be referred to the CC *without delay* for a full and independent investigation. The CC is the only body with the necessary powers, competence and resources to:

- *Demand* access to the relevant commercially sensitive and confidential information held by market participants.
- *Investigate* the extent to which any feature or combination of features prevents, distorts or restricts competition in the GB energy market.
- *Determine* whether any feature or combination of features of the GB energy market has an adverse effect on competition.
- *Quantify* the level of detriment to gas and electricity consumers in GB created by higher prices, lower quality, less choice or less innovation.
- *Decide* what remedies need to be put in place to ensure that the GB energy markets are competitive and can function efficiently and effectively.

6. energywatch believes that consumers have been and continue to be detrimentally affected by the lack of effective competition in the GB energy markets. We are concerned that:

- Consumers pay prices above the competitive level putting affordable energy beyond the reach of many households.
- An estimated half a million households have been put into fuel poverty as a direct result of the price increases in 2008 alone.
- The near doubling of average domestic energy bills since 2003 has been mirrored in a 100% increase in the number of vulnerable households in fuel poverty.
- Prepayment meter consumers pay up to £456 more per year for their energy than consumers paying by online direct debit.
- Small businesses are frequently locked in to higher priced contracts.
- Business consumers’ international competitiveness has deteriorated.
- Production has fallen contributing to over 100,000 manufacturing job losses.
- Investment has been cut back and investor confidence is now under threat.
- Lack of supplier and generator/production diversity negatively impacts innovation, delivery of the environmental and carbon agenda and security of supply.
- Customer service levels are deteriorating rather than improving with consumer contacts with energywatch increasing by nearly 50% between 2004–05 and 2007–08.

7. energywatch believes the key features of the GB energy market that need investigation by the CC are:

- The supply markets are highly concentrated and consumers are vulnerable to abuse of market power. The regional supply markets are dominated by two suppliers with British Gas and the incumbent electricity suppliers controlling at least 60% of each of the domestic supply markets.
- The electricity market is dominated by six vertically integrated firms inhibiting competition in the retail and wholesale markets.
- Firms adopt similar supply and trading policies reducing wholesale market liquidity and leaving consumers vulnerable to abuse of dominance.
- There has been no scale new entry in the 10 years since liberalisation due to high barriers to entry including credit policies, complex industry codes and information transparency. This can negatively impact prices, quality, choice and innovation.
- There is a lack of strategic storage inhibiting our ability to store summer priced gas as an alternative to high priced gas during winter.

- Where other measures are considered insufficient, separation of vertically integrated firms through divestment of plant or function.

8. energywatch believes there are remedies that the CC could put in place to help ensure there is effective competition in the GB energy markets including:

- Requirements for firms to trade minimum gas and electricity volumes through the “over the counter” markets to enhance liquidity and address concerns about the move towards long term “off market” contracting and self supply.
- Enhanced reporting and disclosure requirements for firms to aid transparency and price discovery.
- Greater transparency on gas flows from Europe and the North Sea including flows from outside of our current jurisdiction.
- Creating incentives for investment in strategic storage to ensure GB can benefit from access to lower priced gas.
- Measures to reduce search and switching costs for consumers particularly for domestic consumers paying by prepayment meter and small businesses.

OUTLINE

9. This paper sets out why energywatch believes there are reasonable grounds for suspecting that competition is not working effectively in the GB energy markets, most clearly evidenced in the electricity market. It outlines the features of the market we believe need to be investigated in a full and independent market investigation by the CC.

10. In preparing our submission, we have reviewed in detail the experience of two groups of consumers who face particular problems in the energy markets—prepayment meter consumers and small businesses. We have analysed retail and wholesale prices in GB and undertaken comparative analysis of prices across Europe. We have also tested our concerns about the lack of effective competition in the GB energy markets and the need for a CC investigation with academics, industry commentators and market participants. We provide three energywatch commissioned papers to support our submission:

- Cornwall Energy Associates, *Why the British energy markets in gas and electricity require a competition investigation*, April 2008. Update of our 2007 analysis of the aspects of the supply market that act against the best interests of consumers and our 2004 review of competition in the business market.
- Dominic Whittome, *Competition Report on the GB Gas and Power Markets*, March 2008. Analysis of the uncompetitive aspects of the wholesale markets drawing on almost 50 interviews with market participants and other interested parties.
- Dr Philip Marsden (British Institute of International and Comparative Law), *It is time for an Energy Market Investigation by the Competition Commission*, April 2008. Analysis of recent CC investigations and the role of the CC.

BACKGROUND

11. energywatch is the statutory independent watchdog representing gas and electricity consumers in GB. We help domestic and business consumers with their complaints against energy companies, provide them with advice and information about the market and act as an advocate for their interests to energy companies, government and regulators.

INTRODUCTION

12. GB energy markets are failing to meet the needs of GB consumers. We have seen energy bills double over the past five years yet service levels have deteriorated rather than improved. Prices are not determined on the basis of effective competition and there is distrust in the way prices are set.⁷⁹ We are continually told that we have the most competitive market in Europe yet our electricity prices remain amongst the highest in Europe. Some of our most vulnerable consumers are not able to access the cheapest tariffs in the market as they pay by prepayment meter. The price increases we have seen this year alone mean an estimated extra half a million households are now in fuel poverty. Small businesses find themselves locked into higher priced contracts due to complex contractual arrangements and business consumers more generally are concerned about their lack of choice due to the low number and type of contract offers. Our international competitiveness has deteriorated and we have seen significant job losses.

13. energywatch believes there are reasonable grounds for suspecting that competition is not working effectively in the GB energy market. This undermines consumer confidence and creates consumer detriment. energywatch recommends that the GB energy market be referred to the CC for a full and independent

⁷⁹ European Commission, Competition: energy sector inquiry confirms serious problems and sets out way forward, press release 16 February 2006.

investigation.⁸⁰ A CC market investigation is necessary to unpick the complexities of the structure and competitiveness of the GB energy market that previous reviews, probes and investigations by the regulator and others have failed to do. The CC can put in place the remedies necessary to help ensure GB consumers benefit from effectively functioning and competitive energy markets.

14. energywatch supports markets with fair and healthy competition combined with protections for consumers who are vulnerable or have little chance of influencing a market's competitiveness or a supplier's willingness to trade fairly. We believe vigorous competition should drive firms to deliver higher quality, increased choice, greater innovation and lower prices to the benefit of all consumers. Consumers need to be confident that they are and will be well served by the market. Confident, informed and empowered consumers are a critical driver of economic change. We believe significant reform is required to ensure that prices are determined on the basis of effective competition.

COMPETITION COMMISSION

15. The CC helps ensure healthy competition between companies for the benefit of companies, consumers and the economy. We believe the CC is the only body with the necessary powers, competence⁸¹ and resources to undertake a full and independent review of the GB energy market. The CC can⁸²:

- *Demand* access to the relevant commercially sensitive and confidential information held by market participants.
- *Investigate* whether any feature or combination of features prevents, distorts or restricts competition in the GB energy market.
- *Determine* whether any feature or combination of features of the GB energy market has an adverse effect on competition.
- *Quantify* the level of gas and electricity consumer detriment in GB created by higher prices, lower quality, less choice or less innovation.
- *Consider* whether competition is restricted due, in part, to limited ability or incentive for consumers to search or switch between suppliers.
- *Decide* what remedies need to be put in place to ensure that the GB energy markets are competitive and can function efficiently and effectively.

FEATURES

16. We set out below the key features of the GB energy markets that we believe are a concern and need investigation by the CC.

Consolidation, concentration and market shares

17. We have seen considerable consolidation in the GB energy markets since liberalisation. There has been no scale new entry and 20 suppliers⁸³ have exited the market since 2000 so there are now effectively six dominant firms. These firms are vertically integrated, control over 99% of the domestic supply markets, dominate the business supply markets⁸⁴ and own six of the nine power generators. There is a real threat of further consolidation and vertical integration.

18. On a national level, the combined domestic gas and electricity supply markets are highly concentrated with a Herfindahl-Hirschman Index (HHI),⁸⁵ the most commonly accepted measure of market concentration, of nearly 2,000. Looking more closely at competition across consumer groups, we see even greater levels of concentration. The domestic gas retail market has an HHI of around 2,800. The regional domestic electricity markets are dominated by two firms—BGT and the incumbent electricity firm—and

⁸⁰ It is important to note that the threshold for making a reference to the CC under the Enterprise Act 2002 is based on there being reasonable grounds for suspecting "competition is not working effectively" (Section 131). The threshold is not based on the provision of hard and absolute evidence. It is part of the role of the CC in undertaking an investigation to gather, analyse and validate information and evidence so that it can answer the questions it is obliged to determine under statute (Section 134) namely whether there has been an adverse effect on competition and whether remedial action should be taken.

⁸¹ The CC has a special utilities panel, made up of CC members expert in the energy and related sectors. Most usually the panel deals with water, electricity, gas and energy code modifications but these members would clearly be involved in any market investigation into the energy sector, thus ensuring an expert and thorough review.

⁸² Section 134 of the Enterprise Act 2002 and OFT, *The Interface between Competition and Consumer Policies*, OECD Global Forum on Competition 2008.

⁸³ Appendix 2—Why the British markets in gas and electricity require a competition investigation.

⁸⁴ Ofgem data for January 2008 shows that the six vertically integrated firms control over 95% of the business electricity supply market. The corresponding data for gas was not available as Ofgem does not regularly monitor the business market.

⁸⁵ HHI is a commonly accepted measure of market concentration used by economists. It is the sum of the square of each firm's market share and therefore takes account of the relative size and distribution of the firms in a market. The HHI increases as the number of firms decreases and the disparity in size between firms increases. As noted by the OFT, the US Merger Guidelines characterise as "highly concentrated" a market with an HHI of over 1,800.

have HHIs in the range of 2,500 to 6,500. Research suggests that electricity suppliers who remained vertically integrated with their local distributor have retained a higher market share than those where these functions have been undertaken by separately owned companies.⁸⁶

19. These levels of concentration suggest the six dominant firms have considerable market power. Where this is exercised, the prices charged to consumers will be above the competitive level. We believe the CC should investigate the extent to which consumers have paid higher prices as part of a market investigation.

Prices

20. Domestic gas and electricity bills have risen by 109% and 70% in the past five years.⁸⁷ These increases equate to a combined average bill in excess of £1,000⁸⁸ meaning affordable energy is beyond the reach of many households. This year alone the six dominant firms have increased domestic prices by up to 15% for electricity and 17% for gas putting an estimated half a million households into fuel poverty.

21. The spread in prices varies across payment methods. For example there is only a £26 annual difference—a mere 50 pence per week—in the prices the dominant firms charge for dual fuel paid by direct debit but £107 by prepayment meter. The difference in price between payment types is significant. Prepayment meter consumers can pay up to £456 more⁸⁹ for their energy compared to consumers paying by online direct debit.

22. It is often stated that the GB energy market is the most competitive market in the EU.⁹⁰ The expectation is that energy prices should be lower in GB than in the rest of the EU. However, domestic electricity prices in GB excluding tax are not the most competitive in Europe and are amongst the most expensive.⁹¹ Business consumers have been hit by even more significant price increases than domestic consumers as contract rates offered by suppliers are more closely related to forward market prices. This has had a detrimental impact on their international competitiveness putting investor confidence at risk.

23. energywatch recognises there is upward pressure on prices from the delivery of the environmental and carbon agenda, this makes it all the more important for the wholesale and retail elements of our energy bills to be competitive.

Coordinated effects

24. Given certain market conditions firms may realise that it is in their mutual best interest to “cease to compete” and sustain high prices today rather than face the threat of fierce competition tomorrow. If this behaviour is maintained without explicit agreement then the resulting impact on competition is called “coordinated effects”.⁹²

25. energywatch considers that the conditions necessary for coordinated effects to emerge and be sustainable are present in the GB energy market.⁹³ This means the market is susceptible to abuse of dominance and consumers will pay more than the competitive level for their energy. An analysis of the domestic supply markets suggests:

- **Awareness of competitor behaviour:** there is a high degree of market concentration so firms are aware of each others actions. Prices are transparent—contract terms including price are available on demand under the supply licences and there are a range of price comparison services where firms can readily access comparative price information.
- **Costly to deviate from prevailing market behaviour:** it is in a supplier’s interest to act in a similar way to competitors. Prices charged to domestic consumers can change quickly so any deviation from the prevailing market behaviour can be punished. The prevailing strategy in the domestic supply markets appears to be “risk minimisation” in that the dominant firms seek to be neither significantly better nor significantly worse than their competitors.
- **Weak competitive constraints:** there has been no new scale entry and there is no evidence of a “competitive fringe” influencing behaviour of the dominant firms. It is not clear that the dominant firms actively compete across all consumer groups and regions. For example no supplier has ever actively marketed to consumers in Scotland with dynamic teleswitching and some suppliers do not

⁸⁶ Davies and Price, Does ownership unbundling matter? Evidence from UK energy markets, November 2007.

⁸⁷ energywatch analysis of supplier’s announced headline price changes between 2003 and 2008.

⁸⁸ This is expected to be a low estimate of an average bill as it is based on a conservative estimate of electricity consumption.

⁸⁹ On average consumers paying by prepayment meter pay £255 more than consumers paying by online direct debit. It is not clear that the differential reflects efficient or legitimate additional cost to supply.

⁹⁰ Forward projections of energy market competitiveness rankings—Prepared for the Department for Business, Enterprise and Regulatory Reform, Oxera, 10 December 2007. The Oxera analysis is based on a high level analysis of structural features and fails to consider key factors such as liquidity in the wholesale markets or competitiveness of price.

⁹¹ Based on analysis of data provided by Energy Advice Limited January 2008.

⁹² Ofgem, Domestic Competitive Market Review, 2004.

⁹³ Competition Commission, Market Investigation References: Competition Commission Guidelines, June 2003.

allow consumers paying by prepayment meter to switch through price comparison services. With respect to the business supply market, business consumers tend to have only two or three contract offers to choose from.

26. The CC would need to undertake a more detailed analysis of the existence and effects of coordinated behaviour in the domestic supply and wider GB energy markets.

Switching

27. Though energywatch does all it can to encourage switching, we believe it is a gross error to view switching as hugely successful and many consumers who have switched have ended up paying more. After 10 years of liberalisation around 50% of consumers have never switched and this increases to 65% for consumers over the age of 60.

28. The regulator has argued there has been considerable switching and this is direct evidence of competition. We do not agree that switching is a sufficiently good barometer for healthy competition and is not a theoretically sound basis for a regulator to determine whether there is effective competition.

29. There have always been problems with the switching data as it can be inflated by involuntary and mis-selling transfers and fails to identify multiple switchers. Switching to new entrants appears to have been moderate and tends to reflect the introduction of dual fuel offers. Some consumers are unable to switch due to debt blocking,⁹⁴ others state they are very unlikely to switch⁹⁵ and some state that they will never switch.⁹⁶ Further survey evidence shows⁹⁷ that switching is often ill-advised and consumers have ended up on a worse deal.

30. Search and switching costs are a particular problem for prepayment meter consumers and for small businesses due to the application of complex contractual arrangements by suppliers, a lack of clarity on terms and conditions and a lack of comparative price and service information.

Elasticity of demand

31. Gas and electricity are “necessity goods” and consumers have little choice other than to use energy as and when they require it. In general, the demand for energy might be considered relatively inelastic, the quantity of energy demanded does not change significantly with a change in the price.⁹⁸ There is a low cross elasticity of consumption between fuels—there are effectively no substitutes. It is unlikely that a domestic consumer would change from gas to electricity for heating particularly as gas accounts for 40% of electricity production and would require considerable investment by the consumer. It is unlikely that consumers could survive without electricity and still function in the modern world. Energy is also essential to the day to day functioning of the vast majority of businesses, even if it is not a key input into making a good or delivering a service. These factors make consumers particularly vulnerable to dominant firms being able to extract monopoly rent.

Vertical integration

32. energywatch notes there may be economic rationale for vertical integration. However, it must also be recognised that vertical integration can have a negative impact on supply competition and inhibit the development of effective and healthy wholesale markets. The detrimental effects of vertical integration flow from the likelihood that a vertical structure will empower firms to behave in ways that may be damaging to competition.

- *Monopoly profits*: it can allow firms to extract monopoly profits from the market as a result of control throughout the supply chain.
- *Cross subsidy*: it can facilitate cross subsidy between the generation and supply business and between different groups of consumers.
- *Price discrimination*: a vertically integrated firm can offer different prices for the same product even when the generation costs are basically the same.
- *Barrier to entry*: a vertically integrated firm can deter new entrants by effectively increasing the costs of entry throughout the supply chain.

⁹⁴ Malcom Wicks stated during the fuel poverty adjournment debate 8 January 2008 that “If people are concerned that they are being charged too much, considering switching is very important, but I think that I know enough about this subject to recognise that switching is easier said than done for some of the most vulnerable people, particularly if there is a record of debt payments”—*Hansard* column 23w.

⁹⁵ Accent, energywatch Information and Advice Survey, June 2005—55% of consumers are “very unlikely” to change their gas or electricity suppliers in the near future.

⁹⁶ ORB, 2007 Energy Consumers Survey, 2007—14% consumers stated they would never switch.

⁹⁷ Wilson and Price, Do Consumers Switch to the Best Supplier, July 2007—amongst electricity consumers who had switched suppliers exclusively for price reasons only up to a fifth had switched to the supplier offering the greatest saving and up to one third had switched to a deal that had left them worse off.

⁹⁸ A change in the price level may affect different households differently as demand increases with income but at a decreasing rate—Price, Effect of Liberalizing UK Retail Energy Markets on Consumers.

- *Vertical foreclosure*: a vertically integrated firm can limit the supply of wholesale products and reduce liquidity in the wholesale markets.

33. Despite repeated concerns being raised with the regulator,⁹⁹ it has failed to undertake any open or comprehensive review of the effects of vertical integration on the GB energy markets and consumers.

34. Through a market investigation, the CC can demand access to the relevant commercially sensitive and confidential information that would allow it to determine whether vertical integration has had an adverse effect on supply and wholesale competition and to quantify any associated detriment to non-vertically integrated firms and consumers.

Liquidity

35. energywatch believes the failings of the GB energy market can be most clearly seen in the wholesale markets. Diminished wholesale market liquidity can seriously affect the retail markets.

36. There has been a shift away from trading through the “over the counter” GB wholesale markets, particularly in electricity, in favour of “off market” contracts. There is a lack of visibility about these contracts and there is no transparency of the terms and conditions for other market participants. A lack of transparency will benefit the incumbents and undermine new entrants.¹⁰⁰ We have seen reduced liquidity in the wholesale markets and this has had a detrimental impact on price discovery. Illiquid markets, where there is limited trading and price is formed on the basis of a few or even a single transaction, are usually considered to be volatile and do not necessarily reflect the true market value.

37. Volumes that are being traded in electricity appear to be heavily skewed to shorter durations, particularly in the front quarter or season. The volume traded is only three times physical consumption—considerably below the ten times level said to evidence a healthy market and means liquidity is significantly less than markets such as Germany and the Netherlands that have deregulated more recently. Entrants advise that there is a mismatch between the wholesale products on offer and the volume and shape they require to meet the needs of their customers. There are few independent counter-parties to trade with and where there are volumes, the integrated players insist that monies are posted in advance because they say they are concerned with the credit status of small players in volatile markets. The dominant firms reference the forward market when changing consumer prices yet they are not exposed to these prices for significant volumes as they are vertically integrated. There is no transparency of transfer prices.

38. The wholesale gas market is considered to be more liquid than the electricity wholesale market. However, a significant proportion of gas is subject to long term contracts and the remaining 30% is primarily traded in the run up to delivery rather than months or seasons ahead.¹⁰¹ Forward curve prices are therefore based on limited trading activity and may not be a robust indicator of future costs.

39. The regulator often presents prices from the wholesale forward curves to be representative of supplier costs despite the dominant firms being vertically integrated and without having analysed transfer prices or the impact of reduced liquidity in the wholesale markets.

40. Through a market investigation, the CC can demand information from firms about their trading strategies and obtain copies of their long term contracts under which the majority of gas and electricity are bought and sold to determine whether these have constrained new entry. The CC can also access information about their actual costs of supply to determine whether consumers have and continue to pay more than the competitive level.

Cash-out

41. energywatch believes there is an urgent problem with the cash-out arrangements that needs to be remedied. Market participants have compared the risk of exposure to penal cash-out prices to “playing russian roulette”—in that it may be possible for a smaller player to manage exposure to prices in five games out of six but it is the prices in that one game in six that can undermine the business and could lead to a firm exiting the market.

42. The imbalance settlement or cash-out arrangements are an important part of the wholesale trading arrangements. Problems with cash-out rules harm consumers who are ultimately exposed to the costs resulting from higher wholesale prices, contract risk premia and use of system charges. The dual cash-out

⁹⁹ For example responses to Ofgem proposals to remove the restrictions on self supply licence condition in 2002 and consultation on a non-domestic supply competition review in 2006. The Public Accounts Committee 2003 report on the New Electricity Trading Arrangements recommended that “Ofgem should take seriously the risk that vertically integrated companies may exploit their position and Ofgem should adapt its competition analysis of the wholesale market and retail markets to reflect the new reality of the market”.

¹⁰⁰ European Commission, Competition: energy sector inquiry confirms serious problems and sets out way forward, press release 16 February 2006.

¹⁰¹ Global Insight, Report for DTI on Ensuring Effective and Efficient Forwards Gas Markets, March 2005—70% gas landed in Britain subject to long term contracts. The report characterised the spot markets as “functionally liquid” but believed the forward market to “suffer from a lack of liquidity by global standard”.

arrangements are complex and can act as a barrier to entry particularly where they produce artificially high or volatile cash-out prices. They also make it difficult for new firms to invest in technology to help deliver the environmental and carbon agenda.¹⁰²

43. The regulator has stated there ‘is a proven defect with the current [cash-out] arrangements, namely “system pollution”’.¹⁰³ energywatch is concerned about the level of detriment consumers have borne and will continue to bear from defective cash-out arrangements.¹⁰⁴ It is unclear whether the changes to industry codes that are currently being progressed will address all non-energy actions which may be detrimentally influencing cash-out prices, for example ability to influence prices behind a constraint in certain periods.

44. These arrangements would benefit from an independent investigation by the CC. The CC would be able to determine the extent to which complex market rules constrain new entry and quantify any associated detriment to consumers.

Storage

45. We have relatively low levels of gas storage capacity compared to European peers.¹⁰⁵ Investment in GB storage is expected to double capacity by 2015. However, investment appears to be more geared towards small and medium range storage rather than long range storage. Long range storage allows for low priced gas (typically in the summer in GB) to be injected to provide an alternative source to high priced gas (typically in winter in GB) particularly during periods of unexpectedly high demand. Long range storage should be viewed as an asset that can be used to capture volumes of gas at lower prices as well as better ensuring supply continuity in more testing times.

46. Given our increasing dependence on gas imports and storage, it is important to ensure that the third party access provisions cannot be used to limit market opportunities for other firms and create a barrier to entry. Further, it is important to ensure there is greater transparency of information on flows from Europe and the North Sea including flows from outside of our current jurisdiction.

47. As part of a market investigation, the CC could identify real barriers to investment, review the need to create incentives to invest in strategic storage and consider the potential for market rules on access to storage to create a barrier to entry.

CONCLUSIONS AND RECOMMENDATIONS

Fuel poverty

48. To mitigate the impact of punitive prices on fuel poor households, Government must take the powers necessary to oblige suppliers to offer social tariffs in accordance with minimum standards. Standards should include a stipulation that a supplier’s social tariff represents a rate lower than any other rate available to its other customers, regardless of the eligible customer’s payment method.

49. To address the inequities faced by prepayment meter consumers:

- BERR to take steps to abolish prepayment premiums that are shown to be non-legitimate and inefficient.
- Ofgem to reinstate obligation on suppliers to provide annual statements to prepayment meter consumers and to specify that these provide pricing transparency, including: comparison of cost with other payment methods offered by supplier and breakdown of component costs that underpin the differential. The statement should also offer a comparison with competitors’ prepayment meter terms.
- “Health warning” on till receipts at charging points such as shops and post offices, which state that prepayment meter is most expensive payment method, unless supplier can demonstrate otherwise.
- A condition of doorstep acquisition of prepayment meter consumers should be that the acquiring supplier guarantees in the contract a better per unit deal at time of acquisition than their current supplier offers.
- Priority given to prepayment meter consumers in smart meter roll out.
- Provide greater access for prepayment meter consumers to switch through price comparison services.

¹⁰² New entrants are likely to be exposed to a greater extent to imbalance charges due to forecasting errors arising from lack of historic consumption data, less mature forecasting processes and less portfolio diversification—see Ofgem cash-out review meeting presentation of 26 September 2007.

¹⁰³ Ofgem open letter on BSC modification proposals P211 and P217.

¹⁰⁴ Ofgem cash-out review meeting presentation of 26 September 2007—Cash-out prices are estimated to have been detrimentally affected by between 7% and 9%. 9% average increase in system buy price and up to 7% decrease in the system sell price.

¹⁰⁵ Storage capacity: UK 4% of gas supply and equivalent to about 14 days of supply—Italy, Germany and France have in excess of 20% and upwards of 50 days—Netherlands has 11% even though it has high level of indigenous supply.

Competition

50. energywatch considers the threshold set by the Enterprise Act 2002 for the Secretary of State for Business, Enterprise and Regulatory Reform or Ofgem to refer the GB energy market to the CC for investigation has been met. We believe there are reasonable grounds for suspecting that a feature, or combination of features prevents, restricts or distorts competition in the GB energy market. energywatch recommends the GB energy market be referred to the CC for a full and independent market investigation without delay.

51. The CC can investigate and determine whether any feature or combination of features of the GB energy market has an adverse effect on competition. The CC can also determine what action should be taken to remedy, mitigate or prevent adverse effects on competition or any detrimental effect on consumers. energywatch proposes that consideration be given to:

- *Mandatory trading*: firms to trade a defined level of output through the over the counter wholesale markets to enhance liquidity.
- *Regulatory reporting requirements*: firms to submit information to the regulator on purchase costs to ensure only efficient cost pass through.
- *Disclosure requirements*: firms to publish trading data including prices and segmented financial and operating data about their electricity and gas production and retailing operations to aid price discovery.
- *Simplifying market rules and entry requirements*: a fundamental make-over of the market rules (including cash-out and third party access) to ensure smaller and low carbon operators can access markets and consumers fairly.
- *Information transparency*: greater transparency of information on gas flows from Europe and the North Sea.
- *Investment incentives*: creation of investment incentives for long term strategic storage.
- *Reduced search and switching costs*: introduction of standard terms and conditions and a confidence code for price comparison services for small businesses.
- *Market monitoring*: regular business market monitoring by the regulator.
- *Price controls*: reintroduction of supply price controls for certain consumer groups if alternative measures are unsuccessful.
- *Separation of vertically integrated firms*: if other measures are considered insufficient divestment of plant or function.

Annex A

PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

1. The *Warm Homes and Energy Conservation Act (2000)* obliged the UK Government to *publish and implement a strategy for reducing fuel poverty* and to set targets for the implementation of that strategy. The resultant UK Fuel Poverty Strategy saw the Government set itself binding deadlines for the eradication of fuel poverty in all vulnerable households by 2010; and in all remaining households by 2016.

WHAT IS FUEL POVERTY?

2. Fuel poverty arises when three factors—poorly insulated energy inefficient dwellings with sub-optimal heating systems, low disposable household income and the price of fuel—conspire to put thermal comfort beyond the reach of the household affected.

3. The UK Fuel Poverty Strategy classifies households as fuel poor if they would need to spend in excess of 10% of household income to maintain a satisfactory heating regime.¹⁰⁶ For some fuel poor households the cost of warmth can rise to 20, 30 or even 40% of income. For many low-income households, spending 10% of their income on heating remains an aspiration.

4. The lived reality of fuel poverty is cold, damp homes and the human manifestation of fuel poverty is respiratory illness, depression and heart disease, increased risk of strokes and other cold-related ill health; all of which contribute to the UK's high rate of excess winter deaths.

¹⁰⁶ A satisfactory heating regime is defined as 21°C in the living room and 18°C in other occupied rooms, as recommended by the World Health Organisation.

PRICE AND THE UK FUEL POVERTY STRATEGY

5. The UK Fuel Poverty Strategy recognised that if it were to achieve its stated targets, actions to address the three causal factors of fuel poverty would be required. Most significantly for this inquiry, a key pillar of the Strategy was built on “*continuing action to maintain a downward pressure on fuel bills, ensuring fair treatment for the less well off, and supporting the development of energy industry initiatives to combat fuel poverty*”.

HIGH PRICES HAVE SINGLE-HANDEDLY UNDERMINED THE STRATEGY

6. Since 2003 the escalating cost of domestic gas and electricity has single-handedly undermined the progress that was being made towards meeting the Government’s targets. The reality of competition thereafter has seen suppliers chasing competitors’ prices ever upwards. The collapse of the Strategy’s price focused pillar has left a debilitating policy vacuum at a time when action on the actual price that fuel poor households are paying for their gas and electricity is essential. However, Government have declined to take decisive steps to ensure fuel poor households can access energy at the most affordable prices in the market; relying instead on repeated appeals to suppliers to volunteer assistance.

THE REALITY OF HIGH PRICES FOR LOW-INCOME CONSUMERS

7. energywatch research published in December 2005¹⁰⁷ found that:

- most consumers perceive their energy bills to be rising rapidly and feel that this is having an impact on their household finances;
- organising their finances to be able to spend enough to stay warm is the top priority for most consumers of all ages and income levels, although this may not always be achieved; and
- consumers on low incomes will cut back their expenditure in other areas and budget for their gas and electricity use in order to maintain some level of warmth.

8. More recent research has shown that price increases in the period since have exacerbated the situation further. In 2006 the not-for-profit Home Heat Helpline, the supplier sponsored advice line, published research on the difficulties that single parents experienced with the cost of energy. This revealed that three quarters (73%) of the single parents polled admitted they set their heating at a lower temperature to save money. Over half (55%) also said they heat only selected rooms to reduce their bills.¹⁰⁸

9. A survey published by Help the Aged in November 2007¹⁰⁹ established that:

- One fifth of elderly people spend their winters in one room to reduce heating costs.
- 2.2 million have turned off their central heating.
- 1 million cut back on food expenditure in order pay heating bills.

10. Similarly, research undertaken for energywatch in 2007 found that almost a fifth (18%) of energy consumers say they currently find it difficult to pay their energy bills. This figure rises to 28% of consumers with an income under £11,500.

COMPETITION LOSERS

11. The competitive energy market has shown itself to be ill-equipped to recognise and serve the needs of low-income consumers. They are frequently expected to pay more for the gas and electricity they use and are disproportionately affected by the industry’s more negligent practices, such as debt arising from late token meter recalibration.

PREPAYMENT METERS

12. Prepayment meters (PPMs) present the most vivid example of punitive and discriminatory pricing policies in the energy market. There is a strong correlation between the use of prepayment meters and low-income; and when fuel poverty is measured on the “basic income” definition¹¹⁰ Government data shows that around a third of the fuel poor pay for their electricity through a PPM. This consumer segment live on a

¹⁰⁷ See:

http://www.energywatch.org.uk/uploads/How_well_does_the_Priority_Services_Register_serve_priority_consumers.pdf

¹⁰⁸ Home Heat Helpline, *Single Parents Fell the Strain*, July 2006:

http://www.energy-retail.org.uk/media/press/2006/july06_01.html

¹⁰⁹ 1 in 5 older people live in one room of their home to keep warm and save costs in winter, Help the Aged, November 2007:

http://press.helptheaged.org.uk/_press/Releases/_items/_1+in+5+older+people+live+in+one+room+of+their+home+to+keep+warm+and+save+costs+in+winter.htm

¹¹⁰ Government reports fuel poverty figures in two ways: the first includes housing supplements such as Housing Benefit and Income Support for Mortgage Interest as income and is referred to as the full income definition, while the second excludes housing supplements from discretionary spend and is known as the basic income definition.

budget, are forced to budget their energy use, yet are left paying the market's premium prices. Where a consumer is using a PPM for both gas and electricity they will on average pay £255 more per annum than a consumer using direct debit, online only tariffs.

13. energywatch analysis has shown that three of the six major suppliers do not accept PPM consumers seeking to switch to them via price comparison sites and in some instances will seek to vet PPM users wishing to switch. Agreements between the other three suppliers and price comparison sites to facilitate PPM switching are limited. This means that this highly promoted and commonly used route to market is closed in great part to PPM users. These practices suggest further discrimination against this consumer segment and limits their options to door step sales agents or suppliers' call centres, which can both present additional problems.

14. The accelerating trend of suppliers installing PPMs to recover debt means that close to 1 million PPM users (c 1 in 6) are effectively chained to both their current supplier and this punitive payment method. On average 1,000 prepayment meters per day were installed to recover debt in 2007.

LIMITATIONS OF SWITCHING

15. Ofgem's 2007 review of suppliers' voluntary initiatives¹¹¹ restated its view "that competition is the most effective way to ensure customers are protected from high prices". Such an outlook is at odds with the experience of the 2 million plus households that have become fuel poor as a direct result of escalating energy bills.

16. This view is also at odds with the Sustainable Development Commission which concluded that switching supplier "is not a particularly helpful or appropriate method of reducing low-income household fuel bills and that more proactive steps need to be taken to protect low income and vulnerable consumers".¹¹² Interestingly, the view appears to be increasingly at odds with recent statements by Energy Minister, Malcolm Wicks:

*If people are concerned that they are being charged too much, considering switching is very important, but I think that I know enough about this subject to recognise that switching is easier said than done for some of the most vulnerable people, particularly if there is a record of debt payments.*¹¹³

17. In a number of instances switching can provide a saving and hence play a role in making energy more affordable. energywatch has pioneered projects to actively help low-income consumers make the switch to a better deal wherever that is possible. However, these projects have given energywatch unique first-hand experience about the realities of switching for low-income and vulnerable groups. It has taught us that switching is at best only a partial answer and that in some cases it's not the answer at all. Switching to a more advantageous deal is not as straightforward as its most enthusiastic champions advocate. When the factors that may hinder the process of switching for vulnerable and low-income consumers are taken into account, the picture becomes even more complicated. A paper that discusses the difficulties vulnerable and low-income consumers can face in switching is attached at Appendix 1.

18. Analysis has highlighted the difficulties that low-income and vulnerable consumers can face: *Switching is most prevalent among higher social groups, particularly the professional and managerial ABs. Some of the groups least likely to switch are the state-supported social group E, those aged 65+, those in rented accommodation and PPM users.*¹¹⁴

19. It must also be recognised that in a high price environment where the average bill exceeds £1k per annum,¹¹⁵ the least expensive deal does not equate with affordable energy for those on low-fixed incomes. It is also somewhat academic to point to the best deals in the market and use these as the basis on which to calculate the savings that are available to low-income consumers. Personal circumstances, financial exclusion, market place exclusion and any combination thereof will mean that in reality, the lowest priced offer—internet only direct debit tariffs—are beyond the reach of those consumers who would benefit the most from them.

¹¹¹ Ofgem's Review of Suppliers' Voluntary Initiatives to Help Vulnerable Customers, August 2007: <http://www.ofgem.gov.uk/Sustainability/SocAction/Suppliers/CSR/Documents1/Review%20of%20suppliers%20voluntary%20initiatives.pdf>

¹¹² *Lost in Transmission—The role of Ofgem in a changing climate*, 2007, see: http://www.sd-commission.org.uk/publications/downloads/SDC_ofgem_report.pdf

¹¹³ Malcolm Wicks, Fuel poverty adjournment debate 8 Jan 2008, *Hansard*, column 23w.

¹¹⁴ Ipsos Mori *Switching Rates for Vulnerable Consumers*, report for Ofgem, March 2007, <http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Switching Rates for Vulnerable Customers Report.pdf>

¹¹⁵ This is expected to be a low estimate of an average bill as it is based on a conservative estimate of electricity consumption.

PROGRESS AGAINST TARGETS

20. Between 1996 and 2001 when the Strategy was published fuel poverty declined from around 7.5 million households to 3.5 million. The introduction of initiatives heralded in the Strategy contributed to continuing year on year reductions in the years 2001–03, with the global UK figure declining further to 2.75 million in 2002 and then to 2.5 million in 2003 (on the basic income definition). Appendix two provides Government data on trends in the level of fuel poverty.

21. In England reductions in fuel poverty were attributed to the following¹¹⁶:

- 61% attributable to improvements in incomes.
- 22% attributable to energy price reductions.
- 17% attributable to energy efficiency improvements.

22. This shows a benign price environment prior to 2003 actually making a positive contribution to reductions in fuel poverty, much as the Strategy had envisaged. However, since 2003 escalating prices have outstripped income growth and outpaced the rate at which energy efficiency and heating improvements can be installed in fuel poor dwellings.

23. The Government's 2007 Annual Progress Report on the UK Fuel Poverty Strategy concedes that its 2010 target to eradicate fuel poverty in vulnerable households will not now be met and estimates that up to 1.3 million vulnerable households will still be in fuel poverty in 2010.¹¹⁷

INSUFFICIENT GOVERNMENT RESPONSE TO IMPACT OF ESCALATING PRICES

24. Significantly, the Energy White Paper formally set out a challenge to suppliers to develop adequate programmes of support, with the implication being that if this did not happen, legislation could be used to ensure all suppliers offered adequate programmes of support.¹¹⁸

25. Following the White Paper, energywatch commissioned Cornwall Energy Associates to examine the adequacy of those initiatives that directly related to the actual cost of energy paid by fuel poor households, namely social tariffs and bill rebates. This review was undertaken in line with the methodology that BERR had indicated it would use to assess suppliers' responses to the White Paper challenge. The findings of the report exposed the great variability in suppliers' commitments:

- The six major suppliers are currently committing an estimated £28.1 million—or 0.11% of the domestic supply industry's £24.6 billion turnover—to social tariffs and bill rebates.
- If and when suppliers fulfil the commitments made to government, the industry will invest £62.5 million, or 0.25% of its estimated turnover, in social tariffs and bill rebates.
- For individual suppliers this ranges from British Gas committing 0.49% of its turnover to a mere 0.079% of turnover for npower and Scottish & Southern Energy.
- British Gas has committed to making assistance available to 4.7% of its consumer base, while for npower and Scottish & Southern this figure is 0.79% and 0.34% respectively.
- Only Scottish and Southern Energy and EDF Energy offer social tariffs that cost less than the best deal they offer in the open market.
- The commitments made by British Gas will equate to 71% of the total industry assistance offered, while its market share represents just 33%; whereas npower has an 11% market share but has a social package commitment that will represent 4% of the total.

26. energywatch estimate that if suppliers fulfil the commitments they have made in light of the White Paper, social tariffs will be available to, at best, only 1 in 6 fuel poor energy accounts. A full summary of findings is presented at Appendix 3.

27. Despite it being readily apparent that the White Paper challenge has not forced sufficient progress from suppliers, the Government has hesitated in obliging suppliers to do more, passing up the clear opportunity to use the Energy Bill to at least take the relevant reserve powers. However, increasing pressure, has seen the Government use the Budget to lay down another challenge to suppliers:

*There is common agreement on the need to do more. Energy companies currently spend around £50 million a year on social tariffs; the Government would like to see that figure rising over the period ahead to at least £150 million a year. Acting with the companies and Ofgem, the Government will draw up a plan for voluntary and statutory action to achieve that. To underpin this as necessary, the Government will legislate to require companies to make a fair contribution.*¹¹⁹

¹¹⁶ UK Fuel Poverty Strategy: 3rd Annual Progress Report 2005:
<http://www.berr.gov.uk/files/file10717.pdf>

¹¹⁷ UK Fuel Poverty Strategy: 5th Annual Progress Report 2007:
<http://www.berr.gov.uk/files/file42720.pdf>

¹¹⁸ Energy white paper: meeting the energy challenge, May 2007, para. 2.1.21:
<http://www.berr.gov.uk/energy/whitepaper/page39534.html>

¹¹⁹ Budget Report 2008, chapter 4, para. 4.34:
http://www.hm-treasury.gov.uk/media/7/2/bud08_chapter4.pdf

28. Based on the expertise it has developed on the role that effective social tariffs could play in mitigating the impact of high prices on fuel poor households, it is the firm view of energywatch that the Government has to now take the powers necessary to oblige suppliers to offer social tariffs in accordance with minimum standards. This would:

- Provide a policy response to the escalating prices and ensure that the Government's fuel poverty strategy has an effective action in relation to the cost of energy to fuel poor households.
- Ensure fuel poor households have access to the most affordably priced energy, thus mitigating the detrimental impact of rising prices and discriminatory pricing.
- Complement investment in and efforts on raising incomes and the provision of energy efficiency and heating measures; ensuring a more coherent approach to tackling fuel poverty in the process. Energywatch has advocated that social tariffs should be offered as an integral part of an energy assistance package, which also comprises energy efficiency and benefit entitlement elements.

29. Following a consultation exercise with a range of stakeholders, energywatch last year published a comprehensive set of recommendations which highlighted the minimum standards required and how social tariffs could work with the grain of a competitive market. A summary of these recommendations is provided in a briefing paper at Appendix 4.

APPENDIX 1

VULNERABLE CONSUMERS AND SWITCHING

energywatch discussion paper for Ofgem Social Action Strategy Review Group 12 December 2007

WHO IS A VULNERABLE CONSUMER?

Vulnerable consumers are not a homogenous unit. There is a range of vulnerabilities that—either individually or in combination—act as barriers to the consumer's engagement with the energy market. Consequently, there is no one size fits all strategy to stimulate switching. A range of tailored approaches are required to promote and, more importantly, enable switching amongst different vulnerable groups.

That said, one facet of vulnerability that frequently occurs in combination with and exacerbates others in the energy market context, is the need to survive on low or fixed incomes and the distinct barriers that arise from this.

Ensuring low-income, vulnerable consumers can identify and then successfully secure the greatest savings available to them in the market can play an important role in reducing bills in a high price energy environment. However, stimulating switching amongst this segment remains a significant challenge. As the Ipsos Mori *Switching Rates for Vulnerable Consumers*¹²⁰ report for Ofgem noted earlier this year:

Switching is most prevalent among higher social groups, particularly the professional and managerial ABs. Some of the groups least likely to switch are the state-supported social group E, those aged 65+, those in rented accommodation and PPM users.

¹²⁰ [http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Switching Rates for Vulnerable Customers Report.pdf](http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Switching_Rates_for_Vulnerable_Customers_Report.pdf)

 KEY ELEMENTS TO EFFECTIVE SWITCHING

Switching entails more than a simple transaction between the consumer and the chosen supplier. In reality, for a consumer to engage in an advantageous switch, the presence of the key elements discussed below is required. The absence of any of these will likely leave the consumer either locked out of the market, or in a position where the deal they choose proves to be less than advantageous (leaving the consumer disillusioned by the process):

- (1) An **awareness and understanding** that the market in energy exists, that changing supplier is an option in this market and that switching is potentially advantageous to the consumer in terms of bill savings and/or improved customer service; or can lead to a product that better reflects the consumer's conscience (ie switching is to a green supplier).

Those close to the industry tend to take it for granted that there is a universal awareness of this, but as the work of energywatch's Priority Consumer Team with elderly consumers last winter revealed, a number of consumers still believe they are being supplied by the long defunct gas and electricity boards.

The Prepayment Meter Customer Workshop undertaken for Ofgem by Mori earlier this year revealed a low-awareness amongst PPM users of the premium they were paying:

Participants were shown evidence that on average annually prepayment meter customers pay more than direct debit, or occasionally standard credit customers. Many participants were surprised by this. In fact, only 3 of 20 gas PPM customers and 7 of 28 electricity PPM customers knew theirs was not the cheapest method of paying; many simply did not know.¹²¹

- (2) Once the awareness and understanding of the energy market is in place, the consumer then has to display a **willingness/confidence** to engage with that market, to acquire appropriate information, calculate whether a better deal is available and resolve and have sufficient confidence to act on this information.

Brand awareness and familiarity appears to play a key role in whether a consumer has the confidence to switch or not, especially for elder consumers. For many, the comfort zone may seem a rational place to stay. Many of those consumers who turned to energywatch for assistance during its "Are You Missing Out?" switching campaign last winter would have realised the greatest savings by switching to Ebico. However, because this brand is largely unknown, many consumers were unwilling to opt for this supplier.

Frequent price changes can also inhibit confidence in switching—especially where the savings available are less significant. They reinforce a common consumer perception that although a supplier may appear to offer a good deal in the present, that could well change in a fast moving price environment.

Brand awareness and familiarity and the perception of changing prices also came through strongly in Mori's research for Ofgem into the experiences of PPM users:

Still other participants are sceptical about switching supplier because they do not have the information to be able to discern between an energy deal that is good for them and one that is not. For instance, participants say they know the difference between the quality of a product from Asda compared with Waitrose, but energy companies do not have a brand personality or image that they know about or can relate to. So in that sense, participants say they find it hard to compare the benefit of choosing one supplier over another. There is also some feeling that costs for suppliers are all much the same.

- (3) **Personal circumstances** need to be such that the consumer has the means to assess, obtain and then utilise the deal most advantageous to them. This relates to a range of abilities and capabilities being in place. These include, but are not limited to:

The ability to deduce which offer is in consumer's best interests from available information (ie reasonable literacy and numeracy skills and a working understanding of English).

Financially "included": ie a bank account with a direct debit facility that the consumer has sufficient funds to use with confidence (ie no risk of unexpected payment pushing consumer into overdraft territory), no debt to previous supplier and a credit history that demonstrates "dependability" to new supplier.

Ready access to the Internet and ability to use it effectively: the internet represents the primary source of information on which to make switching decisions and the gateway to best value tariffs. Forthcoming energywatch research indicates that only 11% of social class DE use the internet as a source of switching related information.

¹²¹ <http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents/Prepayment%20meter%20Customer%20Workshop.pdf>

-
- (4) Availability of price and service **information** on which to base switching decisions that is free of charge, impartial, clear, accurate and easy to access. In addition, search costs (accessing, processing and acting on the information) should be minimal—otherwise a consumer’s willingness to switch will be exhausted. The inability to switch through price comparison websites, for example, will undoubtedly increase the search costs faced by PPM users who seek a better deal.
 - (5) Routes to market/gateway to best tariffs must be **universally open** to all consumers (ie not be a filter device by which suppliers skim off more affluent consumers).

The experience of energywatch suggests that major suppliers are discriminating against PPM consumers by refusing to accept them via price comparison sites. This leaves this consumer segment at the mercy of either aggressive doorstep sales agents or suppliers’ call centres, which as Mori’s PPM research for Ofgem also demonstrated, can put consumers off switching.

- (6) **A commitment from suppliers** to facilitate the free, unimpeded movement of consumers in the market (between payment methods and tariffs and between suppliers).

The experience of PPM consumers suggests that this is not always the case. The debt assignment protocol has not worked, price comparison sites are closed doors to PPM consumers, and suppliers can be resistant to recruiting PPM consumers in certain regions (especially token meter consumers). This suggests a dearth of contestability in the PPM market, which in turn shields suppliers from competitive pressures on pricing in this arena and makes the stasis of the status quo a commercially attractive proposition. As a result PPM users are left captive to the resultant price premiums and with limited “escape” routes available to them.

It is also clear that supplier innovation has focused on developing online direct debit tariffs that deliver lower cost energy to more affluent consumers. This has left those consumers who are living on the tightest budgets and are compelled by circumstances to budget energy expenditure through a PPM, as the group least likely to enjoy access to what are effectively the market’s budget tariffs.

Without supplier commitment to the unimpeded movement of consumers, any project to help low-income, vulnerable consumers become effective switchers will struggle (and the premium prices they pay will be maintained).

- (7) **An independent arbitrator** for consumers to turn to when attempts to switch stall; when consumers are dissatisfied with the handling of the transfer; or when consumer expectations on which the decision to switch was made are unmet.

WHAT CAN MAKE SWITCHING DIFFICULT FOR VULNERABLE CONSUMERS?

Conclusions of University of East Anglia research¹²² on the switching decisions of electricity consumers found that amongst consumers who had switched suppliers exclusively for price reasons:

Only 8–19% of consumers switched to the firm offering the highest surplus and, in aggregate, switching consumers appropriated only between 28% and 51% of the maximum gains available to them (and) that 20–32% of switching consumers appear to have lost surplus through their choice of supplier. These consumers lost an average £14–35 per year in increased bills, apart from any other switching costs they may have incurred.

This suggests that switching to a more advantageous deal might not be as straightforward as its most enthusiastic champions have advocated. When the factors that may hinder the process of switching for vulnerable consumers are taken into account the picture becomes even more complicated.

For vulnerable and low-income consumers some or all of these key elements are frequently absent, effectively meaning that they either remain locked out of the market or that the switching process is short circuited. In particular, the absence of the key abilities and capabilities listed under personal circumstances can cause acute barriers to switching in general, and more so in relation to accessing tariffs that offer the greatest savings.

¹²² *Do Consumers Switch to the Best Supplier?* University of East Anglia Centre for Competition Policy, July 2007.

THE WORK OF ENERGYWATCH ON SWITCHING

Over the last seven years energywatch has been active in offering a range of services and undertaking a range of activities that have helped empower consumers to successfully attain a better deal in the energy marketplace:

Campaigns such as the Energy Smart initiative undertaken jointly with Ofgem have raised consumer awareness of the competitive energy market, the right to switch and the potential benefits that can accrue from participation in the market.

Through its media and publicity activity energywatch has consistently raised consumer awareness of the energy market and, with considerable effect, has not shied away from pinpointing overpriced, underperforming suppliers that consumers should leave behind.

energywatch has also provided consumers with a source of accessible and impartial pricing information on which switching decisions can be based. It has also introduced the Confidence Code, to reassure consumers when using accredited price comparison sites. Both are discussed in further detail below.

energywatch has also been effective in the role of independent arbitrator. At the micro-level it has resolved individual consumer grievances that have arisen from the switching experience. At the macro-level energywatch has taken the evidence presented by its caseload to stamp out the root causes of the barriers that have deterred effective switching—doorstep mis-selling and erroneous transfers being two high profile examples. This in turn has helped increase consumer confidence to switch and forced suppliers to address a number, if not yet all, of their practices that have impeded effective switching.

PRICING INFORMATION AND THE ENERGYWATCH CONFIDENCE CODE

energywatch's price comparison service has provided an impartial facility for consumers to view and compare the different prices on offer from electricity and gas suppliers. This service has helped make consumers aware of their rights as energy users and the choice of suppliers available to them.

The 28 factsheets, available from the energywatch website and in hard copy, compare annual bills for the major suppliers for three different energy usage levels—low, medium (average) and high. There are guidelines which sit behind the factsheets to ensure that suppliers featured are treated equally, and so that prices are comparable.

In relation to external price comparison sites, the energywatch Confidence Code is a set of nine requirements that participating online price comparison services must meet and which aim to ensure that consumers can fairly compare prices from all major suppliers. The Code ensures accredited internet price comparison sites deliver impartial, accurate and reliable information to the millions of energy consumers looking to save money by comparing and switching energy supplier. Although participation is voluntary, there are currently twelve service providers that have recognised the benefit of gaining accreditation. In order to be compliant with the Confidence Code, sites participate in a rigorous, independent audit process to ensure that consumers can have confidence in the services they provide.

A recent survey conducted by YouGov for energywatch, found that 60% of respondents advised that they had used price comparison sites to check domestic gas/electricity prices. Overall, 79% of consumers said that they would be more confident using a price comparison site endorsed by energywatch.

energywatch recently completed its review of the first ten months of the Code's operation and carefully considered all the points raised by the accredited service providers, consumers, suppliers and other interested parties during this time. energywatch proposed that further modifications were needed to the Confidence Code and Code Guidance, to ensure that it remained relevant, robust and transparent in today's market. The results and decision paper are nearing publication.

HELPING VULNERABLE CONSUMERS

The initiatives listed above have undoubtedly assisted the generality of consumers. However, from the outset energywatch has been conscious of the challenge posed in reaching and assisting low-income, vulnerable consumers. This segment of consumers has been the least likely to approach energywatch for assistance, either for advice, or for help when things have gone wrong.

energywatch originally sought to overcome this by taking advice and information to the consumer through broad reach out activities which delivered generic messages to vulnerable groups. This approach was necessarily constrained in the number of consumers it could reach. Its use of targeting was limited and the approach fell short of offering bespoke messages and services tailored to the specific vulnerable groups encountered.

It became clear that this approach was only partially successful in accessing those consumers who most needed our help. It was also clear that the reach out activities were not capturing the experiences of low-income vulnerable consumers in a systematic way that would enable us to change the way we worked to help them more effectively.

After a reassessment of its strategy for vulnerable and low-income consumers, energywatch introduced its Priority Consumer Team in 2005. This team has, in a short space of time, made significant headway in developing successful pathways to a range of vulnerable, low-income consumers. The team's approach has been based on developing strong partnerships with a wide range of trusted intermediaries who, through their core activities, have access to and a dialogue with otherwise hard to reach consumers. Through their partnership with the Priority Consumer Team these agencies are able to bolt on an energy dimension to their core work and in doing so take the message to those consumers who would not normally reach energywatch. The intermediaries have then been able to link vulnerable consumers back to energywatch where assistance is required. The Priority Consumer Team have then been able to offer a holistic service by, in addition to delivering its own service, linking upwards to those agencies who are able to offer further relevant assistance: typically Eaga, the DWP/Pensions Service, and in a number of instances suppliers' voluntary initiatives.

The Priority Consumer Team registered approximately 5,000 people for free services via their supplier between April 2006 and March 2007. Approximately 8,000 vulnerable consumers received direct support by being referred on for energy grants and funding support, energy audits and benefit checks.

HELPING VULNERABLE CONSUMERS SWITCH EFFECTIVELY

Last year (2006), in face-to-face interviews around the country, the Priority Consumer Team identified many older consumers on basic state pensions who could not afford to heat and power their homes, but were reluctant to switch energy supplier. Some of these consumers were paying too much for their energy and a number had a very low-awareness of the energy market. It was also apparent that older people mistrusted supplier information and were left confused by pricing information.

In response, energywatch's Priority Consumer Team devised a switching service to encourage older people to participate in the energy market that could deliver bespoke information. Its "Are You Missing Out?" campaign provided older people and their families with a hotline to call and speak to a member of the Priority Consumer Team. The campaign was promoted through local media and partner agencies. Once consumers made contact the team sourced the best possible deals based on actual consumption. After looking at every tariff to see where savings could be made and wrote to the consumer setting out the top three savings. This allowed the consumer to make an informed choice, based on independent information, in their own time. If the consumer was already with the cheapest supplier the team looked at other ways they could save energy. In addition to providing a pathway by which low-income older consumers could participate in the energy market, this campaign was invaluable in generating strategic intelligence which energywatch has used to highlight the barriers that low-income consumers can face when looking to switch.

Headline figures from the "Are You Missing Out?" campaign include:

- Close to 1,400 price comparisons were conducted, highlighting average annual savings of £115.15.
- 238 consumers transferred, achieving an average annual saving of £177.28.
- 198 consumers were already on the cheapest deal, with the cheapest supplier.
- 936 of consumers could save money by changing either their tariff or supplier with an average saving of £139.50.
- The range of savings highlighted was £4–£974.

KEY FINDINGS AND RECOMMENDATIONS FROM THE "ARE YOU MISSING OUT?" INCLUDED

Likelihood to switch increases in line with potential savings:

- Of the consumers for whom it was identified that savings of £51–£100 were possible (the majority of consumers who contacted the Priority Consumer Team)—there was a 21.7% transfer rate.
- Within the £251–£300 saving bracket there was a 36.8% transfer rate.
- Within the £451–£600 saving bracket there was a 50% transfer rate.

The campaign proved extremely time and resource intensive, leaving the Priority Consumer Team struggling to maintain its targeted response time (not least after a brief mention of the campaign in a national newspaper caused an unexpected wave of calls). It is likely that resultant delays in providing the bespoke information will have eroded the willingness of consumers affected to engage further in the process.

Key to providing a bespoke price comparison service is cooperation from consumers' current suppliers in providing historical meter readings. The team spent a disproportionate amount of time trying to source this information, despite suppliers being made aware in advance of the campaign that this would be required. The team was successful though in agreeing a referral pathway with SSE which enabled it to obtain necessary information by email. Unfortunately, despite requesting a similar referral pathway with other suppliers this did not materialise.

Internet Access: the majority of consumers contacting the team did not have internet access, or were not comfortable in accessing online accounts which offered the best deal.

PREPARING FOR THE POST-ENERGYWATCH WORLD

energywatch continues to push for its successor body, the new National Consumer Council, to carry forward and build upon a number of these initiatives and also to adopt the Priority Consumer Team. Despite this pressure and also negotiations with a range of agencies, it remains unclear which bodies will pick up where energywatch will leave off. This has a number of ramifications that will need to be resolved in the coming 10 months:

- (1) Related energywatch initiatives could potentially be dispersed across different agencies—none of which will have the clear remit (or equivalent resource) energywatch has had for undertaking work of this nature.
- (2) Resource intensive initiatives may be scaled back or dropped.
- (3) Consumers seeking arbitration in relation to switching grievances will have no clear path of advice or redress.
- (4) Partnerships established by the Priority Consumer Team that have been successful in reaching hard to reach low-income, vulnerable consumers could lose the energy dimension.
- (5) The already limited support available to encourage and assist vulnerable consumers in their engagement with the energy market will be eroded.
- (6) The continuous and close scrutiny of suppliers' behaviours in relation to switching will diminish.

WIDER ISSUES

As the headline figures from the “Are You Missing Out?” campaign have shown, even with intensive, bespoke advice and the availability of energywatch support, only around 1 in 6 vulnerable consumers (primarily low-income elderly consumers in this instance) switched supplier. Although this ratio appears to increase as the savings on offer become greater, half of those who could have realised a saving in excess of £450 still chose not to even attempt switching supplier. This poses some fundamental questions on what else, short of forced switching, can be done.

As stated earlier, the crucial role played by personal circumstances and the consumer's abilities and capabilities therein (and the limitations these place upon a consumer's ability to access better tariffs) should make us cautious about simplistic assumptions that switching to the best deal is an option available to all vulnerable consumers. Scratching below the surface can reveal fundamental underlying problems that either need to be addressed before the consumer is in a position to switch to a more advantageous deal; or are entrenched to the point that the vulnerable consumer is unlikely to ever be able to switch to the deals that are theoretically available to them.

Also, if we are serious about including vulnerable, low-income consumers in the energy market, and increasing the proportion of this segment that switch to more advantageous deals, the market itself must offer products that are more responsive and amenable to the circumstances of this segment. It must:

- (1) Offer payment methods that reflect the needs of low-income, vulnerable consumers to budget without charging the penalty premium that PPMs currently attract. Options could include a weekly direct debit system, priority access to smart metering for PPM users, and looking at new “stored value” technologies and the potential these have for enabling some low-income, vulnerable consumers to manage their accounts using mobile telephones.
- (2) See a genuine commitment from suppliers to permit the free movement of consumers in the energy market. This would require full cooperation with those agencies that are helping vulnerable consumers access the best deals and a willingness to share historical consumption data with those agencies.

In this respect, there is also a clear need to develop an effective, straightforward mechanism that can replace the Byzantine and ineffectual debt assignment protocol.

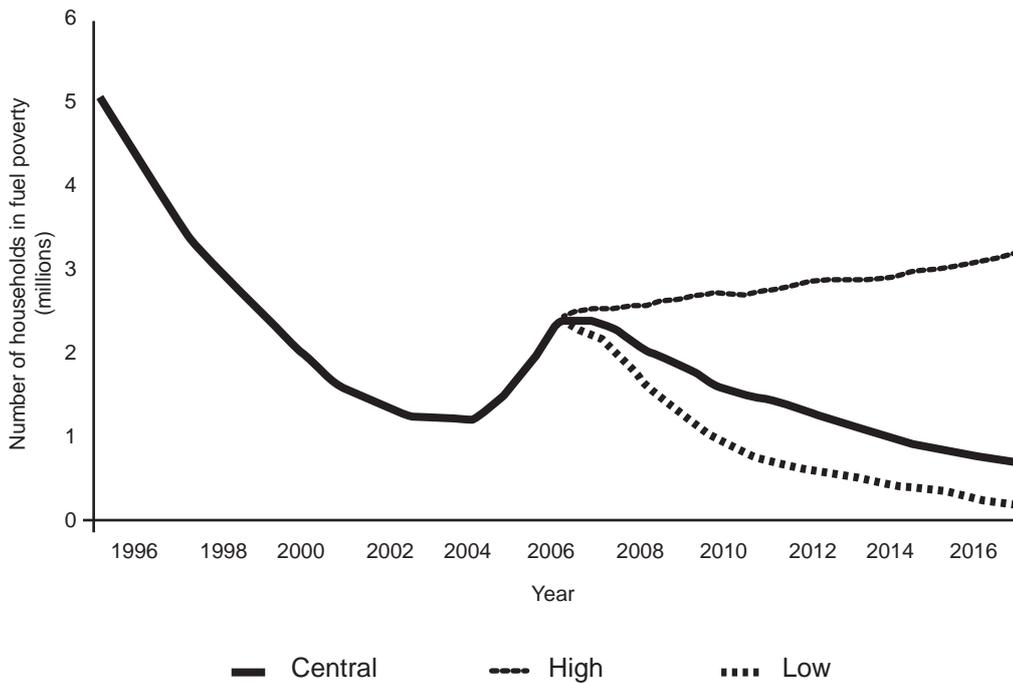
- (3) Ensure switching gateways—primarily the price comparison websites—are available for use by all consumers, including PPM users. They should not act as a filter by which suppliers can skim off more affluent consumers.

APPENDIX 2

TRENDS IN THE LEVEL OF FUEL POVERTY

HISTORIC AND PROJECTED NUMBERS OF HOUSEHOLDS IN FUEL POVERTY IN ENGLAND, 1996-2016

Figure 2.1.1 Historic and Projected Numbers of Households in Fuel Poverty in England, 1996-2016

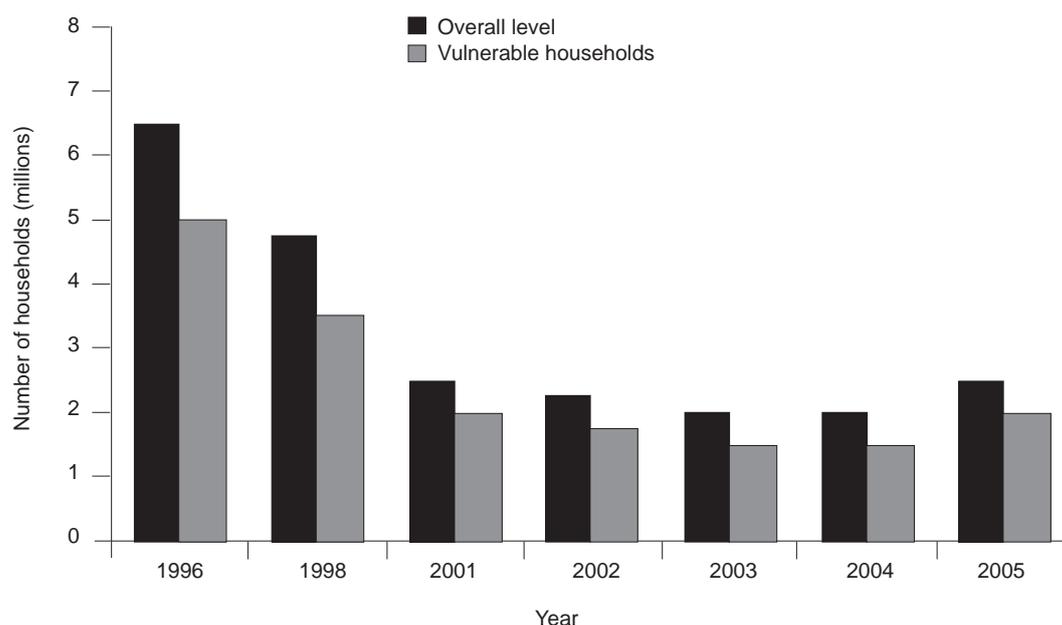


Source: DTI, 2007.

- Positions in 2005 and 2006 are based on the modelling of the impact of income, energy prices movements and energy efficiency measures on the number of vulnerable households in fuel poverty.
- Positions from 2007 to 2016 are based on modelling and show central, low and high price scenarios. These are based on the fossil-fuel price assumptions published at the same time as the White Paper.

Source: UK Government Energy White Paper, May 2007
<http://www.berr.gov.uk/energy/whitepaper/page39534.html>

NUMBER OF HOUSEHOLDS IN FUEL POVERTY IN THE UK, 1996–2005



Source: 5th Annual Progress Report 2007
<http://www.berr.gov.uk/files/file42720.pdf>

NUMBER OF HOUSEHOLDS IN FUEL POVERTY (MILLIONS)

	1996	1998*	2001	2002*	2003	2004	2005
England	5.1 (5.5)	3.4 (4.0)	1.7 (2.3)	1.4 (2.0)	1.2 (1.5)	1.2 (1.5)	1.5 (1.8)
Scotland	0.7 —	— —	— —	0.3 —	0.4 —	0.4 —	— —
Northern Ireland	— —	— —	0.2 —	— —	— —	0.2 —	— —
UK Estimate	About 6½ (7½)	About 4¾ (5¾)	About 2½ (3½)	About 2¼ (2¾)	About 2 (2½)	About 2 (2½)	About 2½ (3)

Figures in brackets do not include Housing Benefit/ISMI as part of income

* Figures for England in 1998 and 2002 are estimates based on movements in energy prices, incomes and energy efficiency

Source: Fuel Poverty Monitoring—Indicators 2007
<http://www.berr.gov.uk/files/file42702.pdf>

APPENDIX 3

SUMMARY OF CORNWALL ENERGY ASSOCIATES' REPORT ON THE PROPORTIONALITY OF SUPPLIERS' SOCIAL TARIFFS

The Energy White Paper challenged the big six energy suppliers to offer adequate and proportionate programmes of assistance to those in most need. To assess suppliers' responses to this challenge, energywatch commissioned Cornwall Energy Associates to independently examine whether the commitments they have made are proportionate and adequate when compared against each other. Cornwall Associates have found that the industry's contribution to social tariffs represents a sub-zero percentage of turnover and that commitment and investment varies significantly at the supplier level. A copy of the full report is available at:

www.energywatch.org.uk/uploads/Proportionality_of_suppliers_social_tariffs_13_January_2008.pdf

This review has deliberately focused only on those initiatives that have a direct impact on the cost of gas and electricity to fuel poor consumers—social tariffs and bill rebates. It therefore excludes trust funds, benefit entitlement checks etc, but it should be noted that the suppliers who come out well in this report also perform well in comparisons of these additional programmes.

The methodology used by the consultants reflects the measures that BERR are likely to use in assessing suppliers' responses to the Energy White Paper—primarily the cost to the supplier as a proportion of turnover, cost per meter supplied by the company, and the benefit to the recipient relative to suppliers' open

market tariffs. Using these metrics ensures that the comparisons between supplier and the gulf in performance that results is not merely a reflection of market share. As you will see, this approach has been effective in revealing the disparity between those who do most and those who do least.

The report's key findings are presented below:

ANALYSIS OF CURRENT SOCIAL TARIFF AND REBATE OFFERINGS COMBINED SHOWS THAT:

The supply industry as a whole commits 0.11% of its estimated £24.6 billion turnover to social tariffs and rebates. At the supplier level this ranges from British Gas committing 0.18% of turnover to its Essentials social tariff to RWE npower committing less than 0.003% of turnover to its First Step social tariff (prior to its new rebate and the widening of its First Step social tariff becoming available).

When the "costs" to the companies are divided by all the gas and electricity accounts they serve (described as "cost £/meters" supplied in the tables) this ranges from £1.04 for British Gas down to £0.02 for RWE npower.

The average benefit to gas and electricity social tariff recipients (excluding rebates) ranges from £181 per annum (gas and electricity) for Scottish & Southern's Energyplus Care to £98 for British Gas's Essentials. Although E.ON UK's Staywarm arrangement comes in at £424, the report was unable to make direct comparisons with the other social tariffs and highlights where further information is required from E.ON UK in relation to Staywarm.

The coverage of tariffs and rebates expressed as a proportion of each supplier's customer base ranges from 1.74% for British Gas to 0.04% for RWE npower (again, E.ON UK is highest at 2.28%, but this is skewed by the 160k recipients of its £10 Age Concern Cold Weather Payment).

ANALYSIS OF SOCIAL TARIFF AND REBATE OFFERINGS IF AND WHEN SUPPLIERS FULFIL THE COMMITMENTS MADE FOLLOWING THE ENERGY WHITE PAPER SHOWS THAT:

In response to the Energy White Paper, suppliers have committed to increasing the availability of social tariffs. If suppliers manage to achieve these targets then the commitment of the supply industry as a whole will increase to 0.25% of its estimated £24.6 billion turnover. The increase will be mirrored at the supplier level if suppliers fulfil their commitments, but with a gulf remaining in the proportion of turnover each supplier commits to these initiatives. If targets are fulfilled British Gas will be committing 0.49% of its turnover to its Essentials social tariff, while RWE npower and Scottish and Southern Energy will be committing just 0.07% of their respective turnover to their tariffs and rebates.

When the "costs" to the company are divided by all the gas and electricity accounts they supply then British Gas will be contributing at £2.77 per customer account reducing to £0.32 for RWE npower and £0.31 for Scottish and Southern Energy.

In terms of benefit to social tariff recipients (excluding rebates), the range remains the same, but will include the introduction of Scottish Power's social tariff at £109.28

The number of recipients of tariffs and rebates expressed as a proportion of each supplier's customer base increases with a range running from 4.67% for British Gas to just 0.34% for Scottish and Southern Energy if and when all commitments are fulfilled.

If the commitment each supplier has demonstrated is measured against their respective market share the disparity that exists is further emphasised:

	<i>Current</i>	<i>Social</i>	<i>Target</i>	<i>Social</i>
	<i>Market</i>	<i>Package</i>	<i>Market</i>	<i>Package</i>
	<i>Share</i>	<i>commitment</i>	<i>Share</i>	<i>commitment</i>
British Gas	33%	59%	33%	71%
EDF Energy	11%	13%	11%	6%
RWE npower	14%	0%	14%	4%
E.ON UK	16%	21%	16%	10%
Scottish and Southern Energy	16%	1%	16%	6%
Scottish Power	11%	5%	11%	4%
Total	100%	100%	100%	100%

PERFORMANCE AGAINST BERR'S MAY BENCHMARK

BERR have indicated that they will review supplier performance against the averages in place at May 2007 when the White Paper was published. The energywatch review shows that on the key measures analysed, both RWE npower and Scottish and Southern Energy remain below the benchmark. (NB: since the report was finalised RWE npower has indicated at its recent price rise that it will increase the value of its Spreading Warmth rebate, but by the same token British Gas has recently announced it will offer a new £90 rebate to c.25k customers).

The report considers what the world would look like if underperforming suppliers met this benchmark and forecasts that it would result in an additional commitment of between £3 million and £3.68 million depending on the measure used. It also forecasts that if the other five suppliers matched British Gas in offering assistance to 4.67% of their customer base this could result in a doubling of the number of accounts (not households) eligible for social tariffs—from the current combined target of 930k to 2.29 million. If all suppliers at least match the May 2007 average the number would increase to 1.37 million accounts (energywatch estimate that 4 million fuel poor households translates as 6.4 million energy accounts, taking account of an estimate of the number of fuel poor without access to gas).

APPENDIX 4
**ENERGYWATCH BRIEFING ON SOCIAL TARIFFS
JANUARY 2008**
CONTEXT

The accelerating cost of energy since 2003 means that social tariffs have an urgent and essential role to play in helping address the impact of high prices on low-income households. Price rises are solely responsible for the reversal of progress towards the Government's fuel poverty targets. The limitations and disparities of the current approach to providing social tariffs—reliant on pressuring suppliers to develop products voluntarily, as part of their corporate social responsibility activity—are now clear and the government must use the Energy Bill to require suppliers to offer social tariffs in accordance with minimum standards.

SOCIAL TARIFFS WOULD BOLSTER THE UK FUEL POVERTY STRATEGY

The government's 2001 UK Fuel Poverty Strategy was built on three pillars, each of which sought to address the three factors that conspire to cause fuel poverty: energy inefficient homes with sub-optimal heating systems, the low level of income on which the fuel poor subsidise, and the cost of energy to fuel poor consumers. The pillar reliant on "continuing action to maintain the downward pressure on fuel bills"¹²³ has long since crumbled. As Malcolm Wicks felt it reasonable to predict in 2007: "*the era of cheap energy has gone for ever*".¹²⁴

Price increases have outstripped income growth and outpaced the rate at which energy efficiency and heating improvements can be installed. The net effect has been an increase in fuel poverty, with the 2007 Energy White Paper observing that UK fuel poverty was back at the 4 million household mark—double the 2004 figure and a return to pre-Strategy levels.

THE PROBLEM(S) WITH A VOLUNTARY APPROACH TO SOCIAL TARIFF PROVISION

The lack of any framework or guiding principles on what constitutes a meaningful social tariff has resulted in a situation where, despite reference to "social tariffs" becoming a staple in the narrative of stakeholders, suppliers have been free to appropriate the term as they see fit and apply it to a divergent range of tariff offers. Research has shown that a number of currently available products see recipients of "social tariffs" actually paying more than the open market tariffs available to other, more affluent consumers with the same supplier in most cases.

energywatch is concerned that the status quo is riddled with inconsistency: inconsistency in the nature of assistance offered, inconsistency in the level and quality of assistance offered, inconsistency in entitlement, and inconsistency in the length of time for which the product is available to recipients.

¹²³ The UK Fuel Poverty Strategy, November 2001:
<http://www.dti.gov.uk/energy/fuel-poverty/strategy/index.html>

¹²⁴ Malcolm Wicks, *Hansard*, 23 January 2007, column 399WH.

Concerns of this nature are not limited to the “fuel poverty lobby”—both EDFE, British Gas and RWE npower have expressed similar views:

British Gas will review its Essentials tariff model in March 2009. In the meantime it will be seeking agreement with other suppliers and stakeholders for industry-wide introduction of social tariffs to broadly common standards which would allow social tariff customers the same choice in the market as other customers.

British Gas press release, 08.02.07

There should be a common industry approach to offering assistance to the fuel poor. This would bring benefits such as clarity to consumers, particularly vulnerable ones, and also to those assessing the effectiveness of social programmes. In addition, it would create a level playing field which all suppliers would compete equally within this market segment.

We believe that after establishing the agreed definition, scale and structure, all suppliers should be required to participate in the scheme. Having led the industry in offering a social tariff we are disappointed that all industry colleagues have not followed suit, indicating that the competitive market needs adjusting.

Levels of benefit available, and eligibility for benefits should be defined by Government.

EDFE response to energywatch social tariff consultation, January 2007

At present, government is encouraging the delivery of a social action solution within a voluntary framework. It is doubtful whether this is the most efficient approach and it is also seemingly inconsistent with a market framework. We believe that the interest of the fuel poor is best served by a mandatory social tariff and this is the only means by which the Government’s 2010 and 2016 objectives can be achieved. There is no obvious reason why these targets will be delivered within a competitive retail market.

RWE npower response to Ofgem’s Five Year Strategy, September 2007

THE ENERGY WHITE PAPER AND OFGEM’S REVIEW OF SUPPLIERS’ INITIATIVES

The Energy White Paper¹²⁵ noted the commitment that certain suppliers had demonstrated in relation to assisting their fuel poor consumers. Significantly, it also challenged suppliers who had done little in this respect to develop adequate programmes of support, with the implication being that if this did not happen, legislation could be used to ensure all suppliers offered adequate programmes of support. This challenge has been effective in driving differing degrees of improvement from suppliers (most notably ScottishPower’s U-turn on social tariffs). The White Paper also tasked Ofgem with evaluating and comparing suppliers’ voluntary measures.

The subsequent Ofgem review declined to rank the quality of suppliers’ initiatives, to declare which suppliers are offering proportional assistance, to highlight best practice, or to examine the effectiveness of each initiative. Also, despite the intention expressed in the Energy White Paper—that Ofgem would *evaluate each company’s Corporate Social Responsibility measures to see exactly how these compare, drawing attention to the most effective initiatives and highlighting where improvements are needed*—the Regulator has neither drawn attention to the most effective initiatives nor highlighted where improvements are needed. This lack of differentiation has granted it the space to underplay the gulf in performance and in so doing present the voluntary approach as an effective response.

Ofgem’s review also advocated competition as the best way to ensure fuel-poor consumers are protected from high prices. Interestingly, the Sustainable Development Commission’s recent report (*Lost in Transmission—The role of Ofgem in a changing climate*) concluded that switching supplier “*is not a particularly helpful or appropriate method of reducing low-income household fuel bills and that more proactive steps need to be taken to protect low income and vulnerable consumers*”. The barriers to this consumer segment switching—frequently lack of access to direct debit and the internet—are well established.

Reliance on the voluntary approach also carries an inherent risk of “backsliding”, either where suppliers renege completely on commitments—especially if rising wholesale prices put the bite on voluntary initiatives; or where the best scale back their activities, causing a levelling down rather than the desired levelling up.

The frustrations voiced by British Gas and EDFE, both of whom have declared they will review their own activities, the disparities in supplier commitment highlighted by energywatch’s own work, and that the status quo hands a competitive advantage to those who do least, all point to a strong likelihood of backsliding unless the government intervenes to level up the performance of those suppliers who do least.

¹²⁵ Energy White Paper 2007, paragraph 2.1.21.

 THE ENERGYWATCH VIEW (AND REVIEW)

Because Ofgem's review failed to bring the disparities between supplier performance and the resultant lack of proportionality to the fore, energywatch commissioned Cornwall Energy Associates to examine the adequacy of each supplier's social tariffs and whether these were proportional when compared to each other. This review was undertaken in line with the methodology that BERR is likely to use. The Cornwall report exposes the pronounced gulf between what suppliers are committed to offering meaningful assistance and reinforces the case for the Secretary of State taking powers in the Energy Bill.

This report has shown that if energy suppliers fulfil the commitments made to government, the industry will invest 0.25% of its estimated turnover in social tariffs and rebates—the initiatives that offer direct assistance with the cost of energy to fuel poor households. For individual suppliers this ranges from British Gas committing 0.49% of its turnover to a mere 0.079% of turnover for npower and Scottish & Southern Energy. British Gas is committed to making assistance available to 4.7% of its consumer base, while for npower and Scottish & Southern this figure is 0.79% and 0.34% respectively. The commitments made by British Gas will equate to 71% of the total industry assistance offered, while its market share represents just 33%; whereas npower has an 11% market share but has a social package commitment that will represent 4% of the total.

BERR has indicated that its own assessment will examine whether suppliers' social package are at or above the average in May 2007 when the White Paper was published. Energywatch's findings are that npower and Scottish & Southern (who offer a generous social tariff, but on a very limited scale) remain below even this level. If all suppliers met at least this average, social tariffs and rebates would be available to the equivalent of 1 in 5 fuel poor accounts. If suppliers matched the commitment shown by British Gas this figure would rise to 1 in 3.

A copy of the full analysis is available at:

www.energywatch.org.uk/uploads/Proportionality_o_suppliers_social_tariffs_13_January—2008.pdf

ENERGYWATCH RECOMMENDATIONS: MINIMUM STANDARDS FOR MAXIMUM IMPACT

energywatch advocates that the Secretary of State takes powers in the Energy Bill that will enable him to require suppliers to offer social tariffs in accordance with minimum standards. This will preserve the momentum created by the Energy White Paper challenge and even out the divergence in suppliers' commitments. Social tariffs represent the clearest way of addressing the Fuel Poverty Strategy's failure in relation to pressure on prices and, if mandatory, will ensure that all suppliers make affordable energy available to a significant number of those consumers for whom the high cost of energy has presented the greatest challenge.

Valid concerns exist over whether social tariffs can be accurately targeted and the extent to which they would distort the market. The accurate targeting of any non-universal welfare mechanism is difficult, but that does not mean it is impossible. As the more progressive energy suppliers are demonstrating, there are ways and means of identifying and reaching households in most need. The White Paper's commitment to facilitate data sharing with the DWP will undoubtedly refine this process further.

In relation to market distortion, if the social tariff is indexed at a set rate against each supplier's open market rates (Scottish & Southern Energy's 20% against the recipient's existing tariff, for example) and made available on a scale that is relative to a supplier's market share this should not be an issue as the obligation will fall fairly across all suppliers and reflect their overall competitive position.

The social tariff model that energywatch has recommended would be built on, but not limited by, minimum standards. Our proposals go with the grain of competition rather than work against it, with the use of targets on suppliers forcing them to compete for a group of consumers that have hitherto been largely excluded from the market. Targets would also ensure that no supplier is unduly disadvantaged by such an obligation.

Social tariffs offered in isolation will not eradicate fuel poverty and neither should they be expected to do so. That is why the proposals put forth by energywatch would see social tariffs form an integral part of an Energy Assistance Package, with the package creating the vehicle for ensuring that the three underlying causes of fuel poverty are tackled.

A full copy of the energywatch report and recommendations on social tariffs—*A Social Responsibility?*—is available at:

http://www.energywatch.org.uk/uploads/A_Social_Responsibility_the_energywatch_consultation_on_the_nature_of_social_tariffs_in_the_energy_market_report_and_recommendations_9_May_20071.pdf

MARKET SHARES AND CONCENTRATION

Not printed here.

LESSONS FROM CC INVESTIGATIONS AND CASE LAW

PURPOSE

This annex considers:

- the findings of two key merger control judgements by the Court of First Instance relating to collective dominance;
- the CC's investigations of coordinated effects and consumer detriment; and
- the application of these cases and investigations to the GB energy markets.

CASE LAW ANALYSIS OF COLLECTIVE DOMINANCE

The *Airtours v Commission* judgement identified three conditions necessary to establish collective dominance (see paragraph 62):

- **Knowledge of others adopting the common strategy:** Each member of the dominant oligopoly must have the ability to know how the other members are behaving in order to monitor whether or not they are adopting a common policy. It is not enough for each member of the dominant oligopoly to be aware that interdependent market conduct is profitable for all of them but each member must also have a means of knowing whether the other operators are adopting the same strategy and whether they are maintaining it. There must be sufficient market transparency for all members of the dominant oligopoly to be aware, sufficiently precisely and quickly, of the way in which the other members' market conduct is evolving.
- **Incentive to maintain the common strategy:** The situation of tacit coordination must be sustainable over time. There must be an incentive not to depart from the common policy on the market. It is only if all the members of the dominant oligopoly maintain the parallel conduct that all can benefit. For a situation of collective dominance to be viable, there must be adequate deterrents to ensure that there is a long term incentive in not departing from the common policy. Each member of the dominant oligopoly must be aware that highly competitive action on its part designed to increase its market share would provoke identical action by others, so that it would derive no benefit from its initiative.
- **Inability of competitors to jeopardise the outcome of the common strategy:** The foreseeable reaction of current and future competitors, as well as of consumers, will not jeopardise the results from the common policy.

The *Impala v Commission* (Case T-464/04) judgement appears to lower the test for proving collective dominance (see paragraphs 251 and 252) by stating that:

- **Collective dominance may be established indirectly:** In certain circumstances, collective dominance may be established indirectly on the basis of what may be a very mixed series of indicia and items of evidence relating to the signs, manifestations and phenomena inherent in the presence of a collective dominant position.
- **Collective dominance may be demonstrated through pricing data:** Close alignment of prices over a long period, especially if they are above a competitive level, together with other factors typical of a collective dominant position might, in the absence of alternative reasonable explanation suffice to demonstrate the existence of a collective dominant position, even where there is no firm direct evidence of strong market transparency, as such transparency may be presumed in such circumstances.

MARKET INVESTIGATION INFORMATION GATHERING

The Competition Commission procedures¹²⁶ highlight that information gathering, analysis and validation is a key part of the investigation. The CC requires access to detailed information regarding the companies and markets in question to make its statutory decisions on the competition and remedies questions. The CC collects information in a variety of ways including:

- Letters and questionnaires to the main parties in an investigation and sometime to third parties.
- Press notices, advertisements and website requesting information.

¹²⁶ Competition Commission procedures
http://www.competition-commission.org.uk/our_role/how_investigate/procedures.htm#information

-
- Publicly available sources of information.
 - Surveys can be commissioned to provide evidence about a particular market.
 - Visits to the main parties to gain a first-hand experience of the workings of the company and industry in question.
 - Commissioning of expert advice.
 - Hearings with the parties.

MARKET INVESTIGATION ANALYSIS OF COORDINATED EFFECTS

The Competition Commission provisional findings report on the supply of groceries in the UK considers the three conditions necessary for coordinated effects to emerge and be sustainable (see paragraph 33 and Section 7 of the provisional findings and paragraphs 3.53 to 3.73 of the Competition Commission guidelines on market investigation references):

- **Awareness of competitors' behaviour:** The market is sufficiently concentrated for firms to be aware of the behaviour of their competitors, and for any significant deviation from the prevailing behaviour of a firm to be observed by other firms in the market. Where prices are transparent any deviation from the prevailing behaviour will be clear.
- **Costly to deviate from prevailing market behaviour:** It must be clear that the consequences of deviating from the prevailing market behaviour would be costly and the threat of future price cuts provides a punishment mechanism for a “cheating” firm. It will be in a firm’s interest to go along with the prevailing market behaviour rather than seek to deviate from it. In many cases, the mere fact of the interdependence and hence strong likelihood of a matching price cut may be enough to create a disincentive.
- **Weak competitive constraints:** The competitive constraints resulting from the actions of non-coordinating firms are weak and would not jeopardize the expected outcome of coordination. A low barrier to entry, a strong competitive fringe and countervailing buyer power might all serve to disrupt coordinated behaviour. The extent to which fringe firms act as a competitive constraint will in part depend on the number and size of fringe companies, their cost and profit margin and their scope to expand output in relation to their current level and the output of the core oligopolists.

With respect to possible coordination strategies, the Competition Commission noted in its provisional findings that (Section 7):

- Coordination is more likely to emerge if competitors have similar views of what actions would make coordination work: for example, setting prices around a focal point.
- Retailers could, in principle, seek to coordinate on large numbers of the products.
- In practice, coordinated action over a vast number of prices would be difficult to achieve.
- A coordination strategy that might potentially be easier to implement would be to focus coordination on a subset of products.

With reference to the supply of groceries in the UK, the Competition Commission notes that (see paragraph 34 to 37 and Section 8):

- There is evidence that suppliers facilitate the exchange of information on retail prices charged by rival retailers. Given the presence of the necessary conditions for co-ordination in grocery retailing, we consider that this exchange of information on retail prices would assist retailers in establishing terms of tacit coordination on a small number of products.
- There is a trend of consolidation among upstream intermediaries in milk and other sectors, particularly in fresh produce. Further consolidation may be a cause for concern if it means that coordination is more likely to emerge in other product categories.
- While there is no direct evidence of tacit coordination at present, we are concerned that, given the structure of the grocery retailing market, such behaviour could occur in the future.

The Competition Commission provisionally found that a combination of one or more features prevent, restrict or distort competition in certain local markets for the supply of groceries (see paragraphs 47 to 49 and Sections 5, 6 and 9):

- A significant number of local markets have high levels of concentration and these high levels of concentration have persisted over a number of years.
- The control of land in highly-concentrated local markets by incumbent retailers acts as a barrier to entry, by limiting entrants’ access to potential sites for new stores.

The Competition Commission also found (see paragraph 50 and Section 9) that the exercise of buyer power by certain grocery retailers and symbol groups with respect to their suppliers of groceries, through the adoption of supply chain practices that transfer excessive risks and unexpected costs to those suppliers, is a feature of the markets for the supply of groceries by all grocery stores, which prevents, restricts or distorts competition in connection with the acquisition of groceries by those grocery retailers and symbol groups.

Application to the GB energy markets

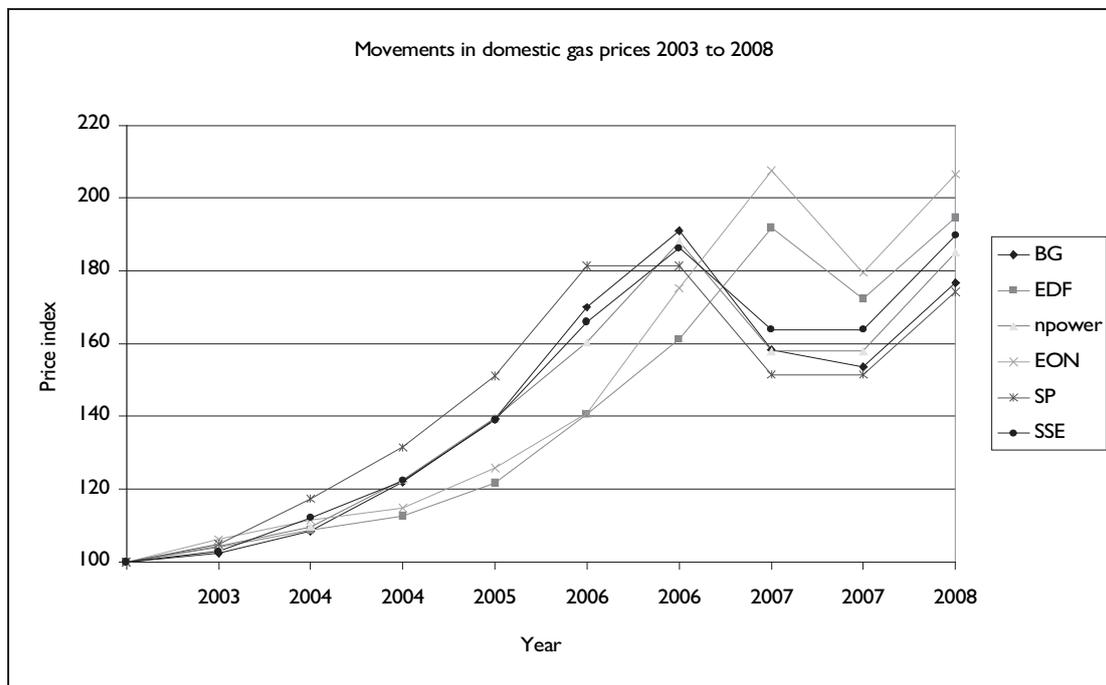
Table 1 considers whether the conditions necessary for facilitating coordinated effects may be present in the GB energy market with particular reference to the domestic gas and electricity retail markets.

Table 1**HIGH LEVEL COORDINATED EFFECTS ANALYSIS**

<i>Condition</i>	<i>Analysis</i>
Awareness of competitors' behaviour	<ul style="list-style-type: none"> — Firms are well aware of their competitors' behaviour. — Products essentially homogenous and there is a high level of interaction. — The domestic gas and electricity retail markets are highly concentrated with six firms supplying more than 99% of the market. — Supply licence condition 22.7 states "If a person requests a copy of any form of Domestic Supply Contract that the licensee may offer under paragraph 22.2, the licensee must send a copy of that form of contract to that person within a reasonable period of time after receiving the request". Supply licence condition 22.4(b)(i) requires a Domestic Supply Contract to identify the charge for the supply of gas or electricity and the charge for any other good or service to be provided. — There are a number of price comparison services that allow users to compare prices across suppliers quickly and easily. There are also a number of firms that provide pricing databases and analysis. — Suppliers issue press releases announcing changes in prices and there is considerable media coverage concerning price.
Costly to deviate from prevailing market behaviour	<ul style="list-style-type: none"> — Suppliers are aware that it is in their interests to act in a similar way. — Five of the main six suppliers increased their prices in January or February 2008. Headline price increases for domestic consumers ranged from 12.9 to 17.2% for gas and 7.9% to 15% for electricity. The remaining supplier increased its prices in April 2008 by up to 15.8% for gas and 14.2% for electricity. Charts 1 and 2 show movements in gas and electricity prices across the last five years. — Price differentials vary across tariffs. There is a £13 annual difference in the dual fuel direct debit offering of five of the main six suppliers—this is equivalent to 25p per week. There is only a £26 annual difference across the six suppliers equivalent to 50p a week. — Energy prices can change quickly so that suppliers not complying with prevailing market behaviour can be punished.
Weak competitive constraints	<ul style="list-style-type: none"> — No scale new entry—entrants control less than 1% of the domestic supply market. — The domestic gas and electricity markets have been characterised by supplier exit rather than entry so entry does not provide competitive constraint. — Suppliers appear to be seeking to move together within a short period of time of each other and in parallel. This is a kind of "risk minimisation strategy" where they do not seek to be particularly better or worse than their competitors. — There does not appear to be any strong competitive constraint that impacts the strategy adopted by the dominant six suppliers.

Chart 1

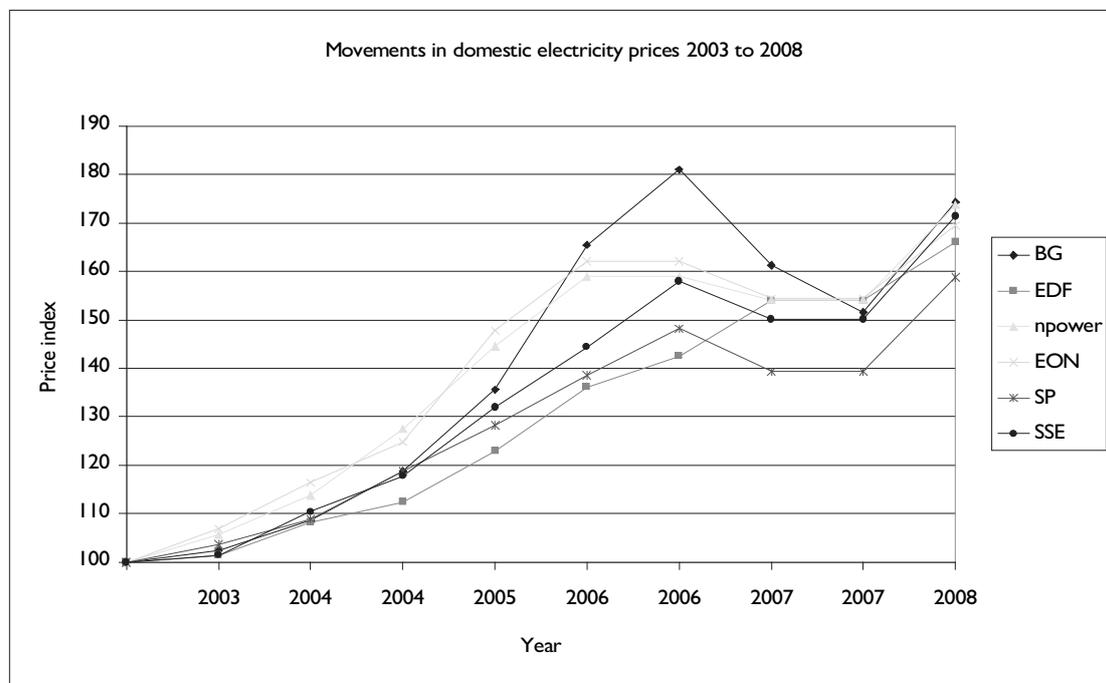
CUMULATIVE INCREASES IN DOMESTIC GAS PRICES 2003 TO 2008



Source: energywatch analysis of suppliers headline price increases as reported in the press

Chart 2

CUMULATIVE INCREASES IN DOMESTIC ELECTRICITY PRICES 2003 TO 2008



Source: energywatch analysis of suppliers headline price increases as reported in the press

energywatch considers that the conditions necessary for coordinated effects to emerge and be sustainable are present in the domestic gas and electricity supply market. This means the market is susceptible to abuse of dominance and consumers will pay more than the competitive level for their energy. The CC would be able to undertake a more detailed analysis of coordinated effects in the domestic supply and wider GB energy market as part of a market investigation.

MARKET INVESTIGATION ANALYSIS OF CONSUMER DETRIMENT

Excessive prices

In Store Cards the OFT referred the supply of store card services to the Competition Commission following its conclusion that there are features of the sector, both in the supply of store card credit to consumers and in the supply of store card services to retailers, that appear to prevent, restrict or distort competition.¹²⁷ In paragraph 1.13 of its report the OFT stated that “*there is insufficient competition to ensure that consumers get good value from store cards and that such lack of competition may lead to increased profits for retailers and store card providers*”.¹²⁸ For the OFT then, the possible harm to consumers resulting from the perceived lack of competition in this sector revolved around the concept of value for money. The idea of “good value” brings to mind the definition of an “unfair price” in the case *United Brands Co. v Commission*; it concerns a price that is “excessive in relation to the economic value of the product supplied”.¹²⁹ In other words, the OFT formulated the possible consumer detriment in this sector in terms of unfair or excessive prices for consumers.¹³⁰ In its investigation the Competition Commission tried to quantify this consumer detriment by comparing the prices actually paid by cardholders who pay interest and insurance charges on store cards with the prices they would have paid had these reflected costs, including the cost of capital.¹³¹

Subsequent market investigation references submitted to the Competition Commission have also concerned the impact of (weak) competition on prices paid by consumers; see for example *Supply of Liquefied Petroleum Gas*¹³² or *Northern Ireland Banking*.¹³³ In the former case the OFT suspected that “*the high switching costs [between different gas companies in the market for the supply of domestic bulk liquefied petroleum gas] may form a barrier to entry, so that competition is restricted and many consumers face higher prices overall than they would in a similar market without switching costs*”.¹³⁴ In the latter case, the OFT held that the conditions for a referral were met as high levels of concentration, significant entry barriers, price parallelism and consumer inertia appear together to result in limited price competition and weak switching competition between the big four banks in Northern Ireland.¹³⁵ Both investigations are ongoing.

In *Home Collected Credit*¹³⁶ the Competition Commission actually attempted to quantify the overcharge suffered by customers in the relevant market; according to the CC customers suffered from “substantial overcharging”:

*[overcharging] may have amounted to as much as £100 million a year over the last five years across the whole market, which would imply that a home credit customer pays over £25 too much for an average loan, or £9 per £100 borrowed, and that home credit lenders have been able to earn more than £500 million in profits in excess of the cost of capital in the last five years.*¹³⁷

This case thus highlights that the Competition Commission: (i) considers overcharging as a form of consumer detriment; and (ii) is willing to quantify the extent of the overcharge when possible. *Home Collected Credit* also demonstrates that the CC will consider the effects of weak competition on particular categories of consumers as well as consumers in general. Indeed, on the facts before it the Competition Commission expressed its belief that the overcharge may have more of an effect on single mothers under 35:

*Home credit customers were more likely than the population as a whole to be female, to be under 35, to have young families, to fall into socio-economic groups D and E, to live in a low-income household and to live in housing rented from a local council or housing association.*¹³⁸

¹²⁷ *Store Cards*, OFT Reference to the Competition Commission, 18 March 2004.

¹²⁸ Emphasis added.

¹²⁹ *United Brands Co. v Commission* [1978] 1 CMLR 429, at paragraph 235.

¹³⁰ At paragraph 6.1 of the reference, the OFT underlined its suspicions that excess prices were being paid by some consumers for certain store cards: “the provision of store card credit may not be working well for consumers. It is possible . . . that the difference between the interest charged on store cards and other credit cards is not fully explained by the offsetting benefits and the differences in the cost of providing these services”.

¹³¹ See Paragraph 1 of Annex 9.1 of the Competition Commission Report, available at: http://www.competition-commission.org.uk/rep_pub/reports/2006/509storecards.htm

¹³² *Supply of Liquefied Petroleum Gas*, Market Investigation Reference, 5 July 2004.

¹³³ *Northern Ireland Banking*, Market Investigation Reference, 26 May 2005. See also: *Home Collected Credit*, Market Investigation Reference, 20 December 2004.

¹³⁴ At paragraph 3 of the OFT Reference (emphasis added).

¹³⁵ See paragraph 75 of the OFT Report.

¹³⁶ *Home Collected Credit*, Market Investigation Reference, 20 December 2004.

¹³⁷ *Ibid*, Competition Commission News Release, 27 April 2006, available at: <http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm>, at p 1. It should be noted that these findings are only provisional and that the Competition Commission intends to discuss them further with home credit companies before making its final conclusions on the matter: *ibid*.

¹³⁸ *Ibid* at p 2.

Non-price factors

In Home Collected Credit signalled how the Competition Commission will also consider different forms of consumer detriment where relevant:

*We shall determine whether any effect on advertisers or users [ie consumers] in the form of higher prices, lower quality or less choice of goods and services, or less innovation has resulted from, or may be expected to result from, any adverse effects on competition in the relevant market or markets.*¹³⁹

Indeed, if the Competition Commission decides that there is an adverse effect on competition it must “take action to ‘remedy, mitigate or prevent’ the adverse effect on competition and to ‘remedy, mitigate or prevent any detrimental effects on customers’ so far as those effects have resulted from the adverse effect”.¹⁴⁰ By definition “any detrimental effects” must also include those detrimental effects which cannot be classed solely as effects on the prices paid by consumers.

In the provisional findings on the supply of groceries investigation, the Competition Commission recommends a number of competition policy solutions, including the introduction of a “competition test” when local planning authorities are assessing planning applications for new large grocery stores, and A requirement on grocery retailers to lift existing exclusivity arrangements that have been in place for more than five years, where these have been identified as a barrier to entry by a competing retailer in areas of high concentration. In addition, however, the Competition Commission has recommended remedies that go beyond what competition law itself could do: namely that the Department for Business, Enterprise and Regulatory Reform amend the Land Agreements Exclusion Order so that agreements which restrict grocery retailing should no longer benefit from exclusion from the Competition Act.¹⁴¹

Application to the GB energy markets

energywatch considers some of the key features that led the OFT to make recent market investigations references to the CC are also evident in the GB energy market. Table 2 provides a high level analysis of these features and some of the areas of consumer detriment that the CC has considered in recent market investigations. energywatch believes that these issues need further investigation along with a quantification of the associated consumer detriment as part of a GB energy market investigation by the CC. Although energywatch has only limited information gathering powers, the CC would be able to demand access to the all the relevant commercially sensitive and confidential information held by market participants.

Table 2**HIGH LEVEL ANALYSIS OF CONSUMER DETRIMENT**

<i>Feature</i>	<i>Analysis</i>
Unfair or excessive pricing	<ul style="list-style-type: none"> — Prepayment meter consumers can pay up to £456 for their energy than a consumer paying by online direct debit. Ofgem has estimated that the additional cost to serve a prepayment meter is estimated to be no more than £85 although this was based on limited information. It is not clear that this estimate is based on efficiently incurred costs ie costs will be higher where is no incentive on the firm to become more efficient if it is confident that it will be able to recoup the cost from a captive consumer. — Firms reference increases in wholesale prices linked to the forward curve when increases retail prices. Forward prices are not a robust indicator of future costs as they are based on limited trading activity and the level of vertical integration means that the dominant firms are not exposed to these prices for significant volumes. There is no transparency of transfer prices.
High switching costs	<ul style="list-style-type: none"> — Small business consumers face significant search and switching costs due to the application of complex contractual arrangements by suppliers, a lack of clarity on terms and conditions and a lack of comparative price and service information. — Survey evidence demonstrates that domestic consumers also face high switching costs—amongst electricity consumers who had switched suppliers exclusively for price reasons only up to a fifth had switched to the supplier offering the greatest saving and up to one third had switched to deal that had left them worse off.

¹³⁹ *Classified Directory Advertising Services*, Market Investigation Reference, 5 April 2005, Competition Commission, Issues Statement, Paragraph 17 (emphasis added).

¹⁴⁰ *Northern Ireland Banking*, Market Investigation Reference, 26 May 2005, at paragraph 83 of the OFT Report (emphasis added). See also Section 138 of the Enterprise Act 2002.

¹⁴¹ Competition Commission, Provisional Decision on Remedies.

http://www.competition-commission.org.uk/inquiries/ref2006/grocery/provisional_decision_remedies.htm

<i>Feature</i>	<i>Analysis</i>
Consumer inertia	— Survey evidence found that 55% of domestic consumers are “very unlikely” to change their gas or electricity suppliers in the near future and that 14% consumers stated they would never switch.
High level of concentration	— 6 firms control over 99% of the domestic gas and electricity markets and 95% of the business electricity market. — The combined gas and electricity domestic supply markets have a national HHI of nearly 2,000. The national domestic gas market has an HHI of 2,800 and the regional electricity markets are estimated to have HHIs of 2,500 to 6,500.
Significant barriers to entry	— There has been no new scale entry to the GB energy markets. — Entrants advise that there are high barriers to entry including lack of liquidity in the wholesale markets, dominance of vertically integrated players, lack of independent counterparties to trade with, information asymmetry, credit policies of the dominant firms, complex industry codes and cash-out arrangements.
Price parallelism	— Suppliers tend to change prices within similar ranges and timeframes. Charts 1 and 2 show how headline prices have changed across the last five years. — Conditions for coordinated effects to emerge and be sustainable through time are present in the domestic supply markets.

Annex D

TERMS OF REFERENCE FOR A CC MARKET INVESTIGATION

PURPOSE

This annex:

- considers the four criteria the OFT considers need to be met before deciding to make a reference to the Competition Commission; and
- sets out possible terms of reference for a GB energy market referral to the CC.

APPROPRIATENESS OF A REFERENCE

To make a CC reference there must be “reasonable grounds for suspecting that any feature, or combination of features, of a market in the UK for goods or services prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the UK or part of the UK” (Sections 131 or 132 of the Enterprise Act 2002). Where this threshold is met, the OFT (or the relevant sectoral regulator) has discretion as to whether to make a reference or not.

The OFT has set out four additional criteria that would normally have to be met before it would decide to make a reference¹⁴²:

- **proportionality**—the scale of the suspected problem, in terms of its adverse effect on competition, is such that a reference would be an appropriate response to it;
- **availability of remedies**—there is a reasonable chance that appropriate remedies will be available;
- **alternative powers**—it would be more appropriate to deal with Competition issues identified by applying the Competition Act 1998 or using other powers available to the OFT; and
- **undertakings in lieu**—it would not be more appropriate to address the problem identified by means of undertakings in lieu of a reference.

These four factors are considered below in relation to a GB energy market referral.

Proportionality

energywatch recognises that a reference to the CC would impose a substantial burden on the businesses affected, particularly in terms of management time, and have considerable recourse implications for the CC itself. However, energy is a necessity product for domestic and business consumers and represents around 3.5% of expenditure for the average household and more than 10% of income for the fuel poor—for some

¹⁴² OFT, Market investigation references: Guidance about the making of references under Part 4 of the Enterprise Act (OFT 511), March 2006.

fuel poor households the cost of warmth can rise to 20, 30 or even 40% of income. The energy sector represents about 4% of UK GDP but is a required input to the other 96%. The benefits of remedying any adverse effects which might be found to exist in the GB energy markets would, therefore, be expected to outweigh these costs.

Availability of remedies

energywatch believes there is a reasonable chance that appropriate remedies will be available. Some possible remedies are considered in Annex E.

The CC has a wide range of discretion and the necessary powers to adopt a wide range of measures designed to remedy identified defects in the market. The CC can:

- Make a significant and direct change to the structure of a market (eg through divestment and unbundling).
- Change the structure of the market indirectly (eg through reducing barriers to entry or search and switching costs).
- Direct firms to discontinue certain behaviour (eg giving adequate notice of price changes and the timeframe in which a change of supplier can be made) or to adopt certain behaviour (eg more prominently displaying prices and other terms and conditions of sale).
- Restrain the way in which firms would otherwise behave (eg the imposition of a price cap).
- Monitor (eg requirement to provide the regulator with information on prices or profits).

Alternative powers

Competition law is more usually applied to vertical agreements that restrain competition rather than integrated firms. Concerns about firm conduct relate to the process of competition between firms across GB as a whole and are not merely isolated local matters.

Undertakings in lieu

energywatch is not aware of specific undertakings that would remove the need for a market investigation reference.

energywatch considers that a market investigation reference would be the most appropriate route for addressing the concerns raised about the features of the GB energy market that appear to be preventing, restricting or distorting competition in the market.

TERMS OF REFERENCE

The Secretary of State for Business, Enterprise and Regulatory Reform, in exercise of his powers under Section 132 of the Enterprise Act 2002, hereby makes a reference to the Competition Commission for an investigation into the supply of gas and electricity in Great Britain (GB).

The Secretary of State has reasonable grounds for suspecting that a feature or a combination of features of the GB energy market or markets prevents, restricts or distorts competition in the supply of gas and electricity in GB.

For the purpose of this reference the expression “GB energy market”:

- Includes the wholesale and retail markets for gas and electricity in GB.
- Excludes the gas and electricity networks in GB.

Issues

The key issues for consideration in a GB energy market investigation appear to be:

Market structure

- How the level of concentration has changed over the past few years and how it might be expected to change in the future.
- Whether the level of concentration has an effect on the conduct of some or all of the firms in the GB energy markets.
- Whether the level of concentration might be indicative of any features of the market that might prevent, distort or restrict competition.
- Whether horizontal concentrations, vertical integration or contracting strategies has reduced competition or created inefficiencies.

Barriers to entry

- What new entry has there been over the past few years and what can be expected in the future.
- What were the key reasons for firms exiting the market over the past few years and what can be expected in the future.
- What the barriers are to new entry and expansion.
- Whether incumbent firms benefit from economies of scale or scope and information asymmetries.

Conduct

- Whether firms compete fairly and vigorously.
- Whether movements in price are consistent with effective competition.
- Whether firms compete on price and whether other aspects such as service and quality are also important.
- Whether there is any variation between regions in how products are offered or promoted or in the application of charges and whether any variation might be due to the extent of local competition.
- Whether service quality as measured by customer satisfaction, mistakes, complaints or adherence to industry codes and redress schemes is at a level consistent with active competition.
- Whether there is a lack of innovation or choice.
- Whether there is sufficient transparency or gaps in information flows.
- Whether there are conditions present that facilitate coordinated effects.

Remedies

The CC can determine what action should be taken to remedy, mitigate or prevent adverse effects on competition or any detrimental effect on consumers. Consideration may be given to:

- Mandatory trading.
- Enhanced reporting and disclosure requirements to aid price discovery.
- Simplifying market rules and entry requirements.
- Greater transparency of information on gas flows.
- Investment incentives for long term strategic storage.
- Reducing search and switching costs.
- Regular market monitoring of the business sector.
- Reintroduction of supply price controls for certain consumer groups if other measures are considered insufficient.
- Divestment of plant or function if other measures are considered insufficient.

Annex E

HIGH LEVEL ANALYSIS OF POSSIBLE REMEDIES*

This annex considers possible remedies that could be put in place to help ensure there is effective competition in the GB energy markets and to address concerns about fuel poverty.

<i>Area</i>	<i>Consequence</i>	<i>Remedy</i>	<i>Vehicle</i>	<i>Timeframe</i>	<i>Benefits</i>	<i>Counterarguments</i>
Fuel poverty	More consumers being thrown into fuel poverty as a result of high prices. Government fuel poverty targets will not be met. Breakdown of government strategy to eradicate fuel poverty.	Mandate social tariffs with minimum standards	Government: Primary legislation (the Energy Bill was a missed opportunity)	Short to medium	Fuel poor have access to more affordable tariffs.	Some industry and government resistance on innovation grounds—suppliers are not doing sufficient to protect the fuel poor at present and the standards only set a minimum against which suppliers can innovate.
Gas flows	Wholesale gas prices and electricity and retail prices will be higher and more volatile than they need to be if prices are driven by market sentiment rather than sound information.	Enhanced information on gas flows from Europe and the North Sea.	Government/Ofgem: Secure agreement from other European governments (particularly Norway) and through the European Commission to provide enhanced disclosure of information on gas flows into GB.	Short to medium	Greater transparency and reduced information asymmetry. Reduced volatility in wholesale prices. Wholesale and retail prices should more closely reflect cost.	Commercially sensitive information—information can be published on a suitably aggregated basis where there is evidence that confidential information would be divulged.
Small business search and switching costs	Small businesses face high search and switching costs due to a lack of comparative price information and are unable to make informed decisions.	Introduce a independently accredited price comparison services for small business consumers	OFT/Ofgem: Develop independent accreditation for price comparison services for small business consumers—this could be taken forward as part of the wider work recommended by the National Audit Office in “ <i>Protecting consumers? Removing Price controls</i> ” to reduce potential consumer confusion by formulating and negotiating ownership of a single code to cover price comparison websites	Short	Reduced search and switching costs for small businesses. Small businesses consumers more able to make informed switching decisions and access more affordable contracts.	No obvious counterarguments.

<i>Area</i>	<i>Consequence</i>	<i>Remedy</i>	<i>Vehicle</i>	<i>Timeframe</i>	<i>Benefits</i>	<i>Counterarguments</i>
Small business contractual arrangements	Small business locked in to higher priced contracts due to complex contractual arrangements.	Introduce standard terms and conditions for small businesses that are fair and easy to understand.	Competition Commission: Direct small business suppliers to offer standard terms and conditions and publicise appropriately	Short	Greater visibility of terms and conditions. Small businesses consumers more able to make informed switching decisions and access more affordable contracts.	Industry likely to resist on grounds of innovation—small businesses are disproportionately disadvantaged in dealing with their energy suppliers because they are neither protected by effective competition, adequate regulation nor general consumer law. Evidence suggests that small businesses operate with a domestic consumer mindset when purchasing energy.
Domestic prices	Domestic consumers paying more than they need to for their energy due to high search and switching costs.	Suppliers to provide additional information to consumers on household bills on alternative offers that may save consumers	Competition Commission: Direct suppliers to provide information on alternative offers on household bills	Short to medium	Reduce consumer search and switching costs for domestic consumers. Domestic consumers more able to access more affordable tariffs.	Potentially complex interaction between tariffs—it will be possible to at least provide some clear messages on alternative offers that could save consumers money. Ofgem play a role in the development of the information to be provided and regularly monitor information provision.
Business competition	No clear basis for identifying problems business consumers face so no route to address consumer detriment	Regular market monitoring of the business market	Competition Commission: Direct firms to submit regular information to Ofgem on competition in the business market	Short	Greater understanding and visibility of the problems business consumers face and the detriment this causes. Provides basis for making positive changes to the benefit of business consumers.	Potential resistance to new regular reporting requirements—the frequency and form of reporting can be set so as to minimise any additional regulatory burden.

<i>Area</i>	<i>Consequence</i>	<i>Remedy</i>	<i>Vehicle</i>	<i>Timeframe</i>	<i>Benefits</i>	<i>Counterarguments</i>
Gas storage	Relative lack of long term strategic storage in GB means we are less able to store low priced gas as an alternative to high priced gas during the winter or periods of unexpectedly high demand and maintain security of supply	Create incentives to invest in long term strategic storage	Competition Commission: Direct government to introduce an obligation on firms to hold a defined proportion of gas in long term strategic storage either through a licence condition or underpinned by legislation if required	Medium	Enhance security of supply. Reduce dependence on high priced gas during winter and periods of unexpectedly high periods of demand. Retail prices should be more stable.	Government may be reluctant to revisit the case for long term strategic storage given it considered this as part of the Energy White Paper 2007—the environment has changed and there have been further increases in wholesale prices since the case for long term strategic storage was reviewed. It is expected that the benefits of investing in long term strategic storage would outweigh the costs.
Trading	Lack of liquidity in the wholesale markets means that prices are higher and more volatile than they need to be.	Requirement for firms to trade a defined level of output through the over the counter wholesale markets.	Competition Commission: Direct firms to trade defined level of output to be monitored by the FSA and/or Ofgem	Medium	Enhanced liquidity. Reduced volatility in wholesale prices. Prices should be more stable and competitive. Reduce barriers to entry.	Interaction with existing contracts and firms commercial decision making processes—there are clear benefits to enhancing liquidity in the wholesale markets.
Market rules	Complex market rules and entry requirements create significant barriers to entry which make it difficult for smaller and low carbon operators to access markets and consumers fairly—this reduces diversity which has a negative impact on innovation, choice and the delivery of the environmental and carbon agenda	Fundamental make-over of the market rules and entry requirements including the cash-out arrangements and third party access provisions	Competition Commission: Direct government and Ofgem to reform market rules	Medium to long term	Reduce barriers to entry and promote new entry. Increase diversity and improved prospect for delivering the environmental and carbon agenda.	Difficult and costly exercise—there should be long term benefits arising from simplification of market rules and entry requirements.

<i>Area</i>	<i>Consequence</i>	<i>Remedy</i>	<i>Vehicle</i>	<i>Timeframe</i>	<i>Benefits</i>	<i>Counterarguments</i>
Disclosure	Consumers pay prices that are higher than the competitive level due to poor price discovery.	Requirements on firms to disclose and publish trading data including prices and segmented financial and operating data about their electricity and gas production and retailing operations.	Competition Commission: Direct firms to publish specific data	Short	Reduce barriers to entry and promote new entry. Prices more reflective of cost.	Publication of commercially sensitive data—information can be provided in a sufficiently aggregated manner.
Reporting	Consumers pay prices that are higher than the competitive level as suppliers reference increases in forward wholesale prices that are not reflective of their actual costs	Requirements for firms to submit data to Ofgem on cost to serve and purchase costs to ensure only efficient cost pass through.	Competition Commission: Direct firms to regularly report cost to serve and purchase cost information to Ofgem for scrutiny and public reporting of its findings.	Short	Greater understanding of firms' costs and margins throughout the supply chain. Prices more reflective of cost. Increase consumer confidence.	Potential resistance to new regular reporting requirements—there used to be regulatory scrutiny of purchase costs and this should be reinstated.

* Where other measures are considered to be insufficient the CC may wish to consider divestment of plant or function and the reintroduction of supply price controls for certain consumer groups. The former should help to promote new entry and the latter would help rebuild consumer confidence in the markets.

Supplementary evidence submitted by Energywatch

**WHY THE BRITISH MARKETS IN GAS AND ELECTRICITY REQUIRE A
COMPETITION INVESTIGATION**

AN ENERGYWATCH DISCUSSION PAPER

1. INTRODUCTION

1.1 *Purpose*

Exactly a year ago energywatch set out some thoughts in a discussion paper *How energy markets are failing consumers*.¹⁴³ The paper followed analysis of aspects of the domestic energy markets in Great Britain (GB) that we thought were acting against the interests of consumers. At that time the concerns centred mainly on whether markets were competitive enough for the fall in wholesale prices being seen then to be passed through to consumers and so alleviate rising fuel poverty and declining industrial competitiveness.

A dominating theme of the paper was the energywatch view—which we continue to hold—that many of the problems acknowledged by regulators with regard to the development of competitive gas and electricity markets on mainland Europe are shared by our domestic markets.

Energywatch is pleased that the earlier paper stimulated discussion that has led to an increase in political awareness of the dysfunctionality of energy markets and the problems faced by British consumers.

Now 12 months on the position the industry finds itself in has changed, and the concerns are different against a background of prices that are once again rising. Most major suppliers, in contrast to last year when price reductions were slow to be announced and slower to be implemented, have moved extremely quickly since the turn of 2008 to levy and implement increases in their household prices. But although the circumstances and symptoms differ, the underlying malady is the same—our energy markets are not properly competitive and are continuing to fail consumers.

Energywatch believes British policy makers and regulators urgently need to focus on these deficiencies. We welcome the decision of the Business & Enterprise Select Committee in February 2008 to investigate key aspects of market design and industry competitiveness. Ofgem has also announced that it is to investigate the retail markets under its Enterprise Act 2002 powers, although disappointingly it has already said in advance of its investigation it does not consider there to be evidence of abuse.

1.2 *Structure*

This second discussion paper addresses the issue of how the markets are working in 2008. It starts by setting out in chapter 2 a summary of pricing developments in the sector over the past five years or so, a period which has seen vigorous cycling of fuel and energy prices, and it looks at the effect on the bills paid by both household and business consumers. It then sets out the key arguments in support of Energywatch's case that current markets for electricity and gas embody now (as they did a year ago):

“a feature or combination of features of a market in the UK for goods or services [which] is, or appears to be, significantly harming the interests of consumers’ (Enterprise Act 2002)”.

The basis for making a Competition Commission referral (Section 131/132 of the 2002 Act) is where the enterprise secretary or sectoral regulator (in this case the Gas and Electricity Markets Authority, usually referred to as Ofgem) has “reasonable grounds for suspecting any feature or combination of features prevents, restricts or distorts competition”. The commission then determines whether a feature or a combination of features, structural or conduct, of the GB energy markets has any adverse effects on competition (AEC) and decide whether action can be taken to address the AEC or any detrimental effect on consumers. Section 134(5) explains that detrimental effect on consumers means higher price, lower quality, less choice or less innovation.

The paper is then structured around the main issues raised in the Business & Enterprise Select Committee's terms of reference but reordered and grouped. They are:

- whether there is effective competition in the wholesale markets for gas and electricity (chapter 3);
- the relationship between wholesale and retail markets and the implications of growing consolidation in the energy market (chapter 4);
- whether the current market structure encourages effective competition in the retail markets for gas and electricity (chapter 5);
- the effectiveness of regulatory oversight undertaken by Ofgem (chapter 6).¹⁴⁴

The paper concludes with recommendations, set out in chapter 7, addressing:

¹⁴³ *First Energywatch brochure 2007*.

¹⁴⁴ The terms of reference also include the status of fuel poverty. A separate discussion paper will address the deteriorating position with regard to this.

- the scope of issues we think the committee should address and require referral to the Competition Commission; and
- energywatch’s options and proposals for rectification of the deficiencies we have identified.

energywatch believes there is a clear evidential basis to substantiate allegations that the gas and electricity markets are not functioning as intended and that consumers are suffering as a consequence. We maintain that a referral to the Competition Commission is necessary. We urge the select committee to endorse this course of action and invite the enterprise secretary or the energy regulator to initiate the process urgently.

2. CONTEXT

This chapter considers developments in the gas and electricity markets that have impacted on consumer prices. It summarises the price changes that have occurred and then looks at the impact on bills in the different retail markets.

2.1 A volatile market

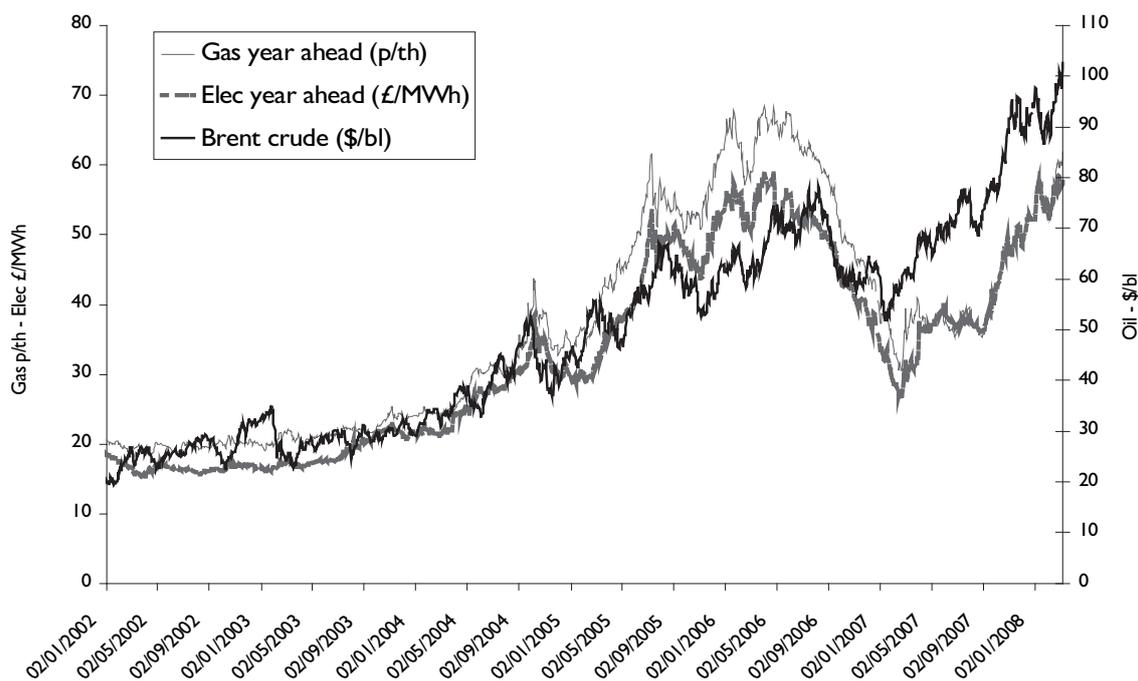
For over 15 years, British policy makers, regulators and energy companies have maintained that British energy markets—the self-proclaimed most competitive energy markets in Europe—have delivered significant benefits for consumers. And for a while price reductions, entry by new participants and product and service innovation did seem to bear out this message, especially given the parlous state of competition in many mainland markets.

But suppliers argued for a while that domestic consumers, who did not benefit from a wholesale electricity price collapse in 2001–03, were lucky because the full effects of a traded market that saw a first wave of large price increases and record high prices between 2004–06 were not passed onto them. This argument has been extended by them to explain why price reductions when they did occur from early 2007 were delayed and, when price cuts were introduced, why they did not fully reflect the magnitude of the reductions in wholesale prices that occurred.

The large suppliers who dominate markets to domestic consumers continue to imply that they are fully or significantly exposed to these wholesale prices, despite their ownership of production assets and the existence of extensive legacy fuel supply arrangements that have allowed them to avoid at least some of the higher costs being seen in traded markets. But these higher costs are again referenced as the main justification for a second wave of double digit price increases seen by consumers since the turn of the year.

Figure 2.1

ANNUAL GAS, ELECTRICITY AND OIL PRICES, 2002–08



Source: Heren

But one constant is that these large companies making supply to retail markets in Britain have virtually all recorded growing profits through the period whether wholesale prices have been high or low. Since 2005 they have also been the beneficiaries of “free” carbon allowances, despite the fact that the nominal cost of these allowances seems to have been passed through in full to consumer prices, creating windfalls and record profits, and even the regulator has called for another windfall tax following an earlier one that was levied by government in 1998.

energywatch acknowledges that wholesale gas and electricity markets have undergone profound change since the turn of the decade as global commodity markets have cycled aggressively. The price path of the key annual contracts is shown at Figure 2.1, together with the corresponding Brent oil price. 2006 was a particularly turbulent year, with then record oil prices compounded by local concerns over security of supply.

2.2 Impact on domestic consumers

Reflecting this price volatility the year 2006 saw 14 major retail price increases levied by the largest suppliers, usually termed the Big Six,¹⁴⁵ who supply all but a handful of the 47 million household electricity and gas accounts in Britain. Subsequently in response to rapidly falling wholesale prices they belatedly proposed general price cuts in 2006–07, but many consumers had to wait until winter was over to get them.

The reductions introduced during 2007 offered only a brief respite. Since the beginning of this year all of the Big Six have reversed out these reductions, and they have increased their prices significantly. RWE npower led the way. The companies all reference rebounding wholesale prices but also new and rising environmental costs as the main reasons for the latest increases. In the case of electricity these increases have more than off-set the reductions made last year.

The price changes to domestic consumers since 2004 are shown at Appendix 1. The changes that have occurred this year so far are shown at Table 2.1.

Table 2.1

HOUSEHOLD PRICE CHANGES LEVIED BY BIG SIX SINCE 1 JANUARY 2008

(%)	Electricity	Gas	Effective date
RWE Npower	12.7	17.2	04 Jan 2008
EDF Energy	7.9	12.9	18 Jan 2008
British Gas	15.0	15.0	18 Jan 2008
Scottish Power	14.0	15.0	02 Feb 2008
E.ON UK	9.7	15.0	08 Feb 2008
SSE	14.2	15.8	01 Apr 2008

Source: Company media statements

These increases have led to a combined average household bill now exceeding £1,000, as shown at Table 2.2, with combined increases in excess of 55% over the past three years based on the latest Energywatch data. But there are indications from analysts that suppliers have been earning increasing returns on their supply businesses. Under the old price controls administered by Ofgem up until 2002 they were allowed a 1.5% margin, and in the early days after these controls were lifted returns rose to around 4.5% reflected perceptions of higher risk.¹⁴⁶ Since then, while some suppliers have claimed occasionally negative margins, at times earnings have been as much as 30% on their retail businesses.¹⁴⁷ The current consensus is that even now margins for those with the lowest prices could be running at over 6%.

Table 2.2

AVERAGE ANNUAL DOMESTIC FUEL BILLS 2005–08—STANDARD CREDIT SUPPLY

	2005	2006	2007	2008 (March)	Change
Gas	£386	£473	£552	£632	64%
Electricity	£285	£338	£383	£405	42%
Total	£671	£811	£935	£1,037	55%

¹⁴⁵ British Gas (Centrica), EDF Energy, E.ON UK, RWE npower, Scottish and Southern Energy and Scottish Power.

¹⁴⁶ *The new electricity trading arrangements in England and Wales*, Second report of session 2003–04, House of Commons Public Accounts Committee (1 December 2003), page 11.

¹⁴⁷ *Financial Times*, 1 February 2007.

Source: Data for 2005 to 2007 is from Berr. That for March 2008 is from Energywatch. Both sources are based on a medium user consuming each year 3.3MWh of electricity and 20.5MWh of gas.

These recent trends are summarised by company at Tables 2:3 and 2:4¹⁴⁸ for electricity and gas respectively.

Table 2.3

HOUSEHOLD ELECTRICITY PRICE CHANGES LEVIED BY BIG SIX (ANNUALISED)

Company	2005		2006		2007		2008		Period	
	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)
British Gas	1	9.4	2	33.5	2	-16.3	1	15.0	6	40.5
E.ON UK	1	11.9	2	29.9	1	-5.0	1	9.7	5	51.5
EDF Energy	2	18.0	2	13.1	0	0.0	1	7.9	5	44.0
RWE Npower	0	0.0	3	39.6	1	-3.0	1	12.7	5	52.6
Scottish and Southern	1	6.7	2	19.1	1	-5.0	1	14.2	5	37.9
Scottish Power	1	12.0	2	18.8	1	-5.5	1	14.0	5	43.3
Average	1	9.7	2	5.7	1	-5.8	1	12.3	5	45.7

Source: Company statements, calculations by Energywatch

Table 2.4

HOUSEHOLD GAS PRICE CHANGES LEVIED BY BIG SIX (ANNUALISED)

Company	2005		2006		2007		2008		Period	
	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)	Changes	Effect (%)
British Gas	1	12.4	2	37.1	2	-19.5	1	15.0	6	42.7
E.ON UK	1	7.2	2	47.3	1	-16.0	1	15.0	5	52.5
EDF Energy	2	19.7	2	36.5	1	-10.6	1	12.9	6	64.9
RWE Npower	0	0.0	3	53.2	1	-16.0	1	17.2	5	50.9
Scottish and Southern	1	9.1	2	32.3	1	-12.0	1	15.8	5	47.1
Scottish Power	2	7.7	2	34.6	1	-16.5	1	15.2	6	39.4
Average	1	9.3	2	40.2	1	-15.1	1	15.2	6	49.9

Source: Company statements, calculations by Energywatch

As a result of these price changes, the advantages liberalisation has brought to UK¹⁴⁹ household consumers have been eroded over the last three years:

- between 2004 and 2007, for example, average UK gas prices to household consumers (excluding taxes measured by Eurostat) increased by nearly three quarters (72%)¹⁵⁰, nearly double the increase of 41% seen across peer EU nations¹⁵¹; and
- household electricity prices have risen 50% in the UK compared to 15% in the same nations over an equivalent period. The extent of the disparity in increases is such that 2007 UK prices were within 2% of the average for this peer group of nations: in 2004 they were a quarter below.

More up to date comparative data from January 2008 is shown at Figure 2:2 for electricity and at Figure 2:3 for gas. It shows the same key finding of UK electricity prices now being above the average of key EU nations once artificial distortions from taxes are excluded.

¹⁴⁸ The figures in these tables differ compared to Table 2.3 because the data in that table is not annualised.

¹⁴⁹ Where available the paper uses GB statistics. Otherwise UK data has been given.

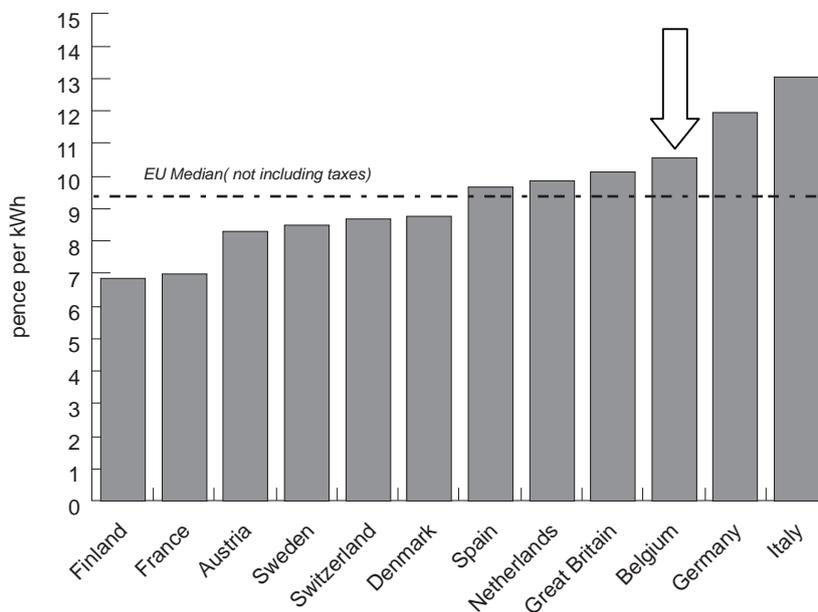
¹⁵⁰ Eurostat data for domestic consumers.

¹⁵¹ Belgium, Germany, Spain, France, Ireland and Italy.

Figure 2.2

AVERAGE DOMESTIC ELECTRICITY PRICES ACROSS KEY EU NATIONS (EXCLUDING TAXES)

Average domestic electricity prices (excluding tax) in the EU as at January 2008

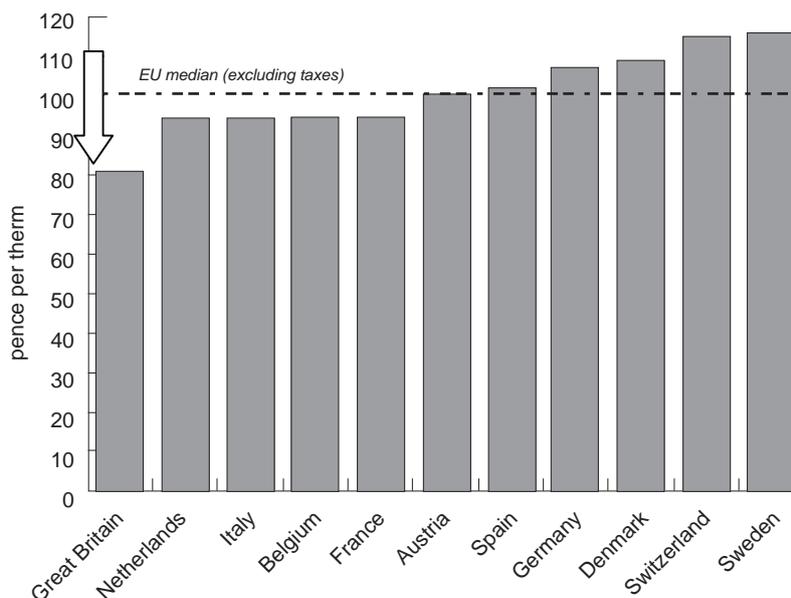


Source: Energy Advice, January 2008

Figure 2.3

AVERAGE DOMESTIC GAS PRICES ACROSS KEY EU NATIONS (EXCLUDING TAXES)

Average domestic gas prices(excludingtax) in the EU as at January 2008



Source: Energy Advice, January 2008

2.3 Impact on business consumers

Business consumers have been hit by even more significant price increases as contract rates offered by suppliers are more closely related to the forward curve, which is a key reference point for the fixed annual contract price and for shorter-term “floating” indices used by suppliers. Over the past four years they have seen their international competitiveness deteriorate markedly.

Eurostat figures for 2007¹⁵² show that UK electricity prices to business were 3% above the EU-15 level having been 30% lower just three years previously. For gas the change is such that UK prices for 2007 were 12% above the EU-15 level in 2007 having been 15% below in 2004.

The consequences of high energy prices for them have been:

- reduced production, which in turn has been a significant contributor to over 100,000 manufacturing job losses¹⁵³; during 2005–06 this reduction occurred at a time of global expansion elsewhere;
- switching to more environmentally harmful fuels;
- some high profile facilities have shut down like Britannia Zinc’s smelter and Imerys china clay; and
- a sharp reduction in UK manufacturing investment even before the current slow-down.

3. BARRIERS TO EFFECTIVE WHOLESALE COMPETITION

This chapter addresses the issue of whether and, if so, what are barriers to effective wholesale competition. It critiques features of current market operation against criteria and characteristics established by the European Commission in a recent influential report on the energy sector. In particular we identify particular problems in the British electricity sector that seem to be having a particularly detrimental effect on the operation of downstream markets.

3.1 The European Commission’s five barriers

In February 2006 the European Commission highlighted in its interim sectoral report¹⁵⁴ five barriers it believed were inhibiting effective energy market competition across Europe, especially at the wholesale level. Attention in Britain triggered by the report tended to focus on the way the development of competition is being constrained in Europe and the possible consequences for consumers here through limitations and distortions on our own markets, especially via access to the gas interconnector, which links Bacton in Norfolk to Zeebrugge in Belgium.

The barriers and their primary characteristics they identified—which they considered widespread on mainland Europe—are summarised in Table 3.1.

Table 3.1

THE EUROPEAN COMMISSION’S FIVE BARRIERS TO COMPETITION

<i>Barrier to competition</i>	<i>Summary of view from interim sector report</i>	
	<i>Electricity</i>	<i>Gas</i>
Market concentration	Most wholesale markets remain national in scope with high levels of concentration in generation, which gives scope for exercising market power.	At the wholesale level, markets generally maintain the high level of concentration of the pre-liberalisation period.
Vertical foreclosure	Vertical integration of generation, supply and network activities has remained a dominant feature in many electricity markets.	Lack of liquidity and limited access to infrastructure prevent new entrant suppliers from offering their services to the consumer.
Market integration	The low level of cross-border trade is insufficient to exert pressure on (dominant) generators in national markets.	Cross-border sales do not presently exert any significant competitive pressure.
Transparency	There is a serious lack of transparency in the electricity wholesale markets that is widely recognised by the sector.	There is a lack of reliable and timely information on the markets—normally the lifeblood of healthy competition.

¹⁵² Eurostat data for business consumers.

¹⁵³ Source: Office for National Statistics as reported by BBC News—<http://news.bbc.co.uk/1/hi/business/4797419.stm>

¹⁵⁴ European Commission Competition DG, ENERGY SECTOR INQUIRY PRELIMINARY REPORT, 16 February 2006. This can be accessed at <http://ec.europa.eu/comm/competition/sectors/energy/inquiry/index.html>.

<i>Barrier to competition</i>	<i>Summary of view from interim sector report</i>	
	<i>Electricity</i>	<i>Gas</i>
Price formation	Price formation is complex, and many users have limited trust in the price formation mechanisms.	More effective and transparent price formation is needed to deliver the full advantages of market opening to consumers.

But energywatch believes that each of these five barriers is an important factor in the current failure of the competitive wholesale energy markets here in Britain to meet the needs of all consumers.

The commission's five barriers are relevant for the reasons set out below:

- market concentration—the increasing search for scale by a diminishing number of players has become the single most defining characteristic in the British energy supply markets. As a consequence wholesale markets are thin or “illiquid”, with modest volumes being traded;
- vertical foreclosure—smaller players and recent entrants are leaving the market because of an inability to source wholesale product from major established players. As the charges levied for uncontracted trades (or “cash-out” prices) are penal,¹⁵⁵ choosing to forego contracts for injections and offtakes does not represent a viable option for competing in the market place. The illiquidity of the electricity wholesale market combined with these penal cash-out prices has created a position of “double-jeopardy” for downstream players, who are exposed to systematic and disproportionate risk compared to the Big Six who are heavily integrated;
- market integration—all of the Big Six have integrated production and supply businesses that primarily focus on dual fuel propositions to direct debit consumers in the retail markets. Since 2001, they have become not only larger but also more integrated, with commercial relationships between energy production and supply being particularly opaque;
- transparency—energywatch-originated unified network code modification 006, whose implementation has brought much greater visibility of offshore gas flows and terminal deliveries onto the mainland. But there is not publication of information in other areas, such as supply business profitability and the terms of trade with upstream affiliates and, it would seem there is no regulatory interest in this key information; and
- price formation—wholesale prices are formed in markets much less liquid than envisaged when the current market designs for centralised trading were implemented, especially in the electricity sector and especially beyond the front seasons that are traded. The use of the forward curve by all the large suppliers in setting transfer prices and offers to consumers means down-stream prices reflect the implied costs of marginal trades on the open markets. These pricing practices have enabled the full pass through of carbon costs and helped maintain oil-gas and gas-electricity price linkages, even though the acquisition costs of the suppliers are very different.

In all cases these factors work against non-integrated players in the British market, and have contributed to both generators and suppliers exiting the market. Going forward they have also created significant barriers to entry.

We set out our arguments in each of these areas in more detail below, with specific reference to the electricity sector.

3.2 Market concentration

The British market has become much more concentrated since full competition was introduced, fuelled by the economies of scale of mass domestic retail markets but also by strong incentives to integrate that arise from the market structures. Vertical integration through asset acquisition is effectively being used as a trading strategy by virtually all the major market participants. This trend has led to three particular outcomes, all of which have been detrimental to the functioning of the wholesale markets. The observations we make apply equally to gas as well as electricity, but the degree of the problem is much more manifest in the electricity sector:

- first ownership of production assets has become more concentrated, and many independent generators have left the market or been swallowed up by the incumbents since 2000 resulting in significant horizontal concentration;
- second there have been a number of supplier failures and acquisitions. At the same time supplier exits have not been counter-balanced by any significant new entry over the same period; and

¹⁵⁵ Both gas and electricity markets in Britain have been designed to provide incentives for participants to be in balance, meaning they should endeavour to be fully contracted for their outputs as a generator or consumption as a supplier. Any uncontracted trades are subject to imbalance or “cash-out” charges, and these tend to reflect the costs of short-term peaking energy, which is expensive. During periods of high demand or supply uncertainty, these cash-out prices can be several times the value of traded prices for the underlying commodity.

-
- as a consequence of the first two factors generation has reintegrated with supply causing significant vertical concentration, which has led to a failure to create the hoped for levels of market liquidity, especially in electricity.

3.2.1 Contraction in independent generation

The British generation market saw significant new entry over the 1990s fuelled by the “dash for gas” and plump pool prices set by generators. “Asset-light” strategies were initially preferred whereby suppliers were able to contract with generators on a long-term basis for firm power. But the collapse in power prices in 2001–02 in part triggered by surplus generation led to the exit of many merchant plant operators and the failure of some over the next two years. Examples are shown in Appendix 2. Several realised huge losses on recent investments through fire sales, while some went into administration or left their assets with the banks. At the same time the integrated players were relatively indifferent to this price collapse as they tended to have high levels of contract cover in place or had a route to market through their supply businesses.

Since 2003–04 alone we estimate that the volume of independently-owned generation, excluding nuclear and long-term arrangements with the Big Six, has dropped from 70TWh out of annual GB supply of around 330TWh or so to less than 25TWh on an annualised basis. These developments made wholesale markets thinner and inherently more volatile.

3.2.2 Supply consolidation

A parallel development has been the loss of independent supply. Outside of a small, niche “green” electricity sector, householders’ choices are restricted to the Big Six as they have absorbed the business activities of smaller competitors that have left the market or which have been acquired. During 2005–06 in particular several small players exposed to high and volatile wholesale prices went out of business. Supplier failures since 2000 are shown at Appendix 3. In all less than 1% of residential consumers now receive their electricity or gas supply from someone other than the Big Six.

And in the business markets there has also been a notable reduction of choice as suppliers have exited the business supply markets. Statoil and BP, prior to its full withdrawal from the market, both developed and then disposed of businesses serving smaller and medium gas users. In electricity the exiting suppliers have tended to focus on segments of the business markets.

It is to be expected that some enterprises will fail during periods of high and volatile prices, especially given the increasing diseconomies of scale in supply. But the combination of wholesale prices that fell dramatically from early 2007 and inflated consumer prices presented the biggest potential opportunity for new entrants seen since competitive markets started. Despite rhetoric from Ofgem about simplifying market entry and licensing procedures, entry remains a complex, expensive and time-consuming process. A range of new licensees have emerged in the gas sector though as yet few have started actively trading; in electricity there has been negligible new activity. In turn this has meant that the incumbent players see no realistic competitive threat from new entry on any scale.

3.2.3 Vertical reintegration

The adjunct to the exit of players in both generation and supply is the significant increase in vertical integration. In the energy markets vertical integration has meant that a market can now be effectively foreclosed with a few long-term contracts, and the position is not significantly different in Britain than it is in continental Europe in this respect. This characteristic means remaining smaller players and new entrants cannot compete fairly or effectively. And because most independent generators have now been acquired by the larger players, the few remaining independent suppliers must buy from a scale player or from volatile short-term spot markets if they wish to avoid being “cashed-out”.

As a consequence electricity trading activity outside of the Big Six is largely dependent on them making volumes available to their competitors, which the market structure disinclines them from doing. This arises because they wish to hold control of spare capacity in effect to help themselves self balance or because they would prefer to do business with other large players, and their credit policies reflect this preference. Anecdotally they often cite credit policies for refusing to trade with less substantial players.

A further effect is that wholesale markets are much less liquid. This is important to competition as they allow suppliers and, in some cases, consumers to source bulk energy. After a surge in the late 1990s, wholesale electricity market activity in Britain has declined as a result of exit of independent trading and supply companies and the disappearance of merchant plant.

We consider the issue of poor market liquidity and its implications further in section 3.3.

3.2.4 Less diversity

Foreclosed markets mean consumers miss out on the benefits of competition brought by diverse and new players. The advantages that arise from new entry are not only price related:

- smaller suppliers are often new entrants and keep larger players on their toes through more innovative offerings and services. They also enable issues about market entry to be kept under closer focus and barriers to entry to be tackled;
- environment—some smaller players are active in green and energy service markets. Energy service companies are emerging that actively pursue low carbon programmes and bespoke consumer offerings;
- security of supply—small suppliers broaden the sharing of the funding burden, in particular facilitating the participation of venture capital providers. On both the generation and supply sides they have introduced a number of innovative financing techniques. A further factor is that commodity-based energy markets introduced in the UK depend on liquid traded markets to enable reliable price discovery and thus facilitate proper investment decisions in new capacity, and these smaller players enable more diverse participation in these markets where they are enabled to work effectively; and
- innovation—small suppliers introduce innovation, and a wider diversity of commercial offerings for all types of consumer.

At a time when the Government is promoting diversity of supply through its policies, it is perverse that market structure actively deters diversity of participant.

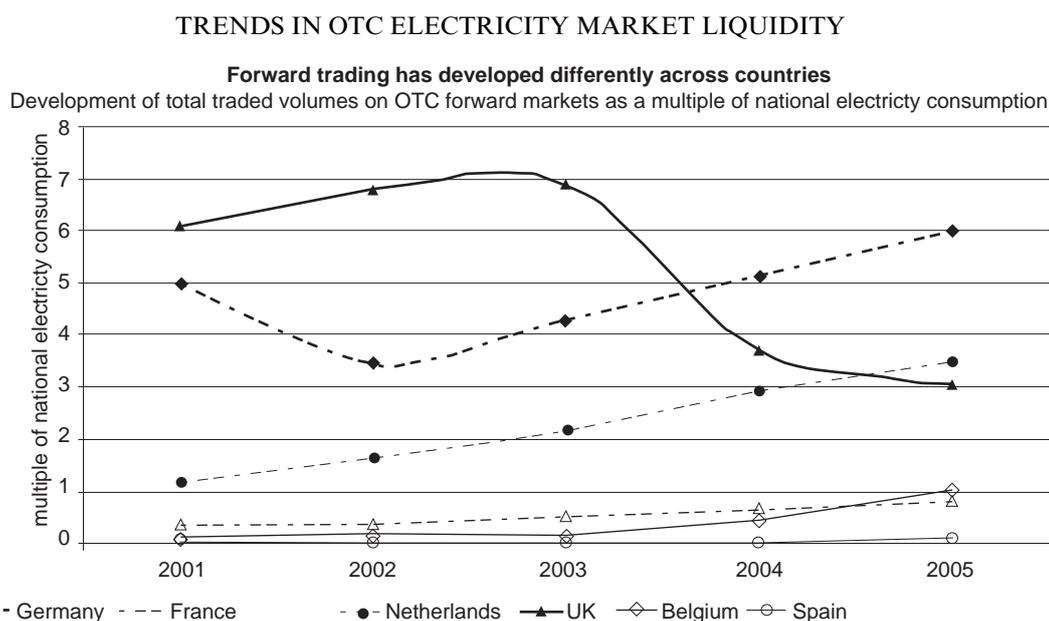
3.3 Vertical foreclosure

Both electricity and gas markets have created strong incentives for parties to balance their supply with their production, which has reinforced drivers to vertical reintegration on a huge scale, reducing access to markets by smaller players. Above all this reintegration in industry structure has had a significant impact on market liquidity.

3.3.1 Market liquidity

The European Commission's interim sector report from 2006 noted: "The UK is the only market in the comparison where traded volumes [of electricity] have significantly declined during the last two years. This is often ascribed by respondents to ongoing vertical reintegration of the industry, ie the trend to bring independent generation and supply businesses into a single operation under the same ownership".¹⁵⁶ The point is illustrated by Figure 3.1, which is extracted from the report.

Figure 3.1



Source: European Commission, Preliminary report into the electricity sector

¹⁵⁶ European Commission's Preliminary report electricity (February 2006), page 113.

Data from the UK Financial Services Authority (FSA) shows that this trend increased in the year to July 2006, with liquidity in UK power falling a further 6%.¹⁵⁷ Activity in the markets it regulated increased in its latest report: electricity volumes were up 52% to 985TWh and gas volumes up 109% to 437bn therms in the year ending July 2007.¹⁵⁸ Although these increases appear impressive, the volume of electricity traded is only three times physical consumption—some way below the ten times level said to evidence a healthy market and means liquidity is still significantly less than markets such as Germany and the Netherlands that have deregulated more recently.

This unhealthy position is reinforced by data reported by one of the Big Six, and shown in Table 3.2. The data, from annual Factbooks produced by RWE,¹⁵⁹ shows that its trading volumes almost halved over a three year period, during which volumes traded on the wider wholesale power market also fell to about a third their previous level. Overall this source shows a similar level of market activity measured as a ratio of physical demand as the information from the FSA. Further analysis on behalf of smaller suppliers shows that typically aggregate volumes of reported seasonal contract trades scarcely exceeds the physical amount of power consumed during these six month periods.

Table 3.2
A VIEW OF ACTIVITY IN THE WHOLESALE POWER MARKET

(TWh)	2003	2004	2005	2006	Change (06 on 03) %
Total trading volume	2,500	1,900	1,469	750	−70.0%
RWE trading volume	501	356	203	272	−45.7%
RWE physical output	38	31	31	31	−18.4%
GB demand	317	316	322	322	1.6%
Trading/demand ratio	7.9	6.0	4.6	2.3	*

Poor UK market liquidity in electricity has been accompanied by a period where wholesale prices have become much more volatile. Energywatch believes the two are directly related and reinforcing, as major players respond by further integrating their upstream and downstream operations and acquire competitors to ensure they can balance production with supply to limit their exposure to wholesale prices. In turn this response limits even further the volumes available for wholesale trading.

These modest levels of liquidity are not helpful to major consumers or independent suppliers either as the opportunities to trade reduce and they therefore tend to be more exposed to short-term price fluctuations. The volume of electricity traded on a very short-term basis reported by the London Energy Brokers Association¹⁶⁰ has fluctuated in the range 2–3TWh on an annualised basis since 2005. Most recently there has been a reduction in volumes on a monthly basis of a third for the November-February winter period of 2007–08 compared with just a year earlier. Ofgem also recently found quantities of day-ahead trading to be particularly thin in GB compared to other liberalised markets.¹⁶¹

Volumes that are being traded are also heavily skewed to shorter durations, typically much less than a year and particularly relating to the front quarter or season. Data on this is hard to distil because trading is fragmented across a number of exchanges and brokers, but anecdotal evidence suggests that what trading there is is “lumpy”. There is also a mismatch in terms of the wholesale products on offer both in terms of shape and volume relative to the annual contracts that suppliers enter into. It can be almost impossible for non-integrated players to access the volumes they need and the “shape” (or the load profile) of their commitments. In the past there were many more independent counter-parties with whom to trade and contracts for structured products such as “load shape 44”¹⁶² were in demand, but often there are no longer volumes of these products available. Where there are volumes made available, larger players often insist that monies are posted in advance because the credit risk is no longer socialised as it was under the pool and the scale players are concerned about the credit status of non-scale players in volatile markets.

While there is much more trading in the gas market, there are still important questions for policy makers and regulators that need to be addressed. In its Ensuring effective and efficient forwards gas markets report for DTI in March 2005, the consultancy Global Insight suggested that 70% of the gas landed in Britain was subject to long-term contracts. The balance, 30%, was available for forward trading. Its analysis also suggested that the majority of this gas (as we have already seen occurs with electricity) was traded in the

¹⁵⁷ FSA report 2006.

¹⁵⁸ FSA report 2007.

¹⁵⁹ RWE fact book 2007.

¹⁶⁰ www.leba.org.uk/ This organisation produces indices based on aggregated trades for periods up to a week ahead reported by its five members.

¹⁶¹ Day-ahead traded volumes as a percentage of demand in 2006 were: GB 8.5%, Netherlands 15.8%, Germany 16.6% and Nordpool 63%. The data was presented at a cash-out review meeting in February 2007.

¹⁶² A typical week-day load shape, with equal base and peak hours, is a crude proxy for the needs of smaller suppliers and a benchmark product. For the 17 months from October 2003 to March 2005 the four components required for a 1-year load shape 44 were traded on the same day on 22 occasions; for the 2-year product this happened on only 2 occasions and for the 3-year product not at all.

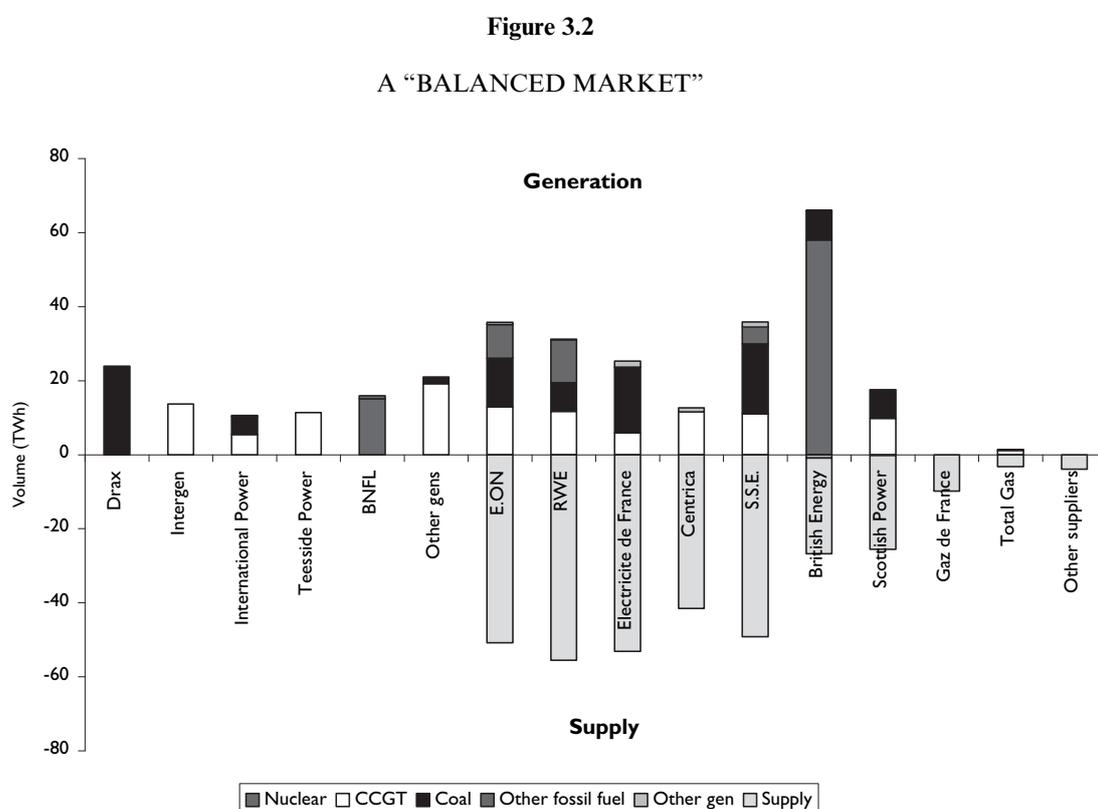
immediate run up to its delivery, rather than months or seasons ahead. As a consequence forward curve prices were posted based on very limited trading activity to the extent that, while the consultant characterised the spot gas market as “functionally liquid”, noting it believed the forward market to “suffer from a lack of liquidity by global standards”.¹⁶³

These arguments provide further evidence that the forward curve is not a robust indicator of future wholesale costs for gas suppliers—and electricity market liquidity is even lower.

3.4 Market integration

As we have seen, consolidation has become a real feature of British energy markets and this has given rise to six large vertically-integrated players who effectively monopolise supply to domestic consumers. In electricity they have as a consequence effectively opted out of wholesale power trading for a significant part of their operations, and they increasingly seek to lock in wholesale volumes of gas by entering into long-term contracts for gas supplies or in some cases acquiring their own gas production assets.

Figure 3.2 illustrates this point for electricity, and compares aggregated settlement data for suppliers for the year ending March 2007 with published data on generation production.



Source: Cornwall Energy, using data from Berr, Ofgem, Elexon

The figure shows total retail sales below the line to both domestic and business consumers. However it does not distinguish between sales to domestic and business consumers. Apart from Centrica, all of the Big Six are “net long” with their generation volumes exceeding domestic sales, and a strong dynamic in the market has been to make sure that domestic sales can be sourced from in-house generation, a phenomenon we call the “balanced market”. Again, apart from Centrica, all have access to coal generation and, in some cases, other fuel sources. They are not wholly exposed to the gas and carbon prices that have become the key driver of forward power prices. In fact the great surge in coal consumption at power stations over the 2005 and 2006 period was one direct consequence of their desire to avoid a gas price exposure.

There are two implications flowing from these observations:

- comparing electricity sales volumes of the major suppliers with output from their power stations shows the major players are targeting their in-house generation output at their “sticky” small business and domestic consumers who are paying the published tariff rates; and

¹⁶³ Global Insight report.

-
- their ability or willingness to compete in the business markets depends on any surplus volumes they have after allowing for supply to their domestic consumers, and traded volumes and their contract price offers at any particular time reflect market prices irrespective of whether they are exposed to them in whole or in part.

These implications and their impact on the retail markets is discussed further in chapter 5.

3.5 *Transparency*

Despite the relatively good transparency in the British real-time market compared to Europe, European regulators through Ergeg have shown¹⁶⁴ there are areas where transparency in the British market remains poor. There are important aspects of wholesale market functioning that are inhibiting visibility of participant actions, which hinders and distorts understanding of integrated operations.

Energywatch believes that given the level of vertical integration in the market, disclosure requirements are inadequate. Further there is no systematic reporting by activity to Ofgem and no meaningful reporting in turn to the wider market. Given the ability of the Big Six to set their own terms of trade, especially through transfer prices they set themselves, there is a need for urgent consideration of these issues.

3.6 *Price formation*

Issues of market dominance and transparency reinforce each other when it comes to wholesale price formation but they impact on market participants in different ways. Current market structures mean independent suppliers and purchasers in both gas and electricity wholesale markets are price takers; they must pay whatever rates are on offer as the demand they supply is largely inelastic. In contrast, the companies which provide them with energy do their best to mitigate their exposure to these markets by purchasing assets or, in the case of generating fuels, seeking to trade on different terms. Nevertheless the concept of the “forward curve” is central to both sets of trading counterparties.

3.6.1 *Forward curve*

At any point in time both electricity and gas will have a unique value, reflecting fundamentals such as the underlying costs they are referenced against, the balance between supply and demand and also the sentiment of those buying and selling. The price at any particular point in time will vary also according to the point of delivery. Thus the price for gas will depend on the point at which it is to be consumed. Market reporters thus quote prices for the annual gas contract in 2008 reflecting views on its average cost over the year, and this is likely to have a different price from the 2009 contract. Likewise the average price for the contracts over either of those years will have different underlying seasonal prices (summer, winter), and the prices of seasonal contracts in turn will have different values to the component monthly contracts, and so forth.

Reflecting these different delivery times price reporters conventionally quote a forward curve, which shows at any particular point in time the traded price for contracts in that commodity across the range of delivery times. A key variable for each point on the forward curve is the volume of trades that occurs for each quoted contract. This facet of trading is termed “liquidity”. A liquid market is one where there is a meaningful volume of trading, which in turn usually enables a representative traded price to be reported. Conversely an illiquid market is one where there is limited trading taking place, and the price is likely to be formed on the basis of a few transactions or even a single trade. In turn illiquid markets are usually considered to be volatile and the price discovered does not necessarily reflect the market value.

Limited market liquidity is a key feature of the current energy landscape, and for electricity the situation is especially poor and has deteriorated over recent years. But this trend has occurred at the same time as the prices it produces have become more important for setting consumer prices. Large user prices in the business markets in particular are usually based on the traded year ahead price derived from the forward curve, to which the supplier adds grid charges, taxes and its profit margin, unless the consumer opts to link their prices to shorter-term measures in the expectation the price will fall closer to delivery.

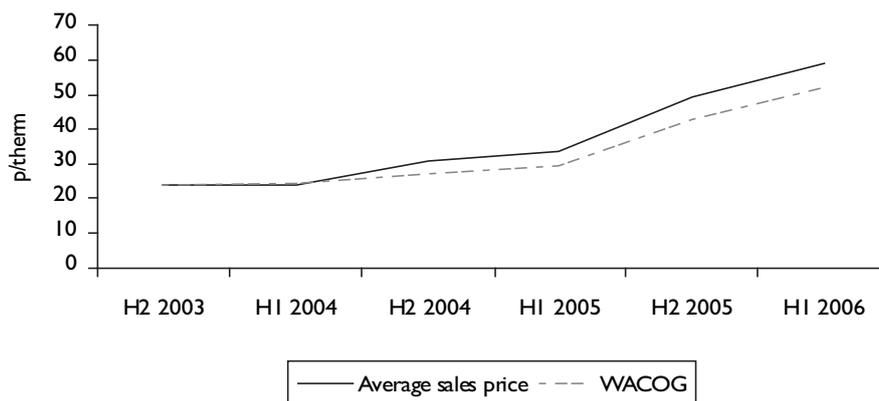
But as we have seen from recent announcements of price rises, the Big Six reference movements in the forward curve in setting their retail prices. This is important not because the suppliers are necessarily exposed to these prices for significant volumes but because the wholesale forward curve, for electricity in particular, is essentially used as a reference price for transactions between different operations of these integrated companies. As a result prices to consumers are not necessarily related to the company’s costs of production. While the major players conduct limited forward trading, reflected by declining liquidity, they still use the forward curve it produces as the indicator of costs when they want to change prices.

¹⁶⁴ www.ergeg.org/portal/page/portal/ERGEG_HOME/ERGEG_PC/ARCHIVE1/GGP_Transparency

Unfortunately financial reporting by the Big Six is insufficiently transparent to make definitive judgments on these matters, and we believe this lack of disclosure of trading between affiliates and of transfer represents a major failing that needs to be addressed. Until recently Centrica's accounts showed that the average selling price for its upstream gas exceeded its average purchase cost for supply onto domestic consumers.¹⁶⁵ This position suggests Centrica has decided to price its equity gas at the forward curve while purchasing from others at lower non-forward curve related terms. Figure 3.3 illustrates this point, though unfortunately it stopped reporting this information in late 2006.

Figure 3.3

CENTRICA'S REPORTED AVERAGE WHOLESALE GAS SELLING PRICE AND AVERAGE COST OF GAS FOR SUPPLY TO HOUSEHOLD CONSUMERS



Source: Energywatch from Centrica financial reports

3.6.2 Other wholesale pricing matters

There are two further points about current wholesale market pricing that Energywatch believes are damaging the British market and further distort the wholesale price setting process. Expressed as questions they are:

- why should wholesale power prices be linked to gas prices (and in turn gas to oil); and
- why should new carbon costs be passed through at marginal cost in power prices?

Power-gas linkage

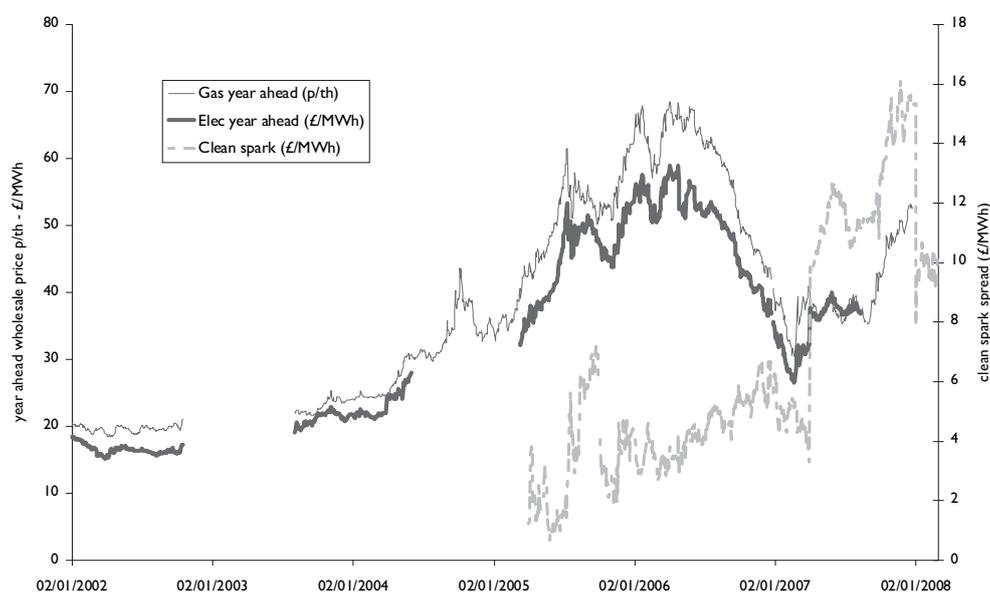
The “spark spread” relationship¹⁶⁶ between wholesale gas and power prices is long-established, with gas remaining the fuel of choice for new investments in power generation. A threshold of about £10/MWh of electricity prices over gas prices is usually seen by developers as the minimum margin required for commercial pay back in new generation plant using gas as a fuel. Spark spreads have scarcely attained those levels over recent years, theoretically making new investment in gas generation unviable.

¹⁶⁵ Centrica ceased publishing its weighted average supply costs for gas and electricity effective from reporting its 2006 preliminary results, removing one of the most important indicators in a sector which is becoming progressively more opaque.

¹⁶⁶ The spark spread is the theoretical net income of a gas-fired power plant from selling a unit of electricity, having bought the fuel required to produce this unit of electricity. All other costs (operation and maintenance, capital and other financial costs) must be covered from the spark spread.

Figure 3.4

SPARK SPREADS



Source: Heren data

While poor returns have undoubtedly squeezed some in the independent generation sector, we think the commercial dynamic is more complex than this. Many gas-fired stations in (and outside) Big Six ownership have long-term fuel supply contracts priced using other price indicators. Centrica's LTI¹⁶⁷ is the best known variant, and it reported its Industrial and Wholesale business selling significant volumes at average prices below 30p/therm during 2005–06. If all of this gas were burnt in base-load CCGTs at this rate, it would fire approximately 6.5GW (equivalent to 26% of capacity) at around £15/MWh.

We have no means of knowing if it all is, but on the other hand we do not believe that all other gas burnt in power stations is priced at market prices, especially given some of the valuations put on such contracts in power station acquisition transactions over recent years. Coal and nuclear generation, which together account for over 50% of power production in 2005, have different economics, and at least until recent when coal prices have soared, these generators have been similarly earning bumper returns from a market regime driven by high market gas prices.

In short there is significant circumstantial evidence that power producers have been able to earn extensive windfall profits as a result of the real relationships between costs and prices even before the impact of carbon pricing is taken into account.

Carbon windfalls

The EU emissions trading scheme was implemented in January 2005. Free carbon allocations of a half to 70% of their requirements under it have earned windfall profits for generators. They have been able to pass through the full marginal cost of carbon into power prices. The view from the City is that full pass-through occurs where the wholesale power market is not competitive.

The costs that consumers bear as a result of this were estimated to be in excess of £1 billion a year in 2005 and 2006, and Ofgem has recently noted that British generators will be making a further windfall of €9 billion over the second phase of the scheme between 2008–12.

We comment further on this issue in chapter 4.

4. LINKAGE BETWEEN WHOLESALE AND RETAIL MARKETS

In this chapter we consider the importance of wholesale prices in setting retail prices. It also examines new environmental costs that are impacting on suppliers and their consumers. The relationship described by suppliers between wholesale costs and retail prices is now a major concern to Energywatch, and the convergence between suppliers' prices, pricing structures and product offerings is also an issue we are worried about.

¹⁶⁷ Long-term interruptible (LTI) arrangements were marketed by the then British Gas plc to power station developers in the early to mid 1990s for supplies up to 15 years with prices formulas linked to changes in energy prices and inflation.

4.1 *Construction of the retail price*

Irrespective of how a tariff to supply electricity or gas to a householder is presented, in preparing it suppliers will assess separately the different costs in the supply chain, namely:

- fuel, including what the supplier pays for the wholesale energy, which in turn includes producer profits, any costs of carbon permits for power generators and gas storage;
- the suppliers' own costs of servicing the consumer, including metering and its profit margin;
- charges for using the delivery networks of transmission and distribution, from production facility to the consumer's meter;
- the costs of complying with regulated obligations to stimulate renewables and energy efficiency activity; and
- value added tax (VAT).

Below we comment briefly on these elements.

4.1.1 Fuel costs

Suppliers secure bulk volumes of fuel for their consumers' requirements. The wholesale cost they pay will be determined by the commercial arrangements they have in place to secure that energy. These arrangements may involve:

- production from assets owned by upstream affiliates. This option is a particularly important one in electricity where the Big Six own more than half of British generating capacity as well supplying the vast majority of household consumers;
- long-term contracts with producers. Many gas fields have been developed as a result of "life-of-field" contracts with suppliers. These arrangements typically pre-date the liberalised era when it was customary for bulk gas prices to be indexed to changes in other indicators such as oil prices. Other contracts for gas and electricity—especially the most recent and those for imported gas—may include rates linked to published wholesale market indicators. In electricity some long-term "tolling" arrangements are in place where the supplier pays the generator an operating fee plus separately itemised fuel and, as necessary, carbon costs; and
- shorter-term purchases—for periods running from days to low numbers of years—of energy at rates linked to published wholesale market or trading exchange indicators or "over-the-counter" transactions facilitated by brokers.

4.1.2 Suppliers' own costs

Suppliers' own costs of serving their consumers include their administrative and service functions, as well as managing the cashflows in their businesses. Suppliers also incur external costs for metering equipment and meter reading, though some suppliers carry out these activities themselves.

4.1.3 Network use of system costs

The delivery of energy through the gas and electricity networks to consumer meters is not competitive, and a number of companies operate monopoly services transmitting and distributing energy around the country. Network use by producers and suppliers is provided on a regulated non-discriminatory, open access basis. This framework means that network operators cannot deny a reasonable request from a licensed supplier for access and must offer fair and transparent terms. Transmission and distribution network use of system charges are published and based on principles approved by Ofgem, with the regulator also periodically setting the total allowed revenues that the network operator can earn.

4.1.4 Regulated obligations

Suppliers also face two specific additional on-costs from regulated obligations when they choose to service the domestic market:

- the Renewables Obligation (RO) for electricity; and
- the Carbon Emissions Reduction Target (Cert), which from 1 April 2008 will replace the Energy Efficiency Commitment (Eec), for both electricity and gas.

The RO obliges suppliers to buy a certain amount of the electricity they supply to consumers from qualifying renewable power sources or pay a “buy-out” charge. A similar obligation exists for energy efficiency but on both gas and electricity sales, with suppliers having to demonstrate they have implemented measures that have enabled consumers to reduce consumption. The shift from the Eec to the Cert will see the basis of this obligation change to carbon reduction from energy savings.

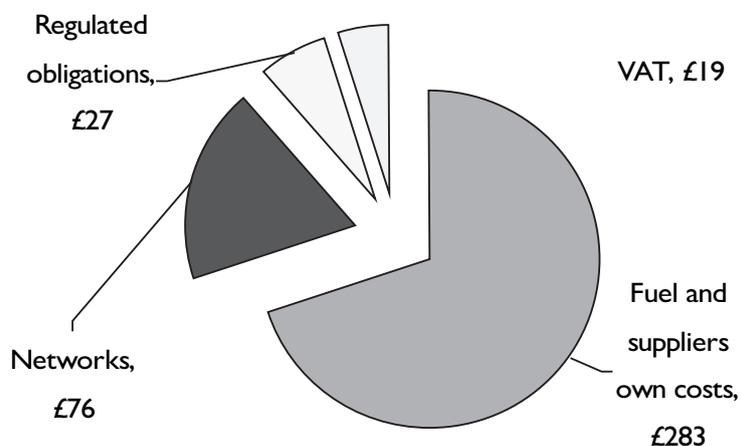
Suppliers endeavour to pass on to consumers their costs in complying with the RO and Cert/Eec, although there is no legal obligation on them to do so.

4.1.5 Value Added Tax

Electricity and gas consumption by household consumers attracts Value Added Tax (VAT) at the rate of 5%.

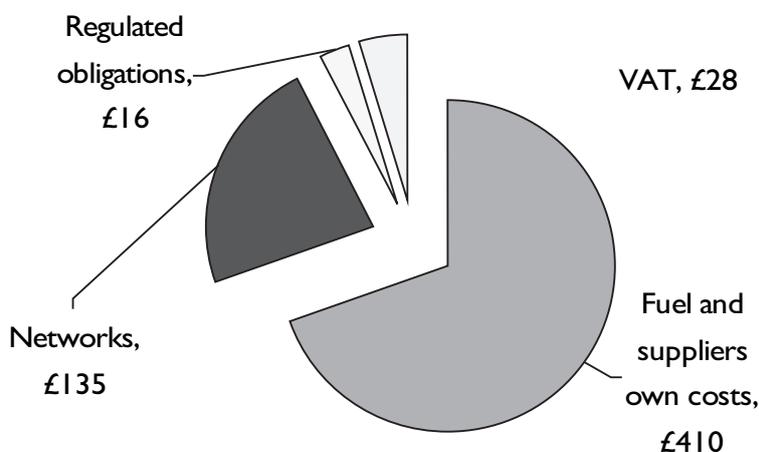
Figure 4.1 shows a breakdown of the average household electricity bill in Great Britain for a medium user supplied on standard credit terms. Fuel and the suppliers’ own costs account for 70% of the bill, with the next highest component being network costs at 19%.

Figure 4.1
BREAKDOWN OF AVERAGE HOUSEHOLD ELECTRICITY BILL MARCH 2008



Source: Analysis of Energywatch pricing data for a 3,300kWh standard supply on standard credit terms
Figure 4.2 repeats this calculation for gas.

Figure 4.2
BREAKDOWN OF AVERAGE HOUSEHOLD GAS BILL MARCH 2008



Source: Analysis of Energywatch pricing data for a 20,500kWh standard supply on standard credit terms

4.2 Representing fuel price movements

As we have seen a feature of Britain's traded wholesale markets for electricity and gas is their volatility and their sensitivity to international commodity prices for oil, gas, carbon and coal. Comparing household price increases with movements in the year-ahead forward price for the appropriate fuels shows that movements in the former can and have lagged the latter, as shown at Figures 4.3 and 4.4. These charts also show that wholesale prices reached their previous peak in the early summer of 2006, while household prices appear to have peaked in the late winter of 2006–07. This cycling suggests a six- to nine-month lag, and this is sometimes explained by the companies as representing suppliers committing to forward purchases to secure winter supplies.

But:

- in electricity five of the Big Six (Centrica is the exception) are “long in generation” compared to expected domestic demand, and the gas and coal for their power stations will not necessarily be secured at prices directly related to forward curves; and
- in gas many of the major players have to some extent access to long-term contracts, which are again priced at historic rates that have risen perhaps by inflation but which have not risen in real terms.

Many of these arrangements for fuel supply are long-term and were put in place in the 1990s. As they lapse, their volumes are much more likely to be replaced by arrangements where there is a closer correlation of prices to forward curves. This shift may explain why over recent months there appears to have been a quicker pass-through of forward curve price changes into household rates. But even so, Energywatch is very concerned that internal transfer pricing arrangements mean the supply operations of the Big Six must pay forward curve-related prices for their energy, while their upstream production counterparts profit by any difference between these levels and what is actually paid for fuel in bulk.

Figure 4.3

TRENDS IN BASELOAD (YEAR AHEAD) WHOLESALE GAS PRICES AND HOUSEHOLD PRICE INCREASES SINCE SEPTEMBER 2004

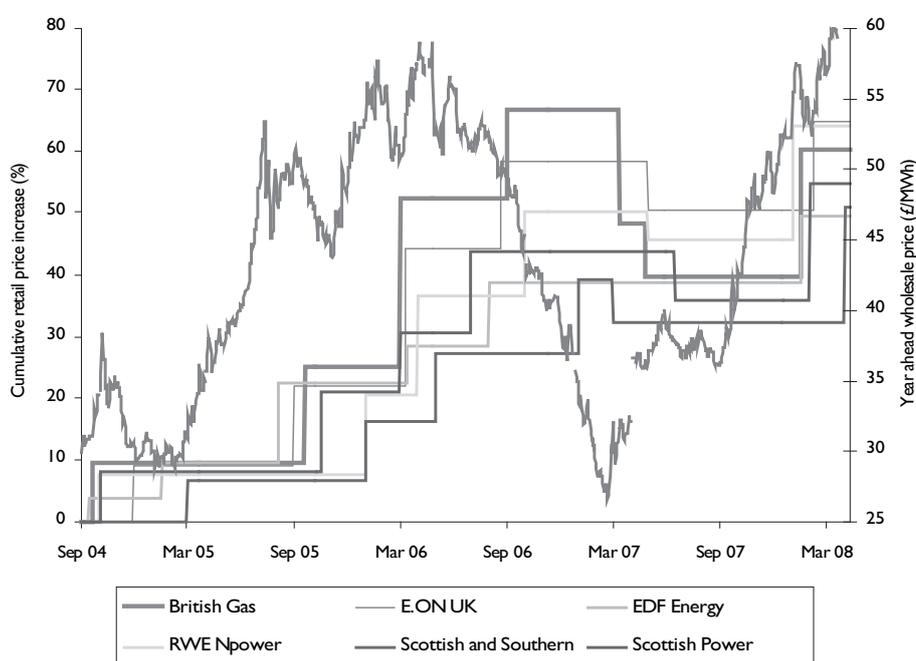
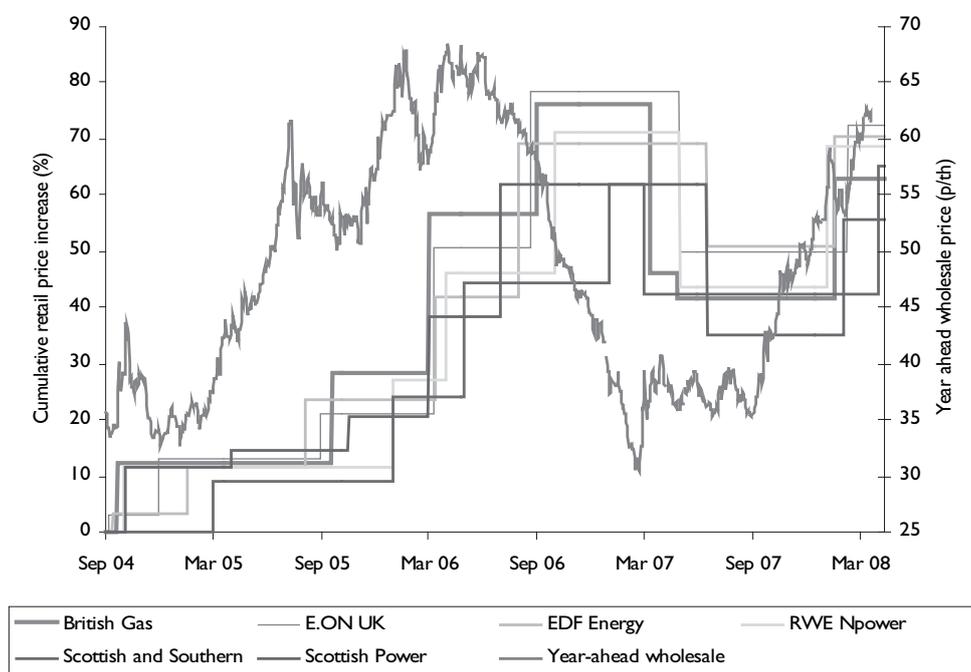


Figure 4.4

TRENDS IN BASELOAD (YEAR AHEAD) WHOLESALE ELECTRICITY PRICES AND HOUSEHOLD PRICE INCREASES SINCE SEPTEMBER 2004



4.3 Importance of fuel costs

The assessment shown at Table 4.1 suggests that average householder bills increased by 2.7p/kWh between 2004 and 2007. Generators fossil fuel costs increased by 0.69p/kWh over the same period, about one quarter of this level. While we do not know the commercial positions of individual companies, the shift away from gas to coal in the generation mix during 2005–06 and a subsequent reversal is a matter of record. It suggests that generators have managed their fuel requirements to minimise the impact on their costs, while at the same time prices paid by consumers have increased by an altogether different factor. This disparity between costs, prices and profits is illustrated at Table 4.1, and this issue needs to be investigated.

Table 4.1

AVERAGE HOUSEHOLD PRICES AND GENERATOR FUEL COSTS 2000–07

(p/kWh)	Average domestic bill (£)	Average domestic bill (p/kWh)	Calculated average fossil fuel cost for generation	Difference
2000	257	7.79	1.23	6.56
2001	245	7.41	1.36	6.05
2002	236	7.17	1.27	5.90
2003	230	6.98	1.30	5.68
2004	230	6.98	1.46	5.52
2005	251	7.59	1.84	5.75
2006	290	8.78	2.16	6.62
2007	320	9.68	2.15	7.54
Change 2007 on 2004	89	2.70	0.69	2.01

Base data from DTI with further calculations by Energywatch. Figures on costs of fossil fuel generation for 2007 are for the first nine months of the year only. Average domestic bill is UK-wide and for a standard supply of 33MWh on standard credit terms.

4.4 Carbon windfalls

The first phase of the EU Emissions Trading Scheme (ETS) commenced on 1 January 2005 for three years, and 1 January 2008 saw it move into its second phase. The ETS is a “cap and trade” scheme designed to reduce emissions of carbon dioxide emissions from major producers, including power generators. Producers must present enough allowances or permits every year issued under the scheme to match their emissions of carbon dioxide. Scheme participants received an allocation of these allowances based on their historic production at no cost while the basic principles of the new arrangement were tested. Allocations to generators have been cut back under phase 2 but still cover the majority of expected emissions. Individual generators have had to purchase extra permits at market rates to ensure their overall holdings which they surrender match their emissions.

But independent research¹⁶⁸ has highlighted the pass-through by generators into their wholesale selling prices of their full marginal costs of carbon, despite the significant free allocations. The authors suggested that this pass through was at levels “around the marginal intensity of coal plant, implying possible over-recovery of true marginal costs by the industry”. Further they suggested the combination of free allocations with full pass-through of marginal costs transferred approximately £800mn/year from UK consumers to power generators over the period 2005–07.

Historically, there has been minimal regulatory scrutiny of forward energy markets, even though Ofgem has recently acknowledged the windfalls being accrued through the full pass-through of carbon costs by generators. It went as far as suggesting that generators would make a further €9 billion windfall gain as a result of phase 2 of the EU ETS.¹⁶⁹

Energywatch thinks this pass-through underlines the ability of large, integrated players to disengage from the traded wholesale markets but to signal prices to retail consumers from a forward curve that reflects marginal costs to which they largely are not exposed. We are also perplexed as to how Ofgem can assert that markets are functioning properly when the marginal carbon cost is being charged in full despite extensive free allocations. It is also acquiescent to the full costs being passed through in transfer prices and be charged in full to retail consumers.

4.5 New environmental costs

On announcing their recent price increases a number of suppliers have drawn attention to the increasing costs they face of complying with the RO and the Cert (see Section 4.1.4):

- EDF Energy said “The doubling of the energy efficiency programme, now called the Cert will, cost our consumers up to £100 million per annum over the next three years”;
- British Gas said that the typical household consumer would be paying £31 each year of compliance costs for the Cert and £12 each year for the RO; and
- RWE Npower said: “The spend to meet the government’s energy efficiency targets (now called Cert) has doubled and Npower will be spending around £300 million on energy efficiency measures for consumers over the next three years”.

There is an increased commitment by suppliers for spending on energy savings with the Cert. But, the new scheme is not introduced until 1 April 2008, meaning that as the price changes announced by all three companies predate this point. So Energywatch is concerned that, by moving early, most of the Big Six suppliers will effectively have been charging their consumers the costs of a scheme that is not yet in force.¹⁷⁰ Likewise there is an increase of 9% in the cost to consumers of the RO that takes effect from 1 April, as a result of a higher target from that date although its impact on bills was at the time of raising prices for five of the companies much less marked.

5. BARRIERS TO EFFECTIVE RETAIL COMPETITION

Energywatch believes that levels of true competition in retail markets for gas and electricity is greatly exaggerated by British policy makers and regulators, and real distortions in the market are being ignored. This chapter addresses:

- our contention that there remains considerable regional market power;
- the dominating characteristic for suppliers to target certain types of consumer but not others;
- the limited usefulness of switching data as a measure of effective retail competition;
- arguments that factors other than costs are relevant in setting consumer prices; and
- barriers to competition in retail markets.

¹⁶⁸ *Implications of the EU emissions trading scheme for the UK power generation sector*, a report to the Department of Trade and Industry, IPA Energy (November 2005).

¹⁶⁹ *Ofgem press release*, February 2008.

¹⁷⁰ Scottish and Southern Energy will not, as their price rise came into effect from 1 April.

5.1 Domestic competition

A decade after the first household gas consumers gained the right to choose their supplier competition for domestic consumers remains strongly focused between the local electricity supplier—or rather in many cases the company that acquired that organisation—and the privatised successor of the British Gas Board. In the gas sector the same players monopolise the domestic market, and five of the same six companies have shares between 7–13%, with the largest supplier still retaining almost a 50% share.

With over eight years of competition in the domestic electricity markets, a similar picture applies. The latest published Ofgem figures at March 2007 show the Big Six have market shares between 12–22%, with relatively stable market shares.

The Ofgem figures are shown at Tables 5.1 (electricity) and 5.2 (gas) respectively. This snapshot of progress, most recently taken in June 2007 to reflect the position at end March 2007 and which we think is taken too infrequently in a volatile marketplace, suggests a picture of continuing retail market concentration.

Energywatch also believes this national overview conceals the unevenness of competition among different regions and consumer categories. Competition is sometimes not as vigorous and widespread as is claimed by Ofgem, and competition has not benefitted some consumer classes at all.

5.1.1 Regional markets

The domestic retail markets have strong regional characteristics, and the dominant players are the successor companies to the pre-liberalisation electricity and gas incumbents. Five of the six whose core business originated in electricity retain high levels of market share in their original licensed areas (“in-area”), with much lower levels of consumer success outside of these historic supply areas (“out-of-area”). And as we will see it is in these historic areas that they seek most aggressively to acquire new gas consumers.

The latest figures from Ofgem¹⁷¹ showed that in March 2007 in six of the 14 electricity supply regions in Britain the home supplier still holds more than half the market, and in some cases considerably more. Berr data also shows that in four of the 12 gas regions British Gas retained more than half of the consumers at the same date. Data comparing regional switching levels for both fuels is summarised¹⁷² in Figure 5.1.

Table 5.1

SHARES OF THE HOUSEHOLD ELECTRICITY MARKET

<i>Electricity</i>	<i>June 2005</i>	<i>September 2005</i>	<i>March 2006</i>	<i>March 2007</i>
British Gas	22%	22%	22%	22%
E.ON UK	21%	20%	20%	19%
EDF Energy	13%	13%	13%	14%
RWE npower	15%	15%	15%	16%
Scottish and Southern Energy	16%	16%	16%	18%
Scottish Power	13%	13%	13%	12%
Others	1%	1%	0%	0%

Source: Ofgem

Table 5.2

SHARES OF THE HOUSEHOLD GAS MARKET

<i>Electricity</i>	<i>June 2005</i>	<i>September 2005</i>	<i>March 2006</i>	<i>March 2007</i>
British Gas	53%	53%	52%	47%
E.ON UK	14%	14%	13%	13%
EDF Energy	5%	5%	6%	7%
RWE npower	9%	9%	10%	12%
Scottish and Southern Energy	9%	10%	10%	13%
Scottish Power	9%	9%	9%	9%
Others	0%	0%	0%	0%

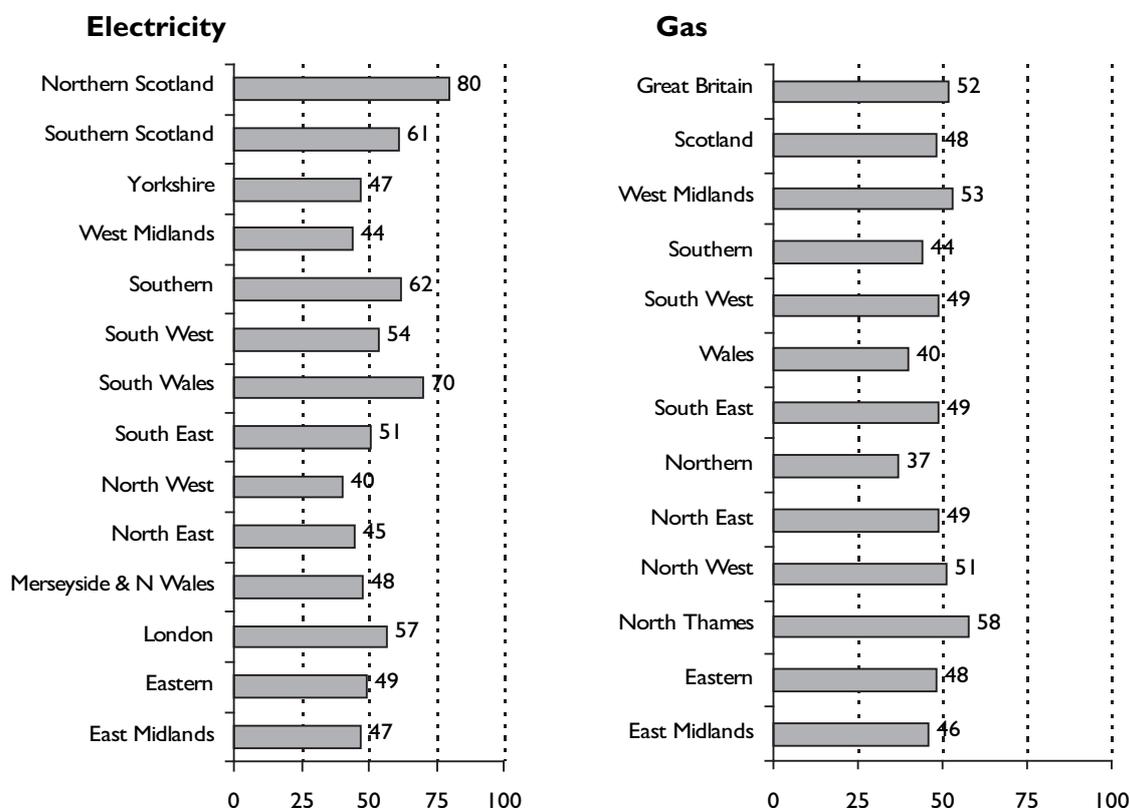
Source: Ofgem

¹⁷¹ Electricity data from Ofgem’s domestic retail market report March 2007. Gas data from Table 2.5.1: Percentage of domestic gas consumers by region by supplier type and Table 3.5.1: Percentage of domestic gas consumers by region by supplier type for the first quarter of 2007. *Quarterly energy prices* (December 2007).

¹⁷² Figures on retained market shares by historic incumbents are separately provided for direct debit, standard credit and prepayment terms but unfortunately not on an aggregated basis. We have derived the single regional figures for gas and electricity shown in Figure 5:1 from this data. Also, unfortunately, the gas and electricity supply regions reflect historic industry structures and are therefore not contiguous. However, we believe there is enough cross-over to make comparison between fuels valid and worthwhile.

Figure 5.1

PROPORTION OF CONSUMERS WHO HAVE NOT SWITCHED BY REGION—MARCH 2007



Source: Electricity—Ofgem March 2007. Gas—Berr figures with further calculations by Energywatch.¹⁷³

The information at Figure 5.1 highlights two further points:

- some areas of relatively low switching by electricity consumers are characterised by high switching of gas consumers. Examples include South Wales, Southern England and the North of Scotland. The owner of the three respective incumbent electricity suppliers is Scottish and Southern Energy; and conversely,
- some areas of relatively high switching by electricity consumers are characterised by low switching of gas consumers. Examples here are the West Midlands, North West and North East.

These two points would seem to underline the point that the main competitive dynamic is based around dual fuel (combined electricity and gas offerings) between the successors to the previous local state gas and electricity boards.

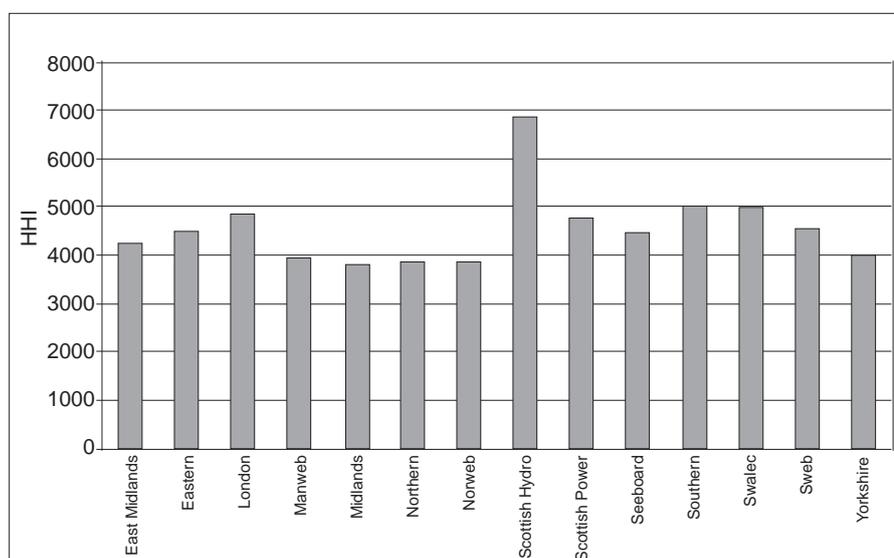
In Energywatch's opinion this situation does not indicate vigorous and healthy competition in a national market with multiple national suppliers. Rather it underlines the regional nature of household energy supply competition and the prevalence of strong legacy relationships.

If the electricity market was looked at on a regional basis, it remains highly concentrated. The published information at the regional level is current at April 2005, but it shows regional measures of market concentration are in the range 3,000–5,000 in all but one instance which is significantly higher, as illustrated at Figure 5.2. Analysis suggests the regional position has not changed significantly since.

¹⁷³ The Berr figures for electricity tend to overstate the degree of switching as they focus only on one licence, the "legacy PES", rather than all the licences traded by the major players. This is especially relevant to E.ON UK and RWE npower and using Berr data rather than Ofgem can lead to a significant understatement (up to 15% in some areas). For example, E.ON UK appears to add all new household accounts to its East Midlands licence even if they may be located in Eastern or the North West.

Figure 5.2

REGIONAL DOMESTIC ELECTRICITY HHIs—APRIL 2005



HHI refers to the Herfindahl-Hirschman Index, a commonly accepted measure of market concentration used by economists. It is calculated by squaring the market share of each firm competing in the market and then summing the resulting numbers. It therefore takes into account the relative size and distribution of the firms in a market and approaches zero when a market consists of a large number of firms of relatively equal size. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.

Markets in which the HHI is between 1,000 and 1,800 points are considered by the US Department of Justice to be moderately concentrated, and those in which the HHI is in excess of 1800 points are considered to be highly concentrated. Transactions that increase the HHI by more than 100 points in concentrated markets presumptively raise antitrust concerns under the Horizontal Merger Guidelines issued by the U.S. Department of Justice and the Federal Trade Commission.

<http://www.usdoj.gov/atr/public/testimony/hhi.htm>

The national values for the domestic electricity market has fluctuated between 1,700 and 1,800 since December 2002, and based on the latest Ofgem data was at just over 1,760 at March 2007.

The gas market does exhibit less of a regional definition of markets than electricity, but because of the focus on dual fuel propositions some of the regional marketing typical of electricity is shared with gas.

5.1.2 Consumer differentiation

Looking at pricing data routinely published on the energywatch website, there are a number of other noticeable factors as well as the prevalence of regional markets that suggest significant distortions have existed in the retail sector:

- competition remains most vigorous for direct debit consumers;
- in many cases some competing suppliers do not try to beat the incumbent price, with typically only one out-of-area supplier competing aggressively at any one time;
- prepayment consumers generally see the least good offers with wide differentials over direct debit and standard credit consumers, especially in gas;
- as we have noted incumbent prices for the non-traditional fuel are usually much more aggressively priced than for the traditional fuel, implying the incumbent can rely on retention despite not being the cheapest provider for its traditional fuel;
- two-tier pricing whereby a supplier will offer different levels of prices between in-area and out-of-area still seems to be prevalent despite the removal of the supply price controls, with some suppliers offering cheaper tariffs out-of-area than in-area; and
- some suppliers adopt specific regional strategies and sectoral strategies depending on their overall supply positions at any particular point in time.

For dual fuel accounts there have been relatively attractive deals for direct debit monthly payment consumers, though there are growing similarities in how suppliers price such deals as we see below. Consumers of both services have been able to shop around at the end of their deal, and it is estimated that multiple switchers of this consumer type account for over a quarter of the total switching in the market.

Even here in this relatively healthy segment of the market academic research suggests there are issues that require regulatory examination. Analysis by Richard Green noted in 2005 that 80% of those who switched move to a dual fuel deal, which tended to be at a lower price than buying the two fuels separately (as they should owing to saved account management and billing costs). However Green notes that “Typically a company will stress the low price it can offer for its non-traditional fuel, while avoiding the subject of the high price it is still charging as an incumbent. The low price in the non-traditional market may not leave much of a profit margin (which is not to say that it is actually predatory), but has the great advantage of helping to retain consumers in the traditional market, where margins remain much higher”.¹⁷⁴

But for others—effectively the rest but especially the fuel poor, other vulnerable consumers and those with prepayment meters—there is little real competition as emphasised by Ofgem’s call in 2006 for the Big Six to be lenient on post recalibration price changes. More recently, in late January 2008, the regulator used its review of debt and disconnection¹⁷⁵ to report that RWE Npower was a supplier whose “procedures for dealing with consumers in debt needed to be improved to bring them into line with best practice”.

5.1.3 Exaggerated switching levels

The health of the market is usually assessed by Ofgem by reference to switching data. Energywatch believes that disproportionate emphasis is placed on this measure, and the conclusions drawn from it can be misleading, not least because multiple switchers and mis-selling transfers are routinely included in the figures quoted.

In April 2007 when Centrica announced its second price cut Ofgem chief executive said “Consumers are firmly in the driving seat and over 600,000 switched in the first two months of [2007] alone”. But Ofgem’s own statistics can be read differently, and say:

- 85% of consumers did not use their right to switch energy supplier in 2006, a year during which the major suppliers levied multiple increases between them;
- switching only increased year-on-year marginally in the first seven months of 2007—the latest period for which figures are available—to 2.8 million households for electricity (compared with 2.6 million in the same period a year earlier) and 2.3 million for gas (compared with 2.2 million). This change occurred against a background of the first price reductions for many years by suppliers;
- research commissioned by the National Consumer Council found that 55% of consumers were unlikely to consider switching or re-switching in both March 2006 and March 2007; and
- nearly half of domestic consumers are still supplied by their incumbent electricity or gas supplier after over a decade of open markets.

Instead of taking account of this market fundamental and the evolution of an homogenous dual fuel market, the current regulatory focus centres on the number of switches by fuel (not switchers), despite the fact that significant numbers of consumers have still never changed supplier. Further academic research suggests that a large number of people who have not switched wrongly believe that the incumbent will reduce price to match competitive prices, which is erroneous.

And despite much publicity from the regulator, net switching levels have only increased slightly over the last three years of higher prices. BERR figures show 36% of direct debit consumers served by British Gas at September 2007, a reduction of seven percentage points in a year from 43%. Equivalent figures for electricity are 39% and 43%, a four percentage point reduction. These figures show much the rosier view of switching as a measure of competition. In contrast six in ten gas consumers on prepayment terms are served by British Gas, and for electricity incumbents retain a half of all these users. More than a half of those on credit terms for gas or electricity remain with their incumbents. We have argued for some time that these differences between types of consumer are significant and require much more focus by Ofgem.

5.1.4 Relative pricing

There is also plenty of comment from the City on retail markets and price movements, which tend to reinforce Energywatch’s interpretation of competitive activity in gas and electricity retail markets. In general its tone is markedly less bullish than the regulator’s about the vigour of competition. Recent comment has tended to highlight the limitations of price reductions last year and the controlled nature of opportunistic price increases this year, as well as the ability the suppliers will have to pass on to their other consumers the increased contribution to their social tariffs the Chancellor of the Exchequer asked them to make in the 2008 budget.

¹⁷⁴ *Dual fuel competition in the British energy retail markets*, Richard Green, then of University of Hull Business School, May 2005.

¹⁷⁵ *Ofgem press release* (January 2008).

Back in February 2007 when limited price reductions were levied Merrill Lynch commented, “In our view, the recent price cuts do not constitute a price war. The magnitude of competitor reductions across all tariffs will depend largely upon each company’s forward hedge position in wholesale gas and power, and the assumed desire to repair retail margins, particularly in gas”.

Citigroup greeted EDF Energy’s cut in gas prices (levied on 15 June but announced six weeks earlier on 30 April) with the comment: “The UK supply companies are acting as we expected, with price reductions such as EDF Energy’s merely bringing them in line with the rest of the sector. We argued that the likelihood of a price war as wholesale energy prices fell was remote. This is because the vertically-integrated generator/suppliers need to rebalance their profits so that they earn sufficient returns from supply to make up for sharply falling generation profits this year compared to 2005 and 2006”.

And UBS’s opinion on the last company to reduce prices in 2007 was that “While price cuts will reduce the profitability of Scottish Power’s supply business, at this point in time, we don’t see evidences of a ‘price war’ between suppliers, but rather evidence of an ordered and disciplined market”.

More recent pricing developments have also attracted comment that highlights limits on competition in the market-place:

- “the generator/suppliers such as RWE no longer have the luxury of bumper generation profits to cushion retail price increases . . . the industry as a whole will be seeking to ensure reasonable levels of profitability from supply”; Citigroup 4 January 2008;
- moreover, the media attention has for once focused elsewhere “this time round Centrica was actually the third company to increase prices, and only Scottish and Southern Energy has [to that point] resisted raising its prices. Therefore there is currently no material price difference between Centrica and four its competitors”; Citigroup 19 February 2008; and
- “the government has asked the companies to work with Ofgem to ensure that prepayment consumers, who pay higher bills, get a fair deal [in the 2008 budget]. This will inevitably be a negotiated compromise. But even in the worst case, if the supply industry equalized tariffs, this cost could be recouped with a 1–3% tariff increase”; Morgan Stanley 12 March 2008.

These observations are from a class of stakeholder that tend to be better informed than most.

They are further backed up by the recent prices set by retailers in their core focus market, dual fuel consumers on direct debit terms, as shown at Table 5.3. The difference between the highest and lowest dual offers of the Big Six is just £48 on a typical spend of £1,000 or so, with five of the Big Six being bunched within a £13 band.

Table 5.3

COSTS OF DUAL FUEL OFFERS AT 1 APRIL 2008—GB AVERAGE, DIRECT DEBIT TERMS FOR A MEDIUM USER

<i>Dual Fuel—Medium User</i>	<i>Scottish Power</i>	<i>EDF Energy</i>	<i>British Gas</i>	<i>E.ON UK</i>	<i>RWE Npower</i>	<i>SSE</i>
Average direct debit	£971	£1,010	£982	£999	£1,014	£966
Average standard credit	£1,111	£1,035	£1,070	£1,063	£1,056	£1,024
Average PPM	£1,062	£1,045	£1,144	£1,097	£1,126	£1,068

Source: Energywatch

It is no surprise then that some stakeholders believe there is a strong case to be answered by the Big Six with regard to tacit collusion.

5.2 Business consumers

There are similar trends in concentration and discretionary competition in the business sector as in the domestic sector. Five of the Big Six plus British Energy emerge as the most important suppliers. According to Elexon data, Gaz de France Energy Supply Services is the only supplier with a non-privatised industry heritage to hold a volume share of the electricity market in excess of 2%, although there are a few niche providers with shares below that level. There has been broad stability in shares amongst the major players in the business sector since the failure and withdrawal from the market by Maverick Energy and Atlantic Gas and Electricity in 2004.

In fact in the business markets scarcely 2% of power volume is supplied by operators who do not own at least one major power station. Consumers in the business sector are also suffering because the regional nature of competitive energy markets often limits their choice of supplier, and it is commonplace for many smaller business consumers to receive few offers at renewal. Despite this business users have traditionally been deemed commercially aware enough not to require the specific protections in place for household consumers.

But many small businesses in particular have a low level of knowledge of the opportunities open to them from energy supply competition, especially when the use of different brands by some of the major suppliers can confuse, leaving them with the perception that there is more competition in the market than is actually the case. They also have difficulties obtaining and evaluating offers from competing suppliers, given a perceived non-comparability of terms and a general lack of transparency. Energywatch pushed hard for—and therefore welcomes—the provision for redress schemes to cover micro-business as well as household users.

In November 2004, because we were concerned that the state of business markets was being neglected by the regulator, Energywatch published a major report on business energy supply markets in Britain.¹⁷⁶ This report noted that supplier activity varied by sector and by negotiating round, and there will strong regional characteristics in these markets. It also highlighted the need for much more structured and routine information gathering on the health of these markets, which we concluded was worse than regulatory statements suggested.

Many of the comments we made then still apply today. At various times since some of the major suppliers have made plain the terms on which they wish to compete, if at all, in competitive business supply markets. Two examples underline this point. E.ON UK posted a 20% year-on-year reduction in gas sales to industry to 30 September 2006 reflecting “a focus on margin rather than volume”. Separately, Scottish Power’s chief executive Philip Bowman talked of “deliberately constraining” the growth of his company’s supply business in December 2006 because of its being “loss-making when measured against current wholesale prices”.

We believe these examples reflect the market power held by suppliers in the current trading environment. They can choose the extent to which they wish to engage with consumers, which cannot be conducive to the health of the sector.

5.3 *Lack of innovation*

Despite some signs of development around micro-generation, there is also a lack of innovation from six large, slow-moving corporations more intent on retaining their powerful regional franchises rather than seeking to develop new opportunities. Such innovation as there has been to date from the Big Six, like wholesale price tracker offerings and online tariffs, is tinkering around the edges and are unexceptional changes in rapidly changing markets.

Major opportunities to deliver consumer benefits are being over-looked or ignored. Areas where much greater activity should be expected include:

- energy savings through more efficient use facilitated by a large-scale roll out of smart metering. Most consumers will still have to wait several years for real activity even if the regional franchise proposal sponsored by the Energy Retail Association¹⁷⁷ is implemented;
- the offer of time-of-use tariffs; and
- the development of energy savings services and stimulation of micro-generation to improve supply security and reduce emissions by cutting demand on the public network.

Whilst Energywatch notes with interest the recent launch of British Gas New Energy and other recent energy service initiatives by some of the Big Six, we remain concerned that these companies see the delivery of the low carbon agenda in terms of big supply-side projects in which only they can invest profitably. We think they are neglecting low cost, innovative demand-side measures that can reduce emissions quickly and without significant capital expenditure.

Although some opportunities have been pursued, these are through a facilitated regulatory framework and not through genuine commercial innovation. The Big Six talk of low carbon being at the heart of their businesses but only take actions when there are strong financial incentives, such as through the Cert and the RO. The energy services market has also failed to take off, and progress with smart metering remains fitful, with the companies looking to government to mandate outcomes so they can in effect recover their costs (either developmental or stranded).

At the same time, while individual supplier performance can vary, the energy supply industry as a whole is not good at billing its consumers and administering contracts. This situation prevails despite the “super-complaint” made by Energywatch in 2004, and can unfortunately lead to heavy-handed treatment of consumers who often correctly question erroneous bills. This treatment also acts as a general inhibitor of consumers exercising their right to access competitive markets. Mis-selling has also proved an issue for some consumers and, once they suffer from it, the experience can deter their participation in the competitive market-place.

¹⁷⁶ *Energy business markets report.*

¹⁷⁷ *ERA briefing note.*

5.4 *Barriers to entry in retail markets*

At the same time the costs of new entry, including accreditation, are significant and timescales protracted, so existing players have limited incentives to change how they approach the market because there is no credible competition. More importantly their influence is now such that they can also dictate the terms on which they will change.

Recent years have seen a number of new licences come forward in the gas sector, especially in conjunction with the significant development and expansion that has occurred in new gas infrastructure. Many of these entrants are focussed on wholesale trading or are financial traders, and it is noticeable that there has been virtually no new entry into domestic supply.

The position in the electricity sector is much worse. Apart from some traders few new parties have engaged in physical supply at wholesale or retail level. As we noted in chapter 3, despite the wholesale price collapse in from summer 2006, there has been minimal new activity in the electricity supply markets despite text book, supporting conditions.

There are a number of factors that have contributed to this, including:

- the complexity of the central trading arrangements and the costs of entry. Registration, transfer and reconciliation processes are all very complex, and dependent on complex systems and extensive rules;
- the problems we have identified arising from dysfunctionality in the wholesale markets, especially electricity and their illiquidity, and the risk of exposure to penal cash-out prices;
- credit is a significant problem with multiple calls across industry codes and trading structures; and
- the economies of scale and the market power of the Big Six, which have become mutually reinforcing.

There are particular issues that bite in the business markets. The regulator has failed to tackle anti-competitive behaviour by acting slowly to counter the blocking of a transfer by incumbents reoffering on notice of a transfer. More importantly the regulator has stood by as the all incumbent suppliers rewritten their supply terms in ways designed to make customer switching much more difficult. This combination of circumstances, combined with the great information advantage the suppliers hold over their small business customers, cedes significant market power to the incumbents who are able to target their activity on potential switchers at a cost funded by their wider customer base.

6. FAILINGS OF REGULATORY OVERSIGHT

This chapter looks at the evolution of engagement by regulators over the gas and electricity sector, focussing on responses by Ofgem since the lifting of price controls on the supply markets.

6.1 *Consolidation by default*

The regionalised nature of household energy supply competition is a direct function of the evolution of the Big Six through corporate transactions rather than direct competition for consumers. None of the transactions that created the Big Six has been properly scrutinised by the competition authorities even though there has been significant erosion in competition. For example no objections were raised by Ofgem as the sectoral regulator when a scale player—TXU—failed in 2002 and its 5.5 million consumers were acquired by E.ON UK. More recently Scottish Power has been acquired by Iberdrola, and rumours suggesting that further takeovers or mergers are in the offing are commonplace within the sector.

The parliamentary Public Accounts Committee warned in 2003 that Ofgem should take seriously the risk that vertically integrated companies may exploit their position, and Ofgem “should adapt its competition analysis of the wholesale market and the retail markets to reflect the new reality of the market”.¹⁷⁸ Despite this, there have been no studies of the implications of this reintegration, either in terms of the retail market impacts or the state of wholesale trading (or the interactions between the two). The pervading feeling among consumer groups is that our regulators have failed to act.

This position has given rise to a situation where large incumbent players enjoy strong market power and where many consumers choose not to switch possibly because of the time and cost issues. It enables all suppliers to price tactically often at premium rates in some areas for some domestic consumers in the full knowledge that they will retain many of them. In business markets, particularly for those consumers with non-standard load and/or multiple sites, it is frequently difficult even after complex and costly approaches to suppliers for consumers to see aggressive offers. Multi-site consumers with non half hourly meters can find it particularly difficult. This situation on the ground by no means reflects the vigorous or effective competition that our policy makers and regulators set out to achieve and whose existence they often invoke.

Against this backdrop levels of transparency and regulatory reporting are minimal and inadequate.

¹⁷⁸ *The new electricity trading arrangements in England and Wales*, Second report of session 2003–04, House of Commons Public Accounts Committee (1 December 2003).

6.2 *Minimalist oversight of supply*

Traditionally, as an important part of the process of setting supply business price controls for each company, Ofgem exercised a thorough—some would say intrusive—supervisory role over both gas and electricity supply businesses. It routinely gathered information on costs, performance and returns for a period of more than three years after the remaining supply franchises were removed and after the sector was opened to full competition. As part of this oversight process the regulator would routinely check the allocation of wholesale purchase contracts against different consumer classes to ensure that consumers with less choice were not treated in a discriminatory manner.

Controversially the remaining price controls were lifted in April 2002, as Ofgem believed—though many disagreed—that retail markets were sufficiently competitive to permit this. But areas identified as potentially problematic for consumers at the time the decision to end price control, especially the treatment of prepayment meters and consumers in Scotland with teleswitching, have not been addressed properly although six years have since passed.

Since 2002 Ofgem has produced occasional reviews on the state of competition, which have tended to focus almost exclusively on national switching levels. Its most recent analysis from June 2007 is on the domestic market and based on data as at end March 2007 and is nearly one year old. It has not issued any analysis on the business markets since summer 2003.¹⁷⁹

6.3 *Defending the incumbents*

Ofgem has periodically addressed aspects of market operations, especially the wholesale price spikes that have been a recurring feature of the British markets since October 2004. The main thrust of its analysis has been:

- to point to supply limitations and competitive bottlenecks on the continent; and
- to attribute price excursions to “market sentiment”.

In response to dissatisfaction among some politicians and stakeholders over suppliers’ resistance to curbing prices after the collapse in oil prices from mid 2006, Ofgem maintained that it was examining supplier behaviour but that competition was fundamentally vigorous and effective. No hard analysis was presented to substantiate these claims beyond generalised, high-level switching data.

On 8 February 2007 the regulator described British Gas decision to cut prices in March that year as “the first shot in what Ofgem expects will be the start of another battle for consumers” It also went to some lengths to explain what it described as the lag between wholesale and retail price falls as being helpful to suppliers in delivering supply security.¹⁸⁰ It also introduced the concept of “full cycle” costs, which seemed to be short-hand term for allowing suppliers to over-recover from consumers at times of lower wholesale prices.

At the time there was plenty of independent comment that contradicted Ofgem’s view, as the following examples illustrate:

- “press reports of a price war among UK energy suppliers are, in our view, misleading. While the industry no doubt welcomes the publicity the price cuts actually announced so far by Powergen [initial new online offers] and Npower are the minimal reaction we would expect to see in response to Centrica’s new tariffs”; Citigroup comment 19 February 2007;
- “in our view, the recent price cuts do not constitute a price war. The magnitude of competitor reductions across all tariffs will depend largely upon each company’s forward hedge position in wholesale gas and power, and the assumed desire to repair retail margins, particularly in gas”; Merrill Lynch comment 19 February 2007; and
- “The reductions result in Npower being marginally cheaper than British Gas (Centrica) on average, although in their original franchise areas, we believe they will be marginally more expensive. Although this has been trailed as an intensification of a price war, we disagree. We see it as further evidence of the disciplined nature of the market, given that Npower has moved prices to almost in line with Centrica. We would expect others to follow suit over the next few weeks”; UBS comment 19 February 2007.

And with the launch of its latest price probe inquiry on 21 February 2008 Alistair Buchanan, the chief executive of Ofgem, said “We, of course, keep the market under constant surveillance but to date we have seen no clear evidence that the market is failing.” Again there was no analysis presented in support of these statements.

energywatch finds it extremely disconcerting that the industry regulator—whose primary duty is the protection of consumer interests—should be making the case for energy suppliers’ price movements. We also find it disingenuous for the regulator, as it often does, to represent prices from the wholesale forward curves as representative of suppliers costs when the leading players are significantly integrated. It has itself

¹⁷⁹ It requested views on the market in November 2005, but took no tangible steps as a consequence subsequently. The earlier review is *Review of competition in the non-domestic gas and electricity supply sectors. Initial findings* (July 2003).

¹⁸⁰ *Ofgem press release* (February 2007).

highlighted the ability of upstream electricity producers to earn windfall gains both in the past and, more recently, going forward.¹⁸¹ In fact we would say its is mutually inconsistent for the regulator to highlight this practice and then assert retail markets—which are the means of recovering these arbitrary costs from consumers—are properly competitive, as it has done consistently over the past three months.

We fear there is a significant gap between the reality of the market and the regulator’s rhetoric.

6.4 *Dangers of self-regulation*

The industry left to its own devices has a very mixed record. The scandal of mis-selling earlier in the decade saw many consumers switched fraudulently and without their knowledge. Further many consumers have found that as reflected in continuing high levels of complaints the service they receive has deteriorated irrespective of whether they have switched.

Regulatory moves to improve the situation for consumers have been dominated by Energywatch, rather than Ofgem, as the following examples illustrate:

- we launched our “Stop now” campaign in January 2002 to cut out mis-selling. This ultimately led to an industry code of practice,¹⁸² which has substantially reduced the problem;
- in June 2003, we were instrumental in creating the consumer transfer programme, an energy industry-wide initiative to improve the switching process for consumers,¹⁸³ and
- in 2003 we launched a “Better billing”¹⁸⁴ campaign to highlight our growing exasperation with the harm such practices were causing consumers, and minimal attempts to address them prompted us to raise a billing super-complaint,¹⁸⁵ which has led to the establishment of a billing ombudsman by the industry.

Whilst we acknowledge that significant efforts have been undertaken by the industry to address these issues once they have been escalated, a common theme emerges which causes us great concern. It is other organisations that have highlighted these consumer issues and prompted the regulator to become involved in some action. Moreover, and despite its recently announced “Consumer first” initiative, we detect in its activities a worrying tendency from Ofgem to keep itself distant from real consumer issues and leave them to others. There is also a worrying tendency for Ofgem to put the onus on energy suppliers to resolve the issues once they have become fixed in the media spotlight.

Even though Ofgem may believe it is practising “light touch” regulation, we believe this disengagement is creating poorer conditions for consumers and will leave significant legacy issues once Energywatch is disbanded. Any arguments that the energy ombudsman scheme is a good example of self-regulation are also, in our opinion, undermined because it was action by an outside body, in this case Energywatch raising the super-complaint, which prompted the scheme to be developed.

Recent statements from the regulator have highlighted the merits of increasing self-regulation within the industry, seemingly as a consequence of managing its own costs following the self-imposition of a RPI-X control on its costs. energywatch sees this as a worrying tendency given Ofgem track record of reluctant engagement and its readiness to act as an apologist for the Big Six.

7. CONCLUSIONS

There is now a growing body of evidence that shows competition is less robust in Britain than generally asserted by regulators, and this publication has synthesised some of the arguments and evidence. This chapter summarises the main reasons why energywatch firmly believes that energy markets are failing British consumers, why the sectoral regulator is not responsive to these problems and why there must be a referral to the Competition Commission. Ultimately the enjoyment of higher gross switching rates means little when there is no effective competition for many consumers and where the Big Six can exert significant influence over the prices they offer.

In this publication energywatch has identified a range of significant deficiencies and questions that require urgent consideration. We believe the various questions that follow should form the basis of a referral to the Competition Commission under its Enterprise Act powers.

¹⁸¹ *Ofgem press release* (February 2008).

¹⁸² *Energywatch press release* (3 June 2003).

¹⁸³ *Energywatch press release* (11 June 2003).

¹⁸⁴ *Energywatch press release* (13 May 2003).

¹⁸⁵ *Energywatch Better billing referral* (May 2005).

7.1 Wholesale market failings

It is clear that the wholesale markets in both gas and electricity share many of the characteristics identified by the European Commission in its recent critique of Europe's energy markets. The British market has a much longer record of liberalisation than virtually all of our continental counter-parts, but this should not obscure a critical appreciation of how our own wholesale markets are working.

Energywatch believes there is sufficient evidence to suggest these markets, especially the wholesale electricity market, is operating in a way that should deeply concern policy makers and regulators. These concerns are amplified given that the Big Six use the forward curve as the basis of pricing through the supply chain.

We have identified several questions with regard to the operation of the wholesale market that require further scrutiny, including:

- have levels of vertical integration gone “too far” and is the resulting industry structure materially undermining competition in wholesale markets;
- what characteristics define liquid wholesale markets and what are the impediments to their realisation in Britain;
- have independent generators and smaller suppliers been forced out of the market or are they facing unfair access as a result of the operation of the wholesale markets;
- do suppliers with electricity generation or gas production interests, or with long-term contracts with independent generators and gas producers, have excessive information and control over the market; and
- does the operation of cash-out mechanisms in gas and electricity aggravate problems of fair access, unnecessarily increasing risk and barriers to entry?

7.2 Market linkages

The incumbents' recent argument that they individually have been exposed to the same increases in costs derived from market prices is incorrect, and access to in-house production and legacy contracts mean that they are shielded from significant elements of the recent wholesale cost increases. In some cases such as new environmental costs these costs are being passed through ahead of the point at which these costs fell on suppliers. The practice of basing tariff increases and contracts price offers on forward prices has greatly exaggerated consumers' prices and resulted in windfall profits being earned by upstream activities in both generation and gas production, in addition to those already acknowledged to arise from carbon trading.

We have identified several questions with regard to the interaction of wholesale and retail markets that require further scrutiny, including:

- do the pricing policies of the Big Six enable excessive production and generation profits to be passed through the supply chain to de facto captive consumers through retail tariffs;
- what transfer prices are used in internal transactions between upstream and downstream businesses;
- to what extent are the Big Six exposed to market prices;
- to what extent are large suppliers misrepresenting wholesale and environmental costs in their retail prices;
- do suppliers have the ability to earn exaggerated margins through their supply businesses as a consequence; and
- what constitutes a reasonable level of margin in retail markets?

7.3 Retail market failings

The retail markets are dominated by a small group of scale utilities sustaining their businesses up the supply chain through strong revenues from a predominantly regional consumer base that has many de facto captive consumers. These players pursue essentially similar pricing strategies in the knowledge that there is little realistic threat of competitive entry. This characteristic is illustrated by the similarity in pricing to key target consumers despite different costs. It appears that the primary purpose of the supply business of the Big Six suppliers is to provide a route to market for their in-house generation.

Further competition in regional markets for gas and electricity consumers is not as vigorous as national measures suggest, with multiple switchers swelling the headline statistics. There is still a lack of real choice for many consumers outside of dual fuel, direct debit consumer propositions, especially for those who are vulnerable or are on lower incomes, and they continue to be disadvantaged in relative terms.

Innovation has been constrained and that the development of advanced metering and energy services remains largely dormant. Service is below standard, with billing proving obdurately inaccurate sustaining high levels of disputes.

Barriers to market entry prevent any realistic competitive threat emerging in the retail markets to a comfortable oligopoly, especially in the domestic markets. Consumers are paying for that lack of diversity through higher prices than necessary. There is also a noticeable lack of differentiation between the large suppliers. With all of them moving their prices typically within a few weeks of each other and by similar degrees, the effect on consumers eventually is very similar—higher bills.

We have identified several questions relating to the retail markets that require further scrutiny, including:

- how vigorous is competition at the local level and by consumer type;
- is there evidence of tacit collusion in price setting;
- how should effective retail competition be defined and what criteria should be applied in assessing competition in these markets;
- why is new entry especially in electricity not occurring on any scale despite volatile commodity prices;
- do complex licensing, code requirements and centralised trading arrangements effectively impose a barrier to entry; and
- if so, how can they be simplified?

7.3 *Failings in regulatory oversight*

Throughout the turbulence of the last four years Ofgem has been complacent at best and negligent at worst. It has consistently refused to consider taking steps to investigate energy utility prices and profits. It makes too many generalisations about the state of competition based on the market for direct debit dual fuel consumers and high-level gross switching data. It fails to recognise prices across the board are artificially high. It relies on the possibility of new entry to act as a constraint on abusive behaviour by suppliers, but it oversees industry codes that in energywatch's view constitute a significant barrier to entry in the domestic markets. It has belatedly and reluctantly agreed to conduct a price probe into supply markets but has done so grudgingly, and still insists there is no evidence that markets are not working properly.

energywatch welcomes the focus of the Business and Enterprise Committee on the effectiveness of regulation of the gas and electricity sector, and we believe in many important respects Ofgem's exercise of its brief has been inadequate, aggravating the detriment caused by the high and volatile consumer prices. We believe Ofgem is failing in its duty to consumers because its views of the markets it regulates are partial, and it is unwilling to engage in real consumer issues. Its publication of analysis on the sector is sporadic and narrowly focussed. Its developing role in Europe is encouraging it in its selective view of the British market, and its preoccupation with reform on the mainland is also increasing the distraction of resources it deploys away from its key activity. We would like to see a much more lucid focus by the regulator on the pattern of competitive activity and its distribution among different types of consumer.

Moreover, the regulator is actively promoting what it believes to be a light touch regime and putting increasing emphasis on the companies it oversees to regulate important aspects of their own affairs, which can only worsen the consumer position as energy suppliers control more and more of their own conduct.

We have identified several questions relating to the performance of Ofgem with regard to oversight of electricity and gas markets, including:

- what on-going surveillance of these markets is carried out;
- what is an acceptable standard and how can market reporting and transparency be improved; and
- how can regulatory accountability with regard to market surveillance and reporting be improved.

7.4 *Remedies*

There are various available policy remedies, all of which we believe have differing degrees of merit. The principal ones include:

- disclosure of trading information: companies above a defined size that have both production and supply interests should be compelled to disclose and publish sufficiently disaggregated information so that stakeholders can see what real trading is occurring and at what prices. All the major suppliers should report segmented financial and operating data about their electricity and gas production and retailing operations to a robust and explicit standard that Ofgem should develop, with clear information being recorded on the returns made by individual activities, but especially gas and electricity supply;
- regulatory reporting requirements: there needs to be greater regulatory scrutiny of purchase costs to ensure that only costs which companies can demonstrate that they are actually incurring should be capable of pass-through. This scrutiny has been part of the British regulatory regime previously and we think it should be reinstated;
- mandatory trading: producers and generators could be required to trade a defined level of out-put with non-affiliated entities. An alternative mechanism would be to reimpose the self-supply limit that used to be enforced by the generation licence;

- simplifying market rules and entry requirements: the current market rules are presently fragmented but very complex. A fundamental make-over is required if smaller, low carbon operators are to be able to access markets and consumers fairly;
- supply price control: the reintroduction of direct supply price controls to protect consumer interests should be seen as a last, though possibly necessary, resort. We think the scale of the current market failure is such that only a period of direct supply price controls may be necessary to rebuild consumer confidence in competitive energy markets; and
- ultimately, if other measures are considered insufficient, divestment of plant or function.

APPENDIX 1

PRICE MOVEMENTS BY THE BIG SIX SINCE 2004

<i>(%)</i>	<i>Electricity</i>	<i>Gas</i>	<i>Effective Date</i>
E.ON UK	0.0	3.1	6 Sep 2004
EDF Energy	3.8	3.5	13 Sep 2004
British Gas	9.4	12.4	20 Sep 2004
RWE Npower	7.6	11.8	1 Oct 2004
Scottish Power	8.0	11.8	4 Oct 2004
E.ON UK	8.9	9.6	29 Nov 2004
EDF Energy	5.4	8.1	17 Jan 2005
Scottish and Southern	6.7	9.1	1 Mar 2005
Scottish Power	0.0	2.6	1 Apr 2005
EDF Energy	12.0	10.7	5 Aug 2005
E.ON UK	11.9	7.2	31 Aug 2005
British Gas	14.2	14.2	19 Sep 2005
Scottish Power	12.0	5.0	17 Oct 2005
Scottish and Southern	8.9	13.6	1 Jan 2006
RWE Npower	12.0	13.7	1 Jan 2006
Scottish Power	8.0	15.0	1 Mar 2006
British Gas	22.0	22.0	1 Mar 2006
E.ON UK	18.4	24.4	10 Mar 2006
EDF Energy	4.7	14.7	13 Mar 2006
RWE Npower	13.4	15.0	31 Mar 2006
Scottish and Southern	9.4	16.5	1 May 2006
Scottish Power	10.0	17.0	1 Jul 2006
EDF Energy	8.0	19.0	31 Jul 2006
E.ON UK	9.7	18.4	21 Aug 2006
British Gas	9.4	12.4	1 Sep 2006
RWE Npower	9.9	17.2	1 Oct 2006
Scottish and Southern	9.4	12.2	1 Jan 2007
Scottish and Southern	- 5.0	- 12.0	1 Mar 2007
British Gas	- 11.0	- 17.0	12 Mar 2007
British Gas	- 6.0	- 3.0	26 Apr 2007
RWE Npower	- 3.0	- 16.0	30 Apr 2007
E.ON UK	- 5.0	- 16.0	30 Apr 2007
EDF Energy	0.0	- 10.6	15 Jun 2007
Scottish Power	- 5.5	- 16.5	15 Jun 2007
RWE Npower	12.7	17.2	4 Jan 2008
EDF Energy	7.9	12.9	18 Jan 2008
British Gas	15.0	15.0	18 Jan 2008
Scottish Power	14.0	15.0	2 Feb 2008
E.ON UK	9.7	15.0	8 Feb 2008
Scottish and Southern	14.2	15.8	1 Apr 2008

APPENDIX 2

EXITS FROM THE LARGE GENERATION MARKET SINCE 2000

<i>Plant type/name</i>	<i>MW</i>	<i>Tech</i>	<i>Seller</i>	<i>Purchaser</i>	<i>Date</i>
Sutton Bridge	790	gas	Enron	EDF Energy	Mar 2000
Corby 2	350	gas	Dominion	Powergen	Sep 2000
Humber Power	1,260	gas	Consortium	Centrica, Elf	Jun 2001
Peterborough/Kings Lynn	705	gas	TXU	Centrica	Aug 2001
Ferrybridge	2,000	coal	Edison Mission	AEP	Oct 2001
Fiddlers Ferry	2,000	coal	Edison Mission	AEP	Oct 2001
West Burton	2,000	coal	TXU	EDF Energy	Nov 2001
Brigg	240	gas	IVO Energy	Centrica	Jun 2002
Roosecote	229	gas	Receivers (formerly owned by Lakeland Power)	Centrica	May 2003
Barry	240	gas	AES	Centrica	Jul 2003
Medway	700	gas	AES/EDF	Scottish and Southern Energy	Oct 2003
Fife	120	gas	El Paso	Scottish and Southern Energy	Feb 2004
Damhead Creek	800	gas	Banks (formerly owned by Entergy)	Scottish Power	Jun 2004
Killingholme	660	gas	Banks (formerly owned by NRG)	Centrica	Jun 2004
FFF	4,000	coal	Banks (formerly owned by AEP)	Scottish and Southern Energy	Jul 2004
Shoreham	200	gas	AEP	Scottish Power	Sep 2004
Enfield	392	gas	NRG	E.ON UK	May 2005
Saltend	1,200	gas	Calpine	International Power	Jul 2005
Yarmouth	420	gas	BP	RWE Npower	Oct 2005
Drax	4,000	coal	Banks (formerly owned by AES)	flotation	Dec 2005
Teesside Power	1,800	gas	Teesside Power Ltd	Gaz de France/Suez	Feb 2008

APPENDIX 3

EXITS FROM THE SUPPLY MARKETS SINCE 2000

<i>Supplier</i>	<i>Date</i>	<i>Comment</i>
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	Reported to be letting gas supply contracts lapse rather than renew.
Team Group	2005	Administration. Contributed to Utility Link failure. Customers to EDF Energy.
Egni	2005	Administration. Contributed to Utility Link failure.
Utilita	2005	Managed transfer of customers to EDF Energy.
Eledor	2005	Administration—licence revoked. SOLR invoked with customers to Npower.
Reepham	2005	Administration—licence revoked. SOLR invoked with customers to British Gas.

<i>Supplier</i>	<i>Date</i>	<i>Comment</i>
Utility Link	2006	Administration—licence revoked. SOLR invoked with customers to EDF Energy.
Greenwich Energy	2006	Administration. Customers to EDF Energy
Zest 4	2006	Administration—licence revoked. SOLR invoked with customers to British Gas.
Telecom Plus	2006	RWE takes customers and acquires call option on 29% share of Telecom Plus.

April 2008

Further supplementary evidence by energywatch

COMPETITION REPORT ON THE GB GAS AND POWER MARKETS

AN ENERGYWATCH DISCUSSION PAPER

1. EXECUTIVE SUMMARY

Research by energywatch has uncovered evidence showing systematic uncompetitive behaviour in the wholesale gas and electricity markets. The last four years have seen gas producers and power generators increasingly bypass their open, forward markets in favour of off-market long-term contracts. The resulting impact on wholesale market competition was cited as a recurrent problem by a majority of the 45 industry respondents we spoke to. Electricity buyers had complained of generators spurning the forward power exchange whilst a recently growing number of gas buyers reported a similar pattern evolving in the behaviour of gas producers, who have essentially “boycotted” the long-dated wholesale market when it comes to delivering gas in very large volumes.

The role played by off-market transactions has significantly reduced liquidity in both forward markets. This has restricted competition in the wholesale gas market and almost cancelled competition completely in the power market. The suppression of liquidity has induced a vicious circle of deteriorating price transparency and higher volatility, preventing market-makers from entering the market and thus lower liquidity still.

Ultimately the wholesale market becomes so susceptible to significant long-dated buying activity and bereft of trustworthy forward prices which buyers can lock into (or hedge against) that they find themselves having to enter into costly “off-market” deals (such as so-called “flexible contracts”) with the same producers or generators whose off-market trading policies caused liquidity to shrink in the first place. Another response has been for buyers to buy a financial swap from a merchant bank. However, such price insurance introduces its own new cost and this rises with increasing volatility in the underlying wholesale market. Whichever way buyers seek to mitigate the liquidity problem, an additional layer of commission is involved which is ultimately borne by the end-user.

Mergers and acquisitions among gas producers and vertically-integrated generators, combined with the exit of US merchants from 2003, had combined to altar the competitive structure of the GB markets. In our research, we found that today’s market incumbents have *collectively* curtailed their over-the-counter trading activities in their forward markets. Instead of selling volume on a forward basis in the wholesale market, producers and generators have increasingly made long-dated deliveries only possible on off-market “long-term contracts” or via “flexible contracts”. Both these contracts are non-standard and not generally re-tradable; they also keep all transaction prices and related energy volumes secret from the marketplace. This practice was widely believed to have significantly reduced transparency in the forward market. It has also caused liquidity levels to fall further still as new entrant traders, merchant generators, independent suppliers and industry buyers found themselves effectively “shut out” of the forward market. The “market exit” and “non-entry” of these players has caused liquidity to decline further and this cycle is essentially self-reinforcing. This has increased volatility in both prompt prices and especially in *long-dated* prices posted out on the forward curve. Consequently, market volatility has reached unprecedented levels and it has risen in unison with the higher forward prices posted by producers and generators.

Wholesale prices are being driven higher still as the higher volatility is being used to justify higher “risk premiums” for selling on a long-dated basis, whether the volume is supplied on the wholesale market or, increasingly, under “long-term contracts” or under “flexible contracts”. Energywatch calculates that the resulting *increase* in the risk premium *alone* has increased long-dated wholesale gas and power prices by around 15%.

Another competition-distorting impact identified was the regime of oil-price indexation in long-term gas contracts. The effect of fixing gas prices to oil also rolls onto the power market since gas sets the marginal generating cost in winter. Oil prices, directly or indirectly, were found to dictate final long-term gas prices.

An underlying long-term gas contract now covers almost 90% of all supplies into the GB system. International oil markets are thus fixing both wholesale gas and power prices. This *contractual* price distortion only exists because the gas producers are collectively selling such a high percentage of their long-dated volumes off-market, instead of making this supply available on the wholesale market. Energywatch has learned of gas producers collectively curtailing their forward trading operations. In just one case, a significant North Sea gas producer/UK marketer had its *forward gas trading operation* closed by the acquiring gas producer soon after these two US majors had merged.

Oil-indexed long-term contracts exert a *coupling-effect* on wholesale markets. They tie up the main gas volumes on long term contracts ranging from anything between 5 to 25 years and this significantly reduces forward market liquidity. They also undermine gas-versus-gas competition as a long-dated market is made superfluous when the forward price is steered by oil prices.

Consequently, the wholesale gas and power markets are structurally flawed. The chosen trading policies of producers and generators are responsible. The companies have behaved in a coherent fashion simply because the current regime gives them all *common incentives* to restrict supply on forward market in favour of off-market deals. This has inevitably led to widespread suspicion of *tacit collusion*. It is simply policy fixing, not price fixing as such, although the competition and price impacts will be identical.

The market evidence that illustrates the absence of effective competition in gas and power is also emerging. For example, some 15 years after privatisation, the forward GB power market is practically closed for business. No meaningful forward trading exists more than two months out on the UK Power Exchange today. However, electricity trading liquidity in German power market has already overtaken the GB market whose liquidity has fallen by almost 75% since 2003. Despite a head-start over its EU peers, the GB market also has one of the lowest churn rates in Europe. Even on the gas side, most of the respondents we discussed this with expect the Dutch Title Transfer Facility to overtake the National Balancing Point as a principal liquidity hub very soon. Again, it is not a question of physical gas, pipeline or terminal capacity, which are plentiful, but the forward trading policies of producers and generators which have led to this new situation.

With the pricing problem entrenched in the forward markets, the suppliers simply pass down the price increases to their customers. The higher posted prices in the forward market (in the instances where the same producers and generators supply on a forward basis) are then used to justify these higher prices. Despite an *improving* GB supply and demand picture, the “Gas Year 2008–09” contract for gas increased by over 44% while that for electricity increased by 45% between 1 June and 31 December last year and forward prices have continued rising since. Contractual gas price indexation to oil prices remains a major distorting factor that explains this increase. Further, barely one third of this price increase has yet been reflected in domestic energy price increases. A new wave of price rises is thus inevitable unless urgent action is taken to resolve the liquidity stalemate and also the contract issues which have been driving up wholesale prices in both markets to artificially high levels. Above all, the market anomalies which incentivise producers and generators to boycott their forward markets need to be removed. Obligations on them to trade more volume openly, on a forward and over-the-counter basis are required now. The market evidence and witness statements that Energywatch has gathered underline the need for an early referral to the Competition Commission.

The GB wholesale markets are not working well and a “business as usual” stance is no longer viable. We also need to refrain from the almost Kafka logic of asserting that there can be no role for a Competition Commission inquiry until definitive evidence of policy collusion or of direct price collusion is produced. Indeed, the Competition Commission was specifically set up and given the effective investigative powers required so as to find this very evidence. No previous inquiry by Ofgem has concluded there is any problem in wholesale markets that needs to be addressed. So the anti-trust lawyers and international industry specialists in the Competition Commission, who should recognise any “de facto” cartel behaviour problem, must be allowed to tackle this matter once and for all.

A referral to the Competition Commission may well impose some compliance costs on the gas producers and generators involved. But in this equation, we also need to consider the financial burden on the consumer. Regulatory inaction is already weighing heavily on householders, British industry and increasingly on the stability of the economy.

The market investigation regime contained in the Enterprise Act exists to address the very type of competition concerns that the majority of our respondents identified. The market distortions and perverse incentives that encourage anti-competitive behaviour can however be ameliorated by the Competition Commission, promptly in our view.

On a final and positive note, energywatch believes that intervention options already exist which could have a positive and early impact on wholesale market competition. These may include tried and tested measures, as implemented successfully in the US and UK markets during the 1980s. Indeed, the requirement on producers to foster (rather than boycott) their trading exchanges and to support over-the-counter trading generally are already working now to various degrees in Continental Europe. Robust liquidity-enhancing measures are also required for the GB gas and power market to recover and not a moment longer should be wasted.

2. BIOGRAPHY

I, Dominic Whittome, have worked in the industry for 19 years, having trained as an economist. I started analysing the energy markets in 1987 when I prepared my postgraduate dissertation into cartel behaviour and pricing in oil futures markets. I went on to work as commercial analyst, contract negotiator and trader for Statoil UK, Mobil North Sea and Agip UK. In 1997, I moved to power and worked for EDF Energy as Head of Gas Trading. Since 2004, I have served as an advisor to commercial and government energy organisations.

In January this year, Allan Asher asked me to assess the efficiency of the GB gas and electricity markets. With a background as a buyer and a seller, I hope to provide an impartial and insider's account on what is happening in our wholesale and retail markets today.

3. APPROACH

This report is essentially a qualitative analysis, based on the viewpoints and actual evidence provided by some forty people working within the industry. They were chosen from a wide cross-section of the gas and electricity supply chain. Throughout this paper, I also interweave trading experience of my own. The assertions made will be on the basis of supporting evidence and testimonies provided over the interviews; forty in total.

The report incorporates contributions made by Allan Asher and his colleagues at energywatch. It also benefits from additional insights provided by the Department for Business, Enterprise and Regulatory Reform, the Office of Gas and Electricity Markets and DGCOMP and DGREN of the European Commission.

The interviews were conducted either over the telephone or in person. The market participants offered their own views on the matters affecting today's markets. In many cases, the respondents also volunteered evidence based on their own experiences working within the companies concerned. These comments, as they relate to evidence of collusion and copycat behaviour, are included in this report. Also included is factual market and circumstantial evidence which I have assembled.

4. OBJECTIVE

The main task of this exercise is to establish whether or not GB gas and electricity prices are being determined efficiently. It will try to identify whether dominant players are acting in active collusion or tacit collusion, both with the same effect. This last point is important because a structurally-flawed market will involve specific, common commercial drivers that induce players to act in consort and distort end-user prices as if they were actively colluding.

I will include verbatim quotes from witness statements and discuss supporting evidence¹⁸⁶ where this is relevant. As well as the markets and price changes themselves, I will focus specifically on the new competitive situation in both wholesale markets, notably in power which has become more centralised. The main aim will be to establish whether or not prices have been over-reacting to market fundamentals, which may result in additional costs that consumers could avoid in an efficiently-operating market. In this regard, I will also examine the evolving role of the derivatives sector and the role played by financial intermediaries. I will discuss the price-fixing services (or market in "swaps") provided by merchant banks. While such services can be very useful, they could be avoided altogether in markets that make adequate long-dated forward supplies available, with robust, undistorted forward price signals so users can hedge directly.

5. DEFINITIONS

To ensure everyone is conversant with the terms and jargon that is unavoidable in such a report, a quick run-through of definitions should be useful. Some of you may wish to skip to Section 6.

(i) *Wholesale Market*

The wholesale market; forward¹⁸⁷ market (which here refers to "long-dated" delivery, ie over six months forward or "on the curve"); spot market (short-dated, prompt or balancing) and "over-the-counter market" (abbreviated to the OTC) are one and the same.

The wholesale market is where gas and electricity volumes are sold openly; traded between counter-parties under standard and hence tradable contracts. Delivery can be agreed for any supply duration and may commence at any forward delivery date. OTC trades are usually executed through a broker or exchange, electronically or over the telephone.

¹⁸⁶ On the question of obtaining the "hard evidence", this is not strictly the role of a watchdog or a regulator but a body such as the Competition Commission with the proper investigative authority; this report should simply assess whether or not there are sensible grounds for any referral.

¹⁸⁷ As distinct from the futures market, which is operated by ICE (Intercontinental Exchange, formerly the IPE (International Petroleum Exchange)). This derivative is cleared through the exchange, not between counter-parties; futures contracts are cash-settled whereas a forward contract may lead to physical delivery.

The executed OTC trades can be registered with pricing reporters and published in pricing bulletins, such as Heren and Argus. OTC trades are also posted on the electronic bulletin boards of energy brokers and power exchanges. OTC transactions therefore play a key role in establishing “headline” wholesale prices for next-day, next-month, next-year delivery, and so on. It is this open, public display of OTC-traded prices that enables “price discovery” to develop along the forward curve. Buyer and sellers alike thus have a degree of certainty and confidence in price transparency of the markets they are trading in and possibly also investing in.

However, the GB wholesale markets operate in parallel with an “off-market” trading environment: the arena of “long-term contracts”. These contracts are secret, bespoke agreements negotiated between large buyers and large sellers and their price remains confidential throughout the contract term. A long-term contract can commit a gas supply for anything between five and 25 years. The contract terms can be longer still in the case of electricity.

Individual long-term contracts can contain any variety of contract price indexation terms, against which the base price will escalate over the contract term. In the case of gas, the contract price is generally indexed to the price of oil and petroleum products.

For example, the escalation formula for a gas contract price $P_{(t)}$ in a long-term contract, where the base price $P_{(0)}$ is agreed at the outset of the negotiation, might look like—

$$P_{(t)} = P_{(0)} \times (50\% \text{ Crude Index} + 25\% \text{ Heating Oil Index} + 25\% \text{ Producer Price Index})$$

Indexation formulae, off-take volumes, nominations and delivery terms will vary from contract to contract. This is in stark contrast to the open OTC market, with only the price, the supply rate (volume) and contract term (start and end dates) to decide.

There has been a trend in recent years to escalate long-term gas contract prices, especially those of shorter length, to OTC prices¹⁸⁸ as traded for delivery at the National Balancing Point (NBP). However, a long-term contract is still an off-market transaction and the volumes they govern will not be registered on reporters’ or brokers’ price bulletin boards.

It is worth appreciating that there is nothing to prevent a producer or importer deciding to sell a long-term gas supply on the OTC market. A largish volume of gas could just as easily be sold in blocks on standard and tradable agreements. In fact, much of the gas volumes are sold on an OTC basis in the States, ever since the FERC¹⁸⁹ liberalised the US market in the mid-1980s. Subject to adequate market liquidity, any forward volume can be sold and risk-managed using the standard trading contracts used on the OTC market. If wholesale market liquidity is robust, the necessity for keeping long-term contracts will decline. We will later explain statements given by respondents who will testify to the sheer dominance of long-term contracts, which account for over 85% of all sourced gas sold into the GB market today. These contracts were asserted to “crowd out” liquidity in the wholesale market and reduce trading volumes and price transparency levels that are required for efficient forward pricing to be possible.

(ii) Reference Prices

As we are interested in trend prices, we will refer to forward Gas Year prices as traded in the wholesale market. This Gas Year price pertains to both gas and electricity volumes. The price is unaffected by transitory events, seasonal or short-term factors, which should affect only the shorter-term prices during the year. In short, we are looking at the “bell-weather” price, which enables us to compare successive prices against one another. It will thus give a snapshot of the wholesale market price level at any one time. This Forward price is also often used as a guide price for establishing $P_{(0)}$ when buyers and sellers sit down to establish the base price at the start of their long-term contract negotiations.

The electricity prices discussed as shown on graphs will be for base-load power volumes covering the same periods as gas. So “Gas Year 2008–09” electricity volumes will start from 1 October, 2008 through to 30 September, 2009; Gas Year “2009–10” volumes from 1 October, 2009 to 30 September, 2010, and so on.

6. BACKGROUND TRENDS

(i) Overview

The forward curves below show a relatively stable picture in the gas and electricity wholesale markets between 1997 and 2004. The significant price rises that followed were accompanied by stark increases in market volatility. Prior to this, Gas Year prices proved generally much more resilient to transitory factors and to changing market perceptions as to future supply and demand. In fact, the forward year price should only reflect changes in long-term supply and demand expectations. They should not, in theory, react to

¹⁸⁸ But this raises a second question: if you price against an OTC index anyway then why are parties still keen to trade off the OTC and on bi-lateral contracts instead?

¹⁸⁹ The Federal Energy Regulation Committee; essentially the US equivalent of Ofgem.

transitory factors or within-year effects, unless very significant changes have happened which are perceived permanent, or to last into the next Gas Year, ie up to 12–24 months ahead or 24–36 months in the case of the following Gas Year.

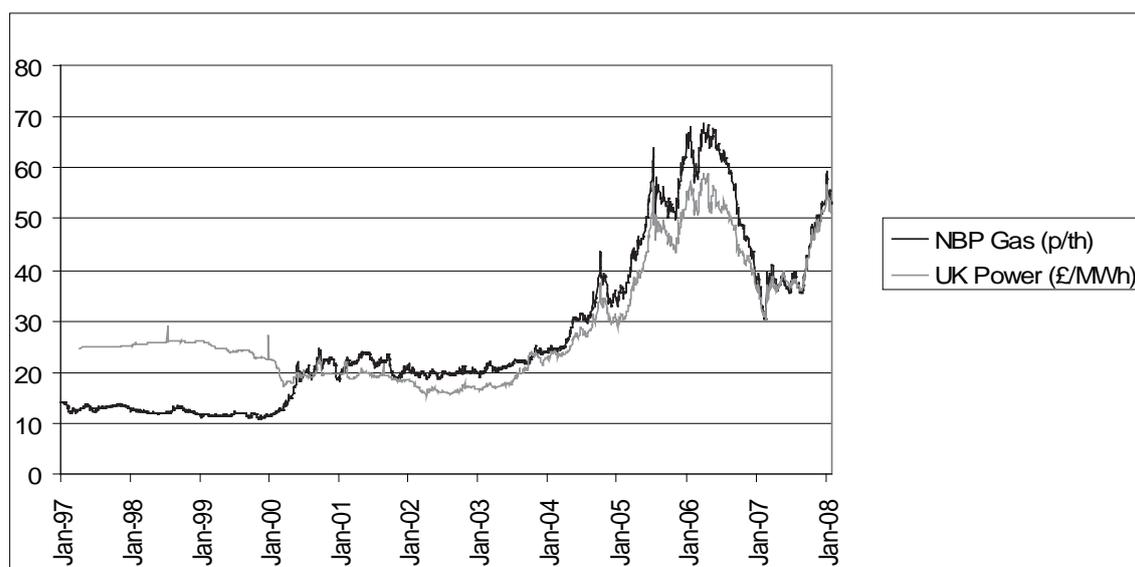
In the background, it is important to dispel the urban myth about “gas shortages” when in fact there is no shortage of gas or any perceived shortage. Whether sourced from the UK or Norwegian North Sea, North Africa, Russia or from other African and Eastern countries, the actual point of production is irrelevant once prices exceed the long-run marginal cost of delivery.

Indeed, the GB market will enjoy access to a greater diversity of gas supplies than ever before due to infrastructure improvements. If the wholesale market was efficient, then one would expect traders’ *expectations* as to forward supply and demand to be reflected into forward Gas Year prices. It would seem odd therefore to see Gas Year prices gyrating dramatically as we enter an era of *improving* fundamentals.

Long-term electricity fundamentals are more of a concern perhaps, although the diversity options are greater still. However, the graph of forward Gas Year prices below shows electricity prices taking their cue almost directly from gas. Gas prices essentially “set” power prices in winter when gas is the marginal generation input fuel, being more expensive than imported coal. Because power prices track gas prices, the impact of any anomaly felt in the gas market will automatically roll onto the power market. Indeed, much of the forward trading in electricity today is on a spark-spread basis, ie with an equal and opposite trade in gas executed each time. As we shall discuss later, genuine forward trading in GB electricity has practically been stopped.

(ii) *Prices in Perspective*

From the start of 2003, which marked the end of a period of relative stability, to the middle of 2006, gas and electricity prices soared by over 220% and 195% respectively. While *market expectations* as to the future supply and demand picture had been changing somewhat, the underlying fundamentals alone did not come close to justifying price increases of this magnitude. Global oil prices had played a part and it is important to assess this impact. The question to ask is whether the jump in wholesale prices has been exaggerated, by players actively colluding *or* by a market that is so deficient that it essentially “rigs itself” and players behave tacitly: they needn’t bother colluding if their commercial incentives are so obvious and common to them all.



Source: Heren Energy

The price of any commodity that trades above its long-marginal cost will be determined by the structure of the market into which it is sold. Our discussion will need to look at not just the wholesale market but at the “parallel world” of long-term contracts, “off market” agreements that are being fixed to oil prices.

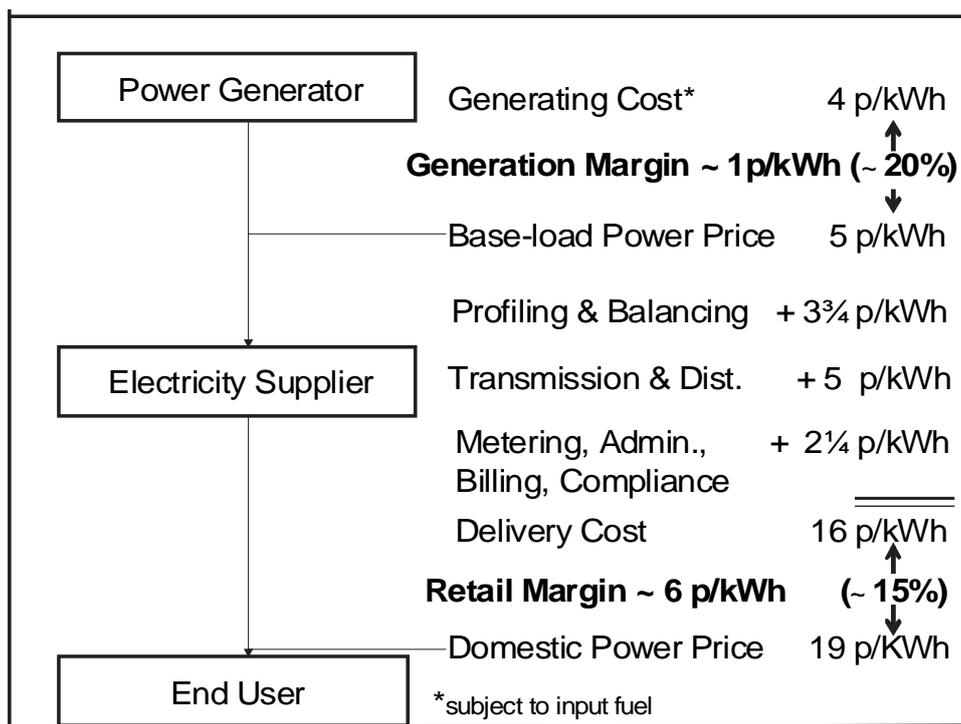
(iii) Value Chain

The diagrams below illustrate the approximate costs and profit margins secured along the supply chain. It should be noted that generation margins do vary considerably. These may be obscured by the almost complete degree of vertical-integration in the electricity sector.

In some interviews, respondents have suggested that power generators have been selling electricity to “larger, prized customers” and also to their own supply businesses at wholesale prices below those posted on the forward market in order to thwart competition. This matter was commonly cited as a “barrier to entry” by new entrant operators, some wishing to build and operate merchant power plants as well as others simply wanting to trade electricity and become suppliers in the market.

Overall, healthy margins are visible along the supply chain, although the wholesale to retail balance is probably muffled by vertical-integration.

In the case of gas sold into the wholesale market and via long-term contracts with base prices fixed against wholesale prices, the margins are simply colossal.



(iv) Recent Trends

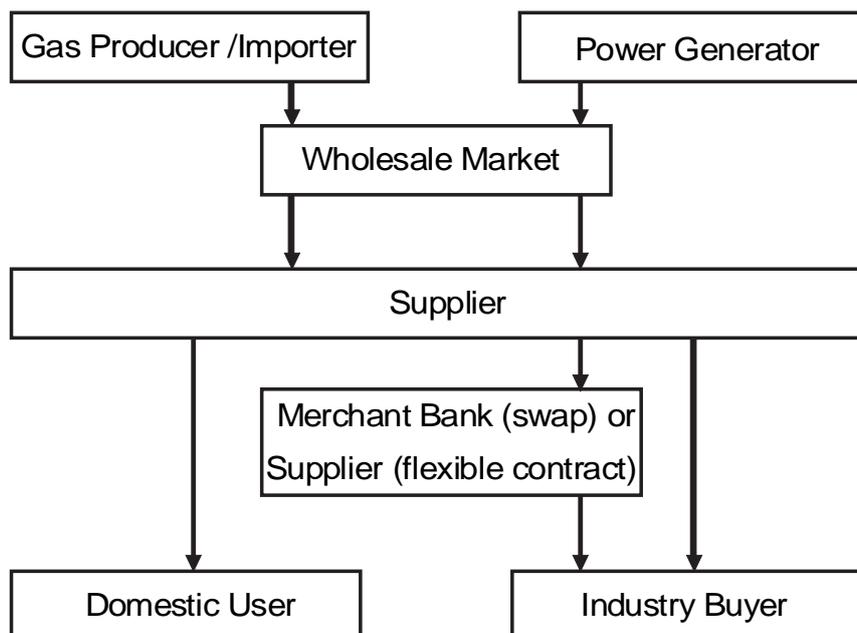
The last in-depth efficiency analysis by a Whitehall department into the wholesale markets was instigated more than three years ago. It concluded that no evidence could be found of market inefficiency although it could benefit from more liquidity. This work was eclipsed by the subsequent rises in wholesale price increases which are depicted on the above graph. We shall go on to discuss the body of recent market evidence gathered and the new facts and marketing situation that has emerged since. The situation has changed mostly in respect of long-dated trading by the market incumbents.

A cursory look at the last six months of last year, ie from 1 June 2007 to 31 December 2007, shows forward GB gas and electricity prices rising up again by 44% and 45% respectively. Again, it is not easy to explain increases of this magnitude by long-term supply and demand fundamentals over that period. These had not altered much and the outlook after 1st October 2008 was and still is improving.

7. THE SUPPLY CHAIN

(i) Flow Chart

The diagrams below depict the supply chains for gas and electricity direct to industrial customers and the commercial and retail sectors.



Large industrial users generally buy gas direct from the wholesale market, whereas commercial customers buy from the suppliers. However, many large gas and especially power users now find they have to buy through a third party intermediary, like a merchant bank who will fix their forward prices for them. In theory, they should be able to do these themselves by hedging on the wholesale market (ie simply buying forward), provided there is adequate liquidity along the forward curve. In the electricity sector, most suppliers are vertically-integrated so the supplier and generator shown in the supply chain are usually one and the same. In fact, many generators are increasingly offering to sell forward volumes on so-called “flexible contracts” that price the energy at par with the forward market although they are essentially off-market agreements.

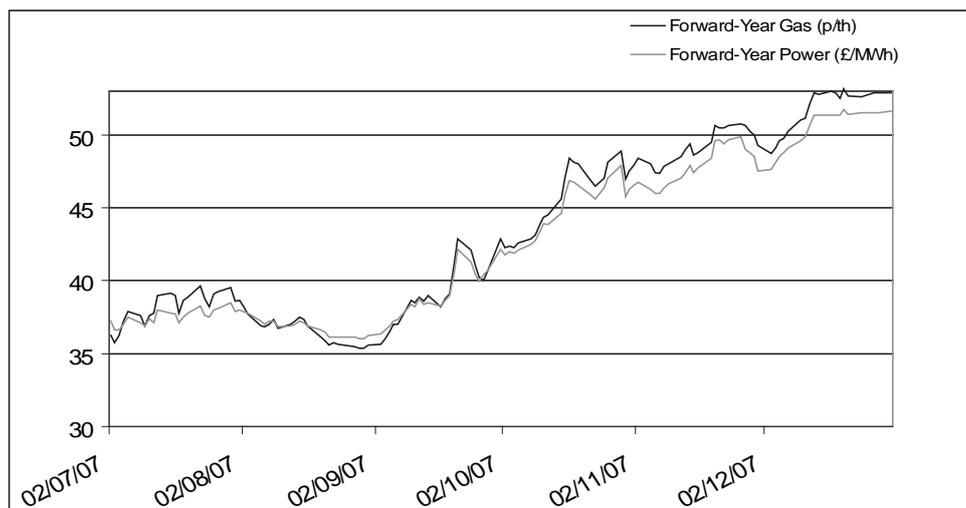
For their part, utilities and generators also rely largely on the wholesale gas market. But they are exposed to this forward market to varying degrees, depending on the size of their assets and portfolio contract pool consisting of long-term contracts and forward wholesale contracts that are still running.

These supply-cost estimates provided are purely indicative. But they do serve as a sensible guide and they also corroborate with figures discussed during several of the interviews held with some of the actual utilities. The profit margins highlight clearly where the significant profits are being made and it is evidently in the wholesale market where the big profit is made at the moment.

The retail market is not (in isolation) especially profitable and here are taxes and payments uncertainties which must also be factored in. This may partly explain the lack of new entry into this sector.

(ii) *Forward Prices*

Referring back to our definition of the Gas Year 2008–09 contract; disappointing gas flows from Norway, delays to LNG terminals and closure of nuclear facilities have certainly affected the prompt market and the mid-term part of the forward curve as well. However, transitory events should not be affecting Gas Year 2008–09 or Gas Year 2009–10 prices in the way seen. Looking again at the second half of last year, between 1 June and 31 December, 2007 there were no significant changes in industry perceptions as to UK demand, gas supply or generation capacity for periods after 1 October 2008. Yet prices jumped by almost half. While the forward curve is bound to be driven by shorter-term factors on the prompt market, it becomes harder to explain forward-year price increases of 44% and 45% in this instance, assuming we had a genuinely competitive market.



(iii) Oil Market Effects

Oil prices have driven gas and electricity prices through oil contractual indexation effects in long-term contracts. With oil prices threatening to pass \$100/bl, gas and electricity prices have simply been dragged up contractually. However, this oil-price distortion should *illustrate* that GB is suffering a structural market problem. All too often the matter of oil indexation is used to *explain, to justify even* increases to GB gas and GB power prices whenever this question is raised in the context of market efficiency. The high prices that we see today would not be sustainable if the wholesale markets operated competitively and without this completely irrational distortion maintained by the policies of oil and gas company executives. From a “sub-optimal pricing” perspective, *the effect* of oil-indexation completely undermines pricing competition in the forward gas and power markets.

However, oil-indexation is just part of the story. The predominance of the long-term contract themselves has also had a serious adverse effect on the forward markets by starving them of liquidity that they need to work properly. The consequent dearth of forward trading activity has created a *self-perpetuating* situation of ever weakening competition and thus artificially high prices posted in the wholesale market.

(iv) Causes

With the background issues now discussed, we can look to the evidence and statements offered by the industry respondents who agreed to be interviewed.

The majority of respondents believe that the forward gas and the electricity markets are intrinsically flawed. A distinct pattern was observed. Rising gas and electricity prices have coincided with falling liquidity, which has followed on from the changing *company supply policies* and the greater market concentration in the wholesale gas and power markets.

The causes of the liquidity problems in both markets were very similar. We can classify these matters as “contract foreclosure” caused by long-term contracts for the wholesale gas market and “vertical foreclosure” caused by consolidation by vertically-integrated generators in the electricity market.

8. CONTRACT FORECLOSURE IN GAS

(i) Forward Market

The majority of our respondents reported a very severe weakening of trading liquidity in the forward gas market. A graver impact still was reported in the forward electricity market, which we shall cover in Section 9.

While the prompt market remains liquid and robust, trading in the back end of the curve, most notably in forward Gas Year contracts, has deteriorated significantly over the last four years. It was also reported that forward volumes that were once being made available by producers on the OTC market are increasingly being sold on secret long-term contracts instead. This company policy appears to be a *coherent one*. Essentially, producers have been selling more and more of their long-dated supplies away from the market. This was widely observed to have a “crowding out” effect on liquidity in the forward gas market.

The decline in liquidity was found to coincide with a rising percentage of physical gas which these long-term contracts now account for. Consequently, most of the gas that initially enters into the GB system *bypasses* the forward market altogether. Furthermore, whereas details of OTC trades are disseminated to other players in the forward market, long-term contract prices remain hidden throughout the contract’s duration. Price, volume and all delivery information remain secret: unknown to price reporters, brokers or

other players in the market. This privileged information question and the lack of market knowledge of actual transaction prices, has a negative impact on price transparency. The market simply has fewer “blocks” of priced gas with which to establish a forward pricing curve. In fact, “weak price discovery” in long-dated prices was one of the most commonly cited reasons by new entrants and merchant traders for their decisions to abstain from the market or to exit the market altogether in some cases.

Some positive reports on forward trading gas liquidity were reported by a small number of merchant banks and financial institutions. However, these entities will have had physical assets to trade against. Indeed, much of the reported “gas trading” could be accounted for by forward hedging operations, matched against the crude oil and power markets. As for physical players aiming to buy significant volumes and hedge their positions directly, little forward trading seems to be taking place.

In theory, it should be quite possible for long-term contracts and wholesale markets to co-exist, provided there is a sensible degree of balance between the two. But this is not so today. The vast bulk of *long-dated* physical volume is sold on long-term contracts. The actual proportion is, if anything, increasing. This is partly due to successive mergers and acquisitions in the North Sea and on the Continent as well as more imports from Europe. However, it is ultimately down to the policies of the producers. These have had *the effect* of limiting the supply of gas that is now traded on the OTC market.

Any efficient forward market will require a critical mass of liquidity to develop before buyers and sellers will enter the market. In relation to forward gas, a “contract foreclosure” problem was claimed to exist by many of the traders and industry buyers we spoke to. The shrinking volume in long-dated transactions was also evident in the market price reports, such as Heren and Argus. The suggestion is that this deal reporting problem is also getting worse.

Consequently, industrial buyers and even gas buying utilities fear that the prices they are being charged for long-dated wholesale gas supplied have been contrived and are even manipulated from time to time. Meanwhile, the “new entrants” which include traders, suppliers and merchant generators are effectively “closed out” of this market as they will not risk trading in a market that they are so deeply suspicious of.

With fewer and fewer supplies made available on an OTC basis, the forward market has become increasingly illiquid. A shallower trading pool has resulted in opaque, sometimes non-existent forward prices posted in specific supply periods out on the forward curve. Price discovery has become “a guessing game” to quote one respondent and “fair game” for dominant players with large volumes to throw around if they want to. A shallow market that can be spooked higher just by minimal buying interest represents a significant barrier to entry for UK investors and UK traders wanting to use the forward market to buy and hedge. Even the market-makers, merchant banks and hedge funds (who have a valuable liquidity-enhancing role to play) are wary of entering a market that is overly sensitive to market information shocks and also prone to manipulation. “We will not be liquidity providers” sums up the overall position. The truth is: only the physical gas producers can make this initial, meaningful contribution to liquidity that is needed. The same applies to vertically-integrated generators in the power market, which we will discuss later on in this report.

A market overly prone to the buying or selling actions of a few traders will become inefficient over time and will be likely to remain so. While the producer and supplier numbers might suggest the gas market is quite competitive, numbers alone can paint an illusory picture. The number of traders in wholesale gas market may well rank in the twenties or thirties, but if just two or three are active traders on the curve, then any one morning or afternoon, between them they can “practically invent their own gas price”. Correspondents have suspected “wash trades” or “phantom deals” from time to time which serve to distort the forward picture. So, the actual number of players active in the forward market may be tiny compared to the headline figures.

Consequently, it is in no individual new player’s interest to inject liquidity and risk the consequences. As merchants, traders and buyers then start to withdraw, market liquidity falls further. Market risks and price volatility increase as a result and so a vicious circle is established. This has happened in spite of an improving gas supply picture and more physical flexibility offered than ever before. Only one of the respondents that we interviewed believed that the wholesale gas market will correct itself.

(ii) *Cost of Foreclosure*

Poor forward liquidity has affected the wholesale gas market significantly and in a variety of ways.

First, low liquidity creates an *impression* of scarcity of supply along the forward curve which has driven prices higher. In commodities generally, low liquidity helps to keep prices high and establish what some call a “*buyers’ market*”. The very use of this term, however, surely suggests that something is wrong with competition, especially in market where the commodity is known to be in plentiful supply. Low liquidity also causes bid/offer spreads in OTC trading prices to widen. This fact is quite visible on electronic screens of exchanges and brokers. Forward year gas volumes are currently trading spreads approaching 1½p per therm, equivalent to almost 3% of the price when they have been less than this in the past.

Second, low trading volumes make wholesale prices vulnerable to over-reacting. It was frequently claimed that wholesale prices have been supported from time to time by players with a commercial interest in maintaining a high “headline price” on the forward curve in order to secure a higher base price in their long-term contracts. This question relates to “flexible contracts” in the power market just as much.

The fragile forward curve was also reported to be deterring buyers from using or even entering the wholesale market lest they drive the price up in the process of purchasing. Consequently, some industry buyers have claimed that they are avoiding the OTC market and instead are entering into the long-term agreements which fuel the liquidity-constraining effects on the rest of the market.

(iii) *Market Evidence*

We can check this question on liquidity effects by referring to the Heren Report.¹⁹⁰ It shows that, at the close of trading on 6 February 2008 only 100,000 therms of gas per day were reported traded for delivery this coming winter.¹⁹¹ This contrasts with a final UK winter demand figure well above 100 million therms per day. So this reported¹⁹² volume, which is used to establish posted forward prices, accounted for less than 0.1% of forward physical demand. Successive low deal volumes like this imply that the lack of physical forward trading is serious. With regards to trading in Gas Year 2008–09 and Gas Year 2009–10, no deal was reported as done that day at all.

The impact of weak liquidity is also evident in the posted prices’ section of the Heren Report. Whereas forward prices were often published on a day-to-day basis in the past, it is increasingly common nowadays to see an * appear just above the price so as to signify an “indicative price”. Here we see a direct relationship between weak liquidity and poor price transparency. This corroborates with the claims that were made by many of the people we have interviewed who still believe that far too little gas is traded today on a forward season and a forward year basis.

The third and more significant price distortion due to low liquidity is the growth of the so-called “risk premium”: the extra premium which producers and suppliers command for making a long-dated delivery. This forward premium has increased to a record level. It is calculated to add perhaps another 10 p/therm (nearly 20%) to the wholesale gas price.

It represents a new cost that eventually passes down to householders and commercial users. In our example, the Heren Report of 6 February, 2008 quotes a gas price of 62.5*p/th for forward delivery over the first quarter of 2009. This price starkly contrasts with the outturn “day-ahead” price quoted on 6 February, 2008 at 48.5p/th. Assuming that prevailing weather, demand and supply conditions are roughly similar next year (they are likely to have improved even), the implied risk premium works out at 14 p/th, which adds roughly one quarter to the wholesale gas price.

The concept of some level of risk premium in forward gas and forward power markets is not new. They do fluctuate over time and they correlate very closely to forward price volatility. However, an implied risk premium of around 25% seems very high for a competitive market. It contrasts with the 1990s when UK gas market exhibited a much lower premium, in the region of 10%. Many commodities, notably crude oil, exhibit a “backwardated” or downwards-sloping forward curve. Although the level of uncertainty in gas has increased to a degree, 25% does look excessive.

A risk premium in the 10%–15% range would be more consistent with supply and demand fundamentals, which should have improved further by next year in which case the premium should have been falling.

One justification expressed by some respondents for higher risk premiums today has been the unprecedented increases in price volatility. This was frequently blamed on poor liquidity levels. With so few merchants and market-makers trading, the forward market is left much more vulnerable to price spikes; caused either by players over-reacting to market events or possibly contrived by two or three dominant players, who see that they have the forward field all to themselves.

There is a fourth cost factor to consider, which again concerns power markets as well. It closely resembles the “risk premium” argument. Large industry buyers need to forward-fix the price of their supply and low liquidity puts them in a difficult predicament. They can avoid buying forward, delay purchasing and simply buy gas on the prompt market where liquidity is still very good. However, this is an exceptionally risky strategy. The alternative is to approach a third party intermediary, such as a merchant bank, to fix the forward gas price for them by selling them a swap. This derivative contract will guarantee them a forward price *as if* the forward market were liquid. However, swaps are expensive and derivatives’ premiums have risen sharply due to underlying gas market volatility. However, if the wholesale market were properly liquid along its forward curve, industry buyers would not need to approach the merchant banks in the first place. It is another example of market inefficiency introducing a new layer of cost in the supply chain.

¹⁹⁰ Daily European Spot Gas Markets price publication of Heren Energy.

¹⁹¹ For period 1 October 2008 through 31 March 2009.

¹⁹² Not all OTC deals are reported to the price publications. Some trades are executed via brokers who establish their own indices, eg Spectron’s daily “Spectrometer”. However, they still are reliable indicators as to the true amount of gas being transacted along the forward curve.

(iv) *Oil Indexation Effects*

The fifth factor concerns price distortions caused by oil-indexation in long-term contracts. There is an automatic impact on gas prices due to indexation to petroleum products in clauses written into many of these long-term bi-lateral agreements. Consequently, GB gas prices are fixed to international crude prices and thus forward gas prices fail to respond effectively to changing supply or demand fundamentals that should be relevant.

The market impact of oil-indexed long-term contracts resurfaced again at the end of the 1990s. This had followed a seven year period during which gas prices appeared to have successfully de-coupled from oil prices. Correspondingly, the forward gas market then saw good liquidity along its forward curve. However, three industry events played a significant part in re-establishing the impact of oil prices on gas and electricity prices.

(v) *Changes in the Market*

Firstly, the UK started limited imports from the Continent where prices are linked to oil¹⁹³ on long-term contracts. Secondly, the market suffered a significant increase in supply concentration following the wave of “super mergers” involving North Sea producers, UK and European utilities. Thirdly, trading activity contracted sharply following the collapse of Enron and the subsequent exit of other US merchants¹⁹⁴ in 2002–03.

The US merchant traders had played an important liquidity-providing role and this had *countered the impact* of oil-indexed contracts that operated in parallel with the evolving forward market. Their departure saw the mantle of “liquidity provider” pass to newly-merged producers, UK and European utilities. Their number included many of the “Old Guard” energy majors who have been resisting European energy market liberalisation. They have fiercely defended long-term contracts and this regime they perceive will be threatened by greater liberalisation in the EU energy market.

(vi) *Impacts on Competition*

It should come as little surprise that the interest of producers in fostering over-the-counter trading has been limited. However, this cursory investigation has already uncovered some evidence of supply policy decisions taken by energy majors, aimed at reducing the amount of gas for supply to the forward market.

Two interviewees who had worked for one very large gas producer gave separate and consistent accounts that forward selling on an over-the-counter basis was halted when their company merged with another large gas producer. The incoming management reportedly “killed off” this formerly significant UK gas marketer’s forward trading activity. Initially its traders struggled to have their credit lines extended and were said to be trading “with their hands tied behind their backs”. Ultimately, the trading floor was reduced to a mere “balancing function”, simply to support the wider long-term contract activities that were now to take precedence. This is no isolated example. The trend has been copied by other gas producers, many of which also merged over the last six years.

The long-term supply policies of producers have converged. Whether this was by design or coincidence, the detrimental effect on market competition has been the same. Common incentives have led to common actions, which have starved forward markets of liquidity, which leads to a greater potential for market manipulation, less competition, higher market volatility still and higher risk premiums, which all combine to force prices above levels that an efficient wholesale market would otherwise dictate.

While the majority of respondents suggested that contract foreclosure was caused by the unwillingness of producers to trade openly in the forward market, only one of these traders expressed the belief that the market liquidity problem would remedy itself. A majority of traders believed the liquidity problem is worse still in the electricity market, which we will now come onto.

A final point concerning gas contracts: the policy decisions here that affect the wholesale market are made entirely or partly by UK-based organisations. While gas imports from the Continent are a factor and EU market liberalisation is important, we are here dealing with a UK problem that requires a UK solution. EU liberalisation is unlikely to resolve this problem. Meaningful European market liberalisation remains some years away. More to the point, the EU Commission’s “Third Energy Package” does not address the matter of long-term contracts. Its focus is the unbundling of energy utilities. A “weak” third directive in this respect will not remedy this UK problem, even when it does arrive. A national initiative is required for our home wholesale market therefore.

¹⁹³ The argument that “oil-indexed imports from the Continent mean UK gas prices are linked oil prices” would not strictly be so if the UK market were competitive. Any spare gas that is available for exporting to the UK has to be sold somewhere if it is subject to take-or-pay obligations and gas is expensive to store. So the exporter concerned should take whatever the going price is: he should not be setting the price in the UK.

¹⁹⁴ With the departure of Enron and other US merchants who helped provide early liquidity into the forward market including TXU, Dynegy, Duke Energy, America Electric & Power, Reliant, AES, NRG, Williams.

9. VERTICAL FORECLOSURE IN ELECTRICITY

(i) *Buyers and Merchant Generators closed out of the Forward Market*

The issues in the electricity market relating to liquidity constraints and adverse impacts on wholesale market competition are almost identical to those in gas. So we will not repeat this part of our discussion here; the pattern of events that leads up to higher prices is much the same. However, we should note the following differences:

Firstly, because gas accounts for a high proportion of the grid's marginal generation capacity, forward prices formed in the wholesale gas market set those in the electricity market. So any anomalies present in the forward gas market automatically rolls onto power.

Secondly, the market has six principal vertically-integrated companies. These are each dependent on the wholesale gas market and long-term gas contracts (which are often priced against this forward market) although the extent of gas dependence varies widely between these companies.

Because they are vertically-integrated and churn in the retail market is quite limited, they can effectively pass down any price increase in the wholesale markets down to their customers. In short, they lack the proper commercial incentive to compete in the forward market.

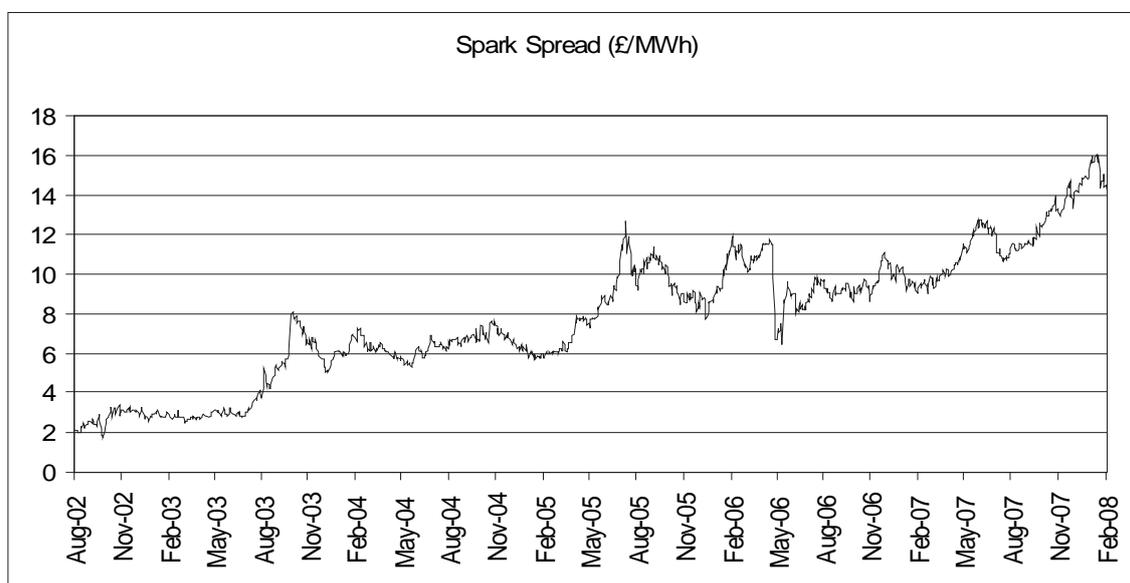
(ii) *Perceived Impact on Competition*

One observer commented that generators do actually not *need* to trade in the forward market at all in order to manage their risk, precisely because of this captive customer base. Respondents repeated there was no commercial incentive for generators to trade in the forward market while the status quo is so favourable to them. Weak liquidity is serving to keep power generation prices at high levels.

There seems little prospect of market forces or an internal industry initiative breaking this cycle. Merchant banks, traders and other new entrants, with no physical generation assets of their own to trade with, expressed that they were unwilling to enter a market which has virtually no liquidity at beyond *one month* forward and is prone to day-to-day manipulation. One respondent asserted that "there are just two companies who trade two months out and they have learnt how to fix this market as well" (referring to the former UK Electricity Pool).

Other respondents have asserted that the incumbent generators have systematically spurned the long-dated forward market. The steady rise in the spark spread¹⁹⁵ underlines the increase in the profitability for gas-fired generators. However, we have witnessed very little entry by new companies into either the power generation or the power supply markets during the last five years.

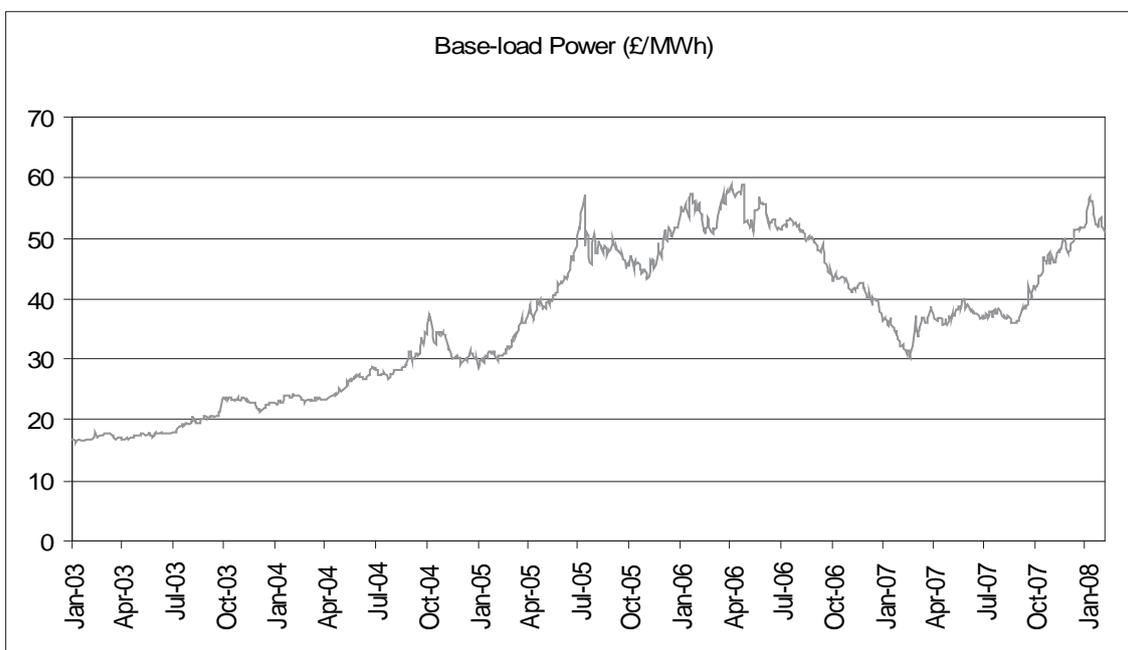
Increasing wholesale power prices have enabled the vertically-integrated generators to benefit both ways: higher generation margins to industrial customers and higher retail prices to their domestic and commercial customers. This doubling-up of profit margins is illustrated in the flow diagramme in Section 6 (iii). It suggests that price rises imposed on household customers are being justified by the very same price increases in the wholesale market, which generators may be exacerbating by boycotting their forward market.



¹⁹⁵ Essentially, a proxy for the generation margin power price minus the efficiency-adjusted input gas price.

(iii) *Forward Prices*

Rising gas prices, the changing competitive climate in the power generation sector and a severe reduction in liquidity have been instrumental in base-load electricity prices soaring by over 210%, from barely £16/MWh just five years ago to over £50/MWh today.



The fall in GB power market liquidity has been more recent and even more severe than that witnessed for natural gas. However, the wholesale power price is influenced by anomalies in the gas market in addition to its own.

(iv) *Evidence of Market Failure*

In fact, the collapse in power market liquidity has been so dramatic that virtually no genuine¹⁹⁶ long-dated trading is believed to be done in the GB market. Even the sporadic few trades that are done on a forward basis are related to a spark-spread or another hedge by a merchant bank or other financial intermediary.

Numerous industry buyers have complained that electricity exhibits the same symptoms of market distortion that they have witnessed in the wholesale gas market. These include fatter bid/offer spreads which tend to widen almost immediately after buying takes place.

To avert exposure to the prompt and forward markets, the electricity buyer again faces the two options. He can either buy a financial swap from a merchant bank, which will fix the forward price for him. Or else he can approach his own supplier. In this case, he will buy a forward volume of electricity on a so-called “flexible contract”. However, these contracts generally tie him to the supplier for a longer time period. The forward price can be fixed at the outset, indexed to the wholesale market (which his supplier may be able to influence), or completely flexible so as to allow him to lock or unlock the price from time to time. However, in all three instances his effective “base price” is still determined in the wholesale market which is prone to manipulation. Further, because the supply is now made under a bespoke (off-market) contract, there is no price reporting or deal transacted through a power exchange. This serves to reduce market liquidity further still.

In fact, quite a profitable sideline business has sprouted among the generators who are now marketing “risk-management services” to industry buyers: “flexible contracts” packaged to protect buyers against volatile and illiquid forward markets that are arguably of the generators’ own making.

Traders and new entrant merchant plant operators have reported that they have been affected by the collapse of forward trading. They have claimed that the extensive liquidity risk that now exists has forced them to approach the incumbent generators for assistance in order to enter the market, which will undoubtedly affect their entry project economics. In other cases, plans to build power stations are understood to have been thwarted altogether.¹⁹⁷

¹⁹⁶ For industrial purchasing, ie unconnected with spark spread and/or financial hedging by merchant banks.

¹⁹⁷ There is a parallel with gas here vis-à-vis international suppliers of LNG.

The power generators themselves have partly blamed uncertainties over carbon prices for new risks and this is preventing them from selling forward electricity volumes. However, a fairly liquid forward year market for carbon already exists. With regards to longer term trading, the logic is probably the reverse. Failing GB gas and power markets may be thwarting the development of a forward carbon price. This would introduce a new risk factor in the economics of new-build power stations.

(v) *Evidence from the Continent*

Liquidity is becoming less of a problem on the Continent compared to the GB market. European power exchanges benefit from both peer pressure and regulatory pressure on generators to foster their wholesale markets by trading openly and injecting liquidity. Capacity/release auctions of the type once used in the UK gas market have contributed to growth in liquidity. For example, the German power exchange traded over 5000 TWh of electricity last year while Nordpool in Scandinavia traded over 2,500 TWh. This contrasts with the forward trading by UK generators. Here, openly-traded volume on the UKPX barely managed 600 TWh. GB liquidity had previously been increasing steadily and it peaked at 2,300 TWh in 2003.

A very significant change to competition, company trading policies generally or both factors must have played a role in this. Fifteen years after privatisation, the GB wholesale market sees a forward curve which simply no longer operates. The UK Power Exchange has essentially been reduced to a “balancing market”. Respondents have claimed that it does not allow them to trade effectively and this is thwarting their long-term investment plans. The incumbents on the other hand have no obvious commercial incentive to change their supply strategy, nor to go out and build the new power plants expeditiously.

Two respondents also suggested very similar accounts that suggested some kind of “understanding” between the generators and UK authorities not to intervene in the market. They said this was due to the need for their wider co-operation in matters ranging from climate change objectives, peak winter cover and the building of a new fleet of nuclear power stations. It was suggested that any referral to the Competition Commission would introduce “inevitable costs and uncertainties” that could serve to delay major projects that only the big companies can build.

10. CONCLUSION

When we talk about these costs, we do need to weigh these against other costs now imposed on the consumer. The impact on British industry and wider UK economy also need to be factored in. The cost of a “business as usual” approach in dealing with the energy contracts and market liquidity problems will probably prove to be inflationary. In fact, there is also evidence of this already.

Our existing gas and electricity trading markets are both defective. They each give commercial incentives to gas producers and generators to act uniformly in blocking the development of a forward market. They have led to significant distortions and a self-feeding cycle of ever reducing competition. The market prices, price premiums, extra layers of price insurance and adverse liquidity impacts have each been identified.

The overall impact on competition is equally clear from much of the corroborated reports and other evidence given to us in the course of this research.

The irony is that rising *forward* Gas Year wholesale prices are still increasing while the underlying gas supply and demand fundamentals are improving into the next two years.

The prospect of a second wave of retail price rises later this year is very possible, as utilities seek to fully reflect the impact of the respective 44% and 45% price increases in wholesale gas and electricity in the last six months of last year.

These market realities, analysis and submitted evidence underscore the importance of an immediate referral to the Competition Commission.

This referral should lead, directly or indirectly, to subsequent market initiatives¹⁹⁸ that may succeed in persuading the companies concerned to foster the forward markets instead of boycotting them. We believe that this will have a significant and early impact on current Gas Year prices.

Only the actual producers and the vertically-integrated generators possess the flexibility to offer the liquidity and transparency improvements required. So neither one group should be excluded. Common, market-distorting incentives need to be rectified in both cases. In each one, we believe tacit collusion exists on a very wide scale although it is subtle: it relates to “inaction” rather than action as such. The adverse competition impact as it plays across these two inter-linked markets is another reason why producers and generators need to be assessed jointly. We do remain optimistic that a solution does lie close to home. A referral to the Competition Commission may well lead to short-term remedies which have worked in the past, akin forward market fostering initiatives that appear to be showing progress in Continental markets now.

April 2008

¹⁹⁸ eg liquidity and price transparency initiatives, such as US and UK 1980s-style release programmes; alternatively, mandatory sponsorship of OTC markets and trading exchanges, as in the improving German and Scandinavian markets.

Supplementary evidence submitted by energywatch

PAPER FOR ENERGYWATCH BY DR PHILIP MARSDEN,¹⁹⁹ BRITISH INSTITUTE OF
INTERNATIONAL AND COMPARATIVE LAW

IT IS TIME FOR AN ENERGY MARKET INVESTIGATION BY THE COMPETITION COMMISSION

In recent years, governments and the European Commission have become increasingly concerned about anti-competitive activity in the energy sector. Several inquiries have made clear that it is a “market that is not working fairly for consumers or many providers. The European Commission’s sector inquiry identified five core problems of market concentration; vertical foreclosure; lack of market integration; lack of transparency; and price formation.²⁰⁰ To try to address some of these problems, Ofgem and other national regulators keep the sector subject to regulatory review; while national competition authorities and the European Commission’s DG-Competition have increased use of their competition law enforcement powers, including:

- reviewing mergers more strictly²⁰¹;
- reviewing state aid and other government support; and
- launching dawn raids that have uncovered further evidence of price-fixing and abusive foreclosure of competitors.²⁰²

These newly discovered anticompetitive practices are particularly troubling, as one would not expect further anti-competitive arrangements to keep arising in a sector under regulatory scrutiny. This strongly suggests the need for more work in this sector. It is energywatch’s view that apart from the recently announced probe into the energy supply markets,²⁰³ Ofgem have not held serious investigations into these markets since 2004 and have made very little intervention at both wholesale and retail levels of the markets.²⁰⁴ In particular, due to its limited resources and primary focus on monopoly infrastructure, Ofgem has paid limited attention to the relation between the retail and wholesale markets. Our current regulatory and competition law review of the energy sector in the UK need to be supplemented if they are to be effective. Fortunately, help is close at hand. In the UK we are in the unique position of being able to benefit from the added scrutiny and remedies available through a Competition Commission market investigation.

We will identify the key benefits of such an investigation, and submit that the Secretary of State should call for such an investigation without delay.

Only a market investigation by the Competition Commission can ensure that OFGEM and the other authorities are assisted in their crucial role of making this market work fairly for consumers in the UK.

Background to the regime

The *Enterprise Act* created the UK market investigation reference regime, whereby the OFT has the power to refer markets to the Competition Commission for further investigation where it has reasonable grounds for suspecting that any feature, or combination of features, of a market is preventing, restricting, or distorting competition.²⁰⁵ Under this system the Competition Commission will decide whether competition is indeed prevented, restricted or distorted, and if so what, if any, action should be taken to remedy the adverse effect on competition or any detrimental effect on customers arising from the adverse effect. According to the legislation “detrimental effect” can take two forms: (a) higher prices, lower quality or less choice of goods or services in any market in the United Kingdom (whether or not the market to which the feature or features concerned relate); or (b) less innovation in relation to such goods or services.²⁰⁶

¹⁹⁹ Senior Research Fellow and Director, Competition Law Forum—<http://www.biiicl.org/philipmarsden/>

²⁰⁰ European Commission, Energy Sector Inquiry, Final Report, January 2007.

²⁰¹ R Owen-Howes and C Thomas, “Freeing Energy” finding that stricter merger control is a major policy tool of the European Commission, when its usual competition law enforcement powers under Article 81 and 82 are found wanting: reviewing the E.On/MOL, GDP/EDP/ENI, Endesa/Gas Natural and Endesa/E.On transactions. Competition Law Insight, 6 June 2006.

²⁰² Spiegel Online reported as late as November 2007 that the German BundesKartellamt and European Commission have found evidence of price-fixing after raids in Germany yielded thousands of documents in dawn raids. “German Energy Giants Accused of Collusion”, Spiegel Online, 5 November 2007. The European Commission is also investigating Distrigas, the dominant gas supplier in Belgium—for suspected violations of Article 82 from its long term gas supply contracts with many of its industrial customers.

²⁰³ <http://www.ofgem.gov.uk/Media/PressRel/Documents1/ProbeFINAL.pdf>

²⁰⁴ Allan Asher, Chief Executive of energywatch, “Consumer welfare—a casualty of ‘light touch’ regulation—The End of Regulation as we know it? . . . so where next?” SBGI 2008 Seminar London, 6 March 2008,

²⁰⁵ See Part IV of the *Enterprise Act* 2002.

²⁰⁶ *Ibid* at Section 134(5). It should be obvious that these two “effects” are the opposite of those defined as benefits under Section 1(a) of the same act; see *supra*. Section 134(8) also defines customer benefit as (i) lower prices, higher quality or greater choice of goods or services in any market in the United Kingdom; or (ii) greater innovation in relation to such goods or services.

Examples of Market Investigation References: in the energy sector, comprehensive review and remedial powers

In 2002–03, the Competition Commission reviewed the acquisition by Centrica plc from Dynegy Inc of two companies that owned and operated the Rough gas storage facility.²⁰⁷ A major issue for the inquiry was whether, as a result of the merger, Centrica would be likely to withhold sources of flexible gas in order to force up wholesale gas prices. The Competition Commission found that Centrica could be expected: (a) to discriminate between customers in giving access to capacity at Rough; (b) to use to its advantage sensitive information gained from the operation of Rough; (c) to withhold information about the operation of Rough; (d) to be less innovative in marketing Rough products than another owner; and (e) to invest less in expanding Rough’s capacity than another owner. As a result, the Competition Commission determined that competition in the markets for flexible gas and domestic gas supply would be weakened, with the likely consequence of price increases will be higher than in the absence of the merger. To prevent these adverse effects, the Competition Commission required that Centrica give statutory undertakings regarding its behaviour as owner of Rough. The major elements of the undertakings were that Centrica would: sell Rough’s full capacity on non-discriminatory terms; auction all capacity remaining unsold no less than 30 days before the start of each storage year, with no reserve price; maintain legal, financial and physical separation between its storage business and all other parts of the group; ensure that no commercially sensitive information arising from the operation of Rough is passed to other parts of Centrica; and make any disclosure of information relating to the storage operations to all market participants simultaneously; facilitate the efficient operation and development of the secondary market in Rough capacity; offer at least 20% of Rough’s capacity on annual contracts. The Competition Commission maintained the power to divest assets if Centrica did not comply with these commitments.

THE COMPETITION COMMISSION WAS THE ONLY GOVERNMENT BODY ABLE TO RECOMMEND THE INTRODUCTION OF COMPETITION INTO THE ENERGY SECTOR IN THE EARLY 1990’S

In 1992 the then Director General of Gas Supply asked the then Monopolies and Mergers Commission (MMC) to investigate whether the operation by British Gas plc of its pipeline system and other facilities for the transportation, and storage of gas, operates against the public interest.²⁰⁸ Related references were sent to the MMC at the time by the Secretary of State into the supply of gas to tariff customers and to non-tariff customers, and into the conveyance or storage of gas by public gas suppliers. reports. The MMC found that because BG was both a seller of gas, and owner of the transportation system which its competitors have no alternative but to use, this dual role gave rise to an inherent conflict of interest which makes it impossible to provide the necessary conditions for self-sustaining competition. The MMC recommended modification of BG’s Authorisation so as to establish its businesses as separate units. The Secretary of State (whose final decision it was) chose not to implement the MMC’s recommendation, but British Gas decided to establish “Transco” as a separate unit in 1994 and the formal demerger that led to the creation of Centrica took place in February 1997. It was only after this MMC report, that competition actually became possible in the gas sector in the UK.

OTHER MARKET INVESTIGATIONS: NO FEAR TO ACT

Excessive prices

In *Store Cards* the OFT referred the supply of store card services to the Competition Commission following its conclusion that there are features of the sector, both in the supply of store card credit to consumers and in the supply of store card services to retailers, that appear to prevent, restrict or distort competition.²⁰⁹ In paragraph 1.13 of its report the OFT stated that “there is insufficient competition to ensure that consumers get *good value* from store cards and that such lack of competition may lead to increased profits for retailers and store card providers”.²¹⁰ For the OFT then, the possible harm to consumers resulting from the perceived lack of competition in this sector revolved around the concept of value for money. The idea of “good value” brings to mind the definition of an “unfair price” in the case *United Brands Co. v Commission*; it concerns a price that is “excessive in relation to the economic value of the product supplied”.²¹¹ In other words the OFT is formulating the possible consumer detriment in this sector in terms of unfair or excessive prices for consumers.²¹² In its investigation the Competition

²⁰⁷ <http://www.competition-commission.org.uk/rep—pub/reports/2003/480centrica.htm#full>

²⁰⁸ http://www.competition-commission.org.uk/rep_pub/reports/1993/335britishgas.htm#summary

²⁰⁹ *Store Cards*, OFT Reference to the Competition Commission, 18 March 2004.

²¹⁰ Emphasis added.

²¹¹ *United Brands Co. v Commission* [1978] 1 CMLR 429, at paragraph 235.

²¹² At paragraph 6.1 of the reference, the OFT underlined its suspicions that excess prices were being paid by some consumers for certain store cards: “the provision of store card credit may not be working well for consumers. It is possible . . . that the difference between the interest charged on store cards and other credit cards is not fully explained by the offsetting benefits and the differences in the cost of providing these services”.

Commission tried to quantify this consumer detriment by comparing the prices actually paid by cardholders who pay interest and insurance charges on store cards with the prices they would have paid had these reflected costs, including the cost of capital.²¹³

Subsequent market investigation references submitted to the Competition Commission have also concerned the impact of (weak) competition on prices paid by consumers; see for example *Supply of Liquefied Petroleum Gas*²¹⁴ or *Northern Ireland Banking*²¹⁵. In the former case the OFT suspected that “the high switching costs [between different gas companies in the market for the supply of domestic bulk liquefied petroleum gas] may form a barrier to entry, so that competition is restricted and many consumers face higher prices overall than they would in a similar market without switching costs”.²¹⁶ In the latter case, the OFT held that the conditions for a referral were met as high levels of concentration, significant entry barriers, price parallelism and consumer inertia appear together to result in *limited price competition* and weak switching competition between the big four banks in Northern Ireland.²¹⁷ Both investigations are ongoing.

In *Home Collected Credit*²¹⁸ the Competition Commission actually attempted to quantify the overcharge suffered by customers in the relevant market; according to the CC customers suffered from “substantial overcharging”:

[overcharging] may have amounted to as much as £100 million a year over the last five years across the whole market, which would imply that a home credit customer pays over £25 too much for an average loan, or £9 per £100 borrowed, and that home credit lenders have been able to earn more than £500 million in profits in excess of the cost of capital in the last five years.²¹⁹

This case thus highlights that the Competition Commission: (i) considers overcharging as a form of consumer detriment; and (ii) is willing to quantify the extent of the overcharge when possible. *Home Collected Credit* also demonstrates that the CC will consider the effects of weak competition on particular categories of consumers as well as consumers in general. Indeed, on the facts before it the Competition Commission expressed its belief that the overcharge may have more of an effect on single mothers under 35:

Home credit customers were more likely than the population as a whole to be female, to be under 35, to have young families, to fall into socio-economic groups D and E, to live in a low-income household and to live in housing rented from a local council or housing association.²²⁰

It is not just about price . . .

In *Home Collected Credit* signalled how the Competition Commission will also consider different forms of consumer detriment where relevant:

We shall determine whether any effect on advertisers or users [ie consumers] in the form of *higher prices, lower quality or less choice of goods and services, or less innovation* has resulted from, or may be expected to result from, any adverse effects on competition in the relevant market or markets.²²¹

Indeed, if the Competition Commission decides that there is an adverse effect on competition it must “take action to ‘remedy, mitigate or prevent’ the adverse effect on competition and to ‘remedy, mitigate or prevent any detrimental effects on customers’ so far as those effects have resulted from the adverse effect”.²²² By definition “any detrimental effects” must also include those detrimental effects that cannot be classed solely as effects on the prices paid by consumers.

In the ongoing *Groceries Market Investigation*, the Competition Commission has recently published its Provisional Remedies notice, which recommends a number of competition policy solutions, including the introduction of a “competition test” when local planning authorities are assessing planning applications for new large grocery stores, and A requirement on grocery retailers to lift existing exclusivity arrangements that have been in place for more than five years, where these have been identified as a barrier to entry by a competing retailer in areas of high concentration. In addition, however, the Competition Commission has recommended remedies that go beyond what competition law itself could do: namely that the Department

²¹³ See Paragraph 1 of Annex 9.1 of the Competition Commission Report, available at: http://www.competition-commission.org.uk/rep_pub/reports/2006/509storecards.htm.

²¹⁴ *Supply of Liquefied Petroleum Gas*, Market Investigation Reference, 5 July 2004.

²¹⁵ *Northern Ireland Banking*, Market Investigation Reference, 26 May 2005. See also: *Home Collected Credit*, Market Investigation Reference, 20 December 2004.

²¹⁶ At paragraph 3 of the OFT Reference (emphasis added).

²¹⁷ See paragraph 75 of the OFT Report.

²¹⁸ *Home Collected Credit*, Market Investigation Reference, 20 December 2004.

²¹⁹ *Ibid*, Competition Commission News Release, 27 April 2006, available at: <http://www.competition-commission.org.uk/inquiries/current/homecredit/index.htm>, at p 1. It should be noted that these findings are only provisional and that the Competition Commission intends to discuss them further with home credit companies before making its final conclusions on the matter: *ibid*.

²²⁰ *Ibid*, at p 2.

²²¹ *Classified Directory Advertising Services*, Market Investigation Reference, 5 April 2005, Competition Commission, Issues Statement, Paragraph 17 (emphasis added).

²²² *Northern Ireland Banking*, Market Investigation Reference, 26 May 2005, at paragraph 83 of the OFT Report (emphasis added). See also Section 138 of the *Enterprise Act 2002*.

for Business, Enterprise and Regulatory Reform amend the Land Agreements Exclusion Order so that agreements which restrict grocery retailing should no longer benefit from exclusion from the Competition Act.²²³

What can the authorities do?

Ofgem

Of course, Ofgem is the port of first resort in examining the energy sector. It is energywatch's view that apart from the recently announced probe into the energy supply markets, Ofgem has not held serious investigations into these markets since 2004 and has made very little intervention at both wholesale and retail levels of the markets. It has also only paid limited attention to the relation between the retail and wholesale markets.

The Competition Commission

Although all of the UK authorities have considered consumer detriment in its many different forms, it appears that the OFT, at least, seems to concentrate primarily on price related consumer detriment. The Competition Commission, by contrast, will consider more readily the other aspects of consumer harm (*viz* the negative impact of conduct on innovation, quality and choice for consumers) especially when considering a particular market in the context of a market investigation reference. The Competition Appeal Tribunal also takes a more dynamic approach to the market. For the CAT consumers may be harmed through the higher long-run price levels, reduction in choice and decreases in quality, which, in general, significant distortion of competition brings.

Greater powers than DG-Competition

In contrast, the type of sectoral inquiry employed at EC level can only be used to enforce the competition law rules enshrined in Articles 81 and 82 EC. In other words the EC Commission is not empowered to adopt any remedies that would aim to resolve the particular market failure in question; rather, it must bring competition law based cases against undertakings if it wishes to use its administrative powers to solve the problem identified. It is obvious then that the above arguments concerning potential benefits are more relevant for the UK market investigation regime

The Competition Commission, in contrast to its counterpart in Brussels, has a wide discretion, and the necessary power to adopt a wide range of measures designed to remedy an identified defect in the market. Such remedies available under Competition Commission guidelines can:

- make a significant and direct change to the structure of a market (eg, through divestment and unbundling);
- change the structure of a market less indirectly (eg, by reducing entry barriers or switching costs, by requiring the licensing of know-how or intellectual property rights, or by extending the compatibility of products through industry-wide technical standards);
- direct firms to discontinue certain behaviour (eg, giving advance notice of price changes) or to adopt certain behaviour (eg, more prominently displaying prices and other terms and conditions of sale);
- restrain the way in which firms would otherwise behave (eg, the imposition of a price cap); and
- monitor (eg, a requirement to provide the OFT with information on prices or profits).

This is an impressive array of potential remedies. The European Commission, in contrast, can only pursue formal competition law cases using its powers to enforce Articles 81 and 82.

Competition Commission Plus

In most cases action to impose the remedies can be taken by the Competition Commission. In other cases (such as changes to industry regulations), the Commission can only recommend such action to government departments or other bodies. The government has committed that it will respond publicly to any such recommendation within 90 days of the publication of the Competition Commission's report.

²²³ Competition Commission, Provisional Decision on Remedies. http://www.competition-commission.org.uk/inquiries/ref2006/grocery/provisional_decision_remedies.htm

 THE COMPETITION COMMISSION HAS AN EXPERT ENERGY PANEL ON-HAND

The Competition Commission also has a special utilities panel, made up of CC members expert in the energy and related sectors. Most usually the panel deals with water, electricity, gas and energy code modification appeals but these members would clearly be involved in any market investigation into the energy sector, thus ensuring an expert and thorough review.

THE COMPETITION COMMISSION EXISTS TO FILL THE EXISTING GAP BETWEEN REGULATION (OFGEM) AND COMPETITION LAW ENFORCEMENT (OFT)

In the words of the Chairman of the Competition Commission, Peter Freeman:

“Not only are market investigations a very useful way of investigating industry-wide issues but, in terms of fairness of process, thoroughness of investigation and practicality of remedies, they can have important advantages over the so-called ‘prohibition’ system. And with a maximum of two years they are comparatively quick for what they can deliver. So, in conclusion, I do not know what chemical is concocted from mixing regulatory “chalk” with competition “cheese”; but . . . the distinction between them is not as clear cut as some would argue and that, in particular, market investigations can act as a bridge over whatever gap divides the two”.²²⁴

So what is needed?

Even before a market investigation is called, it is obvious what is needed to address the problems identified by the European Commission alone:

The most obvious candidate is improved transparency. The recent price spikes in the UK gas market and the difficulties in determining why more gas was not flowing from the Continent to the UK are a clear indication of this. If the authorities have difficulties getting the information that they need, competitors of the vertically integrated incumbents must be operating completely in the dark. So regulation here may well be needed. The Competition Commission is ideally suited to identify further informational remedies to promote transparency in this sector.

However, transparency alone will not suffice. The greatest problems with the sector stem purely from oligopoly, and indeed collective dominance. In such cases, as the European Commission has identified in this and other sectors,²²⁵ the primary problem is one of a forcing out, or keeping out, of rival providers, and thereby allowing incumbents to charge consumers what they wish. Other problems may arise as well, simply out of coordinated effects and tacit collusion that can stem from oligopoly. One of the most common problems in such a closely held market, however, is the fact that two to three players can effectively sew up the market through long-term agreements with downstream distributors. This is precisely the problem identified by the European Commission in the energy sector. In its final report on its sector inquiry, the EC reported that “the prevalence of long-term supply contracts between gas producers and incumbent importers makes it very difficult for new entrants to access gas on the upstream markets. Similarly, electricity generation assets are in the hand of a few incumbent suppliers or are indirectly controlled by them on the basis of long-term power purchase agreements . . . giving the incumbents control over the essential inputs into the wholesale markets”.²²⁶ “The Sector Inquiry has also confirmed the vertical tying of markets by long-term downstream contracts as a priority for review of case situations under competition law and of providing guidance where required”.²²⁷

These problems of vertical foreclosure and long-term contracts, and the linking through de facto integration between the wholesale and retail levels, is precisely the problem that energywatch has identified as prevailing in the UK energy sector.²²⁸ It needs to be addressed as a matter of high priority by Her Majesty’s Government, and it is submitted that the Competition Commission has the analytical tools, the remedial powers and the expertise to do the job.

1 April 2008

²²⁴ P Freeman, “Regulation and Competition—Chalk and Cheese? The Role of the Competition Commission”, *CRI Frontiers of Regulation Conference, Keynote Speech University of Bath 7 September 2006*.

²²⁵ Case T-342/99 *Airtours/First Choice* [2002] ECR II-2585; Case T-464/04, *IMPALA vs Commission of the European Communities*, 13 July 2006.

²²⁶ European Commission, Energy Sector Inquiry, Final Report, January 2007 at 8.

²²⁷ European Commission, Energy Sector Inquiry, Final Report, January 2007 at 13.

²²⁸ energywatch, Efficiency Review of the GB Wholesale Gas and Electricity Markets; Business and Enterprise Committee: Inquiry into possible anti-competitive behaviour in the energy markets.

Further supplementary memorandum submitted by energywatch

1. SOCIAL TARIFFS

Mr Berry questioned what the relationship might be between social tariffs and Warm Front.

It is the view of energywatch that the successful eradication of fuel poverty requires action on all three of its conspiring causes:

- Low-income.
- Poorly insulated housing with energy inefficient heating.
- The actual cost of energy paid by this group.

energywatch believes that Warm Front has a vital role to play in the provision of insulation and efficient heating to fuel poor households and that this work should be closely integrated with suppliers' Carbon Emissions Reduction Target emissions, which also provide energy efficiency measures to low-income households. We do however share concerns over some recipients being asked to pay top up fees and the waiting times that they can be subject to. We are also concerned at reductions by government in funding for Warm Front at a time when fuel poverty is increasing. Various government policies are helping increase incomes of the poorest in society and a government sponsored benefit entitlement checks service to maximise income that suppliers could refer consumers to. Social tariffs would address the actual cost of energy paid by fuel poor households and minimum standards would ensure these are offered in a consistent and effective manner.

It is on this basis that energywatch advocate that social tariffs should be offered as an integral part of an energy assistance package that also comprises energy efficiency and benefit entitlement elements.

2. GREEN ENERGY TARIFFS

In response to comments from Allan Asher about green energy tariffs, Mr Oaten requested more information about these tariffs.

With 19 different green tariffs currently on offer from specialist green suppliers and the big six energy suppliers, it can be extremely difficult for consumers to choose a tariff that is right for them. And what do energy suppliers mean by "green" anyway?

A green tariff can mean one or a combination of three things: a supplier will guarantee to match a percentage of the electricity used (from 10% to 100%) with a supply of renewable electricity back into the grid (a green source tariff); a supplier will make a donation to a fund that supports the development of new renewable generation or environmental causes (a green fund tariff); a supplier will make a donation to a carbon-reduction project in the UK or abroad in order to help offset a household's carbon dioxide emissions (a carbon offset tariff).

The information that suppliers provide about the different green tariffs on offer is not always transparent, and it can be particularly unclear about the environmental benefits that they deliver. There is currently no scheme in place to verify the claims that suppliers make about the "greenness" of their tariffs.

Licensed electricity suppliers are already legally obliged to supply a certain percentage of electricity from renewable sources under the Renewables Obligation. Some of the green tariffs on offer today are simply a "repackage" of this legal obligation. Thus, signing up to one of these tariffs may not amount to environmental benefits (ie carbon dioxide emissions reductions) in addition to those which would already occur under the law. Energy consumers are also actually contributing towards the Renewables Obligation and currently pay around £10 per year on their electricity bill, with this amount likely to double by 2015. It is likely that many consumers are not aware that they are already paying towards renewable energy.

Creating transparency and confidence for consumers

Since last year, Ofgem has been consulting on developing their 2002 guidelines which set out criteria for the use of environmental or green claims in the description and marketing of electricity by suppliers.

energywatch has been heavily involved in these consultations, and we have set out clearly that there is the need for the mandatory disclosure of accurate and transparent information that will allow both domestic and non-domestic consumers to make reliable choices in terms of both carbon emissions reductions and renewable electricity generation. In our view, the existing Fuel Mix Disclosure requirements (joined owned by BERR and Ofgem), with some adjustment, together with strict and even-handed enforcement, are sufficient to deliver the required outcome.

Under the Fuel Mix Disclosure requirements suppliers are obliged to disclose accurate overall information about the generation fuel mix of the electricity they supplier. Suppliers have the option to disclose this information for individual tariffs as well. A small change to the fuel mix disclosure regulations could make it mandatory for suppliers to disclose the fuel mix for every tariff.

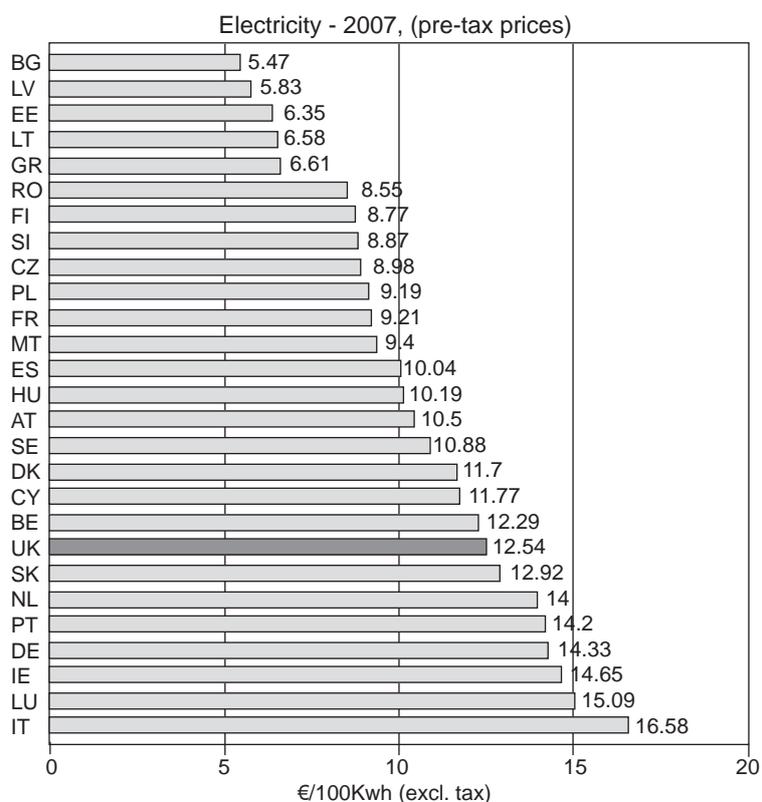
Accurate fuel mix disclosure will allow for the carbon content of the supply to be calculated, and, when compared to the average, will give a picture of carbon emission reductions. It will also allow for ranking of suppliers' offerings in terms of renewable and carbon content. All renewable energy electricity must be backed by renewable energy guarantees of origin (REGOs) and renewable climate change levy exemption certificates (LECs). This will ensure it is not supplied to more than one customer simultaneously and thus double-counted.

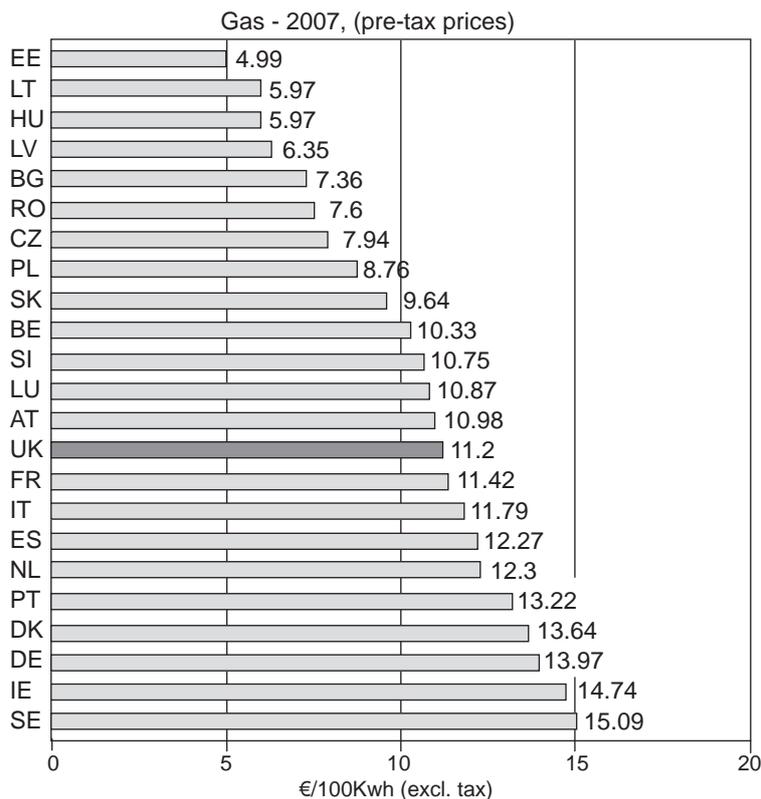
We recommend that the government appoints an independent certification body to monitor and audit fuel mix disclosure and to ensure that certified green tariffs deliver additional environmental benefits. The duty to enforce the rules should remain with Ofgem.

30 May 2008

Figure 12

PRICES OF ELECTRICITY AND GAS





Letter submitted by E.ON UK plc

Thank you for your letter of 11 January.

You will appreciate that, since E.ON UK operates in a competitive market, and such information may well be price sensitive, I am not able to provide you with specific information in relation to any possible prospective price changes (E.ON has made no public announcement of a change in prices). However, I am pleased to provide some background which I hope will help with your evidence session with Malcolm Wicks.

RETAIL PRICING

Ofgem has provided some useful independent commentary on the link between wholesale and retail prices, which I would commend to you. This is provided in depth in their Domestic Market Retail Report (June 2007) and has been updated in light of further wholesale cost increases, in their short Factsheet on Household Energy Bills (January 2008).

In summary:

- wholesale costs are volatile, and high by historic standards;
- advance purchase allows for some delay in passing through cost increases, but not indefinitely (and carries a substantial risk if wholesale costs fall);
- the movement in costs is large (hundreds of millions of pounds) and hedging is not a precise art, so no two suppliers will have the same cost base. Therefore although all suppliers are under similar pressures, there are significant differences in any price change;
- suppliers have to take customers with them, or risk losing market share. The GB electricity and gas markets are amongst the most competitive in the world, and also as competitive as almost any other household sector; and
- environmental costs are starting to be material (notably the subsidy for energy efficiency measures, which has increased over the last 10 years from the original EESOPs scheme costing £25 million, to the £ $\frac{3}{4}$ billion cost of CERT, which is due to start this April).

VULNERABLE GROUPS

In relation to your question about vulnerable groups of customers, for our own part we are very mindful of the impact of higher costs on vulnerable customers with above average energy needs. The most effective mitigation for such customers, both in size of potential saving and in sustainability, is improved energy efficiency. The larger part of the new CERT scheme will result in free measures for the over 70s and customers on benefits. Across all suppliers, this will amount to funding of around £500 million each year for this group of customers.

The next most effective measure is, through information sharing, to increase customers' awareness of the benefits to which they are entitled, so that they claim them. All vulnerable customers are encouraged to call our "Caring Energy" helpline, which will provide a benefits entitlement check as well as energy efficiency advice and which also manages referrals to our hardship fund. (Our hardship fund is designed to help vulnerable customers, particularly those in debt, who cannot afford new appliances or measures offered under CERT or WarmFront, for instance low income customers not on benefits).

Tariff based mitigation has a useful role to play but can only have a limited impact on fuel poverty. For instance we have previously:

- increased the size of the cold weather payment to our Age Concern customers;
- reduced the size of the price increase for prepayment meter customers; and
- deferred increases for some vulnerable customer groups until the spring.

In addition, customers on the social tariff element of our "Staywarm" product have benefited from continuing to pay average energy bills, although their energy needs are significantly above average.

These measures can add up in value to some millions of pounds, and are reasonably well-targeted on the fuel poor, but cannot compensate all vulnerable customers for the full impact of rising wholesale energy and environmental costs. In our view, only government can do this, through full indexation of benefits and winter fuel payments.

THE GOVERNMENT'S DECISION ON NUCLEAR POWER

E.ON UK welcomes the Government's decision on nuclear power and views this decision as being complementary to the recent announcements on the UK CCS competition and UK offshore wind potential, all with the aim of ensuring the country's energy supply is secure, low in carbon and affordable.

Between now and 2020, the UK will close up to 22GW of generation capacity due to the closure of life-expired nuclear, coal and oil plant. E.ON UK itself will close over 4GW of coal and oil generation capacity by the end of 2015 and intends to be a major investor in new UK energy supply infrastructure. The closure of this capacity provides a significant opportunity to reduce the carbon emissions from the UK's power sector but at the same time it is important to maintain diversity of sources of fuel for power generation, to help ensure security of supply.

Therefore, new nuclear plant has a role in contributing economically to the UK's CO₂ reduction targets and, in an era of high fossil fuel prices, to a diverse and secure energy supply. Assuming reasonable licensing and planning processes, we would expect investment in new nuclear plant to be a credible economic option given current expectations of fossil fuel prices and, at the time a final investment decision would be taken (at least four to five years hence), confidence in a sustained value for carbon emission abatement.

In the meantime, to 2015 investment in conventional generation technologies will be required to replace closing coal and oil capacity. The UK market is already responding by building new gas CCGT generation capacity, but reliance on this technology alone will not deliver energy policy objectives.

Investment in new coal generation capacity using supercritical plant technology enables the UK to maintain diversity in supply (and has significantly lower CO₂ emissions than existing coal-fired capacity) whilst carbon capture and storage (CCS) has potentially a key role to play in enabling new coal-fired generation to reduce its carbon dioxide emissions further by around 90%. New coal investments need to ensure that CCS can be retrofitted to allow reduction in carbon dioxide when the technology becomes proven. We support the Government's announcement that it will support demonstration of post-combustion CCS technology and will be entering a project into the competition.

Stability in the existing Renewables Obligation is essential to maintain investor confidence in the market for renewable generation, particularly given the difficulties UK developers are facing as a result of high world demand for turbines, aggressive incentive mechanisms in other countries and limited competition in the supply of equipment. The legally binding target agreed by the European Council, that by 2020 20% of total final energy consumption should come from renewable sources, will reinforce support for investment in renewable technologies in the UK.

Therefore, we do not believe that the Government's decision on allowing private companies to invest in new nuclear power capacity will inhibit investment in conventional or renewable generation capacity. Continued and consistent policy measures are required across all technologies to enable companies to invest in a variety of solutions to tackle energy security, climate change and affordability.

25 January 2008

Memorandum submitted by E.ON UK plc

INQUIRY INTO STRUCTURE OF UK ENERGY MARKET

SUMMARY

- Whether you look at the intense competition on price, the high amount of innovation to win customers, competition in service, the significant changes in market shares or the substantial level of switching, all indicators point to Great Britain having a highly competitive domestic energy market. This has been confirmed in independent analysis carried out for BERR and by Ofgem.
- A market of six larger players, with a number of smaller niche competitors, is consistent with a high level of competition—as is evident from the indicators already discussed.
- Competition benefits all classes of customers, through the close linkage between prices in different customer groups. It is true that switching levels have been lower for pensioners and, historically, prepayment meter (PPM) customers, but this is something that the industry is addressing and where, we believe, improvements are already being seen.
- The wholesale markets for gas and electricity are both competitive, with high levels of liquidity in gas and increasing levels of liquidity in electricity. Both markets are being affected by soaring oil and coal prices, some 83% and 63% higher in March 2008 than a year previously.
- The market for electricity generation is relatively unconcentrated, having seen significant entry since privatisation of the industry some 17 years ago. It faces real challenges going forward, with a need for substantial investment to replace closing capacity.
- There has been relatively little consolidation in the domestic retail electricity and gas markets since E.ON's acquisition of TXU in 2002. There has been no significant change in the concentration of the domestic power market over the last three years and it remains relatively disaggregated.
- Suppliers in the domestic energy market manage the risk of wholesale price changes for their customers—unlike in other volatile markets such as petrol retailing. Changes in input costs can be significant and, whilst a supplier seeks to hedge itself against these changes and shield its customers, it is impossible to manage them completely or always get it right. This leads both to price changes for customers and profit variations for suppliers, who are punished by the market when their competitors manage the risk of hedging better than they do.
- The competitiveness of the GB retail market means that, if suppliers put up their prices in response to an increase in input costs, they risk losing customers as a result.
- Suppliers in the market tend to be vertically integrated to manage risk. However, they trade extensively in the market, both reflecting their “make/buy” trade-off decision and to manage differences between their production and demand. Liquidity is increasing.
- The continental gas market (and oil prices) are having an increasing effect on the UK gas market (and consequently, the electricity market) as our domestic production reduces, we become more dependent on imports and more pipeline import capacity is built. The effect of the continental European market is likely to increase in both gas and electricity.
- Ofgem has wide-ranging regulatory and competition law powers, which it does not hesitate to use. We believe that it is right that Ofgem remains independent of Government, with a principal statutory duty of protecting present and future consumers.
- E.ON, in common with other suppliers in the market, has put in place social tariffs and assistance programmes to help poor and vulnerable customers, with our own measures being predominantly focused on the elderly.
- We believe that the most effective mitigation for poor and vulnerable customers, both in size of potential saving and in sustainability, is improved energy efficiency.
- Rising wholesale prices, to cover increases in primary fuel costs, environmental measures and large investment programmes, will inevitably feed into retail prices. It is not practicable for suppliers to protect fuel poor customers from these rises, except in very specific circumstances, and then only temporarily.

- Given that very substantial funds are already being committed to this area, both by Government and by suppliers, it is essential that further steps are well-targeted on the most vulnerable customers, seek to make the most effective use of resources, and that the Government has clearly defined the goals it wants to meet.

INTRODUCTION

1.1 The UK has the most competitive energy market in the EU and G7 countries. That was the finding of research carried out by an independent firm of economists and presented by the Secretary of State for Business, John Hutton, at the end of January 2008.²²⁹ This also reflected the views expressed by Ofgem in January this year.²³⁰ As recently as 15 January 2008, Ofgem looked at household energy prices in Britain and demonstrated that Britain's electricity bills were "still competitive" compared with most other European countries and that its gas bills were "among the cheapest in Europe".²³¹

1.2 Equally, as we describe below, the wholesale markets in the UK are highly competitive, with low levels of market concentration²³² and growing levels of liquidity.

1.3 The Select Committee asked us to respond to seven specific questions—we deal with these below.

1. *Whether the current market structure encourages effective competition in the retail markets for gas and electricity*

1.4 There are three retail market segments, domestic, small and medium-sized enterprises and corporates, each of which is highly competitive. In this submission we have focused on the nature of competition in the domestic market since we believe that will be of most interest to the Committee, but would be willing also to discuss competition in the other market segments if that would be helpful.

The nature of the domestic retail market—vigorous competition

1.5 The GB energy market shows all the characteristics that would be expected of a competitive energy market. Therefore, as considered by Ofgem in its last published review of the GB domestic energy retail market in July 2007 (the "July 2007 Review"), the market demonstrates competition on price, innovation to win customers, competition in service, substantial changes in market shares and significant levels of switching.

Competition on price

1.6 The analysis that Ofgem carried out, over four years up to July 2007, showed "vigorous competition" on price by energy suppliers.²³³ The scale of price competition can be seen by considering the potential savings available to customers who switch from one dual fuel supplier to another (larger savings still are available for the 25%²³⁴ of customers who have never switched): see Figure 1 below.

²²⁹ Department for Business, Enterprise and Regulatory Reform, Press Release 2008/22, 30 January 2008. Energy market competition in the EU and G7: Preliminary 2006 rankings: <http://www.berr.gov.uk/energy/markets/competitiveness/page28432.html>

²³⁰ "Britain's domestic energy market is highly competitive and remains the most competitive in Europe" Ofgem Corporate Strategy 2008–2013, published in January 2008 (para 1.6).

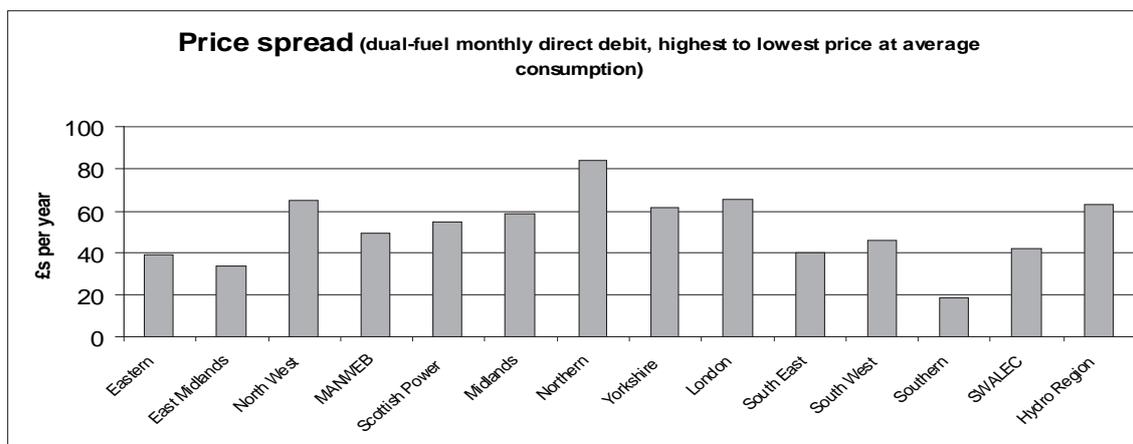
²³¹ Ofgem Factsheet 66: Updated Household energy bills explained 15.01.08.

²³² A recent in-depth study into the EU electricity wholesale markets using six countries as case studies found Great Britain to have the lowest levels of concentration (London Economics for EC Commission, 27 February 2007).

²³³ Ofgem Factsheet 69: Britain's competitive energy market 04.07.07.

²³⁴ Although 50% of customers have not switched in each of the electricity and gas markets, these are not the same 50%—half have switched the other fuel, typically achieving around half the savings available from switching both fuels.

Figure 1
PRICE SPREAD ACROSS REGIONS AT 1 APRIL 2008



Source: E.ON UK

1.7 Ofgem's own analysis, in the July 2007 Review, showed that all energy customers "regardless of payment method, have been able to make significant savings".²³⁵

Innovation to win customers

1.8 Companies have to be innovative to win customers. This means new products, fresh ideas and novel propositions. These include online products, fixed tariff products, capped tariff products, green energy and different types of offerings for poor and vulnerable customers.

1.9 For example looking at E.ON UK, just since January 2007, we have:

- increased our field sales force more than four-fold. This increase in field sales activity is particularly important in ensuring that customers have easy access to the competitive market.²³⁶ Although 65% of households now have internet access²³⁷ (and 31% of low income households), field sales still account for around 50% of sales. Face to face contact is also increasingly important to securing customer interest in energy efficiency measures. These can deliver significantly larger savings than just switching supplier;
- made over 1000 price changes (this includes individual adjustments made within two major changes—a reduction in March 2007 and an increase in February 2008,²³⁸ but around 10% are through the year as we change our competitive position and regularly review products);
- introduced new versions of our Guarantee²³⁹ and capped price products, which seek to overcome customer concerns that price savings will not last;
- continually varied our on-line products, against the background challenge of fierce competition leading to unsustainable margins and low customer loyalty;
- launched new central heating and green energy products;
- reduced the higher charges to customers on independent gas transporter (IGT) networks and gas prepayment meters; and
- invested £15 million in improving prepayment meter technology through the fitting of key meters.²⁴⁰

Competition in service

1.10 We have strived to improve our customer service. Between January 2005 and January 2007, we rose from number 6 in the energywatch ranking of supplier complaints to number 2. Since then, we have reduced our complaint levels by a further 25% but slipped to number 3 in the energywatch complaints table²⁴¹ as our competitors have improved their customer service—the bar is continually being raised. Over the past four years, the July 2007 Ofgem Review states that the number of complaints for five out of the six largest energy suppliers has fallen.

²³⁵ *Op cit* footnote 5, page 1.

²³⁶ Developments such as salesmen's hand-held computers give increased transparency and confidence in price comparisons, though these are not yet in universal use by suppliers.

²³⁷ Ofcom: *The Consumer Experience. Research Report 20 November 2007.*

²³⁸ Delayed to April 2008 for prepayment and Age Concern customers. Separate decisions are made for the 14 regions for 22 products, standard electricity, Economy 7 electricity and gas, plus different payment methods.

²³⁹ Our Guarantee product guarantees savings against British Gas, who is the largest competitor. There is also a saving for first time switchers, from the local electricity supplier and British Gas.

²⁴⁰ Total spend on the project, which will not be completed until later in 2008, will amount to over £21 million.

²⁴¹ EdF is now number 2.

Substantial changes in market shares

1.11 As Ofgem puts it, “customers have punished firms offering high prices and poor service by switching supplier”.²⁴²

- the largest supplier in the market, British Gas, has lost millions of customers through its premium pricing policy and service problems, and seen its market share in gas fall from 67% to 48% between 2001 and 2008, whilst its electricity share grew from 18 to 23% and then fell back to 22%.²⁴³ In 2007 it announced its intention to improve its performance, change its pricing policy and regain market share,²⁴⁴ evidenced by two price cuts in 2007 and huge investment in IT systems;
- Scottish & Southern has consistently priced and sold aggressively, leading to substantial growth in customer numbers. In electricity, it has grown from 13% of the market to 18% of the market over seven years, predominantly through organic growth. In gas, it has grown from 5% to 14% of the market;²⁴⁵
- both EdF and Scottish Power, with huge resources from European parents and a variety of strategies including strong doorstep sales activity, high profile sponsorship and partnerships with leading brands, have grown their market shares over the last seven years;²⁴⁶
- RWE has seen its market share in domestic electricity fall, from 18% to 15%, whilst its gas share has grown a little, from 9 to 11%²⁴⁷; and
- E.ON itself, whilst growing from 8 to 18% of electricity accounts, and 4 to 12% of gas accounts, has also seen its market share eroded as a result of fierce competition.²⁴⁸

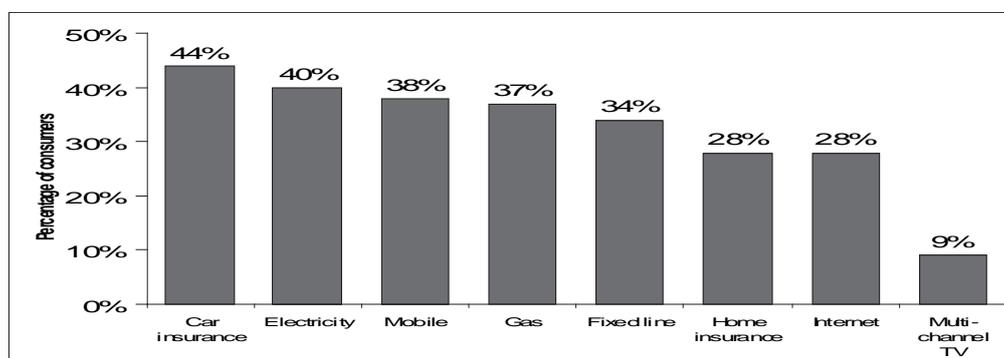
Switching

1.12 Domestic customer switching levels in the GB domestic energy market have continued to increase: some 3.4 million electricity customers and 2.6 million gas customers switched supplier in the first eight months of 2007. These figures showed an increase on the same point in the previous year, despite 2006 being a year of historically high switching because of the level of prices.²⁴⁹

1.13 Ofgem commented in the July 2007 Review that switching does not “reveal the true extent of activity in the market because it does not include customers who have stayed with their supplier but switched to a fixed-price or online deal”. Such customers have clearly engaged with the competitive market but would not appear from the figures. Switching rates in the GB energy market are higher than in many other markets, as shown in Figure 2 below.

Figure 2

COMPARISON OF SWITCHING ACROSS MARKETS



Source: Ofcom The Customer Experience: Research Report 16 November 2006

²⁴² *Op cit* footnote 5, page 3.

²⁴³ Source: Datamonitor figures, from October 2001 to October 2007.

²⁴⁴ See eg *The Times* interview with Phil Bentley, the Managing Director of British Gas, 7 May 2007.

²⁴⁵ Source: Datamonitor figures, from October 2001 to October 2007.

²⁴⁶ *Ibid.*

²⁴⁷ *Ibid.*

²⁴⁸ *Ibid.* E.ON acquired TXU Europe in 2002, which more than doubled its then existing market position and catapulted it into second place behind British Gas, with a 22% market share in electricity.

²⁴⁹ Ofgem Corporate Strategy 2008–2013, paragraph 1.6.

 Market structure and the measurement of competition

1.14 The structure of the retail market is entirely consistent with a competitive market. In the domestic market there are six larger suppliers and a number of niche suppliers. As discussed, there have been quite large variations in market shares amongst the bigger players in response to their different market strategies (data for the smaller players is not available) and high levels of switching. Moreover, the electricity market is a relatively unconsolidated market by accepted measures of market concentration.²⁵⁰

1.15 Evidence of market entry by smaller players suggests that there are no substantial barriers to entry, but the lack of long term success by many smaller suppliers and the preference of well-known brands to work in partnership with existing suppliers (for instance Tesco with E.ON) suggest that profit levels are not viewed as sustainable at an attractive level. However, some niche players have made a success with particular products, notably green tariffs.

1.16 Competition benefits all customers, including those who do not want to switch, despite available savings. Non-switchers are protected by the close linkage between prices in different customer groups. We, for instance, have fixed differentials between quarterly credit and direct debit and single fuel and dual fuel.²⁵¹

1.17 However, concerns have been expressed over two groups of customers—elderly and prepayment meter customers—since switching levels have historically been slightly lower. We compare them below.

Table 1

COMPARISON OF PENSIONERS AND PREPAYMENT CUSTOMERS

	<i>Pensioners</i>	<i>Prepayment</i>
Customers	8.1 million households	3.6 million electricity 2.3 million gas
Switching (to end 2006) ²⁵²	35%	33% electricity 26% gas
Product choice	Staywarm Age Concern All other products	Standard PPM
Barriers to switching	Brand preference for pre 1998 suppliers	Concerns over change of supplier process (eg payment card) 15% repaying debt ²⁵³ (average length of restriction 15 months)
Sales channels	All. Some restrictions on doorstep (cold calling zones; supplier self-regulation, for very elderly) Partnerships—Age Concern	All, except internet

Source: E.ON UK

1.18 We believe the lower switching rate for elderly customers is a natural consequence of features of the competitive market which will diminish in significance over time. In particular, we expect suppliers to improve their ability to target customer segments and develop appropriate propositions and partnerships.

1.19 We agree that, although switching is higher than in a number of other non-energy markets, as shown in Figure 2 earlier, and the price premium is lower than in many other sectors,²⁵⁴ competition has yet to be fully effective for prepayment meter customers. However, this situation is changing rapidly as market solutions emerge:

- the savings available to prepayment meter customers are larger than in other parts of the residential market, as shown in Figure 3 below;

²⁵⁰ The gas market measures of concentration are distorted by the continuing large market share of British Gas. Although this has decreased dramatically over the last five years, from 67% down to 48%, this will still greatly influence the results on, for example an HHI basis.

²⁵¹ For simplicity these are percentage differentials (eg 3% for direct debit compared to quarterly cash/cheque). Percentages result in a slight widening of the differential if there is a price increase—£2.50 at the last price increase on a £400 bill. Switching to direct debit would save £12.

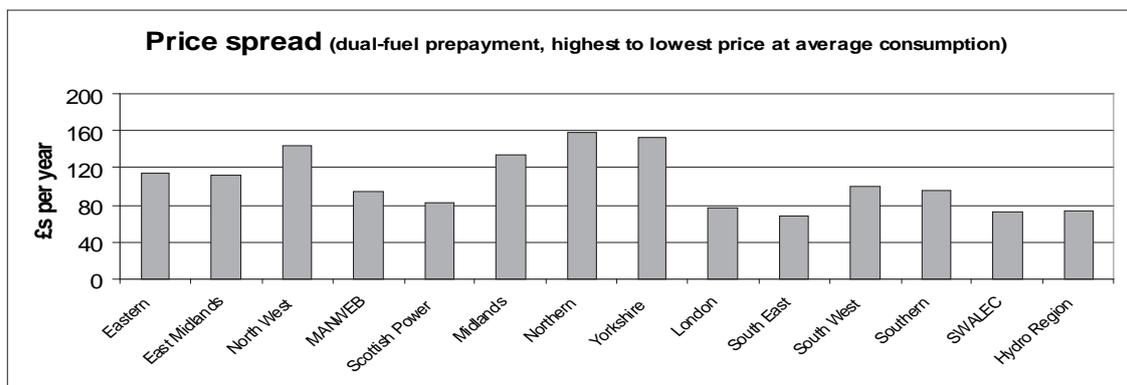
²⁵² Percentage of customers who have switched once or more, as at December 2006, as reported by customers to Ipsos Mori for Ofgem. Switching rates for vulnerable customers—Summary Report March 2007.

²⁵³ The majority of PPM customers in debt, those with debts under £100, can in fact switch, and assign their debt to the new supplier, but experience is that few customers use this.

²⁵⁴ Family Welfare Association/Save the Children: home contents insurance + 33%, mobile phone prepay + 25%, car insurance + 20%, energy prepayment + 10%—example low-income household costs compared to typical costs for other customer groups.

Figure 3

PRICE SPREAD AT 1 APRIL 2008



Source: E.ON UK (note that the scale is double that shown in Figure 1 for direct debit customers)

- our experience is that switching rates are higher now for prepayment meter customers than for other payment types, reflecting the changes in sales activity (increased doorstep sales forces and increased effectiveness in the use of house moves as a sales opportunity);²⁵⁵
- suppliers are investing in new metering technology and in payment infrastructure, which will allow a much wider range of prepayment meter propositions; and
- suppliers are seeking to be more innovative in the propositions offered to PPM customers. We, for instance, are negotiating with switching sites to allow click-through switching for PPM customers.

1.20 Suppliers' social programmes are also delivering lower tariffs to some prepayment meter customers,²⁵⁶ but widespread reductions, based on lower costs, will require implementation of smart meters.

1.21 We believe that these market developments will remove stakeholder concerns over PPM pricing, but accept that the challenge is for us and Ofgem to show that these steps will be effective.

2. Whether there is effective competition in the wholesale markets for gas and electricity

2.1 The BERR competitiveness report referred to above found that the UK had a highly liquid, transparent wholesale gas market and a highly competitive increasingly liquid electricity wholesale market.²⁵⁷

2.2 The gas and electricity markets are linked at the wholesale level, given that gas is used to generate around 36% of Britain's electricity. High world oil prices are also reflected in gas prices because, outside Britain, the price of gas tends to be linked to the price of oil and, as Britain is increasingly having to import gas,²⁵⁸ this feeds through into gas prices in Britain and therefore also into electricity wholesale prices. Electricity wholesale prices are also affected by prices for coal, which is used to generate around 37% of electricity. International coal and oil prices have risen strongly. As at the end of March 2008, international coal for prompt delivery to mainland Europe stood at 137 \$/tonne whilst crude oil stood at 105 \$/barrel, an increase of 83% and 63% respectively over prices a year earlier. Even allowing for the effect of the appreciation of sterling against the US dollar, prices were 79% and 59% percent higher than a year earlier.

Competition in the gas wholesale market

2.3 Competition in the wholesale gas market is well developed. We do not have access to precise market share data but, based on our counterparties, we believe there are around 60 active market participants.²⁵⁹ Liquidity in the wholesale gas market is increasing significantly (see Figure 4 below) with traded volumes accounting for around 10 times physical supply. The UK gas market is becoming increasingly integrated with the continental gas market, as discussed under question 5 below, and this trend will continue as UK gas production declines.

²⁵⁵ Three suppliers may be interested—two from the old property, assuming the customer has not previously switched, and possibly a different supplier at the new property.

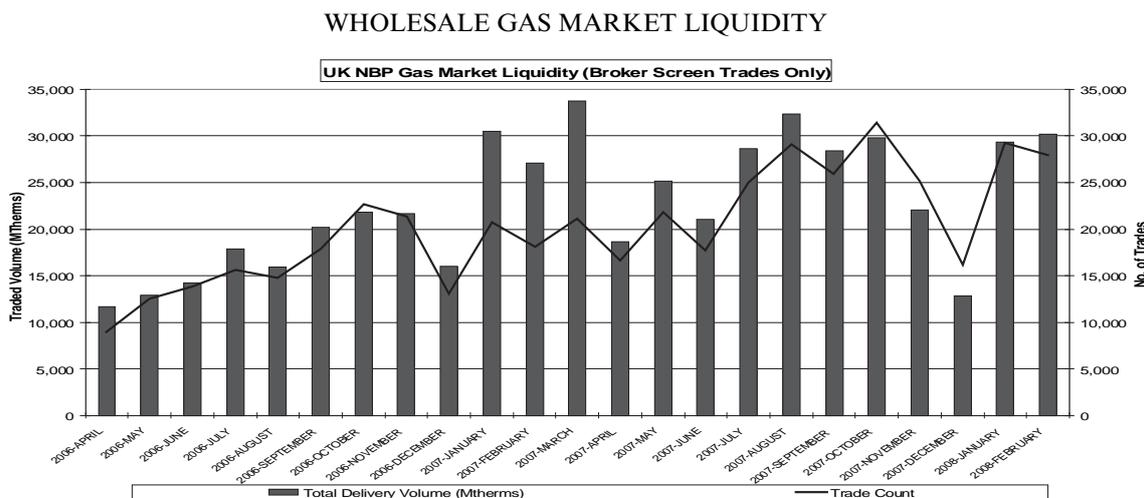
²⁵⁶ However, these are typically available to customers on benefits and so can exclude the 40% of fuel poor customers who are not on benefits, and are thus relatively poorly targeted as a means of supporting fuel poor customers.

²⁵⁷ *Op cit* footnote 1.

²⁵⁸ According to BERR statistics, the UK has been a net importer of gas since 2004 and the figures show that the extent of this is increasing (BERR Digest of UK Energy Statistics 2007, Table 4.1).

²⁵⁹ There are around 180 gas shippers, according to Ofgem's list of Gas Shippers but not all are active.

Figure 4



Source: E.ON UK

Competition in the electricity wholesale market

2.4 Competition in the wholesale power market is very well developed. In terms of market structure, the wholesale power market is quite disaggregated, with low levels of concentration.²⁶⁰ Since privatisation in 1991, when there were only three major generating companies in England and Wales,²⁶¹ there has been a very high degree of new entry, with twenty generators with capacity above 200MW. The level of concentration has been broadly unchanged over the last three years.

2.5 Wholesale market liquidity is a key measure of competitiveness. Concerns had been expressed in the past about whether vertical integration by companies had caused liquidity in the market to fall but, when the EC Commission looked at this issue as part of its Sector Inquiry into the Energy Industry between 2005 and 2007, it did not find vertical integration to be the cause.²⁶²

2.6 The Commission recognised in its Report on the Energy Sector Inquiry that, within the electricity sector, even vertically integrated companies continue to have incentives to trade on the wholesale markets, in particular to optimise their generation portfolios. The Commission comments that a vertically integrated company that owns sufficient generation capacity to produce enough electricity to cover all of its customers' requirements will benefit from buying instead of producing electricity if the wholesale market electricity price is lower than the short run marginal cost of the last generation unit in the merit order of its own generation capacity.²⁶³ This is commonly known as the "make/buy" decision.

2.7 Liquidity did reduce following the departure of Enron and some other traders from the market in 2002–03, but is now improving quite markedly (see Figure 5 below) and, based on the number of counterparties we traded with, we believe there are about 50 active participants. Traded volumes now account for 3 times physical generation.

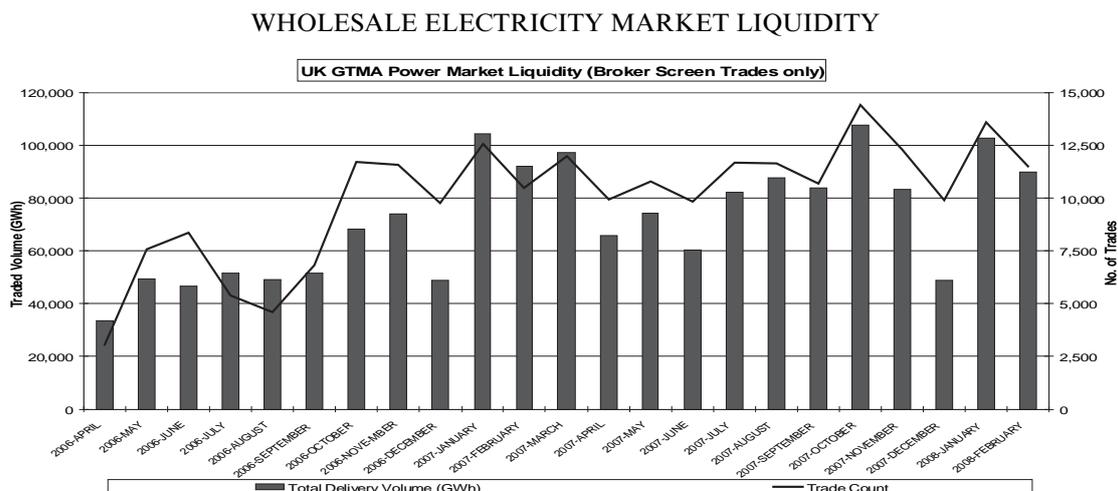
²⁶⁰ The HHIs in the generation market in 2007, on both an output and a capacity basis, are below 1000, tending to denote a competitive market.

²⁶¹ These were National Power (now RWEpower and International Power), Powergen (now E.ON UK) and British Energy. Other generators included imports across the interconnectors, pumped storage and some very small generating stations owned by supply companies.

²⁶² DG Competition report on Energy Sector Inquiry SEC (2006) 1724 10 January 2007 page 154, paragraph 460.

²⁶³ *Ibid* page 151 footnote 261.

Figure 5



Source: E.ON UK

2.8 Competitive pressures will increase further in future if projected increases in interconnection with the continental and Irish markets go ahead. A further factor is the emerging requirement for substantial investment in new generating capacity.

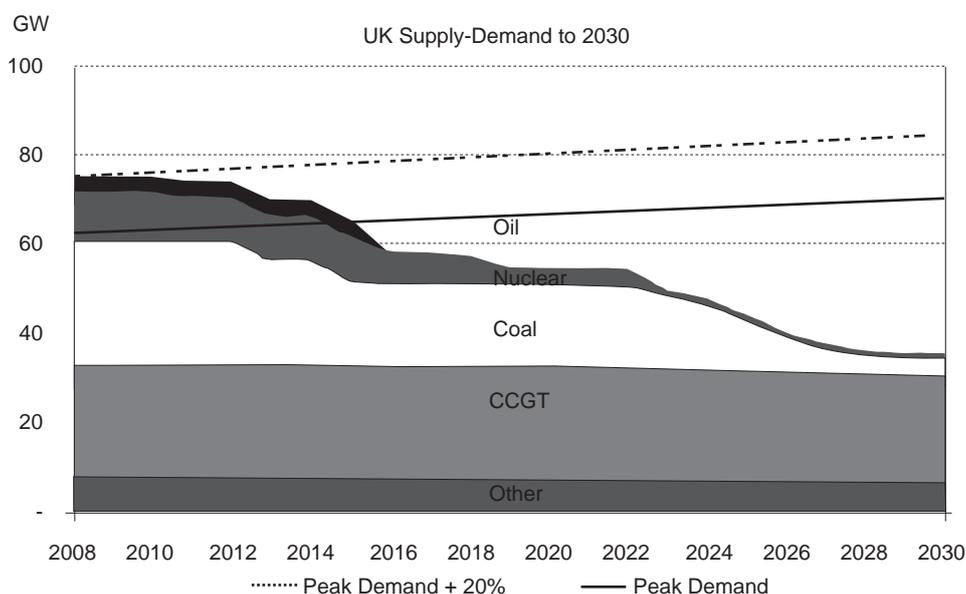
2.9 The UK needs significant investment in new energy infrastructure, sustained over the long term. Between now and 2020, the UK will close up to 22GW of generation capacity due to the closure of life-expired nuclear, coal and oil plant. Between now and 2030, the majority of today’s coal and nuclear capacity will be closed and the capacity gap could be up to 48GW, representing up to 60% of current capacity, if replacements are not made.

2.10 The Government’s recent announcement to target 33GW of offshore wind capacity by 2020 would alone mean an investment of around £50 billion. However, given the intermittent nature of wind generation, only 11GW of this capacity could be deemed effective. Figure 6 below illustrates that this gives rise to a further investment requirement of up to 36GW of alternative technologies over the period to 2030, in order to provide for an adequate generation security margin.

2.11 By way of illustration, the level of investment required in conventional technology to 2020 could be over £10 billion, assuming replacement of closing nuclear with new nuclear (£3 billion), replacing closing coal with a mix of new gas and new coal with CCS or carbon capture capability (£8 billion). Continued investment is required after 2020 to replace further closure of nuclear and coal capacity.

Figure 6

UK SUPPLY-DEMAND TO 2030



2.12 The closure of this capacity provides a significant opportunity to reduce the carbon emissions from the UK's power sector but, at the same time, it is important to maintain diversity of sources of fuel for power generation, to help ensure secure and affordable energy supply. Replacement and additional capacity is needed in base, flexible mid-merit and peaking roles.

2.13 Given the replacement timescales, the default answer is to build more gas generation but this could result in a system that is 70% dependent on gas. This would leave UK energy supply even more highly exposed than it is at present to the price and availability of gas on international markets with unacceptable consequences, in our view, for security of supply. In terms of carbon reduction, whilst gas is less carbon intensive than traditional coal, it remains a relatively high carbon fuel. Further reductions would be possible by retrofitting CCS to gas plant but it is much less commercially attractive to fit CCS to such plant, given the lower carbon content of gas, and a much higher carbon price would be required to render it economic.

2.14 We therefore believe that there is a role for new nuclear, gas, coal (CCS ready) and renewable technologies to address the supply gap whilst meeting energy policy goals:

- new nuclear plant has a role in contributing economically to the UK's CO₂ reduction targets and, in an era of high fossil fuel prices, to a diverse and secure energy supply. This should also be supported by the expected further tightening of the EU ETS in Phase 3 from 2013;
- some new gas CCGT generation capacity will be needed but reliance on gas alone will not deliver the UK's energy policy objectives;
- investment in new coal generation capacity using supercritical plant technology will enable the UK to maintain diversity in supply (and has significantly lower CO₂ emissions than existing coal-fired capacity) whilst carbon capture and storage (CCS) has potentially a key role to play in enabling new coal-fired generation to reduce its carbon dioxide emissions further by around 90%; and
- the legally binding target that, by 2020, 20% of total final energy consumption should come from renewable sources, will reinforce support for investment in renewables in the UK, as will the tightening of the EU ETS.

2.15 E.ON UK itself will close over 4GW of coal and oil generation capacity by the end of 2015 and intends to be a major investor in new UK energy supply infrastructure. E.ON's investment in new capacity in the UK over the next three years to 2010 will exceed £4.5 billion, which is equivalent to reinvesting over 100% of our EBIT.

3. *The implications of growing consolidation in the energy market*

3.1 There has in fact been relatively little consolidation in the domestic retail electricity and gas markets since E.ON's acquisition of TXU in 2002. There has been no significant change in the concentration of the domestic power market over the last three years and it remains relatively disaggregated. There has been some consolidation at the European level but this has not led to any increase in concentration in the UK on a relevant market basis. In any event, any proposed mergers are subject to the scrutiny of the UK or EU merger control authorities, as well as to the views of Ofgem.

3.2 To the extent that consolidation has occurred over a longer timeframe we do not see this as having been detrimental to competition. Indeed consolidation can bring important benefits in terms of efficiency (with fixed costs spread over a larger customer base) and economies of scale, which include the ability to fund the very large capital investments which the sector now requires. In any event, as discussed above, competition in both retail and wholesale markets is well developed.

3.3 In future it is important that the market structure is not frozen and is able to evolve to reflect changing market conditions and challenges. It would not be conducive to market efficiency if managements felt they were immune from acquisition.

4. *The relationship between the wholesale and retail markets for electricity and gas*

4.1 Suppliers in the retail energy market seek to manage billions of pounds worth of highly uncertain costs, which make up 50–60% of the retail price to domestic customers, on behalf of those customers. There is therefore a clear relationship between wholesale and retail markets.

4.2 Some other markets have a similar scale of cost variability, for example, petrol retailing and mortgage provision. However, in both of those markets the uncertainty is wholly passed onto customers. In petrol, pump prices change frequently, whilst in the mortgage market the cost of many products will vary with changes in the Base Rate and customers have to choose the right product for them, for example, a fixed rate product, to manage the risk.²⁶⁴

²⁶⁴ Capped or fixed price products are an increasing feature of the energy market but are only 7% of our customer base.

4.3 One well-respected economic consultancy, Oxera, in a paper issued last year, put it as follows:

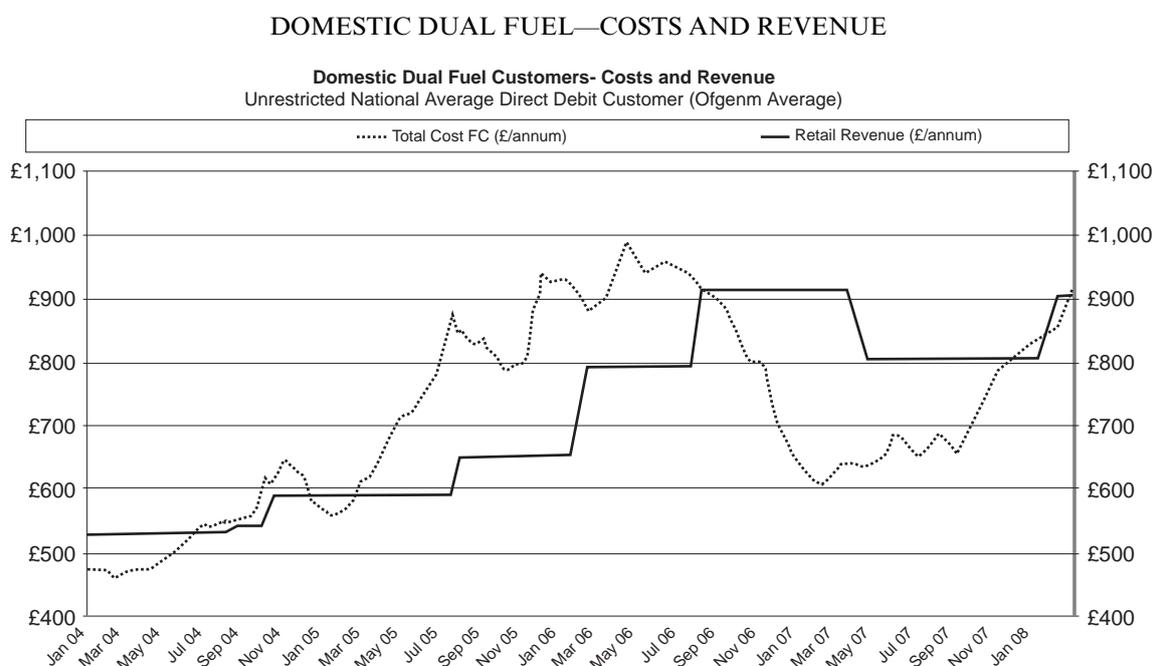
“in recent years energy retailers (supply companies) in the UK appear to have been hesitant to pass through the rapidly increasing wholesale gas and electricity prices to domestic customers. In contrast, after the reductions seen in wholesale prices over the past six months, energy suppliers have been quick to announce forthcoming price cuts, but may also hope to see higher margins in the future”.²⁶⁵

4.4 The hesitancy can be explained by the competitiveness of the UK supply market. Whilst companies may be suffering as a result of the increased costs, their decision on whether to increase prices has to be based on their own reading of the market and of what their competitors might do. As Ofgem puts it, “In Britain’s competitive market, if they increase bills they have to weigh up how much that increase will lead to a loss of customers”.²⁶⁶

4.5 It is impossible for energy suppliers to manage this risk completely through hedging, even for the medium term, or always to get it right. Price changes are therefore inevitable, but suppliers will be punished whenever they misjudge their positions and their competitors manage the situation better than they do.

4.6 The scale of wholesale cost movements is such that price changes can be substantial and year to year profit variations larger still. The volatility of energy costs compared to retail prices is shown by Figure 7 below.

Figure 7



Source: E.ON UK

4.7 In a Press Release of 8 February 2007,²⁶⁷ Ofgem commented on how energy companies manage the relationship between wholesale and retail markets. It said:

“Energy suppliers buy much of their gas and electricity for domestic customers in advance. This helps them to deliver security of supply and means that domestic prices do not track movements in the price of gas from day to day. This allowed suppliers to delay putting up prices when wholesale gas prices began to increase.

It is a myth that companies were swift to increase prices and slow to cut them in line with wholesale price changes. Wholesale prices started increasing sharply in June 2003 but it wasn’t until June 2004 that customers saw the effects. Since then, energy companies have continued to fight to hold onto or gain customers by absorbing substantial amounts of the wholesale cost increases they were incurring. One analyst report—unchallenged—showed that all but one of the companies made a loss in their retail businesses last year”.

4.8 Ofgem calculated that on average, customers had saved approximately £572 through suppliers’ delay in passing through wholesale costs.

²⁶⁵ Assessing energy supply profitability: does a margins approach make sense? Oxera Agenda April 2007, page 1.

²⁶⁶ *Op cit* footnote 3, page 1.

²⁶⁷ Energy Companies have a choice: Cut prices or lose customers, 8 February 2007.

4.9 A number of market participants are active in both the wholesale and the retail electricity markets.²⁶⁸ This raises the issue of vertical integration in the market and its effect on competition. Vertical integration does not, of itself, affect competition; the only questions are whether competition is effective at each level in the supply chain and whether it has led to a lack of liquidity on wholesale markets. We have already demonstrated above that competition is well developed in both the retail and wholesale markets and that liquidity in both the gas and electricity markets is increasing.

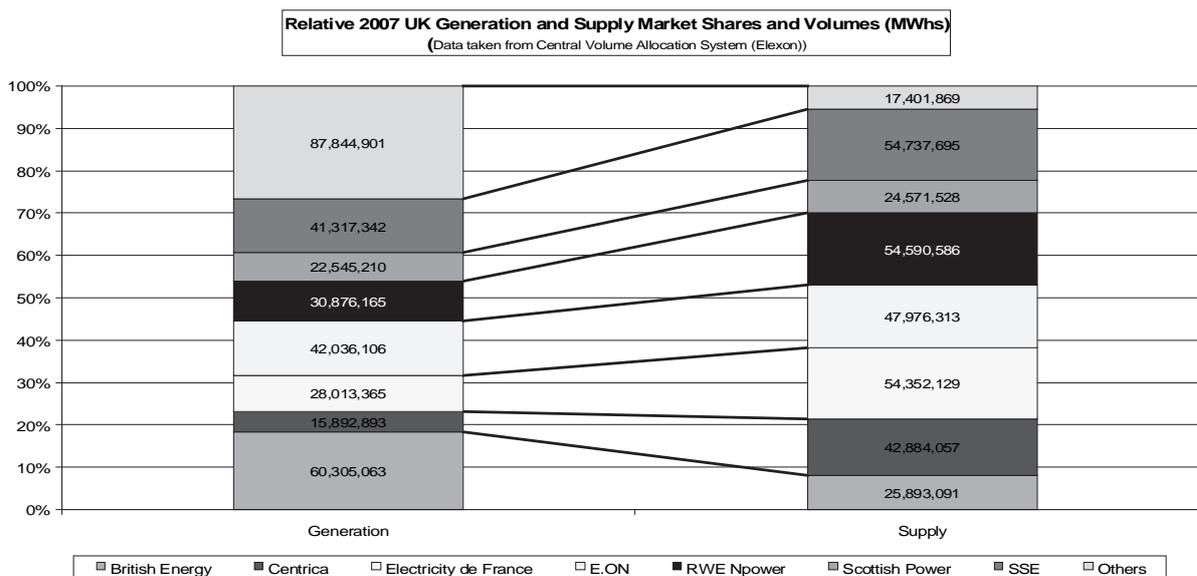
4.10 Vertical integration arises from the need to manage risk in this market. A player in the market wishes to ensure that, commercially, it has a natural hedge between the risks in the wholesale and retail markets. When wholesale prices collapsed to avoidable cost levels after the introduction of NETA in 2001, those companies with some degree of vertical integration were able to weather the storm more effectively than those such as British Energy who had not.²⁶⁹ NETA, and subsequently BETTA, have made it more difficult for standalone suppliers or generators than under the previous Pool structure.

4.11 Aside from the “make/buy” decision, which has already been discussed, vertically integrated companies in the electricity wholesale market must also trade to manage differences between their production and demand, both in total and arising from the “shape” of a company’s generation relative to its customers’ load profile. The shape of a domestic customer’s load, for example, is very peaky, with sharp increases in demand in the morning and after work, compared to a corporate profile, which is likely to be much flatter over the day.

4.12 There are major differences in the positions of the market participants who are traditionally regarded as vertically integrated (see Figure 8 below). A number of companies generate more than the volume they supply to customers while others generate significantly less.

Figure 8

MARKET POSITIONS OF VERTICALLY INTEGRATED ELECTRICITY MARKET PLAYERS



Source: E.ON chart, using Elexon data

4.13 All these factors have led to a situation of increasing, rather than decreasing liquidity in the wholesale markets, as discussed.

5. The interaction between the UK and European energy markets

5.1 In relation to gas, as indicated already,²⁷⁰ the decline of the amount of gas in the UK Continental Shelf has meant that the UK is increasingly having to import gas. The UK has a more significant interconnection with the continental market in gas than in electricity. There are four import pipelines; three from gas fields in the Norwegian Continental Shelf (Langeled, Tampen Link and Vesterled) and one from the Netherlands, the Bacton Balgzand Line (BBL). In addition, there is one interconnector with Belgium (Interconnector UK (“IUK”)).

²⁶⁸ This is mostly an electricity question since, in the gas market few of the major UK gas suppliers are vertically integrated with gas production to any real extent, with the exception of Centrica.

²⁶⁹ Indeed, the Commission’s decision approving the UK Government’s grant of state aid to British Energy to rescue it at that time noted as a factor in BE’s marked decrease of revenues in 2002 its lack of hedging (see Commission Decision of 22 October 2004 (C (2004) 3474 COR, paragraph 13).

²⁷⁰ Footnote 30, *supra*.

5.2 BBL operates on the basis of advance contractual commitments for its capacity and is predominantly insensitive to price. By contrast, the three Norwegian pipelines are sensitive both to prevailing prices within Europe and to contractual requirements since they can both import either into the UK or into Continental Europe. IUK is highly responsive to price changes and can also be used to export gas from the UK to Europe.

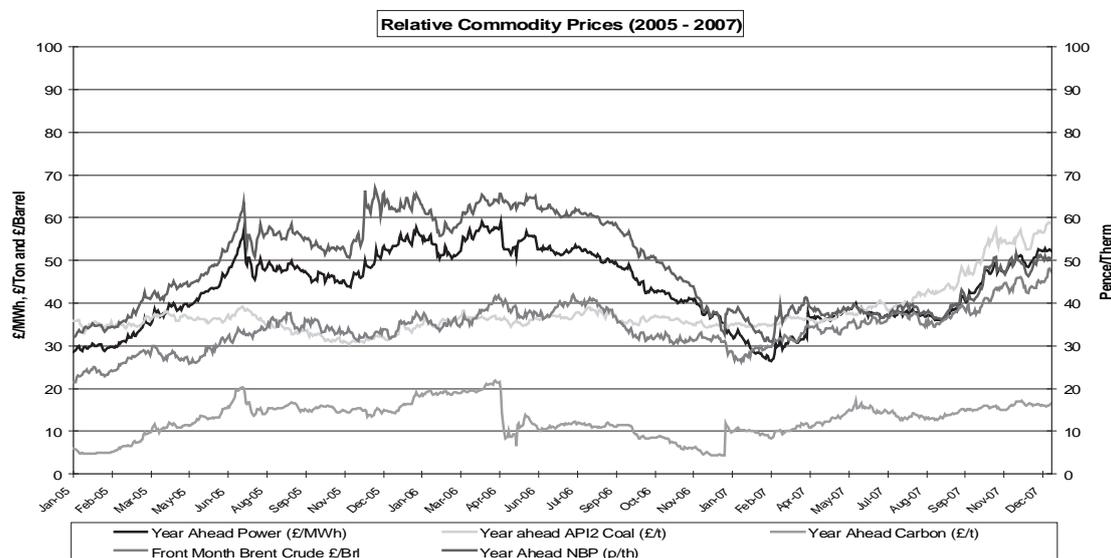
5.3 The other way that gas comes into the UK is through cargoes of LNG. There are two existing operative LNG terminals, at Grain and Teesside, and five others are being built or are in the advanced stages of development. National Grid forecasts that LNG will constitute up to 39% of UK gas supplies by 2017. However, whether an LNG cargo actually makes it to the UK market will depend on demand for LNG elsewhere in the world. The Times reported on 9 March 2008²⁷¹ that, although Grain had been set up to receive at least a cargo a week, in fact, at that date, the last time a ship had docked had been 29 January 2008, since intervening cargoes had gone to countries prepared to pay more, such as Japan and Korea.

5.4 As the UK has become a significant importer of gas, market conditions in the UK have become increasingly determined by European market conditions. When the UK market requires continental gas imports to meet marginal UK gas demand, UK gas prices rise to parity with (or slightly above) European contract price levels. If European demand for gas is itself very high, for example because of unusually cold weather, prices may rise to very high levels. If UK gas demand is low and/or there is a surplus of gas supplies from other sources (UK, Norway and LNG), gas prices will fall below European contract prices and surplus gas may be exported to the continent. European gas contracts are often indexed to oil products and European gas prices have therefore shown a close historic relationship with Brent crude prices, with a lag to allow for the indexation delay.

5.5 Figure 9 below shows the inter-relationship between year ahead prices for National Balancing Point (NBP) gas, and for oil, coal and power. This reveals strong correlation between gas and oil prices, strong correlation between oil and coal prices from mid 2005 onwards and very strong correlation between coal, gas, oil and power from January 2007 onwards. Thus, whilst the UK gas and power prices are not directly linked to oil, there is a strong indirect influence.

Figure 9

RELATIVE COMMODITY PRICES 2005–07



5.6 Continental gas market conditions are therefore of increasing significance for UK gas and power consumers given that gas prices are a major determinant of power prices as discussed above. Liberalisation of European gas markets will lead to more liquidity and increasing competition but it seems likely that the main external gas producers to the EU, who will account for an increasing proportion of EU supply, will continue to have a significant influence on end prices to consumers.

5.7 The right response to this from a UK and continental perspective is to encourage alternative sources of gas, particularly LNG, to increase investment in gas storage and to diversify away from sole or excessive reliance on gas in the power market, by investing in alternative generation, including renewables, nuclear and cleaner coal-fired generation.

5.8 In electricity, the main effect of interconnection on the UK power market is observed in the short term markets—this is because the UK does not need to import significant volumes of power. This has resulted in the 2GW interconnector between England and France being a point of price arbitrage between the UK and

²⁷¹ Price war threat to UK gas supplies, Times Online 9 March 2008.

French markets. Historically, flows over the interconnector have been predominantly toward the UK, reflecting the availability in France of a large volume of nuclear generation at low avoidable cost. This has the effect of reducing UK power prices. Whether this position persists will depend partly on whether sufficient investment will be made in continental power markets to meet substantial future capacity requirements there.

5.9 In future, increasing levels of interconnection with continental Europe and Ireland and the development of common market rules and more harmonised regulatory structures are likely to mean that the UK power market is increasingly influenced by continental market conditions, in effect becoming part of a regional European market encompassing North Western Europe, France, the UK and Ireland.

6. *The effectiveness of regulatory oversight of the energy market*

6.1 Ofgem has wide-ranging powers under a range of utility and competition legislation, which are broader than those of most other EU regulators, and is well-resourced. It does not hesitate to make use of these powers as is evident from its current inquiry into the retail energy market under which it has expressed its intention to use its powers under the Enterprise Act, and its recent fine of NGC in respect of the gas metering market. Whilst independent, it is also sensitive to changing political priorities and consumer perceptions. On balance, we think this is a good thing as consumer perceptions are important. Nevertheless, we expect it to retain an evidence-based approach to its work in response to pressures to intervene in the market which are always most apparent when prices are rising rather than falling.

6.2 Ofgem's principal statutory objective duty is to protect the interests of the consumer, wherever appropriate by promoting effective competition. Consumer includes for these purposes both present and future consumers. It performs that function as an autonomous economic regulator, independent of Government. We believe that it is right that Ofgem should maintain that independence and its focus on protecting customers.

7. *Progress in reducing fuel poverty and the appropriate policy instruments for doing so*

7.1 E.ON, in common with other suppliers in the market, has in place social tariffs and assistance programmes to help poor and vulnerable customers. Our Staywarm tariff and partnership with Age Concern are predominantly focused on the elderly, whilst all vulnerable customers are encouraged to call our "Caring Energy" helpline, which provides a benefits entitlement check as well as energy efficiency advice and which also manages referrals to our hardship fund.

7.2 We believe that the most effective mitigation for poor and vulnerable customers, both in size of potential saving and in sustainability, is improved energy efficiency. The Government's own strategy has a strong focus on improving the energy efficiency of property as the means of reducing fuel poverty. Expenditure on the CERT priority group, WarmFront and the Decent Homes programme will total around £900 million/year, with suppliers through CERT playing the largest part in this programme, around £500 million/year.

7.3 Rising wholesale prices, to cover increases in primary fuel costs, environmental measures and large investment programmes, will inevitably feed into retail prices. It is not practicable for suppliers to protect fuel poor customers from these rises, except in very specific circumstances, and then only temporarily. Indeed, it is unhelpful to customers to suggest that this can be done. Both CERT and WarmFront substantially depend on customer pull—ie customers wanting measures to be put in place to reduce their expenditure.

7.4 Given that very substantial funds are already being committed to this area, both by Government and by suppliers, it is essential that further steps are well-targeted on the most vulnerable customers and seek to make the most effective use of resources. Market intervention, in the form, for example, of a mandatory social tariff, would impose additional costs on other customers who may be more in need and have side-effects which distort the energy market by removing from the competitive market customers who qualify for the social tariff. Further, it would be likely to be unsustainable and potentially detract from the long term goal of eradicating fuel poverty.

7.5 We expect to participate fully in any taskforce established to consider these issues. We will also continue to develop our social programme and seek to target it on customers in greatest need. However, we do not believe that social programmes can sustainably protect consumers from increases in energy prices, whether due to rising wholesale or environmental costs. This can only be achieved through improvement to the quality of housing.

7.6 We believe that the Government needs to reassess how it can more effectively focus resources and the efforts of the many parties involved to deliver lasting solutions for those in real need, avoiding quick fix market interventions which will in the end do little to address the underlying problem. The Government is beginning to make very significant progress in improving the energy efficiency of the UK's housing occupied by consumers on low incomes through the programmes described above but needs to consider a number of potential areas for change:

- targeting policy in a way which recognises the circumstances of different customer groups, for instance, that elderly owner occupiers are in a quite different situation from tenant families;
- increasing emphasis on higher cost measures needed for “hard to heat” homes (such as homes off the gas grid or with solid walls), given that these customers may be in the greatest need (the flexibility mechanism within the CERT priority group, which gives an incentive to solid wall insulation and ground source heat pumps, is a useful step);
- exploring more imaginative approaches to incentivising customers themselves to finance necessary investment in their properties. For example, the Government could support schemes enabling customers to fund energy efficiency improvements by releasing value in their properties, with additional interest costs funded by lower energy costs; financial support could be directed at households with low value properties while a measure of compulsion might apply for landlords;
- enhancing the benefits system to give more explicit recognition to energy costs which have to be met by low income consumers, for example, adjusting housing related benefits to recognise that lower cost poorer quality housing is often offset by high energy costs; and
- clarifying its view of the ultimate policy objective. The Government has a target of eradicating fuel poverty, as far as reasonably practicable, for vulnerable households by 2010 and for all households by 2016. However, while the Government can have a significant impact on housing energy efficiency standards and benefit levels, it has little influence over energy prices prevailing in international markets. The Government should define more specifically what outcomes it wants to achieve over the next eight years, to 2016, given the levers that it has and does not have, and then focus policy on delivering these outcomes.

March 2008

Supplementary evidence submitted by E.ON UK plc

WHOLESALE MARKET LIQUIDITY

1. At the Select Committee hearing on 24 June 2008, it was indicated that Ofgem had suggested that the value of the total Over the Counter (OTC) market in 2007 was £31 million. A question was raised about the limited size of this market, with the underlying concern being that the companies before the Committee (in the particular session, E.ON UK, EdF and RWE) were not trading in the market but instead were only trading internally, hedging between their generation and supply businesses, without this volume ever reaching the market.

2. Initially, it is worth correcting the picture given above. In fact, the value of the UK wholesale market that is screen traded through brokers (ie part of the OTC market), was nearly £31 billion in 2006–07 (April to March) and more than £41 billion in 2007–08. The volume in 2006–07 was 767TWh and in 2007–08 was 928TWh, where physical output volume in each of those years was around 332TWh. Trades through brokers are available to anyone who uses that broker (brokers are, for example, GFI, ICAP, Spectron, Tullett Prebon), subject to credit risk. In addition to the brokers, a small amount of trades (perhaps 1–2%) go through exchanges and there are also some bilateral contracts on OTC or bespoke terms.

3. It is certainly not the case that the players in the market who are vertically integrated do not trade in the market. They all do so, to greater or lesser extents. This may be for a variety of reasons—including because they run their supply and generation trading businesses entirely independently of each other; because they need to add “shape” to their trading profile to meet their retail demand which their own generation portfolio cannot provide; because they may be “short” or “long” in generation and therefore need either to make up volume or to sell it on; or because they wish to optimise their trading position—the “make/buy” decision.

4. For E.ON’s part, it trades more than 100% of its generation volume through the wholesale market. Indeed, in 2007–08, this was more than 200% of its generation volume, as shown in the table below. All of this volume was through brokers.²⁷²

<i>ESI Year</i>	<i>Generation Volume (MWh)</i>	<i>Wholesale Market Sales Volume (MWh)</i>	<i>Sales as a % of Generation</i>
April 2006 to March 2007	37,049,369	49,560,875	134%
April 2007 to March 2008	41,480,605	92,239,488	222%

5. In fact, as was set out in our written evidence, liquidity in the electricity wholesale market is not falling²⁷³—it is increasing. We provided graphs in our response that demonstrated that, as do the figures in paragraph 2 above This has also been independently confirmed by the Financial Services Authority (FSA)—

²⁷² E.ON also trades a small amount through the APX, a power exchange.

²⁷³ It did fall between 2004 and 2006.

the FSA analysis of activity in energy markets 2007 states that UK traded power volumes increased 52% in 2006–07 over 2005–06.²⁷⁴ The electricity wholesale power market is actually quite disaggregated, with low levels of concentration. Based on the number of counterparties we trade with, we believe there are about 50 active participants.

6. However, we do believe that the trading market structure can be improved. As the market is currently set up, liquidity is dispersed across the various different product pools and there is no robust reference price that can be used as a basis for a simple, cash-settled futures contract. This contrasts with many European markets that have a centrally organised spot market with a single, published, reference price that encourages the use of financial swap and futures contracts, reducing credit risk and the need to take power to physical delivery.

7. This was recognised by a number of players in the industry and therefore the “Market Design Project” was initiated by the Power Trading Forum (registered to the Futures and Options Association (FOA)) in March 2006 to review the current market structure and provide alternatives, with the goal of stimulating forward power liquidity. A Market Design Project Steering Group was set up on which E.ON sits, together with representatives of other major players in the wholesale market, including Drax and International Power, as well as representatives from the FOA and others.

8. The following rationale was developed for the project:

- In order to attract additional forward liquidity, the correct products, easy access and financial and physical contracts must be developed;
- To trade financially settled contracts, robust reference prices are required;
- Reference prices are best established day ahead from the underlying physical market, and it is proposed to do this through both continuous trading and an auction process—this suggests a platform which hosts continuous and auction based trading;
- For reference prices to be robust, all (or a significant majority) of trades must be captured. A central clearing platform (energy exchange) is the most efficient way of achieving this goal (this in addition provides a revenue stream to the platform provider);
- This platform should then form the starting point for the future development of financial trading, once the reference prices have been accepted.

9. The Market Design Project proposal, therefore, is for a platform which hosts continuous and auction based trading, capturing all, or a significant majority of trades, through a central clearing platform (energy exchange).

10. A request for proposals from potential service providers was issued in June 2007 to try to find solution providers who could host the auction and intraday platforms and provide clearing services. The process was delayed due to the time required for providers to submit detailed responses and for the Market Design Project to evaluate those proposals thoroughly. Commercial negotiations began with the leading provider but subsequently broke down due to issues with commercial arrangements between the two parties that had put forward that solution. The RFP process has now begun again with the short-listed parties and it is hoped that a recommendation for a way forward will be made in August 2008, with implementation as soon as possible after that, but realistically likely to be in Quarter 2, 2009.

11. The aim of the Market Design Project is to encourage players operating on the fringe of the wholesale market, or operating indirectly, to participate. Many industrial players and brokers take part in other European markets such as Nordpool and EEX because of the ease of entry and the fact that credit risk is reduced via the use of cleared instruments, as described above. So, for example, Bizz Energy and other independent suppliers will be able to participate more fully and the new arrangements should also attract new risk capital that will further enhance liquidity. Other large players on the demand side such as Corus, SCA, Linde Group, and Ineos Chlor are also interested in these developments and E.ON has worked to keep them informed of development.

12. The Market Design Project is an example of the market seeking its own solutions—the market is not perfect and is looking to evolve and improve through its own initiatives and actions. The proposed structure will allow a better range of hedging instruments, thereby encouraging companies without their own generation assets, or large industrial companies to enter the market and enabling more active hedging and trading by market participants.

June 2008

²⁷⁴ This gave a market size of 984.8TWh in the period August 2006 to July 2007, with a value of £31 billion, see: www.fsa.gov.uk/pubs/others/analysis_energy_2007.pdf

Supplementary evidence from E.ON UK plc

ADDITIONAL NOTE ON PREPAYMENT METER (PPM) CHARGES AND SOCIAL TARIFFS

Prepayment meter charges

1. The question (Q862) asked companies to confirm whether they charged prepaid meter customers around 17% more than direct debit. There seemed to be some confusion around the answers given, which it might be helpful to try to clarify.

2. This question was answered for our electricity customers, who make up 63% of our prepayment meter customers, where it was explained that, whilst the extra costs to serve such customers were around £45, the additional amount charged was around £35.²⁷⁵

3. The reasons for the apparent difference between the question asked and the answers given are, first, that the question looked only at final prices to customers, without taking into account the extra costs to serve, and also whether one looks at dual fuel, gas or electricity. Therefore, whilst it is the case that, for E.ON's electricity customers, for example, we are charging them less than the additional cost of that metering, it is also the case that the total price charged to such customers is 10% of the direct debit price higher than the amount charged to direct debit customers. Comparable figures for gas and dual fuel customers are given below—but again, these are the “bare” figures, without taking into additional costs to serve. The size of those costs is being looked at as part of the work with Ofgem on PPM customers.

4. The percentage of our PPM customer base represented by each category is also provided below, to show the relative size of group covered.

	<i>Differential (ignoring costs differences) as % of DD price</i>	<i>% of PPM customers in category</i>
Electricity	10%	63%
Gas	16%	8%
Dual-fuel	13%	29%

Social Tariffs

5. The question (Q889) was around the benefits of clarity and transparency in terms of social tariffs. In our response we supported that clarity, particularly if it led to fuel poverty being tackled on a long-term sustainable basis. As is clear from our response to Q888, we subscribe to a view that it is right to stand back and take a long hard look at how we tackle fuel poverty in this country, which process should be carried out in an open and honest fashion, with clear direction from Government.

6. That remains our position and, indeed, it is essential if we are really to tackle fuel poverty. However, we do not support a mandatory social tariff—not least because we do not know what it is that we are being asked to support. If the Committee were minded to recommend a mandatory social tariff, it would need to be clear what the proposal was, that it was costed, well-targeted and sustainable and that the cross-subsidy from other customers was recognised.

7 July 2008

Memorandum submitted by ExxonMobil

INTRODUCTION

1. Several subsidiaries of Exxon Mobil Corporation are involved in the parts of the European natural gas business that involve the UK. For ease of reference, such subsidiaries are referred to both individually and collectively as ExxonMobil in this submission.

2. ExxonMobil's participation in the UK natural gas business involves upstream production, transportation and processing, as well as sales at the wholesale level of the gas supply chain. ExxonMobil is also a joint venture participant with a minority interest in the South Hook LNG import terminal currently under construction near Milford Haven, Pembrokeshire.

3. ExxonMobil is no longer involved in the retail gas market and our focus in making this submission is, therefore, on the wholesale sector in the UK and factors that are relevant to the functioning of that sector.

²⁷⁵ This was rounded, it should be £38.

4. Our submission covers observations on the evolution of the gas sector in the UK, competition in the UK Continental Shelf and wholesale gas markets, the UK's legislative and regulatory framework and the evolution of the European gas market.

5. We support the Government's strategic objective to meet the UK's need for secure long-term, competitively priced energy by developing an open, competitive market for energy, within a transparent and stable fiscal and regulatory framework. As long as the current market framework remains, we believe the UK will continue to be successful in attracting the long-term capital investment required to meet its future energy needs.

UK GAS SECTOR DEVELOPMENT

6. Throughout the 1980's and 1990's the UK natural gas sector was not connected to Continental Europe, and UK demand was met by gas produced from the UK Continental Shelf (UKCS) and Norwegian Frigg imports to St Fergus. After the Bacton-Zeebrugge Interconnector was completed in 1998 the UK was in a position to import or export gas from Continental Europe in line with domestic supply and demand.

7. In recent years, additional infrastructure has been put in place to allow further natural gas imports into the UK. In 2001 the capacity of the Frigg (renamed Vesterled) import line was expanded and additional Norwegian production sources were connected as Frigg production declined. Norwegian import capacity was increased further in 2006 when the Langeled pipeline was installed and again in 2007 when the Tamen Link was completed. In 2005, the Isle of Grain LNG peak shaving facilities were converted to an LNG import terminal and in 2006 the BBL pipeline was commissioned allowing gas to be imported from the Netherlands.

8. Natural gas production from the mature UKCS reached its natural plateau between 2001 and 2003 and has been in decline since that time. UK gas demand reached a plateau of around 100 bcm/annum in the same timeframe having grown at an annual average rate of about 5% during the 1990's to support new gas-fired power generation. The decline in UK production during this period when gas demand remained on a plateau has led to a steady increase in gas imports to meet demand. During the 2007-08 winter period the UKCS supplied around 75% of total gas delivered to the National Transmission System (NTS) the balance of supply coming from Norwegian and Netherlands production areas.

9. ExxonMobil believes the UK has effectively transitioned from gas self sufficiency by allowing market signals to prompt the need for new import capability and by creating the right conditions for new investment. We see this trend continuing; over the next two years over 25 bcm/annum of additional LNG import infrastructure is expected to be completed, pipeline interconnection capacity will increase by up to 8 bcm/annum, and new storage deliverability of around 30 mcm/day is projected to be added.

10. The UK operates the most transparent, stable and liquid natural gas market structure of any country in Europe and this places it in a strong position to compete for its future gas supply. In the future, the UK can expect gas imports from an increasingly diverse number of sources including Norway, Qatar, Russia, offshore West Africa and other gas-producing countries. A global gas market is developing through LNG interconnection which the UK is part of and well positioned to compete within through new import capacity. Global gas prices now reflect a range of factors including increasing international demand for oil, gas and coal, the flexibility of these fuels to respond to market conditions, environmental considerations, declining gas supplies in mature production basins located close to established demand centres and the fact that replacement gas supply sources are typically further away, more difficult and therefore more expensive to access and to extract. Global demand is also growing for all types of fossil fuels and, as a result, commodity prices for gas, oil, oil products and coal have all increased (although, on a BTU-equivalent basis, gas remains a very competitive fuel).

MARKET CONDITIONS: UPSTREAM NATURAL GAS PRODUCTION

11. Natural gas production activity in the UKCS has seen a significant trend towards diversification over the past eight years. This period has seen asset restructuring as established oil and gas companies have sold part of their interests in maturing fields and, in some cases, infrastructure to new entrants to the UKCS.

12. Information produced by Wood Mackenzie shows that in 2000 there were 32 companies producing gas from the UKCS; this number has increased to 49 in 2007. In 2000, the largest single producing company accounted for 19% of total UKCS gas production, in 2007 the largest single producing company accounted for under 12%. Overall, we see no evidence of consolidation among UKCS gas producers; rather the trend is in the opposite direction with increasing numbers of companies producing gas and decreasing levels of individual production share.

13. The construction of major new infrastructure (LNG import terminals, storage facilities and interconnector capacity) is continuing to widen industry participation in various segments of the UK gas market. LNG import terminals, in particular, enable the UK to access gas from producing countries across the globe including Qatar, Algeria, Indonesia, Malaysia, Brunei, Nigeria, Egypt, Trinidad and Tobago, Oman, Norway and Australia. Overall, this geographical diversity enhances security of supply for the UK.

MARKET CONDITIONS: WHOLESALE NATURAL GAS

14. The UK's main natural gas wholesale trading point, the National Balancing Point (NBP), is the most liquid and transparent gas trading hub in the EU. It has seen continued growth in trading, with the volume traded reaching a record 3.4 billion cubic metres per day in December 2007. Liquidity is enhanced by the high level of trading churn, with total volumes traded in 2007 around nine times physical throughput on average. In 2007, the NBP had around 150 participants registered as shippers and approximately 60,000 trades were carried out. Evidence of the willingness and ability of new participants to continue entering this market can be seen from the estimated 20 companies that have applied for and been granted a gas shipper licence by Ofgem over the last 12 months.

15. Significant market information is available to participants, providing an effective level of transparency that allows clear market signals to develop. National Grid provides real time access to detailed information on demand and supply flows. In addition, a number of independent industry publications, such as Heren, Platts and Argus, provide news on developments in the market and publish gas price indices that enhance participants' ability to trade. The International Commodity Exchange also provides an accessible trading platform that facilitates entry by new participants.

16. We believe that the wholesale sector in the UK is increasingly competitive and liquid and we remain confident of our ability to place gas and receive a market price. ExxonMobil is not active in the retail gas sector so we are unable to comment on this area.

LEGISLATIVE AND REGULATORY FRAMEWORK

17. The UK energy sector has steadily evolved since the 1986 Gas Act when the British Gas Corporation was privatised, the gas and electricity regulators (at that time Ofgas and Offer respectively) were formed, and markets for industrial consumers first opened. There have been numerous milestones in the evolution of the UK's regulatory framework including the 1995 Gas Act (which paved the way for the introduction of competition into domestic gas and electricity markets) and the ownership unbundling of British Gas (leaving Transco as a separate, regulated-monopoly gas pipeline business). This led to a Network Code in gas being established and regulators' powers being enhanced to include aspects of competition. The Utilities Act 2000 went further by creating the Gas and Electricity Markets Authority (GEMA) and contained provisions to make regulation more transparent and predictable.

18. ExxonMobil believes that strong, independent national energy regulators in Europe exercising well-defined powers within a clear, legal framework are essential to the correct functioning of energy markets. ExxonMobil believes Ofgem has progressively earned its reputation as a strong and competent regulator. Over the years, its activities have helped to create a market with the following characteristics:

Transportation access

- Open access on non-discriminatory terms and at efficient, regulated transportation prices.

Market transparency

- A mature system for the assessment of long-term energy supply and demand and investment plans (NGG 10 year statements).
- On-the-day access for all to detailed information on demand and real-time supply flows.
- Storage and LNG import terminal stock information.

Ease of Transaction

- Standard contracts at the National Balancing Point (NBP) which make the selling and buying of gas more accessible for interested shippers.
- Several sources of independent market pricing and gas supply information.

Investment Environment

- The ability for shippers to stimulate new pipeline investments through participation in well structured, long-term transmission capacity auctions.
- The opportunity for investors to seek exemption from regulated Third Party Access for major, new infrastructure under the Gas Act.

UK AND EUROPEAN ENERGY MARKETS

Regulatory Development

19. In North West Europe we have seen many significant developments that enable us to anticipate greater integration and increased liquidity in the wholesale gas market, in part led by the First and Second European Gas Directives. There has been steady regulatory development in the Netherlands over the last five years or so and, in Germany, changes over the last couple of years have been considerable including the establishment of an independent regulator (the Federal Network Agency) in 2006 which has already ruled on tariff reductions in 2006 and on a new grid access model in 2007.

Hubs and Liquidity

20. There are now a number of trading hubs established across North West Europe including the TTF (Netherlands), EGT and BEB (Germany), PEG-Nord (France) and the Z-Hub (Belgium). Standard contracts are available at each, along with independent reporting of trades. Price indices are reported for both TTF and Z-Hub.

21. At the TTF in the Netherlands there has been rapid growth in liquidity, the Z-hub remains important and the level of business being conducted at France's PEG-Nord has exceeded what many might have expected. Overall we see a growing trend in trading and liquidity across North West Europe.

Investment Access and Competition

22. Transmission System Operators are offering open seasons to enable network expansion and to improve access for new entrants, whilst new LNG and storage terminal proposals are being actively developed across Europe. This demonstrates how hitherto national markets in Europe are beginning to integrate, that independent regulation is proving effective and that there are increasing opportunities for participants to trade.

23. This process is evolutionary, often having to overcome historic network complexity. ExxonMobil believes there is clear evidence of wholesale market integration and increased competition; it is important to allow these changes to take hold and that further changes to legislative frameworks are made with care to avoid unintended consequences or the slowing of progress.

CONCLUSIONS

24. Overall, ExxonMobil believes that the UK's current approach to energy policy will enable it to continue to attract the future natural gas supplies it will need.

25. The increasing diversification of ownership of upstream oil and gas assets in the UKCS and the large number of companies operating in the wholesale gas sector are, we believe, indicative of healthy market conditions.

26. We believe Ofgem to be an effective and well informed regulatory agency for the UK's energy sector which has created the right conditions to attract capital investment and ensure market transparency; cross-border trade in gas will continue to increase as long as investment in new capacity is encouraged.

April 2008

Memorandum submitted by the Fuel Poverty Advisory Group

1. The Fuel Poverty Advisory Group (FPAG) is a group of external members appointed by the Government (Defra/Berr). Our job is to report on progress on fuel poverty in England and on the additional policies that are needed to deliver the Government's fuel poverty targets. The Group's membership and terms of reference are attached as Appendix 1.

2. As will be seen the Group consists of a wide range of organisations with different views and this is one of its strengths. On many of the issues there is a very large measure of agreement, on others—including energy prices—there are more differences and the views in this report do not always therefore reflect the views of all our individual members.

INTRODUCTION

3. FPAG takes a pragmatic view of the operation of the market, reaching its judgements on the benefits or otherwise of the market, on the basis of evidence and of developments rather than on the basis of prejudged views. Thus we appreciate that for many years energy prices were very low, partly as a result of the operation of the market. We also believe that the market works well for some customers. We also think

that there are some serious problems with its operation and we have been more willing than Ofgem or Government to face up to the difficulties. There are now signs that the Government and Ofgem approaches may be changing.

4. In this evidence we cover:

- The differentials between the prices paid by different customers;
- The overall level of prices;
- Other issues relevant to prices;
- Regulatory oversight; and
- Progress and instruments for fuel poverty.

PRICE DIFFERENTIALS

5. This section sets out the current situation, and then briefly considers the announcements of the 2008 Budget.

- The position here is extremely troublesome and has been getting worse.
- Customers using prepayment meters for electricity and gas, according to Berr data, are paying on average £990 pa in 2007 compared with the average for a direct debit customer of £845 pa. This is a gap of £145, a huge differential of 17%.
- In 2004 the gap was £70 per annum and it was similar in previous years, so the gap has increased a very great deal.
- The average gap between prepayment and online direct debit prices is higher still—as much as £250.
- Customers on standard credit for electricity and gas (ie those paying by cash or cheque) are paying £85 more than direct debit customers in 2007 compared with £36 pa in 2004. This is another huge increase.
- In the very recent increases early in 2008, there was little change in absolute terms on average in the differentials, except that the differential between prepayment/standard credit and online tariffs seem to have increased still further.
- There are very significant differences between the companies. In some companies prices to prepayment and standard credit customers and/or the differentials are more reasonable than in others. There are also differences in service levels e.g number of payment outlets, availability of 24/7 service.
- Prepayment customers have lower incomes than others; 40% were in the two lowest deciles in England in 2005–06 compared with 20% of all customers and less than 5% were in the top two deciles. In 2006 19% of those paying for both fuels by prepayment were fuel poor compared with 6% of direct debit customers—an incidence of fuel poverty more than three times as high amongst prepayment compared with direct debit. The incidence of fuel poverty amongst standard credit customers is also fairly high.
- The prepayment /direct debit gap was a big one even before the increases of the last few years, for instance it was £28 in electricity in GB in 2004 (compared with £6 in Northern Ireland).
- The increase in the gap is difficult to understand. Margins on prepayment and standard credit customers appear to have increased significantly in relative terms as there is no reason why relative costs should have gone up.
- About three quarters of gas and electricity costs are wholesale supply and transportation in which there is little difference between prepayment and direct debit costs; the £145 differential thus represents over 60% of the remaining price.
- Ofgem in its Domestic Retail Market Report (June 2007) estimate that costs to companies for prepayment customers for both fuels are £85 more than the costs for a direct debit customer (although some of the companies believe that the cost differences are greater than this). The costs for a standard credit customers are £25 greater than for a direct debit customer. Thus the gap in the prices paid by customers is far greater than the gap in costs. Prepayment and standard credit customers are therefore significantly subsidising direct debit customers.
- There has been good progress on social tariffs and social programmes offered by the energy companies and this is important. However—as is now acknowledged—it is in no way adequate to offset the sharp deterioration in the relative prices paid by low income customers, because of the widening price differentials described above.

6. The very large divergence between prices and costs suggests that the market is not working well at least for prepayment and cash/cheque customers. The prepayment-online price gap is over £250 per annum compared with Ofgem's estimate of the cost difference of a little over £85 pa. The standard credit-online price gap is £180 pa compared with the Ofgem estimate of a cost difference of £25 pa. Even if the cost

differences are slightly greater than this e.g for online customers, either some companies are making extremely large margins on their prepayment and cash/cheque customers or they are making losses on their direct debit/on-line offers or both.

7. If, as it is likely, there are some high margins, these would be competed away in a well functioning market—very large numbers of customers would move to companies offering lower prices and taking lower margins. Many of those who are paying particularly high prices are likely to be vulnerable and elderly.

8. There is a whole range of actions that could be taken by Ofgem in particular and also by Government. A menu of possible actions is set out in Appendix 2. These should be driven forward, in the context of Ofgem's probe into the energy markets and of the actions following the Budget announcements. It is very important that the review and the post Budget actions should result in tangible improvements.

BUDGET 2008

9. Two issues relevant to this enquiry were picked up in the Budget:

- Differentials between prepayment and other prices.
- The companies' social programmes and social tariffs.

10. FPAG is very pleased that the severity of the fuel poverty situation has begun to be recognised. It is particularly important that the Budget in effect recognised that the market has not been working satisfactorily for all customers and that the issue of the price differentials is being addressed. Our key points at this stage are:

- It is important that the intentions should be translated into action.
- We strongly believe, as the Government does, that progress can be made on these issues, but the impact of any proposals on fuel poverty needs to be carefully assessed so as to secure the most effective measures possible.
- In assessing companies' performance the level of their prices as well as their social programmes is important.
- The differential between the prices for cash/cheque and direct debit/online customers is also important.
- Independent electricity generators as well as the energy supply companies should contribute to any fuel poverty fund as their profitability has increased sharply and this will increase the size of the fund and/or reduce the adverse impact on prices to customers generally.

11. Overall Price Levels:

- World forces have increased energy costs, but the cost increases do not explain all of the price increases in the UK.
- Specifically, between 2003 and 2006 expenditure by gas and electricity customers increased by £8.2 billion (or 60%). Higher fuel costs only accounted for a little over half of this—£4.5 billion—in spite of claims that the price increases are attributable to rising world energy prices. Other cost increases explain £1/1.5 billion of the increase. It seems that there has been a significant increase in margins along the supply chain, especially in electricity, of over £2.5 billion, accounting for as much as 30% of the price increases.
- Some increase in margins, especially in power generation, is reasonable given the low prices in 2003, but it seems most unlikely that this could explain and justify such a big increase in margins.
- We do not know exactly where the extra customer payments have gone and where the extra margins have been taken. The bulk of the extra payments have probably gone to generators—both independent generators and to some (although not necessarily all) of the big six integrated suppliers. Traders and also owners of storage and distribution networks will also have gained.
- There will be significant differences between companies in the extra margins made.
- These data on prices, costs and margins come essentially from a detailed report on this by Cornwall Energy, commissioned by the National Right to Fuel Campaign and UNISON. Further data based on this report are in Appendix 3.
- Ofgem also believe that electricity generators are making some windfall profits—as a result of the free allocation of permits under the EU Emissions Trading Scheme. They and FPAG share the view that current and future profits from this source should be removed over time by the auctioning of the EU ETS permits, and in the interim by other means, and the proceeds should be recycled into fuel poverty programmes.
- However, FPAG's view based in part on the Cornwall analysis is that the issue is wider than just that of the EU ETS. In 2006 the EU ETS accounted for £0.4bn extra margins out of a total of £2.5 bn, ie 15%.
- FPAG has, over a number of years, asked Ofgem to carry out a proper analysis of prices, costs and margins along the whole energy supply chain. They have not been willing to do this. They should now carry out a full enquiry into where the extra expenditure by consumers has gone. It is

hoped that this will now be done in the context of Ofgem's recently announced probe into the energy market. In doing this they should give their views in detail on the National Right to Fuel Campaign/Unison analysis—do they agree with the basic quantitative conclusions and if so what in their view are the implications?

- Now it has been demonstrated that this work can readily be done, Ofgem should carry out such analyses at regular intervals in an objective way when they review the operation of the market.
- The Government has also been surprisingly passive on the price increases. given that there are macroeconomic as well as fuel poverty implications.

12. It is acknowledged that there are difficult issues here—volatility of profitability, low levels of profitability in the early 2000s and the need for incentives for new investment. We also appreciate that there are significant variations in the position of the different companies. Nevertheless the companies have not only been able to pass on substantial additional costs in full, but they have also significantly increased their margins as well. This would not happen in a properly functioning strongly competitive market.

OTHER ISSUES ON PRICES AND COMPETITION

13. FPAG are clearly not experts on competition issues, but we would just make a few brief comments.

- The six major suppliers of electricity and gas to households are all vertically integrated, especially in electricity. It is therefore necessary to look at the whole energy supply chain and not just at the supply companies. It is also necessary to look beyond the relationship between retail and wholesale prices, as wholesale prices are often prices paid by one part of a company to another part of the same company. It is sometimes claimed by Ofgem that wholesale price increases are not fully reflected in retail prices and that this shows that the market is working well. This argument seems false to us—as the losses or low profitability in the supply company affiliates of the energy company are often offset by higher profitability in the electricity generating part of the company—so it is necessary to consider the whole chain.
- Ofgem often argues that there is no evidence of anti-competitive behaviour. FPAG is not suggesting that the companies are operating in an overtly anti-competitive way. It is, however, our view that the outcomes are not satisfactory, prices are too high certainly for some customers and the market is not working well.
- Ofgem and the Government suggest that the level of UK prices compared with those on the Continent is evidence of the satisfactory operation of the competitive market. We agree that such price comparisons are relevant. But in making any comparisons for current purposes, prices excluding taxes should be quoted, as low prices stemming from low UK taxes do not provide any evidence of a better functioning market. In July 2007 UK domestic electricity prices excluding taxes were the same as the average for the EU 15 and gas prices were 15% lower. This is relevant, but UK gas prices should be lower—irrespective of the competitive situation—as the UK still gets the bulk of its gas from the UK Continental Shelf rather than from much more distant sources, and the UK is densely populated with a high penetration of gas and hence lower gas transmission and distribution costs. When these factors are stripped out the differences between the UK and the Continent appear to be small. These comparisons are also very much affected by exchange rates and as result of the fall in the pound against the Euro in recent months it is possible that the gap between the UK and Continental European gas prices will now be significantly eroded.

EFFECTIVENESS OF REGULATORY OVERSIGHT

14. Ofgem does some good work on social issues, but regulatory oversight of the working of the market especially, but not only, for vulnerable customers has been poor. It is possible that this will now change.

- Ofgem was very slow to recognise the sharp widening in the differentials between those paying by different methods.
- They have done little so far about these really troublesome differentials although there are signs that this may now be changing.
- Ofgem has plenty of potential tools to help to deal with the situation of the differential prices and these are included in the list of possible measures in Appendix 2.
- Ofgem has been complacent about the level of margins and has been unwilling over the past few years to assess where the extra expenditure by consumers of gas and electricity has gone.
- The Government has also given the impression that they have been satisfied with the working of the market and have not, until recently, given any indication of disquiet.

15. It is a complex task to assess the functioning of the market, but Ofgem (and Government) have, in our view, been too eager to believe that the market is working well and have not been willing to face up to the difficulties and to take an objective view. This may be changing now, although this is not yet certain. We hope very much that there will be tangible outcomes from the Budget announcements, Ofgem's probe of the energy markets and the Ofgem summit.

PROGRESS ON FUEL POVERTY AND FUEL POVERTY POLICY INSTRUMENTS

16. FPAG has just published its 2007 Annual Report and these points are covered in detail in the Report. The Report is attached.

PROGRESS ON FUEL POVERTY

Table 1 sets out the position on fuel poverty in England.

Table 1

<i>Table 2: Fuel Poverty in England</i>	<i>Number of households (m)</i>				
	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>Projected</i>	
				<i>2006</i>	<i>2007</i>
Households in fuel poverty	1.2	1.2	1.5	2.5	2.9
Vulnerable households in fuel poverty	1.0	1.0	1.2	2.0	2.3
Households in fuel poverty (broader definition)	1.5	1.4	1.8	—	—
Vulnerable households in fuel poverty (broader definition)	1.2	1.1	1.4	—	—

17. It will be seen that 1.2m people were in fuel poverty in England in 2003, the lowest number reached. In 2006 this had doubled to 2.4 million households (according to the Government's Annual Fuel Poverty Progress Report) and in 2007 this will rise to about 2.9 million. The 2008 price increases will take the total to over 3 million. This is close to the 1998 position when 3.4m households were in fuel poverty, although still well below the 1996 level of 5.1 million. (These estimates take no account of improvements since 2005 in energy efficiency from the fuel poverty programmes and they are in general "broad brush" although it is likely that they will be in the right order of magnitude).

18. FPAG only covers England, but we understand that the numbers in fuel poverty in 2006 were about 4 million in the UK (compared with 2.5 million in England).

POLICY INSTRUMENTS

19. Fuel poverty results from a combination of the energy efficiency of homes and equipment, incomes and energy prices. Fuel poverty policy instruments need, therefore, to take account of all of these.

- The fuel poverty programmes need to be maintained at reasonable levels. In particular it was decided in the Comprehensive Spending Review that annual expenditure on Warm Front (the Government's main fuel poverty programme) will be nearly 25% lower in 2008 to 2011 than it was in 2007–08. At the very least Warm Front annual expenditure should be restored to its 2007–08 level of £350 million. This can easily be done if Government expenditure is better targeted, eg by discontinuing Winter Fuel Payments for higher rate tax payers, which would free up £200 million into Warm Front and which would make possible increases in Warm Front over the three year period. Alternatively the programme could easily be funded if, as Ofgem has proposed, the windfall gains being made by some electricity generators as a result of the EU emissions trading scheme were recovered. Finally the Treasury has received an additional £400 million pa of VAT payments from energy customers as a result of the price rises and this is another source of funding.
- More generally, the balance between capital and revenue measures should be reconsidered. It will be essential, in a world of high energy prices, to secure the highest possible energy efficiency in the dwellings, heating and equipment of low income households. Although the recent increases in Winter Fuel Payments will clearly be welcomed by pensioners, it would be better to spend some of the money on energy efficiency measures, which could also be better targeted—in order to make progress towards the fuel poverty targets.
- The Government is considering the energy supply companies' carbon reduction obligations after 2011, and a sizable social obligation will continue to be required along with the carbon reduction programme.
- Tariff differentials should be reduced as discussed in Section 2 above and in Appendix 2.
- Ofgem and the Government should do everything possible to keep energy prices as low as practicable, again as discussed above.
- Energy companies' social programmes should be expanded, following the Budget announcement.
- There should be more drive by Government to ensure that Benefit take-up is increased. In particular there are opportunities for automating the take-up of Council Tax Benefits for those in receipt of other benefits or tax credits.
- The Government should, with the necessary safeguards, make available data on customers on benefit to Local Authorities and to Energy and Energy Efficiency companies so that they can target their social tariffs and energy efficiency programmes to vulnerable customers more efficiently.

-
- Smart meters are potentially good news for customers generally and low income customers in particular. The provision of low cost “pay as you go” meters will be a major breakthrough and accurate bills with no estimates will provide significant benefits. The decision should therefore be made to introduce smart meters for all customers over a specified period and this should be mandated by Government to avoid long delays in resolving some of the issues.
 - Other shorter run lower cost payment methods should also be pursued eg fuel direct should be expanded.
 - The Public Service Agreement and Government Target Framework and that for Local Government must provide adequate priority to fuel poverty, given that the eradication of fuel poverty is a statutory requirement. It does not currently do so.
20. A series of detailed recommendations is set out in section 13 of the FPAG Annual Report.

CONCLUSIONS

21. The fuel poverty situation is now very serious. Action in a range of areas is needed in order to meet the Government’s fuel poverty targets in England. A key area is energy prices. It will be important to ensure that prices are no higher than necessary—for all customers and for vulnerable and low income customers in particular. This is now beginning to be recognised by Government and Ofgem. This will not, on its own, resolve the fuel poverty problem as other measures are needed, but it is a necessary step and it would make a noticeable difference.

APPENDIX 1

MEMBERSHIP OF THE FUEL POVERTY ADVISORY GROUP

Peter Lehmann, Chair.

John Chesshire, Vice Chair—Energy Efficiency Partnership for Homes.

George Mayhew, Director of Corporate Affairs, National Grid.

Ian Peters, Chief Operating Officer, British Gas Centrica Plc.

Graham Kirby, Retail Regulation & Energy Policy Manager, E.ON.

Jenny Saunders, Acting Chief Executive Officer, National Energy Action.

Kevin Miles, Chief Executive Officer CEO, Npower Retail.

Gill Owen, Chair, Public Utilities Access Forum.

Sarah Webb, Director of Policy and Practice, Chartered Institute of Housing.

Dr Noel Olsen Public Health Physician, Trustee, National Heart Forum.

Jerry Robson, Chairman, Association for the Conservation of Energy.

Mervyn Kohler, Special Adviser, Help the Aged.

Jonathan Stearn, Head of Campaigns, energywatch.

David Pickles, Energy Agency Manager, Local Government Association.

John Clough, Chief Executive, Eaga plc.

Teresa Perchard, Director of Policy, Citizens Advice,

Eva Eisenschimmel, Chief Operating Officer, EDF Energy.

TERMS OF REFERENCE

The Fuel Poverty Advisory Group is an Advisory Non-Departmental Public Body sponsored by Defra/DI. Its primary task is to report on the progress of delivery of the Government’s Fuel Poverty Strategy and to propose and implement improvements to regional or local mechanisms for its delivery.

The role of the Group is:

- To consider and report on the effectiveness of the current policies in delivering reductions in fuel poverty and the case for greater co-ordination.
- To identify barriers to the delivery of reductions in fuel poverty and to the development of effective partnerships, and propose solutions.
- To consider and report on any additional policies needed to deliver the Government’s targets.
- To enthuse, and encourage, key players to tackle fuel poverty.
- To consider and report on the results of the work to monitor fuel poverty.

APPENDIX 2

RECOMMENDATIONS ON RELATIVE PRICES

There is a menu of possible actions on relative prices. Some of these are alternatives. We set out below the range of possible activity. In order to drive all this forward there should be the following actions by Ofgem and Government. Ofgem's probe into the energy markets is a welcome first step, but it is very important that the review should result in tangible improvements. The list below includes many of the issues and outcomes which should be considered by the review.

- Ofgem should make the issue of price differentials a Special Project with adequate resources.
- The Government should provide further resources (from the abolition of Winter Fuel Payments for higher rate tax payers or the auctioning of EU ETS Permits) to enable extensive local advice to be given to low income households on switching and on the best tariff available, linked to other advice on energy efficiency, in order to cut fuel bills.
- As proposed last year the Treasury should, within Government, take the lead with a determination to find a solution on low cost payment methods.

The menu of specific actions is:

- Ofgem should assess the relationship between relative prices and relative costs and, for companies where prices and costs are far out of line, should consider whether further action—legal, regulatory, guidance, persuasion—should be taken. It may well be possible to use existing Licence conditions and sales codes and/or it may be necessary to introduce changes. Ofcom is taking action on similar issues and it may be possible to learn from this.
- There should be reserve powers in the Energy Bill to prevent companies with exceptionally high prepayment prices from taking on new prepayment customers. This is important as there is evidence that a very large number of prepayment customers, who switch, are switching to worse deals.
- As an alternative where prepayment customers are applying to switch to a worse deal, companies about to receive such customers should by self-regulation or by Energy Bill provisions, be obliged to explain the position to such customers in a clear way. It is appreciated that this will be affected by differences in service levels.
- The Government should strengthen its Environmental and Social Guidance to Ofgem.
- The Government should, as it is doing, consider the use of its existing powers on prepayment prices under the Utilities Act.
- Those companies with wide differentials should radically re-examine their policies.
- The market is clearly not working for many low income customers. Much more advice and guidance should be provided by voluntary and local organisations for low income customers on the benefits of switching suppliers, the advantages and disadvantages of different payment methods and on the best prices available. Many very elderly people for instance will need careful guidance. Local organisations will need to be resourced for this. This guidance should be linked to energy efficiency and money advice services.
- Eaga, with its very good contacts with, and channels to, low income customers could play a useful role here, but an important proviso is that additional funds would be needed—this should not be at the expense of the already inadequate fuel poverty programmes for energy efficiency and central heating.
- It will be important to ensure that no more prepayment meters are installed than necessary in debt situations eg where payment by instalments or fuel direct would be feasible.
- The price comparison and switching sites should provide the same facilities for prepayment as for other customers.
- The debt blocking situation should be reconsidered especially but not only where the receiving company is willing to take on the debt.
- Smart pay as you go meters are now available which would significantly reduce the cost to serve of prepayment customers. There should be a determined drive by Government and Ofgem to secure the installation of such meters at the earliest possible opportunity.
- Banking arrangements can make a contribution by encouraging more customers to pay by direct debit and the Treasury should play a significant role here.
- Post Office budgeting arrangements are well worth pursuing and the Government should be encouraging such arrangements for the successor to the Post Office Card Account.
- Energywatch has provided tireless support and advice for customers, especially low income customers, on prices and other issues, and it will be important for the successor to the National Consumer Council to take on this role as far as is feasible.

- There should be strong minimum standards on social tariffs and the Government should take reserve powers in the Energy Bill on Social Tariffs and Programmes.
- If progress is not made by other means, the size of the differentials between different payment methods should be re-regulated. The Government should take powers in the Energy Bill to direct Ofgem to do this.

APPENDIX 3

GAS AND ELECTRICITY PRICES

In total expenditure by consumers on gas and electricity increased by £8.2 billion between 2003 and 2006. Fuel cost increases only accounted for a little over half of this—about £4.5 billion.

The changes for gas and electricity are set out in tables 1 and 2 below.

Table 1

INCREASES IN PRICES AND PAYMENTS 2003–06—GAS

<i>P per kwh</i>	<i>P per kwh</i>	<i>£Bn</i>	<i>£Bn</i>
Increase in Price of Gas to Domestic Customers	Increase in Price of Purchased Gas	Increase in Payments of Gas by Domestic Customers	Increase in Payments for Gas to UKCS Producers and for Imports and Storage
1.12	0.92	3.95	3.34

Table 2

INCREASES IN PRICES AND PAYMENTS 2003–06—ELECTRICITY

<i>P per kwh</i>	<i>P per kwh</i>	<i>£Bn</i>	<i>£Bn</i>
Increase in Price of Electricity to Domestic Customers	Increase in Price of Fuel Purchased for Power Generation	Increase in Payments of Electricity by Domestic Customers	Increase in Payments to Fuel Suppliers
3.49	0.99	4.27	1.20

The numbers are all from published Berr data.

- It can be seen that in electricity there is a marked gap between price and fuel cost increases. The price of electricity to domestic customers increased by nearly 3.5p per kwh between 2003 and 2006, far more than the increase of 1p per kwh in the price paid for fuel used in power generation.
- Expenditure on electricity by domestic customers increased by over £4.3bn, far more than the £1.2 billion increase in payments for fuel use in power generation.
- The price of gas to domestic customers increased by 1.12 p per kwh between 2003 and 2006, compared with the increase in the price of 0.96p per kwh paid for purchases of gas from the UK Continental Shelf and from imports and for storage.
- Expenditure on gas by domestic customers increased by nearly £4bn—with an increase of a £3.3 billion in payments to UKCS producers and for imports and storage.
- Other costs have increased by £1.4 million—£370 million for gas and just over £1 billion for electricity. Tables 3 and 4 give a breakdown of these cost increases.

Table 3

INCREASES IN NON-FUEL COSTS 2003–06—GAS

	<i>£m</i>
Transportation	43
Metering	37
Suppliers cost to serve	31
Energy Efficiency Commitment	73
VAT	188
Total non fuel costs	372

Table 4

INCREASES IN NON-FUEL COSTS 2003–06—ELECTRICITY

	<i>£m</i>
Transmission network use of system	108
Distribution network use of system	124
Metering	16
System losses	379
Suppliers' cost to serve	4
Renewables Obligation	108
Energy Efficiency Commitment	84
VAT	204
Total non fuel costs	1,028

- It will be seen that the main increases for the two fuels taken together are VAT [nearly £400 million], transportation/network charges [£275 million], system losses [nearly £400 million] and EEC/Renewables Obligation [£260 million].
- two points from this are worth noting—additional VAT payments account for £0.4 billion of the extra £8 billion paid by customers. Environmental policies, taken together [the whole impact of EUETS, EEC and the Renewables Obligation] account for £800 million of the extra £8 billion, with EU ETS accounting for by far the largest part of this. While the additional costs of the environmental policies are clearly material, they only account for a relatively small proportion (nearly 10%) of the large increase in payments by customers.
- The cost increases are overstated here and margin increases are understated as substantial increased profits in gas storage and in distribution are not reflected in the above figures.
- Thus prices paid by customers have increased by nearly £4bn more than the costs of fuel, and between £1 billion and £1.5 billion of this can be explained by other cost increases. It seems that there has been a significant increase in margins along the supply chain of over £2.5 billion, accounting for as much as 30% of the price increases.
- Some increase in margins, especially on power generation, is reasonable given the low prices in 2003, but it seems most unlikely that this could explain and justify such a big increase in margins.
- The estimates of the extra margins exclude additional margins made by gas and oil producers on the UK Continental Shelf.
- The overall position in 2007 will not be very much different.
- We do not know exactly where the extra customer payments have gone and where the extra margins have been taken, The bulk of the extra payments have probably gone to generators—both independent generators like Drax and International Power and to some (although not necessarily all) of the big six integrated suppliers such as Scottish Power and Powergen. Generators with a great deal of coal fired plant will have been the biggest gainers. Traders, and also owners of storage and of distribution networks, will also have gained.
- There will be significant differences between companies in the margins made.
- In any case customers are paying more than they should be.

April 2008

Memorandum submitted by GMB

THE STRUCTURE OF THE UK ENERGY MARKET

EXECUTIVE SUMMARY

1. GMB is the United Kingdom's third largest trade union with 600,000 members employed in virtually every sector of the economy, and is the largest and most influential trade union in the energy sector. Regardless of who they are employed by, our members are also all energy consumers. Many GMB members are low-paid workers, and have been amongst those who have suffered financially as a result of the failure of the liberalised UK energy market to supply gas and electricity at affordable prices.

2. GMB believes that there is a wealth of evidence to sustain our view that the energy market is failing, and we are confident that the figures on gas and electricity costs and the rise in fuel poverty, which we anticipate will be submitted by others to the Committee, will speak for themselves. Our submission therefore predominantly focuses on a single one of the seven aspects of the energy market that the Committee

announced as the focus of its review, namely the effectiveness of regulatory oversight of the energy market. Central to our argument about how and why the energy market is failing consumers is that the regulatory mechanism for protecting their interests by keeping the energy market under close and effective scrutiny is failing.

3. GMB therefore urges the Committee to take a detailed and critical look at the performance of the energy regulator, Ofgem. It is our belief that this body has comprehensively failed to regulate the energy market effectively, and has, by its failings, been a major contributor towards the uncompetitive and dysfunctional market for energy that now prevails. The behaviour of the major energy companies that operate within this oligopoly is a reflection of the regulator's complacency. Ofgem's inability or unwillingness to consistently safeguard the interests of consumers stems from its slavish adherence to a set of dogmatic economic "principles" that have little to do with the real world in which the energy market operates. Inevitably, this seriously impacts upon consumers, who suffer the consequences of Ofgem's inadequacy in the form of rising prices for gas and electricity.

INTRODUCTION

4. GMB is the largest and most influential trade union in the energy sector with over thirty thousand members employed throughout the UK in the Electricity, Gas, Nuclear, Coal, Oil and Renewables industries, undertaking activities ranging from production and distribution to retail and service. GMB's long history of representing members employed in the energy sector, which has been on-going since the Union began as the Gas Workers and General Union in March 1889, has given us vast experience and a clear insight into the workings of the energy sector. This has helped GMB to develop a comprehensive understanding of the importance of the energy market and its influence over the economic well-being and daily lives of the UK's citizens.

5. GMB warmly welcomes the investigation by the Business, Enterprise and Regulatory Reform Committee into the structure of the UK energy market. We believe that this decision to put the market under such an independent scrutiny by conducting a full scale inquiry into the structure of the energy market is a very important one which is long overdue.

6. In considering whether the current market structure encourages effective competition in the retail markets for gas and electricity, the Committee will undoubtedly need to carefully consider a wide range of factors in order to form a view. GMB fully recognises the need for the Committee to examine the wholesale markets for gas and electricity, growing consolidation in the energy market, the relationship between the wholesale and retail markets for electricity and gas, the interaction between the UK and European energy markets and progress in reducing fuel poverty.

7. All of these are undoubtedly crucial to the effectiveness of the current market, and, if called to give oral evidence to the Committee, GMB would be pleased to elaborate our views about how these factors impact upon the energy market. However, GMB is focusing our written submission upon the lack of any effective regulatory oversight of the market. We believe that the poor performance and inertia of the regulator directly contributes towards the market failing consumers, and that the lack of progress in reducing fuel poverty and the shortcomings of the regulator are inextricably linked.

THE EFFECTIVENESS OF REGULATORY OVERSIGHT OF THE ENERGY MARKET

8. GMB is aware that the regulator for the gas and electricity industries in Great Britain is the Gas and Electricity Markets Authority and that Ofgem's role is to support the Authority. However, for reasons of simplicity, this memorandum refers to Ofgem as "the regulator" and/or "the energy regulator".

9. Central to the whole of the Government's energy policy approach is the promotion of competitive energy markets. The underlying assumption is that the market provides the most effective and efficient mechanism for ensuring the supply of energy and protecting the interests of energy consumers. The extent to which the "competitive energy market" (which is in reality not a free and fair market, but an oligopoly, dominated by a few sellers who can greatly influence price and other market factors) operates fairly is determined by the strength and effectiveness of the regulatory regime. A robust regulator is absolutely essential to prevent a small number of powerful energy providers acting against the interests of consumers by exploiting their position in order to maximise profits.

10. Given the crucially important role of the regulator in the UK's energy market, it is impossible for GMB to comment upon the efficacy of the market without reference to the shortcomings of the regulator. In our view, Ofgem, the regulator for the gas and electricity markets, has been an abject failure. GMB firmly believes that the lack of robust and effective regulation of the market for gas and electricity is of crucial importance to this investigation. Although our view is that the private market is not the most effective mechanism for ensuring that gas and electricity is available at affordable prices to all, if such a market is to prevail, then it simply cannot do so without the regulator doing its job properly.

11. In short, left to its own devices, the UK energy market will not operate fairly because the barriers to entry are such that only a few suppliers actually operate within the market. However, the only price control mechanism that Ofgem appears to recognise, advocate and rely upon—the notion that within such a limited

market consumers will keep prices down by switching suppliers—does not work in practice. Nevertheless, Ofgem adheres rigidly to this doctrine, despite the evidence to the contrary, and its inertia in the face of rising prices and a real increase in the number of UK citizens in fuel poverty is staggering.

12. In our view, Ofgem is arrogant and out of touch with the industries that it regulates, and repeatedly fails to understand and take account of the concerns expressed by stakeholders (consumer groups, and the unions representing employees working in the gas and electricity industries, for example) about issues of major concern to the companies, workers and consumers who are affected by its decisions. Ofgem's failings have an impact that reaches far beyond the GMB members who work in the energy sector—all our members are energy consumers, and all of our members are affected in some way by Ofgem's inability to see beyond its narrow economic dogma and provide effective regulation.

13. Our contention that the regulator is complacent, arrogant and out-of-touch is strongly re-inforced by reference to a number of Ofgem's most recent actions and announcements. What is distinctive about the three examples that follow is the way that this recent flurry of activity by Ofgem contrasts so sharply with its previous inactivity. This provides a powerful illustration of how the regulator operates, in effect doing little or nothing to protect the consumer with any consistency, then rushing to react once the price hikes are announced and the storm breaks as a result.

14. A prime example of the energy regulators' weak, inconsistent and unconvincing performance was Ofgem's surprise announcement, made on 21 February 2008, that it was launching a probe into the energy supply market.

15. To announce this probe, which was in effect a complete u-turn by the regulator, smacks of opportunism and desperation. Less than five weeks beforehand, Ofgem had insisted the market was sound. In a press release dated 16th January 2008, following a meeting between the Chancellor and Ofgem's most senior executives (Chairman Sir John Mogg and Chief Executive Alistair Buchanan), Ofgem "confirmed that Britain's competitive market in energy is working". To make such an unequivocal statement, when the real-world experience of consumers was that the market was clearly not working—huge prices rises had just been announced almost across the board—beggars belief. The announcement of an investigation a few weeks later begs the question: why make such a bold and confident assertion and then shortly afterwards announce that Ofgem will take "a more detailed look at the retail market"?

16. The tone of the announcement of the enquiry was also somewhat grudging, whilst also hinting that its outcome was already foreseen and its intention was to reassure the public that competition was working. Ofgem thus appeared to be "going through the motions"—either reacting to events, or responding to some "behind the scenes" arm-twisting by Ministers. In belatedly making this announcement, and thereby "being seen to be doing something", did Ofgem jump or was it pushed? Whichever of these it was, and it could conceivably have been a combination of both, Ofgem demonstrated its inability to act independently and reliably. It does not inspire any confidence, and provides no lead whatsoever in scrutinising and monitoring the companies operating in the market.

17. This came as no surprise to GMB, which for several years has been urging Ofgem, without success, to launch just such an investigation. Yet Ofgem only stirred from its slumber once the Business, Enterprise and Regulatory Reform Committee had announced its investigation, thus putting a political and public focus on the energy market and Ofgem's failure to regulate it effectively. We see the Ofgem investigation less as evidence of its concern about the behaviour of the energy companies, and more about its concern over Ofgem being open to criticism if it doesn't appear to be putting the market under the microscope. We urge the Committee to examine why Ofgem announced its own investigation so quickly after declaring the market to be sound.

18. A second example of Ofgem's inconsistency was its decision, announced on 25th February 2008, to fine National Grid £41.6 million, for a breach of competition law that it claims restricted the development of competition in the domestic gas meter market. After an investigation lasting almost three years, what motivated Ofgem to act in the manner that it did, when it did? The scale of this fine was totally disproportionate to the offence that National Grid allegedly committed, as the cost of any such anti-competitive behaviour related to gas metering is paltry. Even if the company's actions did cause a 40% increase in the costs of gas meters to domestic gas consumers, (which amount to £12 per year per customer) that represents less than £5 per year per customer.

19. In our view, what this fine represented was Ofgem once again behaving in an opportunistic and ineffectual manner. Ofgem baring its teeth and taking inappropriate action over this issue is simply no substitute for consistent and meaningful regulation of the type of company behaviour that imposes the really painful costs upon gas and electricity customers. Consumers need a regulator that has real teeth and takes action on their behalf over issues of mainstream importance—ie the cost of gas and electricity, not on matters that have only a peripheral effect on prices. It is difficult to escape the conclusion that the timing and nature of Ofgem's sanctions reflected its desire to appear tough, because of the energy market being in the political and media spotlight.

20. The third example of a recent announcement by Ofgem was that of 6 March 2008, when the regulator announced a review of the regulatory regime for energy networks. This two-year internal review of a regime that has been in place for 20 years, and which Ofgem described in its press release announcing the review as a success, is also consistent with the "flavour of the month" approach that Ofgem now seems to favour,

following the recent increase in public and political interest in the energy market. Is this review prompted merely by the possibility that the regulator is aware that it is not perceived as being consumer-friendly enough? At a length of two years, this appears to be a major and very comprehensive investigation into a regulatory regime which until now has enjoyed Ofgem's unshaken faith. On the other hand, two years is also more than sufficient to allow the grass to grow and for this review to disappear from view. GMB is unconvinced, especially in view of the comments in the Ofgem press release celebrating the achievements of the regime, that Ofgem is doing anything more than posturing.

21. We offer the examples in paragraphs 14–20 above to illustrate the manner in which the regulator fails to address the real issues affecting consumers. Contrast the action taken against National Grid over gas meters with the total lack of action against those companies that exacerbate the problem of fuel poverty by charging prepayment meter users—often poorer households—an average of £255 a year more than online customers. This is a very real problem with serious effects upon low-income households, and the £5 per year that National Grid's actions apparently cost is chickenfeed by comparison. We would urge the Committee to question Ofgem about its lack of action in support of those households “trapped” into paying higher bills.

22. Ofgem complacently responds to claims of unfairness about the prices charged by the “big six” suppliers by saying that consumers should switch. Of course, many consumers do—in 2007 four million out of 36 million energy account holders did so. However, just under half of consumers have never switched supplier and market research suggests they are unlikely to. Amongst pensioners, only around a third have ever switched, while the six million consumers with prepayment meters are unlikely to be able to switch using the convenient online switching services. The two million consumers in debt are prohibited from switching by the suppliers, and hundreds of thousands more in Scotland are prevented from switching through technical restrictions on their accounts. The reality is that switching is just not working for the most vulnerable.

23. Ofgem's job is, apparently, to make sure it sets the framework for healthy and fair competition. If the ability of consumers to switch is central to its strategy, and this clearly isn't working, shouldn't Ofgem have a plan B? The public perception is that the existing big six suppliers are making excessive profits. People should not be expected to accept big price rises, by every supplier in the market, on products and services that they have no option but to buy. Whatever the regulator says about its role and how it isn't Ofgem's responsibility to interfere with the market, some four million households (and growing) meet the Government's official definition of “energy poverty”, in that 10% or more of their disposable income is spent on energy bills. In our view, this is clearly an issue for the regulator, which isn't doing its job properly if it persistently ignores the reality of the situation that exists, in favour of its belief in the purity of some theoretical construct known as “the market”.

24. The real-world effect upon lower-income households of excessively high prices for gas and electricity should not be under-estimated. Fuel is a basic human need, and one of the first duties of any Government is to ensure the provision of a safe and secure supply of affordable energy to its citizens. For these reasons, the failure of the regulator to exercise any form of consistent oversight of the energy market, and put consumers at the heart of what it does, represents a very serious failing that directly contributes towards the rising levels of fuel poverty that now prevail. GMB urges the Committee to put the lack of any effective regulatory oversight of the market at the heart of its investigation, and take these failings up with Ofgem.

March 2008

Memorandum submitted by Good Energy

COMMITTEE TO INVESTIGATE POSSIBLE ANTI-COMPETITIVE BEHAVIOUR IN THE UK'S ENERGY MARKET

EXECUTIVE SUMMARY

1. Good Energy believes that the current market is not fully competitive, and this is principally down to the operation of the wholesale market which favours large vertically integrated participants. This is of particular concern as we believe that this is stifling innovation in the market as it responds to the pressures to combat climate change.

ABOUT GOOD ENERGY

2. Good Energy is a small energy supplier, active in the electricity market since 1999. We supply 100% renewable electricity to approximately 25,000 customers in the UK, most of whom are domestic customers. We have recently received our gas supply licence and hope to offer a carbon accountable dual fuel product in the near future. The Good Energy group also owns a wind farm in Cornwall, but buys most of its energy for small size renewable generators.

3. We have restricted our comments to the electricity market as we do not feel sufficiently experienced to comment on the gas market, and have structured our response to match the questions posed in the call for evidence

Does the current market structure encourage effective competition in retail markets for gas and electricity?

4. The current retail market is dominated by the big six oligopoly, all of whom have an inert customer base inherited from their previous existence as monopoly providers of electricity or gas. There are a handful of independents and entry into the retail market is not difficult *per se*, although expensive as the fixed costs are high due to the requirements that need to be in place before a supplier can acquire its first customer. Good Energy estimate the breakeven point is 20,000 domestic customers or the equivalent.

5. There are also regulatory hurdles as smaller suppliers are required, except in a few cases, such as CERT to meet the same regulatory requirements as the big six. These however are not insurmountable provided the smaller participant is not attempting to compete with the big six on price.

6. The difficulty of market entry lay in entering the wholesale market, and the unpredictability of prices and lack of liquidity and transparency in that market. The number of independent generators has diminished considerably since the introduction of NETA (New Electricity Trading Arrangements), which in turn reduces the sources of generation for any new electricity suppliers entering the market. Conversely, the lack of independent suppliers is also a barrier to entry to small generators.

Is there effective competition in the wholesale markets for gas and electricity?

7. The current trading arrangements were designed by the regulator on the basis of ensuring that energy trading was cost effective, as opposed the previous “pool” arrangements which set a market price for energy in each half hour, which was received and paid by all participants. The result of this arrangement was twofold, consolidation by market players, and vertical integration. The reasons for this are complex, but the principle is the mitigation of risk.

8. Suppliers offer prices to customers which change periodically maybe two or three times a year max. However, at a wholesale level they have an exposure to the market where prices on the edges of their portfolio are unpredictable by each half hour. To mitigate this risk, then the ownership of a generation portfolio seems a logical business step. As the market was designed around large generation units, then to ensure a sufficiently sized portfolio of generation required a large customer base.

9. As a result this limits competition to large integrated players. New entrants on either side of the market, generation or supply find that the market is illiquid and not transparent which poses a business risk. Suppliers below a certain size are unable to buy in the small quantities required and thus are exposed to the unpredictability of the cash out market. Something that removed several players in the winter of 2005–06.

10. If a liquid market existed, then independent suppliers and generators could see market prices and be sure of buying or selling to hedge their position. Equally, a level of predictability of the cash out prices would remove some of the financial risk of exposure. Which can be very real.

11. Independent players due to the market risks are also required to provide credit to counter-parties either as cash or letters of credit. This in itself is a cash drain on players which restricts growth of new entrants.

What are the implications of growing consolidation in the energy market?

12. The implications of consolidation in the market are a lack of consumer choice, and a stifling of innovation. It also impacts Government ability to manage the energy aspect of the economy because it has to go “cap in hand” to the big 6 to deal with important issues such as climate change and fuel poverty. If there was effective competition in the market then specialist companies would be developing innovative tariffs for different market sectors. For example, specialists in Pre-payment metering using new technology to bring down the cost to serve or premium lifestyle tariffs linked to other product offerings.

13. Competition would not necessarily reduce energy prices, as the two predominant costs, fuel for generation and transportation are limited in the differential that can be applied. Although improvements in the wholesale market and reduction of risk could bring lower pricing. It could however lead to a wider spread as specialist in certain sectors focus on their offering rather than trying to be everything for everybody.

14. As new entrants are deterred from entering the retail market because of the wholesale market risks, then the need for innovation decreases and the expectation of customers become lower.

15. Good Energy’s concern is that this lack of competition is impeding the delivery of the UK’s 2020 target by market means and requires the government to “horse trade” deals with the oligopoly to deliver. Something which only increases their hold on the market and increases the risk of non-delivery on these targets.

What is the relationship between the wholesale and retail markets for electricity and gas?

16. The two markets are closely interlinked and it is the problems with the wholesale market structure that are restricting competition in the retail market. The wholesale market is structured around cost reflectivity, ie That generators and suppliers buy and sell on the open market. In reality, the risk this has created has led to vertical integration by the largest players, and as such the market has become illiquid as most energy is self-supplied and thus a market price is based on a small number of hedging trades.

17. It is not possible to be in the retail market without being a player in the wholesale market, and thus, the structure of the wholesale market dictates the structure of the retail market. ie The need for a balanced portfolio of generation dictates the need to have a large retail base to use that portfolio of generation.

18. Good Energy also believes that NETA was conceived at a time when economic priorities were the predominant driver, and sustainability and carbon markets were not high on the agenda. If the UK is to meet its 2020 and 2050 commitments, then NETA is a hindrance rather than benefit as it favours large, predictable generation at the expense of smaller, less predictable generation. To deliver a low carbon economy, NETA is not fit for purpose. It also puts NGC in a powerful position on this debate.

What is the interaction between the UK and European energy markets?

19. In electricity there is little interaction between the UK and European market, as the interaction is limited to capacity of the interconnectors. It is noted however, that different wholesale market structures in the EU are helping some countries to increase the levels of renewable or low carbon generation to compete better with fossil fuel based generation.

What is the effectiveness of regulatory oversight of the energy market?

20. In essence the market regulator, Ofgem is a financial regulator. Its role is either to regulate prices, where there is a monopoly service, or ensure that competition means that energy prices are cost reflective. Bolted on to this primary objective are social objectives surrounding fuel poverty and sustainability.

21. In managing its primary role, the regulatory oversight depends on the definition of competition. If competition means that customers can move from one supplier to another with ease, then the job is well done. If however, you define competition as being that the market is open to new entrants to offer new and innovative products to customers, then the regulatory oversight has failed.

22. The perception of most domestic customers is that there are six “Dinosaurs” suppliers offering very much the same deal. Parts of Ofgem itself appears to have this view as small suppliers such as Good Energy often have to gate crash meeting where Ofgem has only invited the big six suppliers to consult “the industry”.

23. On the two secondary roles, the regulation is failing because Ofgem, as an economic regulator, and staffed by a multitude of economists, has difficulty running these objectives which are often against the grain of its primary objective. Good Energy has consistently argued that Ofgem remit should be changed to deliver a low carbon energy market as cost effectively as possible. Rather than a cost effective energy market as sustainably as possible. This would require Ofgem to provide leadership to the market, rather than act as a policing body.

What progress has been made in reducing fuel poverty and the appropriate policy instruments for doing so?

24. Fuel Poverty (as defined) is increasing as raw energy prices increase. This is outside the control of the market players, and competition, whilst offering a better choice, will not deal with the fundamental issue of rising energy prices. The solution to fuel poverty lies in reducing the energy demands of those in poverty. The correlation between fuel poverty and poorly insulated housing stock is high and thus improving housing must be a priority. This would also assist in reducing carbon emissions. We believe there are more efficient ways of implementing this than obligating electricity suppliers.

What is currently missing within the UK energy market is any form of heat market?

25. Heat is outside the remit of Ofgem, except where it coincides with the provision of power, and thus has no market driver. If, as mentioned above an energy regulator was set up to drive the UK to a low carbon energy market, then heat would be within its remit. The provision of locally distributed heat, if aimed at social housing could go a long way to drive down fuel poverty. However, the current vacuum of regulation makes investors nervous of what may be regulated. (eg Competition access etc)

RECOMMENDATIONS

26. Good Energy's recommendations are:

- Set-up an energy regulator in place of Ofgem with the remit to lead the UK to an efficient, market based, low carbon energy market.
- Restructure the wholesale electricity market to make it suitable for new entrants on both the supply and generation side by establishing stable pricing and market liquidity and transparency.

April 2008

Memorandum submitted by Green Energy UK Plc

Green Energy (UK) plc is a small independent "white label" supplier, supplying electricity from renewable and chp generation to domestic and small business customers.

Green Energy UK started trading in 2001 and hence has first hand experience is the barriers to entry and growth displayed by the electricity markets.

SUMMARY

There are three main points I wish to make:

- (1) The lack of liquidity in the wholesale electricity markets.
- (2) The use of credit and security cover.
- (3) The inherent bias within the consultation process in regulatory reform.

LACK OF LIQUIDITY IN THE WHOLESALE MARKETS

The markets have consolidated, with few new entrants in recent years and the "big 6" becoming increasingly vertically integrated. With a smaller and smaller open market, there are fewer "risk" management options or products available to small and new entrants creating both a barrier to entry and a barrier to growth.

There is a separate submission from a group of smaller suppliers, Bizz energy and others, which covers these points in more detail, and whose recommendations on opening up the market we endorse and support.

USE OF CREDIT AND SECURITY COVER

A form of credit cover or security cover is required at many points in the market, from the forward purchase of electricity, the use of the distribution or transmission networks or the use of the balancing system.

The reasons for these arrangements are to protect the industry from any "domino" effect resulting from a company failure. However for the large and established players these are of little cost, as they are providing credit to one another but for a new entrant these are considerable financial obstacles to overcome. If a new entrant or small supplier was to fail, the cost to the industry is minor, when put against this the cost to the consumer of deterring competition which is probably greater. In protecting the industry from failures, the industry has created a barrier to innovation and entrepreneurialism.

REGULATORY REFORM

To change any part of the regulation within the industry, a change is proposed, and then goes out to consultation for views from both within and without the industry.

In reality, the large organisations (which means the big six) have the resources to put into a carefully crafted response, whereas the smaller organisations, and those from without the industry, but with a valid concern, rarely have the resources to respond to the consultations in detail if at all. The result is an inbuilt bias in favour of the larger players, who in turn will naturally be responding with their own companies' best interests in mind. As any new entrants can only grow by taking customers away from the established players, the incumbents will naturally favour measures which will maintain or build barriers to entry or growth.

March 2008

Memorandum submitted by Growhow UK Ltd

Growhow UK Limited is the largest industrial consumer of gas in the UK (used as feedstock for manufacture of ammonia and fertilisers) and a major consumer of electricity. We have followed closely the evidence that has given to the Committee. There are a small number of key inaccuracies in the information has been given to the Committee that we feel strongly need to be addressed. In the light of this, we have elected to submit the following brief note.

1. LNG DELIVERIES TO BOTH UK AND US

Deliveries to the Isle of Grain (IoG) in Winter 2007–08 have been well below capacity. In Q4 2007 seven cargoes were delivered and in Q1 2008 three cargoes. So out of a total of “26 slots” only 10 were used this winter. It was suggested that LNG was not readily available and that the high price of LNG was a cause of high gas prices in the UK.

It was further suggested that no LNG deliveries are being made to the US. The table below shows that the US has slightly more dependence than the UK on LNG imports. LNG imports to the US have continued through winter 2007–08 and into summer 2008. US market prices for gas remain well below UK prices as shown in the data later. In our view the TPA access arrangements at Isle of Grain are inadequate to ensure an optimum flow of LNG into the UK market.

2. FORWARD PRICING AND THE COMPETITIVE DISADVANTAGE FACED BY LARGE CONSUMERS

We wish to be clear that as a large consumer of gas we wish to be able to lock in forward prices for our business. However we are almost always faced with the problem that UK forward prices are grossly uncompetitive compared to the US and mainland Europe and this forces us to rely on short term pricing. Essentially we are forced to buy short term in order to have some chance of buying gas at competitive prices. This is not a position with which we are comfortable.

The competitive disadvantage we face is illustrated below.

<i>Forward price (p/therm)</i>	<i>Winter 2008–09</i>	<i>summer 2009</i>
UK	104	95
USA	61	72
Europe	83	88

3. MEASURES TO ADDRESS INEQUALITIES

It is important to emphasise that the UK has sufficient capacity for the supply of gas to the market (pipelines and LNG) but the capacity is not being utilised. The problem is lack of physical gas being delivered to the UK.

There are a number of measures we believe government could take to improve the position of UK industrial gas consumers. These include:

- (a) Suppliers who trade gas and electricity in several European countries as well as UK should be forced to offer UK consumers the same terms and conditions and pricing arrangements that they offer in other European countries. (This may include gas prices linked to oil though we are not arguing for a major move to oil indexation. In the long term we wish to see gas to gas competition in a fully functioning UK market).
- (b) The UK requires much more storage capacity. The market is failing to deliver this and difficulties obtaining planning permissions are not the only reason. The government needs to take action to encourage development of new storage. Ideas include an obligation on gas suppliers to the domestic sector to hold stored gas for winter, and a small tax on gas to raise funds to ‘seed’ investment. (0.1p/therm per annum would raise £35 million per annum).
- (c) There need to be major changes to allow proper Third Party Access to LNG facilities at IoG and Milford Haven to ensure capacity is utilised. At present, LNG supply to IoG is severely hampered by a combination of:
 - (i) the existence of a preferred supplier agreement with only three companies; and
 - (ii) insufficient notice provision for available slots (7–10 days). Cargoes would need at least 30 days notice of a slot to make IoG a viable destination for LNG.

Deborah Pritchard Jones

7 July 2008

Memorandum submitted by Professor Dieter Helm, Professor of Energy Policy, University of Oxford

1. This memorandum addresses possible anti-competitive behaviour in the UK electricity and gas markets, the relevant evidence, and the extent to which the structure of the market distorts competition.

THE VARIOUS CLAIMS MADE BY THE TREASURY, OFGEM AND OTHERS

2. Recent large increases in retail electricity and gas prices have given rise to claims that the energy markets are not sufficiently competitive. It has further been claimed by Ofgem that the electricity companies have benefited from a windfall of some £9 billion as a result of the grandfathering of the EU Emissions Trading Scheme (EU ETS) permits for the second phase, 2008–12. Ofgem has recommended that a windfall tax for this amount be levied on the electricity companies and that the revenues be used to cross-subsidise the fuel poor. The Treasury, through a series of “star chamber” meetings with the industry, has conflated these issues further, by arguing that, because of the alleged excess profits (whether from the permit grandfathering or otherwise), the main suppliers should cross-subsidise the fuel poor “voluntarily” against the threat of a windfall tax.

3. These claims confuse three separate questions:

- (i) whether there is anti-competitive behaviour?
- (ii) whether there is a windfall, and whether this amounts to £9 billion?
- (iii) whether in a competitive market, cross-subsidies are appropriate from one group of customers to another?

EVIDENCE ON ANTI-COMPETITIVE BEHAVIOUR

4. The main claims that have been made about anti-competitive behaviour have not been substantiated by empirical evidence. Ofgem claims that this is because there is no evidence. The industry claims that retail prices have increased because wholesale prices have risen (and by more than retail prices), and that there is customer switching between suppliers.

5. In the NETA market structures, which went live from 2000, the evidence is extremely hard to assess from the outside. Unlike the Pool, which NETA replaced, generators and suppliers are free to contract as they choose, whereas the Pool required all significant electricity to be sold into the Pool and anyone could purchase supplies at the Pool price. The Pool was compulsory, transparent and (very) liquid. The introduction of NETA encouraged vertical integration, and pluralised the contracting strategies of the participants. As a result, vertical integration became highly desirable, creating physical hedges for the integrated companies, and leaving generation-only and supplier-only companies at a competitive disadvantage. NETA has proved a major barrier to entry by both merchant generators and supply-only businesses. It is therefore not surprising that there is no significant entry up or downstream since its introduction.

6. NETA also made consolidation within the vertically integrated players attractive, and indeed the result has been that a small number of companies now dominate the market.

7. It is impossible from the outside to establish whether the result has been consistent with the behaviour of a competitive market. In the absence of entry, the incumbents could be engaged in an intensely competitive battle for market share—and, in the key test for a competitive market, prices could be related to costs.

8. The problem for external observers is that the costs upon which prices are based vary, and in a non-transparent way. In particular, it is not sufficient to claim that prices in the wholesale market are tracked by retail prices. The reasons include: the determination of wholesale prices and the influence on those prices of the vertically integrated players; the impact of different fuel mixes on the costs of particular players; and the extent of physical hedges.

9. It is therefore not possible for Ofgem to claim that the market is competitive (or not)—as, for example, in response to the Chancellor of the Exchequer’s questioning in January 2008 (and it is surprising that Ofgem then announced that, although it believed the market was competitive, nevertheless due to “public pressure” it would conduct its own wide-ranging inquiry). In order to make an informed judgement, there will need to be close scrutiny of the contracts, costs and their relation to prices.

THE WINDFALL CLAIM AND THE EU ETS

10. Ofgem claims that the generators have made a windfall profit of some £9 billion from the grandfathering of permits for the EU ETS phase two, and that these ought to be taxed, with the proceeds given to the fuel poor. This is extremely simplistic. Whilst there was a case for an ex ante auction, the arguments for an ex post windfall tax are very different. There are very considerable implications for the market. It is very surprising that Ofgem claims that it knows what the generators would have paid had there been an auction (and the example of the 3G licences for telecoms indicates the possible scale of error in such

predictions). It is also very important to bear in mind the impact on balance sheets of such a tax and the particular implications for the smaller generation-only players, whose competitive role would probably be significantly diminished by an ex post windfall tax.

11. It is also extremely surprising that Ofgem and the Treasury chose to conflate the windfall tax with the fuel poor, given that there are generators without retail customers, and the climate change problem is distinct from the fuel poverty concerns.

CROSS-SUBSIDIES AND COMPETITIVE MARKETS

12. The Treasury's intervention has gone further in its conflation of different issues. The Chancellor's initial concern was with the degree of competition, but then the Treasury used "star chamber" meetings to try to get the main vertically integrated players to cross-subsidise from the bulk of their customers to the fuel poor. Such cross-subsidies are patently inconsistent with competition, so either the Treasury wanted to exploit the claimed (excess) revenues from the claimed anti-competitive behaviour for the benefit of achieving a separate policy goal, or it wanted to handicap the incumbents against entrants.

13. Fuel poverty remains a serious issue—which might get worse if incomes fall and/or prices rise further. There are at least three possible permanent solutions: a levy on all suppliers, a levy on distribution, or social security spending. The latter is the least distorting (and the most appropriate). Distribution is a monopoly, and hence distribution customers can be in effect be taxed for this purpose. Supply is supposed to be competitive, and therefore only if a levy is applied across all suppliers on an equal weighting can it be consistent (roughly) with maintaining competition. The (political) trouble with the explicit supply or distribution levy is that they both make transparent that some customers are subsidising others—a redistribution policy that is normally regarded as a function of the tax and social security systems.

TOWARDS A MORE COMPETITIVE MARKET

14. The current market design—NETA—lies at the heart of competition problems in the UK energy markets. In the NETA market, the combination of a lack of transparency and the competitive advantages under this market form for vertically integrated large companies tend to limit competition in effect to the main players. This was predicted at the time, and it was not surprising that these large players were enthusiastic advocates of the replacement of the Pool by NETA. Given the close involvement and advocacy of NETA by Ofgem, it is unlikely that it will be willing to take a close enough look at this market design.

15. Serious consideration may need to be given as to how to place supplier-only businesses on a level field with vertically integrated players, and NETA needs appropriate reform in this regard.

16. NETA also replaced the capacity market. Whilst the Pool-based capacity market was seriously flawed, the elimination of this market has further reduced the scope for merchant entry into generation. A capacity market, with auctioned slots, would provide a more even field for entrants.

CONCLUSIONS

17. The main conclusions are:

- (i) the voluntary nature of the NETA market makes it impossible to externally establish whether there is evidence of anti-competitive behaviour. This requires detailed scrutiny of the costs of generators, to see whether these are closely related to prices. It is not apparent that Ofgem is in a position to know the answer at this stage;
- (ii) the relationship between wholesale and retail prices is not a sufficient test of competition;
- (iii) the case for an ex post windfall tax is very weak;
- (iv) Ofgem is not in a position to know what generators would have paid ex ante in a permits auction for phase two of the EU ETS;
- (v) the relationship between the grandfathering of permits and fuel poverty is at best tenuous—especially given that not all generators are vertically integrated;
- (vi) the Treasury's attempt to "persuade" vertically integrated companies to "voluntarily" cross-subsidise the fuel poor has been very unfortunate;
- (vii) fuel poverty requires a permanent solution which does not distort competition—cross-subsidies are not consistent with a competitive market;
- (viii) NETA is a major cause of market distortions and it acts as a significant barrier to non-vertically integrated entrants; in this regard it is anti-competitive;
- (ix) the absence of a capacity market under NETA further reduces the scope for new entry.

Memorandum submitted by John Huggins

UK NATURAL GAS COMPETITION

1. EXECUTIVE SUMMARY

1.1 There is strong evidence to suggest that competition is working for large industrial gas consumers but is no longer working for small consumers.

1.2 this evidence is based on BERR's own figures and shows that the price differential between the largest and the smallest consumers has more than doubled since the third quarter of 2005 and in the third quarter of 2007 was around 40p/therm.

1.3 The differential between large and small consumers is justified by the higher transmission, distribution and administration costs associated with small consumers and there is no evidence that these costs have more than doubled over the two year period.

2. PERSONAL INTRODUCTION

2.1 I have 40 years' experience in the energy industry, most of it in senior commercial positions buying or transporting gas.

2.2 My last employed position was a Director of Gas Transportation at British Gas.

2.3 I now work as an independent commercial gas advisor and have worked in several countries.

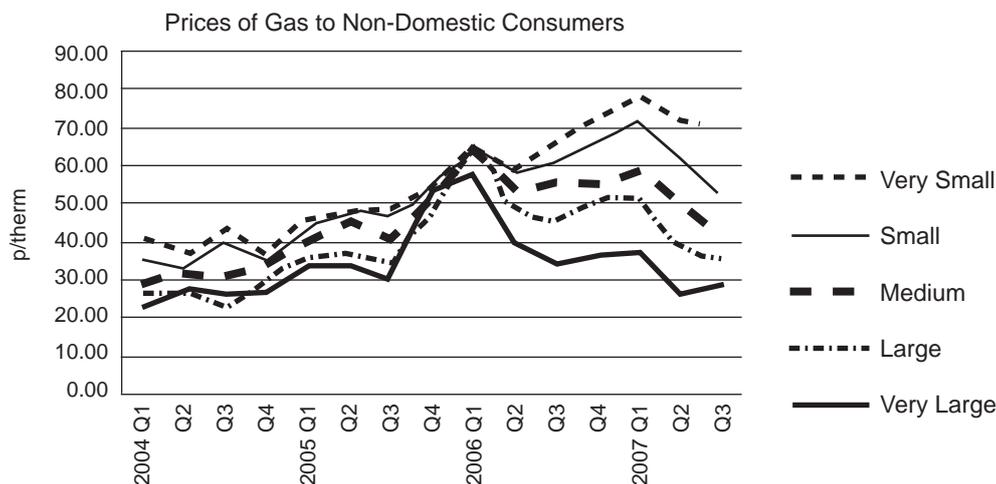
3. GAS PRICES 2004–07

3.1 Chart 1 shows how gas prices to non-domestic consumers²⁷⁶ has varied, depending on size, between the first quarter 2004 and the third quarter 2007.

3.2 Until the third quarter of 2005 the prices moved more or less in line.

3.3 In the fourth quarter of 2005 there was a substantial increase in all prices and thereafter prices no longer moved in line, as the prices to the largest consumers dropped back to around their original level, while prices to the smallest consumers remained high.

Chart 1



4. GAS PRICE DIFFERENTIALS

4.1 Chart 2 shows the differentials between prices to the largest consumers and others.

4.2 The historic differential between the largest and the smallest consumers averaged between 9 and 18p/therm until the third quarter of 2005. A significant differential is to be expected because of the higher transmission and distribution costs associated with the smaller consumers.

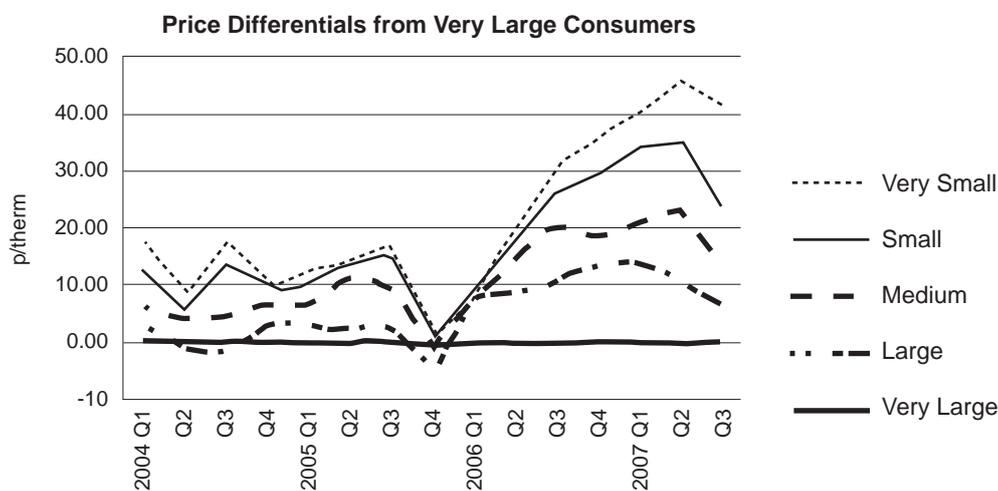
4.3 By the third quarter of 2007 this differential had widened to over 40p/therm. This would appear to indicate an increase in the profitability of the smallest consumers of over 20p/therm unless, of course, sellers were making a loss on sales to the largest consumers in the third quarter of 2007.

²⁷⁶ Quarterly Energy Prices: Table 3.4.1 Prices of fuels purchased by non-domestic consumers in the United Kingdom (excluding the Climate Change Levy).

4.4 There is here evidence that competition is working well for large consumers, but progressively, less well for smaller consumers.

4.5 Directly comparable figures are not available for domestic consumers but the category of very small non-domestic consumers can be considered a good proxy for domestic consumers.

Chart 2



5 February 2008

Memorandum submitted by INEOS ChlorVinyls

1. EXECUTIVE SUMMARY

1.1 INEOS ChlorVinyls is a major chemical company operating throughout Europe. We are able to provide evidence based on extensive and comprehensive knowledge of the gas and electricity markets in which the Company operates.

1.2 Our evidence is based on first hand experience of the operation of UK and Continental European markets.

1.3 The UK and industrial consumers in particular need secure supplies of competitively priced energy—absolute price level is less of a concern if all consumers are similarly affected. Since the Department of Trade and Industry Committee’s “Security of the Gas Supply” Report (Report HC 632), UK market prices have gone through a period of very high price volatility. For a brief period the UK did enjoy comparatively low and therefore competitive prices. However, this was short-lived and once again both UK gas and electricity prices are significantly higher than other major European markets. (See Addendum 1).

1.4 For example, we can broadly assess UK gas market forward prices as being at close to European levels in summer but having a significant premium above this in the winter. As a result UK annual prices are uncompetitive. This situation is apparently driven by the price required to attract LNG supplies to the UK in winter. With the expected need for growing LNG imports in future years this situation seems set to deteriorate further.

1.5 Such uncompetitive price levels are a huge concern to us and other industrial consumers. The need for increasing imports could lead to further severe price distortions as witnessed in Winter 2005–06. During this period we had to severely curtail production with significant financial impact on our business. Meanwhile a number of manufacturing sectors, including paper and glass reported site closures as a result of high energy prices.

1.6 The electricity market is a cause for further concern. The anticipated short-fall in generation capacity in the medium term creates further uncertainty. While there is now clear intent to allow new nuclear capacity to be built we consider ideally this needed to be clarified a number of years earlier.

1.7 It is rather surprising that this situation has arisen again when the UK has apparently the most competitive gas market in Europe and remains a major producer of natural gas.

1.8 In this evidence we have made various comments in response to the specific questions asked in the original call for evidence.

1.9 We have covered a range of themes, some of which we have highlighted in previous submissions to Select Committee Inquiries. These themes include:

- Barriers to entry to energy markets.

- Market complexity.
- Market transparency.
- Issues with LNG.
- Interaction of UK and Continental European markets.

1.10 Previous Committees have acknowledged the price distortions created by the interaction of the UK market with the less liberalised European markets. We recognise the support the UK Government has given to the liberalisation agenda. However, we remain extremely concerned at the rate of progress due to the clear resistance that remains in some of the major European energy markets.

2. EFFECTIVE COMPETITION IN THE RETAIL MARKETS

2.1 We consider that for there to be effective competition in the retail markets we would expect to see a diverse mix of market players.

2.2 The UK Government and Regulator (OFGEM) frequently herald the UK as the most liberal and competitive energy market in Europe. However, we believe that such statements do not properly recognise a number of structural faults within the operation of the gas and electricity markets in the UK.

2.3 In the case of electricity, the UK market is now characterised by large vertically integrated players with broadly identical product offerings. The early days of market liberalisation in the UK found many small independents offering differentiated products, independent generators operating single (or a small number of) power stations and competing successfully with the incumbents. This is no longer the case.

2.4 INEOS has extensive experience of electricity markets throughout Europe. In our opinion the UK offers a significantly poorer market structure for small and independent players than, for example, Germany and the Nordic countries. This is borne out by the number of industrial consumers accessing wholesale markets directly in these countries providing a strong base for increasing liquidity, in stark contrast to the UK position.

2.5 It is not only our view that the UK market is failing to provide the desired liquidity. We note that there has also been very significant concern highlighted by a number of the major market players. As a result of this the Power Trading Forum of the Futures and Options Association is leading a “Market Design Project” to “encourage a more liquid traded market” (see <http://www.foa.co.uk/forums/power.jsp>).

2.6 We would suggest that the problem is largely a result of the increasing consolidation and vertical integration found within the UK electricity industry. This is compounded by the increasing difficulty for independents and small companies to operate alongside the major vertically integrated companies. Increasingly modifications to the major UK Codes strive to deliver better economic models with increasing complexity and risk without regard to the impact upon the UK market in the broadest context. As a result we are delivering an electricity market where small independents have disappeared and new entrants are wholly absent.

2.7 As an independent operator in the power market (and to our knowledge the only UK industrial operating in this way) we suggest that the above situation is driven to a large extent by market rules that are significantly over complicated and appear to us to go well beyond what is required for effective and efficient market operation. These rules create a major hurdle for small players and new entrants to overcome and create significant risk and hence competitive disadvantage for such small operators.

2.8 As an absolute minimum a test for all modifications to the governing Code Structures should be an over-arching objective that they make the market simpler and more accessible thus increasing participation and liquidity.

3. EFFECTIVE COMPETITION IN WHOLESALE MARKETS

3.1 In this section we have highlighted our particular views on the operation of the wholesale UK gas market—an area we have made much comment on in the past few years including written submissions to inquiries undertaken by the Trade and Industry Select Committee.

3.2 Those inquiries were triggered by rising UK wholesale gas prices that reached record levels during the winter of 2005–06. In early 2007 UK wholesale prices fell to comparatively low and competitive levels as the gas supply and demand balance in the UK and across Europe improved—albeit this was significantly influenced by an extremely mild winter across Europe.

3.3 Later in 2007 prices again started to rise. Significantly these rises have been much greater than comparative price rises in other markets. The result of these increases is that UK wholesale prices in both gas and electricity (which is largely driven by gas price) are once again uncompetitive (Addendum 1). As an industrial consumer we would stress that our concern is much less about absolute price level than the absence of a level playing field (Addendum 2).

3.4 Forward summer prices now trade at levels which are broadly around European price levels (for either gas or coal²⁷⁷). In winter, UK prices have a premium of at least 20% to wholesale markets around the Atlantic Basin.

3.5 Over recent months through discussions in various market forums (individually or through industry associations including the Energy Intensive Users Group and Chemical Industries Association) we have highlighted our view of key issues in the UK gas market:

3.5.1 *Liquified Natural Gas (LNG)*

- Deliveries of LNG so far this winter, through the only operating terminal at Isle of Grain, have been very significantly below the maximum available capacity. We note OFGEM have asked for information from parties with regard to use of spare capacity at this facility and we have yet to see the outcome of this review. However, it does appear that there is significant concern regarding the effectiveness of the Use It Or Lose It (UIOLI) regime in place as to our knowledge, released capacity has never been used by another party.
- It is apparent that LNG prices can now determine UK gas prices at least in winter as UK prices have to rise to the highest in the world to attract any cargoes. In the winter of 2005/2006 it was suggested that the price levels at the time were a short-term issue as new infrastructure had arrived too late to match UK Continental Shelf production decline. However, with the need for LNG imports expected to increase dramatically in coming years (source National Grid), then we are hugely concerned that uncompetitive prices are set to become an enduring issue in the most (or only) liberalised market in Europe.

3.5.2 *Norwegian Flow Information*

- Norway has become a crucial supplier of gas to the UK market—and this is set to grow significantly over the coming years.
- We note the contrast in the amount of information now available to the UK Gas Market (largely through the efforts of consumers) compared with the information from offshore and in particular Norwegian imports to both the UK and other European gas terminals. Most disturbingly this lack of information is in sharp contrast to the situation deemed suitable by the Norwegians for trading in the Norwegian electricity market (Nordpool).
- We believe that UK Government must push at EU level for much greater transparency of information on Norwegian (and other importing countries) flows into European gas terminals.

3.5.3 *Impact of the Large Combustion Plant Directive*

- It is becoming apparent that the Large Combustion Plant Directive is having a more significant impact on the gas and power markets than perhaps even some of the more pessimistic forecasts.
- It is very noticeable that gas demand for power generation has increased above that which would have been expected from market prices. Most particularly, from the introduction of the LCPD, we have seen a requirement for gas fired generation to replace coal generation as baseload supply.
- Of most concern is that a significant amount of “opted-in” coal plant is off-line for extended periods whilst they await completion of Flue Gas Desulphurisation (FGD) projects. These facilities appear to have been given far more stringent constraints than the “opted-out” plant and have been largely removed from the generation mix.
- This situation appears perverse, particularly while we have a period where nuclear generation capacity and gas availability are both low. Our greatest concern is the apparent failure of government to properly consider the impact of policy (be it European or UK) on the market. The introduction of this policy in January, the period of maximum demand in the UK energy market suggests, at the very least, a failure of adequate impact assessment.

4. GROWING CONSOLIDATION IN THE ENERGY MARKETS

4.1 As we noted in section 2, we do now see greater consolidation in the UK energy markets. In the previous “dash for gas” during the nineties, there were a number of new entrants who entered the market.

4.2 Many of these new players have since withdrawn from the market for a number of reasons. These issues largely prevail and include:

- Credit issues;
- Risk; and
- Market complexity.

²⁷⁷ In this context the coal price referenced is the equivalent price of coal and gas when converted to electricity in a power station.

There are now a very small number of new/small entrants (in the UK) and we believe that we are also seeing a move towards increasing market concentration throughout Europe by large and vertically integrated companies.

4.3 Our view is that these current market developments rather suggest that the balance of risks within the market is wrong such that new entrants are effectively excluded and size and vertical integration overly rewarded. This cannot be conducive to the development of a healthy and competitive market.

5. RELATIONSHIP BETWEEN WHOLESALE AND RETAIL MARKETS

5.1 We consider the situation in the gas and electricity markets is rather different so we have considered these separately.

5.2 *Gas*

5.2.1 In the UK market end user prices are determined based on the Wholesale (NBP) market prices plus “add-on” costs.

5.2.2 We consider that the cost of the add-ons is quite transparent and in particular the “retail margin” is relatively low compared with the total cost of the bill.

5.2.3 However, we do find that the UK market, in our experience, offers no alternative to this “NBP plus delivery” model. We have explored different approaches at great length but have been unable to achieve any alternative. The UK is “NBP—take it or leave it”. This approach prevents UK consumers procuring gas at competitive prices or managing competitive risk. Further, the NBP market essentially only offers a relatively short-term market—two to three years—as there is limited market trading beyond this period.

5.2.4 Large European utilities refuse to offer contracts in the UK that are freely offered to INEOS sites and other consumers throughout North West Europe. The inability of consumers to procure natural gas on “common contractual terms”—that is on the terms that retailers operating in the UK market offer in other European markets—represents a significant failure of European Market regulation.

5.2.5 We have already commented on the significant price differentials between UK and other markets, particularly in winter. This situation is considered in part to be due to the lack of storage in the UK—a situation arising from the UK having had highly flexible production for a number of years. It is apparent that the need for storage will increase as import dependency increases. This situation is being recognised throughout the rest of Europe as gas demand is expected to grow.

5.2.6 We understand that Planning Reforms seek to enable nationally important infrastructure projects to be developed more quickly. We believe the need for this to be implemented and to deliver the intended benefits will be crucial in the very near future.

5.3 *Electricity*

5.3.1 In the UK market prices are related to the wholesale market with pass-through costs. These costs are less transparent and represent a significantly greater add-on to the wholesale price than is the case with gas. Nonetheless our experience is that retail margins are low.

5.3.2 Our greatest concern lies with the “other” costs that are passed to consumers. The cost of imbalance through Balancing Mechanism costs (Energy Imbalance) or Balancing Services costs (BSUoS) is significant and adds hugely to the retail price. Our experience in Germany and NordPool is that large industrial consumers pay significantly less on top of the wholesale price than in the UK.

6. THE INTERACTION BETWEEN UK AND EUROPEAN MARKETS

6.1 The impact of the interaction between the UK and European markets was highlighted and accepted as a significant issue in previous Select Committee Inquiries.

6.2 We recognise that there has been a major political drive through the various European bodies and particularly DG Competition. The so called “3rd Package” was a major statement of intent and makes clear the desire to progress the liberalisation agenda across Europe.

6.3 However, we note that very strong resistance remains to some of the key elements of this package and in our view it will still be a number of years before we see the markets functioning effectively. The view of a previous Select Committee (HC 279-1) that market liberalisation would not happen before the end of this decade appears to have been correct.

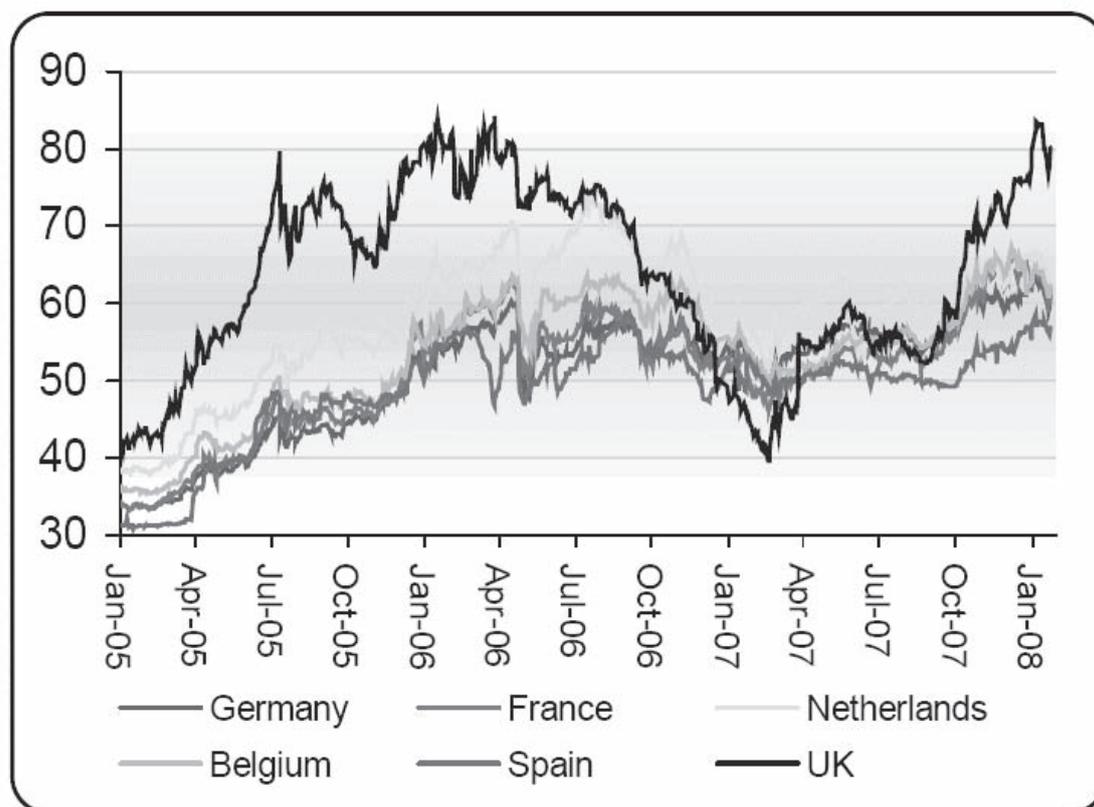
6.4 During the interim period, the UK will continue to be exposed to the market distortions that we have seen in recent years.

6.5 It is essential that UK government maintains its resolve and exerts its influence to ensure that properly functioning markets are developed across Europe.

6.6 We would also stress that it is no longer simply Europe that results in the UK “importing uncompetitive prices”. LNG is a rapidly increasing part of our primary energy supply mix. Despite the expectation of secure supply arrangements from countries such as Qatar, there is concern that such supplies will only arrive if the UK can “out-bid” other markets and so driving UK prices to un-competitive levels.

ADDENDUM 1

WHOLESALE ELECTRICITY PRICE COMPARISON



Source: Energyquote)

ADDENDUM 2

BACKGROUND TO INEOS

INEOS Chlor is based in Runcorn, Cheshire where we produce 80% of the UK’s chlorine and caustic soda. These products are vital building blocks in the production of most chemicals made in the UK. Chlorine is used to purify 98% of our national water consumption, to produce 96% of crop protection products and 85% of pharmaceuticals. It is also a major raw material for the manufacture of plastics. Caustic is used in every major chemical production process and is essential to a wide range of everyday products including soap, cosmetics, clothes, antiseptics and cleaning products. INEOS Chlor has around 1,400 direct employees based in Cheshire.

The manufacture of chlorine is energy intensive. INEOS Chlor purchases energy in the form of natural gas, which is used to produce electricity for use in the chlorine production process (electrolysis of brine).

INEOS Chlor purchases around 250 million therms per year of natural gas for use in the Runcorn manufacturing activities. As such we understand we are probably in the top three of industrial consumers (by volume) in the UK, outside the power generation sector. Natural gas represents some 60% of the total business variable production costs. Every penny added to the wholesale cost of gas increases our production costs by some £2.5 million.

INEOS Fluor, INEOS Vinyls and INEOS Enterprises also have operations within the same site at Runcorn. While these businesses are not as energy intensive as INEOS Chlor, energy is a significant cost. More importantly, these businesses are extremely dependent on the chemicals produced by INEOS Chlor. Runcorn site is the home of a number of other companies including APL and BOC that again are dependent on the chemicals produced by INEOS Chlor.

INEOS Chlor and INEOS Vinyls also have manufacturing assets located in Germany and Italy as well as several smaller UK sites. The various sites consume significant amounts of energy in the form of both natural gas and electricity.

March 2008

Supplementary evidence from INEOS ChlorVinyls

INTRODUCTION

Further to the oral evidence session on Tuesday 17 June 2008 (Mr Alistair Buchanan and Mr Andrew Wright of OFGEM) there are a number of points of clarification and factual corrections that we would like the Committee to be aware of.

We have structured these into sections that do not follow the same order as the actual evidence session. Where appropriate we have provided supporting data and/or links to sources of public information.

We will, separately, provide comments directly to OFGEM.

SHORT TERM VERSUS LONG TERM TRADING (Q560)

We are surprised at the remark that industrial users “*seek to trade short term*”.

We (and we are aware that this is the case for other industrial consumers) have consistently argued that we need to have the ability to contract for our energy supplies on a forward basis at competitive prices. We have made this point clearly, we believe, to previous Select Committee Inquiries as well as more generally.

The very harsh reality is that we are (again) forced to a position where we no longer have a choice. Purchasing forward contracts is simply not an option as prices are unaffordable.

For the avoidance of doubt, we have presented again in Appendix 1, wholesale price comparisons for key energy markets.

MOVING PRODUCTION AND UK/GERMANY PRICE COMPARISONS (Q564)

The answer to this question included a comment that there was the “*the inference [INEOS Chlor] could pack up Runcorn*”.

We refer back to our own oral evidence. We actually highlighted that the longer the current situation of high energy prices persists, the more we will be driven to put our investments into Continental plants. Our business does need to continually re-invest to maintain our assets and we always have to consider where is the best place to do this.

Ofgem also suggested that once other factors (such as the cost of carbon and transportation) are taken into account, the UK actually is no more expensive than for example Germany.

We can only comment specifically on the situation facing Energy Intensive Users such as ourselves. For these end users, “other factors” are actually lower in Germany than they would be for comparable plants in the UK. Taking the points raised by Ofgem in turn:

- It is beyond doubt that the cost of carbon is being passed across all European Power markets largely irrespective of the actual carbon intensity of generation in the market. For example the Norwegian power market—which is almost entirely hydro and nuclear (carbon free)—still has an uplift because of the price of carbon as the markets are physically connected to others in Europe. We believe that the uplift from inclusion of CO₂ costs between the UK and German power markets is actually very similar.
- For “other factors” we share with the Committee publicly available information on the cost of Extra High Voltage (grid) electricity connections in Germany and the UK, and the add-ons faced by Energy Intensive Industry in both countries for renewable generation. These confirm that in Germany for very large users such as ourselves “other factors” are SIGNIFICANTLY LOWER than corresponding charges in the UK. We have shown a more detailed comparison in Appendix 2.

LNG

There are two key points that we would like to clarify.

Q543. It was stated that 63 out of 64 delivery slots were used. This was quite clearly not the case, with Isle of Grain being idle for much of the this year and importantly last winter. We understand there were three cargoes delivered through the Isle of Grain terminal in Quarter 1 2008. The terminal has delivery slots scheduled approximately every seven days, indicating a utilisation of less than 25% of capacity.

Q546. With reference to imports of LNG to the United States, it was stated that they “are taking none”. We have made further enquiries and would like to stress that cargoes have continued to arrive in the US through the winter despite price levels being much lower than in the European or Asian markets.

The latest official data can be found in the link below (Energy Information Administration). It shows steady volumes arriving from Trinidad.

http://tonto.eia.doe.gov/dnav/ng/ng_move_imp_c_s1_m.htm

GAS IMPORT CAPACITY (Q541)

Reference was made to new pipelines and LNG import capacity—around 100 to 120 MCM/day.

We would like to stress, again, that new capacity does not (and demonstrably has not) guaranteed new supply. Unless this new capacity actually has firm supply agreements behind it (as appears to be the case in many other markets) then the UK will remain exposed to high and volatile prices.

INFORMATION TRANSPARENCY (Q578)

It was stated that storage information is not available in Germany.

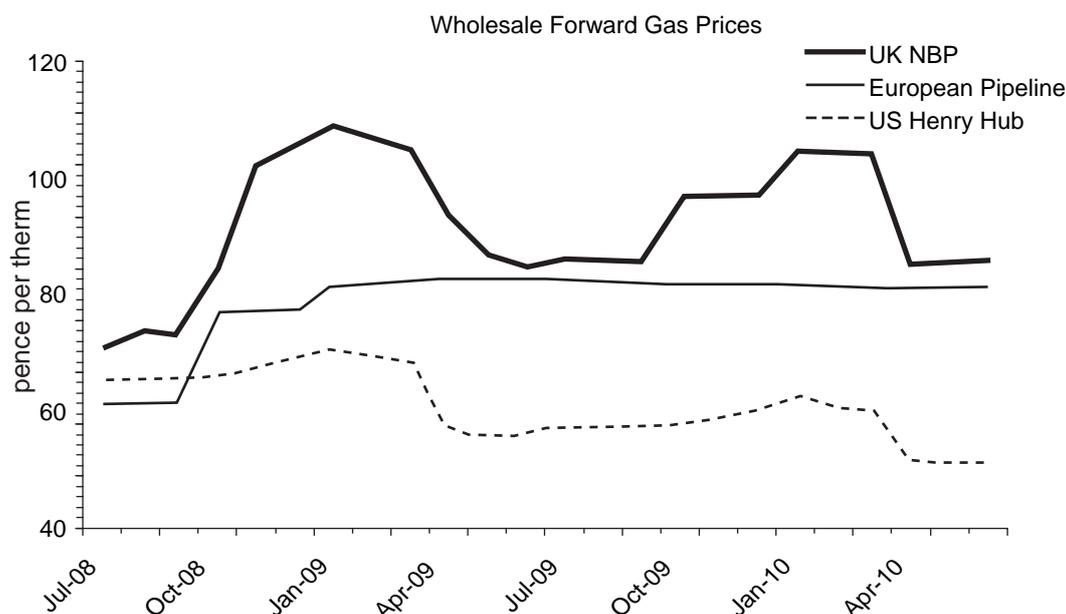
While information provision is not as good in Germany as it is in the UK, German stock data is published weekly and can be found at:

<http://transparency.gie.eu.com/>

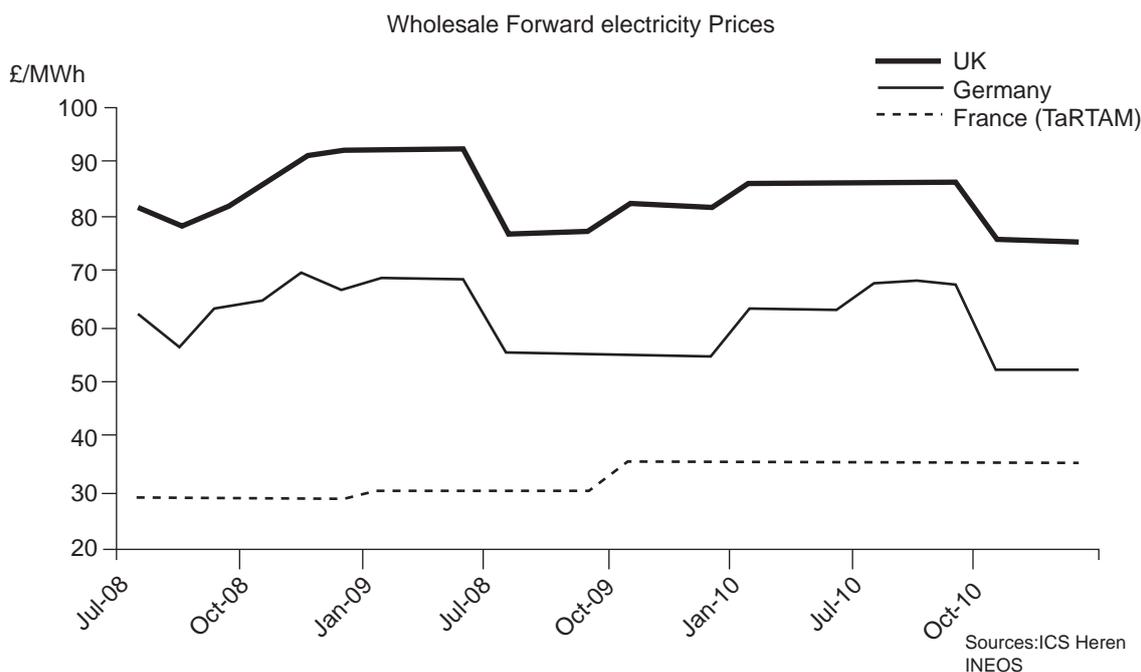
Although we believe better information is a positive step, it is clear that on its own it will not change the situation we face in the UK.

APPENDIX 1

WHOLESALE GAS AND ELECTRICITY PRICES



Source:EPSUK Ltd



APPENDIX 2

COMPARISON OF “OTHER FACTORS” ADDING TO THE COSTS OF WHOLESAL ELECTRICITY TO ENERGY INTENSIVE USERS IN GERMANY AND THE UK

Our comparison is (by nature of common experience) between large directly connected sites (that means connected to the National Grid directly at very high voltage and not through a local distribution company) in the UK and Germany. In both cases the sites are purchasing wholesale power through a supplier, and delivering it to the site. The site is a high load factor industrial user with a normal demand of 50MW consuming 400 GWh per year. Treatment of losses has been ignored for simplicity.

CHARGES IN GERMANY

Grid and connection charges

We assume the user is connected to Eon NET (as is our sister site in Germany). The published connection tariffs for the site are:

- a unit charge of 0.06c/kWh; and
- a capacity charge of €27.39/kW_a;

for the example above this gives rise to an annual unit charge of €240,000 and an annual capacity charge of €1,369,500—a total annual connection charge of €1,609,500—equivalent to €4/MWh.

Other charges

Supplier charges in addition to the wholesale price are very low. Our experience suggests these are in the range €0.05–€0.15/MWh. The most significant other charge in Germany is the Renewables charge.

Businesses in Germany are obliged to buy a proportion of their energy as Renewable Energy at a higher price than the normal rate. For a non Energy Intensive business, the obligation would be to purchase an average of 18.34% of electricity consumption at an average price of €118.8/MWh. For Energy Intensive users, German law caps the amount at a value of €0.5 million per year. The actual additional cost of this is estimated to be €0.25 million per year,²⁷⁸ or €0.63/MWh for our 50MW site.

²⁷⁸ The €0.5 million payment delivers approximately €0.25 million of electricity—hence the true cost is actually half of the obligation.

CHARGES IN UK

Grid and connection charges

The charging regime is slightly different in the UK. The “capacity” charge is paid for in a fee commonly known as “Triad” charges. Unit charges would be more commonly recognised as “BSUoS” charges, which vary by half hour.

- In the North Wales and Mersey region of England connection charges are £15.46/kW for 2008–09.
- The forecast rate for 2008–09 for BSUoS is £1.24/MWh (see http://www.nationalgrid.com/NR/rdonlyres/11BE6CED-FD6B-49FF-BF90-F1FB69C14F1B/26463/01_Op_Perf_OpsForumJun08.pdf)

Therefore for our 50MW site, the annual unit charge (BSUoS) charge is £496,000 and the annual (triad) charge is £773,000—a total annual connection charge of £1,269,000—equivalent to £3.17/MWh.

Other charges

As in Germany, the largest “other” single element is payment for renewables. For 2008–09, UK electricity suppliers are obliged to buy Renewables Obligation Certificates for 9.1% of their supplies, or alternatively pay the buy-out price of £35.76/MWh (recently published by OFGEM). Irrespective of the way suppliers meet this obligation, our experience is that they charge the impact of the buy-out obligation, averaged over the whole supply. This means that £35.76 on 9.1% of the supply is equivalent to £3.25/MWh charged on 100%.

SUMMARY OF “OTHER FACTORS”

In Germany, an Energy Intensive User connected directly to the grid would face costs of less than €5/MWh for delivered electricity in addition to the wholesale price.

In the UK a similar site would face costs of over £6/MWh for the same elements.

11 July 2008

Memorandum submitted by International Power plc

SUMMARY

1. International Power plc (IPR) is a UK-based FTSE-100 company with experience of operating and trading generation assets in a range of markets across the world—in the UK it controls a diverse independent portfolio of assets amounting to 7% of GB installed capacity.

2. IPR believes that that the GB wholesale energy markets are viable, competitive and relatively attractive to investors. The company has demonstrated its long term commitment to the market, and is an active trading participant.

3. It is concerned however with the potential increase in regulatory risk to its investments, as a result of the plethora of market reviews, investigations, and impact of EU proposals. We anticipate some change, evolution and ongoing scrutiny of markets, however, ongoing uncertainty over market design is unwelcome.

4. Although the market is in good health, we do believe that any additional consolidation amongst the six major vertically-integrated companies could be detrimental to competition and threaten liquidity.

CAPABILITY STATEMENT AND PERSPECTIVE

5. IPR is a fast-growing FTSE 100 company based in London, with interests in 40 power stations in 20 countries amounting to a net ownership of 18,824 MW of generating capacity worldwide.

6. In conjunction with its partner, Mitsui & Co. Ltd., it owns and operates a diverse generation portfolio in Great Britain, representing 7% of installed capacity.²⁷⁹

7. IPR’s growth strategy targets key regions around the world (Europe, Australia, Middle East, South-east Asia, and the USA).

8. It has built up extensive knowledge and experience in a range of market environments, typically as an independent market participant, competing with utility incumbents.

²⁷⁹ The portfolio includes the 1,000 MW coal-fired station in Rugeley, Staffordshire, a 500 MW gas-fired CCGT station in Deeside, North Wales, a 1,200 MW cogeneration plant at Saltend, Hull, a 140 MW oil-fired plant at Indian Queens, Cornwall, and 2,088 MW of hydro-electric pumped storage capacity at the Dinorwig and Ffestiniog power stations in Snowdonia.

In the GB market:

9. The company sells its output through the wholesale power market, and manages its fuel and carbon requirements through trading in the gas, coal, oil and emissions markets. It relies on sound liquidity, and transparency to support its business model and its remit is straightforward: it seeks to optimise its profits from these generation assets through active participation in the wholesale energy markets.

10. It has a substantial presence in the generation market, but its UK business remains much smaller than the main six vertically-integrated players. Without the diversity that having a significant supply business would bring, IPR is sensitive to the potential for large vertically-integrated players to influence wholesale prices such that they could undervalue generation costs, thereby cross-subsidising retail businesses.

11. Given that our experience and expertise in the UK is limited to the wholesale markets, this is where we focus our comments.

INVESTMENT CRITERIA

12. IPR's global portfolio is geographically diverse, and spread between merchant style markets, and those that offer long term power purchase agreements. The company's strategy is to seek profitable, and sustainable growth in power generation and associated markets. This means that its investments in merchant environments are considered very carefully against the company's rigorous investment criteria, and political and regulatory risks clearly form part of that assessment.

13. These investments are made for the long term, and IPR therefore seeks stability, predictability and transparency in market arrangements. It recognises that market design will evolve, and also that energy policy and security of supply remain highly political issues, but bases its investment on the assumption that this will not materially alter the fundamental economics of the opportunity.

OBSERVATIONS ON THE GB MARKETS

General

14. The GB energy markets have developed rapidly over the past 20 years, both in structure and in market design. The nature of electricity in particular (eg that it cannot be stored in large quantities) means that whilst commodity style markets can and have been allowed to form, some central controls are required to enable the market to balance and supplies to be delivered to the customer instantaneously. This is the basis of the NETA/BETTA market.

15. In general, there is much to be positive about with respect to the UK's energy markets. In comparison with other national energy markets, in the EU, retail competition is well advanced and market concentration is low. In the generation market levels of market concentration are even lower. Many of the continental markets are typified by one or two dominant firms, with few independents (in either retail or generation.) Market shares in the GB market are reasonably well spread between at least six players.

16. These views are supported by the government's own analysis, which concludes that the UK energy markets are the most competitive in the EU.²⁸⁰

17. However, as with all markets, there are imperfections and potential problems (eg inconsistent liquidity, volatility.) We are not convinced that these are material, and in any case, do not justify major market investigation and overhaul. This leads onto the next point:

Regulatory Risk

18. As a UK-based independent player with a diverse portfolio of global investments, we are increasingly concerned about the sheer volume of market change proposals, policy announcements, and major industry reviews (eg Transmission Access Review, Cashout Pricing Review, Industry Governance Review etc) that appear to be running in parallel in the UK.

19. Furthermore, the lack of uncertainty regarding the future shape of the EU Emissions Trading Scheme and the adoption of the EU Renewables Targets creates longer term price uncertainty in the power and carbon markets and threatens timely and efficient new investment in the industry.

20. These factors necessarily affect our willingness to invest, pushing up risk premia, and serving to deter potential new entrants that could deliver valuable competition to the incumbent players.

21. Therefore from our perspective, we perceive the issue of regulatory risk to be a much more serious issue for competition, and ultimately consumers, than any market imperfections.

22. We very much hope that this inquiry, and the separate inquiry into retail markets being undertaken by Ofgem, do not lead to significant market reforms. This would damage investor confidence.

²⁸⁰ Energy Market Competition in the EU and G7: Preliminary 2006 Rankings, by Oxera for BERR.

Price levels

23. It is important to note that increases in wholesale prices seen in recent years do not necessarily indicate a more attractive market to independent generators such as IPR. Market value to generators is actually driven by the available spreads between price and fuel costs. Since the introduction of the New Electricity Trading Arrangements in 2001, IPM has not seen spreads sustained at levels where it would be prepared to invest in new build projects—high fuel costs have reduced margins available to wholesale generators. However, the company has pursued such projects in a range of other markets across the world where margins have been more attractive.

24. We therefore do not believe that any analysis of the wholesale market undertaken by the BERR committee could conclude that prices are “too high”.

25. In any case, if higher prices were coupled with higher generator margins, this should, from time to time, be a natural feature of the market cycle, encouraging new investment when it is needed, and allowing operators to recover (material) capital costs. Any regulatory actions designed to suppress prices at these critical times are likely to be detrimental to customers in the longer term.

Liquidity

26. Liquidity in gas and carbon emissions is strong and does not warrant examination. However liquidity in the power market is less consistent. Under the NETA market when it was launched in 2001, traded volumes were slow to build, largely due the impact of the collapse of Enron (and subsequently British Energy amongst others) and the associated credit concerns.

27. In our view, despite improved confidence in trading since then, power market liquidity has not recovered to the levels that it would be expected to reach. This is in no small part due to the increased levels of vertical integration in the market—meaning that many trading opportunities are now internalised within vertically-integrated organisations. The design of the market is based on the external trading of a net position, quickly incentivising consolidation in order to reduce risk.

28. This does tend to limit strategic bilateral trading opportunities for standalone generators such as ourselves—increasing reliance on liquidity in uncertain, short term markets.

29. However, we do have confidence in the power market as it stands to deliver sufficient liquidity for our portfolio. We would become more concerned if market concentration was allowed to increase further, through potential M&A activity (eg EdF and Iberdrola.) between the large vertically-integrated players. This could start to seriously marginalise independents to the point where new entry would not occur.

CONCLUSIONS

30. IPR believes the GB wholesale energy markets are fundamentally sound, and the sector is one of the most competitive and liberalised in the world.

31. Regulators need to be wary of the threat of any increased consolidation amongst the main vertically-integrated players, to this position.

32. Regulatory risk is a growing concern in the UK to potential investors such as International Power. Regulators and politicians should be aware of the impact of unnecessary market upheaval on competition and ultimately consumers

March 2008

Memorandum submitted by the LGA

The LGA is proposing a council-led programme to ensure every home in the country is insulated, reducing energy bills in 10 million homes by on average £200 a year, lifting 500,000 out of fuel poverty and cutting household carbon emissions by 20%.

The programme would be paid for by energy suppliers paying an annual charge of £500 million a year to match pound for pound the existing contributions made by householders through the Carbon Emissions Reduction Target (CERT) scheme. Ofgem would ensure that these extra costs would not be passed on to consumers.

PROBLEMS WITH THE WAY ENERGY SUPPLIERS ARE REGULATED

Our new report “*Switch off, switched on*” has identified three main faults with the current way that energy suppliers are regulated to cut carbon emissions and tackle fuel poverty through the CERT scheme:

- Energy suppliers spend huge amounts of money trying to market and advertise a scheme nobody has heard of often failing to reach the householders who need it most.

- Companies often abruptly end programmes as soon as targets have been met—regardless of local need.
- There is little public understanding or scrutiny of the scheme—even though it is householders' money being spent.

Regulations are trying to force energy suppliers to do something that goes against their core business of selling energy. Instead we propose that a duty should be placed on them to work with councils who would be able to lead on offering households free insulation and are used to dealing with social and environmental objectives.

HOW COUNCILS CAN HELP HOUSEHOLDS REDUCE ENERGY CONSUMPTION AND TACKLE FUEL POVERTY

- Councils know their own area and know which households are most likely to suffer from fuel poverty and would be trusted to help the elderly empty their lofts to be insulated.
- A one off payment to properly insulate a home is a much more efficient way to cut fuel poverty than giving money each year to help pay for extra fuel use.
- Councils can operate on a larger scale offering free insulation to every household in a neighbourhood.
- Councils are democratically elected and can be held accountable for promoting energy efficiency and tackling fuel poverty.
- We estimate that if councils were able to insulate every household they could take half a million people out of fuel poverty.

HOW INSULATING EVERY HOME AND TACKLING FUEL POVERTY COULD BE PAID FOR

We are calling for energy companies to match the average £35 per household, contribution that customers already pay towards the CERT scheme. This could raise an extra £500 million a year and if they worked with councils to achieve economies of scale they would be able to ensure every household in the country is properly insulated over a three year period.

It would have to be Ofgem's role to ensure that these costs are not just passed on to the consumers. The CERT scheme will be reformed for another three year period in 2011, but regulations can be put in place straight away to ensure energy suppliers work with councils to promote carbon reduction and tackle fuel poverty more effectively.

I have included with this submission our report "*Switch off, switched on*" which sets out in detail our proposals for how energy bills could be reduced by reforming the CERTs scheme.

25 April 2008

Memorandum submitted by Major Energy Users' Council (MEUC)

I am writing on behalf of the Major Energy Users' Council (MEUC), which is an independent body representing the interests of a large number of industrial, commercial, retail and public sector organisations for which the use of electricity and gas is a significant factor in their operations.

The MEUC was formed 20 years ago, shortly after the England and Wales gas market was privatised and opened up to competition, as there was no other body in being at that time to represent industrial consumers' interests.

Its principal objectives are to keep members informed of developments, to advise them on energy matters (purchasing and energy efficiency) and where appropriate offer a consumer's view to government and regulatory bodies.

Before answering the questions you have put directly we should stress that we quite understand that the rise in prices is a world wide phenomenon and that they are likely to remain high. Our concern is for the competitiveness of British industry.

We would add that the effect on industry's costs became apparent about two years ago with the first steep rises in wholesale prices. There is always a delay before the increases are reflected in domestic prices. It is worth noting that it is quite likely that if wholesale market prices remain at this level for any length of time domestic consumers may well find themselves subjected to further price increases later in the year.

1. *Whether the current market structure encourages effective competition in the retail markets for gas and electricity*

The current market structure does not encourage price competition in the retail gas and power markets as energy prices are in the main derived from the traded screens which are common to all suppliers. There are however a choice of contract structures which can be used to differentiate between one supplier and another. Some of the more flexible and innovative products are only available to very large users. By way of example risky “day ahead” prices may be an option for certain energy intensive users to consider.

2. *Whether there is effective competition in the wholesale markets for gas and electricity*

There are a sufficient number of generating companies in the market place to provide effective competition if they so choose to do so. However, many of them also have downstream operations in the supply of electricity to customers, ie are vertically integrated. This provides a supply demand balance position which reduces their risk as the amount traded is limited to imbalances only. The screen based traded market prices therefore become the mechanism for pricing contracts and not the operational costs of generation.

While there is no shortage of physical gas itself, gas market liquidity is adversely affected by producers who are adopting a virtually identical supply model that involves selling less and less gas on the open forward market in favour of long-term contracts, which are not traded in this open market. Consequently, only short-dated and residual contract gas supplies are available for sale in the wholesale market and this exacerbates price transparency and volatility problems.. Despite having access to a variety of gas sources, long term contracts, stored gas and the open forward market, suppliers’ offers are linked solely to the last source, which of course is the smallest traded volume and highest price. For annual or longer gas contracts all suppliers use an identical pricing model, the average forward price plus transportation plus the supplier’s admin margin. Therefore the buyer finds that there is very little difference in the offers they receive and is leading them to question the value of changing supplier and hence competition. The alternative available to the buyer is to increase the risk and buy on index-linked contracts, linked to the month or day-ahead prices on the forward market.

Constrained liquidity in the long-dated market also serves as a barrier to entry for new entrants, energy merchants and independent suppliers.

3. *The implications of growing consolidation in the energy market*

The consolidation of the energy sector both through mergers, acquisitions and vertical and horizontal integration limits choice to the customers. For industrial and commercial customers that choice now is limited to six for electricity and a few more for gas. Even then some suppliers refuse to tender on the basis of credit risk, unattractive load shape or don’t like the unpredictable nature of industrial loads, etc. There appears to be an inherent reluctance from some supplies that have upstream and downstream in balance to take on additional risk. In these cases a quotation, even if one is submitted, can be very unattractive.

You will be aware that EDF Energy has recently indicated that it would like to purchase Iberdrola, the Spanish owner of Scottish Power. Should this takeover be confirmed the six would become five.

Small suppliers have almost disappeared from the market. The complex supply and distribution code structures are clearly a barrier to new entrants, who are disadvantaged anyway by the wholesale price structure and the power of the vertically integrated six.

4. *The relationship between the wholesale and retail markets for electricity and gas*

There is a very close relationship between the wholesale and retail markets in both gas and power especially for Industrial and Commercial customers. As already mentioned above customer contract prices are based on the traded market screens even though only a small amount of volume is actively traded there. The thin liquidity of the traded markets can be an encouragement for the activity of financial institutions (banks and traded funds) and produce increased volatility but they have no direct role in the supply of gas or electricity. The forward price of power and gas can be driven upwards by high volume purchases by these organisations. Everyone seems to be aware that it goes on but there are no market rules which prevent or limit this speculative activity. This is particularly difficult for the smaller manufacturing companies to manage and undoubtedly adds to their vulnerability.

5. *The Interaction between the UK and European Energy Markets*

With an interconnected European energy network one would have expected price convergence between member states. A comparison between gas and electricity prices across Europe would seem to demonstrate the opposite. One may question why the Interconnector to Zeebrugge, which has a capacity of 76 mcm/day, the average daily flow for the last three months has been 9 mcm, ie 1/8th of the capacity. The attached graphs show UK forward 2008 and 2009 electricity prices in comparison to those on the continent.

For several years the UK Government has been striving for a liberalised market throughout Europe. As is well known France, Germany and other countries have remained implacably opposed to any moves to open their markets to real competition. The effectiveness of several countries Regulators' is questionable. The Government of France, indeed, has gone in the opposite direction by encouraging the merger of Suez and Gaz de France and by doing so has made it clear that its policy is to protect what it describes as its strategic assets.

The British Government's desire for competitive markets throughout Europe is laudable but the lack of progress should be acknowledged and it should take a more pragmatic approach to protect its own citizens.

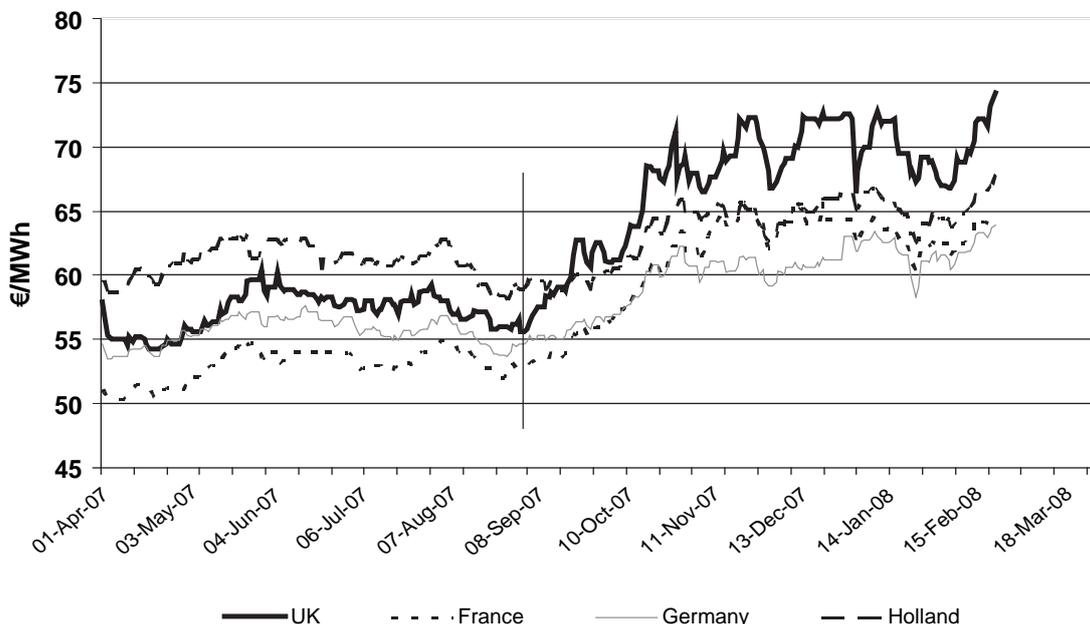
6. *The effectiveness of regulatory oversight of the energy market*

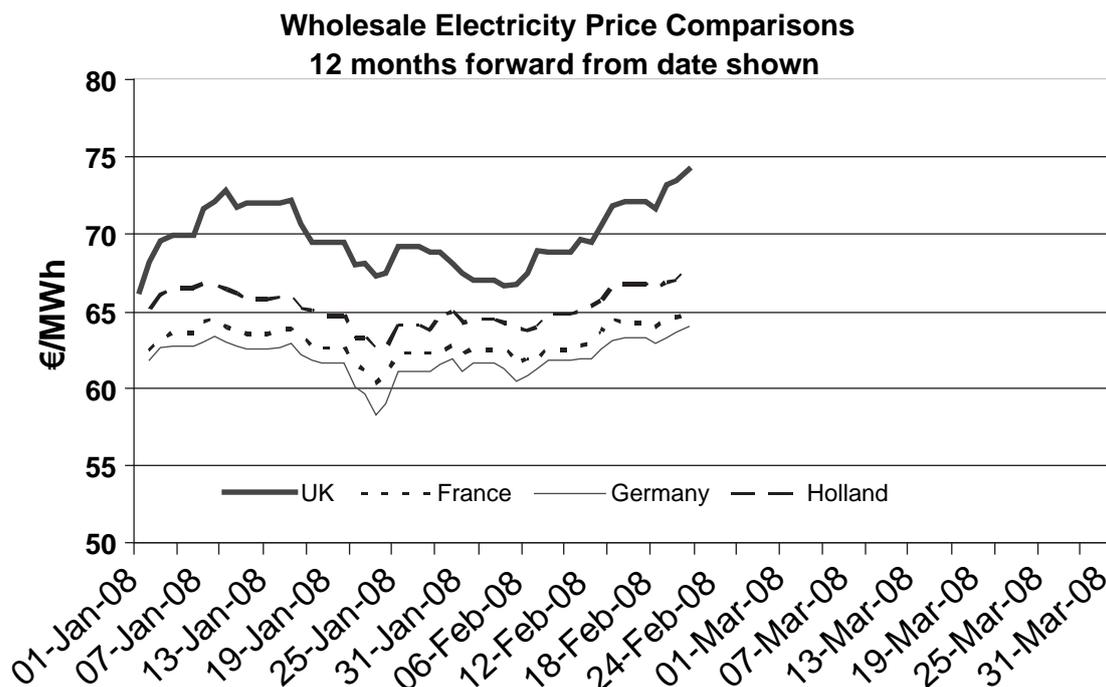
We acknowledge the effectiveness of Ofgem in taking a proactive overseeing role in many instances and its work in driving matters forward in Europe. However we believe that there are systematic weaknesses that become apparent during periods of high prices which it is failing to acknowledge or address. We note that immediately following a meeting with the Chancellor of the Exchequer on 16 January, Ofgem issued a press release stating that the "Market is Sound". However Ofgem announced on 21 February that there would be an Energy Supply Markets Probe. Its call for evidence was announced on 27 March. Our concern is that Ofgem's view of a competitive market fails to take account of consumers' perception of fundamental flaws and seems limited to the calculation of the number of domestic customers that switch supplier in any one year.

In conclusion our major concern with the current UK energy supply is the lack of liquidity in what is supposed to be a competitive market and the dominance by a small number of vertically integrated generation and gas supply companies. It is not helped by restricted access to supplies from Europe. To a certain extent the European companies are the same ones that dominate in the UK.

We cannot see an easy solution to resolving the issues detailed above other than by a fundamental review. The last review on power was held in 1999 and resulted in the New Electricity Trading Arrangements (NETA). At least in the old days of the electricity pool, the operational costs of generation played a more important role in marginal pricing than it does today and now that so much electricity generation is dependent upon gas supplies and an increasing reliance upon imported gas a fundamental review of both gas and electricity markets would be a necessary conclusion to draw.

**Wholesale Electricity Price Comparisons
12 months forward from date shown**





27 March 2008

Memorandum submitted by Morgan Stanley & Co.

Morgan Stanley & Co. International plc welcomes the opportunity to comment on behalf of itself and its affiliate Morgan Stanley Capital Group Inc., with regard to the Business Enterprise and Regulatory Reform (BERR) Investigation into Energy Prices, Fuel Poverty and the Structure of the Market, as well as Security of Supply. Morgan Stanley's commodity business is an active participant in the UK's electricity market and in other commodity markets worldwide. As a financial intermediary we facilitate access to the market for new entrants as well as providing risk management services to more established participants. This response reflects our activity in this capacity and the knowledge of the market gained. The focus of our comments relates to Energy Prices and the Structure of the Market. We should be grateful if you would treat this as a non-public, confidential response.

The best protection against excessive costs to consumers is well-designed, transparent, liquid markets at both a wholesale and retail level. Markets allow entities with a competitive advantage to enter and compete in specific market segments without needing to be vertically integrated. Other specialist entities competitively provide other components or attributes that form the final bundled product to consumers. Thus consumers get a wide range of choice in both price and service. Reducing barriers to entry should thus be a core objective for regulators. Low barriers to entry are key attributes of an efficient market. An efficient market should have a diversity of participants and should not result in vertical integration.

The most significant barrier to entry for new participants in the retail market is the cash-out mechanism, which is currently being reviewed by Ofgem. Retail power suppliers and generators will always have some level of imbalance which they cannot avoid because load cannot be predicted with complete certainty. Imbalance volumes will be a smaller percentage of the total power supplied for a larger portfolio, due to its greater forecastability. Thus smaller players are disadvantaged by the current arrangements.

There are two important issues in the cash-out mechanism. Firstly, the assignment of costs to participants does not follow the principle of cost assignment to cost causation. Cash-out charges should relate to the cost of energy imbalance, but they currently also include a large proportion of system balancing costs that should fall under BSUoS.

The second, more significant issue is the highly punitive dual pricing structure. This strongly benefits larger, vertically integrated participants who have at least some ability to reduce imbalance charges for their combined portfolio via adjustments to the output from their generation assets. A single cash-out price, or a significantly less punitive spread between SBP and SSP for the first X MW of imbalance would reduce the imbalance cost burden on small suppliers and generators, thereby removing this barrier for new entrants.

The overview above captures Morgan Stanley's views on the competitiveness of the retail and wholesale markets at this time. Listed below are answers to selected specific questions asked by BERR:

1. *Whether the current market structure encourages effective competition in the retail markets for gas and electricity.*

The core of the market structure is sound. However, early competitive pressures have naturally driven the market towards consolidation. After achieving this type of equilibrium state, it is not unnatural for companies to migrate towards more defensive positions whereby defending existing market share of supply points is more important than vigorous additional competition. The best market design to protect against such a state is to ensure that there are no institutionally supported barriers to entry or assessments of costs that are not related to cause. This maximizes opportunities for innovative, specialised market entrants to compete for any profit making opportunities that may exist. Morgan Stanley have outlined one barrier to entry that we believe needs addressing. There may be others.

2. *Whether there is effective competition in the wholesale markets for gas and electricity.*

There are a number of wholesale competitors. Some however are vertically integrated which harms wholesale competition. The harm comes primarily from the reality or perception of unfair advantage. We note that regulators in some jurisdictions forced divestiture and vertical disaggregation. Morgan Stanley does not believe this is necessary. A market design with low barriers to entry and a level playing field tends to drive vertical disaggregation. A primary barrier to wholesale market efficiency is the balancing market.

3. *The implications of growing consolidation in the energy market.*

Morgan Stanley observes that highly efficient and competitive markets can be dominated by a few large participants. Horizontal consolidation would be an expected outcome in such a market. However, significant vertical integration would not be an expected outcome. It would instead be a consequence of a market that is not fully competitive. Thus barriers to entry must be kept low so that small innovators can continue to bring improvements.

4. *The relationship between the wholesale and retail markets for electricity and gas.*

A wholesale market should service the interests of retailers. This is occurring and exemplary evidence can be seen. An example is Morgan Stanley's product offerings to small retailers. However as already noted, we and our clients are disadvantaged by the wholesale balancing market.

5. *The interaction between the UK and European energy markets.*

We believe there should be tight coupling between markets. If cross border capacity is explicitly auctioned, holders of capacity whether long term or short term, should be able to rely on the transmission system operator (TSO) to optimize flows on their capacity on their behalf, with capacity holders keeping the resulting congestion revenues. Only the TSO has the real-time information to ensure that all flows are easing and not increasing congestion.

6. *The effectiveness of regulatory oversight of the energy market.*

7. *Progress in reducing fuel poverty and the appropriate policy instruments for doing so.*

Morgan Stanley views reduction of fuel poverty as a societal goal, not directly related to energy markets. As such, remedies should be provided and funded by society generally, not via mandates or restrictions on energy markets. However, if energy markets are vigorously competitive, prices will be fully cost-reflective. The resulting level of fuel poverty will be minimised relative to levels that may otherwise be experienced if the market is not fully competitive. Therefore, actions taken to ensure vigorously competitive energy markets have the additional benefit of reducing fuel poverty.

1 April 2008

Memorandum submitted by National Energy Action (NEA)

1. INTRODUCTION

1.1 NEA is a national charity working to eliminate fuel poverty through a combination of policy development and practical programmes. NEA's primary objective is to address fuel poverty through measures to improve heating and insulation standards in dwellings occupied by vulnerable households. Energy efficiency is the most rational and sustainable approach to delivering long-term affordable warmth solutions to disadvantaged households.

1.2 However poor energy efficiency is only one of three components that predispose to fuel poverty, the others being:

- low household income; and
- unaffordably high domestic energy prices.

1.3 Consequently, NEA welcomes the BERR Select Committee Inquiry into the working of the energy market and the opportunity to submit evidence and comment on how the market is failing vulnerable consumers. Since the Committee's remit clearly does not extend to income-related matters NEA's comments will centre on energy prices within the competitive market.

1.4 Given NEA's key areas of concern, comment will be limited to those aspects of the Committee's inquiry related to market structures and fuel poverty.

2. WHETHER THE CURRENT MARKET STRUCTURE ENCOURAGES EFFECTIVE COMPETITION IN THE RETAIL MARKETS FOR GAS AND ELECTRICITY

2.1 There is one clear flaw in the operation of domestic gas and electricity markets and this relates to the anomalous relationship between the incumbent²⁸¹ supplier and in-area customers. Despite the fact that competition within the domestic sector has existed since the late 1990s, almost half of all customers have never switched supplier. This, in itself, would not pose a problem were it not for the tariff structures devised by energy suppliers which exploit the failure to switch from the incumbent.²⁸² In effect the incumbent supplier treats "legacy" customers as a cash cow. These customers are charged significantly more than would be the case in a properly functioning market. Whilst these differential charges may have galvanised and to some extent still sustain the competitive market it is clearly at the expense of almost half of all consumers many of whom are vulnerable and disadvantaged. The perverse effect of this arrangement is that a perfect manifestation of market forces would require all customers to have switched away from their original supplier.

2.2 However the perfect market has refused to develop. Almost 50% of domestic energy consumers remain with their original supplier despite clear economic disadvantage—a circumstance which incumbent suppliers are happy to exploit. Instead of their offering competitive terms to their in-area customers in order to retain their business they have relied on a combination of lack of knowledge, anxiety about the process and inertia to continue a form of exploitation. In other cases, suppliers have been able to prevent indebted customers from switching supplier thereby locking in to a high cost arrangement those who clearly cannot afford existing charges. Paradoxically, whereas most commercial arrangements provide a positive return for loyalty the energy industry imposes a financial disadvantage on those who do not switch. Ofgem is unacceptably sanguine at this clear distortion of the market.

3. SWITCHING AND MARKET FAILURE

3.1 Ofgem maintains that supplier switching continues to develop but there are signs that we are approaching a point where the potential for switching may have reached saturation point, at which time it seems likely that a permanent minority of non-switchers will remain and that these will predominantly comprise households who are not confident consumers and who face other economic or social disadvantage.

4. CHARACTERISTICS OF NON-SWITCHERS

4.1 The table below illustrates the disparity in switching rates by socio-economic characteristics. It is clear that certain categories of disadvantaged consumers are more likely to compound this disadvantage by remaining with their original supplier.

CUSTOMER SWITCHING RATES TO DECEMBER 2005

	<i>Average</i>	<i>Over 65</i>	<i>Prepayment</i>	<i>Low income</i>	<i>Rural</i>	<i>Disabled</i>	<i>State pension</i>
Gas	47%	37%	37%	39%	46%	50%	37%
Electricity	48%	44%	43%	43%	46%	54%	41%

Source: Social Action Plan, Ofgem, 2006

4.2 More recent data confirm the reluctance or inability of certain customers to switch. Whilst use of prepayment meters is not a precise proxy for disadvantage it is associated with difficulty in managing energy costs.²⁸³ It should be noted that the Government has now undertaken to address the existing fiscal disadvantage faced by prepayment meter users²⁸⁴ but has done little to remedy their disproportionate exclusion from the market.

²⁸¹ The incumbent supplier is British Gas or the original regional Public Electricity Suppliers which have now reduced in number from fourteen companies to five companies.

²⁸² See for instance: Consumer Choice and Industrial Policy: A Study of UK Energy Markets, Centre for the Study of Energy Markets, Working Paper 112, 2003.

²⁸³ Ofgem reports that in 2006, 66% of prepayment meters were installed in cases of debt.

²⁸⁴ Budget Statement 2008.

INCUMBENT MARKET SHARE BY PAYMENT METHOD 2006

	<i>Gas</i>	<i>Electricity</i>
Direct debit	41%	42%
Standard credit	56%	55%
Prepayment	63%	53%

Source: Domestic Retail Market Report, Ofgem, 2007

5. PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

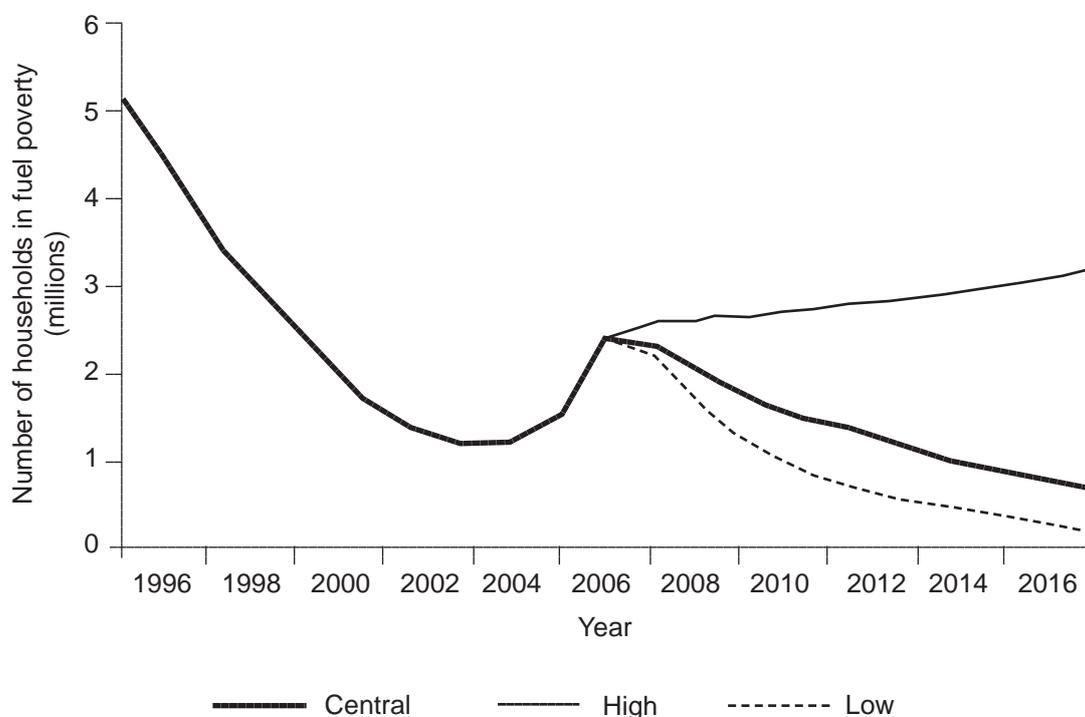
5.1 As discussed earlier, NEA views heating and insulation improvements as the only permanent and sustainable approach to fuel poverty whilst recognising the role of income maximisation and action to control energy prices as other key elements. Defra has primary responsibility for energy efficiency, and income support policy clearly rests with the Department for Work and Pensions but there are a number of areas where the Department for Business, Enterprise and Regulatory Reform has both the powers and responsibility to intervene.

5.2 The 2003 Energy White Paper²⁸⁵ published by BERR’s predecessor, the Department for Trade and Industry, positioned the need to: “ensure that every home is adequately and affordably heated” as one of the four key goals of energy policy.

5.3 The subsequent 2007 White Paper²⁸⁶ revealed just how far the Government was from achieving this objective. The graph also illustrates the gulf between the Government’s commitments to eradicate fuel poverty for vulnerable households by 2010 and for all households by 2016 and the likelihood of these objectives being realised.

Figure 2.1.1

HISTORIC AND PROJECTED NUMBERS OF HOUSEHOLDS IN FUEL POVERTY IN ENGLAND, 1996–2016



Source: DTI, 2007

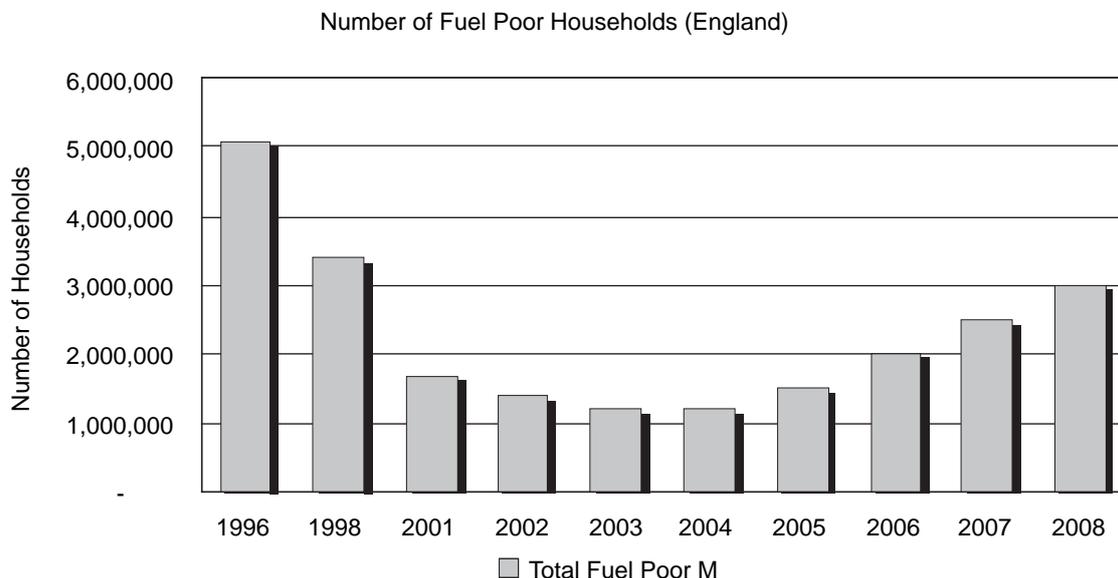
- Positions in 2005 and 2006 are based on the modelling of the impact of income, energy prices movements and energy efficiency measures on the number of vulnerable households in fuel poverty.
- Positions from 2007 to 2016 are based on modelling and show central, low and high price scenarios. These are based on the fossil-fuel price assumptions published at the same time as the White Paper.

²⁸⁵ Our energy future—creating a low carbon economy, DTI, 2003.

²⁸⁶ Meeting the Energy Challenge, DTI, 2007.

6. THE CURRENT INCIDENCE OF FUEL POVERTY

6.1 NEA has calculated the actual effect of energy price movements since 2004 to spring 2008. By March 2008 all six major energy suppliers had announced significant increases in both gas and electricity prices. The impact is illustrated in the graph below and indicates that the prevailing situation is worse than in even the high price scenario posited in the Energy White Paper.



7. ACTION ON ENERGY PRICES

7.1 The 2008 Budget Statement promised some measures to mitigate the impact of unmanageable energy prices on disadvantaged households and this is welcome. The Chancellor's key proposals centred on the need to address the existing pricing differentials associated with prepayment meters and the need for energy suppliers to provide additional assistance to certain categories of consumer through more effective and better resourced social tariffs.

7.2 This in itself raises some issues around the extent to which Government social policy objectives can be devolved to commercial organisations. The Government simultaneously celebrates market solutions to a range of social problems whilst recognising that social welfare considerations are not uppermost in the priorities of companies whose primary loyalty is to their shareholders.

7.3 NEA concludes that Government cannot delegate responsibility for delivering fuel poverty solutions to any other agency least of all energy suppliers. Nor can it rely completely on Ofgem, a regulatory body which sees its main role as the promotion of competitive markets, even where these markets have self-evidently failed a considerable number of vulnerable and marginalised customers.

7.4 The Government does have powers to act on other areas of fuel poverty policy but demonstrates a reluctance to support households in, for example, extension of Winter Fuel Payments to those non-pensioner households in the greatest need. It should also be noted that the Government has cut funding for its main fuel poverty programme, Warm Front, leading inevitably to tens of thousands of households being denied heating and insulation improvements.

8. PREPAYMENT METERS

8.1 After many years of ignoring the strong case for intervention to address the growing disparity between charges made to more affluent direct debit customers and those made to disadvantaged prepayment meter users, the Government has resolved to act. The case for action is compelling. The differentials between prepayment and other payment methods have increased to an unacceptable level. Whereas suppliers, with the endorsement of Ofgem, have cited cost-reflective pricing as the justification for any differential it is clear that additional costs associated with maintaining the prepayment infrastructure are not responsible for growing disparities in charging practice.

ADDITIONAL CHARGES TO PREPAYMENT USERS COMPARED TO
ONLINE DIRECT DEBIT

	<i>Average differential</i>	<i>Additional cost to service individual prepayment customer</i>	<i>Number of prepayment customers (millions)</i>	<i>Total additional cost incurred by prepayment customers (£ millions)</i>	<i>Total additional cost to service prepayment customer base (£ millions)</i>	<i>Excess charges levied by energy suppliers (£ millions)</i>
Gas	£146	£52	2.3 million	£340	£120	£220
Electricity	£85	£35	3.6 million	£304	£123	£181
Total				£644	£243	£401

Source: energywatch, March 2008

8.2 The differential between online direct debit and prepayment may to some extent reflect the benefits to the supplier of an administratively efficient system but the rationale for the gulf between prepayment and other payment methods is also significant with prepayment customers paying on average 13% more than for conventional direct debit arrangements and as much as £270 more than the lowest standard credit charges.

9. ADDRESSING THE PREPAYMENT SURCHARGE

9.1 NEA's main concern relating to prepayment meter surcharges reflects the view that many disadvantaged households are compelled to use this payment method. However it is also recognised that the majority of fuel-poor households do not pay by this method and that these households would face additional costs were charges to be equalised. Ofgem calculates that equalisation of prepayment tariffs with direct debit or standard credit would cost the average household £14 or £6 per year respectively.

9.2 Clearly, NEA does not wish to see any fuel-poor household further disadvantaged; nor does the charity wish to see perpetuation of unjust and inequitable charges to any prepayment customers. Consequently, NEA proposes that prepayment charges be capped at the level charged to standard credit customers; this degree of cross-subsidy would constitute a reasonable compromise. NEA further proposes that Ofgem carries out research to verify not only the additional cost of supply but also the benefits accruing to suppliers as a result of prepayment:

- Receipt of payment in advance for energy costs rather than in arrears.
- Minimal meter reading and billing procedures.
- No expensive debt recovery procedures associated with this payment method.

10. SOCIAL TARIFFS

10.1 In fact, NEA sees social tariffs as making a much greater contribution to fuel poverty alleviation than any reduction in the prepayment surcharge. A well targeted social tariff can ensure that those in genuine need are the beneficiaries. The key issue is the degree of discretion allowed to suppliers in designing such a tariff against a strongly prescriptive mandate from Government setting out eligibility criteria and the overall and individual benefit that must result from such a tariff. NEA has set out its view of the essential criteria for a social tariff (See Appendix).

10.2 The Gas Act 1986 and the Electricity Act 1999 provide the Secretary of State with powers to intervene in the market where—[he] considers that members of any group (a “disadvantaged group”) of customers of authorised suppliers are treated less favourably than other customers of theirs as respects charges for electricity [or gas], he may make an order containing a scheme for the adjustment of charges for electricity [or gas] with a view to eliminating or reducing the less favourable treatment.

10.3 NEA understands that these provisions could be used to minimise cases of disadvantage such as the prepayment surcharge. However it is further understood that the legislation cannot be used to require preferential treatment of certain categories of consumer ie whilst the legislation can be used to reduce or eliminate disadvantage it does not authorise the Secretary of State to require action to provide preferential treatment. Consequently, an alternative method is required to devise a system of discounted or subsidised charges that can be made available to the most disadvantaged energy consumers.

10.4 The Chancellor alluded to this issue in his Budget Statement: “*The Government believes further action is now needed to help vulnerable groups deal with rising energy prices. The Government welcomes the steps the energy companies have already taken to help vulnerable households cope with higher prices. There is common agreement on the need to do more. Energy companies currently spend around £50 million a year on social tariffs; the Government would like to see that figure rising over the period ahead to at least £150 million a year. Acting*

with the companies and Ofgem, the Government will draw up a plan for voluntary and statutory action to achieve that. To underpin this as necessary, the Government will legislate to require companies to make a fair contribution”.

10.5 The Government’s intimation of willingness to legislate makes it all the more strange that the opportunity to do this in the current Energy Bill was rejected. However the Government is presumably confident that an equivalent legislative mechanism exists and is prepared to use it. NEA believes that an effective social tariff is essential to protect the well-being of millions of vulnerable households and welcomes the Government’s endorsement of this view provided that the end result is significant, consistent and effective.

APPENDIX

SOCIAL TARIFFS

A1. INTRODUCTION

A1.1 There is no consensus as to what constitutes a social tariff, but for the purposes of this paper it is taken to mean any special payment arrangement, over and above those specified by suppliers’ Licence Conditions, devised with a view to benefiting disadvantaged energy consumers. The Government’s commitment to eradicate fuel poverty by 2016 has focused the minds of suppliers, and the energy regulator Ofgem, on how innovative tariffs can contribute to this wider policy objective. Consequently there have been a number of tariff initiatives developed by companies to address specific elements of fuel poverty. Further information on company initiatives can be found on the Social Action Plan section of the Ofgem website.

A1.2 This paper sets out NEA’s view of the essential elements of a social tariff for domestic energy consumers.

A2. ELIGIBILITY CRITERIA

A2.1 As indicated above, beneficiaries of a social tariff should be those most disadvantaged financially and who can also be categorised as vulnerable. Whilst individual energy suppliers are free to develop their own criteria, and already do so in some of their Corporate Social Responsibility offerings, NEA offers as a potential example those households who qualify for the Department for Work and Pensions’ Cold Weather Payment scheme.²⁸⁷ Eligible households comprise:

- A household in receipt of Pension Credit.
- A household in receipt of Income Support or Income-based Jobseeker’s Allowance and where the benefit includes one of the following:
 - Disability Premium;
 - Severe Disability Premium;
 - Disabled Child Premium; or
 - Higher Pensioner Premium.
- A household in receipt of Income Support or Income-based Jobseeker’s Allowance and with responsibility for a child under five years old.
- A household in receipt of Child Tax Credit which includes a disability or severe disability element.

A2.2 All of these households are on a minimal income and share a further degree of vulnerability through age (elderly or very young) or disability.

A3. THE POTENTIAL CUSTOMER BASE

A3.1 Some 2.8 million households are currently in receipt of some form of Pension Credit and a further 1.5 million non-pensioner households qualify for the Cold Weather Payment. Consequently, around 18% of all households in Great Britain would be eligible for a specially developed social tariff. It should be noted that the Department for Work and Pensions can readily identify all of the households who would qualify for this form of social tariff.

²⁸⁷ Cold Weather Payments are made automatically to eligible households where a period of exceptionally low temperatures has occurred or been forecast to occur, households in receipt of Pension Credit and to households in receipt of Income Support or Income-based Jobseeker’s Allowance provided the benefit includes a premium related to disability or the family includes a child aged under five. Payment is triggered by a 7-day period of exceptionally low temperatures.

A4. THE STRUCTURE OF THE TARIFF

A4.1 Since the purpose of the tariff would be to protect low-income households and to provide them with affordable warmth, one option would be to adopt the fuel poverty formula (a maximum spend of 10% of household income on fuel costs) in determining how much in cash terms a household could afford to spend in meeting energy bills. The theoretical household income would be assumed to be the lowest amount that that household type could receive in Pension Credit, Income Support or Income-based Jobseeker's Allowance and cap energy costs at 10% of this figure. The virtue of this approach is that, by definition, it removes a household from fuel poverty; the negative aspect is that it completely separates energy consumption from cost and would be extremely unlikely to be well received by energy suppliers. For this reason it is not proposed that a fixed charge scheme of this type be adopted.

A5. ESSENTIAL CRITERIA FOR A SOCIAL TARIFF

A5.1 The fundamental principle of a social tariff is that it should offer terms and conditions equivalent to, or better than, the best existing offer available from an energy supplier in terms of total charges for the number of units of energy consumed. It is also essential that there be consistent charging by suppliers regardless of the payment method used or the geographical location of the customer.

A6. ENERGY EFFICIENCY

A6.1 All households qualifying for the social tariff should be offered a comprehensive energy audit, a full package of energy efficiency measures and energy advice. Practical measures would be funded through a combination of Warm Front and Carbon Emissions Reduction Target Priority Group budgets²⁸⁸ and should seek to improve the energy efficiency standard of the property to a minimum of SAP 65. Eligible households should also be offered advice on benefit entitlement and support and guidance in making any subsequent claim.

A6.2 Since Warm Front is specific to private sector housing and the Carbon Emissions Reduction Target Commitment has no formal fuel poverty objective there is a strong case for an improved hybrid programme that merges the affordable warmth objectives of Warm Front and the considerable funding resources available to the Carbon Emissions Reduction Target in a single, national programme to deliver optimal benefits to the maximum number of households.

A7. MARKETS AND SOCIAL TARIFFS

A7.1 Whilst NEA has reservations about the role of commercial organisations in delivering social objectives that are properly the responsibility of Government, it seems inevitable that the market will be asked to deliver a solution in respect of social tariffs. NEA considers this to be somewhat dogmatic and confusing since the market is clearly subject to a degree of external control through direct regulatory intervention and rather less direct involvement through Government. Vulnerable low-income households are least likely to participate in the competitive market and NEA would see considerable merit, at least at the present time, in effectively removing certain categories of household from the vagaries of competitive markets. However the degree of prescription required for a universal social tariff is not an option at this time and, in this instance, a modified market is certainly preferable to a free market.

A8. THE GOVERNMENT ROLE

A8.1 Seemingly the Government sees a comparatively biddable market (a clear oxymoron) as a means to promote its own fuel poverty objectives whilst stopping short of formal intervention through mechanisms such as the benefits system. It is instructive to note the example of the Republic of Ireland and that country's operation of a Household Benefits Package which last year increased the number of free gas and electricity units provided to low-income elderly households, all persons aged over 70, carers and people with disabilities to 2,400 kWh and 2,226 kWh respectively.

A8.2 NEA's argument that fuel poverty is too important to be left to commercial enterprises received some support with publication of *The Stern Review: The Economics of Climate Change*. The Stern Review considers briefly the implications of domestic energy costs in the context of carbon abatement and appears to conclude that subsidies are not the way forward: "But it is inappropriate to deal with poverty by distorting the price of energy. Addressing income distribution issues directly is more effective. There are a number of ways to achieve this. One is by indexing social transfers to a price index, taking account of different consumption patterns of poorer groups in the relevant price index for those groups. Other more direct means include making special transfers to those with special energy needs such as the elderly, and the use of 'lifeline'

²⁸⁸ The Warm Front budget for 2008–11 is £800 million whilst funding for the CERT Priority Group in this period is some £1.5 billion.

tariffs, whereby people using a minimal amount of power pay a sharply reduced rate for a fixed number of units". NEA would understand this as an endorsement of our view that whether social or environmental objectives are the issue Government should develop and implement the policy.

A9. OTHER ISSUES

A9.1 A number of additional issues will have to be addressed including how continued eligibility for a social tariff will be monitored and the role of the Department for Work and Pensions in promoting the tariff. However these and other practical details will have to be resolved in discussions involving the Government, the energy supply companies, Ofgem and energywatch and relevant voluntary sector organisations. Ofgem should urgently convene a meeting of high level representatives from these agencies to refine and develop the concept of a universal social tariff.

NEA RECOMMENDATIONS

The Committee should consider the extent to which the competitive market has failed to engage with a significant percentage of disadvantaged energy consumers and the reasons for this lack of engagement.

The Committee should investigate the continuing disadvantage faced by consumers who, for whatever reason, have not switched from the incumbent supplier and Ofgem's passive response to this demonstration of market failure.

The Government is minded to act to reduce differentials between prepayment and other payment methods; the Committee should form an opinion on the appropriate level of intervention needed to eliminate or minimise disadvantage.

Most suppliers provide a "social tariff" of some kind to a predetermined segment of their customer base; the Committee should provide some degree of guidance to Government, Ofgem and suppliers on what form and level of support could be considered proportional.

The Committee should take a view on whether a social tariff should be highly prescriptive, standardised and mandatory on all suppliers or whether decisions on this issue can be left to the discretion of energy suppliers.

The Committee may wish to consider the principle of Government delegation of responsibility for social policy objectives to commercial entities. The Government affects not to understand that the primary, possibly exclusive, purpose of private enterprise is to generate profit and not to act as a philanthropic agency.

The Committee may wish to question BERR ministers and officials on the drastic reversal of progress towards 2010 and 2016 fuel poverty targets and the inadequate and unconvincing response of Government to date.

The Committee should consider whether additional guidance should be given to Ofgem by Government or new duties should be placed on the regulator to protect vulnerable consumers.

28 March 2008

Memorandum submitted by National Grid

INTRODUCTION

1. National Grid plc owns and operates the high voltage electricity transmission system in England and Wales, and as Great Britain System Operator (GBSO), we operate the Scottish high voltage transmission system. National Grid also owns and operates the gas transmission system throughout Great Britain and through our low pressure gas distribution business; we distribute gas in the heart of England, to approximately 11 million offices, schools and homes. In addition National Grid owns and operates significant electricity and gas assets in the US, operating in the states of New England and the state of New York.

2. In the UK, our primary duties under the Electricity and Gas Acts are to develop and maintain efficient networks and also facilitate competition in the generation and supply of electricity and the supply of gas. Our activities include the residual balancing in close to real time of the electricity and gas markets.

3. Through our subsidiaries, National Grid also owns and maintains around 20 million domestic and commercial meters, the electricity Interconnector between England and France, and a Liquid Natural Gas importation terminal at the Isle of Grain.

4. National Grid is pleased to have the opportunity to contribute to this inquiry. Our submission will focus on:

- the regulatory checks and balances in place around the scale of transportation charges;
- how National Grid transportation charges feed through into end users energy bills;
- demonstrating the efficiency savings achieved through the cost saving measures;
- our role in promoting a competitive market environment through effective and timely provision of information; and
- the role of National Grid's Affordable Warmth Programme in tackling fuel poverty.

HOW NATIONAL GRID DETERMINES ITS CHARGES

5. National Grid's charges that feed through to end users' bills are designed to be non-discriminatory and cost reflective, and are set by applying methodologies regulated by Ofgem. The total revenue National Grid collects through its charges is restricted by the allowed revenue and tariff caps set by Ofgem as part of five-year price controls. The transmission businesses in gas and electricity along with gas distribution and regulated metering business are all subject to separate price control reviews. The consultation period for changing the price control typically lasts for two years. The process involves not only just licence holders, but also consumer interest groups, market participants, major energy consumers and any other interested parties.

6. In electricity transmission, the high level regulatory framework is set out in our transmission licence. This includes prices controls and incentives schemes for our Transmission Owner and Systems Operator functions. Revenues remunerating transmission assets are regulated through a price control running until 31 March 2012. The transmission licence also details National Grid's annual system operation incentives to efficiently balance the system in real time. Annual charges for market participants are determined by applying a Charging Methodology.²⁸⁹ This is published, together with the resulting charges, in a number of Charging Statements. Changes to the Charging Methodology can be made following consultation with market participants and must improve cost reflectivity and promote competition. Any changes are subject to an Ofgem veto, and Ofgem can conduct a Regulatory Impact Assessment, if necessary, before making any decision.

7. In gas transmission, National Grid's regulatory framework is set out in our gas transporter licence. National Grid is subject to a five year Transmission Owner (TO) price control for gas transmission activities that currently runs to 31 March 2012. The TO price control sets a maximum allowed revenue which covers assets and related expenditure. We are also subject to a System Operator (SO) price control which covers operating costs and mechanisms to fund the additional provision of transportation capacity for new connections to the system. In addition the SO activity is subject to a number of financial incentive schemes of varying durations aimed at driving efficiencies in the overall costs of system operation and market operation.

8. Similar price controls exist for the four gas distribution networks that National Grid owns. The level of distribution charges is regulated by Ofgem in respect of each network. The current price control for the distribution activities run to 31 March 2013. Along with the other gas distribution network owners, National Grid establishes the charging methodology that determines the structure of the distribution charges.

9. Any potential change to the gas transmission and distribution charging methodology has to be consulted on with the gas shippers through the Joint Office of Gas Transporters.²⁹⁰ All the staff for this office are seconded from the different gas transporters involved. The role of this office is to provide an even handed service to all parties to the Network Code and the wider gas industry by publicly providing information and acting as a forum for discussing modifications of the commercial regimes. A report on the consultation highlighting representations made and any consequential change proposals has to be provided to Ofgem which has the power to veto any proposed change.

NATIONAL GRID CHARGES AS PROPORTION OF CONSUMERS' END BILLS

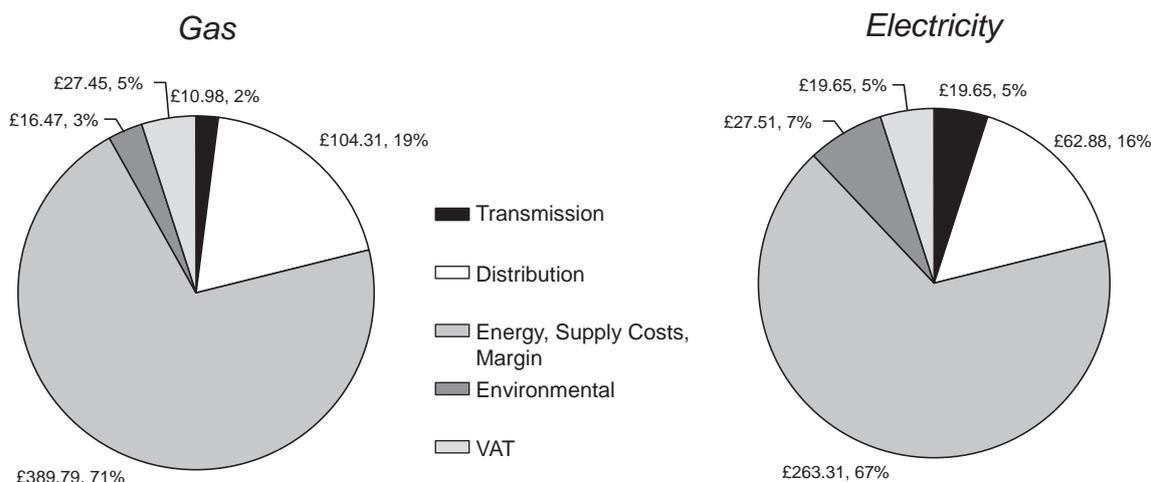
10. National Grid's transmission and distribution charges are a small component of the end users bills and we have made considerable steps in reducing the costs these charges seek to recover.

11. The contribution of gas distribution charges from National Grid and the four distribution companies to an average consumer gas bill of approximately £549 pa make up around £104 (19%). Gas transmission charges levied by National Grid account for £11 (2%) of that bill. The electricity transmission charges which recover the costs of the Scottish transmission companies as well as National Grid Electricity Transmission account for about £20 (5%) of an average electricity bill costing approximately £393 pa. The charts below illustrate these charges as an approximate proportion of current end users gas and electricity bills.²⁹¹

²⁸⁹ National Grid, Electricity Charging. <http://www.nationalgrid.com/uk/Electricity/Charges/>

²⁹⁰ Joint Office of Gas Transporters Home Page. <http://www.gasgovernance.com>

²⁹¹ The analysis of the charges making the consumer bills is based on information from a number of sources: Energy Watch, Ofgem, BERR and other gas and electricity companies.

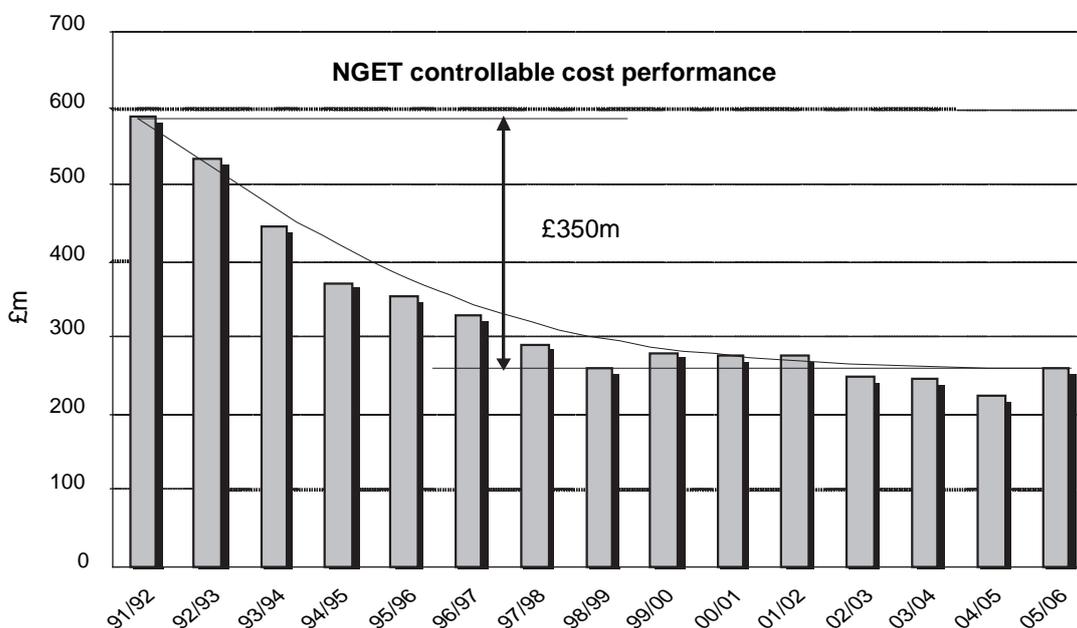


EFFECTIVE OPERATION OF OUR BUSINESSES

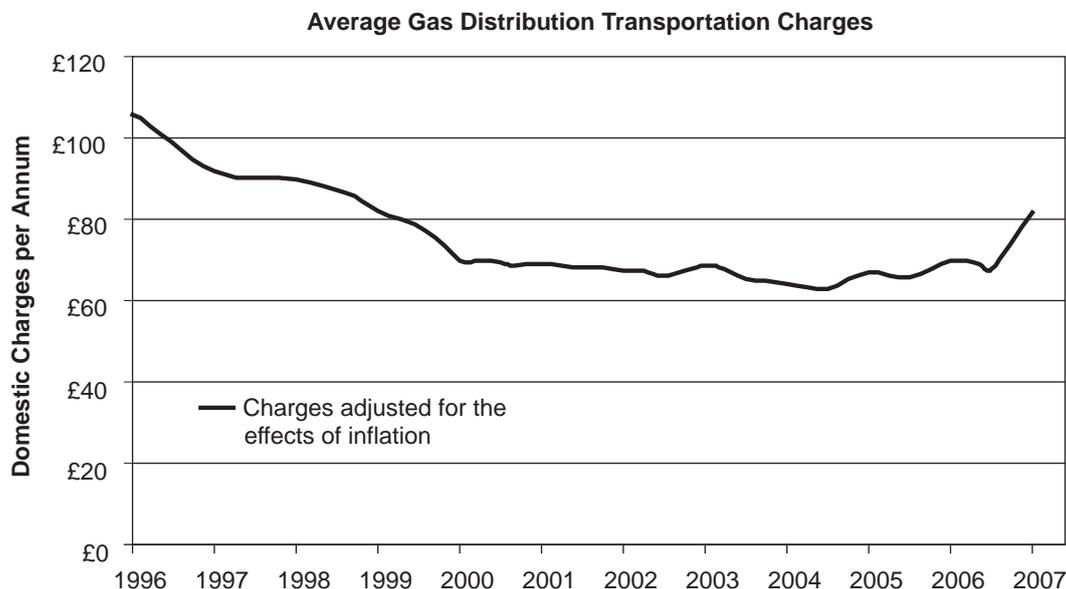
12. National Grid is dedicated to delivering the highest level of safety, reliability and efficiency while controlling the cost of our operations borne by the customers.

13. National Grid has been subject to the RPI-X regulation for around 20 years. The Ofgem price control reviews use this method to incentivise National Grid to achieve efficiency savings that are in turn passed on to end users through lower bills. National Grid has also undertaken a programme of cost reduction measures to deliver best value to gas and electricity consumers, as well as to shareholders. The chart below gives an example of how we have performed in this area. In electricity transmission, National Grid has delivered estimated cost reductions of around £350 million in the period between 1991 and 2006.

COST REDUCTIONS IN ELECTRICITY TRANSMISSION



14. Between 1996 and 2006, the contribution of National Grid's gas distribution charges on an average consumer gas bill fell by approximately 23% in real terms. There was an increase between October 2006 and 2007 which can be attributed to the outcome of the one year distribution price control review for 2007/8. The review gave an 11% increase in allowed revenue and partly reflected the company's existing and planned investment in replacing iron mains pipes. The replacement projects aim to minimise leakage and to allow the company to maintain our excellent safety record and ensure security of supply over the long term.



FOSTERING A COMPETITIVE MARKET ENVIRONMENT THROUGH INFORMATION PROVISION

15. National Grid endeavours to promote a competitive market environment by providing useful, relevant and timely information to the market in order to assist operational and commercial decision making by participants such as generators, suppliers and energy traders.

16. Under our licences, National Grid is obliged to provide long term outlook of seven and 10 years for electricity and gas respectively.^{292, 293} The statements outline the company's latest capacity forecasts, system reinforcement projects and investment plans. This information assists existing and prospective new users of the GB transmission system in assessing opportunities available to them for making new or additional use of the GB transmission system in the competitive market. In conjunction with the industry, we compile summer and winter consultation reports to provide the market with analysis of the supply and demand backgrounds in the gas and electricity markets under a range of weather conditions.

17. Other market information is available closer to real-time such as normalised demand data, latest weather forecast, indicated generation and system reserves information. The majority of information from National Grid related to the electricity transmission system is published on a website operated by a third party.²⁹⁴ Information related to gas transmission is published on National Grid's own websites.

NATIONAL GRID'S AFFORDABLE WARMTH PROGRAMME (AWP)

18. In 2000 National Grid launched the Affordable Warmth Programme which is designed to generate consumer benefits, with an emphasis on deprived consumers by increasing household energy efficiency.

19. This programme systematically targeted households at estate, community, local area and most recently at regional level.

20. The principal outcomes of the programmes under AWP have assisted almost 600,000 households, with over 130,000 homes receiving a central heating system. Over thirty communities have been connected to the gas network where otherwise under usual regulatory mechanisms it would be uneconomic to do so. A further twenty five network extension projects are under construction or subject to detailed contractual negotiations.

21. In addition, a further 5700 people have received training in schemes ranging from domestic gas appliance installers, energy efficiency advisors to cavity wall insulators.

²⁹² National Grid, Seven Year Statement. <http://www.nationalgrid.com/uk/Electricity/sys>

²⁹³ National Grid, 10 Year Statement & Long Term Investment Plan. <http://www.nationalgrid.com/uk/Gas/TYS/>

²⁹⁴ Elexon Ltd, The New Electricity Trading Arrangement Home Page. <http://www.bmreports.com>

METERING

22. National Grid Metering is a subsidiary of National Grid and is responsible for National Grid's regulated metering service to around 18 million domestic, industrial and commercial customers in Great Britain. The costs of providing a meter contribute on average about 2% to domestic gas bills. The charges made by National Grid Gas to energy suppliers for domestic meter services are subject to a price control set by Ofgem. OnStream is another subsidiary of National Grid offering competitive metering services thus affording choice to suppliers in gas and electricity. OnStream currently own 1.7 million meters in gas and 0.7 million meters in electricity.

23. On 25 February Ofgem announced that they found National Grid to be in breach of the Competition Act and imposed a fine of £41.6 million in respect of a number of metering contracts entered into with gas suppliers in 2004.

24. In 2004 National Grid signed Metering contracts with most of the major gas suppliers. The contracts offered suppliers the option of continuing with their existing arrangements or receiving lower metering prices in return for a commitment to leave National Grid's meters in place for a specified period (or completing payment on them if they removed them before the end of the contracted period).

25. On 24 June 2005, Ofgem announced that it was undertaking an investigation into the new contractual arrangements between National Grid and the gas suppliers concerning the provision of gas metering services.

26. Ofgem's original allegation was that the contracts locked suppliers in for a significant share of their gas meter requirements and thereby restricted the development of competition in metering. Ofgem alleged that this conduct amounted to an abuse of dominance, which would infringe competition law. Throughout the course of the investigation, this allegation narrowed and focused more on the technical aspects of the contracts rather than the contracts themselves.

27. We support competition in metering and strongly believe we have never acted anti-competitively in the development of our contracts. We believe the contracts, which were developed over a two year period with gas suppliers and in consultation with Ofgem, have:

- Delivered immediate and substantial financial benefits to customers in the form of lower metering prices, saving customers around £120 million over the four years of operation.
- Not inhibited the development of competition, such that the market share of National Grid's metering business is now around 40% of the new and replacement meter market, from a starting point of over 90% in 2002.
- Provided scope for large numbers (about 1.2 million per annum) of existing meters to be replaced annually in an orderly and sustainable way, whilst limiting consumer disruption, and wasteful replacement of good working meters.

28. Ofgem was consulted throughout this process of contract development and negotiation and has acknowledged that National Grid had no intention to breach the Competition Act. National Grid has consistently demonstrated its support for competition in metering.

29. We remain convinced that the contracts do not infringe competition law, and we are taking steps to lodge an appeal with the Competition Appeal Tribunal (CAT). This appeal will deal with both the decision and the size of the fine (£41.6 million). It will be a diversion from our primary focus on improving the services for our customers and will also distract the industry from the important development of Smart Metering solutions for the UK—which we strongly support.

CONCLUSIONS

30. Our written evidence to this inquiry has demonstrated the transparency and regulated nature of the process through which our transportation charges are derived.

31. We believe we have a role to play and duly discharge our duties in fostering competition in the market by providing an array of information about our assets and operations.

32. Support for and involvement in the drive to tackle fuel poverty continues to be important to us as demonstrated by our investment over the last eight years in the Affordable Warmth Programme.

33. We hope that this submission is helpful to the Business, Enterprise, Regulatory Reform Select Committee investigation into possible anti-competitive behaviour in the UK's energy market.

April 2008

Memorandum submitted by National Housing Federation

SUMMARY OF EVIDENCE

1. The Federation believes that Ofgem is failing in its duty to help low income customers because it allows energy suppliers to charge their poorest customers (pre-payment meter customers) a premium for their energy.

The Government recently acknowledged that pre-payment meter customers get an unfair deal and has threatened energy suppliers with the introduction new legislation if they don't improve the situation by winter 2008. The Government should not have had to make this threat if Ofgem was fulfilling its duty to low income customers.

2. We believe that Ofgem's current position that switching is the solution to helping over a million fuel poor pre-payment meter customers is flawed, as many customers cannot switch suppliers for various reasons.

Ofgem should advocate the equalisation of pre-payment meters tariffs to standard credit tariffs as the instrument to help over one million customers in fuel poverty.

ABOUT THE FEDERATION

The National Housing Federation represents 1300 independent, not-for-profit housing associations in England and is the voice of affordable housing. Our members provide two million affordable homes for five million people.

The mission of the National Housing Federation is to support and promote the work that housing associations do and campaign for better housing and neighbourhoods.

Our pre-payment meter campaign

Over the last year the Federation and housing associations have been campaigning for energy suppliers to give pre-payment meter customers a better deal for their gas and electricity.

On average pre-payment meter customers pay a premium for their energy compared to other customers who pay for their gas and electricity by standard credit and direct debit. Some suppliers have equalised their gas or electricity pre-payment meter tariffs to standard credit but we want all energy suppliers to equalise their tariffs.

OUR EVIDENCE

Our evidence to the committee comes under the following issue headings:

1. The effectiveness of regulatory oversight of the energy market
2. Progress in reducing fuel poverty and the appropriate policy instruments for doing so

The effectiveness of regulatory oversight of the energy market

The Federation believes that Ofgem is failing in its duty to help low income customers because it allows energy suppliers to charge their poorest customers a premium for their energy.

The Utilities Act 2000 gives Ofgem the principal objective of protecting the interests of consumers and it places duties on it in respect of a number of groups within society, namely the disabled or chronically sick, pensioners, those on low incomes and those living in rural areas.

Ofgem acknowledges that pre-payment meter customers on average have lower incomes compared to customers who pay for their energy by standard credit (customers who pay on receipt of a quarterly bill) and direct debit.²⁹⁵ [NHF1] Yet it continues to allow the market to charge these low income customers the most for their energy.

Everyday 1,000 new pre-payment meters are installed and these meters come with a premium of up to £162 more per year compared to standard credit. The differential between pre-payment meters and direct debits can be as much as £200 and this continues to grow.

²⁹⁵ Ofgem, Domestic Retail Market Report—June 2007..

CURRENT ENERGY PRICES²⁹⁶

Tariff Type - Gas - Medium User										
	Standard Tariff									
	Current SPower	Current EDF	Current BGas	Current E.ON	Current Npower	1 April SSE	Max Bill	Min Bill	Average Bill	
Average direct debit	£604	£633	£588	£603	£610	£584	£633	£584	£604	
Average standard credit	£679	£650	£656	£642	£631	£618	£679	£618	£646	
Average PPM	£643	£660	£712	£676	£673	£662	£712	£643	£671	

NOTE: Source: energywatch price comparison factsheets
Based on an average Gas consumption of 20,500kWh per annum.
Prices include VAT.

Tariff Type - Electricity - Medium User										
	Standard Tariff									
	Current SPower	Current EDF	Current BGas	Current E.ON	Current Npower	1 April SSE	Max Bill	Min Bill	Average Bill	
Average direct debit	£367	£377	£394	£396	£404	£382	£404	£367	£387	
Average standard credit	£432	£385	£414	£421	£425	£406	£432	£385	£414	
Average PPM	£419	£385	£432	£421	£453	£406	£453	£385	£419	

NOTE: Source: energywatch price comparison factsheets
Based on an average Electricity consumption of 3,300kWh per annum.
Prices inclusive of VAT.

Over the last few years Ofgem has consistently fought against equalisation of pre-payment meter tariffs to standard credit tariffs. They have continually produced briefings and reports which have made the case against this reduction in pre-payment meter tariffs.

Ofgem has argued that “if pre-payment were aligned to standard credit tariffs a typical customer would pay an extra £6 per year. Equalisation would therefore make the 3 million DD [direct debit] and SC [standard credit] customers who are fuel poor worse off”.²⁹⁷

Ofgem is adamant that this £6 a year increase would be catastrophic to those in fuel poverty and yet it allowed some suppliers to make price increases of up 17% gas and 15% electricity in early 2008. These increases have brought the average yearly energy bill over £1,000.

Ofgem also declined to comment on the Government’s decision to introduce policies which add £80 yearly on to bills. This increase will go toward environmental schemes such as Renewable Obligation Certificates (ROC) and the European Union Greenhouse Gas Emission Trading Scheme (EU ETS).

Energy suppliers recently received a £9 billion windfall when they were given free allocations of EU ETS allowance. It would cost energy suppliers less than 1% of the £9 billion to equalise pre-payment meter tariffs to standard credit tariffs this winter.

There has been some hope recently for pre-payment meter customers. In his budget speech the Chancellor, Alistair Darling, acknowledged the plight of pre-payment meter customers. He now wants a ‘fairer deal’ for these customers and has threatened energy suppliers that it will introduce new legislation if they don’t improve the situation by winter.

The Government should not have had to make this threat to energy suppliers for action if Ofgem was fulfilling its duty to low income customers.

There is no pre-payment premium in Northern Ireland. The market has shifted to benefit pre-payment customers. Their pre-payment meter customers get 2.5% discount off the standard rate and can buy top-ups over the telephone 24 hours a day.

RECOMMENDATIONS

We recommend the Committee:

- seeks clarity from the Government on what it would count as a successful outcome to its discussions with energy suppliers on reducing the price differential between pre-payment and standard credit tariffs
- asks Ofgem why the Government has had to intervene to get a “fairer deal” for pre-payment meter customers.

²⁹⁶ Based on figures from Energywatch on 20 March 2008

²⁹⁷ Ofgem, Domestic Retail Market Report—June 2007.

PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

There are one million pre-payment meters customers in fuel poverty. Ofgem's advice to those customers who pay the highest prices for their energy has simply been to switch to a cheaper energy supplier.

This advice is not helpful for some pre-payment meter customers who cannot switch supplier or payment method for various reasons. On top of this the National Audit Office has said that "problems such as complex tariffs and a lack of information mean that some consumers, particularly those classified as vulnerable, are still unable to take full advantage of the competitive market."

The Federation believes that switching is part of the solution but should not be seen as a panacea. We firmly believe that many low income customers do not have the ability to switch.

Energywatch recently said that "The sad truth is that millions of consumers are switching but their bills still rise. For millions more consumers switching to a cheaper tariff is either fraught with difficulty or just plain impossible. No-one can seriously think that switching, by itself, provides the answer for Britain's besieged energy consumers."

Currently the best deals for gas and electricity are online and are not readily accessible to millions of low income consumers who are in energy debt, without bank accounts or access to home internet.

Ofgem has just announced that switching is at its highest rate for the past five years but Energywatch believes that figures may not be truly positive "[we] don't know what proportion of those reported to have switched are multiple switchers or what proportion have actually saved money". We question how many are from low income back grounds.

RECOMMENDATION

Ofgem should advocate the equalisation of pre-payment meters tariffs to standard credit tariffs as instrument to help one million customers in fuel poverty.

April 2008

Memorandum by the National Right to Fuel Campaign

INTRODUCTION

NRFC was established in 1975 with a key objective to end fuel poverty by securing a warm, dry, well-lit home for all, regardless of income and location, and has taken a leading role in putting fuel poverty high on the political agenda. The Campaign has a membership comprising voluntary organisations, local authorities, trade unions, individuals, academics and professionals in housing, social welfare and environmental health.

Currently, it focuses on campaigns to ensure that there is continuing commitment by Government, Industry and the regulator to end fuel poverty for all households by 2016. We also believe that there should be no unfair taxes or fuel price increases which adversely affect low-income consumers. This includes all aspects of energy supply from unfair tariff differentials to prices which are a proper reflection of industry costs.

Our response to the questions posed by the BERR select committee as part of its full scale inquiry into energy prices have focused on those which are directly relevant to fuel poor consumers and which fall into the areas of expertise of Campaign members.

Our overall impression is that markets do not work for the fuel poor who are at the bottom of the heap for government, industry and the regulator in that they neither get the benefit from a functioning market or adequate protection by regulation or sufficient income.

INQUIRY QUESTIONS

- Whether the current market structure encourages effective competition in the retail markets for gas and electricity;
- Whether there is effective competition in the wholesale markets for gas and electricity; and
- The relationship between the wholesale and retail markets for electricity and gas.

PRICING

NRFC wanted to understand whether or not the price increases over the past several years could be legitimately explained—could they be accounted for by significant increases in profit or dividends to shareholders? Or was there some other, less transparent explanation for the increases which have caused an increase in the numbers in fuel poverty. This information was not readily available in the public domain, using publicly available data. One might expect that this information would be publicly available from the industry regulator, Ofgem, but this was not the case so NRFC commissioned its delivery (attached at appendix 1)

The findings from our research, *Gas and Electricity Costs to Householders*, demonstrate that domestic consumer expenditure on gas and electricity increased by considerably more than costs in the period 2003–06 (the most recent period for which all relevant data is available). Expenditure rose by around £8 billion over the period to £22.5 billion. However, and despite comments by energy companies, fuel costs rose only by £4.5 billion at most. Other costs such as gas storage, electricity system losses, VAT, support for renewable energy and energy efficiency and network costs account for a further 15% of the increases.

As much as £2.5 billion of the extra monies paid by consumers for the energy therefore seems to have gone into increased margins. Most of these higher margins have been in electricity generation, with some also in gas storage and gas and electricity distribution (the latter two being regulated by price control by Ofgem)

<i>£mn</i>	<i>2003</i>	<i>2006</i>	<i>Change</i>	<i>% change</i>
Reported expenditure	14,264	22,491	8,227	58%
Estimated fuel costs	4,391	8,936	4,545	104%
Estimated other costs (inc some profits)	7,849	9,249	1,400	18%
Increase in margins	2,025	4,305	2,280	213%

Consumers have paid more than £2.3 billion more for their energy than they ought to have done over 2003–06 and are continuing to pay over the odds as they deal with price increases in 2007 and 2008. Ofgem's failure has allowed over half a million low-income consumers to be pushed into fuel poverty. There are 2.5 million households in the UK whose lives are blighted by cold homes who because the British energy market is not working effectively.

As we come out of another winter, it is the case that all suppliers have raised their prices again, even before some consumers could gain the benefits of the tardy price reductions over 2007. This is despite the lack of evidence of shortage or constraints on security of supply.

Government and Ofgem must take action now to prevent further hardship or face the consequence of more fuel poverty and excess winter deaths. Further fuel price increases should not take place until a full investigation has taken place. Government should take steps to recover excess profit through a windfall tax to be used to fund fuel poverty programmes.

The Government's energy strategy relies upon independently regulated competitive energy markets as the most cost effective way of delivering its objectives.

The evidence here is clear that government should have no such confidence in a market that allows companies raise prices with impunity earn huge margins at the expense of vulnerable low income consumers.

Many energy companies pleaded for sympathy when wholesale gas prices were increasing and as has been described by one author "lamented that they are just as much victims as consumers and that it has been painful indeed for them to have to inflict inevitable price rises on consumers."²⁹⁸

A market where suppliers can require consumers to bear disproportionate risk is not healthy and action now is needed to address this problem.

Government has suggested that price increases are in part the "recovery of wholesale electricity prices from unsustainably low levels."²⁹⁹ However the evidence here suggests companies have been able to regain profit levels that more than compensate for these low prices.

NRFC is shocked that it may be the case that companies have used the high wholesale gas prices as a means of gaining profit levels that would not be sustainable in markets that worked well.

²⁹⁸ Wright, P (2007) Competition in gas and electricity; companies profit, consumers pay Consumer Policy Review vol. 17 no. 1 pg 3

²⁹⁹ BERR (2007) The UK Fuel Poverty Strategy: 5th Annual Report pg 37

 THE EFFECTIVENESS OF REGULATORY OVERSIGHT OF THE ENERGY MARKET

Suppliers have been able to raise prices and earn excessive profits because of poor regulatory oversight in the energy market. Ofgem's recent decision to investigate the energy market can be described as grudging at best and we have little positive expectation of the outcome. Ofgem have also failed to provide analysis about the way in which the energy market has worked over the period of price increases. We believe that it is now appropriate for regulatory responsibility for the competitive elements of the energy market be transferred to the Office of Fair Trading.

It should not be the responsibility of a campaigning body to produce market analysis when there is a publicly-funded regulatory body with a specific remit to address the issues raised here.

PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

The government has statutory targets to remove all vulnerable consumers from fuel poverty by 2010 and all other consumers by 2016. The targets are set down in legislation by the Warm Homes and Energy Conservation Act 2000. The increases in energy prices have had a profound impact on those who live in fuel poverty who spend more than 10% of their income on gas and electricity.

While energy price increases have been difficult for all consumers, they have been especially challenging for consumers who live with fuel poverty. The energy price increases have had a significant impact on the numbers in fuel poverty. Work by NRFC suggests that every 10% increase in energy prices in England puts another 50,000 people into fuel poverty.³⁰⁰ This means that they face stark choices between paying for fuel and eating. Official fuel poverty figures, recently published in the 5th Annual Fuel Poverty Strategy Annual Report³⁰¹ by Government confirm the impact that energy prices have had on their progress to achieving fuel poverty targets.

For England, Scotland and Wales fuel poverty numbers have risen from 1.75 million in 2004 to 3.39 million in 2006—this represents an increase of just under 95%. This is likely only to get worse with further price increases already happening.

<i>England</i>	<i>Scotland</i>	<i>Wales</i>
In 2004 there were 1.2 million households in fuel poverty which had increased to 2.6 million by 2006.	In 2002 there were just under 300,000 households in fuel poverty (13.4% of all households) This had increased to nearly 420,000 households in 2004–05 and 543,000 in 2005–06 (23.5% of all households)	In 2004 130,000 households were in fuel poverty which had increased to 243,000 by 2006. This is an 87% increase.

Government continually protests that they are committed to ending fuel poverty by 2016 but its actions belie these intentions. It has cut the budget for Warm Front this year which will mean that fewer fuel poor households will be helped as their numbers are increasing dramatically. It has also reduced the proportion of the energy efficiency commitment (now renamed as the CERT) that will be dedicated to vulnerable consumers. It increased the Winter Fuel Payment to all pensioner households but only for one year. There was no additional financial help for other fuel poor households announced in the budget.

They are relying on the voluntary action of industry to solve the problem suggesting that industry increase its expenditure on social programmes from £56 million per annum to £150 million per annum. On the face of it, this may seem significant but amounts to £44 for every fuel poor household which is the equivalent of around two weeks gas and electricity (based on the notion of the £1,000 annual bill).

Government has failed to use the opportunity of the Energy Bill to provide itself with sufficient powers to make companies deliver services to fuel poor households (for example social tariffs) and is not using the powers that it currently has under the Utilities Act 2000. This legislation would allow Government to set up a scheme requiring companies to remove the differential in tariffs between groups that are treated less favourably than others. The suggestion is that prepayment tariffs should be equalised to those of standard credit, however the legislation would also them to be equalised to direct debit tariffs.

March 2008

³⁰⁰

³⁰¹ BERR (2007) The UK Fuel Poverty Strategy: 5th Annual Report URN/07 pgs 10–13

Memorandum submitted by NHS Purchasing and Supply Agency

Please find attached written evidence to the Select Committee from the NHS Purchasing and Supply Agency regarding the new inquiry investigating possible anti-competitive behaviours in the UK's energy market.

While we assume sole responsibility for its content, we would like you to note that this evidence has been produced in consultation with HM Treasury's Office of Government Commerce and the Ministry of Defence, the programme lead and sponsoring department respectively for the cross-government collaborative procurement project for energy currently being delivered as part of the HM Treasury policy Transforming Government Procurement, published January 2007.

I would like to take this opportunity to confirm that the NHS Purchasing and Supply Agency, together with representatives from the collaborative programme, would welcome the opportunity to present oral evidence should the Committee require it.

SUMMARY OF MAIN POINTS

- Retail markets for gas and electricity are dominated by a small number of suppliers.
- There is a difference between companies registered to supply and those actually active within the market so the number of registered companies is not an accurate measure of customer choice or competition.
- All major electricity suppliers and all but one major gas supplier is vertically integrated. Given that there have been no new market entrants for large, multi-site portfolios, vertical integration is a significant barrier to entry.
- Liquidity within the gas market has improved but there is no effective long term market; the lack of liquidity in the electricity market is still more pronounced.
- The speed of liberalisation and continued lack of visibility and transparency between different markets causes uncertainty and may be detrimental to customer interests.
- We are not convinced that the regulator is effective in delivering value for the customer in terms of delivered cost of the commodity.
- The regulator is focused on the domestic market, but the final delivered price for all customers is produced as a result of basic structural factors (in the market and in the supply chain) which even large Industrial and Commercial (I&C) customers are not in a position to influence significantly.

WHO WE ARE

The NHS Purchasing and Supply Agency (NHS PASA), established in April 2000, is an executive agency of the Department of Health. We work to ensure that the NHS in England makes the most effective use of its resources by getting the best possible value for money when purchasing goods and services.

The NHS PASA Energy team provides the NHS with a strategic service for the procurement of electricity, gas, oil and coal. Buying energy is a highly complex and specialised area and our strategy involves influencing this area of significant spend through a variety of flexible procurement options (including trading on the wholesale market) to improve service delivery and reduce costs in the NHS.

NHS PASA is a strong and experienced advocate of collaborative procurement across government departments and is actively supporting HM Treasury's Transforming Government Procurement policy, this includes developing a price risk management model for the UK public sector.

RECOMMENDATIONS

- The UK moves to a central cleared exchange based market to increase liquidity and access to wholesale markets for new market entrants and customers.
- The regulator aligns its measures for assessing the competitiveness of the market to the real underlying factors driving delivered prices so that all consumers can be assured that the market is operating effectively.

WRITTEN EVIDENCE

Each topic on which the Select Committee request our view is reproduced in bold italic below. Each is followed by our brief written evidence, produced by NHS PASA in consultation with the Office of Government Commerce and the Ministry of Defence.

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

Response

We recognise that the current markets for gas and electricity differ. Within electricity there are concerns about the extent of vertical integration which exists between generators and suppliers. Although there is no direct evidence that this in itself has an effect upon the competitive nature of the market, the general purpose of backward vertical integration is to increase company profitability and its presence raises questions over visibility and accountability (especially regarding input costs).

The retail markets for both gas and electricity are dominated by a small number of suppliers. In a truly competitive market, suppliers should be seen to drive innovation in an attempt to differentiate themselves, gain competitive advantage and win market share. Again, while a small number of suppliers by itself does not stifle competition, there is little evidence of suppliers within the UK market rushing to introduce new and innovative product offerings. Such market offerings as have been made available have tended to come as a result of persistent customer demand.

Within the Industrial and Commercial (I&C) arena, there is a further limitation to competitiveness—namely, the tendency for the already small number of suppliers to segment the market. This leads to an element of specialisation and reduces the numbers of suppliers actively competing for some customer segments. A recent national NHS procurement exercise for electricity attracted only a small number of compliant bids, which—while disappointing—is in conformity with the bidding pattern across the UK public sector as a whole. Such apparent segmentation is consistent with established analysis of how companies seek to maximise profits in an oligopolistic market (c.f. Porter, *Competitive Strategy*, 1980). At the very least, customer choice is constrained (by the self de-selection of suppliers). Recent supplier meetings conducted as part of Treasury collaborative procurement programme indicate that suppliers are more concerned with retaining existing customers than actively competing for new business.

There is a difference between companies registered to supply and those active within the market, so a mere register of suppliers with licences within the UK does not accurately reflect customer choice or competition. Likewise, using switch rates as a measure of competition will not show the true extent of competition if the customer is given little or limited choice at the time of renewal.

We also note that all major electricity suppliers are vertically integrated, and all but one of the gas suppliers is as well. Backward vertical integration is a trend that has expanded significantly over the last five years. At the same time, we note increasing supply market concentration. There have been no new market entrants for large multi site portfolios such as the public sector, which raises the questions about barriers to entry—one of which is precisely the need to be vertically integrated!

Whether there is effective competition in the wholesale markets for gas and electricity

Response

Customers within the I&C market have pushed for contracts which allow them access to the wholesale market. This option is now available to a large majority of customers and has enabled some benefits, especially around risk management. For a customer purchasing gas in the wholesale market competition can be seen to be represented by choice. This choice can be measured in terms of visibility, availability and number of trades. Within the gas market, we make the following observations:

- the day ahead and prompt market are working effectively, at least in relative terms; and
- it is possible to obtain pricing for periods further out in the curve, but liquidity is very thin.

It is our view, therefore, that while liquidity has improved within the gas market over the last couple of years, there is no effective longer-term market. Consequently, the ability to optimise the management of risk is constrained even for large users, potentially increasing final out-turn costs.

In the electricity market, we have yet to see even these minor improvements in liquidity. We acknowledge that the electricity market is less mature than that for gas, but this cannot be accepted indefinitely as an excuse for limited visibility and availability of offers.

The lack of liquidity is perhaps more effectively explained by the vertically integrated structure of the electricity market. This reduces the need to trade volumes in the open market and results in a lack of visibility. The consequent market inefficiency can be viewed as a goal of vertical integration as it tends to deliver more control over price and output to suppliers. Liquidity in electricity is limited even for the first 12 months forward, and it is almost impossible to purchase peak load beyond the next 12 months making it impossible for large customers to manage their longer-term cost exposure risk effectively.

As more customers move towards contracts which include a wholesale market approach to the purchase of the commodity element, and develop a longer term approach to spreading risk by purchasing further out in the market, the limitations within both the gas and electricity markets will become a still more significant problem in securing value from the wholesale markets.

We also think that moving to a central cleared exchange based market would significantly increase liquidity and access to the wholesale markets for new market entrants and customers. Nord pool serves as a good example of this—and liquidity is significantly higher compared to the UK.

The implications of growing consolidation in the energy market

Response

Consolidation of suppliers within both the gas and electricity markets has been a concern for a number of years. It can be argued that an element of the supplier consolidation within both gas and electricity markets has been offset by new entrants, especially those from Europe. However, in reality the out-turn position has been left very much unchanged and if anything the general decline in suppliers within the market since liberalisation is evident. Combined with our observations on customer segmentation—or “cherry-picking”, as it is sometimes known in the market—we are of the view that consolidation is more likely to diminish choice and increase costs for customers than it is to deliver efficiency benefits.

It should be noted that there have been no major new entrants to the market in the last five years. Some niche players (such as GazProm or Wingas) have entered the gas market, but only where they have access to production and are thus vertically integrated. There have been no new entrants to the electricity market of sufficient size to meet large scale customer volumes.

The relationship between the wholesale and retail markets for electricity and gas

PASA Response

Our contracts facilitate interaction at wholesale market level and as such we cannot make further comment on this issue.

The interaction between the UK and European energy markets

PASA Response

The liberalisation of the European energy market has been slow. As the UK has become more reliant on gas flows from Europe the speed of liberalisation and the continued lack of visibility and transparency between the different markets creates uncertainties. Market regulation within the various member states appears to differ. These differences, coupled with the apparent lack of visibility (of, for example, information on real gas flows within Europe), do raise questions as to whether the UK market is operating on a level playing field with its European counterparts. A typical frustration arises when the UK and continental market prices diverge (eg UK prices are higher) but the expectation of gas flowing to the higher priced market does not materialise and is not adequately explained (gas is not delivered to the UK). We are concerned that supplier control of much of the infrastructure may be detrimental to customer interests.

The effectiveness of regulatory oversight of the energy market

Response

We have insufficient evidence on which to make a judgement of the effectiveness of current regulatory oversight. We offer the following observations:

1. The UK regulator appears however to be hampered by the complexities and slow pace at which other nations states are approaching liberalisation.
2. We have no evidence that the regulator has any control over the upward pressures on energy prices—at least one of which is the market structure (vertical integration, supplier concentration, high barriers to entry, limited competition).
3. We welcome the recent action aimed at driving competitive behaviour associated with Meter Asset Management.
4. We observe that one of the drivers of price is speculative trading which impacts on consumer value and yet it is an area outside of regulatory control.
5. The focus of the UK regulator seems to be on the domestic rather than the I&C market.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

Response

We have neither expertise nor responsibility in this field and as such we can offer no further comment.

28 March 2008

Letter by Ofgem

ENERGY PRICES

1. The Chairman of the Business, Enterprise and Regulatory Reform Select Committee, Peter Luff MP, has asked the independent energy regulator, Ofgem, to submit an information note on certain recent developments in the energy markets. This note addresses five particular questions:

- Why are energy prices rising?
- Is the energy market uncompetitive?
- Are suppliers quicker to pass on wholesale price rises than wholesale price cuts?
- What can be done to help vulnerable customers affected by higher energy prices?
- How does Britain's energy market compare with that on the continent?

Why are energy prices rising?

2. Energy prices have risen since 2003 due to a range of factors. Rising global demand for energy has led to higher oil and coal prices, which in turn have put upward pressure on gas and electricity prices.

3. High world oil prices (close to \$100 a barrel) are reflected in gas prices because, outside Britain, the price of gas is linked to the price of oil. This affects Britain because our North Sea reserves are declining so we now have to import a growing amount of gas from the rest of Europe via pipeline links and from elsewhere as liquefied natural gas (LNG). Liquefying gas, shipping it to Britain and converting it back into gas is more expensive than transporting it by pipeline. LNG prices have risen substantially, with pressure from Asian markets (notably Japan) paying high prices to secure LNG imports. There have been delays in completing the construction of two major LNG terminals at Milford Haven in South Wales. The first phase of these two facilities, which have a combined capacity totalling around 16.5 billion cubic meters, was scheduled to be ready for the start of this winter (2007–08). Gas imports from the Norwegian Ormen Lange gas field have been less than expected due to production problems.

4. Currently gas is used to generate around 36% of Britain's electricity. Increases in wholesale gas costs will therefore have a knock-on effect on electricity generation costs. Prices for coal, which is used to generate around 37% of our electricity, have also increased to record levels. In addition the second phase of the European Emissions Trading Scheme (EU ETS), which began in January 2008, has increased the price of carbon which in turn increases electricity prices.

5. Whether suppliers need to put up prices as a result of higher wholesale costs will depend on how much gas and electricity they bought on the wholesale markets when prices were lower earlier in 2007, and how much they have bought more recently at higher prices. In Britain's competitive market, if a supplier increases bills they have to weigh up how much that increase will lead to a loss of customers. If a supplier can keep prices lower, they will retain existing customers and attract new ones.

6. In addition, prices have also risen as a result of programmes introduced by the government to help tackle climate change. For example, the Carbon Emissions Reduction Target—which replaces the Energy Efficiency Commitment on suppliers in April 2008—doubles the cost of the scheme to customers. Defra estimate that this will add another £20 to customers' bills in addition to the £18 customers are already paying for EEC, giving a total of £38. Furthermore, network charges—which pay for the transportation of gas and electricity through the pipes and wires—rose by an average of £22 for gas and £2.96 for electricity in 2007–08. Increases over this period have varied considerably between regions: in London the increase was around £52 compared to £2 in the East Midlands. In 2008–09 they will rise by £1 in electricity and £2 to £6 in gas, depending on the region. Taken together, all of these wider factors mean that energy prices are unlikely to fall back to the levels of a decade ago.

Is the energy market uncompetitive?

7. Ofgem constantly keeps the market under surveillance, and we look at it even more closely when prices are rising, but our monitoring has not revealed any evidence of anti-competitive behaviour. All suppliers are facing similar cost pressures, driven by rising wholesale gas and electricity prices, environmental costs and energy network costs. The extent to which they need to pass on rising wholesale prices will depend on

how smart they have been at buying their energy. So far this year, three of the major suppliers have announced price increases; two suppliers have made no announcement; one supplier has promised to hold its prices at least until the end of March, when most customers' energy consumption begins to fall.

8. Another sign of healthy competition is that we see companies gaining and losing significant market share, plus record switching levels and innovative deals. The supplier which has consistently offered the lowest prices and best service has doubled its number of customers to eight million over the past three years. At the same time, others have been punished severely by customers switching away to suppliers offering better deals. What is more, this level of customer switching is on an increasing trend. 4 million customers switched their supplier in 2006 and 4 million customers are now on fixed price or other innovative deals. There are now differences of around £100 per household between suppliers' prices—so customers could still make big savings.

9. Although this evidence suggests a strongly competitive market, Ofgem continues to monitor it constantly and regularly publish our analysis. If anybody has evidence of anti-competitive behaviour, we urge them to send it to us. We have a tough set of penalties at our disposal, including our formal statutory powers as well as the informal pressure we can exercise as a regulator. For example, last year we “named and shamed” two suppliers—EDF Energy and Scottish Power—who had not passed through falling wholesale prices to their customers. Within days they had announced retail price cuts for their customers. More formally, the Competition Act gives Ofgem the power to impose fines of up to 10% of a company's turnover if they break the law by abusing their dominance or engaging in agreements which distort competition. We will not hesitate to use our powers to investigate and, if necessary, impose penalties on any supplier that has been found to have broken competition law.

Are suppliers quicker to pass on wholesale price rises than wholesale price cuts?

10. Not necessarily. If a supplier buys badly and has to keep its prices up, it risks losing customers and their cash.

11. Wholesale energy prices began to rise in 2003, due mainly to a decline in Britain's gas reserves at a time of rising global demand. From 2004, retail prices began to increase significantly for customers. In 2006, wholesale gas prices began to fall and in 2007 all suppliers reduced bills at least once. However, in 2007 wholesale prices rose again. Comparing average day-ahead prices over in January 2008 with the same period in 2007 shows that wholesale gas prices have increased by 66% and wholesale electricity prices have increased by 64%.

12. Suppliers will be affected by these price changes differently because they have different buying strategies. Some buy most of their energy in advance and others are more exposed to day-to-day fluctuations in wholesale prices. Those who have been smarter at buying their energy have been able to offer lower prices and gain market share. Contrariwise, more expensive suppliers have been punished severely by customers switching away to cheaper deals. For example, in 7 of the 14 British regions, the old incumbent suppliers have lost more than half their market share. The cheapest major supplier, on the other hand, has gained four million extra customers in Britain in the last three years.

13. Ofgem believes these challenging conditions will clearly show which companies have been the most successful in buying their energy ahead at keen prices, as they will be able to keep prices low. Much of the increase in wholesale prices is due to high global commodity prices particularly for both coal and gas. Pressure on prices could ease if global prices for these commodities fall.

What can be done to help vulnerable customers affected by higher energy prices?

14. Fuel poverty has three main causes: high energy prices, low incomes and poor housing. Prices are unlikely to return to the lower levels of the 1990s because of rising global energy demand and higher commodity prices (see above). An enduring and sustainable solution to fuel poverty will, therefore, need to focus on the issues of housing and incomes.

15. Significant strides have been made to improve the energy efficiency of housing and to install cost effective heating systems through the Decent Homes standard, the Warm Front programme and the Energy Efficiency Commitment. However, Warm Front is focussed on private sector housing. Social housing, on the other hand, is covered by the Decent Homes Standard and this provides for lower standards of thermal comfort. We would therefore encourage Government to take a “find and fix” approach, ensuring that where work is being done on a property under the Decent Homes Standard, a comprehensive solution is provided. We would also encourage government to ensure effective inter-working between the various schemes.

16. In addition, Government should keep focussed on the vital role of the tax and benefit system in raising incomes. Benefit entitlement checks can help ensure vulnerable customers are getting their fair share of the millions of pounds of unclaimed benefits. Government could also review the Winter Fuel Payment and refocus the payments on those who need them the most. Furthermore, additional funding for fuel poverty programmes could be made available by recycling revenues from environmental schemes. For example, Ofgem identified a windfall to electricity generators of up to £9 billion of permits which are allocated for free under Phase II of the European Emissions Trading Scheme (EU ETS) which runs from 2008 to 2012.

This windfall could be used to help customers in fuel poverty. If Government were to auction allowances for the following phase of EU ETS, some of the revenue generated from this could also be used to fund further measures to help tackle fuel poverty and environmental improvements—as recommended by Ofgem in our submission to the Government’s 2006 Energy Review.

17. On prices, vulnerable customers can make big savings if they are in a position to switch supplier or payment method and if the support available from Government and suppliers is better targeted. There are now differences of around £100 per household between suppliers’ prices, and the biggest savings available are to prepayment meter (PPM) customers.

18. Ofgem, along with other agencies, works to help improve consumer awareness of these choices and to help vulnerable customers access the benefits of the competitive energy market. For example, we are calling an energy summit this Spring to look at the specific issue of how to improve switching levels among vulnerable customers, including lower income customers, the frail, the elderly and those with low literacy and numeracy skills. We are also working with Citizens Advice Bureaux to develop a pilot programme to help educate low income and hard to reach customers in how to make better choices in the energy market. We also work to tackle any barriers that unreasonably prevent customers switching supplier. For example, this year we will be reviewing suppliers’ policies on blocking customers who are in debt from switching.

19. Government can keep up the “Winter Initiative”: a practical way to improve targeting, using Department of Work and Pensions data, of suppliers’ social measures as well as the energy efficiency help available from Government under the Warm Front scheme and the Carbon Emissions Reduction Target. Ofgem led the first such initiative in winter 2006–07, and BERR are repeating this in January with the active involvement of energy suppliers and Ofgem. Consideration could also be given to extending the remit of the Warm Front scheme. For example, customers could be referred to their supplier for tariff advice or to go onto their social tariff, where applicable.

How does Britain’s energy market compare with that on the continent?

20. Competition in the supply market, effective regulation by Ofgem of the energy networks, and lower taxes mean Britain’s electricity bills are still competitive compared with most other European countries. Britain’s gas bills are also still among the cheapest in Europe. For example, the German media have been reporting likely price increases in their retail market of 25% in electricity and 15% in gas.

21. Britain’s wholesale gas markets are closely linked to European prices, due to the interconnector pipelines connecting us with the continent and declining supplies from the North Sea. Thanks in large part to Ofgem’s efforts through the European regulators’ groups CEER (Council of European Energy Regulators) and ERGEG (European Regulators’ Group for Electricity and Gas), currently chaired by Sir John Mogg, we have made significant strides in improving transparency in European power and gas markets. We now have access to important information on the levels of gas in store in all the major European markets and can see how much gas is taken out of store each week. Through the ERGEG “Regional Initiative”, which seeks to make practical progress at the regional level so as to facilitate cross-border trade, we can now see daily gas flows on major pipelines in France, Belgium and the Netherlands and we will have an even wider range of information available to us by the end of the year. Germany remains a problem and less progress has been made there. There is also limited transparency on production from the Norwegian gas fields. It remains impossible to understand total Norwegian gas supply and this adds uncertainty and volatility in the GB and north-west European regional market. The picture is much better in the power market with most countries, including Germany, now publishing regular and detailed information on the availability of their generating stations, maintenance plans etc.

22. However, a longer term solution to the structural problems in the European market will require changes to the legal and regulatory framework in the EU. The European Commission (EC) adopted legislative proposals in September 2007 with a view to establishing such a legal and regulatory framework at national and EU level—the “third package”. The proposals aim to complete integrated EU energy markets, achieve security of supply and allow the markets to deliver on sustainability (when combined with the EU Emissions Trading Scheme). The proposals have now been passed to the European Parliament and Member States for full legislative scrutiny. This co-decision process usually lasts two to three years, although the EC have set a target of reaching agreement by the next European Parliament elections in June 2009. Ofgem is providing advice to the Government on the proposals and continues to play a lead role within ERGEG. In particular, we strongly support the work of the EC to end the large multinational companies’ domination of the European energy market, as fair access to EU gas supplies would bring significant benefits to UK consumers. Ofgem has been instrumental in assisting in that work, including during the 2006 Sector Inquiry.

23. Ofgem would be happy to provide any further information to the Committee on any of these issues.

Memorandum by the Office of Gas and Electricity Markets (Ofgem)

INTRODUCTION

1. Ofgem is the regulator of the gas and electricity industries in Britain. We welcome the announcement of the Committee's inquiry. Like the Committee, we have noted the increasing public concern at recent events in the energy supply markets. Although we have not seen conclusive evidence that the market is failing, we know that customer confidence is vital in order for a market to function well—and it is clear in this case that customer confidence has been damaged. On 21 February, therefore, we launched an investigation which will look at whether the energy supply markets are working well for all consumers—and not just particular groups such as those who are on the cheapest online deals. The probe will be carried out under Ofgem's Enterprise Act powers which will give us access to detailed company information that is not routinely made available. We expect to report on our initial findings from the investigation in September.

THE ENERGY MARKET IN BRITAIN

2. It is useful to consider the energy market as comprising two elements. In the *wholesale* markets, electricity generators and gas shippers sell their energy onto suppliers. In the *retail* markets, suppliers then sell this energy onto business and domestic customers.³⁰² At the time of privatisation all customers received their gas from British Gas and their electricity from the Public Electricity Supplier for their region. Since the gradual rollout of competition in the late 1990s, customers have been free to switch to different suppliers.

3. There are parts of the supply chain in which competition is very limited. This is true for the energy *networks*—the pipes and wires that carry the gas and electricity. It would be too expensive for every energy supplier to build its own pipes and wires, so there are monopoly companies which transport gas and electricity from shippers and generators to customers.³⁰³ In order to protect consumers, the revenues that the network monopolies can earn and the structure of their charges (ie the proportion of these revenues they can collect from business and domestic customers) are regulated by Ofgem in five-yearly price controls.

4. This combination of liberalised markets and independent regulation has brought significant benefits to British consumers. Britain's energy market was recently assessed to be the most competitive in Europe.³⁰⁴ The stable regulatory framework has proved attractive to investors, with £30 billion being invested in the networks since privatisation. Consumers, in turn, have benefited as costs have been driven down by companies, a greater range of tariff offerings has been made available, and service levels and quality of supply have improved.

5. However, there are times when companies do not play by the rules or customers' confidence in the market is damaged. In these cases, the regulator must be prepared to investigate and act where necessary. As recently as February 2008, we imposed a fine of £41.6 million on National Grid for abusing its dominance in the gas metering market—the biggest fine ever imposed for this kind of competition law breach. Now, in response to customer concern at recent events in the energy supply markets, we are conducting a probe to ensure the market is working well for all customers—including the vulnerable. We welcome the insight that the Committee's work will bring.

6. In this memorandum we have addressed all seven of the questions posed by the Committee and we have provided background analysis wherever possible. Since our investigation is at an early stage, there are inevitably some points on which we are not yet able to offer definitive conclusions. Where this is the case we have sought to provide advice to the Committee on the issues it may wish to consider and the information on which it could draw in reaching its own view. In addition, if Members or Staff have any further questions, we would be happy to explore these issues in more detail, either in oral evidence or in a supplementary memorandum.

Q1. *Whether the current market structure encourages effective competition in the retail markets for gas and electricity*

7. We think a range of indicators should be used to assess the effectiveness of competition in a market. These include changes in prices relative to costs (and hence margins) over time; product innovation and improvements in customer service; customers' responsiveness to suppliers' offerings (measured by switching rates); the resulting changes in suppliers' market shares; and the concentration of the market amongst suppliers. The retail market is increasingly complex with a range of different types of energy contract offered (fixed and capped rate deals, market trackers, standard variable price contracts, green tariffs) and payment methods (direct debit, standard credit and prepayment). In looking at these indicators it is important to look at them in each of the various segments of the retail energy market to assess their competitiveness and also to look at trends in movements of customers between market segments over time.

³⁰² The retail markets are often also referred to as the supply markets.

³⁰³ Independent Gas Transporters and Independent Distribution Network Operators represent a very small exception to this. These operators sometimes install systems on new housing developments.

³⁰⁴ "Energy market competition in the EU and G7: preliminary 2006 rankings", prepared by Oxera for BERR, October 2007.

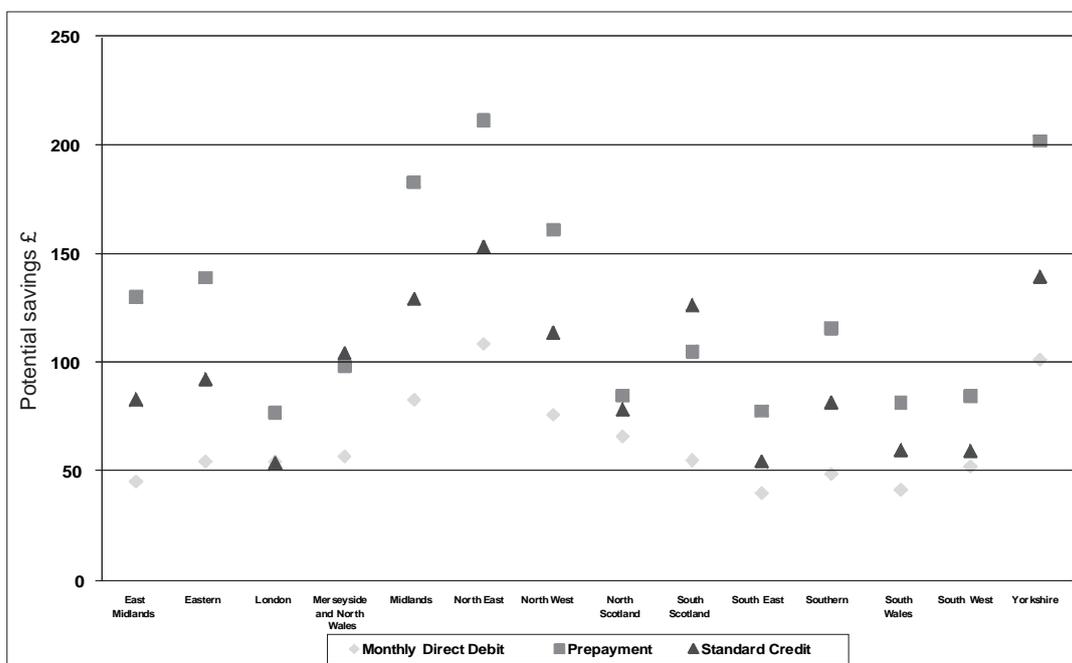
Pricing and costs

8. There are six big players active in the energy retail market in Britain: British Gas Trading (BGT); E.ON (which until recently traded under the name Powergen); EDF Energy; Npower; Scottish Power; and Scottish and Southern Energy (SSE). Together, these six suppliers account for over 99% of the domestic retail market.

9. Since the beginning of this year all six major suppliers have increased their gas and electricity prices. SSE was the last to increase prices, waiting until the end of March by which time most customers' energy consumption has begun to fall. Customers can still make savings by switching supplier, particularly if they are still with the incumbent gas and electricity suppliers in their region and if they pay on receipt of their bill (ie standard credit) or through a prepayment meter (PPM). Customers who have never switched supplier can make considerable savings on their annual gas and electricity bills. These combined savings are, on average across regions, £125 for a PPM customer, £93 for a standard credit customer and £56 for a direct debit customer. The following graph shows the best savings available in each region by payment method, at the time of writing.³⁰⁵

Figure 1

POTENTIAL SAVINGS FOR ENERGY CUSTOMERS WHO HAVE NEVER SWITCHED SUPPLIER—APRIL 2008



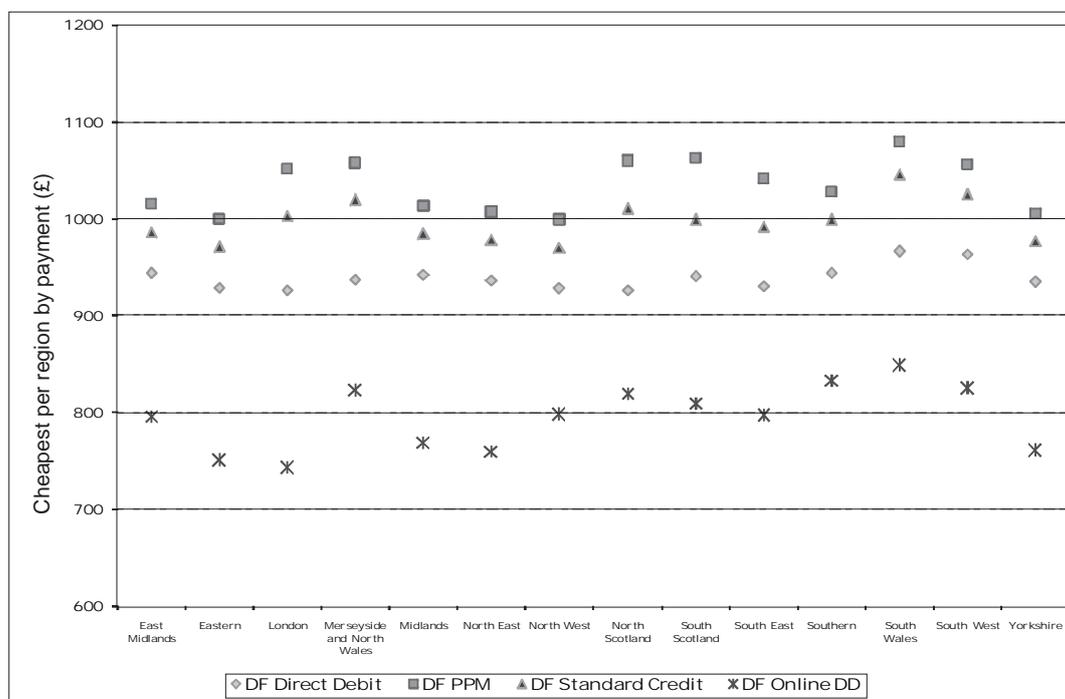
Source: Ofgem

³⁰⁵ The savings shown in these tables do not include additional savings available through online deals or switching to dual fuel. They sum the savings from moving from the incumbent gas supplier to the best gas offer, and moving away from the incumbent electricity supplier to the best electricity offer.

10. Further savings are available to customers who switch their payment method or who move to dual fuel (DF) ie taking both gas and electricity from the same supplier. In particular, online tariffs are growing in popularity and are often the cheapest tariff. The chart below shows, region by region, the cheapest deal by payment type for an average dual fuel customer.

Figure 2

LOWEST DUAL FUEL (DF) PRICE PER PAYMENT TYPE BY REGION—APRIL 2008



Source: TheEnergyShop.com and Ofgem

11. Despite the regional savings for customers who have never switched, we have noted that the recent price changes have resulted in the six major suppliers setting their average national dual fuel direct debit prices to within £19 of each other. The following table sets out the range in dual fuel prices (based on national average annual bills) between suppliers and shows how this has changed over the last year. While this level of price convergence could indicate effective competition, we will consider whether there are other reasons for this as part of our probe.

Table 1

DIFFERENCE BETWEEN THE CHEAPEST AND MOST EXPENSIVE SUPPLIERS OVER THE LAST YEAR BY PAYMENT METHOD

<i>Payment method and year</i>	<i>Price range based on each supplier's average annual dual fuel bill</i>
Direct Debit	
2007 (Feb)	£118
2007 (July)	£72
2008 (April)	£19
Standard Credit	
2007 (Feb)	£158
2007 (July)	£85
2008 (April)	£93
Prepayment	
2007 (Feb)	£159
2007 (July)	£92
2008 (April)	£108

Product innovation

12. As well as price competition, suppliers are also innovating to retain and win customers. Innovative products offer more choice to customers and have proved to be very popular. Last year we estimated there were some 9 million gas and electricity accounts on green, fixed price and online deals, accounting for roughly 20% of all energy accounts.

13. When retail prices were rising, suppliers responded by introducing price guarantee deals such as fixed price, capped price and tracker deals. The first price guarantee tariff was introduced in 2003 and by March 2007 all suppliers not only offered the products, but the tariffs had evolved as competition increased. An example of this evolution was the removal of termination charges to allow customers to switch without penalty. Figure 3 shows the increasing popularity of price guarantee tariffs over time. As at March this year around 6 million product accounts (gas and electricity)—or around 13% of the market—were on price guarantee tariffs.

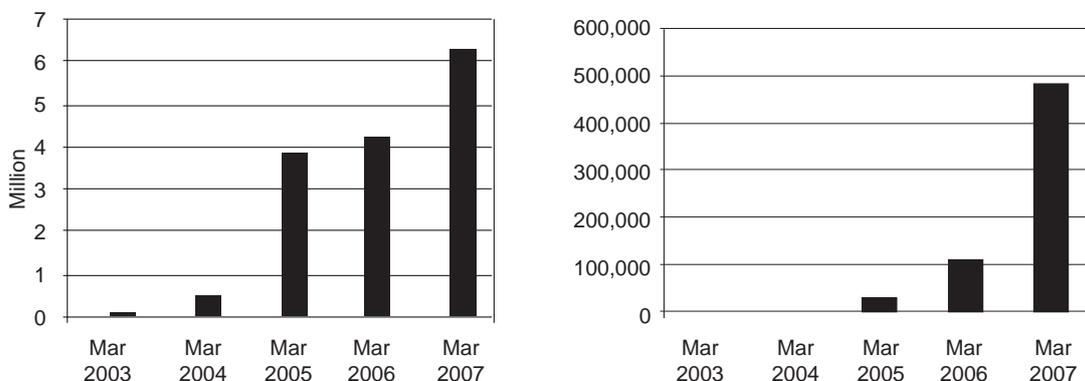
14. Online tariffs are another growing product area, often offering additional cost savings to customers. These offer customers savings for managing their accounts online. We estimate there are about 2.5 million online accounts with the biggest six suppliers.

15. Green tariffs have grown in popularity as customer concern for the environment has risen. This interest has allowed small suppliers specialising in green energy to enter the market, and large suppliers have introduced more green products to their tariff offerings to attract climate conscious customers.

16. More recent developments in the market have shown signs that suppliers are beginning to compete in the provision of services aimed at reducing energy consumption. For example, one supplier offers cash credits to match the reduction in energy use.

Figure 3

Product accounts signed up to price guarantee tariffs Customer accounts signed up to online tariffs



Source: Ofgem

Changes in suppliers' costs

17. Table 2 below provides an illustrative estimate of the increase in costs that suppliers face in 2008. Various costs that suppliers need to recover from domestic customers are increasing, including network charges and measures to tackle climate change.³⁰⁶ However, such has been the increase in wholesale costs, we think this is the dominant area of higher cost for a number of suppliers, particularly for gas. In the table, the “energy, supply costs and margin” is a residual figure, based on an annual bill minus the known costs to suppliers.

³⁰⁶ The Renewable Obligation increases from 7.9% to 9.1% on 1 April 2008. The RO currently adds around £10 to an electricity bill per year and is set to rise to around £20 a year by 2015. The Carbon Emission Reduction Target (CERT) replaces the Energy Efficiency Commitment in April 2008 and it is estimated that the cost will increase from £18 to £38 for the average customer bill in 2008. The cost of the European Emissions Trading Scheme (EU ETS) is estimated at £31 per customer for 2008 and this is already reflected in the wholesale electricity cost. Network charges to pay for upgrades to invest in Britain’s pipes and wires increased on average by around £11.37 for gas and £1.37 for electricity in 2007–08; and in 2008–09 they will rise on average by around £2 in gas and £1 for electricity for a typical domestic customer.

Table 2

ESTIMATED AVERAGE DOMESTIC ENERGY BILL COMPOSITION

Bill Composition	2007-08		2008-09		YoY % Change		Share of total bill 2008-09	
	Gas	Elec	Gas	Elec	Gas	Elec	Gas	Elec
Energy, supply costs and margin	£404	£254	£454	£283	12%	11%	71%	69%
Distribution	92	62	115	62	25%	0%	18%	15%
Transmission	12	13	10	13	-17%	0%	2%	3%
VAT	28	18	31	20	11%	11%	5%	5%
Environmental	9	16	19	30	111%	88%	3%	7%
Meter provision	12	4	14	4.5	17%	13%	2%	1%
Average current bill	£557	£367	£643	£412	15%	12%	100%	100%

Source: Ofgem

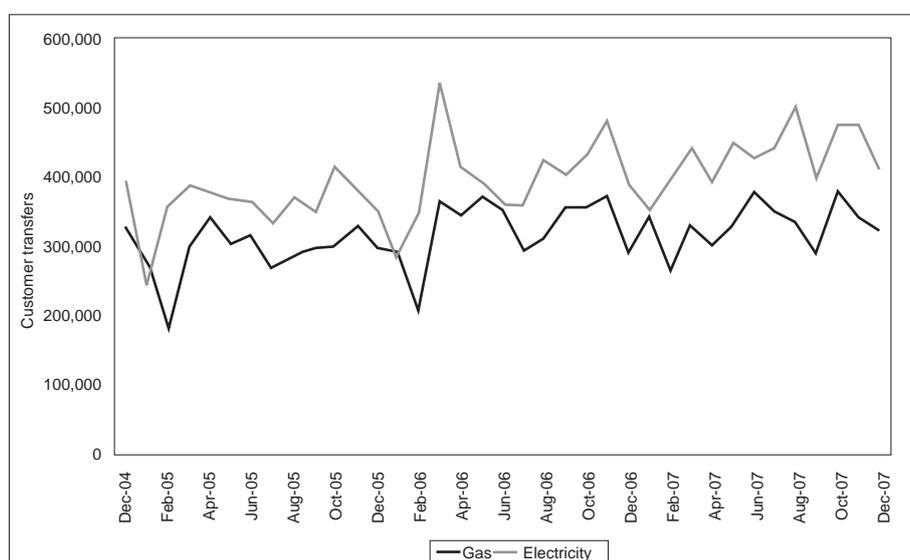
18. The Renewables Obligation (included above in environmental costs) obliges electricity suppliers to source an increasing share of their power generation from renewable sources. Where a power supplier is unable to meet their obligation from their own generation they must buy renewable energy from accredited suppliers or pay a buyout price to meet the obligation. The share of energy that suppliers are obliged to source from renewable increases on 1 April 2008 from 7.9% to 9.1%.

Switching

19. In response to competition on price and the introduction of new products, there has been a steady increase in the level of switching between gas and electricity suppliers, with the level in 2007 exceeding that seen in 2006. Figure 4 and Table 3 below show the number of monthly and annual transfers of domestic gas and electricity customers.³⁰⁷

Figure 4

MONTHLY CUSTOMER TRANSFERS IN GAS AND ELECTRICITY



Source: Ofgem

³⁰⁷ The figures show the number of meter points that are transferred from one supplier to another. Therefore, customers who switch more than once will be counted more than once in the annual switching figures.

Table 3**TOTAL ANNUAL TRANSFERS IN GAS AND ELECTRICITY**

<i>Total transfers</i>	<i>Jan to Dec 2004</i>	<i>Jan to Dec 2005</i>	<i>Jan to Dec 2006</i>	<i>Jan to Dec 2007</i>
Electricity	4,229,023	4,316,401	4,820,756	5,157,028
Gas	3,588,634	3,510,976	3,915,480	3,982,207

Source: Ofgem

20. There are approximately 26 million domestic electricity and 21 million domestic gas customers in Great Britain. Based on a consumer survey undertaken by Ipsos Mori in early 2007, around 22% and 19% of these electricity and gas customers respectively switched their supplier in 2006.³⁰⁸

21. Datamonitor has estimated that of the 21.5 million customers taking both gas and electricity, 80% have switched either their gas or electricity since the market opened to competition. Taking the market as a whole, and including electricity only customers, Datamonitor estimates that 70% of households have engaged in the energy market by switching either their gas or electricity supplier.³⁰⁹

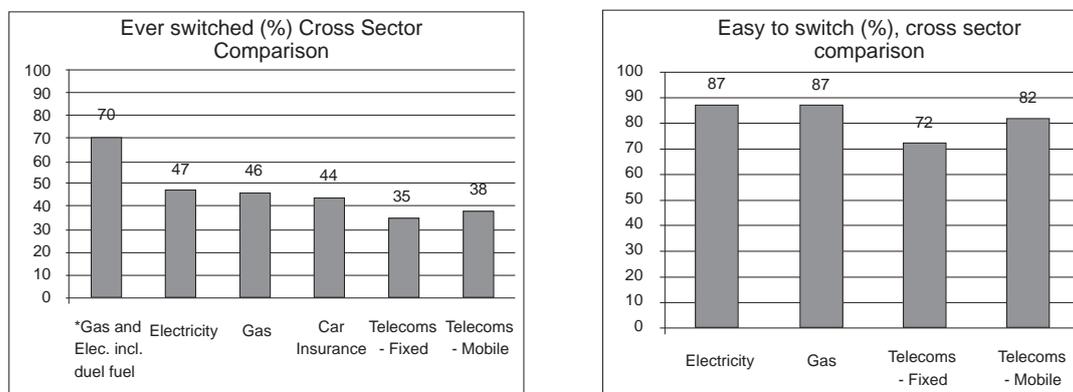
22. However, there is evidence that within some groups of customers, the percentage who have never switched supplier is higher eg amongst those who pay by standard credit. We will be doing more work to understand the reasons for this and what action can be taken as part of the probe.

Cross-sector switching comparison

23. Evidence from Ofcom research in 2006 provides a benchmark with which to compare switching rates and the ease of switching in the gas and electricity markets. The first chart in Figure 5 indicates that relative to sectors with similar characteristics (eg network characteristics and the presence of an incumbent in the case of telecoms) the number of customers who have switched is broadly similar. The second chart in Figure 5 indicates that when compared to the telecoms industry the relative ease of switching is deemed to be similar.

Figure 5

COMPARISON BETWEEN SECTORS OF THE PERCENTAGE OF SWITCHERS AND EASE OF SWITCHING



Sources: Accent 2005 for gas and electricity (commissioned by Ofgem) and Ofcom's Consumer Experience Report 2006 for telecoms and car insurance. *Datamonitor Report "The true state of the market—an analysis of dual fuel switching in the UK energy market" January 2008.

³⁰⁸ The Ipsos Mori consumer omnibus survey is available from our website at <http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Switching%20Rates%20for%20Vulnerable%20Customers%20Report.pdf>

³⁰⁹ Datamonitor's report is available from www.datamonitor.com.

Market shares

24. Customers are still leaving their incumbent suppliers and the market shares of the incumbents continue to fall. British Gas' market share for gas has continued to decline (in December 2007 it was 46%), while the electricity market incumbents have less than half the customers in 8 of the 14 regions.

25. Nationally, in electricity and gas, SSE has seen the biggest increase in its share of customers. It has gained four million extra customers in Britain in the last three years and has moved to the second biggest supplier behind British Gas. During this period SSE has consistently been one of the most competitive suppliers on price and has been rated the highest supplier for customer service. British Gas has seen the biggest fall in market share in gas, while E.On has seen the biggest fall in electricity.

Table 4

NATIONAL MARKET SHARES IN GAS

<i>Group</i>	<i>Dec 2002</i>	<i>Dec 2003</i>	<i>Dec 2004</i>	<i>Dec 2005</i>	<i>Dec 2006</i>	<i>Dec 2007</i>	<i>Change in market share 2002–07</i>
British Gas	63	61	57	52	48	46	–17
E.On	12	12	13	13	13	13	1
EDF Energy	5	5	5	5	7	7	2
npower	9	9	9	10	11	12	3
Scottish Power	5	6	8	9	9	9	4
SSE	6	7	8	10	12	14	8
Others	0.2	0.6	0.3	0.4	0.0	0.0	0.2

Source: Ofgem analysis

Table 5

NATIONAL MARKET SHARES IN ELECTRICITY

<i>Group</i>	<i>Dec 2002</i>	<i>Dec 2003</i>	<i>Dec 2004</i>	<i>Dec 2005</i>	<i>Dec 2006</i>	<i>Dec 2007</i>	<i>Change in market share 2002–07</i>
British Gas	22	24	23	22	22	22	0
E.On	22	22	21	20	19	18	–4
EDF Energy	15	14	13	13	14	13	–2
npower	17	15	15	15	16	15	–2
Scottish Power	10	11	12	13	12	12	2
SSE	13	14	15	16	17	18	5
Others	0.3	0.7	0.4	0.6	0.2	0.3	0

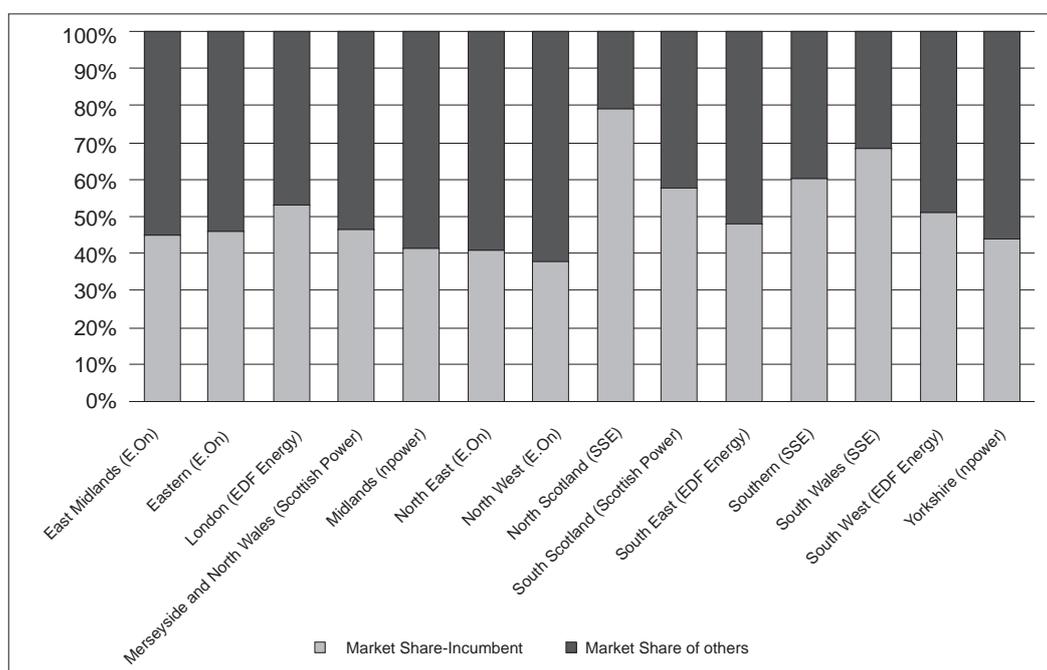
Source: Ofgem analysis

26. To understand in more detail the change in electricity market share it is necessary to consider the market shares of the incumbent electricity suppliers in each of the old Public Electricity Supply regions. This is because there was originally a monopoly electricity supplier in each of these 14 regions.

27. In December 2007 the market shares of the electricity incumbents was below 50% in 8 out of the 14 regions. Figure 6 shows the regional market share of the incumbent electricity supplier in each region. The incumbent supply group is identified in brackets alongside the name of the region.

Figure 6

ELECTRICITY REGIONAL MARKET SHARES (DECEMBER 2007)



Source: Ofgem analysis

Retail market concentration

28. In some markets there may be many buyers and sellers. In others, the market may be concentrated in the hands of a very small number of participants. In extreme cases there may be only one seller (a monopolist) or one buyer (a monopsonist). The level of market concentration can, therefore, provide further clues as to the nature of competition. Very generally, the more concentrated the market, the weaker the competitive influence firms are likely to have.

29. The Herfindahl-Hirschman Index (HHI) is one method of measuring the level of concentration and is part of the conventional toolkit used by competition authorities as part merger assessments. The HHI takes account of the differences in market participants' size and it is calculated by summing the squares of the market shares of all the firms engaged in the market. The maximum that an HHI can be is 10,000. The OFT consider that a market with a HHI score of above 1,000 would be regarded as concentrated and a score above 1,800 would be regarded as highly concentrated. That said, care should be taken in interpreting HHI scores. For instance, in comparing HHIs in different markets, account should be taken of the different cost structures in operation.

30. Tables 6 and 7 show the HHI in the national gas market and the average HHI across the 14 regions in electricity respectively. These tables illustrate that both sets of HHIs have been declining steadily over the past five years.

Table 6

MEASURE OF CONCENTRATION (HHI) IN THE GAS MARKETS

	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006	Dec 2007
National	4,301	4,049	3,610	3,206	2,841	2,722

Table 7

MEASURE OF CONCENTRATION (HHI) IN THE ELECTRICITY REGIONAL MARKETS

	Dec 2002	Dec 2003	Dec 2004	Dec 2005	Dec 2006	Dec 2007
Average across Regions	4,892	4,557	4,236	4,002	3,724	3,461

Source: Ofgem analysis

Small new entrants

31. As well as the “big six” domestic suppliers, there are six active small suppliers licensed in the energy market. In a number of cases, these suppliers offer products in niche markets. For example, Ecotricity and Good Energy offer “green” products or tariffs. One newer supplier, First Utility, is offering a smart meter to its customers, complete with a home display unit, and Utilita is offering competitive pricing focused at PPM customers. In the small and medium enterprise (SME) market three new entrants are Opus, Corona and Bizz Energy.

32. There are also other active small suppliers who are not licensed but have ongoing arrangements with more established suppliers. These companies may provide specialised social offerings such as EBICo. EBICo is a not-for-profit energy company that offers PPM customers the same unit price as customers paying by other payment methods. This company obtains energy from one of the larger suppliers, but has separate pricing arrangements.

33. While these suppliers have been gaining customers, they have less than 0.5% of the market. As part of the probe we will be looking to understand the reasons why small new entrants have not been able to enter the market more effectively.

Q2. Whether there is effective competition in the wholesale markets for gas and electricity

34. In wholesale markets, as in retail markets, a range of information is used in assessing the nature of competition. Below we consider evidence on price movements, market shares, liquidity in the market and also the interaction between the UK and continental markets.

Price movements

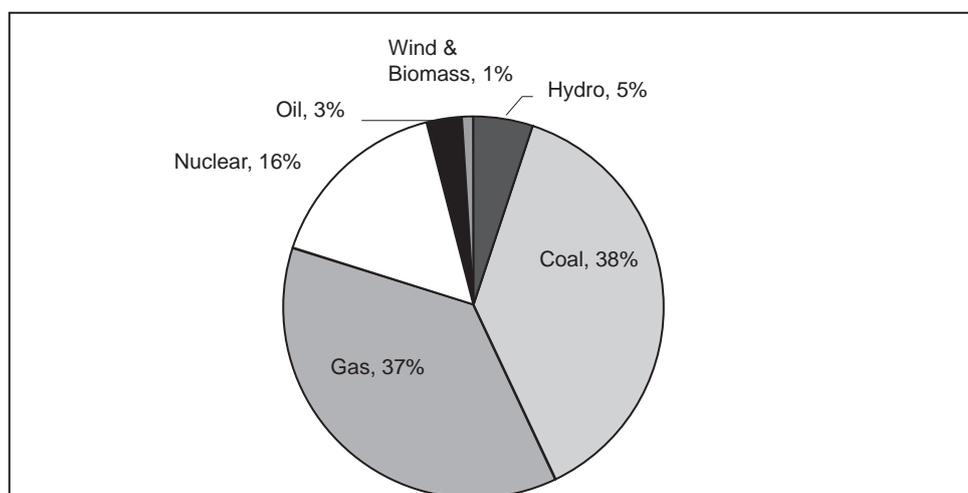
35. Understanding price developments is key to understanding whether competition is operating effectively. In particular, we need to understand whether price levels and changes in prices are driven by changes in demand or supply (ie cost) conditions or whether firms are exploiting market power and raising prices above competitive levels. Below we present evidence on the factors we view as having contributed to recent increases in wholesale price levels. The evidence suggests that recent wholesale gas and electricity price increases appear to be largely driven by the main cost drivers.

Wholesale energy price increases

36. To understand the determinants of electricity prices, it is helpful to note that a significant share of GB electricity generation is gas and coal fired (around 75%) as shown in Figure 7 below, this is important since these sources of generation are usually the ones called on when an extra unit of electricity is needed—ie they are the marginal source of supply. Both these energy sources are exposed to the international markets and can consequently be affected by price movements in these markets.

Figure 7

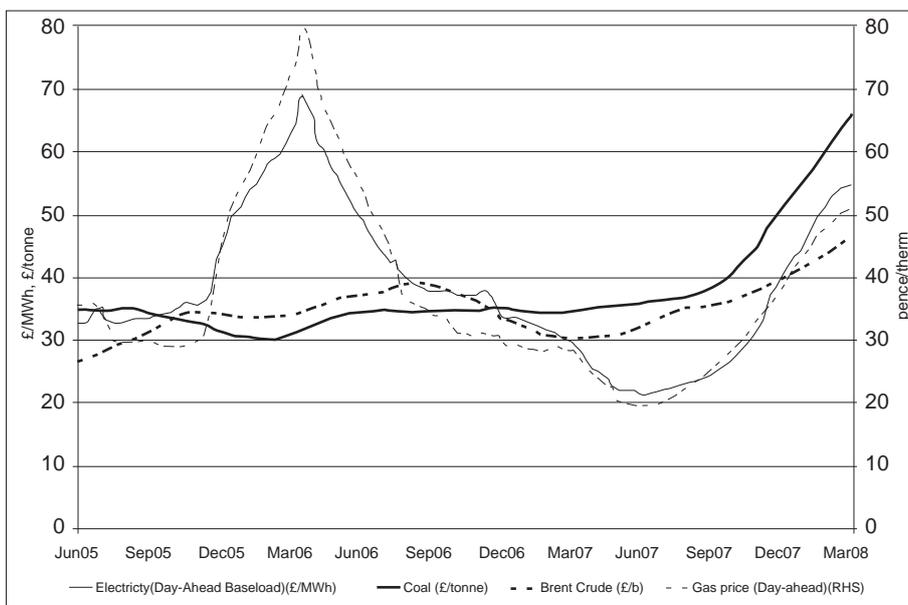
GB ELECTRICITY GENERATION CAPACITY (2007)



Source: National Grid

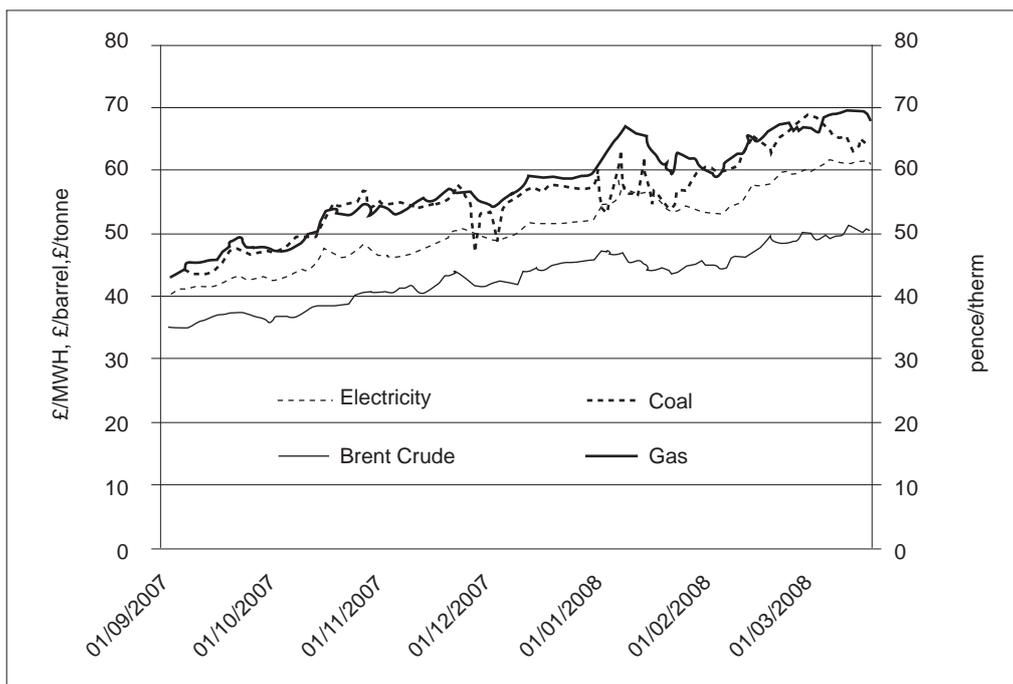
37. High world oil prices are reflected in gas prices, particularly since the GB market is now increasingly exposed to the European markets where oil and gas prices are closely linked as a result of the market's structure.³¹⁰ The price of all four main energy sources (coal, oil, gas and electricity) have increased significantly between August 2007 and now. Global Liquefied Natural Gas (LNG) markets were also much tighter than winter 2006–07 due to unexpected higher global LNG demand, particularly from Asian markets such as Japan. Charts 8b and 8c show that prices are expected to remain high for next winter and summer 2009.

Figure 8a
UK ENERGY PRICES MAY 2005—MARCH 2008 (30 DAY MOVING AVERAGE)



Source: Bloomberg

Figure 8b
FORWARD CONTRACT PRICE WINTER 2008–09 FOR ELECTRICITY, COAL, OIL (BRENT CRUDE) AND GAS

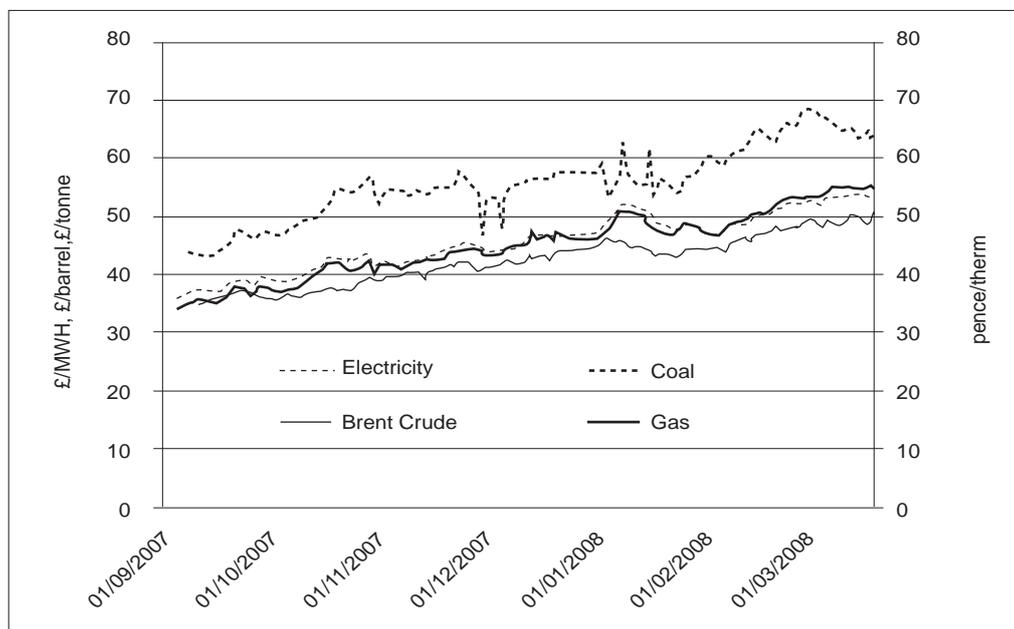


Source: Bloomberg

³¹⁰ Specifically, it is because gas prices are linked to oil prices through formulae in long term contracts.

Figure 8c

FORWARD CONTRACT PRICE Summer 2009 FOR ELECTRICITY, COAL, OIL (BRENT CRUDE) AND GAS



Source: Bloomberg

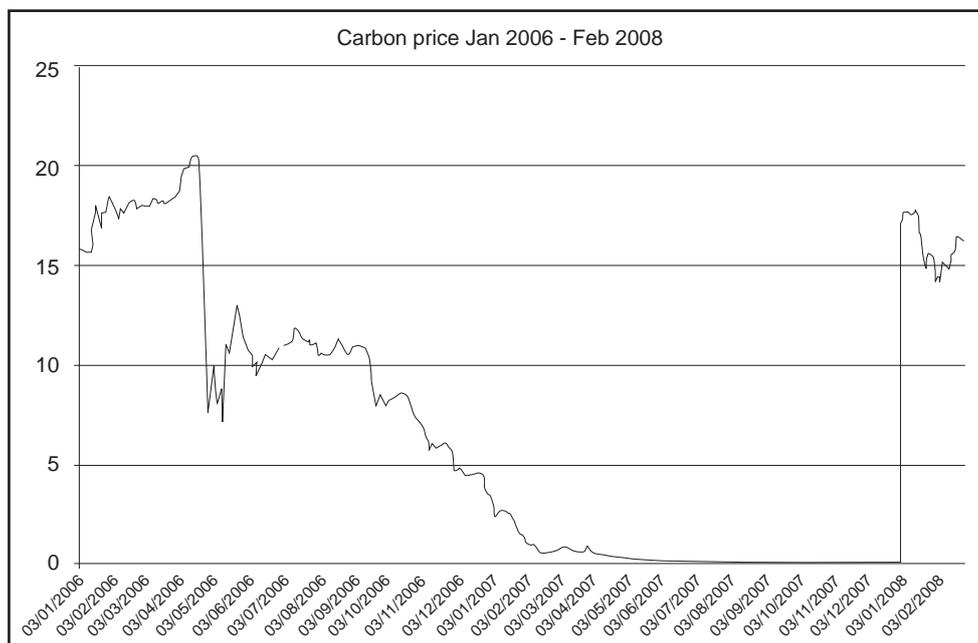
Environmental costs

38. In addition to upward pressure from global oil, coal and gas prices, GB prices have also risen as a result of programmes introduced by the government to tackle climate change ie Phase II of the EU Emissions Trading Scheme (ETS) and the renewable obligation for GB power generation.

39. Phase II of the ETS started in January 2008. As a result, the price of carbon has increased from virtually zero before the turn of the year to around €23/t (euros per tonne) today. Generators will seek to recover the costs of these permits through the price at which they sell their generation, either in the wholesale market or to their own supply business. Even though they receive some of the permits for free they will still seek to recover the value of the permit, since otherwise it would be more profitable not to generate and to sell the permit in the EU ETS market. The impact of this increase in the carbon price accounts for about an extra £9/MWh (pounds per Megawatt hour) in wholesale electricity prices. Under the UK's National Allocation Plan, large electricity generators receive slightly less than half of their emission allowances free of charge, so the resulting increase in the price of power represents a windfall gain for these generators. Based on today's carbon prices, these free emission allowances represent a windfall of emission allowances of around £9 billion pre-tax over the five year compliance period.

Figure 9

ETS CARBON PRICE



Source: Bloomberg

Possible infrastructure constraints

40. Constraints on gas supply infrastructure can cause peaks in prices, choking off consumer demand when the market believes supply capacity constraints are significant. While the UK gas infrastructure position is significantly better in 2007–08 with more import and storage capability than in winter 2005–06, some of the expected capacity is now coming on later than planned. However, compared to winter 2006/07, last winter was very mild both here and on the continent which helped to keep GB gas prices lower than this winter to date.

41. Overall, evidence points to a combination of energy price increases driven by price increases in global energy markets, as well as, environmental policy levies. However, it is useful to consider other indicators commonly used to assess the potential effectiveness of competition in a market. The next section considers evidence on market shares in the wholesale gas and electricity markets.

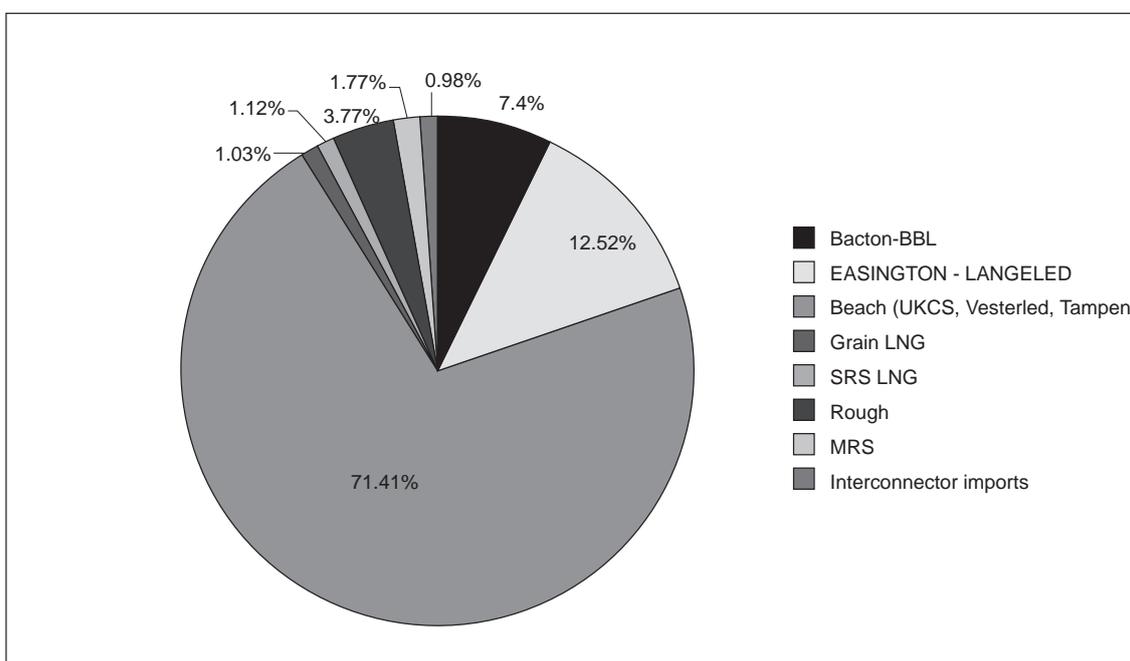
Wholesale gas market shares

42. For market definition purposes here we consider the relevant gas market to encompass those companies involved in supplying gas on to the GB National Transmission System (NTS). There are around 120 companies that were active in supplying gas onto the NTS in 2007. Due to the large number of companies active in the gas market we provide an overview of gas supply by broad supply source, below.

43. The gas supply shares for the four main gas delivery sources in calendar year 2007 were: 70% from Beach (a combination of more mature UK continental shelf (UKCS) and Norwegian fields); 12% Langedled (a pipeline carrying gas from Norwegian fields); 7% Bacton Balgzand Line (the new gas import pipeline from the Netherlands, known as BBL); and the remainder from LNG, storage and the gas interconnector (a two way gas pipeline, known as IUK, connecting the UK with Belgium). Within each of these key sources of supply a varying number of companies operate.

Figure 10

WHOLESALE GAS MARKET SUPPLY SHARES, BY SUPPLY SOURCE 2007



Source: National Grid

Gas market concentration

44. The level of market concentration can provide clues as to the nature of competition. Generally, the more concentrated the market, the weaker the competitive influences are likely to be. As in the retail markets, the concentration of the gas and electricity wholesale markets can be considered using estimates of Herfindahl-Hirschman Indices (HHI).³¹¹

45. One way of defining the market share for calculating concentration ratios in the gas supply market would be the share of gas deliverability in gigawatt hours per day³¹² (GWh/day). On this basis, the overall gas wholesale supply market's HHI is estimated to be 430, indicating a relatively low concentration.

46. As well as looking at the overall market it is also useful to look at market concentration with respect to the source of gas delivery. This is because different gas sources will be marginal at different times, depending on the level of demand, as illustrated in Figure 10. When a gas source is marginal it is possible that operators have relatively more market power—enabling them to influence prices to a greater extent. While the overall HHI score indicates that there are a relatively diverse number of players, some of the UK's individual gas supply sources are relatively more concentrated.

Table 8

ESTIMATED MARKET CONCENTRATION BY SUPPLY SOURCE

	<i>Estimated HHI</i>
UKCS	704
Norway	2023
Storage ³¹³	708
IUK	1,164
BBL	4,400
LNG	3,342
Overall wholesale gas market	430

³¹¹ For more information on HHIs see paragraph 28.

³¹² This analysis combines a number of data sources, reflecting Ofgem's best HHI estimate at the time of writing. Examining each source of gas delivery on an individual basis can provide a more rounded picture.

³¹³ Excludes Short Range Storage (SRS) controlled by National Grid.

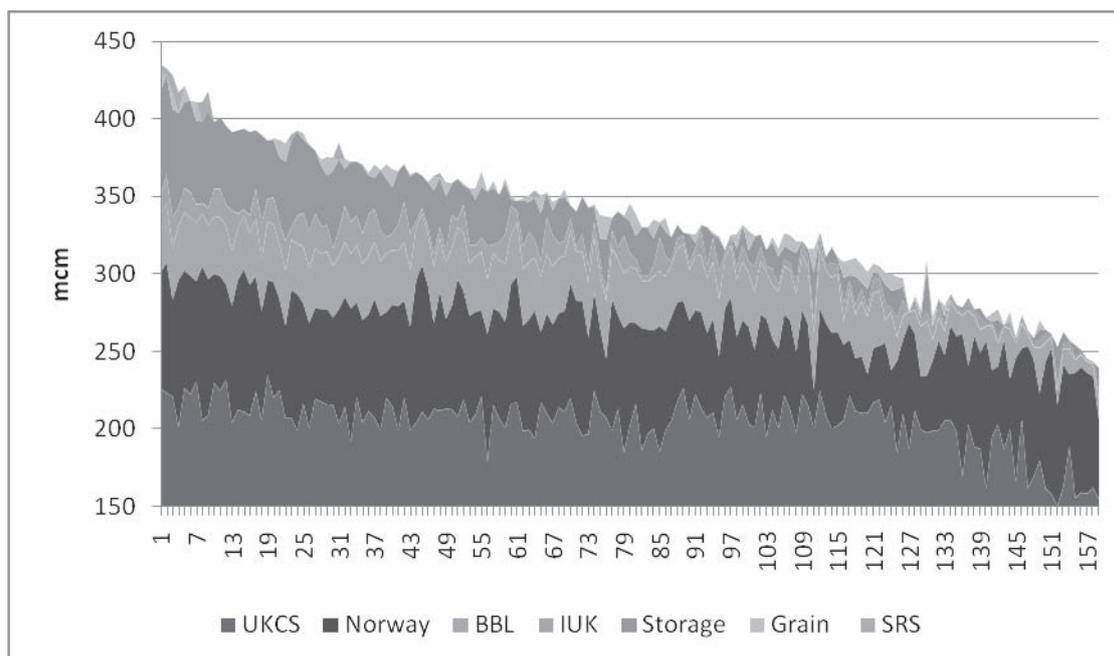
Source: Ofgem analysis

47. UKCS and storage are the sources with the lowest market concentration, while BBL, LNG and Norway have relatively higher concentrations.

48. Figure 11 shows daily gas supply for each supply source. Gas supply has been ranked by gas demand, so day 1 on the chart represents the highest gas demand during the period, and shows the sources used to meet demand.³¹⁴ As demand increases more expensive sources of gas bid into the market. While we do not know exactly what the costs of each supply source are, the chart makes conventional assumptions about the merit order of each source.

Figure 11

ESTIMATED GAS SUPPLY BY DEMAND ORDER, OCTOBER 2007 TO MARCH 2008



Source: Ofgem analysis, National Grid data. (SRS is mostly controlled by National Grid for balancing, although some capacity is auctioned)

49. Overall, Figure 11 gives an indication of the number of days each supply source is at the margin. A concentrated marginal source may have the ability to influence prices temporarily, bidding them above a competitive level. Combining the gas load stack with its components concentration ratios enables us to see which source is at the margin and the sources concentration.

50. Table 9 below, shows the volume of gas delivered per day during Winter 2007–08, as a share of the estimated total volume each gas source can deliver per day (one way of measuring capacity). The data showing the maximum volume of gas delivered over the Winter 2007–08 period indicates that, even on these maximum delivery days, each source is still likely to be capable of delivering more gas. This provides evidence that it is unlikely that more concentrated supply sources are able to influence the price of gas at the margin, since other supply sources still have remaining supply capacity to compete.

Table 9

WINTER 2007–08 GAS DELIVERED AS SHARE OF ESTIMATED TOTAL DELIVERABILITY
(A MEASURE OF CAPACITY)

	<i>Ave delivered gas</i>	<i>Max delivered gas</i>	<i>Min delivered gas</i>
UKCS	73%	84%	54%
Norway	62%	95%	22%
BBL	70%	88%	17%
IUK	22%	58%	0%
Storage	23%	72%	0%
LNG	16%	74%	0%
SRS	1%	28%	0%
Total	53%	68%	38%

³¹⁴ For example, since gas from UKCS is likely to be the cheapest to supply, this is the first source to satisfy demand.

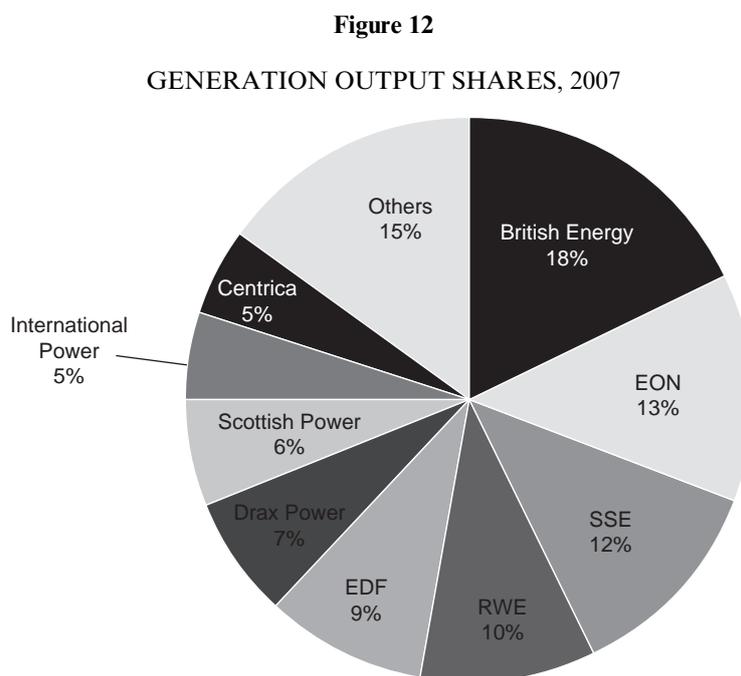
Sources: Ofgem analysis

51. While some of the more concentrated gas sources are at the margin during periods of peak demand, the following should be noted: (i) there are very few days during which these sources are the marginal source supplying peak demand, (ii) the supply market overall has a relatively low concentration, (iii) total supply capacity is in excess of peak demand, (iv) the total deliverability of each source is in excess of maximum gas delivered (each source has some additional margin which they can supply to the market), and (v) wholesale energy buyers have the ability to hedge in advance of the gas delivery day. Hence, on the basis of this evidence, there are limited signs of one source being able to influence market price to a significant extent.

52. In addition to examining the competitiveness of the gas supply market it is also noteworthy that at certain price levels a demand side response occurs. This can act as an additional break on potential market power. The demand side response seen in winter 2005–06 when gas supply capacity was tighter than normal saw examples of this response.

Wholesale electricity market shares and concentration

53. Similar to the market definition for gas, we define the wholesale electricity market as those players who supply electricity to the National Grid. This definition hence overstates the case for some electricity users since 12.7 gigawatts of generation is embedded and not supplied to National Grid. This volume of generating capacity is four times the output of the very large Drax power station. Figure 12 below shows the market shares of generators in Great Britain.



Source: National Grid

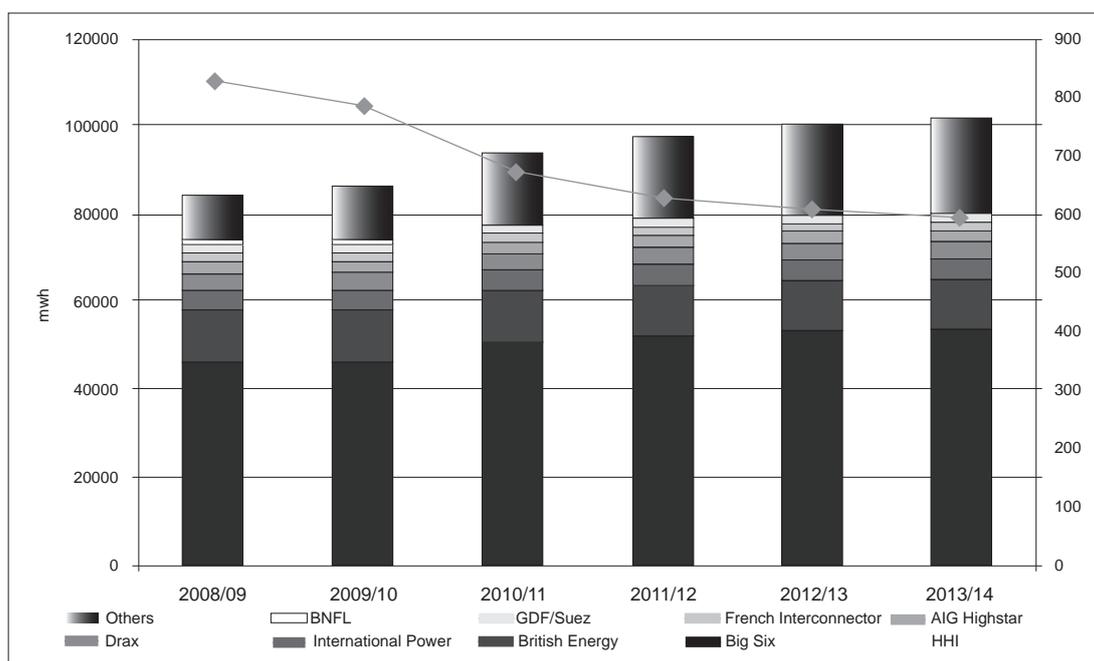
54. As for the gas market, we present HHI measures for the electricity market. The HHI of the wholesale electricity market (based on output) is estimated to be around 986, indicating a relatively low concentration.

55. Looking ahead to the ownership of the generation capacity anticipated to be entering commission, the concentration outlook continues to be one of a relatively low HHI. Proposed new generating capacity is being commissioned by the “big six” as well as smaller independents. Figure 13 below shows the forecast HHI and new generation capacity coming on stream between 2008–09 and 2013–14.³¹⁵

³¹⁵ Based on a scenario where all generation which has a connection agreement with NG gets built.

Figure 13

CAPACITY IN MWh (LHS) AND CONCENTRATION OUTLOOK (RHS) IN HHI



Source: HHI from Ofgem analysis, Capacity from National Grid.

Vertical integration

56. Evidence suggests the six majors are becoming increasingly vertically integrated. Vertical integration is often an efficient response by firms aiming to minimise their transaction costs and optimise their risk management strategies. For instance, since the depth³¹⁶ of the day ahead electricity market is limited (due in part to the innate inflexibility of certain types of generation plant), suppliers can gain greater control of their potential supply liabilities by owning generation capacity. In particular where they own flexible plants, enabling a quick response to prices and demand.

57. However, vertical integration, can, in some instances raise competitive concerns. In the energy market, a high concentration of generation capacity in the hands of a small number of electricity suppliers could preclude other players from gaining competitive access electricity supply. Figure 14 below shows the estimated supply—generation balance across the power market, and we can see that the main six retail suppliers are able to cover their own domestic and SME supply liabilities with their own generation.

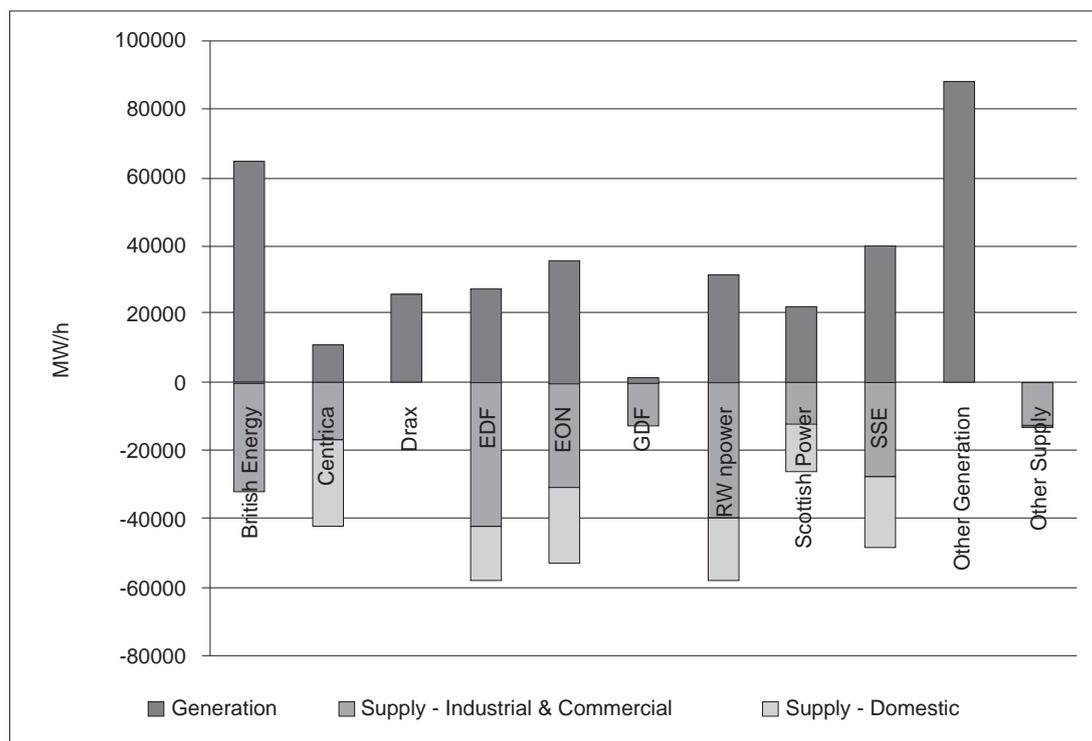
58. Around 55% of generation capacity is owned by the six main domestic suppliers (see Figure 12), and the remaining share would seem sufficiently large and flexible enough for potential new entrant to contract to supply energy for their customers.³¹⁷

³¹⁶ Depth is defined here as the volume of day ahead power can be bought in the short term markets.

³¹⁷ For example, Drax is a large flexible coal plant of between 3 and 4 Gigawatts. Furthermore, much of the new renewable, as well as new conventional, build is not owned by the main six suppliers. See Figure 11.

Figure 14

ESTIMATED SUPPLY—GENERATION BALANCE BY SUPPLIER 2006



Sources: Generation data: BERR and Elexon. Domestic supply data: Ofgem data and analysis. I&C: Datamonitor Report “Q4 2006 B2B Market Share Monitor”, 18 January 2007.

Liquidity

59. Liquidity refers to the ability to quickly buy or sell a particular item without causing a significant movement in the price. A liquid market will feature a large number of buyers and sellers ready and willing to participate in the market at all times. Liquid markets are important in ensuring that price signals to participants are accurate and to allow participants to adjust contractual positions without materially altering the prevailing price. Short term exchange liquidity might also lower barriers to entry for new suppliers.³¹⁸ It is important to note that a high level of liquidity is not an end in itself, and is merely one indicator of a healthy market as it makes new entry relatively easy.

60. It is worth noting that there may be a number of benign explanations for falls in liquidity, for example improvements in initial contracting, supply-demand balancing and forecasting may cause liquidity to fall. In addition, more sophisticated products (eg options) are a substitute for direct trading in physical products. However, at very low levels of liquidity, confidence in traded prices can be undermined.

61. There are a wide range of measures of liquidity, including number of market participants, number of trades, volumes traded and churn (the number of times a single unit is traded).

Gas

62. The majority of total volume traded in the UK is traded over-the-counter (OTC), with most activity observed close to real time and close to the delivery of the product, ie volumes are highest for near term products (day-ahead, week-ahead, month-ahead).

63. The Financial Services Authority (FSA) conducts an annual survey of energy brokers in the UK to determine total OTC traded volumes, these are reported below.

³¹⁸ Since the financial risk of not being able to buy generation to meeting their supplier obligations could be reduced.

Table 10

ESTIMATED VALUE OF UK GAS MARKET

	<i>Volume traded (billion therms)</i>	<i>Est value of market (£billion)</i>
2006–07	437	134
2005–06	209	108
<i>Increase on 2005–06</i>	<i>226 (109%)</i>	<i>26 (24%)</i>

Source: Financial Services Authority

64. According to the FSA, the total volume of forward traded gas through electronic or voice brokered services year from 1 August 2006 to 31 July 2007 was 437 billion therms, an increase of 109% on the previous year.³¹⁹

Electricity

65. As with gas, the majority of trades in electricity take place OTC, so that the share of trades over exchanges (usually the APX or ICE) is very small as a share of total trades.

66. As in the gas market, parties trading gas in the UK can utilise a wide range of trading platforms. The FSA annual survey is reported in the table below.

Table 11

UK ELECTRICITY OTC TRADING VOLUMES

	<i>Vol traded (TWh)</i>	<i>YoY growth</i>	<i>Est value of the market (£m)</i>	<i>YoY growth</i>
2006–07	985	337 (52%)	31	1 (3%)
2005–06	648		30	

Source: FSA

67. The relative lack of depth to the exchange traded power market relative to the gas market in the UK is likely, in part, to be a function vertical integration. That is, power suppliers own a sizable portion of their own generation capacity, when compared to the UK gas market. In addition, the UK power market is less well connected in infrastructure terms than some European power markets. For instance, Germany and France are well connected, allowing greater scope for trading power across borders.

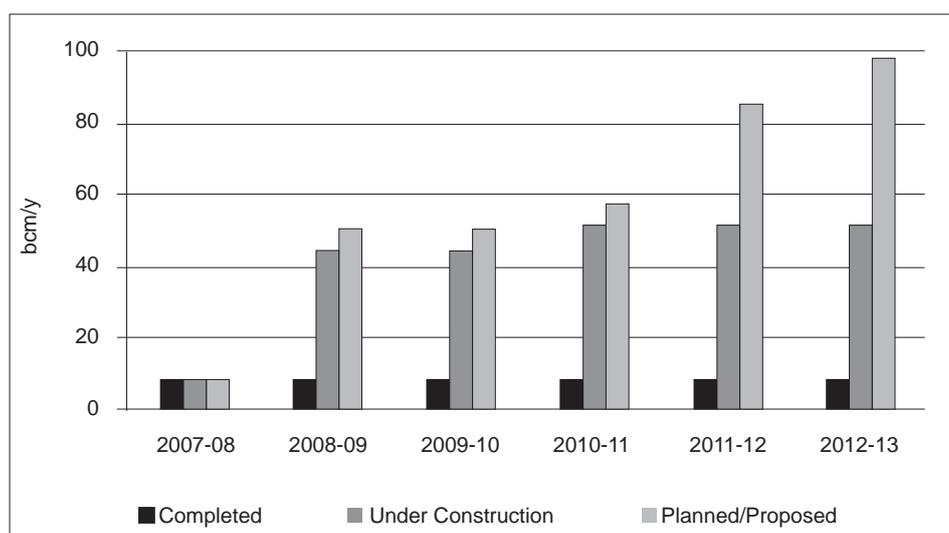
*Investment**Gas*

68. The increased diversity of gas supply sources goes towards strengthening competition in the wholesale market as well as ensuring security of supply. Over the last few years the market has delivered several new import infrastructure projects, including the Langeled pipeline, the BBL interconnector, expanded capacity of the IUK interconnector and LNG import facilities at Teeside, Isle of Grain and Milford Haven. In addition to this a number of new storage facilities have also been constructed by market participants and others are in various stages of the planning process. These have the potential to double the GB storage capacity; if these projects gain planning permission the extra storage capacity will assist the market in managing peak winter demand as North Sea production continues to decline. Figure 15 shows the outlook for LNG infrastructure capacity between 2007–08 and 2012–13.

³¹⁹ As some voice and electronic brokered services are cleared through exchanges, energy traded on exchanges are excluded from this analysis to avoid double counting.

Figure 15

NEW LNG INFRASTRUCTURE



Source: Ofgem estimates. National Grid data

Electricity

69. We would expect a properly functioning market to send price signals to investors encouraging them to build the generation capacity to meet required future demand. Below we assess some of the evidence on market signals for investment.

70. A standard industry measure of profitability in electricity generation is to consider the “spark and dark” spreads.³²⁰ These provide an indication of the expected return from investment in new generating capacity over the short term. There is much debate about the levels required to encourage new investment in generation capacity, particularly in the context of current pressure on new plant capital costs. Some of these capital costs may be attributed to current high commodity prices. Forward spreads for winter 2008–09 can be found below in Table 12. Different efficiency factors can be used to calculate spreads, and it is noteworthy that new gas plants are able to achieve efficiency rates of around 58%, where 49% to 54% might be more normal for existing plants.

Table 12

WINTER 2008–09 FORWARD SPREADS (13/3/2008)

	Winter 2008–09 (£/MWh)
Spark	17.56
Dark	34.60
Clean Spark	12.11
Clean Dark	22.10
Clean Spark (+ O&M + Transportation ³²¹)	11.71
Clean Dark (+ O&M + Transportation)	16.21

Source: Ofgem analysis, Bloomberg data. Efficiency factors (heat rate) taken to be: Spark 54% and Dark 37%.

71. Long lead times for building plant, combined with large fixed costs and long payback periods mean that market uncertainty can lead to higher discount factors and risk coefficients being used in making investment decisions. A variety of factors can affect these investment payback calculations, not least of which is confidence in the market.

72. Rates of proposed investment in new generation capacity provide some evidence that the wholesale market is encouraging the private investment needed to meet future UK energy demand. For each of the years in Figure 16 below, the first bar shows the amount of generation capacity which is already in existence

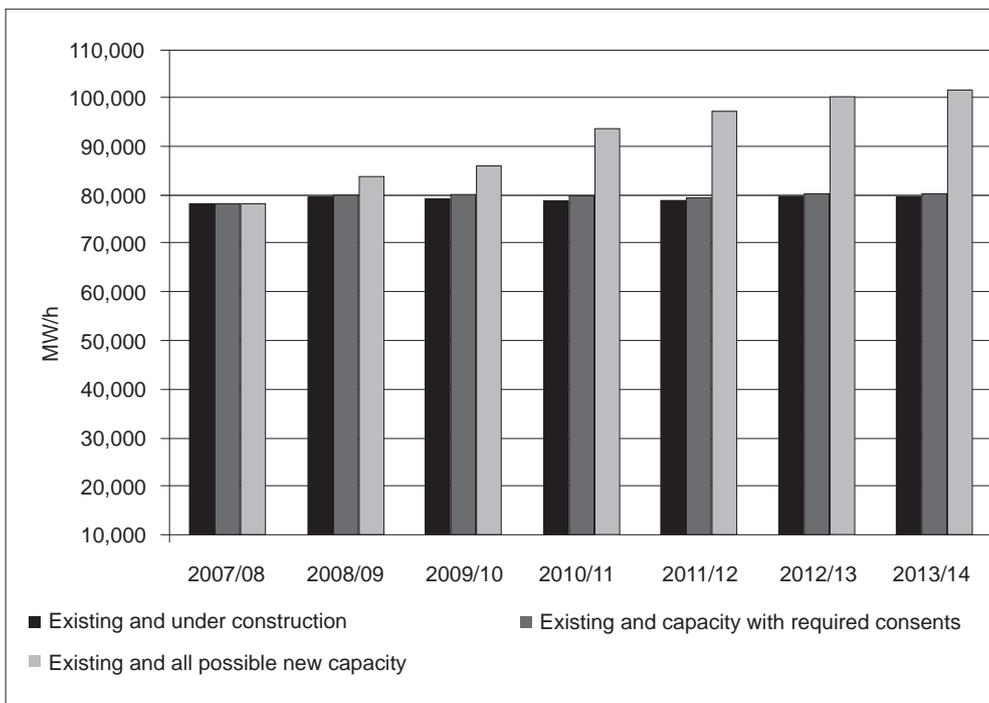
³²⁰ The spark spread is the difference between the electricity price and the price of gas used to generate it. The dark spread is the difference between the electricity price and the price of coal used to generate it. Clean spreads also take into account the cost of buying allowances to emit CO₂ under the European Emissions Trading Scheme (EU ETS).

³²¹ O&M stands for Operation and Maintenance. Many GB coal plants are built near disused GB coal fields and not near to coal sources, such as ports. These adjustment factors can, therefore, play a significant role on indicating efficiency.

or under construction; the second bar adds to this the generation capacity not yet built but which has consent under section 32 or section 36 of the Electricity Act 1989; and the third bar adds in all possible capacity from generation that has a connection agreement with National Grid.

Figure 16

NEW GENERATION CAPACITY OUTLOOK



Source: Ofgem analysis. National Grid data.

73. The extent of investment in new generation capacity we have seen over the last 10 years, as well as planned capacity, suggest the market is functioning well and encouraging investment.

European interaction

74. GB—European energy market interaction has increased significantly over the last few years, and short term prices on the GB, Zeebrugge (Belgium), and TTF (the Netherlands) markets are becoming increasingly correlated. That said European market liberalisation is crucial to increase price transparency and increase European and GB market efficiency. We cover the GB markets interaction with European markets in response to question 5, below.

Q3. *The implications of growing consolidation in the energy market*

75. A discussion of the impact that consolidation may have had on energy market competition is covered in response to questions 1 (on the retail market) and 2 (on the wholesale market). Ofgem’s market probe will examine the nature of competition in the gas and electricity retail markets.

Q4. *The relationship between the wholesale and retail markets for electricity and gas*

76. The volatility in energy prices means that the cost of the gas and electricity is the largest and most difficult component of energy supply cost to estimate. While network and environmental cost will be subject to the same influences for all suppliers, a supplier’s actual energy costs depend on its own forward purchasing strategy—how much gas and electricity it has bought to cover customer requirements at different times. In the more volatile gas market we have witnessed, with wholesale gas prices rising by around 40% to 60% over the last year (depending on the time period measured), forward purchasing strategies are likely to be an important determinant of cost.

77. A key decision a supplier makes in energy procurement is what proportion of the energy should be bought ahead (hedged) on the forward markets. If they don’t buy all of their customer’s energy requirements in advance they must buy them at day ahead or spot prices. Hedging reduces suppliers’ exposure to the

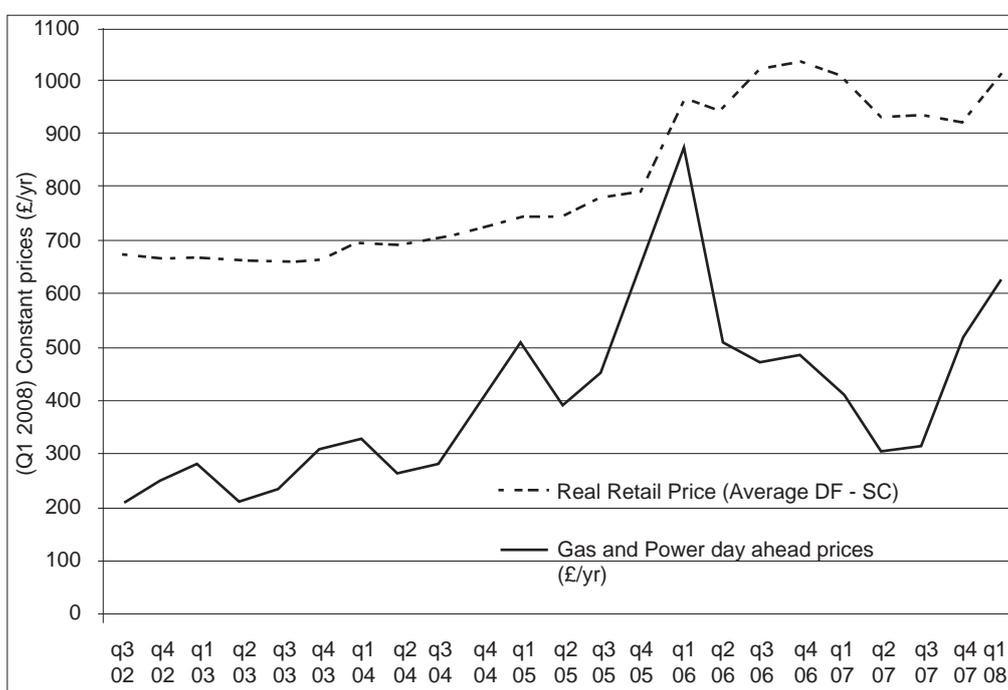
volatility of day ahead and spot prices. But it also leaves suppliers in a less flexible position, and more reliant on their forecasts for their customer numbers and their customer demand being accurate. The balance between hedging and buying at spot can impact heavily on the wholesale costs faced by a supplier.

78. Britain has faced increased exposure to global markets (from increased supplies being sourced through new infrastructure connections with Norway and the Netherlands) at a time when wholesale energy prices have increased significantly. The rise in energy prices means that the spread of different wholesale energy prices faced by a supplier also increases. Some suppliers are, therefore likely to be more effective at buying low cost than others.

79. Figure 17 shows the correlation between the average annual dual fuel standard credit tariff (the red line) and the wholesale day-ahead energy price for an average domestic consumer's annual consumption³²² (the green line). Wholesale energy costs are only one part of the costs faced by suppliers, but do represent around 70% of the total cost in the average 2007 domestic customer bill.

Figure 17

WHOLESALE AND RETAIL ENERGY PRICES, CONSTANT Q1 2008 PRICES



Source: Ofgem analysis, Heren and TheEnergyshop.com data

80. Wholesale prices rose between q2 2005 and q1 2006 and subsequently fell between q1 2006 and q2 2006. However, retail prices did not fall to the same extent as wholesale prices between q1 2006 and q2 2007. It is possible that this relationship results from a combination of factors affecting suppliers. These factors might include: (i) increases in environmental costs, (ii) increases in charges to maintain the network, and (iii) heightened price uncertainty in the European and global energy markets going forward—such uncertainty could be manifesting itself in an aversion, on the part of retail suppliers, to pass through price falls in the short term, because the risk of short term prices increasing again might be deemed to be high.³²³

Q5. The interaction between the GB and European energy markets

81. The interaction between GB and European markets has increased significantly in the last few years. The declining production of the UK continental shelf, the advent of new supply infrastructure from Norwegian fields, and a new import pipeline from the Netherlands³²⁴ mean that the UK is becoming increasingly exposed to European energy markets.

82. In this section, we examine the behaviour of GB gas and electricity prices and infrastructure connections with Europe, as well as providing an overview of the European energy market.

³²² The weighted average of day ahead gas and power prices.

³²³ The increased volatility of global commodity prices (not least of which is crude oil rising to \$100 barrel) is likely to be a good indicator of increased uncertainty.

³²⁴ The BBL pipeline entered commission in late 2006 and provided around 7% of UK gas supply in the calendar year 2007. See chart in Q2—BBL pipeline.

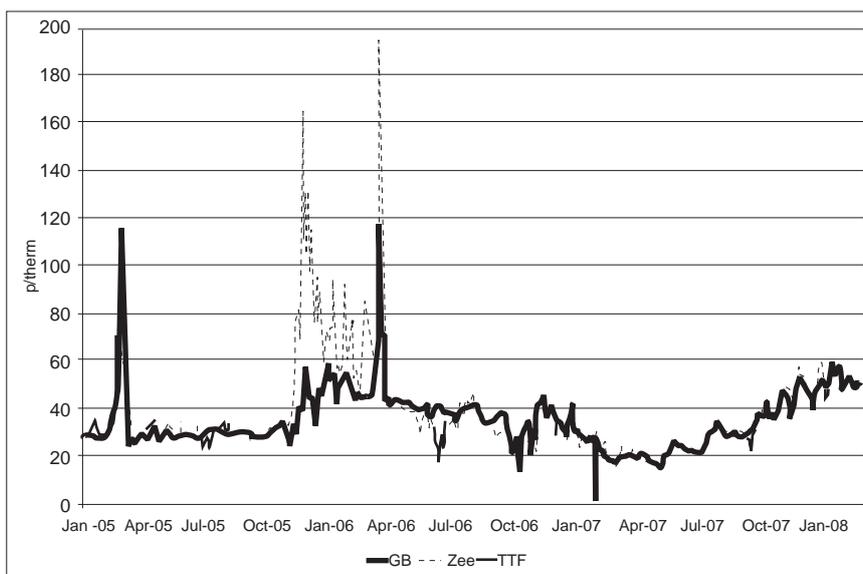
Gas: price differentials and infrastructure flows

83. GB gas supply infrastructure with the continent consists of two major interconnectors, BBL³²⁵ (flowing from the Netherlands to GB) and IUK³²⁶ (flowing in both directions, to and from Belgium to GB). In addition to this there are a number of pipelines supplying gas from UK and Norwegian gas fields.

84. Figure 18 shows the correlation between day ahead gas prices in Britain, Zeebrugge in Belgium and the Title Transfer Facility (TTF), a gas trading hub based in the Netherlands. It is clear that apart from a relatively short period around January 2006, there is a strong price correlation. This is likely to be due in part to the commissioning of the BBL pipeline in late 2006.

Figure 18

GB, ZEE AND TTF DAY AHEAD PRICES



Source: Bloomberg

85. On examination of Figure 19 (showing IUK exports from GB to Belgium and BBL flows from the Netherlands to GB) there is some evidence that IUK flows respond to price differentials between GB and Belgium. Broadly, where the Belgian price is higher, flows to Belgium increase, and where the GB price is higher, flows switch to GB. This is consistent with the reasonable price correlation observed (particularly from January 2007 onwards) between GB, Belgium and the Netherlands in Figure 18.

86. BBL is a one way pipeline between the Netherlands and GB, and is generally used by UK suppliers for sourcing gas under longer term contract. Since, flows are only one way it is not possible for the BBL pipeline to respond in the same way as the IUK interconnector, although some price driven behaviour may be observed—for instance a drop off of flows between September and October 2007.

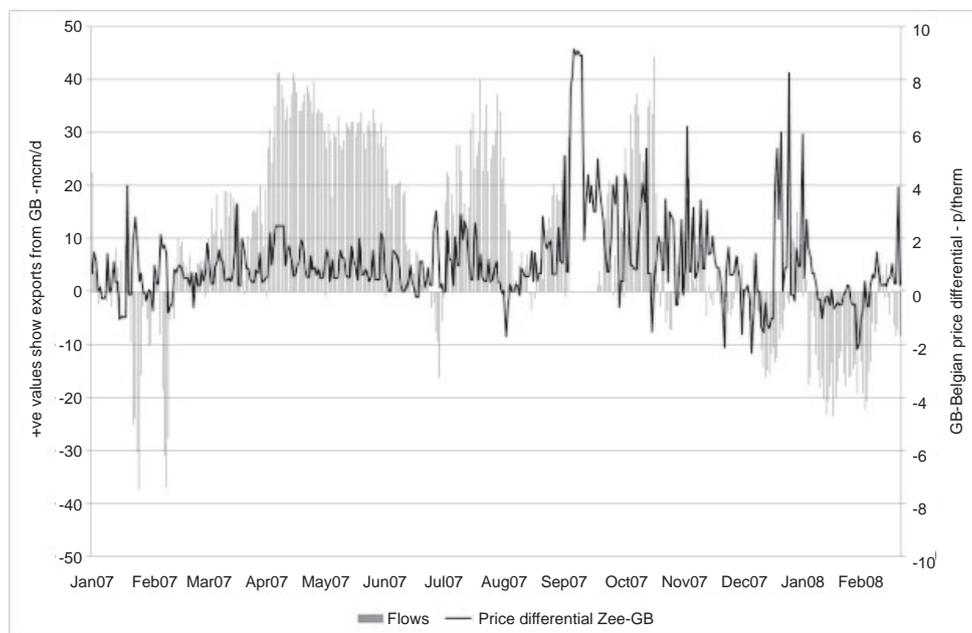
³²⁵ Bacton Balgzand Line (BBL) entered commission in Q3 2006.

³²⁶ Interconnector UK (IUK).

Figure 19

IUK AND BBL FLOWS AND PRICES

IUK EXPORTS FROM GB



BBL FLOWS



Sources: Bloomberg, National Grid.

87. It is noteworthy, however, that the depth of the short term markets in the Netherlands and Belgium is very limited in comparison with the GB market. The vast majority of European gas is traded on long term (oil indexed) contracts. Consequently, only a small share of European supply is sourced from the Belgian and Dutch markets, meaning the large GB wholesale market heavily influences day-ahead Belgian and Dutch prices. The prices European energy suppliers actually face are relatively opaque.

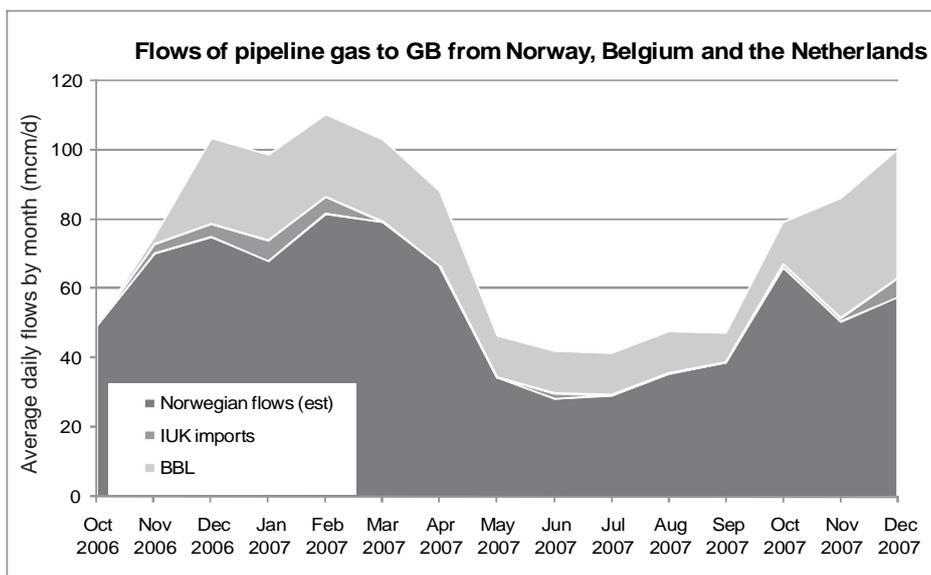
88. In relation to flows from Norwegian gas fields, we initially observe a reduction in flows to the UK in winter 2007 compared to the previous winter, while at the same time flows to the continent increased. Although GB gas supplies have been adequate this winter, this fall may initially seem of concern.

89. One possible explanation for this drop in early winter is that the GB market is receiving this gas via BBL instead. It is clear from Figure 20 below that GB received around 10–15 million cubic metres (mcm) per day more through BBL this winter (November and December 2007) than last winter. It is also clear that the significant fall off in Norwegian flows to GB in the last week of October 2007 coincides closely with the ramp up of BBL (approx 25 mcm/day). In addition to Norwegian gas the BBL pipeline can be used to source flows from and through Germany and Belgium.

90. Another explanation for the drop off in flow to GB in October/November could be a combination of production outages at Norwegian fields, (eg Njord, Kviteebjorn, Ormen Lange) and continental buyers exercising flexible terms in their contracts to increase their supplies. For instance, figure 20 shows a year on year fall in flows to GB and an increase in flows to Germany, France and Belgium from October/November onwards.

Figure 20

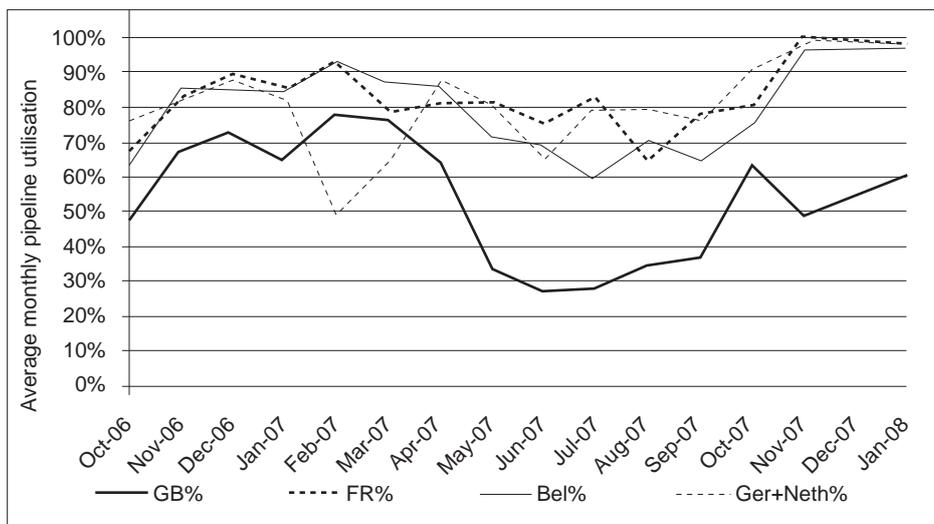
NORWEGIAN, IUK AND BBL IMPORTS



Source: Bloomberg, National Grid

Figure 21

AVERAGE MONTHLY PIPELINE UTILISATION



Source: Ofgem analysis. NPD, Fluxys, GRTgaz, and National Grid data

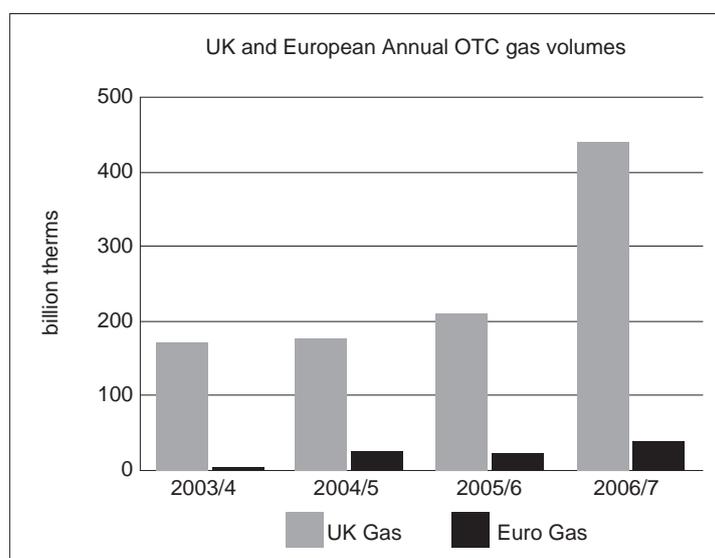
UK-European gas liquidity

91. Trading in the UK gas market is significantly higher when compared to European markets in recent years, the open market for wholesale gas in GB is the most mature energy market in Europe, both in terms of traded volume and value. Greater market liquidity is generally thought to increase market efficiency, and as such is generally accepted as a feature of a well functioning market. As shown in Table 10, the volume trade on the GB gas market has increased rapidly, year-on-year (YoY) between 2005/06 and 2006–07 the volume of trade rose 109%, and the value of trade on market increased by 24%.

92. Figure 22 showing GB and European gas trading statistics from the FSA illustrate that the volume of gas traded on the open market in GB is significantly greater than that traded on the European open market.

Figure 22

GB-EUROPEAN ANNUAL GAS TRADING VOLUMES (OVER-THE-COUNTER)



Source: FSA

Lack of liberalisation and transparency in euro market

93. The lack of effective gas market liberalisation on the continent means that the GB market is unlikely to get the full benefits of gas producers and suppliers seeking out the most attractive destination for their gas and supplying gas to GB at times when our market has relatively high prices. Related to this point is the fact that European gas markets are far less transparent than the GB market. This can make it difficult for market participants to assess where Norwegian flows are going and to track movements in customer demand on a daily basis. This uncertainty is likely to add to the daily and within day volatility of GB spot prices, increasing prices and the risk premium that customers need to pay to fix prices.

Euro gas contracts oil indexed

94. A feature of the less liberalised continental gas market is that contract gas prices are generally linked to oil prices through pricing formulas meaning that contract gas prices adjust to oil prices with a lag. Oil prices have increased over the last year to over \$100/barrel. This means that European buyers can take the opportunity to arbitrage their long term contract gas price against the spot gas price using the flexibility they have to vary the volumes they take under contract. It also means that European gas prices rise to higher levels than gas supply and demand fundamentals might suggest they should, which in turn means that GB prices have to be higher to attract marginal gas supplies for domestic consumption.

95. European long term contract prices move with changes in the oil prices with a lag of around six to nine months. Therefore, we expect the high sustained oil price to continue to be a factor behind high UK and European gas prices looking forward.

Electricity

96. The GB electricity market is heavily influenced by international coal and gas prices, as shown in Figure 6, 38% and 37% respectively, of GB power generation is fuelled from these fuel sources. In addition to a 2 gigawatt interconnector with France,³²⁷ the remainder of GB generation is from nuclear, oil, and renewable sources.

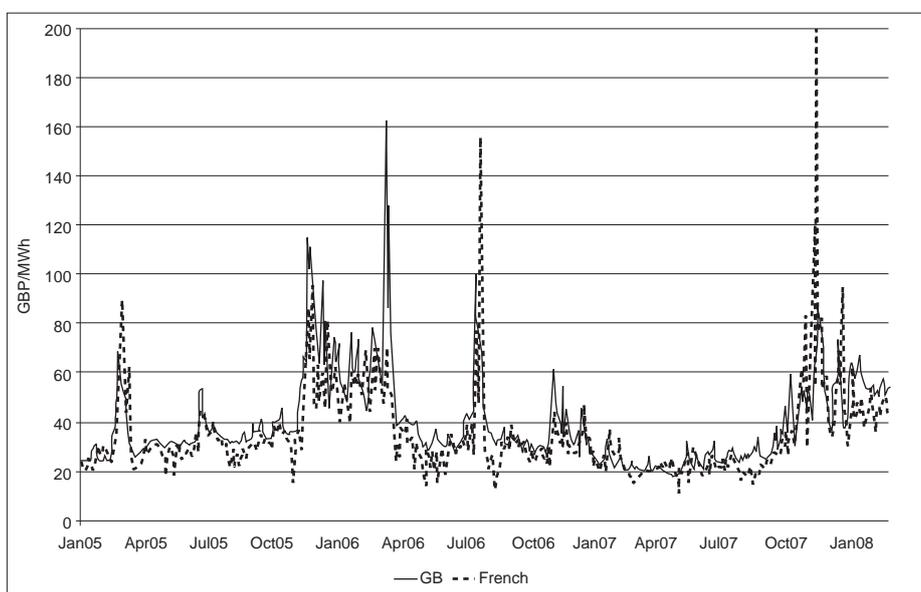
GB-France power price correlation

97. Figure 23 below shows the correlation between GB and French electricity prices. Detailed Ofgem and National Grid analysis suggest there is strong evidence that the interconnector is functioning well, and responding as expected to price differentials.

98. Taking into account the limited 2GW capacity, the GB and French power prices show a strong correlation. More recently the spike in prices in December 2007 saw French power reach above £200³²⁸ and GB prices peak at around £93.

Figure 23

GB AND FRENCH ELECTRICITY PRICES



Source: Bloomberg

99. Overall, GB and French prices show a correlation, which has increased more recently as gas infrastructure and supply sources have become more interlinked.

Q6. *The effectiveness of regulatory oversight of the energy market*

100. Strong independent regulation has a key part to play in maintaining a well-functioning market. Companies want to know that the investment climate will remain stable and that they will not face unacceptable burdens—otherwise they may invest their money elsewhere. Customers want to know that if their supplier does not play by the rules, firm action will be taken and consumers will be protected. It is important to consider whether these challenges are being met.

101. Let us consider the customer perspective first. Markets are never perfect. Sometimes customers are treated unfairly and sometimes companies behave in an anti-competitive way. We have a range of powers at our disposal to deal with this activity and these can be considered across four main areas: our ongoing monitoring of the markets; the informal influence we can exercise through encouraging best practice and “naming and shaming” companies; the rules we place on suppliers in their licences; and the formal powers we can exercise under the Gas and Electricity Acts and competition law.

102. Monitoring the market: We conduct surveillance into the retail and the wholesale energy markets, analysing prices, supply, demand and market activity, plus more specialised analysis of individual areas eg quantitative analysis of the relationship between wholesale and retail prices. This constant market monitoring can bring problems to light and lead to action under our powers below.

³²⁷ UK peak demand recorded in 2002 was 61.7 GW—source: DTI.

³²⁸ French peak thought to be driven by French power station outages due to strikes.

103. Naming and shaming: In 2007 we “named and shamed” two suppliers—EDF Energy and Scottish Power—who had not passed through falling wholesale prices to their customers. Within days they had announced retail price cuts for their customers. In June 2007, we singled out Npower and British Gas for their prepayment meter (PPM) tariffs relative to other suppliers urging customers on these tariffs to consider switching away. In February 2008, we named and shamed Npower for not doing as much as other suppliers to help customers in debt.

104. Placing obligations in suppliers’ licences: In our 2007 supply licence review we lifted certain conditions which were either redundant or no longer required given other protections, to help promote new entry and the development of new tariffs and services. For vulnerable customers however we strengthened the range of protections. For example, we have extended a ban on gas suppliers from disconnecting older customers over the winter to electricity suppliers. New obligations now require the timely recalibration of prepayment meters after a price change, following earlier intervention by Ofgem and guidelines to bring three suppliers into line. We have maintained requirements in the licence on suppliers to provide a full range of payment options to suit customers’ needs. We have broadened the requirements on suppliers to provide information to customers on the dangers of carbon monoxide poisoning and the benefits of fitting carbon monoxide alarms. This is in addition to the existing requirement to provide free gas safety checks for pensioners in receipt of certain benefits.

105. Using powers under energy and competition legislation: Ofgem has a range of powers under the Gas and Electricity Acts and under the Competition and Enterprise Acts. We have used these to good effect to help make the market work better for customers. We have in the past taken action against suppliers for mis-selling and for blocking customer transfers, including the imposition of a £2 million fine. More recently we have used the Competition Act to tackle anti-competitive behaviour by National Grid in the gas metering market which has harmed competition and consumers. Our investigation resulted, in February 2008, in the imposition of a £41.6 million fine—the biggest ever fine for this type of competition law breach. The Enterprise Act gives us powers to refer the market to the Competition Commission, and to gather detailed financial information from the companies we regulate. It also gives the Office of Fair Trading (OFT) the power to prosecute individuals who engage in cartels. We have drawn on some of these powers in the past, during the wide-ranging wholesale market probe in 2004–05, and we are currently making use of them again as part of our investigation into the energy supply markets.

106. Although we have not seen conclusive evidence that the market is failing, we know that customer confidence is vital in order for a market to function well—and it is clear in this case that customer confidence has been damaged. Our investigation into the energy supply markets, announced on 21 February, will look at whether the market is working well for all consumers—and not just particular groups such as those who are on the cheapest online deals.

107. We expect to publish our initial findings before the end of September. If we conclude that further action is required, this could take several forms. For example, we could refer the market to the Competition Commission for another investigation or we could take more immediate action under our existing powers eg investigating and imposing penalties on companies that have broken competition law; changing the licences under which all companies in the energy market have to operate; recommending legislative changes to the government; or campaigning to promote customer awareness and participation in the market.

108. If anyone has any evidence of anti-competitive behaviour, we urge them to bring it to us. We will not hesitate to use our powers to investigate and, if necessary, impose penalties on any energy company that has been found to have broken competition law.

109. From the companies’ perspective, Britain’s stable regulatory regime has proved attractive to investors. Between privatisation and 2006 over £80 billion has been invested in new oil and gas production from the North Sea; over £30 billion in the gas and electricity networks; and £14 billion in new electricity generation stations and in refurbishing coal fired stations to create a more diverse generating mix. This is clearly good for energy companies—and it is good for consumers too. Britain’s domestic gas supplies are declining faster than expected and we have ambitious targets for renewable energy. In order to secure our energy supplies and protect the environment, therefore, unprecedented levels of investment are required. In addition, where new players enter the market, competition increases and customers benefit from greater choice.

110. We must therefore maintain a stable regulatory regime which gives investors confidence and removes unnecessary administrative burdens, whilst being prepared to boost consumer protection where it is necessary and proportionate. In the energy supply markets, Ofgem is working to tackle barriers to entry and give more choice to customers. In 2007 we cut the energy supply licence from 160 pages to 60 pages, removing barriers to entry like the “28 day rule” which many saw as preventing suppliers from offering long term energy services such as the installation of household electricity generation or measures to improve energy efficiency. We also amended the rules to make it easier for suppliers to install smart meters which have the potential to help cut emissions and improve the accuracy of customer bills. All these steps help to encourage investment in the market.

111. Overall we believe that our work is helping to support the operation of the market whilst providing customer protection where necessary.

Q7. Progress in reducing fuel poverty and the appropriate policy instruments for doing so

112. A household is considered to be in fuel poverty when it spends more than 10% of its income on gas and electricity. Three main factors are responsible: high energy prices, low incomes and poor housing.

113. The number of customers living in fuel poverty declined steadily between 1996 and 2003, with little movement in overall figures in 2004. These reductions resulted from a combination of improvements to income (such as the new pension credit arrangements), improved energy efficiency (primarily through the Energy Efficiency Commitment and Government funded fuel poverty schemes such as the Warm Front and its counterparts in Scotland and Wales) and reductions in energy prices. The Government estimates that nearly three quarters of the reduction in fuel poverty numbers in England between 1996 and 2005 was as a result of improvements to incomes, 20% was due to improving energy efficiency and only 5% was due to falling fuel prices.³²⁹ In Scotland, half of the reduction in fuel poverty between 1996 and 2002 was attributed to rising incomes, 35% to falling fuel prices and 15% to improvements in energy efficiency.³³⁰

114. However, the number of households in fuel poverty has risen in the last three years as a result of electricity and gas price increases. Current estimates suggest that there were over 4 million households in fuel poverty in the UK in 2006.³³¹ Ofgem is committed to doing all it can to ensure prices are no higher than they need to be. However, prices are unlikely to return to the lower levels of the 1990s because of rising global energy demand and higher commodity prices. An enduring and sustainable solution to fuel poverty will, therefore, need to focus on the issues of housing and incomes which are principally for Government to address.

Housing

115. Significant strides have been made to improve the energy efficiency of housing and to install cost effective heating systems through the Decent Homes standard, the Warm Front programme and the Energy Efficiency Commitment. However, Warm Front is focussed on private sector housing. Social housing, on the other hand, is covered by the Decent Homes Standard and this provides for lower standards of thermal comfort.³³²

116. We encourage Government to take a “find and fix” approach, to ensure that when someone is identified as being in fuel poverty a comprehensive solution is provided to help lift them out. Joined-up action across Government is therefore essential. For example, we would encourage data sharing between the Department for Work and Pensions, the EAGA Partnership and energy suppliers to improve the targeting of the help available. In addition, consideration could be given to extending Warm Front so that customers are also referred to their supplier for tariff advice or to go onto their social tariff, where applicable.

Incomes

117. In addition, Government should stay focussed on the vital role of the tax and benefit system in raising incomes. Benefit entitlement checks can help ensure vulnerable customers are getting their fair share of the millions of pounds of unclaimed benefits. Government could also review the Winter Fuel Payment and refocus the payments on those who need them the most. Furthermore, additional funding for fuel poverty programmes could be made available by recycling revenues from environmental schemes. For example, Ofgem identified a windfall to electricity generators of up to £9 billion of permits which are allocated for free under Phase II of the European Emissions Trading Scheme (EU ETS) from 2008 to 2012. This windfall could be used to help customers in fuel poverty. If Government were to auction allowances for the following phase of EU ETS, some of the revenue generated from this could also be used to fund further measures to help tackle fuel poverty and environmental improvements—as recommended by Ofgem in our submission to the Government’s 2006 Energy Review.

Prices

118. On prices, vulnerable customers can make big savings if they are in a position to switch supplier or payment method and if the support available from Government and suppliers is better targeted. Customers who have never switched supplier can make big savings by switching. On average, across all regions, switching savings amount to £125 for a PPM customer, £93 for a standard credit customer and £56 for a direct debit customer.

³²⁹ *The UK Fuel Poverty Strategy, 5th Annual Progress Report* (2007).

³³⁰ *Scottish Household Condition Survey* (2002).

³³¹ Ofgem estimates based on Government’s Energy Review Report—July 2006 (projected figures for 2005 and 2006).

³³² The Warm Front scheme sets a target SAP rating of 65 for properties benefiting from remedial works. The Decent Homes Standard requires a SAP rating of greater than 35.

119. As well as savings available from switching payment method and supplier, a number of suppliers offer special discounted tariffs and packages to vulnerable customers that meet certain criteria (such as those in receipt of government benefits). Ofgem published two reports in 2007 in order to “shine a light” on suppliers’ social measures, encourage best practice and inform consumer agencies of the range of assistance available.

120. Ofgem, along with other agencies, works to help improve consumer awareness of these choices and to help vulnerable customers access the benefits of the competitive energy market. For example, Sir John Mogg chairs Ofgem’s Social Action Strategy Review Group and will host an Ofgem Fuel Poverty summit in April. This Summit will focus on identifying ways to ensure that vulnerable customers are able to take full advantage of the savings available by switching supplier. Where switching is difficult or not possible, we will look at what other help may be available to reduce the amount customers have to pay for their fuel.

121. We are also working with Citizens Advice to develop and launch a pilot programme to help educate low income and hard to reach customers on how to make better choices in the energy market. If the evaluation of this pilot proves successful, we are hoping that the Government will consider funding a national rollout of this programme.

122. As part of Ofgem’s energy supply markets probe, referred to above, we are focussing in particular on whether competition is benefiting all customers. This includes those who pay by PPM and Standard Credit, given the concern about the differentials between these tariffs and Direct Debit. In addition, we will look at whether there are any immediate actions we can take in this area to improve consumer awareness of the options available. Furthermore, we are looking to tackle any barriers that unreasonably prevent customers switching supplier. This work includes a review of suppliers’ policies on blocking customers who are in debt from switching.

123. Given the challenge of targeting help, we would recommend that the Government keeps up the “Winter Initiative”: a practical way to improve targeting, using Department of Work and Pensions (DWP) data, of suppliers’ social measures as well as the energy efficiency help available from the Government under the Warm Front scheme and the suppliers through the Carbon Emissions Reduction Target. Ofgem led the first such initiative in winter 2006–07. The Government should also consider how it could facilitate data sharing between the DWP, HM Revenue and Customs and energy suppliers to improve the targeting of their social programmes to assist those who need them most.

124. I hope that this information and analysis is useful to the Committee. If Members have any further questions, my colleagues and I would be happy to explore these issues in more detail, either in oral evidence or in a supplementary memorandum.

1 April 2008

Further supplementary memorandum submitted by the Office of Gas and Electricity Markets (Ofgem)

1. On 17 June 2008 Ofgem’s Chief Executive, Alistair Buchanan, and Managing Director of Markets, Andrew Wright, gave oral evidence to the Business and Enterprise Select Committee. There are several issues on which we thought it would be helpful to provide the Committee with further information.

INVESTIGATING THE WHOLESALE ENERGY MARKETS

2. We can assure the Committee that our decision to launch a probe into the energy supply markets neither precludes us from investigating the wholesale markets nor stops our ongoing monitoring.

3. The background to our announcement of February 2008, which focused principally on the downstream supply market, was of rising customer concern about bills. When we met the Chancellor in the previous month, only one major supplier had raised its prices. A month later five of the six had done so, and the spread between the offers available to customers had narrowed significantly. In addition, the differentials between the tariffs for different payment methods had been rising. Our view was that the level of customer concern about this behaviour in the retail market justified investigation.

4. At the same time, our eye remains very firmly on the position in the wholesale markets. Current work in that area includes:

- an investigation into Scottish Power and Scottish and Southern Energy, focusing specifically on allegations of uncompetitive behaviour in the upstream generation market;
- examining the relationship between wholesale and retail energy prices as part of our current supply markets probe;
- the impact of vertical integration on energy supply markets is also being covered in the probe; and
- we have also recently published National Grid’s latest winter outlook report, analysing the outlook for security of supply in gas and electricity this winter.

5. This work will continue and, should we receive any evidence of anti-competitive behaviour in the wholesale markets, we will not hesitate to investigate that information very thoroughly.

LIQUIDITY IN THE WHOLESALE GAS MARKET

6. The Committee requested our views on the figure cited by energywatch in their evidence that “80% or so of all of the gas coming in is covered by these mysterious [off-market] contracts and we do not know whether there are restrictive clauses.”³³³ Energywatch have now advised us that this figure is not correct. Furthermore, their revised assessment of 70% is based on a report by Global Insight from 2005 which is now out of date.

GB WHOLESALE GAS MARKET LIQUIDITY

7. As we explained in our oral submission, liquidity in the GB gas wholesale market is significantly higher than in other European markets. This makes the GB market the most liquid in Europe by some distance. (See Chart 1 for more information.) Information from a range of sources suggests that the level of gas made available to the market is significantly higher than the 20% suggested by energywatch in their oral evidence, since revised by them to 30%.

- Gas market liquidity has increased steadily since 1996, with 11,000TWh of gas traded in 2007–08 up from 7,329TWh in 2006–07. (The volume in April 2008 alone was 1,253TWh). The current gas churn ratio (the total level of gas trading divided by actual throughput) is almost 11, meaning that on average each unit of gas is traded 11 times before delivery. This figure includes all reported trades to National Grid and includes products for delivery in under a few months (known as the prompt) and those for delivery further in advance (the forward market).³³⁴ In comparison, the Nordic power market has a churn of 10 whilst oil churn is around 18.
- Figures from National Grid indicate that 60 to 70% of total gas physically delivered is in fact visible to the market, ie it is traded via the National Balancing Point (NBP). This is up from just 20% in 2000. National Grid’s figures are based on all trades registered on NG’s systems for daily balancing, BP, Shell and ExxonMobil have confirmed (as part of their evidence to the Committee) that around 60% of their gas is not tied up under long term contracts but is sold into the market.

8. Ofgem investigated the wholesale gas market in 2004. As part of that probe we examined whether any of the long term contractual arrangements for the supply of gas from the North Sea were restrictive or capable of withholding gas from the market. We only found concerns that justified further investigation with one set of contracts relating to the Sean field. We concluded, after a thorough investigation that these contracts were not problematic. All of our analysis and the reasons for our conclusions were published in a series of detailed reports. Given the decline in North Sea production and the size of new fields that have been commissioned since that report we doubt if any new contracts signed since 2004 would be likely to have restrictive features or be capable of having a significant impact on the GB gas market. The most significant long term contracts signed since then have been related to imported gas through the major new import infrastructure, such as the Langeled pipeline from Norway and the Bacton-Balgzand (BBL) pipeline from the Netherlands. The existence of these long term contracts relating to Norwegian supplies and supplies through BBL are in the public domain and were announced by the relevant companies as part of their financial reporting when signed.

9. The majority of these new infrastructure projects have applied for and been granted an exemption from the requirements to offer third party access. As part of the process for determining whether an exemption should be granted, Ofgem takes into consideration the allocation of capacity, including where this is done on a long term basis, to determine whether it will have a detrimental impact on competition. In addition, the exemption application and all supporting analysis is provided to the European Commission which is able to review and has final sign-off on many exemption applications.

10. The European Commission also carried out its own detailed sector inquiry into both the gas and electricity markets across Europe and requested detailed information on all of the long term contracts in place. The Commission’s report highlighted a number of concerns with the effects of these contracts in a number of continental European gas markets but did not directly raise any specific concerns about their effects in the GB market.

11. As a result, we have no evidence or grounds to be concerned about the effects of existing restrictive long term contracts to the GB market.

12. In addition, long term contracts can and do have an important role to play in helping to maintain security of supply. Long term contracts may be necessary to support substantial investment in new infrastructure necessary to bring imported gas to the GB market and to promote security of supply. In assessing the impact of long term contracts, it is important to assess the terms of the contracts and to determine whether downstream companies are able to compete effectively to sign them. If the contracts do not prevent re-sale of the gas to other suppliers and are not indexed to commodities such as oil, then there is no reason to assume that they will have any detrimental effects on the market. In fact, they are likely to

³³³ Response to Q 277.

³³⁴ The trades included in the churn figure are all trades for the month of gas flow and not the month of the trade.

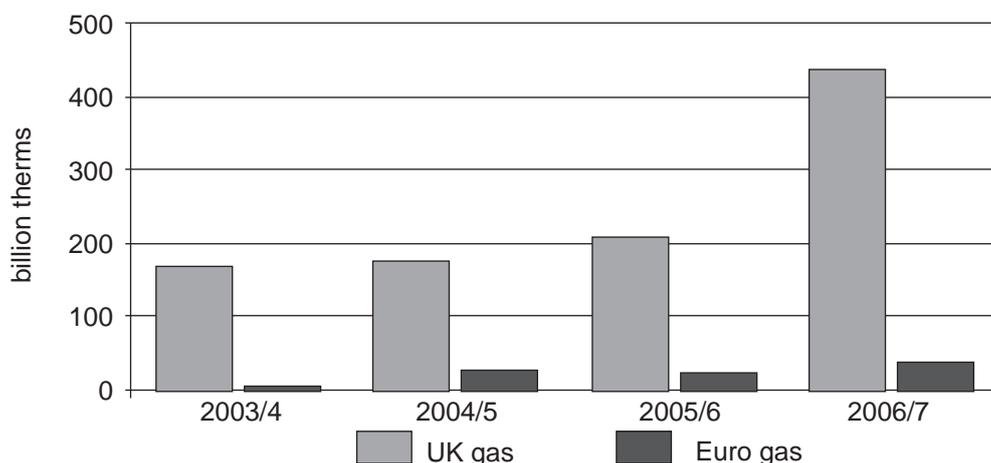
have a positive impact on both competition and security of supply. Most of the existing North Sea long term contracts, and the new import contracts, index the delivered price of gas to the spot price of gas. This helps make sure that the price under the contract rises and falls in line with changes in demand and supply.

13. For these reasons, we have focused on whether spot gas markets are competitive and liquid. We also undertake routine market surveillance to make sure that any change in price in the spot market can be explained by changes in demand and supply. We see this as a more useful measure of whether the market is competitive than the share of long term contracts. However, we would have concerns if long term arrangements had an impact on liquidity in wholesale markets and we will not hesitate to investigate any evidence of anti-competitive behaviour.

14. Trading in gas is focused on the prompt, rather than the forward market. A similar issue is found in the forward market for oil, a commodity for which the market is commonly thought of as liquid. Bank of England research suggests that liquidity in oil further out on the forward curve is very low compared with the prompt.³³⁵ We have seen some increase in forward trading in gas. This increase in trading has occurred on exchanges as well as over the counter (OTC)³³⁶ as can be seen in Charts 3 and 4.

15. Contracts need two parties and since our appearance before the Committee both Major Energy Users Council (MEUC) and Ineos Chlor have confirmed to us that they will be submitting additional information to you. This broadly confirms our oral submission on the spot/short term purchasing habits of the large users. They will outline their reasons for this strategy, but it has been confirmed to us by a number of larger purchasers that Stock Market considerations are a key factor behind this.

Chart 1: GB and European gas traded volumes

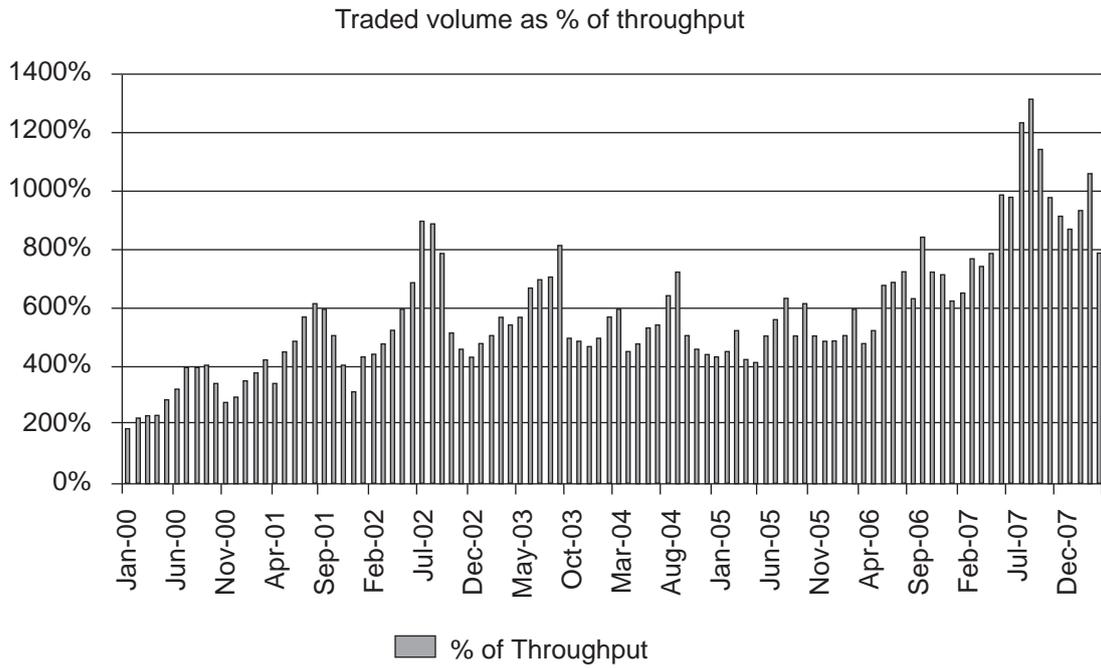


Source: Financial Services Authority

³³⁵ <http://www.bankofengland.co.uk/publications/quarterlybulletin/qb060105.pdf>

³³⁶ OTC trading describes trading of financial instruments such as commodities directly between two parties and can be conducted via a number of routes including over the phone and via net. In contrast exchange based trading takes place at one physical location. Exchanges are organised to provide "trading" facilities for brokers and traders for example clearing services.

Chart 2: Total monthly traded volume as a percentage of gas throughput (churn)



Source: National Grid

Chart 3: Exchange based trading by product

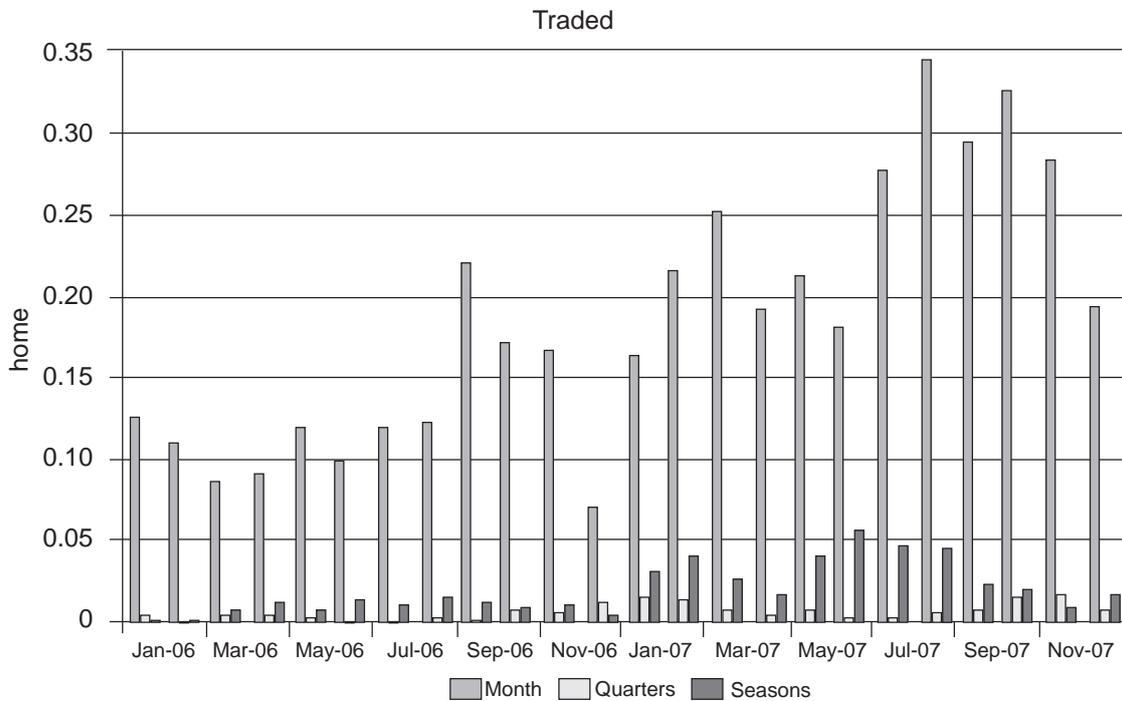
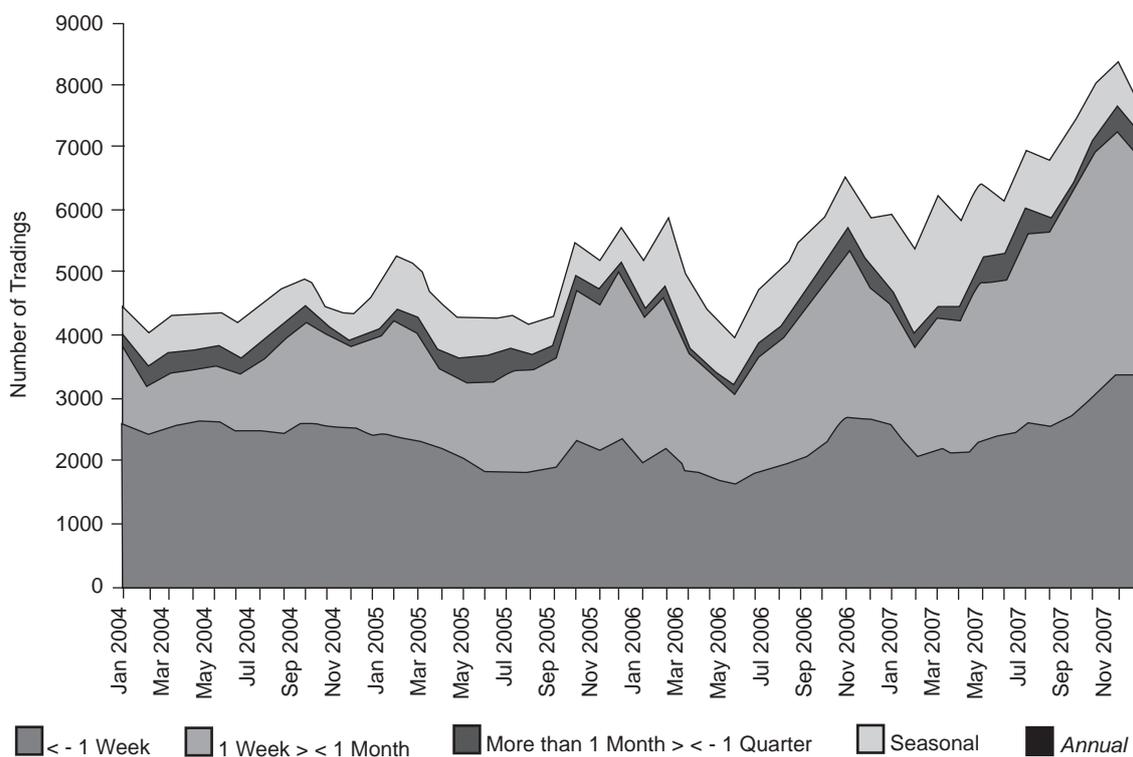


Chart 4: OTC trading on Spectron (smoothed to eliminate seasonality)



Source: Spectrum

GB WHOLESALE ELECTRICITY MARKET LIQUIDITY

16. The wholesale market for electricity is considerably less liquid than that for gas. The estimated value of electricity traded over the counter in 2006–07 was £31 billion.³³⁷ This represents an increase of £1 billion, roughly 3%, on the previous year. Total traded electricity—including both OTC and exchange—is around two to three times the total physical delivery. This is low compared with other commodity markets such as gas, where total traded volume is roughly 11 times the total physically delivery. In addition, trading in electricity is very heavily weighted towards products on the prompt rather than the forward market.

17. In the oral evidence session on 24 June, Members expressed interest in comments by some witnesses who said they still trade heavily in the market despite being vertically integrated. It is worth noting that a vertically integrated company may still trade extensively on the open market, partly to hedge its position but also to speculate on the price of power, and so its total volume traded may be close to its total physical generation.

18. One factor that may inhibit liquidity in the wholesale electricity market is the current operation of the “cash out” arrangements. These denote the commercial incentive on generators and suppliers to balance their contractual and physical positions at any given time, thus helping National Grid to balance supply and demand and maintain security of supply. Parties who are not in balance incur charges that are designed to reflect the costs incurred by National Grid in dealing with any imbalance. The charges are known as cash out prices. We have conducted a review of the cash out arrangements and our impact assessment suggested that the current cash out prices often do not reflect supply and demand conditions and prices can be too high when the system is not under stress. This creates additional risk for the parties involved and may reduce the role that financial institutions such as banks and companies without generation or supply businesses could play in trading electricity and improving liquidity. There are currently two proposed changes to the rules that are being developed through the industry’s governance process. These proposals will shortly come to Ofgem for a decision.

³³⁷ Not £31 million as stated in Table 11 of our written submission.

 GAS STORAGE CAPACITY

19. As we outlined in our oral submission most European countries have significantly more storage than the UK and this needs to be seen in the context of their indigenous production. The British market is in a period of transition as, until recently, we were self-sufficient in gas. Large swing fields in the North Sea were capable of significantly ramping up production either between seasons or—in the case of fields such as Morecambe and Sean—within day.³³⁸ This meant there was less need for storage to cope with supply shocks and the seasonal pattern of demand. Britain also had a large fleet of gas fired power stations that were capable of running on back up fuel and the ability to switch between gas and coal generation. This provides a significant source of “virtual” storage as was seen in the winter of 2004–05. Gas production from the North Sea has been declining in recent years and therefore the commercial rationale for storage has become much stronger. This has been reflected in the significant increase in the price of capacity at existing storage facilities.

20. Current investment in storage—which is not limited to the existing main energy suppliers—suggests that the incentives to invest in storage are strong. Customers want a reliable and continuous supply, and suppliers have strong market incentives to meet their contractual supply obligations. Therefore, they are willing to pay for storage to meet the uncertainty of very high demand periods. In addition, the fact that there is demand for storage means that companies can make sufficient returns to justify investing in new facilities. We can see this happening in practice. Major investments in new storage facilities are planned by energy companies, including Scottish and Southern Energy and E.ON, and by companies who are not existing energy suppliers. For example, Statoil and Ineos Chlor are both investing in storage. A list of proposed and under construction gas storage facilities can be found in Annex 1, Table 1. If all the above projects are completed, our gas storage capacity will double by 2010.

21. However, the planning regime remains a major barrier. For example, Canatxx want to build a large facility in Fleetwood, Lancashire, that would store 1,660 million cubic meters (mcm) of gas—but it has been blocked by the local planning authority. At a minimum this will delay the commissioning of a significant new storage facility by at least two years from 2010–12. Furthermore, it sends a damaging signal to all companies wanting to invest in storage in the UK. Developers have to incur substantial costs in getting to the stage of making an application; the length of time it can then take to get a final decision makes the case for investment in storage much less compelling.

22. One witness has suggested that an additional blockage could be the regime for gaining access to the gas transmission system. This is not the case. The arrangements for access to the gas system are relatively simple and any new user, including storage sites, can secure access to the system by using the annual long term or shorter term capacity auctions. Once they have agreed contracts to secure capacity rights, they are entitled to compensation if National Grid does not deliver the capacity. A number of storage sites, including Aldbrough, have used this mechanism, secured rights and connected to the system. Canatxx also used this mechanism to secure access to the system for their planned facility from 2010 and secured long term rights for the next 20 years.

23. An additional facility at Hornsea bought capacity in the September 2006 auctions that commence in January 2010 when it will be ready to enter commercial operation.

24. It is important to emphasise that there are strong commercial incentives to invest in storage and companies are ready and willing to invest. The major barrier remains the planning regime.

ISLE OF GRAIN LNG IMPORT TERMINAL

25. National Grid opened a Liquefied Natural Gas (LNG) import terminal at the Isle of Grain in July 2005. BP entered into a contract to secure half of the slots and Sonatrach the other half. In addition, the terminal has “use it or lose it” arrangements. These arrangements were part of a package of demands by Ofgem in return for the facility being exempted from directly regulated third party access. The “use it or lose it” arrangements allow other companies to gain access to the facility if it is not being used by the primary capacity holder (BP/Sonatrach). The current arrangements for the Isle of Grain facility are that if a slot is not going to be used it must be offered to the secondary market 10 days in advance, with an auction held seven days in advance.

26. Since February 2006, there have been 127 slots available for the importation of LNG. BP/Sonatrach have used 63 of those slots themselves. In accordance with the rules they have offered 64 for sale on the open market. None of the slots that have been offered to the secondary market has ever been bought. This assessment is consistent with National Grid’s figures which cover the period since the opening of the terminal in July 2005. NG state that, since July 2005, there have been 158 possible slots for cargoes to import LNG. Of those 158 slots, 74 have been used. In our oral submission we caused some confusion by only focusing on the 63, rather than the 64. We wish to clarify this and refer to the caveat we provided the committee in answer to question 545 in the Hansard transcript.

27. The above figures raise two obvious questions. Are the current arrangements for third-party access appropriate? Are there other reasons why more LNG is not being delivered?

³³⁸ This is likely to become more limited in the future.

28. In November 2007, Ofgem published an open letter requesting comments on the way that the “use it or lose it” arrangements at the Isle of Grain work. Of the responses received, none suggested that the current arrangements had ever prevented a cargo being brought into the terminal. Many of the respondents were companies who have purchased capacity at one of the future LNG terminals.

29. Concern has been expressed about the lack of LNG arriving at Grain during winter 2007–08, despite high spot gas prices, with only 11 of 32 slots being used. There are two important points to make. The first relates to the LNG market. The fact that more LNG did not come to Britain in that period can be explained by the higher prices on offer in other LNG importing countries. For example, demand and prices in Asia were much higher than spot prices in Britain at the NBP, reflecting nuclear outages in Japan and high demand from China and India. Most Asian countries have no alternative source of natural gas and will therefore pay whatever is needed to secure it. Closer to home, shortages in Spain and Turkey meant that any available cargoes in the Atlantic Basin went to these markets in preference to the UK.

30. Second, there was an alternative to the Isle of Grain if suppliers wanted to import LNG to the UK. Exceleerate now have a facility to import LNG through the Teesside terminal using special ships that can regasify LNG without the need for an onshore terminal. They are also able to transfer LNG from conventional tankers to their ships. No deliveries were made through this facility either, thus suggesting that it was not the lack of effective “use it or lose it” arrangements at the Isle of Grain that prevented more LNG arriving.

31. A large increase in UK LNG importation capacity is due for winter 2008–09. The Dragon and South Hook terminals at Milford Haven are expected to have a base-load delivery of 16mcm/day and 29 mcm/day respectively. In addition, the facility at the Isle of Grain is due to expand by 25mcm/day (phase two). The new capacity at the Isle of Grain will see a number of new capacity holders³³⁹ with primary rights to use the terminal. All these facilities are due to be in operation by Q4 2008. This will see much greater competition and availability of LNG import capacity in GB. As with last winter, however, there are uncertainties over the amount of LNG that will be attracted to the UK market if demand in Asia remains strong and prices in other markets remain above UK prices.

32. We would be pleased to answer any further questions, and to provide any additional information that the Committee may require.

June 2008

Annex 1

Table 1

OPERATIONAL STORAGE FACILITIES

Facility	Space (GWh)	Deliv. (GWh)	Start date	Capacity Holder
Rough	36,800 (max)	455	1985	Centrica (subject to Third Party Access)
Hornsea	3,496	195	1979	SSE (subject to Third Party Access)
Avonmouth	877	156	1978	NG
Dynevor Arms	303	49	1983	NG
Glenmavis	509	101	1975	NG
Partington	1,126	219	1972	NG
Hole House Phase 1	325	58	2007	EDF
Hatfield Moor	1,260	22	2002	Scottish Power
Humbly Grove	3,100	82	2005	Petronas

Table 2

POSSIBLE, PROPOSED AND UNDER CONSTRUCTION STORAGE FACILITIES

Facility	Space (GWh)	Deliv (GWh)	Proposed start date	Applicant
Aldbrough (completed)	4,550	421	2008	SSE/StatoilHydro
Hole House Phase 2 (under construction)	325	58	2009	EDF
Humbly Grove Expansion (under construction)	630	—	2008	Petronas
Holford (under construction)	1,758	175	2009–10	EON
Holford H165	50	75	?	EON
Aldbrough phase II	4,550	0–210	2013	SSE/StatoilHydro
Whitehill Farm	4,548	433	2012	EON

³³⁹ Centrica (3.4 billion cubic meters (bcm)), Gaz de France (3.3 bcm) and Sonatrach (1.9 bcm).

<i>Facility</i>	<i>Space (GWh)</i>	<i>Deliv (GWh)</i>	<i>Proposed start date</i>	<i>Applicant</i>
Stublach (under construction)	5,800	525	2013	GDF/Ineos
Caythorpe	3,000	120	Planning inquiry	Warwick Energy
Portland	10,830	216	2011–12	Portland Gas
Saltfleetby	7,650	85	Planning stage	Wingas/Gazprom
Gateway	12,775	305	Planning stage	Stag Energy
Esmond/Gordon	44,403	567	Planning stage	Petronas
Albury I	1,850	46	2011	Petronas
Welton I	2,520	63	2011	Petronas
Welton II	1,258	32	Planning stage	Petronas
Gainsborough	1,730	63	2011	Petronas
Bains	6,000	Unknown	2011–12	Centrica
Bletchingley	9,450	126	2012?	Petronas
Albury II	7,553	945	2012?	Petronas
British Salt	10,800	Unknown	After 2010	British Salt
Larne Lough	Unknown	Unknown	Planning stage	Portland Gas
Fleetwood 18,400	650	2010–delayed, planning refused	Canatxx	

Source: Ofgem.

25 June 2008

Further supplementary evidence submitted by Ofgem

I enclose our supplementary memorandum to the inquiry into energy prices.

As I mentioned last week to you I apologise once again for the inaccurate figure cited in our oral evidence and I won't hide behind the caveat I gave the Committee (in reply to Q 545 of the transcript). The accurate figures are shown in our follow-up memorandum to BEC.

There are two key points in our supplementary memorandum which I think it is particularly important to reinforce. The first is in regard to long-term contracts.

Energywatch claimed that 80% of gas entering Britain comes from off-market long-term contracts. Energywatch have now advised us that this figure is not correct. They have revised that figure to 70%. Even this figure is, in our view, inaccurate in that it is based on a report by Global Insight, which dates from 2005 and is itself now out of date. Indeed I believe that this admission from energywatch relating to the dubious quality of their evidence will upset many observers.

Secondly as we observed in our oral submission our assessment is that the GB wholesale gas market is the most liquid in Europe by some distance. This is supported by information from a range of sources, including the following:

- The current gas churn ratio (the total level of gas trading divided by actual throughput) is almost 11, meaning that, on average, each unit of gas is traded 11 times before delivery. This figure includes all reported trades to National Grid and includes products for delivery within a few months (known as the prompt) and those for delivery further in advance (the forward market). By way of comparison, the Nordic power market has a churn of 10.
- Figures from National Grid indicate that 60 to 70% of total gas physically delivered is in fact visible to the market, ie it is traded via the National Balancing Point (NBP). This is up from just 20% in 2000.
- BP, Shell and ExxonMobil each confirmed (as part of their evidence to the Committee) that around 60% of their gas is not reserved under long-term contracts but is sold into the market. Indeed at Ofgem's Annual Open Meeting (our AGM) last week Richard Guerrant confirmed that this figure for ExxonMobil is nearer 70%.

Contracts are not one-sided and in my evidence I spoke about the information provided to us with regard to the Industrial and Commercial Purchasing Customers. The Major Energy Users Council (MEUC) and Ineos Chlor have since confirmed to us that many of the larger users do trade spot/short-term. At the time

of the last severe price increase I received a delegation of large consumers, led by John Hall Associates, and they were very clear that stock market considerations were key factors in buying spot/short, as well as a perceived lack of contract choice.

The wholesale market for electricity is considerably less liquid than that for gas. I will not repeat the comments from our previous discussions but that I did acknowledge the “profound illiquidity” in my oral submission. I would urge that the historical context of this market be considered carefully in your analysis. This is available in our written and oral submission.

26 June 2008

Further supplementary memorandum from the Office of Gas and Electricity Markets (Ofgem)

1. The Committee asked Ofgem, following our oral evidence on 17 June, to submit a supplementary memorandum containing our reflections on the regulation of domestic heating oil. Members also raised the issue of how customers can have greater confidence in green energy tariffs.

DOMESTIC HEATING OIL

2. Approximately 5 million households in Great Britain are not currently connected to the gas network. The best starting point may be to step back and ask how these customers heat their homes. At present, many rely on domestic heating oil and so it is important to be sure that there are no barriers to that market working as effectively as it could. Secondly, rising prices are pushing more users of domestic heating oil into fuel poverty and so concerted action is required to alleviate the difficulties they are facing. Thirdly, it is important to look at longer term options too. For example, in some cases, extension of the gas network or district heating may be a long term solution and customers’ electricity could come from the public network or from microgeneration.

3. If the concern is that there is a problem with the market for domestic heating oil, the Office of Fair Trading (OFT) has the remit to look at the market and if necessary refer the matter to the Competition Commission (CC) for them to undertake a full market investigation. The CC has the power to put in place whatever regulatory remedies it considers appropriate. Indeed, as you may be aware, this is the approach that has already been taken with the market for bulk liquefied petroleum gas (LPG or propane). In 2004 the OFT conducted a study of that market and referred it to the CC in July of that year. The CC published its final report in June 2006 and is now in the implementation phase, putting in place a number of remedies to help overcome barriers to the effective working of the market.

4. I understand that the Committee has raised with the OFT the issue of the domestic heating oil market. This matter can be pursued as a supercomplaint by a designated consumer body, such as the National Consumer Council, and in those circumstances the OFT is required under the terms of the Enterprise Act to carry out an investigation and report within 90 days.

5. Our work on Ofgem’s energy supply markets probe will look, among other things, at how well markets are serving the needs of different groups of customers, including those who are customers of electricity only. In addition, our broader work on fuel poverty—such as helping to improve the targeting of existing measures—should play a part here.

6. Even if there are no structural failings in the market for domestic heating oil, it is still clear that prices have increased significantly and that many customers are at risk of fuel poverty as a result. In this case, there are several appropriate routes for action:

- The Government’s Fuel Poverty strategy covers this group of customers who, as National Energy Action indicated in their evidence, account for a disproportionately high number of the fuel poor. For example, in considering the new arrangements for the Carbon Emissions Reduction Target (CERT) Defra introduced a flexibility mechanism to allow more expensive measures to be provided to groups most at risk of fuel poverty. This includes the provision of ground source heat pumps for those not on the gas grid. This is addition to any Warm Front grants or CERT measures that the suppliers provide to these households as electricity customers.
- Defra are considering the needs of this group in the context of the Energy Services Directive which covers these other fuel types as well as gas and electricity and where they are looking to secure voluntary commitments from the providers involved. There is thus already a clear remit for Defra to consider the needs of this group of customers from a fuel poverty perspective.

7. We believe it is important to seek longer term solutions wherever possible, facilitating the use of electricity and gas where appropriate, including as an alternative to heating oil:

- Approximately half the communities which are off the gas network in Britain are only 2 km from a gas main, meaning it would be relatively easy to connect them. Within that half, there are some 220,000 fuel poor households. Providing new gas connections to these communities could reach a lot of fuel poor households and possibly cut their fuel bills in half, if they were previously using

LPG and switched to gas. Ofgem has put in place incentives in our gas distribution price control for 2008 to 2013 that encourage the gas distribution networks to extend the gas networks to deprived communities.

- The Department for Business has announced funding of £3 million as part of a pilot project within the low carbon buildings programme (LCBP) to introduce fuel saving microgeneration to fuel poor communities off the gas grid.
- We also recognise that customers off the gas grid may be well placed to benefit from support to use renewable heat, or district heat, and this may be a relatively cost effective contribution to meeting renewable targets. The Department for Business, Enterprise and Regulatory Reform (BERR) has lead responsibility for heat, and we understand they plan to publish a heat strategy later this year, we are providing input to them on these issues.

GREEN ENERGY TARIFFS

8. Many consumers want to play their part in the fight against climate change through buying green energy deals. However, when they look at the range of tariffs available, they can find it hard to tell how much of an environmental benefit each one actually offers. Ofgem therefore launched a project last year to produce new guidelines for suppliers and an independent accreditation scheme that will give customers confidence. We have engaged extensively with consumer bodies, environmental groups and energy suppliers and expect to publish our proposals next week.

9. Our proposals will focus on two main principles:

- Transparency: to ensure clarity on supplier claims.
- Additionality: requiring that green tariffs provide some benefit to the environment, as customer research shows this is the core requirement.

10. We will be happy to provide the Committee with full details of the proposals as soon as they are published and we expect to finalise the guidelines in September.

4 July 2008

Memorandum submitted by Opus Energy

BACKGROUND

Opus Energy is an independent supplier of electricity to business customers. Formed in April 2002 Opus Energy now supplies electricity to in excess of 40,000 customer sites in the UK. By any normal financial analysis, such as profitability or return on invested capital, Opus Energy is the most successful small supplier. We believe this gives us a unique insight into overcoming the barriers to entry and understanding the problems facing a small supplier.

REDUCING ACCESS TO POWER GENERATION

Opus Energy believes that new entrants and small suppliers are a necessary and important element to a competitive supply market. Whilst in practice their market share remains small they increase competition and provide innovation. A simple example of this is Opus being the first company to provide free smart meters to all of its business customers. Furthermore, new entrants seek to drive a regulatory agenda that promotes competition rather than favouring incumbents. An example of this has been the efforts of Bizzenergy in changing the regulatory structure regarding objections in the business supply market.

Current market conditions do allow for properly funded, well managed, innovative new entrants, such as Opus Energy, to thrive. However, we believe that the conditions which have allowed new entrants to prosper have, and continue to be, eroded. The key market condition required is to be able to purchase electricity on a long term market related basis. If a supplier cannot access market related power then it is impossible to operate. In order for there to be competitive access to power there needs to be competition in the generation market.

When Opus Energy entered the market in 2002 we reviewed possible providers of electricity. This list included generators and intermediaries, such as energy trading desks at larger international energy companies. At that stage none of the investment banks had trading desks sufficiently developed to deal with our requirements. Eight companies were willing or able to provide Opus with competitive access to the energy products to meet our customers' needs. We signed a long term arrangement with Magnox Electric Plc (now part of the NDA). That arrangement concluded in late 2005, due to the decommissioning of the Magnox nuclear plants. We then conducted a further review of the market place and the number of potential counterparties reduced from eight to five (including two investment banks). A number of generators had

exited, in the main through acquisition by the Big six. In May 2006 Opus signed a long term power purchase agreement with International Power Plc. Since 2006, with the imminent exit of British Energy, the number of possible counterparties has decreased even further.

This reduction in the number of counterparties will have a massive impact on the number of new entrants entering the market. We have also seen independent generators entering the supply market. Haven Power Limited, Smartest Energy and International Power Retail Limited have all either recently entered the market or have applied for supply licences. The trend has seen the Big six suppliers buying generators and now generators entering supply. The ultimate conclusion of this is that it will only be realistically possible to compete as a vertically integrated electricity company. This would produce an enormous barrier to entry. New entrants would need to own generation assets prior to entering the market. This would severely reduce the number of new entrants and significantly reduce competition.

POSSIBLE SOLUTIONS

Opus Energy believes that competition in generation is key to a competitive electricity supply market. We believe there are two possible solutions:

Firstly, The Government or Regulator could restrict the further sale of generation or even force divestment from the Big six suppliers. This would encourage a broader ownership of these assets and would bring benefits of competition with it. However, we do not think this is a realistic option, due to the financial impact and distortion of asset values it would produce.

Secondly, and more realistically, legislation could be introduced that would require, on a regular, long term basis, for all generators to publicly auction a certain percentage of their output, say 5–10%. These auctions would need to be carried out on defined industry terms. This would provide a liquid market with pricing transparency. Whilst small and large suppliers would be able to participate in the auctions, it would also encourage intermediaries such as investment banks. They would then be encouraged to provide the products and services that the suppliers and new entrants require.

This would provide price transparency, liquidity and long term access to power generation. These are the conditions required to allow good suppliers to thrive and encourage new entrants into the market.

IN CONCLUSION

- New entrants are necessary for a competitive supply market.
- Innovative suppliers can thrive in the current market.
- Those conditions are significantly worsening due to increased vertical integration.
- Competition in generation and access to electricity is vital for competition in supply.
- Requiring generators to auction part of their output would provide a liquid, transparent and accessible wholesale market to new entrants, current suppliers and intermediaries alike.

If you require any further information please feel free to contact me.

19 May 2008

Letter by RWE npower

Thank you for your letter of 11 January. In response to the two questions that you raise:

1. npower increased its prices on 5 January 2008. The steps that we have taken to mitigate the impact on vulnerable customers are:

(a) We have not increased our prices for those on our First Step tariff. First Step is our cheapest tariff; it is 22.5% cheaper (based on estimated consumption) than our average price, across all payment methods, for an annual dual fuel bill. The tariff forms part of our First Step programme, under which advisers provide one-to-one account management for customers who are struggling to pay for their energy usage. In addition First Step advisers will assist with energy efficiency. Under the programme certain customers who follow a payment plan will become eligible to have any outstanding debt cleared through the resources of the First Step Fund established by npower.

(b) In addition to the First Step programme, a further 50,000 vulnerable customers will receive rebates this winter totalling £80. These customers are also offered free energy efficiency measures and, if taken up, will receive an extra £20 in rebates. We direct the rebate towards customers who are vulnerable and fuel poor, identifying recipients through our vulnerable customer programme and through fuel poverty modelling based on internal customer information.

(c) In 2000 npower established its Health Through Warmth Scheme (HTW). The scheme benefits the vulnerable; people living in cold or damp homes whose health is adversely affected. These people are often hard to reach and HTW works with key community workers who, when visiting people in their own homes, can identify those who are most vulnerable and refer them to the HTW team. HTW is not tenure specific, in other words clients do not need to be or become an npower customer.

Once a referral is made to the HTW team, its home advisers facilitate access to statutory national grant schemes and other locally available funds. If clients are not eligible funding is sought from charitable organisations on their behalf. Financial support may also be offered from the npower HTW crisis fund. HTW also facilitates the installation of energy efficiency and heating measures such as insulation, energy efficient boilers etc.

There have been some 36,000 referrals to the HTW scheme, and practical help to the value of £30m has been delivered to vulnerable households. The npower HTW crisis fund has itself contributed £3m in circumstances where households would otherwise have received no assistance.

HTW is completely independent of any statutory obligations under the Government's EEC/CERT scheme, npower recently agreed a further commitment of £4.5m for the continued operation of HTW.

(d) Although I would stress that pre-payment is not necessarily a proxy for vulnerability or fuel poverty, we have also put the following measures in place:

- (i) The impact of the increase will be reduced, for customers with and electricity prepayment meter, by an average of £10 per customer per annum (there are more than 475,000 electricity pre-payment meter customers) and an average of £4 per customer per annum for gas pre-payment customers (there are 280,000 gas pre-payment meter customers);
- (ii) There will be no increase in prices for some of our token meter customers (in total 135,000 customers) until April 2008. In addition we are currently carrying out a programme of debt write-off and accelerated replacement of token meters. npower has to date replaced 67,000 token meters and existing debt of more than £70 from price increases has been written off.

(e) Macmillan Cancer Support has been our chosen corporate charity since 2004; the company gives £ for £ matching for all fundraising, as well as supporting a number of commercial initiatives (eg TV advertisements for the World's Biggest Coffee Morning in support of Macmillan). The npower First Steps Team is currently piloting a fuel management programme with Macmillan Cancer Support aimed at helping people living with cancer manage their energy bills.

(f) The npower Spreading Warmth Programme is designed to specifically assist vulnerable customers (those in receipt of means tested benefits) and brings together a number of initiatives and products and services such as large print bills, free gas safety checks, energy measurement devices and energy efficiency advice. This programme forms part of our regulatory obligations and specific elements include:

- (i) The Warm Response Helpline, a free-phone service with trained advisers who assist the customer in the light of his/her situation. This line also takes calls from the Home Heat Helpline.
- (ii) An energy efficiency advice telephone service based on close examination of the customer's energy bill and consumption history to provide personalised and relevant advice.
- (iii) A network of in-home advisers who specialise in providing face-to-face advice in how a customer can heat their home affordably. Integrated within this service is the provision of real-time display devices to the customer so they can understand their household's electricity consumption.

(g) npower operates a detailed 14 point programme to seek to ensure that we would never knowingly disconnect the electricity or gas supply of a vulnerable customer who was unable to pay his or her bill.

(h) This winter we are working with all of the major energy suppliers, EAGA (the UK's leading provider of residential energy efficiency solutions) and BERR in mailing 250,000 members of the public who are in receipt of, or are eligible for but are not claiming pension credit. In the letter to them we are offering free insulation and central heating grants as well as other services such as benefit entitlement checks, energy efficiency advice and registration on our Warm Response Service.

- (i) In 2007 under our Energy Efficiency Commitment npower spent over £50 million helping consumers improve the energy efficiency of their homes, over half (£25.5) of which was spent helping a priority group of customers. From April we will double our programme under the CERT scheme, the programme being introduced to replace the Energy Efficient Commitment.

We provide the opportunity for all of our employees to volunteer to help in the delivery of many of these programmes. At present more than 10% of our employees are actively engaged in our volunteering programme.

In summary therefore, npower has a wide number of measures to protect vulnerable customers from price increases and generally assist those most in need with energy costs. These include: no increases for our First Step customers, debt write-offs for such customers, the provision of rebates of up to £100 for 50,000 customers, the provision of home advisers and payments through the crisis fund as part of the Health Through Warmth Programme, mitigating the cost increase for pre-payment meter customers, delaying the increase for many token pre-payment customers until 1st April and not recovering outstanding debt for some such customers, the products and services of the Spreading Warmth Programme, our 14 point

programme relating to disconnections and the offers for those in receipt of, or eligible for pension credit. In addition more than half of our 2007 expenditure under the Energy Efficiency Commitment related to priority group customers.

2. Your second question asked about our increase in prices and the underlying reasons. We increased our residential prices by on average 12.7% for electricity and 17.2% for gas from 5th January 2008. Our preceding change in prices, and a price reduction came into effect in April 2007 based on our expectation at that time of forward costs. Almost immediately wholesale costs rebounded and forward wholesale commodity costs for 2008 have increased by 66% for electricity and 60% for gas.

Our retail business buys electricity and gas on the wholesale market. Whilst this increase in wholesale costs is the major reason for the price increase, there have also been substantial cost increases in two other areas:

- (i) The costs of the CERT scheme are double those under the EEC scheme.
- (ii) There have been substantial increases in distribution costs, most particularly in gas where there has been a major increase in transport costs. In electricity, although not of the same order of magnitude, distribution and transmission costs are increasing.

npower's retail profits in 2007 will be substantially below those in 2006. The position was not sustainable into 2008 with the further level of cost increases in that year.

I hope that I have adequately responded to the two questions that you raise in your letter. In conclusion the huge level of commodity cost increases, the substantial increases in non-commodity costs for energy transportation and distribution costs and the doubling of the costs to meet CERT have resulted in our price increase, but we have implemented the change in conjunction with a wide programme of measures to protect vulnerable customers from energy costs.

25 January 2008

Memorandum submitted by RWE npower

BACKGROUND

1. RWE npower, part of the RWE Group, is one of the UK's largest energy suppliers, with some seven million electricity and gas customers and a diverse portfolio of some 10 GW of generation capacity in the UK. We also sell our expertise in power generation in key markets.

2. We welcome the opportunity to contribute to the BERR Select Committee's inquiry into the UK's energy market. In our evidence below we concentrate on those areas raised by the Committee where we feel our comments will be most useful.

WHETHER THE CURRENT MARKET STRUCTURE ENCOURAGES EFFECTIVE COMPETITION IN THE RETAIL MARKETS FOR GAS AND ELECTRICITY

3. Ofgem stated in January¹ that: "Britain's domestic energy market is highly competitive and remains the most competitive in Europe. Energy companies continue to compete vigorously on price, service and the range of products they offer their customers." We agree with this assessment. The six major companies in the domestic energy supply market are competing aggressively as reflected in the changing market shares, the number of customers who choose to switch supplier, the degree of product innovation, the improvement in customer service, brand positioning and low margins earned by retailers. These aspects are discussed further below.

4. In 1996, British Gas had a 100% market share of residential gas customers as a consequence of its statutory monopoly in the supply of gas to those customers. That legacy position has been aggressively unwound through competition from other suppliers so that in March 2007 it stood at 47%². Similarly, the market shares of the 14 regional Public Electricity Suppliers (PESs), which in 1998 had a 100% market share in the supply of electricity to residential customers in their regions, have been aggressively competed away. This significant collapse in the market shares of the former statutory monopolists is indicative of a dynamic national market for the retailing of electricity and gas, and has been defined as such by the Office of Fair Trading³, with customers free to choose from a number of competing suppliers.

5. The major shifts in market shares we have observed over the past ten years have been due to the high level of customer switching that has occurred, and which remains a feature of the market. As Ofgem has stated⁴ the level of switching has increased over time and in October 2007 over 2.8 million households switched supplier in the first seven months of the year. The European Commission noted in January 2007⁵ that the UK rates for switching are among the highest for electricity and exceed all other Member States for gas. This is facilitated by the range of ways customers can access products and services, namely: web comparison sites, company websites, telesales, direct mail and face to face sales and marketing. A National Consumer Council study⁶ shows that electricity and gas have higher switching rates than home insurance, mortgages, fixed and mobile telephony and current and savings bank accounts. npower's own aggregate

residential customer gains and losses together over the last three years, ie gross transfers, have amounted to 38%, 44% and 48% of the year-end total number of customers respectively for 2005–07. In 2007, on the same basis, our customer switching rates by product type were: Prepayment Meter 81%, Standard Cash & Cheque 42% and Direct Debit 39%.

6. Product innovation shows a dynamic market developing to meet customers' needs. As Ofgem commented last July, there has been an increased take up of dual fuel contracts which it expects to continue to rise⁷; around 4.2 million households are choosing new ways to buy energy ranging from on-line (1.2 million households), fixed and capped rates, green products (nearly 350,000) to low-priced deals for fuel poor customers⁸. In addition to providing a range of such innovative products, npower also has a product which tracks wholesale energy prices and provides low carbon/energy efficiency products such as microgeneration along with export tariffs, solar thermal and PV systems and ground source heat pumps. It also provides associated services of gas boiler and central heating installation, servicing, repair and other cover products as well as electrical installation.

7. In this fiercely competitive market, consumers' expectations of service levels continue to increase and the industry is having to adapt and evolve to keep ahead of these expectations. Consumers expect to be able to make contact outside normal business hours, to be able to handle their accounts on line and to receive innovation in service (eg graphs on bills and SMS text for meter reading). The competitive market is further reflected in the decline of complaints over the last four years for five of the six largest energy suppliers as Ofgem commented last year⁹. Over the period 2004 to 2007 complaints against npower reported to energywatch have fallen by 9,144 to 3,709.

8. The market participants have taken slightly different positions on branding and marketing, as would be expected in a competitive market, with some building more of a national focus, some more local, some channel specific sub-branding (eg Atlantic) and some positioning themselves based on, for example, product innovation and the carbon agenda.

9. Competitive pressures have recently reduced domestic energy retail margins as E.ON UK¹⁰ and Centrica¹¹ have commented. Since 2002 npower's domestic energy retail margins have been in single figures and at times negative.

10. In summary, these characteristics confirm a thriving, dynamic market, with customers free to choose amongst several retailers all competing aggressively for their business.

WHETHER THERE IS EFFECTIVE COMPETITION IN THE WHOLESALE MARKETS FOR GAS AND ELECTRICITY

11. The GB wholesale electricity market is widely regarded as being highly competitive. In addition to BERR¹² and Ofgem¹³, a range of other bodies from the European Commission¹⁴, the Office of Fair Trading¹⁵ and the International Energy Agency¹⁶ to Oxera¹⁷ have all described the UK wholesale electricity market as competitive. The DTI's UK Energy Sector Indicators 2007¹⁸ illustrates the decline in the HHI for electricity generation from above 2,000 (which is normally regarded as highly concentrated) in 1991 to around 1000 (the level below which the market is conventionally regarded as unconcentrated) in 2006. We calculate that the HHI for electricity generation in 2007 was below 1000. This collapse in the level of concentration was due to new entry in power generation as well as plant divestments in the late 1990s, both of which have significantly increased the competitiveness of the sector.

12. Financial performance of generation plant needs to be assessed over its lifespan of 20 years or more. The returns need to be such as to provide a basis for future investment. In fact the returns in the generation market are volatile and this places a premium on risk management skills. Its difficulties are highlighted by the financial problems experienced by some major operators; at the end of 2002 British Energy required support from the Government and TXU Europe withdrew from the market leading in 2003 to AES giving Drax up to its creditors—a clear demonstration of the intensity of competition in the generation market. Profitability assessment therefore needs to take account of financial performance over a long period of time.

13. What is important is that the market provides clear signals for new investment and entry in order to promote the right level and mix of generation plant to meet the demands of customers. Hitherto, that has been the case—the market has delivered the right level of capacity, and delivered it efficiently.

14. Over the next ten years from 2008 RWE plans to incur considerable capital expenditure on low-carbon generation plant in the UK to replace its existing plant. The generation programme will reduce the amount of CO₂ npower emits (per unit of power generated), compared to 2000 levels, by around 33% by 2015.

15. As a consequence, the npower generation business is forecast to be substantially cash negative over the next ten years. RWE's CEO has recently outlined RWE's intent to invest widely in generation across Europe. As a result our UK business is effectively in competition for those funds. For example, the RWE Group has announced its intention to spend €1bn a year from 2008 on renewable generation and much of this investment is expected to be made in the UK. It is therefore vital that the UK generation market remains a stable and credible environment in which to invest.

THE IMPLICATIONS OF GROWING CONSOLIDATION IN THE ENERGY MARKET

16. We do not consider that there are significant barriers to entry to the energy markets. We would suggest that if there were profitable opportunities, there are a number of companies that would have the resources to enter the energy retail supply market such as retailers from other sectors, European energy companies and energy retailers to non-domestic customers. We note that there currently are a number of smaller players in the energy supply markets offering specialised and specific niche products.

17. Ofgem has and is continuing to address some of the complexities of the energy market such as through its Review of Energy Supply Licences¹⁹ and on the generation side is undertaking a Review of Industry Code Governance²⁰ to assist distributed energy providers and micro-generation interests.

THE RELATIONSHIP BETWEEN THE WHOLESALE AND RETAIL MARKETS FOR ELECTRICITY AND GAS

18. The link between the wholesale and retail markets is provided by the trading activity that enables generators to sell power, and retailers to buy power. This trading creates contracts between parties that enables them to balance their physical position in advance of “gate closure”, and also enables them to manage price risk. Whilst most retailers also own generating plant, the retailers still need to trade, not only with their own generation business, but also with other generators and traders. There are a number of reasons for this.

19. First, the wholesale market arrangements (NETA/BETTA) set up by DTI and Ofgem prohibits the netting off of generation and retail imbalances forcing both the retail and generation arms of the same business to trade in the market. Second, no producer/retailer is in perfect balance either in terms of the total amount of electricity produced and demanded, or the time profile of that production and demand over the course of the day, and therefore needs to buy from the market when it is short and to sell when it is long.

20. npower operates its generation and supply businesses independently, each transacting all its volumes through RWE Supply & Trading (RWEST). Generation volumes are sold in a manner determined by the RWE Group’s hedge policy. This hedge policy is subject to liquidity available in the wholesale power, fuel and carbon markets. Encouragement of liquidity is therefore a key focus of the RWE Group, and much of the RWEST business is focussed at encouraging liquidity in the markets in which we operate (as reflected by the Market Design Project sponsored by the Futures and Options Association).

21. npower’s retail business has a separate hedge policy determined by its management team. npower retail’s hedging model applies its hedging policy and npower retail operates within strict position limits. This ensures that npower retail has little room to speculate on commodity prices, but is incentivised to concentrate on cost, service, pricing and brand as its value drivers.

22. RWEST is a separate company from RWE npower and operates in the energy wholesale markets as the RWE Group’s sole face to the wholesale markets. All transactions with both the generation and retail business units of npower are made at arms length and are subject to stringent and routine “fair value” testing by an independent team within the RWE Group. During 2006 and 2007 of about 140 TWh transacted by RWE npower through RWEST only around 11% were netted trades. Netted trades occur when one npower business unit effects trades “simultaneously” with another, where “simultaneously” roughly approximates to the same day.

23. It is clear from the discussion above that retail prices are fundamentally driven by wholesale prices, which for electricity are in turn fundamentally driven by the prices of gas and other fuels. npower’s domestic electricity and gas price increases in early 2008 were necessitated by the rising forward electricity and gas wholesale commodity costs for 2008 which increased by 66% and 60% respectively since mid-February 2007 as well as increases in network charges, social obligations and environmental costs, the last of which will inevitably continue to rise.

24. Our customers, however, have been protected from the full impact of wholesale prices increases over recent years as a result of our effective hedging policy. A view of the movement in costs (on a rolling forward 12 month wholesale commodity costs basis for electricity and gas, plus transport, EEC and metering costs) and of npower’s Dual Fuel Quarterly Cash and Cheque annual bill size from 2004 to 2008 shows that the difference in prices and costs is now less than in 2004 and that the retail price changes significantly lag changes in costs (mainly increases) (see Appendix A).

25. Whilst all companies are subject to similar increases in energy commodity costs as well as network charges and the Energy Efficiency Commitment/Carbon Emissions Reduction Target (EEC/CERT) at the same time, there is in fact a significant variation in the timing of price movements for domestic customers. This variation in the timing and scale of price changes may be due to differences between suppliers in hedging or business strategies.

THE INTERACTION BETWEEN THE UK AND EUROPEAN ENERGY MARKETS

26. The UK has moved from being an exporter to an importer of gas. Consequently, and as a result of improved infrastructure links to European and world markets, it has become more exposed to international prices. Continental gas prices have been pushed up by the rise in oil prices as most are indexed to oil and LNG prices have increased as a result of demand from Asia notably Japan. With regard to Europe, RWE supports measures that strengthen competition in the EU (and contribute to an economically and ecologically sensible climate protection strategy).

27. We note that, as Ofgem showed in January 21, Britain's domestic electricity bills are competitive with most other EU countries being on a par with the EU average and that its domestic gas bills are amongst the cheapest in Europe being considerably below the EU average.

THE EFFECTIVENESS OF REGULATORY OVERSIGHT OF THE ENERGY MARKET

28. Ofgem has clearly successfully created competitive generation and retail energy supply markets. Ofgem has continually monitored the development of the wholesale and retail energy supply markets to make sure that competition remains effective and periodically publishes information, for example through at least annual Domestic Retail Market Reports. In addition, Ofgem has successfully embarked on delivering on its "better regulation" duty as illustrated by the recent Supply Licence Review, where it sought to protect the interests of consumers with an appropriate balance of sectoral regulation and a blend of self-governance, competition and consumer law.

29. Historically, Ofgem has focussed on promoting effective markets and cost reflectivity in charges. However, this approach is coming under increasing pressure as Ofgem appears to become a vehicle for the pursuit of social and environmental goals rather than as a pure economic regulator. Experience shows that there are increasing tensions between the objectives set for Ofgem as illustrated by the following example.

30. Ofgem's Proposed Corporate Strategy and Plan for 2008–13²² suggests that the retail energy market may become increasingly like a normal service industry market. In practice, recent developments show the reverse is the case. These include:

- Ofgem's two CSR reports in 2007.²³
- Ofgem's debt and disconnection "best practice" report in January 2008.²⁴
- The 2008 Budget.²⁵
- The doubling of CERT from April 2008 compared to EEC2.²⁶

31. All the evidence that has been adduced by a large number of studies indicates that the market does work well. If there are policy objectives which will not naturally be delivered by the market, it would be better to be clear about what those are and to seek to identify appropriate interventions which introduce the least distortions. This would improve regulatory certainty, both for Ofgem as to its role, and for market participants.

32. Ofgem has also explained in its Proposed Corporate Strategy and Plan 2008–13²⁷ that: "investors will require a stable political and regulatory environment before making investment in new generation capacity". However, it is difficult to see how this reconciles with its recent proposals for a windfall tax on energy companies²⁸, particularly at a time when additional generation investment of some 20–25GW is required by 2020, in order to replace capacity that will have to be taken out of service.

PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

33. npower's mandatory expenditure on fuel poverty through energy efficiency programmes is increasing markedly. The Government recognises the benefit of the Energy Efficiency Commitment/Carbon Emission Reduction Target (EEC/CERT) for priority group customers (those in receipt of income/disability based benefits, tax/pension credit or those aged 70 or over), announcing the combination of its expenditure on Warm Front and increasing expenditure on CERT as together increasing the spending on fuel poverty, but energy suppliers receive little credit. Of its expenditure on energy efficiency under EEC1 (April 2002-March 2005) £48m and EEC2 (April 2005-March 2008) £147.7m, 50% of the savings were targeted at priority group customers. Expenditure under CERT (April 2008-March 2011) group customers is estimated at around £400m of which 40% of the energy savings will be targeted at the priority group. In all cases, the proportion of expenditure on the priority group exceeds 50% of the total because of the increasing difficulty of identifying and implementing measures for this group of customers.

34. In addition, npower already has an extensive range of measures available to support vulnerable customers which include:

- (a) npower's Health Through Warmth Scheme (HTW) which benefits the vulnerable (not necessarily npower customers) by using its working in partnership with local authorities and the health sector to identify people living in cold or damp conditions whose health is adversely affected by these conditions and facilitating access to statutory national grant schemes and local funds. If clients are not eligible for statutory or charitable funding, HTW offers a crisis fund and facilitates installation

of energy efficiency measures. It has had 36,000 referrals that delivered practical help to the value of £30m and the HTW crisis fund has contributed £3m. npower has agreed a further commitment of £4.5m to HTW.

- (b) The First Steps Programme targeted at those most in need. This includes social tariffs, debt relief, one to one account management, energy advice & measures and benefit entitlement checks
- (c) First Steps is just part of our Spreading Warmth Programme which offers assistance to a wider group of vulnerable npower customers through products and services such as large print bills, free gas safety checks, energy measurement devices and energy efficiency advice. Specific elements include: the Warm Response Helpline, an energy efficiency helpline and a network of in-home advisors.
- (d) A detailed 14 point programme to ensure that we would never knowingly disconnect the electricity or gas supply of a vulnerable customer.
- (e) Working with other major energy suppliers, EAGA and BERR to inform 250,000 people in GB who are eligible for pension credit by letter of free insulation, central heating grants and other services.
- (f) A commitment to fund the Home Heat Helpline: an impartial, single-point of advice for vulnerable customers set up by the ERA in conjunction with energy suppliers.
- (g) In relation to npower's January price increase we provided additional protection for the vulnerable by:
 - (i) Not increasing prices for thousands of customers on our first step tariff
 - (ii) Committing to rebates of up to £100 for 50,000 of npower's most vulnerable customers
 - (iii) Mitigation of the cost increase for pre-payment customers by halving the average electricity differential and reducing the differential for gas
 - (iv) A delayed price increase for many token pre-payment customers.

35. As a result of the announcement in the Budget, we are presently in discussions with government on a possible way forward. We hope that this might lead to a long-term sustainable approach to tackling poverty. We would like to see all parts of government as well as other relevant industries working collectively on this important issue.

36. Other measures that could alleviate fuel poverty include:

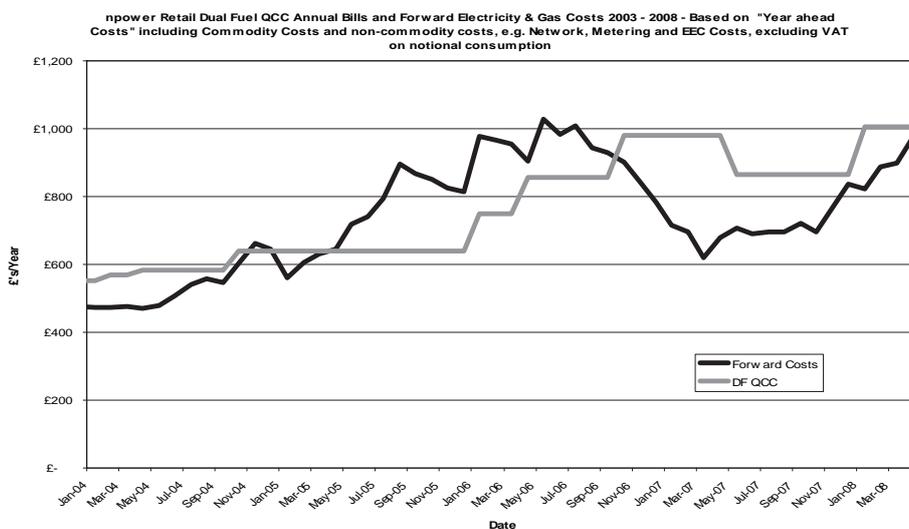
- More help through data sharing with suppliers required to enable them to identify and so more effectively target vulnerable customers.
- Increased use of Fuel Direct by extending its availability to those on benefits and not just those in debt. This would help us offer more attractive tariffs.
- A universal roll-out of Smart Metering.

NOTES

1. Ofgem (14 January 2008) Proposed Strategy and Plan 2008–13, para 1.6
2. Ofgem (4 July 2007) Domestic Retail Market Report June 2007, p 22
3. Office of Fair Trading (11 March 2006) Anticipated acquisition by Npower Ltd of the electricity and gas business of Telecom Plus plc, p 2.
4. Ofgem (17 October 2007) Press Release OVER 2.8 MILLION HOUSEHOLDS SWITCH SUPPLIER.
5. European Commission (January 2007), UNITED KINGDOM—Internal Market Factsheet, p 1.
6. National Consumer Council (November 2005), switched on to switching? A survey of consumer attitudes and behaviour, 2000–2005, p 3.
7. Ofgem (4 July 2007) Domestic Retail Market Report June 2007, p 4.
8. Ofgem (4 July 2007) Factsheet 69 Britain's competitive energy market, p 2.
9. Ofgem (4 July 2007) Factsheet 69 Britain's competitive energy market, p 2.
10. FT.com (6 March 2008) Eon chief hits out at “myths” on profits www.ft.com/cms/s/0/d24843e4-ebb6-11dc-9493-0000779fd2ac.html
11. Centrica (14 December 2007) Full Year 2007 Trading Update.
12. BERR website www.berr.gov.uk/energy/markets/competitiveness/page28432.html
13. Ofgem website www.ofgem.gov.uk/Markets/WhlMkts/Pages/WhMrkts.aspx
14. DG Energy and Transport's Country by Country Review for Great Britain, issued as part of the 10 January 2007 Energy Package, comments: “for electricity, there would appear to be a sufficient range of companies to suggest that the market is both competitive as well as being open to new entrants”.
15. Office of Fair Trading (20 February 2006) Completed Acquisition of Great Yarmouth Power Limited by RWE Npower plc.

16. International Energy Agency (2007) Energy Policies of IEA Countries The United Kingdom 2006 Review states (p 117): “Overall the UK electricity market appears to be competitive and there are numerous market players ready to respond by investing in new generating capacity according to the needs of the market—eg in mid-2006 two CCGTs, Langage (885 MW) and Marchwood (859 MW), were constructed”.
17. Oxera (October 2007) Energy market competition in the EU and G7: preliminary 2006 rankings (prepared for BERR) places the UK first with a score of 8.3 for the electricity market with the UK electricity wholesale market among the leading markets.
18. DTI (26 July 2007) UK Energy Sector Indicators 2007 Background Indicators Annex p 67.
19. Ofgem (1 June 2007) Supply Licence Review—Final Proposals (128/07).
20. Ofgem (28 November 2007) Open letter announcing review of industry code governance (284/07).
21. Ofgem (15 January 2007) Factsheet 66 Updated Household energy bills explained, p 3.
22. Ofgem (14 January 2008) Proposed Strategy and Plan 2008–13, para 1.17.
23. Ofgem (8 October 2007) Review of suppliers voluntary initiatives update (235/07) and (6 October 2007) Review of suppliers voluntary initiatives to help vulnerable customers (203/07).
24. Ofgem (25 January 2008) Debt and Disconnection Best Practice Review (07/08).
25. HM Treasury (12 March 2008) Budget 2008 Economic Fiscal and Strategy Report p 66.
26. Defra (June 2007) UK Energy Efficiency Action Plan 2007 Table 3 Energy Savings associated with UK energy efficiency policies and measures, p 14.
27. Ofgem (14 January 2008) Proposed Strategy and Plan 2008–13, para 3.6.
28. Ofgem (16 January 2008) Press Release MARKET IS SOUND—OFGEM ASSURES CHANCELLOR.

APPENDIX A



Supplementary memorandum from RWE npower

At the Select Committee hearing on 24 June 2008 Mr Oaten asked for information on the percentage increase in the last year for customers who are defaulting on their bills. I would therefore be grateful if you could place this response before the Select Committee.

The total number of debtors in June 2008, compared to June 2007, has increased by 3.8%.

We have improved our practices in the way in which we help customers to manage debt. In particular the number of customers disconnected in the first half of 2008 was less than half those of the corresponding period in 2007. various schemes and payment methods are in place to help manage debt levels and £3.5 million of debt of vulnerable customers has either been written-off or put on hold over the last two years under our “First Steps” social programme.

10 July 2008

Letter by Scottish and Southern Energy

In response to the Business, Enterprise and Regulatory Reform Committee's request for energy companies to submit in writing details of any price increases they plan to implement in the near future, ahead of the oral hearing with the Minister of State for Energy on 31 January, below is a contribution from Scottish and Southern Energy (SSE).

In our contribution we outline our recent price commitment, how it fits in with the competitive UK energy market, explain how in the current climate of energy price increases we support our most vulnerable customers, and highlight how we feel the fuel poor are best supported longer term.

SUMMARY

- SSE, already the cheapest of the major suppliers, has committed to keep our electricity and gas prices for domestic customers at their current levels for the rest of this winter, when people are having to use most energy, and until at least the start of British Summer Time.
- In the highly competitive GB market the ultimate safeguard for customers is their ability to switch supplier if they are dissatisfied with the service they receive.
- Our track record in customer service and in regard to responsible pricing proves this as we had a net gain of over one million customers between December 2006 and December 2007.
- SSE's fair pricing policy is that it seeks to be the last, or one of the last, of the energy suppliers to increase prices if it has to and the first, or one of the first, to lower prices if it can. As a result, following the recent British Gas price rise, a typical SSE customer pays around £175 a year less for their electricity and gas than an equivalent British Gas customer.
- This, backed up with our voluntary social tariff and tailor-made approach to payment arrangements for vulnerable customers, means that SSE is making a meaningful contribution towards assisting the fuel poor.
- The case for a mandatory social tariff is not supported by SSE as it would be a very blunt and inflexible way of targeting support to fuel poor households.

OUR ENERGY PRICES

SSE adopts a "fair pricing" policy and we seek to be the last, or one of the last, of the energy suppliers to increase prices if we have to, and the first, or one of the first, to lower prices if we can. At a time of sustained rises in wholesale energy prices and other upward pressures on domestic prices, SSE is aiming to protect its customers from the worst effects.

Household energy consumption is at its highest in the first quarter of the year, with the average household in Great Britain using around 40% of its annual gas consumption and around 30% of its annual electricity consumption in January, February and March. That is why SSE has committed not to increase prices this winter. The company is keeping its electricity and gas prices for domestic customers at their current levels for the rest of this winter, when they are having to use most energy, and until at least the start of British Summer Time.

THE UK ENERGY MARKET

SSE believes that our ability to keep our prices down and the fact that we have almost doubled our customer base to over eight million in the past five years shows that the UK has a vibrant and highly competitive energy market. SSE is the second largest energy supplier, having been fifth six years ago.

Our achievements in recent years demonstrate the highly competitive nature of the market: by offering lower prices and achieving the best performance ratings for customer service we have outperformed our competitors in this market, and customers have voted with their feet.

SSE last changed prices in early 2007. On 1 March 2007, SSE started implementing a cut of 12% in its average gas bill and on 1 April 2007 it started implementing a cut of 5% in its average electricity bill.

However, this is not the only evidence of the energy market being highly competitive. Consumers have a wide choice of energy suppliers and they are exercising that choice. According to Ofgem's Domestic Retail Market Report June 2007 annual rates of switching were at the highest levels in four years. On average 30,000 more switches took place per month than in the previous year. This is an 11% increase in monthly switching rates over the year.

This trend is set to continue. The most recent statistics published by Ofgem show that more than 2.8 million customers switched supplier in the first seven months of 2007. Energy suppliers will continue to compete heavily on price and service, strive for innovation and customers will continue to benefit from switching supplier.

Britain's energy supply market also stimulates new product development. Towards the end of last year, SSE launched the "better plan", a unique and innovative package which offers customers financial rewards for reducing their energy consumption.

CONTRIBUTORY FACTORS TO PRICE RISES

Whenever price rises are examined, it is very important that people understand the reasons behind price rises.

One of the key drivers is the recent rises in the wholesale gas price across the world. This is not the fault of suppliers and the effect of this on gas prices within a country importing significant quantities of its gas is obvious. However, it must also be understood that with much of the UK's electricity coming from gas power stations, it will clearly affect electricity prices also.

In addition, Government policies to tackle climate change and improve energy efficiency, which command broad support, put an upward pressure on energy prices for all customers. The Carbon Emissions Reduction Commitment (CERT) for example, will add around £38 to the average Energy Bill for 2008. Network infrastructure costs have also increased to support the delivery of new renewable energy and the upgrading of energy networks to ensure they are safe and secure for another generation. The total costs to customers in delivering network infrastructure and environmental policies have risen by almost 50% in the last four years, from almost £170 on electricity and gas bills in 2004 to almost £250 in 2008.

It is also important to understand that for entirely responsible reasons suppliers "hedge" their requirements by buying a significant proportion of their customers' energy needs in advance. When wholesale prices are going up, customers benefit as there is a lag before suppliers raise retail prices; similarly, when wholesale prices fall, it takes time for suppliers to see reduced purchasing costs and pass these through to customers. Our ability to work effectively and efficiently in this area has helped us to succeed in this competitive market, and not pass on the full extent of wholesale price increases to customers. As a result, our customers have paid an average of around £400 less for their gas and electricity between 2004 and 2007 than have customers of British Gas—a gap which will grow over the rest of this winter.

These are not all the contributory factors. Issues as diverse as Japanese nuclear plant problems, LNG supplies, Chinese coal demand, logistical and freight transport issues, Russian and Norwegian gas, and the Oil price and its effect on the global economy, all play their part in influencing wholesale energy prices. It is against these contributory factors that a supplier must make its price choice and suppliers, of course, have their own internal company structure and cost variations.

HELPING VULNERABLE CUSTOMERS

SSE takes fuel poverty very seriously and our strategic approach is to ensure prices are as low as possible for as long as possible. At the same time, we target deeper help to the households who need it the most. The "fair pricing" policy ensures that SSE's customers consistently enjoy the lowest prices for gas and electricity in the UK, ensuring that many of our customers are prevented from being fuel poor by virtue of cheaper supply deals.

In recent months, the energy regulator Ofgem has conducted two reviews of suppliers' voluntary initiatives to help the fuel poor. This review shone a light on the way in which SSE conducts its business through responsible pricing strategies and a focus on high quality customer service: "SSE has adopted a strategy around competitively priced energy and excellent customer service, which benefits all of its customers, including those who are fuel poor and vulnerable and hard to reach . . . SSE's fuel poor customers will be around £40 per annum better off than the average as a result of SSE's competitive pricing strategy". (Update: Ofgem's review of Suppliers' voluntary initiatives to help vulnerable customers, October 2007.)

SSE was one of the first suppliers to introduce a social tariff to help its most vulnerable customers. Those qualifying for Energyplus Care (people spending 10% or more of their income on energy) are offered: a discount of at least 20% off their current tariff; a benefits health check, where appropriate; free energy efficiency measures such as loft and cavity wall insulation; and the loan of an A-rated fridge or fridge freezer if the existing one is inefficient. We believe this tariff makes a significant difference to families living in fuel poverty as it addresses energy efficiency as well as price reductions, while some of our competitors' purported social tariffs have, on occasions, been more expensive than our standard tariffs. We are working now to double the number of customers on Energyplus Care by March 2008.

However, the case for a mandatory social tariff is not supported by SSE as it would be a very blunt and inflexible way of targeting support to fuel poor households. A fixed tariff would also be insensitive to the market and presents potentially perverse consequences which could result in higher prices than the market price to such who are highly price-sensitive.

To complement our general strategy of low prices, over 140,000 customers benefit from our policy to equalise electricity Pre-Payment Meter tariffs with standard credit tariffs. As a result SSE has the lowest electricity Pre-Payment tariff on the market. We also have the second lowest gas pre-payment meter tariff. SSE also offers tailor-made payment measures, used on a daily basis by hundreds of thousands of people, in order to help them to pay their bills in a manner which suits their financial situation.

Finally, SSE's product portfolio includes the "better plan", a unique package that provides financial rewards to customers for using less energy. This product is designed to encourage households to become more energy efficient but can also make a contribution to reducing the energy bills of some fuel poor households.

A LONGER TERM SOLUTION TO FUEL POVERTY

Investing in energy efficiency measures and the energy systems of poorer households is critical in bringing down overall energy costs and while much progress has been made through the Energy Efficiency Commitment, there is a long way to go before many buildings are as efficient as they could be.

In time, part of the solution may lie in the opportunities afforded by smart metering to allow more communication between energy suppliers and their customers. In tracking energy usage, smart meters enable householders to use energy optimally. Beyond this, intelligent heating controls could allow people to manage their energy use so that they are able to heat their homes in the most efficient way possible. To help identify the potential for smart meters, SSE is sponsoring Energy Demand Reduction Trial in a number of locations throughout the UK.

COMPANY INFORMATION

Scottish and Southern Energy is one of the largest energy companies in the UK, employing around 15,000 people. We are involved in the generation, transmission, distribution and supply of electricity; energy trading; the storage, distribution and supply of gas; electrical and utility contracting; and telecoms. We have over eight million energy customers operating through the brands of Southern Electric, Scottish Hydro Electric, Atlantic and Swalec. For further information on the company, please visit our website (www.scottish-southern.co.uk).

January 2008

Memorandum submitted by Scottish and Southern Energy plc

INQUIRY INTO THE ENERGY PRICES AND STRUCTURE OF THE ENERGY MARKET

Scottish and Southern Energy (SSE) is grateful to have this opportunity to submit evidence to the Committee's inquiry into the structure of the energy market in the UK. SSE is the UK's second largest supplier of electricity and gas, with around 8.5 million customers, having been the fifth largest six years ago. It supplies energy as Southern Electric, SWALEC, Scottish Hydro-Electric and Atlantic Electric and Gas. It is also involved in the generation, transmission and distribution of electricity and in the storage and distribution of gas. SSE is listed on the London Stock Exchange and employs over 14,000 people in the UK.

KEY POINTS

This submission makes the following key points about the UK's energy market:

1. the market is competitive;
2. there are no significant barriers to entry;
3. price decisions are the result of many issues; and
4. there should be meaningful support for the fuel poor.

In the light of this, SSE believes the Committee should encourage progress to be made in the following key areas:

- securing additional transparency to increase market confidence in the European wholesale gas market and, indeed, the UK's offshore gas market;
- adopting the right principles to ensure there is meaningful support for the fuel poor;
- reinstating metering as a regulated product of the distribution business; and
- simplifying the industry arrangements, to the benefit of potential new entrants and existing market participants and customers.

1. THE MARKET IS COMPETITIVE

- The UK's energy market is the most competitive in the EU and G7—Oxera.
- All segments of the market remain highly competitive—Ofgem.
- Successful suppliers increase customer numbers.
- Responsible and fair pricing.
- Effective customer service.
- The UK's competitive market encourages innovation.

The UK's energy market is the most competitive in the EU and G7—Oxera

Multiple studies have been undertaken into the competitiveness of the UK Energy Market. In October 2007, Oxera, the independent economic consultancy, undertook an independent study examining energy market competition in the EU and G7. Its key conclusion was as follows: “*On aggregating the electricity and gas markets, the UK is found to have the most competitive energy market in the EU and G7 in 2005—a position it has held since Oxera first analysed competitiveness of energy markets in 2001*”.³⁴⁰ On a scale of 1 to 10, the UK's competitiveness score was 9.1, compared with 7.8 in second-placed Sweden and 6.3 in fifth-placed Germany.

As the Secretary of State for Business, Enterprise and Regulatory Reform put it: “*Creating an open and competitive energy market has meant that UK consumers have consistently benefited from amongst the lowest energy prices in Europe. While it is true that wholesale energy prices are rising, greater choice and transparency are clearly the best protection against these costs being disproportionately passed onto consumers*”.³⁴¹

All segments of the market remain highly competitive—Ofgem

In addition, Ofgem's Domestic Retail Market Report of June 2007 found that: “*Our analysis shows that all segments of the market remain highly competitive and not just for customers who pay by direct debit or online*”.³⁴²

Ofgem's analysis hinged upon a number of findings, including that: price competition has led to the spread between prices shrinking and the most expensive suppliers being forced to become more competitive; how innovative products are emerging as suppliers seek to win and retain customers; how customer service is improving; and how switching rates are increasing.

Consumers have a wide choice of energy suppliers and they are exercising that choice. According to Ofgem's June 2007 Report, annual rates of switching were at the highest levels in four years. On average 30,000 more switches took place per month than in the previous year. This was an 11% increase in monthly switching rates over the year.

This trend is set to continue. Statistics published by Ofgem show that, between January 2007 and July 2007, 2.8 million customers switched their electricity supplier and 2.3 million switched their gas supplier.³⁴³ This compares favourably to the figures for 2006 between January and July, when 2.6 million electricity customers and 2.2 million gas customers switched supplier. Energy suppliers will continue to compete heavily on price and service, strive for innovation and customers will continue to benefit from switching supplier.

In addition, Ofgem have found that of those customers who have not switched, the majority (more than 70%) say they are happy with the price and service they get from their supplier. Around 15% have not switched as they “do not see the point”, while under 3% have not switched as they see it as too difficult, or were unaware of switching as an option.³⁴⁴

Successful suppliers increase customer numbers

SSE, which supplies energy as Southern Electric, SWALEC, Scottish Hydro-Electric and Atlantic Electric and Gas, gained one million customers during 2007 and now has well over eight million electricity and gas customers. This enabled it to overtake EON UK to become the UK's second largest energy supplier, having been fifth six years ago.

This achievement in recent years demonstrates the highly competitive nature of the market: by offering lower prices and achieving the best performance ratings for customer service SSE has outperformed its competitors in this market, and customers have voted with their feet.

³⁴⁰ Oxera Report: Energy Market Competition in the EU and G7: October 2007.

³⁴¹ GNN ref 156920P.

³⁴² Ofgem Domestic Retail Market Report June 2007.

³⁴³ Ofgem Press Release R/45.

³⁴⁴ Ofgem Domestic Retail Market Report June 2007.

Responsible and fair pricing

SSE adopts a “fair pricing” policy: it seeks to be the last (or one of the last) of the major energy suppliers to increase prices if it has to, and the first (or one of the first) to lower prices if it can. At a time of sustained rises in wholesale energy prices and other upward pressures on domestic prices, SSE aims to protect its customers from the worst effects.

Household energy consumption is at its highest in the first quarter of the year, with the average household in Great Britain using around 40% of its annual gas consumption and around 30% of its annual electricity consumption in January, February and March. That is why SSE committed not to increase prices during this winter period. The company kept its electricity and gas prices for domestic customers at their pre-existing levels for the whole of the winter, when they are having to use most energy, and will not implement a price increase until after the start of British Summer Time, on 1 April.

In addition, SSE believes that the following displays further evidence of its fair pricing policy:

- During the period of rising wholesale energy prices, SSE passed on to its customers much less than the full extent of the increases in wholesale prices and environmental costs experienced in that period and it delayed any price rises for as long as possible.
- As a result, its customers have paid an average of a total of £433³⁴⁵ less for their gas and electricity between April 2004 and March 2008 than have customers of British Gas.
- SSE was one of the first suppliers to introduce a social tariff to help its most vulnerable customers. Those qualifying for Energyplus Care are offered: a discount of at least 20% off their current tariff; a benefits health check, where appropriate; free energy efficiency measures such as loft and cavity wall insulation; and the loan of an A-rated fridge or fridge freezer if the existing one is inefficient.
- SSE has aligned its electricity prepayment prices with standard credit prices. However, given that only around 25% of customers on PPMs are classified as fuel poor, we are not certain that this decision was an optimal solution for helping our most vulnerable customers.
- SSE has tailor-made payment measures, used on a daily basis by thousands of people, in order to help them to pay their bills in a manner which suits their financial situation.
- As a result of its fair pricing policy, SSE’s standard direct debit tariff is actually cheaper than the tariff British Gas claims to be their social tariff—“essentials”. Essentials is a tariff designed to help fuel poor customers pay for their energy bills.

Effective customer service

While SSE attributes a significant amount of the credit for its customer growth in terms of attracting new customers upon its pricing strategy, it also retains customers by leading its sector in customer service and complaint handling. Suppliers are competing on complaints and customer service performance as well as price, so SSE considers service to be a primary part of its offering to customers.

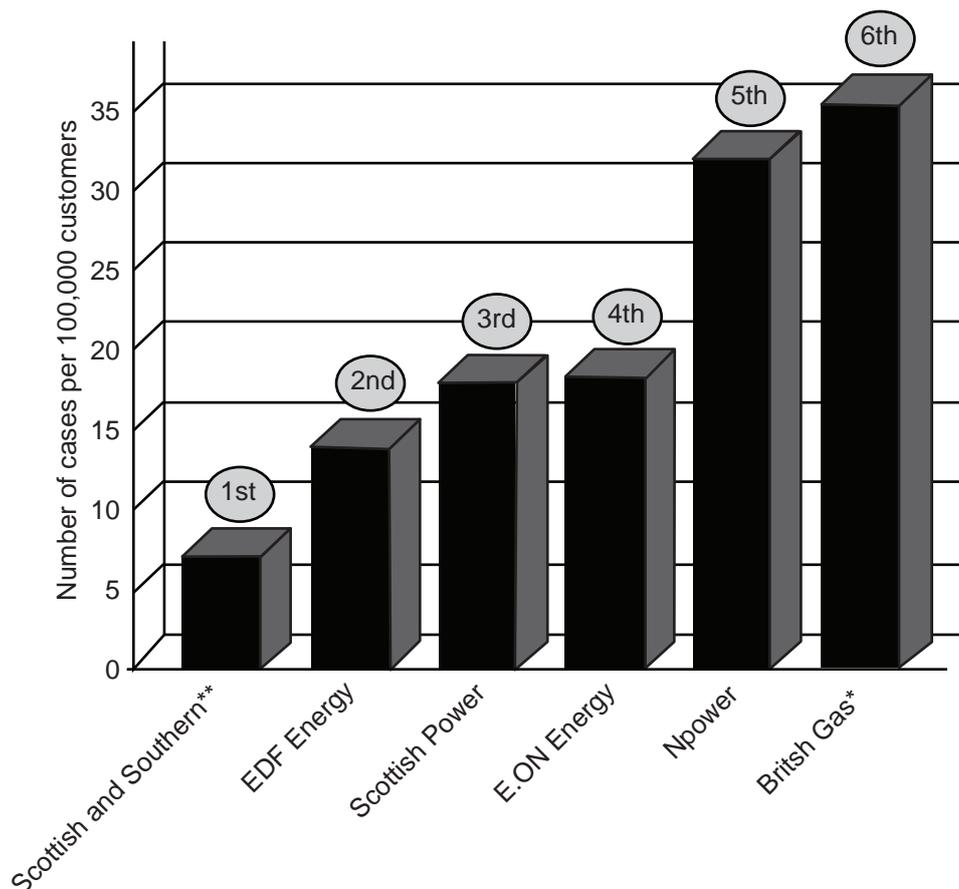
SSE has consistently been the best performer in the energy sector because of its high standards in complaint handling and it continues to make significant improvements in its complaints handling procedures.

In the year to March 2007, SSE significantly reduced the total number of complaints referred to energywatch for resolution by 47%, to an average of 70 per month. This has been further reduced during 2007–08, with the number of complaints so far averaging just over 50 per month.

According to energywatch investigated complaints cases, SSE is consistently the best performer. See graph below taken from energywatch website which shows performance across the industry for November 07—January 08.³⁴⁶ In contrast British Gas’s complaints doubled.

³⁴⁵ Based on an average over the 14 supply areas for a dual fuel customer consuming 20,500kWh of gas per annum, and 3,300kWh of electricity per annum and paying quarterly. Prices include VAT.

³⁴⁶ http://www.energywatch.org.uk/help_and_advice/supplier_performance/index.asp



In addition to the figures above, SSE had its reputation for providing the best customer service in the energy supply industry confirmed, by topping three independent surveys—J.D. Power and Associates 2007 UK Electricity and Gas Supplier Customer Satisfaction Study, uSwitch.com’s Customer Satisfaction Report, and the quarterly supplier performance report by energywatch. This was the fourth consecutive year SSE had topped JD Power Customer Satisfaction awards.³⁴⁷

Furthermore, in the highly competitive GB market the ultimate safeguard for customers is their ability to switch supplier if they are dissatisfied with the service they receive. SSE’s track record in customer service proves this, with its net gain of one million customers in the year to December 2007.

SSE will continue to work to ensure that the quality of service it provides to its customers is sector leading and that it responds effectively to its customers’ concerns about products and services. In 2006, it implemented a new Domestic Energy Customer Charter, the first of its kind in the UK. It made a series of specific commitments in respect of customer service, such as a pledge to respond to letters from customers within five days of receipt. SSE intends to publish a revised and enhanced Charter later this year.

The UK’s competitive market encourages innovation

In addition to stimulating competition in service levels, evidence also suggests that Britain’s energy supply market drives new product development: 20% of the market is now served by new products such as fixed or capped rate products, online deals or green supply products.³⁴⁸

As a supplier SSE has responded to competition by launching a number of competitive innovative tariffs, catering for different customers’ needs. Towards the end of last year, SSE launched the “better plan”, a unique package which offers customers financial rewards for reducing their energy consumption. Customers receive 100% hydro-electricity at no extra cost and can earn cash credits by being helped to take a few steps to being more energy efficient. New joiners also receive a monitor displaying their energy usage.

SSE also offers a feed-in tariff called Solar Energyplus. It offers grid-tied photovoltaic solar system owners a market leading 18 pence/kWh export tariff. It is aimed at small businesses and households and SSE pays to install export meters, obtain Renewable Obligation Certificate (ROC) accreditation, and act as ROC agent for owners of solar energy systems. At 18 pence per kWh exported, a system generating 1500kWh per

³⁴⁷ J.D Power and Associates 2007 United Kingdom Electricity Supplier Domestic Customer Satisfaction StudySM. SSE came first place in both the electricity and gas JD Power Customer Satisfaction Survey, the first time one company has won both since the studies’ inception. SSE was significantly above industry average for all categories except metering in both studies.

³⁴⁸ Ofgem Domestic Retail Market Report June 2007.

year (equivalent to half the UK average for household energy consumption) will earn £135 per year if it exports 50% of power generated. It is also important to note that tariffs such as Solar Energyplus and other flexible innovative tariffs would be aided substantially by the introduction of smart meters.

2. THERE ARE NO SIGNIFICANT BARRIERS TO ENTRY

- 150 licensed suppliers.
- Market entry by high profile names.
- Simplifying industry arrangements.
- Metering needs to be reinstated as a regulated product of distribution businesses.

As explained above, the energy supply market is vigorously competitive, with strong evidence of customer awareness of the competitive market, a switching process that is straightforward for customers, a wide range of offers from suppliers and large numbers of customers exercising choice to switch to alternative suppliers. SSE believes that on each of these counts the competitive energy supply market would compare favourably with other similar competitive markets.

150 licensed suppliers

Nevertheless, one criticism that has been levelled at energy supply is that it is “too difficult” for new entrants to break into the market. Again, SSE does not believe that the evidence supports this. It is relatively easy for any party to obtain a supply licence and sign up to the relevant industry agreements. There are, for example, currently 150 licensed suppliers and in the last 12 months alone there have been a total of 13 applications for supply licences (six applications for gas supply licences and seven applications for electricity supply licences).

It is true that, since competition began, a number of smaller players have exited the market, notably the insolvency of Independent Energy in September 2000 and the exit of a number of electricity and gas suppliers between December 2005 and February 2006 (Zest4, Utility Link, Reephram Limited, Elador and Team Group UK Limited). There has, however, also been exit and failure by “incumbent” generators and suppliers, including the Government intervention to prevent British Energy going under and the failure of the former Eastern supply business under TXU.

Market entry by high profile names

It is also important to note that there has been market entry by a number of high profile names, such as affinity deals with Nectar, Tesco Clubcard, Argos, British Heart Foundation, BA Airmiles and RSPB. In addition, a number of niche players have emerged in the electricity market such as Ecotricity and Good Energy, who specialise in green energy products. Good Energy has also recently been granted a gas supply licence.

Simplifying industry arrangements

SSE is, however, sympathetic to the view put forward by some that the industry trading arrangements at both wholesale and retail level are complex and are becoming increasingly so. It would not agree that at present those arrangements are an insurmountable barrier and the fact that there has been some entry into the market is evidence of that. Nevertheless, SSE does believe that more could be done to simplify the industry arrangements, to the benefit of potential new entrants and indeed existing market participants and customers.

There have been some significant steps taken in this regard, such as the recent supply licence review which halved the bureaucracy of the supply licence, for which Ofgem deserves praise. The remaining obligations were deemed necessary either to facilitate the smooth operation of the competitive market or to afford the most vulnerable domestic customers with additional—but necessary—protection and support.

There is, however, more that can be done. For example, SSE supports Ofgem’s review of the industry governance arrangements and would hope that it would lead to a much reduced regulatory burden on the industry, as well as a more streamlined modification process. It also believes that Ofgem could do more to reduce the complexity of some of its reforms, for example in relation to the mind-bogglingly complex auctions for gas entry capacity which have, in SSE’s view, reduced competition offshore. Similarly complex arrangements are now being introduced for gas exit capacity and, if Ofgem has its way, would be introduced in electricity. SSE understands the public policy reasons behind the introduction of these arrangements but would urge Ofgem to take wider account of the effect of its complex reforms on the market.

Metering needs to be reinstated as a regulated product of distribution businesses

Another example at a retail level is metering, where the introduction of metering competition has not produced the anticipated benefits, but has led to a fivefold increase in the amount of data that must be processed on change of supplier. Backing out metering competition and reinstating metering as a regulated product of the distribution business would not only simplify the industry change of supplier process significantly, it would also better facilitate the roll-out of new smart metering technologies (which would in turn bring competitive benefits).

3. PRICE DECISIONS ARE THE RESULT OF MANY ISSUES

- Wholesale markets.
- Delivering climate change initiatives.
- Network infrastructure costs.
- Bill breakdown.
- Other contributory factors.
- Wholesale gas market in Europe.
- UK wholesale markets are liquid.
- EU ETS was not a “windfall”.

The Committee is concerned about what it termed “the continuing controversy over energy prices”.³⁴⁹ Whenever price rises (and falls) are examined, it is very important that people understand the reasons behind the decisions. In the sections below, SSE outlines some of the contributory factors to price rises (and falls) covering wholesale gas prices, network costs, and the costs associated with tackling climate change.

Wholesale markets

One of the key drivers to recent supplier announcements to raise prices is the recent rise in the wholesale gas price across the world. This is not the fault of suppliers and the effect of this on gas prices within a country importing significant quantities of its gas is obvious. However, it must also be understood that with much of the UK’s electricity coming from gas power stations, it will clearly affect electricity prices also. Between 2003 and 2008 wholesale energy prices have increased by a factor of 2.5.

It is also important to understand that for entirely responsible reasons suppliers “hedge” their requirements by buying a significant proportion of their customers’ energy needs in advance. When wholesale prices are going up, customers benefit as there is a lag before suppliers raise retail prices; similarly, when wholesale prices fall, it takes time for suppliers to see reduced purchasing costs and pass these through to customers.

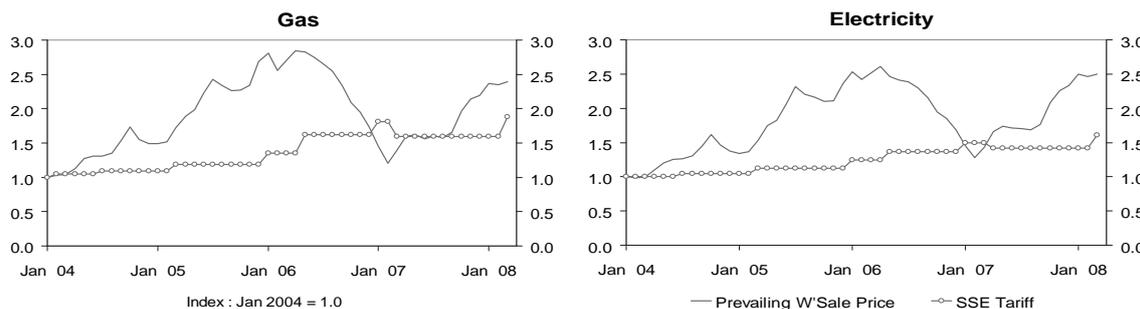
SSE’s ability to work effectively and efficiently in this area has helped it to succeed in this competitive market, and not pass on the full extent of wholesale price increases to its customers. As a result, its customers have paid an average of around £433 less for their gas and electricity between April 2004 and March 2008 than have customers of British Gas.³⁵⁰

The graphs below illustrate the relative change in wholesale prices and SSE’s domestic prices³⁵¹ for electricity and gas since January 2004, clearly showing how SSE has prevented its customers from facing the full extent of wholesale price increases.

³⁴⁹ BERR Committee PN 19.

³⁵⁰ Based on an average over the 14 supply areas for a dual fuel customer consuming 20,500kWh of gas per annum, and 3,300kWh of electricity per annum and paying quarterly. Prices include VAT.

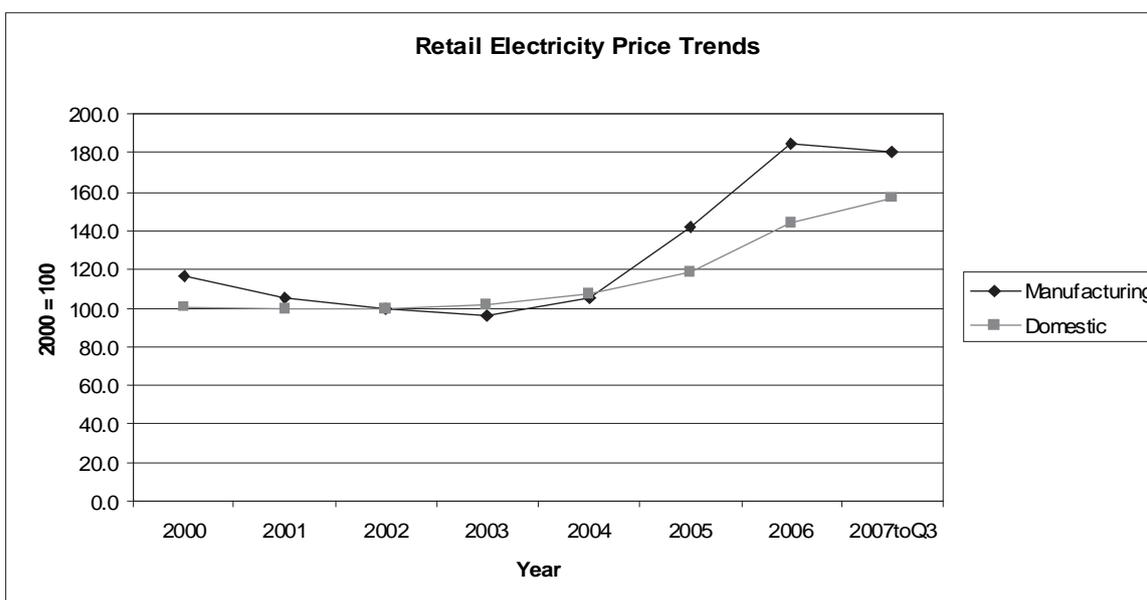
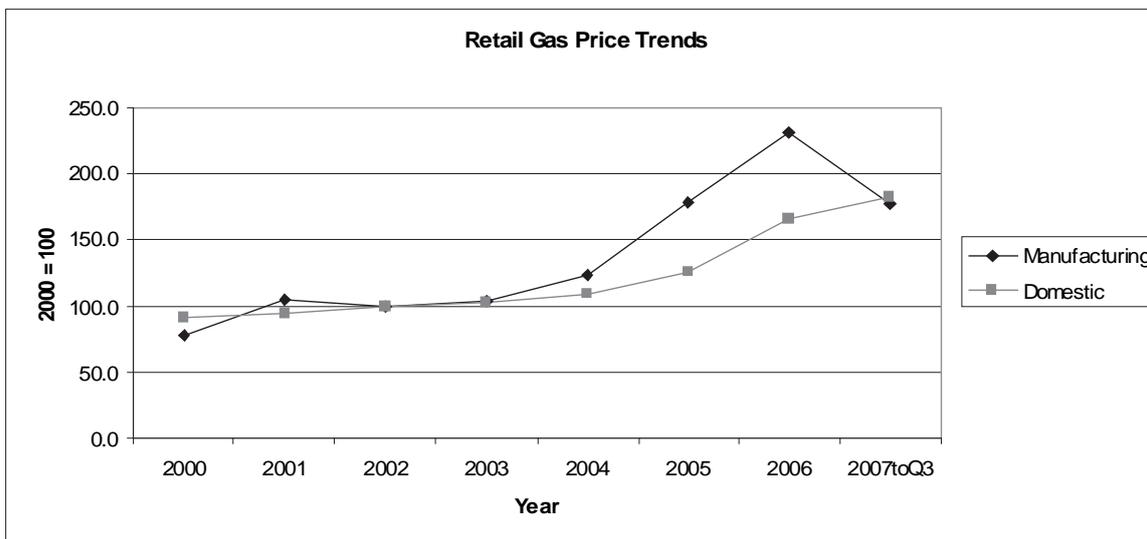
³⁵¹ Domestic prices are based on the expected annual bill using typical annual consumption of 3,300 kWh for electricity and 20,500kWh for gas. Prices include VAT and are based on a national average of prevailing tariff rates for customers who pay their bills quarterly. Energy prices are based on the forward view of annual prices within the prevailing wholesale market.



In addition to the above, there is often a misconception that suppliers treat businesses preferentially to domestic customers in terms of passing rising costs on to them. However, the following graphs³⁵² showing retail price trends for domestic and manufacturing customers tell a different story.

Taken in conjunction with wholesale price trends outlined above, they show that the upsurge in costs in recent years was passed through much faster to business customers than to domestic customers. This might be expected since business customers regularly contract for fixed prices on an annual basis and suppliers arrange short periods of backing accordingly.

Government data is not particularly timely so we can only get as far as Q3 2007 in our modelling, where we see the impact of falling wholesale prices bringing a rapid fall in business prices so that the gap with the domestic trend closes. Since that time however, wholesale prices have started to rise again and we can expect the next data set to show a gap opening up again.



³⁵² Source: BERR Quarterly Energy Prices (December 2007).

Delivering climate change initiatives

In addition, Government policies to tackle climate change and improve energy efficiency, which command broad support, put an upward pressure on energy prices for all customers. The Carbon Emissions Reduction Commitment (CERT) for example, will add around £38 to the average energy bill for 2008.

Network infrastructure costs

Network infrastructure costs have also increased to support the delivery of new renewable energy and the upgrading of energy networks to ensure they are safe and secure for another generation.

The total costs to customers in delivering network infrastructure and environmental policies have risen by almost 50% in the last four years, from almost £170 on electricity and gas bills in 2004 to almost £250 in 2008.

In total, this additional investment in networks and environmental improvements has added at least £80 per annum to the typical household's³⁵³ energy bills.

Bill breakdown

The below table indicates how all of the above affects the breakdown of a typical bill, showing the price of SSE's tariffs, the use of distribution and transmission costs (UoS); the costs of ROCs; the cost of EEC, now CERT; and metering and billing costs. These figures are then added up to make a "Non Energy Cost". In addition, the "Energy" costs are included, which include the cost of buying the energy (therefore wholesale costs) and include our profit margins.

It is useful to note the following:

- The portion of the electricity bill allocated to "Energy" has increased by a factor of x1.9. Wholesale energy prices have increased x 2.5 in this period.
- In addition, the portion of the gas bill allocated to "Energy" has increased by a factor of x1.7. Wholesale energy prices have increased x 2.4 in this period.

Breakdown for typical bill

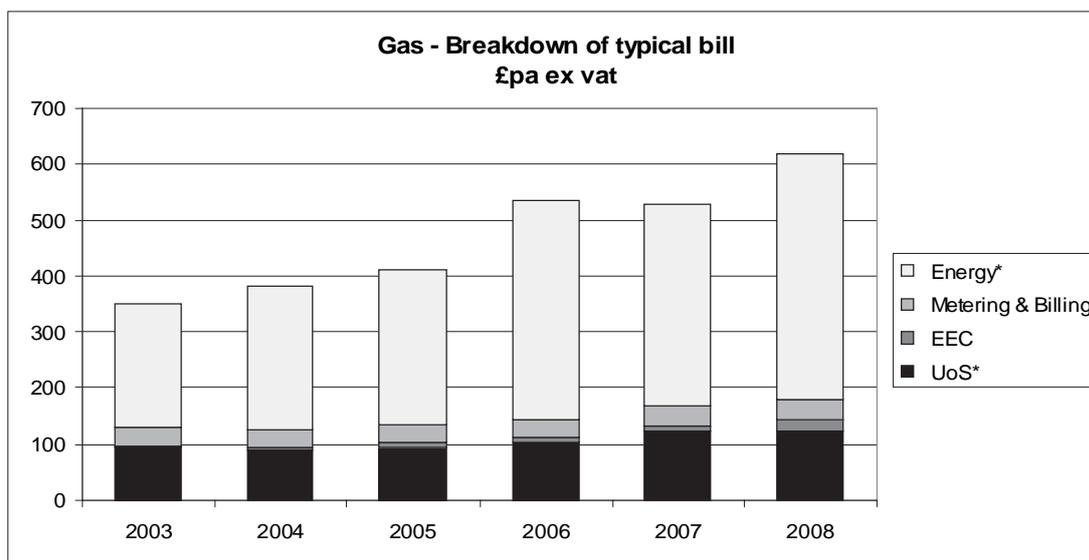
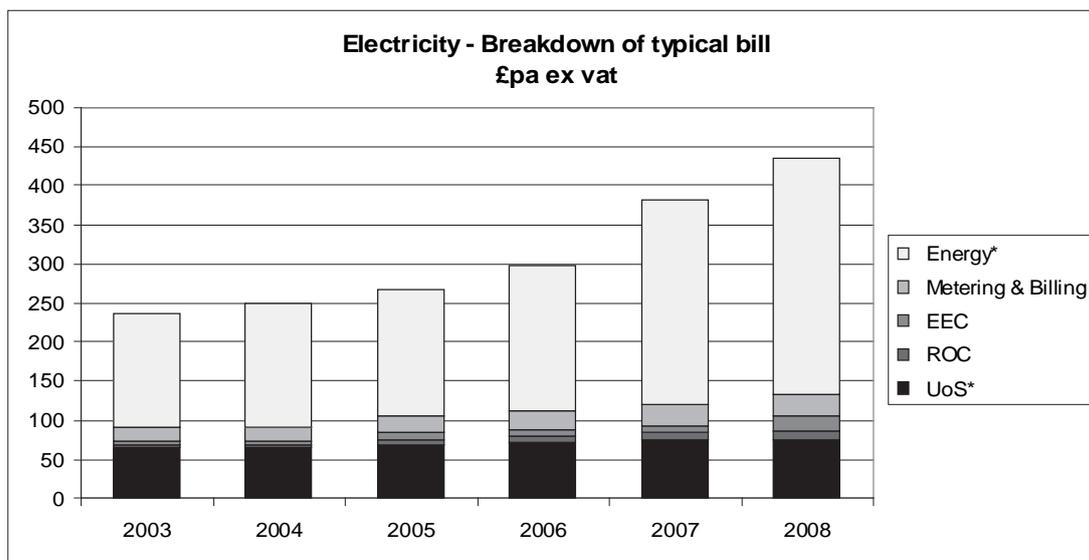
<i>£pa</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>	<i>2006</i>	<i>2007</i>	<i>2008</i>	<i>2008</i> <i>£pa</i>	<i>v</i>	<i>2004</i> <i>Change</i>
ELECTRICITY									
Tariff	238	251	267	298	382	436	185		x 1.7
UoS*	64	64	70	72	75	76	12		x 1.2
ROC	4	5	6	7	9	11	6		x 2.1
EEC	4	4	9	9	9	19	15		x 5.3
Metering & Billing	18	18	22	25	27	28	10		x 1.5
Non Energy Costs	90	91	107	113	120	134	43		x 1.5
Energy*	148	160	160	185	262	302	142		x 1.0
GAS									
Tariff	319	348	380	500	495	584	236		x 1.7
UoS*	94	91	94	101	124	124	33		x 1.4
EEC	4	4	9	9	9	19	15		x 5.3
Metering & Billing	33	33	33	34	35	36	3		x 1.1
Non Energy Costs	97	94	103	110	133	143	49		x 1.5
Energy*	222	254	277	390	362	441	187		x 1.7

* UoS refers to distribution and transmission costs. Prices generally refer to levels at April for electricity and October for gas. Gas in 2008 has been kept at 2007 level.

* Energy includes supply profit/loss

³⁵³ Based on a standard general domestic customer with typical annual consumption of 3,300 kWh for electricity and 20,500 kWh for gas.

To make this information easier to digest, the information is also translated into graphs below.



Other contributory factors

The above are not all the contributory factors to price rises and falls. Issues as diverse as Japanese nuclear plant problems, LNG supplies, Chinese coal demand, logistical and freight transport issues, Russian and Norwegian gas, and the oil price and its effect on the global economy, all play their part in influencing wholesale energy prices. Outside Britain, for example, the price of gas is linked to the price of oil.

It is against these contributory factors that a supplier must make its price choice and suppliers, of course, have their own internal company structure and cost variations. At the same time, however, the issue of the wholesale gas market in Europe looms very large.

Wholesale gas market in Europe

In recent years there have been a number of investigations into the wholesale gas market which have examined whether high gas prices were attributable to supply and demand fundamentals, or manipulation by producers or European interconnector effects. There has been no firm conclusion regarding the real cause of the problem, however the opacity of upstream information has been identified as a common concern with the market. In the downstream gas market there has been some improvement in the resolution of information available to market participants which has been beneficial, but it is not on a par with that available to participants in the electricity market.

For example, the transparency of a change in flow at an entry sub-terminal informs market participants in that it updates the overall supply position and allows an assessment to be made of short-term prices. On its own though, because the flows are aggregated, this does not provide sufficient information to allow the market to understand which party has suffered a loss and who is likely to come to the market to balance a position. There is no field-specific flow information which would be equivalent to the instantaneous individual power station data that is available in the electricity market.

In SSE's experience it is difficult to contract for long-term gas on fixed price contracts as the majority of contracts are sold on the basis of a floating prompt month index price, leaving only a small volume of gas to be sold prompt. This creates a market where a small volume of gas is being chased by a large number of buyers. Parties like SSE do not therefore have access to information relating to the entire gas supply chain, unlike in electricity. The lack of transparency in the activities of upstream players makes it difficult to understand the true picture in terms of the dynamics on prices.

In Europe, SSE firmly believes that additional transparency is a pre requisite to increasing market confidence which will lead to further trading activity and hence greater liquidity at the gas hubs.

A series of gas pipelines connects the UK with the continent, with the result that this country's wholesale gas market is inevitably affected by prices for gas in Europe. It is likely that dealing effectively with the wholesale gas market in Europe would make the cost of gas imported into the UK less than it otherwise would be.

This illustrates that what goes on in Europe is having a growing and major effect on energy in the UK. It has rightly been observed that Britain can no longer be regarded as an isolated and self-sufficient market for electricity and gas. As a result, the relative lack of competition which the Oxera report (above) identified in Europe is a source of significant concern, and needs to be addressed as a priority.

UK wholesale markets are liquid

Despite the well-documented issues with the wholesale gas market in Europe, it is generally recognised that the UK's wholesale energy markets are the most liberalised and competitive in the EU.

The UK's six leading energy suppliers all own and operate electricity generation capacity, but the wholesale electricity market is much more complex than that. With gas being used to generate over one third of the UK's power needs, rising wholesale gas prices have a follow-on impact on electricity prices. In addition, prices for coal, which is used to generate another one third of the country's power needs, have recently risen to record levels.

Over 50 parties participate in the UK power and gas markets: the major energy suppliers; other generators (such as Drax, British Energy and International Power) financial traders; foreign utilities (mainly European gas and power incumbents); other utilities; and gas producers (such as Shell, Conoco, Gazprom and BP).

This means that the virtual trading location for the sale and purchase of UK natural gas (the National Balancing Point or NBP) is a fully liquid and competitive market, in which active trading provides liquidity, risk capital and market direction. Traded volumes in the UK power market are good, although the lower level of financial interest in this market means companies like SSE make a greater contribution to the overall liquidity of the market.

EU ETS was not a "windfall"

In recent weeks, it has been suggested that the energy industry has received a windfall through the award of carbon emissions permits under the EU ETS. This is completely wrong. The fundamental point is that the permits did not represent a "windfall", but were carefully conceived and designed to ensure the smooth introduction of EU ETS. Moreover, uniquely, the UK electricity generation sector had to operate within tighter emissions limits. Where those limits have had to be breached—often to ensure the overall stability of the country's electricity system—generators have had to purchase permits. SSE, for example, has incurred significant costs in securing permits to make up for the shortfall in our allocation. This is in marked contrast to the position before the EU ETS was introduced, when power stations could emit carbon dioxide free of charge. All of this means that the UK has been a net buyer of permits to emit carbon dioxide.

The approach adopted by the UK government when EU ETS was introduced has ensured stable supplies of power while confirming that carbon dioxide should have a market price. It has, therefore, been very successful and a similar, measured approach to future phases of EU ETS should ensure a progressive move towards lower carbon power generation while maintaining secure supplies of energy.

4. MEANINGFUL LONG TERM SUPPORT FOR THE FUEL POOR

In Budget 2008, the UK government said that it wanted to see energy companies spend a total of £150 million a year to help tackle fuel poverty. SSE has published a draft Code of Practice for helping vulnerable customers that it believes should be adopted across the energy supply industry. This draft Code is founded on two key points:

- the single biggest contribution which suppliers can make to preventing fuel poverty is to keep prices as low as possible for as long as possible. On this basis, those suppliers who charge most for electricity and gas should contribute most to helping vulnerable customers. At the same time, account does need to be taken of the number of customers which each supplier has. The way to combine these principles is to base suppliers' contribution on the annual turnover of their domestic energy supply businesses—a simple and fair formula which reflects suppliers' total customer numbers and the prices they charge for electricity and gas; and
- suppliers should ensure that any “social” tariff which they offer to vulnerable customers is the lowest cost tariff that is made available by them to any type of customer, or any type of payment plan or sign-up method. This will ensure that the lowest-cost tariffs are available for the customers who have most difficulty in paying their bills. As an additional safeguard, SSE believes that suppliers should be required to ensure that their “social” tariff for “dual fuel” is lower than the average UK direct debit tariff.

SSE's voluntary efforts to assist our fuel poor customers have been founded on these two principles. Given the notorious difficulty there is in identifying and targeting fuel poor households, we firmly believe that our twin track strategy makes the greatest contribution in alleviate fuel poverty in Britain. Our determination to keep prices as low as possible for all our customers has prevented many thousands of families falling into the formal definition of fuel poverty.

This approach to general pricing is complemented by a deep and meaningful package of support measures through our social tariff “energyplus care”. Eligible households receive at least a 20% discount from their energy tariff in addition to other help including benefit entitlement checks, free energy efficient appliances and homes insulation, where appropriate.

At the time of writing we are engaged in detailed discussions with the Department for Business, Enterprise and Regulatory Reform is devising a voluntary agreement where we will radically increase our voluntary contribution to target even more support to our fuel poor customers.

We will welcome however greater support from government in the future to help us identify the right customers with our programmes to assist the fuel poor. Without that help, we cannot be sure that our voluntary programmes are reaching the right customers.

SUMMARY

SSE understands why there has been so much attention focused on energy supply in the UK in recent months. There are clearly areas which would benefit from progress being made, and SSE has highlighted some which would deliver significant benefits going forward.

Nevertheless, the market is fundamentally sound, delivers for customers and represents the best prospect for the delivery of sustainable, reliable and affordable electricity and gas in the years to come.

SSE would be happy to supplement this written evidence with oral evidence to the Committee if that would be helpful and could be arranged.

1 April 2008

Supplementary evidence submitted by Scottish and Southern Energy

ENERGY MARKET INQUIRY: FOLLOW UP TO ORAL EVIDENCE ON 24 JUNE 2008

I am grateful to the Committee for giving me the opportunity to set out views on the issues being considered in its inquiry into the UK energy market, and I would like to take up your invitation to follow up the evidence given on 24 June by addressing briefly three specific points: the EU Emissions Trading Scheme (EU ETS); so-called “social tariffs”; and vertical integration.

EU ETS

It is absolutely vital that the Committee does not fall into the trap of concluding that allocations of permits to emit carbon dioxide, under the EU ETS, represent any kind of “windfall”. They have been carefully conceived and designed to ensure the smooth introduction of EU ETS. Moreover, uniquely, the UK electricity generation sector had to operate within tighter emissions limits. Where those limits have had to be breached—often to ensure the overall stability of the country's electricity system—generators have had to purchase permits. SSE has incurred significant costs in securing permits to make up for the shortfall in our allocation. This is in marked contrast to the position before the EU ETS was introduced, when power stations could emit carbon dioxide free of charge. All of this means that the UK has been a net buyer of permits to emit carbon dioxide.

The approach adopted by the UK government when EU ETS was introduced has ensured stable supplies of power while confirming that carbon dioxide should have a market price. It has, therefore, been a positive first step and a similar, measured approach to future phases of EU ETS should ensure a progressive move towards lower carbon power generation while maintaining secure supplies of energy.

A retrospective tax on previously-allocated permits would severely undermine the EU ETS going forward. The impact of such a move would also resonate well beyond the EU ETS. Investors in the UK electricity sector would undoubtedly see such a proposal as a short-term populist gesture—but one which would have profound long-term consequences. It would reverberate across the sector, leading to a step-change increase in investors' perceptions of regulatory and political risk in the UK—at a time when the country is looking for massive levels of investment in power generation and distribution and gas storage. It is likely to discourage existing—or new—investors from putting their money into energy in the UK.

“SOCIAL” TARIFFS

I hope I was able to impress upon the Committee the strength of SSE's feeling about so-called “social tariffs”. In April 2008, we published a *Code of Practice for Fuel Poor Customers* which contains two key principles:

- Energy suppliers should ensure that any “social” tariff which they offer to fuel poor customers is the lowest-cost tariff made available by them to any type of customer, via any type of payment plan or sign-up method; and, as an additional safeguard,
- Energy suppliers should ensure that their “social” tariff for customers is lower than average direct debit tariffs in the UK.

Vulnerable customers need the lowest prices available, not simply a tariff labelled “social”, and that principle is at the heart of our Code of Practice. Most claims about “social” tariffs do not conform to this principle, but SSE believes they should. In that way, Britain's poorest customers should be able to access Britain's cheapest energy prices.

That said, SSE is of the firm belief that whatever superficial attractions it may appear to have, a mandatory social tariff would be a retrograde step. Firstly, it would be yet another contentious piecemeal intervention in the country's already complex benefits system. Secondly, it would distort competition by effectively encouraging suppliers to avoid (loss making) customers who could qualify for the social tariffs whereas, in fact, the industry should be working on innovative schemes to help them. Thirdly, it does not tackle energy efficiency, so is further subsidising people to heat inadequately insulated homes. Fourthly, it creates additional issues in terms of establishing and then identifying eligibility.

All these issues have to be addressed along with that of what standards would this mandated tariff consist of? This is the fundamental aspect of social tariffs, mandated or otherwise. If a mandate was given that allowed British Gas's Essentials tariff to count as a social tariff, then none of SSE's customers (fuel poor or otherwise) would be on a deal that benefitted them significantly. Likewise, if the entire “fuel poor population” (by the Government's definition) were mandated to be put on a tariff as deep as SSE's social tariff—all suppliers would have to raise their standard prices extremely, and unsustainably, high (potentially putting yet more people into fuel poverty).

In addition, such an imposition does not cater for the eventuality of wholesale prices falling, making an imposed “one size fits all” social tariff more costly than the market price, nor does it cater for the fact that some people are in deeper poverty than others, and therefore need more support.

Against this background, the Committee certainly should consider recommending mandatory principles for a social tariff, thus ensuring that suppliers do not get away with inflated claims about their contribution in this area, but should think very seriously about the implications of a “one size fits all” tariff, which, on reflection is inflexible, unworkable and inadequate.

VERTICAL INTEGRATION

There is a real inconsistency in some of the arguments that have been made relating to vertical integration, and I hope this section clarifies this for the Committee. Of particular concern to me are the suggestions that being vertically integrated is a bad thing, leading to an unfair deal for consumers. In fact, the reverse is the case.

In almost every market in the world, major energy companies are vertically integrated. The reason they are is so that in periods where supply businesses are making a loss (which occurs very often, including at present) the supply business can survive because another part of the wider company is covering the loss, thus protecting customers. If SSE did not have any generation business at present, it could not have kept its prices as low as they have been, and they would have been raised far more frequently, and to even higher levels, over the last year.

However, just because SSE has both a supply and generation business, it does not allow it to actually specifically sell units of energy from its generation business to its supply business in some form of underhand advantageous way, outside of the boundaries of the market and out of sight of Ofgem. This type of practice is not allowed within the BETTA arrangements and any evidence that you have been given that suggests this is true, indicates a fundamental lack of understanding in how energy is traded in the UK.

In summary, we believe the wholesale electricity market is liquid and transparent and allows individual generators and suppliers to trade as equals.

SUMMARY

I would like to repeat my thanks to the Committee for its time on 24 June and I would be happy to provide any further information that might be helpful in advance of the publication of its Report.

25 June 2008

Letter by ScottishPower

Thank you for your letter to José Luis del Valle of 11 January 2008, asking for us to provide written evidence on energy prices and the Government's recent decision on nuclear power. I am replying as Mr del Valle is out of the country on business.

RETAIL PRICING

At the time of writing, ScottishPower has not increased its prices this year. However, we are actively reviewing the position; in the light of sharply higher input prices affecting our business, it seems inevitable that an upward movement will need to occur in the early part of 2008.

We already have a programme of assistance for vulnerable customers, involving the ScottishPower Energy People Trust and our new social tariff which will come into operation shortly.

The tariffs charged to prepayment meter customers have received particular attention in recent weeks. ScottishPower is, we believe, the first and only large supplier to provide prepayment electricity and gas at prices lower than standard quarterly credit.

We are giving careful consideration to the position of our most vulnerable customers and considering if there are any further steps we can take to mitigate the impact on them of any price increase we have to make.

As we approach finalising our pricing review, we will be looking at the following factors:

- the “end to end” income from the business. It is important that income from customers covers the input costs needed to serve them (coal, gas, ETS permits; energy efficiency and renewables programmes; operational costs etc) plus a return on the substantial capital invested. Many of these factors have gone up sharply since February 2007, especially:
 - coal and gas (market prices for both are up approximately 80%);
 - energy efficiency programmes (estimated by DEFRA to rise from April 2008 by about £10 a year for a single fuel customer and £20 for dual fuel); and
 - ETS costs (where allocations are lower and permit costs have gone from nearly zero to about €20 per tonne);
- the prices in the wholesale market. In the long term, net income from retail sales needs at least to match what we could achieve in the wholesale market, taking account of the capital deployed in retail; and
- the competitive landscape. We monitor our customer numbers daily and we need to take account of the likely impact on our customer numbers of any pricing change we make.

It is important to emphasise that the retail business does not track the wholesale market precisely in the short term. Retail margins tend to grow when wholesale prices are low and shrink when they are higher. When wholesale power prices fell below cost in 2001–02, a significant number of generators without sufficient retail customers became insolvent; conversely, in winter 2005–06 the retail market was not fully covering its costs against wholesale prices and several small retailers could not survive. However, end to end margins were broadly sustainable throughout that period, enabling integrated suppliers to maintain reliable supplies to consumers and to continue investing.

The free ETS allowances for phase II have acted as an incentive to investment in generation (both gas fired power stations and FGD plants) and a number of significant investments would not in our judgement have gone ahead without them. It is important, to maintain a stable framework for investment, that this position is not changed retrospectively. The free allowances will have contributed to the adequacy of

generation margins in the next few years, reducing the likely level of price spikes in the wholesale market, as well as directly reducing the upward pressure on end to end margins. A significant proportion of the value of these allowances is therefore likely to accrue to customers.

NUCLEAR

Our parent company Iberdrola is a significant nuclear operator in Spain. The Group is closely examining the prospects for investment in new nuclear power in the UK, focusing on opportunities in England and Wales.

We believe that the facilitative actions the Government has announced are broadly the right ones to secure the policy objective of allowing new nuclear to proceed without subsidy. It is a significant programme of work that will need to be driven forward with determination; we will play our part in helping this. Inevitably, there will be many details that will need to be resolved as the work moves to the next level and we as potential investors will participate in this.

ScottishPower Renewable Energy Limited is the UK's largest wind generator. We think that the proposals on nuclear will make no discernible difference to deployment of renewables which will be determined in the short term by the amount of progress made on planning and grid issues, and in the medium term by the Government's decisions on extending the duration and level of the renewables obligation.

We are satisfied that the wider electricity wholesale market in Great Britain has sufficient capacity, depth and flexibility to accommodate nuclear plant at the likely rate of construction without an adverse effect on the construction of sufficient other plant to maintain security of supply.

Carbon Capture and Storage (CCS) is also a technology which can play an important role in minimising the emissions of CO₂ from power generation. While there is a great deal of work still to do on both the economic and the regulatory frameworks for CCS to succeed, the Government's approach of seeking a post combustion demonstration starting by 2014 and then moving on to a wider deployment seems right and best calculated to secure a positive result.

25 January 2008

Memorandum by ScottishPower

SUMMARY

1. ScottishPower is a major participant in the energy market at a retail, networks, wholesale and generation level. We believe that there is strong competition—almost certainly the best in Europe—in both the retail and wholesale markets and that the quality of this competition has been confirmed by studies undertaken at a national and EU level.

2. As a supplier, we have been affected by very large increases in our input costs arising from conditions in the international markets in gas and coal (by 83% and 97% respectively in the year from February 2007 to February 2008), together with increased costs for energy efficiency and renewables programmes. Inevitably, these increases have impacted the amount we need to charge our customers; measured against current wholesale and retail prices, we judge that domestic supply remains a loss-making activity.

3. We believe that similar factors will also have affected our competitors in retail markets and this may explain why they have made similar adjustments to their pricing. Switching remains intense, with some 400,000 electricity and 330,000 gas accounts changing hands every month. The very strength of competition tends to bring prices closer together as any supplier charging significantly more than its competitors is likely to lose a large number of customers to others. Based on the usual indices, the domestic retail market does not give grounds for concern, though this could change adversely in the event of further mergers. The wholesale market is less concentrated and this would remain the case with further consolidation.

4. We remain concerned that European markets, especially in gas, are not as open as they should be and that the market is not clearing efficiently between the UK and the continent. This may be contributing to additional volatility of gas prices in the UK and possible excess profits for upstream hydrocarbon producers. For these reasons, we support the progress being made on liberalisation of EU markets.

5. A huge investment programme is needed over the next decade to ensure security of supply as a number of older fossil fuelled and nuclear generation plants are retired. It will be essential, in bringing forward that investment, that there is confidence in the operation of the market and in the ability of participants to earn a return sufficient to remunerate their capital. At present, wholesale market prices and spreads are not sufficient to support the investments that are needed. We do not consider that suggestions of a windfall to generators from the free ETS allowances are correct; a significant part of the benefit from the allowances—perhaps all of it—will accrue to customers. In these circumstances, a windfall tax would be neither fair nor

likely to facilitate the necessary power sector investment. Indeed, serious consideration needs to be given to some form of capacity payments, or free ETS allowances for phase III, in order to ensure that adequate investment is made.

6. Like many market participants, we agree with Ofgem's judgements in some specific areas and are seeking opportunities to persuade them to re-assess their policies in others. For example, we have serious reservations about their approach to the allocation of transmission charges to generators. However, we have a high degree of confidence in the ability of Ofgem to provide the necessary regulatory oversight of competition in the retail market. Competition is clearly the best way to protect consumer interests because it drives the industry to innovate to raise standards and improve efficiency. Accordingly, we are supportive of Ofgem's policy of avoiding detailed intervention in competitive areas where possible, and of promoting self-regulatory solutions where appropriate. Ofgem also acts as a competition regulator and has shown a willingness to be very tough in this sphere, as evidenced by the recent £41.6 million fine imposed on National Grid.

7. ScottishPower is supportive of efforts to address questions of fuel poverty. We support a large and effective trust fund, the ScottishPower Energy People Trust, and have recently introduced a social tariff, Carefree Plus, for our most vulnerable customers. We are holding discussions with the Government with a view to establishing how their aspiration of almost trebling the industry's social programmes to £150 million a year can be made an effective reality. We look forward to participating constructively in Ofgem's Fuel Poverty Summit on 23 April.

INTRODUCTION

8. In April 2007, ScottishPower was acquired by Iberdrola SA, the leading Spanish energy utility. The combined group is one of the top five utilities globally and its renewables business is the clear world leader in the field.

9. ScottishPower is a major participant in the UK energy market. Its activities include generation, where we own 3,456 MW of coal fired plant, 1,915 MW of gas fired stations and various hydro and other plant; networks, where we own the transmission system in South and Central Scotland, as well as the distribution system in that region and the former Manweb area; renewables, where our sister company ScottishPower Renewable Energy Limited is the UK's largest wind power generator; and retail, where we have some 5.25 million customer accounts.

10. We believe that the Committee's Inquiry will provide useful independent investigation of the gas and electricity markets. Since the privatisation of the electricity industry in the early 1990s we have played a full and active role in the promotion of competition in Great Britain's electricity and gas markets, growing our customer base from around 3 million customer accounts in 1998 to its current level today, witnessing first hand the competitive nature of these markets.

COMPETITION IN RETAIL MARKETS FOR GAS AND ELECTRICITY

Current Market Structure

11. It is widely recognised that Great Britain has amongst the most competitive retail energy markets in Europe and indeed globally. Much of the evidence for this is set out in Ofgem's June 2007 Domestic Retail Market Report³⁵⁴ which provides a wealth of information and analysis. That report indicates that switching is taking place at a rate of about 400,000 electricity and 330,000 gas accounts per month, a much higher rate than for many other products including telephony, broadband, banking and mortgages. This level of competition is emphasised by the changes in market shares as a result of customer switching that have been witnessed in recent years, with at least one supplier significantly increasing its market share over the period from 2002 when the last major structural change through acquisition occurred (this was the purchase of TXU's UK assets by Powergen).

12. The opening of the separate gas and electricity markets to competition has meant that incumbent suppliers in one fuel can now also compete for customers in the other fuel. The market is rapidly evolving from separate electricity and gas markets into a national market in dual fuel supply, though some customers are likely to continue to buy their gas and electricity separately and 20% or so use only electricity. Figures published by Ofgem in April 2007 indicate that almost 80% of customers who switch choose a dual fuel deal,³⁵⁵ and our own internal research indicates that 99% of all dual fuel customers who switch supplier will switch both fuels.³⁵⁶

³⁵⁴ Domestic Retail Market Report—June 2007 (Ref No 169/07)

<http://www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents1/DRMR%20March%202007doc%20v9%20-%20FINAL.pdf>

³⁵⁵ Press Release: Big Gap Opens Up in the Energy Market As Switching Rates Rocket—April 2007 (R/17)

<http://www.ofgem.gov.uk/Media/PressRel/Documents1/Ofgem17.pdf>

³⁵⁶ Based on a sample of 3,209 ScottishPower dual fuel customers who deregistered between July 2006 and March 2007. Interviews conducted by Progressive between October 2006 and May 2007. The definition of dual fuel customers in this case is those who take both fuels from ScottishPower.

13. A simple way to assess market shares and the competitive position is to use the Herfindahl-Hirschman Index (HHI). In assessing whether or not a merger should be referred to the Competition Commission the Office of Fair Trading (OFT) uses this index to assess the level of competition in a market. The HHI is defined as the sum of the squares of the market shares of all participants and ranges from around 100 for an almost perfect market (100 participants each with 1%) to 10,000 for a pure monopoly (1 participant with 100%).

14. In previous cases the OFT has referred to guidelines issued by the US competition authorities defining a market with an HHI less than 1,000 as “unconcentrated”, between 1,000 and 1,800 as “moderately concentrated”, and over 1,800 as “highly concentrated”. Any merger resulting in an HHI over 1,800 or producing an increase of over 100 and resulting in an HHI between 1,000 and 1,800 “potentially raises significant competitive concerns”.

15. We estimate that the HHI for the domestic retail electricity market is around 1700 (ignoring dual fuel for this purpose), and that it would increase by at least 300 if there was a merger of any of the six major players. Accordingly, the electricity market is presently moderately concentrated, but would become highly concentrated if there was a merger. The retail gas market, again ignoring dual fuel, rates at around 2650, which is considered to be “highly concentrated”. This reflects the historic dominance of British Gas, though concentration levels in this market have reduced progressively since the introduction of competition and British Gas’s share is now around 45%, meaning that more than half gas customers have switched at least once. Consolidation would however increase the HHI in gas by 130 or more from a high base. Precise data on the dual fuel market is less readily available at present. Indicatively, we consider that the HHI for dual fuel would resemble the position in the retail electricity market.

Competition and switching

16. The best means of protecting customers in terms of price and service quality is by ensuring that the energy markets remain fully competitive. Since the market was opened to full competition, 52% of UK customers have switched their energy supplier. In contrast, in Germany that figure has been about 4.5%. The best country to compare GB with is Spain, which has reached levels of around 20%, well short of the GB level.

17. Ofgem regularly monitor and report publicly on retail market developments to ensure that energy consumers can benefit from competition and to check that the market is operating as effectively as possible. Their most recent review³⁵⁷ confirms that all customer groups are benefiting from the competitive market and showed:

- vigorous price competition between the big six suppliers for all customers—the spread between prices has shrunk and the most expensive suppliers have been forced to become more competitive to stem customers losses;
- suppliers are innovating to retain and win customers—there has been rapid growth in: fixed and capped price deals that shield customers from rising wholesale prices; cheaper online deals; and green tariffs. They now account for roughly 20% of the market with one in five households signed up to a fixed price deal or other innovative offer;
- customer service is improving: suppliers are investing huge sums to improve their systems and five suppliers have cut the number of unresolved complaints;
- annual customer switching rates are at a very high level of around 400,000 electricity and 330,000 gas each month. Over four million switches took place in 2006, a figure which Ofgem has stated to be the highest in four years.

18. Ofgem has also specifically commissioned Mori to review switching rates for vulnerable customers.³⁵⁸ The resultant report clearly showed that the key motivation for switching supplier is price, with 76% of gas switchers and 71% of electricity switchers doing so with the aim of saving money. The research highlights that as well as price, service quality is an important consideration for many customers with one in ten customers citing this as the main reason they had switched energy supplier. It also demonstrated that there were very few (2%) customers who thought that the switching process would be too complex, or that they were prevented from switching by an existing debt. Ofgem’s study showed that of those customers who had never switched supplier, over 80% said that this was because they were happy with their current suppliers or that they simply “couldn’t be bothered”.

³⁵⁷ Domestic Retail Market Report—June 2007 (Ref No 169/07)
<http://www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents1/DRMR%20March%202007doc%20v9%20-%20FINAL.pdf>

³⁵⁸ Switching Rates for Vulnerable Customers—March 2007
<http://www.ofgem.gov.uk/Sustainability/SocAction/Publications/Documents1/Switching%20Rates%20for%20Vulnerable%20Customers%20Report.pdf>

19. While the competitive market offers all customers the opportunity to switch supplier, the Ofgem report did recognise that switching rates among lower income groups and older people are slightly lower than for the population as a whole. However, it should be noted that (at 24% for electricity and 23% for gas) switching levels in the lowest switching group (customers in Social Group E) are still higher than switching rates across all other major European markets.

20. At ScottishPower, we are anxious to encourage switching to us across all customer groups including those traditionally perceived as vulnerable, such as low-income groups and older customers, and we welcome initiatives to help customers overcome their caution to switch. We believe that Ofgem have sought to do this and have struck an appropriate balance in the work that they propose in this area. In particular, they have committed to a number of initiatives including building their understanding of the different facets of vulnerability and the issues facing vulnerable customers; looking at more direct ways of encouraging customers, that are vulnerable to switch to cheaper deals and continue to publish annual reviews of suppliers' initiatives in this area to help inform debate, promote best practice and aid consumer advisers in helping consumers understand the offers that exist. We support this work and believe that placing greater focus on this customer group will encourage even more customers to engage actively with the competitive supply market.

21. Although price comparison websites have a high profile, many other routes to market continue to be used. Face to face marketing remains an important source of switching that does not depend on the internet. Currently, over 2 million switches take place every year as a result of visits by Energysure Accredited Agents.³⁵⁹

Pricing in retail markets

22. Our retail pricing decisions have been made independently at all times. As many parties, including Ofgem, have recognised, energy prices will fluctuate for a number of reasons, particularly in relation to the input costs faced by energy suppliers. All market participants are subject to broadly similar cost structures and common input cost pressures and this can be expected to result in comparable price increases and decreases.

23. Customer behaviour in relation to switching shows that pressure from customers who wish to switch will encourage suppliers to keep prices competitive. Over the last few years, suppliers have had to reposition their prices in order to remain competitive, particularly in their incumbent areas. This has resulted in a narrowing price spread across the suppliers and has meant that those suppliers who are the most expensive have had to re-think their prices in order to compete and retain customers. For example, British Gas was the most expensive dual fuel supplier until falling customer numbers in 2007 forced it to cut prices.

24. Pricing decisions in fully competitive markets reflect a variety of factors, including:

- “end to end” company specific cost structures. It is important that income from customers covers the input costs needed to serve them (for example, coal, gas, ETS permits; energy efficiency and renewables programmes; operational costs etc), plus a return on the substantial capital involved;
- prices in the wholesale market. In the long term, net income from retail sales needs at least to match what we could achieve by selling the energy in the wholesale market, taking account of the capital deployed in retail; and
- our position in relation to competitors, as discussed above.

25. Energy companies tend to buy most of their requirements, whether generation fuels (coal and gas) or wholesale energy, some time in advance. This is because spot markets are highly volatile and because there may be delivery timescales on some items such as coal and LNG. Accordingly, it may be several months between a change in the headline wholesale price of energy and it filtering into suppliers' cost bases. This explains why retail price movements (in either direction) tend to lag movements in the wholesale market.

26. When considering prices, it is important to recognise that these must reflect the costs incurred by suppliers in supplying the customer, and that this will vary across products, regions and payment methods. A flat pricing structure, without variation, would fail to signal the benefits of low cost behaviours to consumers, resulting in higher costs in the industry and eventually raised prices to all customers.

COMPETITION IN WHOLESALE MARKETS FOR GAS AND ELECTRICITY

27. The GB wholesale electricity market is recognised as being the most competitive energy market in the EU and G7 with over 30 major generators competing in a single GB market and the largest individual market share being around 15%. The wholesale market has changed fundamentally since privatisation in the early 1990s from a highly concentrated market with five main generating companies to an unconcentrated market with many diverse generating companies. The change has largely been driven by new gas-fired capacity built by new entrants and plant divestment by incumbent generators. Significant changes to trading arrangements have also increased competition with new bi-lateral trading arrangements

³⁵⁹ See EnergySure leaflet <http://www.energy-retail.org.uk/documents/EnergySureFINAL.pdf>

introduced in 2001 in England & Wales to replace the Electricity Pool, implemented at privatisation, and the extension of these new arrangements to Scotland in 2005. These arrangements allow all generators to be price setters through forward and futures markets, short term power exchanges and a balancing mechanism.

28. When assessed under the Herfindahl-Hirschman Index, the GB wholesale electricity market scores in the range 840–910. This is categorised as un-concentrated and mergers could still take place in this market between major players without the market being rated as highly concentrated under the index.

29. We do not consider that suggestions of a windfall to generators from the free ETS allowances are correct. The free allowances for phase II have acted as an incentive to investment in generation (both gas fired stations and FGD plants) and a number of significant investments would not in our judgement have gone ahead without them. These investments will ensure that there is more generation plant available in the years to come—a factor which will both increase security of supply and reduce wholesale prices. Additionally, the free ETS allocations have had the effect of causing the postponement of plant closures, with similar positive impacts on security of supply.

30. This issue was studied in a Consultants' report published by BERR alongside the Government's 2007 Energy White Paper.³⁶⁰ This concluded that, as a result of more investment and fewer closures, some 90% of the benefits of free allocations in phase III would accrue to consumers (through reduced scarcity in the power market) and not to generators. It also concluded that free allowances would eliminate the substantial dip in capacity margins projected for around 2017 and the corresponding peak in unserved energy.

31. In addition to the impact on the wholesale market described above, free allowances granted to integrated companies are likely to reduce the pressure for retail price increases because they contribute toward ensuring that end to end returns on capital are being met. Taking account of both these factors, we believe that it is clear that a significant part of the benefit of the phase II allowances—perhaps all of it—will accrue to customers. In these circumstances, a windfall tax would be neither fair nor likely to facilitate the necessary power sector investment. Indeed, consideration could usefully be given to capacity payments or free ETS allowances for phase III in order to ensure that adequate investment is made.

32. The GB wholesale gas market is also highly competitive with over 20 active shippers with the largest individual market share around 20%. Price information is publicly available for the complete market and standardised contracts are available to all participants. This results in a highly competitive market on whatever basis is used to assess the level of competition. Since international long term gas contracts are indexed to the price of oil, high oil prices—frequently over \$100 a barrel—are impacting gas prices. Thus underlying market fundamentals are resulting in high prices at the current time but the market has remained highly competitive throughout this volatile period and without this level of competition, we believe prices would have been even higher.

33. The GB gas storage market is also competitive with six current storage operators and a further seven operators for storage projects under construction or seeking planning approval. Although a single operator is responsible for over 75% of the current storage capacity, this capacity is required to be offered to other market participants to ensure all participants in the gas market have access to storage.

THE IMPLICATIONS OF GROWING CONSOLIDATION IN THE ENERGY MARKET

34. There has been no major consolidation in either the electricity or the gas retail markets since 2002 when E.ON and EDF significantly increased their market shares through acquisition. Since 2002 there have been significant changes in the market shares of some participants achieved through organic customer acquisition. Over the recent difficult period of fuel and wholesale price volatility, the retail market structure of six major vertically integrated competing suppliers has demonstrated its ability to continue to deliver competitive pricing without the failure of any of the major market participants as happened in 2002 and previously.

35. In our view, the market consolidation that has occurred since 1995 has benefited final customers in that it has resulted in a number of strong players competing in the market, who are able to withstand volatility in fuel and wholesale prices. They have been able to shield customers from much of the short and medium term market volatility by using the natural hedge for much of their customers' demand through owning upstream power generation assets. The market is also used by the major suppliers to hedge their positions and thus the volume traded on the market can be many times the volume finally delivered to customers. This volume of trading ensures sufficient market liquidity for the long term and the short term market. In the long term, however, final customers must pay prices reflecting market fundamentals. Analysis of the HHI figures suggests that further horizontal consolidation at the retail level would be undesirable.

36. To date, over 6 million customers have benefited from a smooth transition between suppliers in cases of supplier failure. Without such transfers, the impact on customers could be considerable, leaving a number of customers without a secure supply of energy and many vulnerable customers particularly at risk. The great majority of these transfers took place without invoking the formal Supplier of Last Resort (SoLR) procedures. However, these procedures are necessary when a trade sale is not possible, to ensure continuity

³⁶⁰ Dynamics of GB Electricity Generation Investment: Prices, Security of Supply, CO₂ Emissions and Policy Options. <http://www.berr.gov.uk/files/file38972.pdf> See pages 55–58.

and security of supply for consumers and help to prevent increased costs across the market. Appointing a SoLR only for domestic customers would leave other customers without a supplier and at risk of possible disconnection. It could also expose other industry parties to bad debt as customers continued to use electricity or gas for which the failed supplier was not paying.

37. The retail gas market benefits to a lesser extent from vertical integration with the majority of the major competing suppliers having limited ownership of upstream assets. There is benefit, however, in the major suppliers owning gas-fuelled generating plant allowing them to spread gas purchases across both the retail market and the electricity generation market and thus enabling them to reduce the volatility in their gas prices to final customers.

THE RELATIONSHIP BETWEEN THE WHOLESALE AND RETAIL MARKETS FOR ELECTRICITY AND GAS

38. The structure of our energy market has evolved over time, with the business models of the six main energy suppliers reflecting a natural level of vertical integration in the power market (from generation and trading through to electricity supply) and a desire to achieve an increasing level of integration in the gas market. This positioning is understandable and reflects a desire to mitigate commodity sourcing, trading and market price risk in a period of unprecedented volatility in global financial and commodity markets and the need to secure input fuels from new sources around the world. It is our strong belief that this structure provides benefits to retail customers by ensuring security of energy supply, mitigating commodity risk and protecting customers from the extremes of wholesale price movements.

39. We believe that the returns earned in the GB integrated energy market can not be considered excessive and in fact have not been sufficient on a sustained basis considering the inherent level of risk faced in our competitive markets. Since the introduction of competition profitability levels along the various parts of the energy value chain have been highly cyclical, with independent retailers such as Independent Energy facing financial distress and at other times generators such as British Energy experiencing a similar fate.

40. During 2005 and early 2006, retail margins were highly negative at prevailing market prices and these losses were offset by improved industry returns in power generation. The subsequent fall in wholesale prices in late 2006 and early 2007 improved retail economics and coincided with a significant fall in returns available to coal generators. Recent industry wide tariff increases reflect the very strong rebound in global commodity prices (gas increase 83% and coal increase 97% from February 2007 to February 2008) and industry wide costs such as the CERT programme and the Renewables Obligation. We believe that retail energy prices do not currently show a sustainable margin over wholesale prices and we are continuing to monitor the position.

THE INTERACTION BETWEEN THE UK AND EUROPEAN ENERGY MARKETS

41. A fully competitive energy market in Europe is very important for the long term future of the UK energy market. While this is important in electricity it is essential in gas, where a significant part of UK requirements are imported. We remain concerned that European markets, especially in gas, are not as open as they should be and that the market is not clearing efficiently between the UK and the continent. This may be contributing to additional volatility of gas prices in the UK and possible excess profits for upstream hydrocarbon producers. For these reasons, we support the progress being made on liberalisation of EU markets.

42. The domestic retail gas market is significantly larger in GB than in the majority of EU Member States and thus gas price volatility has a more detrimental impact on GB domestic customers. The GB wholesale gas market is closely linked to European prices due to the interconnector pipelines connecting with the continent and the increased volume being sourced through these interconnectors. It is essential that a true European gas market is developed to ensure that GB suppliers have access to gas in Europe on the same terms as other European energy companies and are able to make full use of gas storage.

43. Ofgem continues to play a key role in working with the European Commission and other European regulators with the aim of ensuring that a genuine and open market is developed. Such a market would benefit energy consumers both in Britain and elsewhere in the EU. Significant progress has recently been made in improving transparency in European power and gas markets with key information now available on daily gas flows on major pipelines and on gas storage in all the major European markets. Regional energy markets are being developed towards the eventual goal of a competitive single European energy market.

THE EFFECTIVENESS OF REGULATORY OVERSIGHT OF THE ENERGY MARKET

44. Like many market participants, we agree with Ofgem's judgements in some specific areas and are seeking opportunities to persuade them to re-assess their policies in others. For example, we have serious reservations about their approach to the allocation of transmission charges to generators. However, we have a high degree of confidence in the ability of Ofgem to provide the necessary regulatory oversight of competition in the retail market. Competition is clearly the best way to protect consumer interests because it drives the industry to innovate to raise standards and improve efficiency. Accordingly, we are supportive of Ofgem's policy of avoiding detailed intervention in competitive areas where possible, and of promoting

self-regulatory solutions where appropriate. Ofgem also acts as a competition regulator and has shown a willingness to be very tough in this sphere, as evidenced by the recent £41.6 million fine imposed on National Grid.

45. The Government's response to the House of Lords Select Committee Inquiry on Economic Regulators³⁶¹ points out that Ofgem's regulation of energy markets is widely regarded as successful and the Government would not want to change its objectives in a way that hampered its ability to continue to regulate effectively. We support the Government's position in this area and believe that Ofgem provides effective and adaptive regulatory oversight within the current market.

46. The highly competitive GB wholesale and retail energy markets were achieved through strong national regulatory oversight. In particular the establishment of a market structure separating monopoly activities from competitive activities has been key to ensuring that owners of monopoly assets do not gain a competitive advantage over other market participants. These markets have, however, been highly competitive for some time and are now able to be governed increasingly by general competition law. Over-regulation can stifle competitive innovation, which in the long term will be detrimental to customers.

47. Overall Ofgem's ability to oversee the GB market relies upon a variety of tools to cater for differing circumstances as a market with both monopoly regulation and robust competition demands flexible, targeted and often innovative approaches to regulation. It is also important to note that Regulators have a duty to take account of the costs that they impose on industry and hence consumers, and to find new and cost effective ways to achieve their objectives. Examples of effective regulatory oversight can be seen in a variety of cases including:

- The sustained success of self-regulatory initiatives in the retail market such as the Association of Energy Suppliers (AES) Selling Code of Practice, recognised by the OFT's Market Study on Doorstep Selling as a significant effort made by the energy suppliers, which has resulted in the number of selling complaints falling by around 90% since 2002.
- Ofgem's review of the gas and electricity supply licences which was aimed at opening the market to new entrants, improving protection for vulnerable customers and creating a path for the development of more innovative products and technologies, including micro-generation.
- The change in the GB market to increase the amount of information available to industrial customers on supplies of gas from offshore sources thus removing unnecessary problems for customers, traders and suppliers and demonstrating Ofgem's desire to see greater transparency in energy markets across Europe.

PROGRESS IN REDUCING FUEL POVERTY AND THE APPROPRIATE POLICY INSTRUMENTS FOR DOING SO

48. In the current climate of increasingly higher energy prices, some customers, including some of the most vulnerable, find it difficult to achieve affordable warmth. ScottishPower is committed to playing its part, with Government, in helping to combat fuel poverty. We have undertaken a number of initiatives in this area, which involve improving the housing stock, implementing social tariffs, providing winter rebates to vulnerable customers and establishing the ScottishPower Energy People Trust (an independent charity established to help combat fuel poverty in the UK).

49. We are holding discussions with the Government with a view to establishing how their aspiration of almost trebling the industry's social programmes to £150 million a year can be made an effective reality. We believe that a voluntary approach on the basis the Government has outlined is achievable and would deliver the best results by allowing suppliers to innovate to find the best solutions. A mandatory social tariff could stifle innovation and prevent the best solutions being found.

Prepayment meters

50. Concern has been raised over the difference in some suppliers' retail prices for prepayment meters compared to other payment methods, particularly direct debit. Nearly 11% of gas customers and 14% of electricity customers pay by prepayment meter (PPM). All PPM systems require customers to pre-purchase electricity or gas at a vendor outlet (eg post office, shop, petrol station etc). The customer needs to bring a card or key to the vendor outlet for the card or key to be "charged", or for a token to be sold so that when the customer inserts the card, key or token into the meter they obtain credit on their meter. The establishment and maintenance of a network of vending outlets, along with the additional costs associated with payment devices such as cards and keys makes PPMs a more expensive payment method when compared to standard credit meters. In addition, some PPMs are more susceptible to fraud, theft and other forms of misuse. They can often require more frequent visits by field staff than traditional credit meters.

51. Ofgem's breakdown of the estimated cost difference between supplying a PPM and a direct debit customer for both gas and electricity shows an additional cost of £85 per annum. ScottishPower currently views the cost differential as being slightly higher—a little above £100 per annum, and prices accordingly. However, this is an area we keep under review, and if we are satisfied that the cost differential is less than

³⁶¹ <http://www.parliament.uk/documents/upload/GovRespRegulators.pdf>

the figures in our current tariffs, we would take account of this in future price adjustments. We believe that our cost reflective approach to pricing provides the best deal for customers who pay by PPM, and the minority of PPM customers who are fuel poor³⁶² are best served by a programme of social assistance directly targeted at reducing fuel poverty.

52. ScottishPower remains the only GB energy company to set standard pre-payment prices for both gas and electricity lower than standard quarterly credit prices. This ensures a good deal for all PPM customers—with an estimated benefit to them of nearly £8.4 million per annum.

53. We welcome Ofgem's announcement of a Fuel Poverty Summit which will be held later this month as this form of co-ordinated action between Government and industry often results in new and innovative solutions being developed to address the many dynamic and complex factors that contribute to the problem of fuel poverty in the UK.

ScottishPower activity

54. ScottishPower has always been committed to providing assistance for vulnerable customers and our current efforts in this area include:

Housing Stock

ScottishPower was the first company to achieve the Government's challenging Energy Efficiency Commitment (EEC) target, which was set in 2005. To deliver the required reduction in energy demand, an extensive programme was implemented to improve the energy efficiency of homes across Great Britain.

Over the three year period, half of the energy savings were targeted at people in receipt of state benefits ensuring that those most in need could also benefit. To achieve their target ScottishPower insulated over 150,000 lofts and 270,000 cavity walls and distributed over 5 million energy efficient light bulbs.

Social Tariffs

Our Carefree Plus Tariff, which was launched on the 1st February 2008, is designed to help our most vulnerable customers save money. The tariff means that eligible customers will save up to £112 (including VAT) on their energy bills each year.

All Carefree Plus customers will also be offered a free Energy Efficiency Survey to help them save on their energy bills and identify whether they qualify for insulation or other energy efficiency measures, and a Benefits Health Check. Our experience of carrying out Benefits Health Checks through the ScottishPower Energy People Trust suggests that for every £1 spent on this work, £20 of unclaimed benefit is recovered for customers. As such we have developed this as a key component of our Social Tariff offering.

Winter Rebates

This Winter, we took mitigating action against the impact of retail price increases on our most vulnerable customers. For customers who were on our Carefree Priority Services Register, ScottishPower provided a rebate of up to £31 to offset the effect of the recent price increase until 31 March 2008.

Trust Fund

The ScottishPower Energy People Trust was established in November 2005 to fund not-for-profit organisations that help vulnerable people including families, young people, the disabled and the elderly who need to spend more than 10% of their income on energy bills. So far, the Trust has awarded £3.6 million to 87 projects across Great Britain, assisting over 215,000 individuals in over 88,000 households.

Proactive Approach to Debt Prevention

Ofgem's 2005 review of energy suppliers' debt and disconnection procedures identified ScottishPower as a market leader in terms of finding innovative ways of helping consumers avoid debt and disconnection. A more recent review part of which was done in collaboration with energywatch, concluded that since Ofgem's last review in 2005 there has been an increased focus by all suppliers on debt and disconnection issues.

³⁶² Of all customers who pay by PPM, less than 20% are fuel poor. See Accent survey results, published as an Appendix to the June 2005 Domestic Retail Market Report, Ref 24b/06
<http://www.ofgem.gov.uk/Markets/RetMkts/Compet/Documents/1/12882-2406b.pdf>

Community Liaison Officers (CLOs)

We offer targeted and detailed face-to-face advice to customers through our unique network of CLOs. Thirteen dedicated staff represent ScottishPower within the community, assisting customers and providing training across the business, including on how to identify and deal with vulnerable customers. Last year ScottishPower's CLOs undertook around 7,200 customer visits, the majority of which will have included providing energy efficiency advice.

Clear Information on Savings

ScottishPower has launched a "Savings Challenge" to encourage existing customers to ensure that they are on the company's best deal. Over 80% of ScottishPower customers could pay less by making simple changes to their energy account such as changing payment method.

Home Heat Helpline

ScottishPower currently supports the national Home Heat Helpline, an independent free telephone service that offers help and advice to people struggling to pay their energy bills. We are in discussion with Government about the best method for its continued funding. The helpline can assist vulnerable people in a number of ways, including providing advice on:

- Identifying grants that are available to make homes more energy efficient.
- Alternative payment methods.
- Accessing a priority service team in each supplier to provide specialist advice.
- Linking with other support agencies.

Government activity

55. Given the wider causes of fuel poverty there will inevitably be a limit to the role that the industry and indeed the regulator can play in tackling it. While we will play our part, the primary focus has to be on raising incomes and improving housing, both of which are more the responsibility of Government. We believe that there are a number of helpful tools available to Government that would reinvigorate the focus on fuel poverty at this time. These include:

Winter Fuel Payment

We welcome the Chancellor's recent announcement of a one-off additional Winter Fuel Payment for 2008–09. We would suggest that consideration is given to discontinuing the Winter Fuel Payment for higher rate taxpayers and using the money saved to fund other schemes which would more directly help with fuel poverty, including Warm Front.

Warm Front

Funding should be increased for Warm Front, the Government's main grant funded programme for tackling fuel poverty. The budget for Warm Front was cut before Christmas from £350 million in the current year to around £270 million in each of the next three years. This move was contrary to the recommendations of the Fuel Poverty Advisory Group which stressed it "is essential that Warm Front funding be maintained in 2008 to 2011 at the 2007–08 level of around £350 million".

Benefit take-up

Consumer income should also be maximised through an increased drive from Government to encourage benefit take-up, including automating the take-up of Council Tax benefits and other tax credit. The Government estimates that up to £9.3 billion of benefits went unclaimed in 2005-06.³⁶³

ScottishPower

1 April 2008

³⁶³ The Office for National Statistics, "Income Related Benefits Estimates of Take-Up in 2005–06", 13 September 2007; issued on behalf of the Department for Work and Pensions.

Memorandum submitted by Shell

INTRODUCTION

In the UK, Shell is engaged in exploration and production, oil refining and marketing, gas and power, chemicals, renewables and research and development.

As regards gas:

- Shell does not sell gas to UK households. Indeed Shell does not have a domestic gas supply licence.
- Shell sells gas to ca 6500 Industrial and Commercial (I&C) customers in the UK. The volumes represent about 2.5% of the total UK gas market.
- We believe Shell is one of approximately 60 companies involved in UKCS gas production. Our share of UK gas production is approximately 8%.³⁶⁴ This gas is sold to a range of UK energy companies.
- Shell also brings in its own gas from abroad, mainly Norway. In 2007, these volumes amounted to less than 1% of UK annual demand.
- Shell trades gas at the National Balancing Point (NBP), partly for supply/demand balancing purposes to support the above activities.

Our comments below concentrate on the wholesale and I&C market.

STRUCTURE AND COMPETITIVENESS OF THE UK GAS MARKET

The UK gas market was the first to liberalise in Europe and provides in our view a good framework for a competitive market. An unbundled, price-regulated grid operator that is prohibited from engaging in other commercial activities provides for the correct environment in which competition in non-monopoly activities, eg shipping and supply can develop. Shell believes that this market structure has also been conducive to the development of a liquid traded market at the National Balancing Point (NBP), thus helping to facilitate gas-to-gas competition.

The traded market for instance has witnessed growth both in terms of traded volumes and the number of parties involved. The growth in recent years of the APX Exchange illustrates this point. Traded volumes, for example, have grown from 106 TWh in 2004 to 131 TWh in 2007. During the same period, the number of members has grown from 55 to 74.³⁶⁵

In the I&C sector we now experience a market where not only are margins low but customers readily able and willing to switch, and also where intermediaries invite several potential suppliers to compete for business.

Shell sells gas from own production and third party gas in the UK market partly under medium- or long-term contracts with other merchants and partly by selling directly to I&C customers under short-term contracts. The conclusion we draw from Shell's involvement in the gas market is that we see competition, with the company both losing and gaining business.

In a mature and liberalised market, one would expect not only new market entrants but also consolidation to take place in parallel. The UK gas market has seen both and this is likely to continue in the coming years. So far as we can see, any consolidation so far has not diminished competition in the market. This is our practical experience. In that context, we note that BERB's own calculation of indices such as the Herfindahl-Hirschman Index that assess market concentration, appears to indicate a satisfactory position.³⁶⁶ Should there be any tendency in future for consolidation to diminish levels of competition, we believe national and EU competition authorities have the necessary information and powers to intervene effectively.

INTERACTION BETWEEN THE UK AND EUROPEAN GAS MARKETS

It should be noted that the gas market is developing towards a global market with global effects on availability and prices. With ever more physical interconnections and LNG regas terminals (Interconnector upgrade, BBL pipeline, Langede pipeline and LNG regas terminals on the Isle of Grain and in Milford Haven), the UK has an increasing number of gas supply options and is increasingly part of the European and even global gas market.

In saying this, however, it is important to note that additional capacity does not directly translate to equivalent gas flows. Rather, gas flows to the UK will be determined by market attractiveness and price. This is supported by our own experience. Shell has in late 2007 and early 2008 redirected gas volumes to the UK that were originally destined for the European continent (in the same way, LNG cargoes initially earmarked for Spain have been diverted to North America). With the integration of the UK into European and global markets, the number of such transactions is set to increase.

³⁶⁴ <https://www.og.berr.gov.uk/pprs/pprsindex.htm>

³⁶⁵ Source: <http://www.apxgroup.com/index.php?id=106>

³⁶⁶ <http://www.berr.gov.uk/energy/statistics/publications/indicators/page39558.html>

Given that gas prices are a response to the demand and supply balance, the impact of the globalisation of the gas market as described above must be considered when assessing market effects in the UK. Energy prices in general must be taken into account, as primary energies are in principle interchangeable.

In the UK, natural gas is mainly used for power generation and space and water heating. In power generation gas is competing against coal and nuclear energy and against oil and electricity for space and water heating. In addition there is gas-to-gas competition between different gas installations. Policy decisions on the energy mix and climate protection will also have an impact on overall energy price levels.

In line with the above, the changes we have seen in wholesale prices appear broadly consistent with supply and demand fundamentals, inter- and intra-fuel competition and an increasing reliance on imported gas.

REGULATION OF THE GAS MARKET

A clear distinction should be drawn between the role of a regulator and the role of competition authorities. These bodies should, of course, have adequate powers to carry out their respective functions but the two roles are not the same as each other.

Competitive market activities such as shipping and supply should not be subject to economic regulation of the type that logically applies with respect to monopoly grid operators. Rather, such activities should be subject to regulatory oversight and, where necessary, applicable competition rules.

Additionally, we would question the extent to which regulatory policy has concentrated on the core activity of the economic regulation of grid networks. Increasing emphasis appears to have been placed on subjecting competitive market activities to increasingly complex market rules and arrangements. The result is that the complexity of market rules and arrangements that are also subject to constant change—see for example the development and growth of the Uniform Network Code over the past 10 years—create difficulties not only for market participants but also for regulatory authorities in understanding the market. As such, there may be some merit in the regulatory authorities waiting for new rules and arrangements to bed-in and take effect before trying to demonstrate the need or otherwise for further change.

SUMMARY

In our view, the UK gas market is characterized by:

- Competition in the sectors in which we are involved.³⁶⁷
- More and more integration—physical and financial—into European and global markets.
- Increasing diversity in terms of players and sources.
- A market framework, as described earlier in this response, that does not appear to have any obvious deficiencies and, notwithstanding the comments above, to a large degree this comment also applies to the regulatory framework.

11 April 2008

Memorandum submitted by the Sussex Energy Group³⁶⁸

ABOUT THE SUSSEX ENERGY GROUP

There is growing awareness that a transition to a sustainable energy economy is one of the main challenges facing us in the 21st Century. Although climate change is a significant factor, there are many other reasons why we need to address the energy transition, including security of supply, fuel poverty and the attractions of innovations such as renewable energy resources, distributed generation and combined heat and power. Critically, the energy transition needs to be designed in such a way that maximises economic efficiency. An effective response requires technical ingenuity, behavioural change and virtually unprecedented political commitment. These are the challenges that the Sussex Energy Group is addressing. We undertake academically excellent and inter-disciplinary research that is also centrally relevant to the needs of policy-makers and practitioners. We are supported through a five-year award from the Economic and Social Research Council from April 2005, but also have funding from a diverse array of other sources.

³⁶⁷ As mentioned, Shell does not sell gas to the UK's residential market.

³⁶⁸ This response was written by Professor Gordon MacKerron, Director, Sussex Energy Group, SPRU, Freeman Centre, University of Sussex, BN1 9QE; Tel 01273 873539; Email g.s.mackerronsussex.ac.uk, with inputs from Dr Jim Watson, Deputy Director of the Group (w.j.watson@sussex.ac.uk)

INTRODUCTION

The committee has requested evidence on seven inter-related questions. In line with our competences, we have chosen to respond in two areas: competition and market structure (effectively spanning the first three of the Committee's issues); and the final issue, fuel poverty. The main theme of our evidence is the implication of market structures, regulation and fuel poverty policy for the vital long-term objective of reducing carbon emissions

COMPETITION, MARKET STRUCTURE AND LOW CARBON OBJECTIVES

Energy policy in the UK wants: competition (low costs and potentially low prices); radically lower carbon outcomes; energy security; and abolition of fuel poverty. These are very difficult to pursue simultaneously and various trade-offs will usually exist. Competition may impede low carbon objectives (for instance if coal prices are low); and energy security may exacerbate fuel poverty if we pay an "insurance premium" to get more secure supplies or more rapid reductions in demand.

The main focus for this inquiry is competition. This can come in several different forms: in the UK liberalised market-place it has usually taken the form of short-term price competition, rather than competition—for instance—in offering different quality/type of service (eg green tariffs or energy services rather than selling a simple energy commodity). This kind of short-term price competition in the retail sector puts a premium on reaping economies of scale and this has meant a minimum financially viable size for energy suppliers of several million customers. Given, too, that economic regulation is vigilant against market domination by too few companies this has led to an apparently quite stable oligopolistic market structure consisting of six main suppliers who hold some 98% of the market: companies can be neither too small nor too large.

A given market structure (in this case oligopoly with substantial vertical integration of retail and generation businesses) cannot in itself tell you if behaviour is competitive. Where there are as many as six firms in oligopoly, a high degree of competition is at least possible. It is impossible to judge whether or not behaviour is anti- or pro-competitive without detailed and difficult analysis. If different companies' prices move together and tend to converge, they may do so either because the market is competitive or because it is implicitly or explicitly collusive. Price convergence in competition is a result of the need on one hand for firms to avoid charging too high a price (or they will lose market share) and on the other, to avoid engaging in price-cutting to gain market share (because the regulator will not allow much further market concentration). Equally prices may converge in the opposite situation of implicit or explicit collusion.

It is sometimes argued that high levels of consumer switching between suppliers is evidence high levels of competition. However, a very high proportion of vulnerable and elderly consumers have never switched,³⁶⁹ and while consumers can make small short-term gains from switching, the high levels of switching seem evidence more of the way in which regulation and advertising have facilitated switching in the British system, rather than that there have been significant long-term consumer benefits. It is certainly the case that there have been no major changes in long-term market share among the six suppliers as a result of switching activity.

The two critical questions then become:

- are these more or less common price levels allowing high profit margins relative to activities of the same risk (indicating little or no competition) or low margins (indicating high levels of competition)? We have not conducted no recent work in this area and have no comment to make.
- are there major barriers to entry? If so, there are concerns that while there may still be a degree of competition, incumbent firms may collectively (for example) be slow to pass on input price falls to their customers, but much quicker to pass on input price rises.

The fact that the six retailers have 98% of the market and that a significant number of smaller new entrants have failed to establish themselves suggests that barriers to sustainable entry (mainly due to economies scale represented by large customer numbers) are high. Whatever the results of these barriers may be for short term profitability, this is a serious issue in relation to the longer term objective of low carbon.

New niche players have tried to establish themselves on the basis of radically greener tariffs and offering energy services rather than energy commodities. Some, such as Good Energy, have been successful in offering green tariffs but still have a very small market share. The regulatory system—dominated by the need to show that prices to consumers are minimised in the short term—has also taken a rather individualistic view of competition and consumer choice. An example is that Ofgem has seen smarter metering (which could open up avenues for lower carbon futures) as a matter of individual consumer choice and preference, rather than as an infrastructure issue facilitating wide-ranging, national-level learning and innovation in providing new ways to deliver energy (especially less energy) in efficient and effective ways.

Another example of the limited approach to competition within the UK is the lack of an energy service market for households.³⁷⁰ Although this has long been talked about (BERR has been working in this area since 2000),³⁷¹ it has not yet happened. The current market structure makes it very difficult for new entrants

³⁶⁹ energywatch *energywatch welcomes MPs' inquiry into energy market* Press release 5 February 2008.

³⁷⁰ For more, see J Watson (2006) *Domestic Energy Services: What Will it Take?* Power UK No 154, December.

³⁷¹ See the final report of the government's Energy Services Working Group from 2003: <http://www.berr.gov.uk/files/file20139.pdf>

to establish themselves with such a different business model. Reforms are now planned for a new “supplier obligation” to replace the Carbon Emissions Reduction Target which mandates energy efficiency action by suppliers in 2011. This is expected by many to shift suppliers towards a more service-oriented approach to minimise emissions from the energy they supply. But it will be important to design the new obligation so that it allows diversity of approaches (including new entry)—and therefore helps to encourage more meaningful competition between suppliers.

Overall the rather static supplier market structure, reflecting the particular UK liberalisation context and regulatory structure, has both channelled competition into a narrow focus on short-term price movements in energy prices, and acted as an impediment to longer term objectives of a lower carbon system.

FUEL POVERTY

Fuel poverty is real: it is not just a simple sub-set of poverty in general. It is true that most people in fuel poverty have quite low incomes but the match is not anything like exact. The reason is that those on relatively low incomes experience great variety in the level of energy efficiency of both their housing fabric and their space heating system. A poorly insulated house with a highly inefficient heating system may need to consume up to four times as many units of delivered energy (in kWh) to achieve the same comfort level as a well-insulated house with an efficient heating system.

Fuel poverty cannot be eradicated just by raising incomes (though that helps a little) and the Government can do little to affect energy prices in a liberalised market. This means that the principal policy approach to fuel poverty needs to be via improved efficiency of both the building fabric and/or the heating system. There has been recent advocacy of lower “social” tariffs for those in fuel poverty. While such a measure could substantially improve the fuel poverty status of many families:

- it is a short to medium term measure at best and should not be used as a substitute for improving energy efficiency, which is a necessary component of a long-term low carbon and sustainability objective. If energy prices remain high, the cost of social tariffs to Government will be correspondingly high; and
- it is unlikely to work unless made mandatory, and this raises the problems of identifying all those who are eligible for such tariffs and overcoming probable resistance from the supply companies. This resistance may have two origins: a general resistance to the idea that their total company revenues will initially suffer (and a possible response, in compensation, to raise tariffs for other customers); and more specific company resistance that may come from those suppliers who have a disproportionately high proportion of customers in fuel poverty.

This suggests a need to persist with, and intensify, existing Government programmes which do recognise the importance of improved energy efficiency to overcome fuel poverty—for example the Warm Front scheme and the Energy Efficiency Commitment (now the Carbon Emission Reduction Target) which has historically required companies to concentrate much of their effort on the fuel poor. There is some way to go before fuel poverty can be eradicated but concentrating on intensified energy efficiency measures is both the most reliable policy approach and the one most consistent with long term lower carbon goals.

However, recent decisions by the Government have gone in the wrong direction. Before the recent Budget, annual (revenue) expenditure on Winter Fuel Payments (WFP) was around £2,200 million per year. Following the WFP increases announced in the Budget—of roughly £550 million—this WFP expenditure in 2008–09 will now rise to something close to £2,750 million. By contrast, and against the strong advice of the Fuel Poverty Advisory Group, the pre-Budget report cut (capital) spending on Warm Front for 2008–11 by 25%, from roughly £350 m pa, to about £270 m pa. Thus, revenue spend on WFP in 2008–09 is now roughly 10 times annual capital spend on Warm Front.

This growing, order of magnitude difference between capital and revenue spend is a poor way to tackle the fuel poverty question. This not least because households treat their WFPs as just another source of income (consumers are just as reluctant as Government to hypothecate revenues) and can be expected to spend relatively little of it on fuel. This is especially so if they experience low energy efficiency, as a given financial outlay will have a limited outcome in terms of greater warmth. A continuation of growing WFPs with diminishing capital spend on better household energy efficiency will be both expensive in absolute terms and do little to tackle the experience of fuel poverty. For both low carbon and fuel poverty alleviation reasons, it is urgent that Government reverse this recent trend.

Memorandum submitted by Trading Standards Institute

The Trading Standards Institute is the professional body for Trading Standards professionals working in the private and public sectors.

It is the national body responsible for representing, supporting, lobbying, and championing Trading Standards to a range of stakeholders including government, business, consumers, and the media.

We look to provide innovative solutions across the regulatory arena; to administer and award professional qualifications; to accredit and certify training and ensure the ongoing competence of members; and to influence and lobby on behalf of the profession as a whole.

We aim, through our actions and our members' actions, to empower consumers and reputable business to contribute to a vibrant economy.

We strive to eliminate rogue traders and unfair trading practices from the marketplace; to promote environmental sustainability; and to make an effective contribution to the health and social wellbeing of citizens and communities.

Whether the current market structure encourages effective competition in the retail markets for gas and electricity

1. Regarding the effectiveness of competition, TSI believes that more onus should be put upon the energy companies to ensure that the information they give consumers is as clear as possible in terms of their pricing policies—it is currently extremely difficult for the average consumer to compare 'like for like' price plans and make informed choices.

This is also very important for helping consumers to manage their energy consumption: at present energy information makes it difficult for customers to do this. TSI would like to see smart meters so that consumers can easily see their energy consumption costs as it happens.

2. Price comparison websites are complicated and this is compounded by the fact that the price plans change so frequently that a company which may be the cheapest one month is unlikely to be the cheapest the following month. Trading Standards Services have dealt with a number of consumer complaints where this has been the key issue. It is a cause of great frustration amongst the individuals with whom TSI Lead Officer Richard Matthews has dealt with as a local authority Trading Standards Officer.

3. A further factor that affects competition is the apparent difficulties which can arise when a consumer makes the decision to move from one energy supplier to another. Trading Standards Services across the country deal with complaints owing to administrative mistakes which occur during the transfer of customers between companies. It could be said that if the internal procedures of these companies were to be tightened up then customer confidence would be increased and customers would feel more confident in their ability to change energy supplier more easily. At present TSI feels that this puts customers off switching energy suppliers and is a barrier to customers being able to obtain the best possible energy deal.

The effectiveness of regulatory oversight of the energy market

4. Whilst Energywatch, the independent gas and electricity watchdog, has responsibility for policing this sector, it is often felt by Trading Standards professionals and consumers alike that its powers do not go far enough. Whilst Energywatch is able to advise consumers, if the complaint results in deadlock, the consumer must then refer their complaint to the Energy Ombudsman.

TSI would like to see a more streamlined system which makes it easier for consumers to complain and also get a faster response from the energy companies, particularly where the complainant has problems paying his or her bill.

TSI is also concerned that later on this year when Energywatch is disbanded the regulatory regime could be weakened and not strengthened.

Progress in reducing fuel poverty and the appropriate policy instruments for doing so

5. In the main the policy of the energy companies surrounding fuel poverty appears to be concerned with energy saving techniques, such as additional insulation. Whilst from an environmental perspective this is a commendable step, those on the lowest incomes may struggle to implement those measures where there may be a one-off cost involved if the grants that are currently available stop in the future.

6. Supporting consumers in making energy efficiency improvements is essential. Currently, subsidies and discounts can even, in some cases, make insulation measures, for example, free—but it should be noted that such help is variable by area and/or supply company. However, even if there is a one-off payment required, better-insulated buildings mean lower long-term costs, which is even more important as energy prices rise.

It is true that problems may occur because of lack of awareness of the efficiency savings possible from insulation measures and subsidies and discounts available, and the perception of high capital costs. An additional problem may be the lack of consistency in grants and subsidies available. Energy companies need to provide clarity in supporting their customers to find out what is available.

7. Advice on energy efficiency measures is essential, but should sit alongside advice to reduce actual energy cost. eg by changing the way that bills are paid.

8. Pre-paid energy contracts are increasing in popularity and TSI believes that it would be of value to consumers if the energy companies gave them adequate information on the volatility of wholesale energy prices, thus enabling them to make informed consumer choices.

For example, energy providers may wish to use the following wording: “the cost of energy fluctuates and at some periods you may pay more for the energy you use”.

9. Information about energy consumption of different appliances and simple energy savings tips may be more helpful than general statements, helping consumers to save money and reduce emissions.

10. It tends to be the case that those customers living on lower incomes find themselves using pre-paid energy as the only option available to them. However, these customers may find themselves paying up to 50% more for the energy they use, which puts them at the greatest disadvantage.

TSI appreciates that there are circumstances where these customers have issues obtaining credit and may not even hold a bank account. However, we feel that something should be done to address this issue so that the poorest members of our communities have the ability to heat their homes sufficiently. One action, for example, could be the more consistent use of social tariffs by energy companies.

All suppliers should be obliged to offer energy assistance packages to the most vulnerable groups based on minimum standards set nationally. The tariff should be set at the lowest rate offered by that supplier, regardless of payment method.

11. It could be said that in order to effectively tackle fuel poverty and ease the financial burden on those in society who are least well off, it is essential that those in the energy sector make links with organisations tackling other areas of poverty so that tangible benefits are delivered to the poorest communities.

12. TSI remains concerned over the controls on sales on the doorstep and the complaints that are still received. This is particularly important for the more vulnerable in society.

Our research has determined that over 90% of consumers surveyed do not wish to buy on the doorstep.

TSI feels that more could be done by the energy retailers to expose opportunities for switching to better deals without the pressure of purchasing such a complicated product on the doorstep.

They could, for example, engage further with community groups to market their services in a more comfortable environment for the community.

28 March 2008

Memorandum submitted by the University of East Anglia

1. SUMMARY OF MAIN POINTS

We believe that there are important doubts about the intensity of competition in the retail market. On structural grounds, there are concerns about high concentration (fewness of effective competitors), and barriers to the entry of potential new competitors. There is at least a case to be answered that the vertical integration of the six remaining firms provides them with the ability to foreclose any future entrants. Following liberalisation in the late 1990s, it was hoped that cross-region and cross-fuel entry by the traditional electricity incumbents and British Gas would replace monopoly with competition amongst a large number of sizeable firms. In the event, however, cross-entry by electricity incumbents has been relatively insignificant, and all regional markets remain effectively duopolies—British Gas and the previous electricity incumbent. For this and other reasons, the characteristics of the market are such that “tacit collusion” is a possible outcome. It is important to stress that this term does NOT imply a cartel, but rather a “soft” form of competition—loosely speaking, a mutual recognition that it is in no-one’s interest to compete very aggressively. Tacit collusion, so defined, may not be illegal in competition law, but it is most certainly not in consumers’ interests. The evidence on various features of “performance” also merits deeper scrutiny. In particular, the extent of switching by consumers is controversial. There are those, including OFGEM, who argue that effective switching has been substantial, and that this is direct evidence of healthy competition. However, this is unconvincing for three reasons: (i) much of the switching that has occurred reflects the introduction of dual-fuel bundles, which would be cheaper than single-fuel supply even in the absence of competition; (ii) survey evidence suggests that much switching by consumers has been ill-advised and ill-informed, (iii) with the exit of so many firms since 1999, it is increasingly doubtful that consumers have any genuinely low price suppliers to whom they can switch. A second topic on which sound evidence would be invaluable is retail price cost margins and profitability, but here the data are difficult to unravel—

not least because of the integrated structure of all the majors, raising uncertainty about what is the appropriate transfer price from wholesale to retail. However, we do know—and this seems to be uncontested—that the traditional incumbents are not only still dominant in their traditional markets of incumbency (in terms of market share), but, even to this day, they continue to offer the consumer price tariffs which are more expensive than those offered by non-incumbents. Other things equal, high market shares coupled with high price are inconsistent with vibrant competition—especially when, as here, all firms sell essentially an identical product (what economists call an “homogenous” good).

2. BRIEF INTRODUCTION OF AUTHORS

Stephen Davies is Professor of Economics in the School of Economics at UEA and a Principal Investigator of the ESRC Centre for Competition Policy. His research interests include: the economics of competition policy; European industrial structure; mergers and merger simulation; and multinational firms. He is a member of the Academic Panel which advises the Office of Fair Trading. He was formerly the General Editor of *The Journal of Industrial Economics*. He is currently working on: mergers, competition with non-linear pricing in the electricity market; and the resale price maintenance.

Catherine Waddams (formerly Price) is founding Director of the ESRC Centre for Competition Policy at the University of East Anglia and Professor of Regulation in the School of Management. She joined UEA from the University of Warwick in 2000. She has studied the development of utility privatisation and regulation, and is particularly interested in the effect on different income groups of introducing competition to such industries, both in developed and developing economies; and in the role of consumers in competition policy. Much of Catherine’s research centres on the energy sector. She is a part time member of the reporting panel of the UK Competition Commission.

The ESRC Centre for Competition Policy (CCP) at the University of East Anglia (UEA) undertakes interdisciplinary research into competition policy that has real-world policy relevance without compromising academic rigour. Our members are drawn from a range of disciplines, including economics, law, business and political science.

The Centre was established in September 2004, building on the pre-existing Centre for Competition and Regulation (CCR), with a grant from the ESRC (Economic and Social Research Council). It currently includes a total of 17 faculty members (including the Director and a Political Science Mentor), seven full- and part-time researchers and 14 PhD students.

The Centre produces a working paper series, runs weekly seminars, holds a number of events throughout the year (including a yearly conference), and publishes a regular newsletter and e-bulletin. Its members welcome links with academics, practitioners, policy makers and the voluntary sector.

3. FACTUAL INFORMATION FOR THE COMMITTEE

The committee asks:

- Whether the current market structure encourages effective competition in the retail markets for gas and electricity;

1. *How vigorous is competition?*

3.1 There is concern that the retail energy suppliers may be competing less aggressively than they might. In general, the ability of consumers to choose a better (usually cheaper) supplier is an important curb on any unilateral market power which incumbents of previously monopolised markets might otherwise wield. However such choice provides no countervailing power if suppliers co-ordinate their prices. There is little evidence of any explicit collusion, which is illegal, but there is a suggestion of tacit co-ordination: this is sometimes referred to as “tacit collusion”, in which firms do not compete vigorously with each other, resulting in “co-ordinated effects”. The UK Competition Commission (following the decision of the European Court of First Instance judgement in the *Air tours* case, 2002) describes three necessary conditions for co-ordinated effects. First, firms must be aware of the behaviour of others. In energy markets the prices are highly transparent: publicly available information on offerings clearly provides firms with information about each other’s actions. Secondly it must be costly for firms to deviate from the prevailing (non competitive) behaviour. Since six large firms interact repeatedly in 15 markets (14 regional electricity markets and a national gas market), there is plenty of opportunity for any deviation from the “non competitive” position to be detected, so that the market will revert to the less profitable but more competitive situation as firms note any individual departure from the “collusive” situation. And, thirdly, competitive constraints are weak. Small independent companies have struggled to enter and survive in the household energy market; if they do manage to enter they generally exit (through failure or takeover) within a couple of years. The national recognition of the brand names of the main leaders can act as a significant barrier for new entrants.

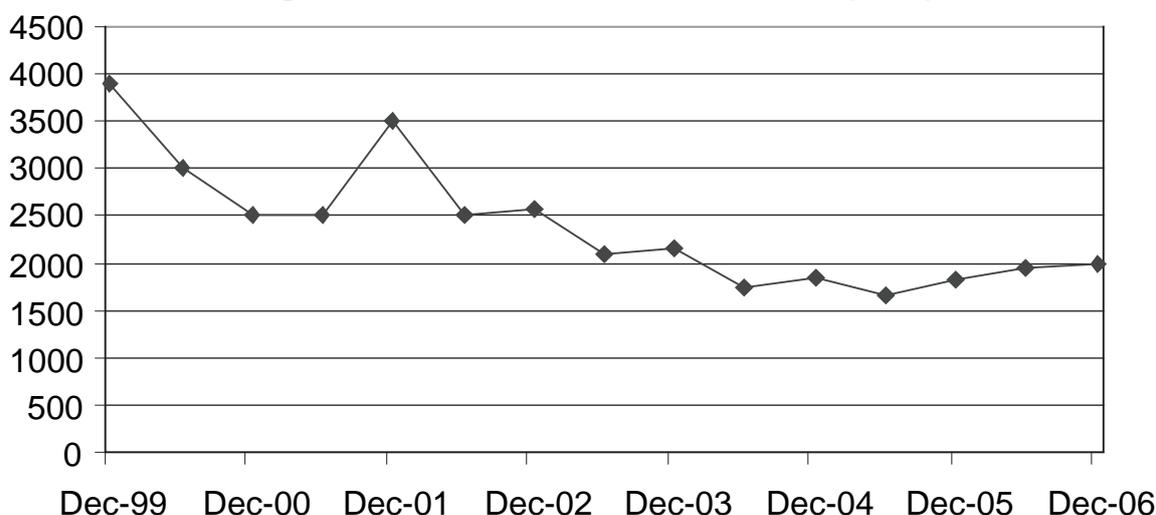
3.2 Add to these market characteristics, the homogeneity of energy, and the conditions certainly seem ripe for co-ordinated effects. The energy regulator noted such concerns in a 2004 review (Ofgem, 2004) but has not publicly revisited this issue in detail since then. Companies interact regularly to discuss “best practice” in areas such as social concerns. There is little evidence to support allegations (as reported in the Sunday Times in January 2008) that such meetings are used to fix prices, but they do provide an opportunity for the industry to share common approaches. Such legitimate interaction is likely to increase as the environmental and fuel poverty agendas become more pressing, raising such concerns further. Moreover, the problem is not just in the UK. Four of the six large energy companies are major European players (EdF, EOn, RWE and Iberdrola each own incumbent suppliers in three of the electricity regions) and interaction is at international as well as UK level. This is likely to be a continuing issue for the European Commission as well as the UK authorities.

3.3 The analysis of such problems depends partly on whether the energy markets are regional or national. The evidence points strongly in the direction of markets being regional. We estimate that, in the typical electricity region, 10 times more consumers buy from the original electricity incumbent than from other, entrant, suppliers who were previously incumbents outside that region. This means that, within each region, market structure still amounts to little more than a duopoly involving British Gas and the local regional electricity incumbent.

2. Consumer switching

3.4 Householders continued to change energy supplier after the removal of price caps in 2002, unsurprisingly at a slower rate than when the market was initially opened, and not always away from the incumbent. Interestingly, there has been only a slight increase in switching rates in the last two years. Given the rapid recent acceleration in retail electricity prices, one might have expected a sharp upturn in switching as more and more consumers were galvanised into actively searching for cheaper suppliers. While the figure does suggest an upturn, it is only very moderate.

Figure 1: number of switchers (000)



3.5 By September 2007 the market share of the incumbent gas supplier remained as high as 47% on a national level; and at the same date the average market share of the incumbent electricity suppliers in their “home” area ranged from 39% for direct debit to 53% for standard credit customers. Across the markets, incumbents retained exactly half the prepayment customers.

3.6 The role of switching in a newly opened market is clearly crucial. If consumers are loyal to their incumbent suppliers, then no amount of entry by those offering alternatives can exert competitive pressure on the firm. In energy, the first decade of consumer choice has shown a little less than half of consumers remain loyal to the incumbent at the kind of savings which entrants are able to offer.

3.7 The energy regulator has encouraged consumers to switch supplier and at various times has hailed high switching rates as a sign that competition is working well in the household energy market. However, if consumer errors are large, high rates of switching are not necessarily a sign of a well functioning market—nor are they necessary for the market to function effectively. The threat of switching could act as a powerful discipline on the incumbent’s behaviour, and if it responded by lowering its price to a competitive level to retain consumers, then the market might indeed be functioning well. In that case there would be little mark-up by incumbents. However, as noted below, consumers often appear to make erroneous switches, incumbent markups remain, and it is therefore improbable that the threat of switching is in fact disciplining the market.

3. *Relation of prices to costs*

3.8 One indication of the competitiveness of the retail market is provided by analysing how closely the charges to consumers reflect the costs of the suppliers. The closer prices are to costs, the more competitive the markets are. Such analysis also provides an indication of whether (and how much) the incumbent is able to charge more than other suppliers, once other factors are taken into account.

3.9 Such an analysis was undertaken for three consumption levels and three payment methods (ie nine times in all) in the electricity market, seeing how the charges for high/medium/low consumption level consumers, and for different payment methods, depended on the charges paid by retailers for use of the distribution system in December 2006 (results tables shown in Annex 1).

3.10 Results across the markets are very similar, with distribution costs, the main cost category that we can identify, being reflected almost one to one in retail charges, except for medium consumption prepayment consumers. Other costs are transmission, which accounts for only 3% of retail tariffs, and generation and supply costs, which we cannot observe. Generation costs at least are likely to be similar for each company in each region, so if they are just reflecting costs in their prices we would expect the “company effect” to be similar across consumption levels and price methods.

3.11 All credit customers pay more if they are supplied by the incumbent. The differential, compared to British Gas, is between £9 and £33 per year, and, in turn, British Gas prices are higher than those of (non incumbent) electricity competitors by an average of around £63 a year. This reveals a fair degree of incumbency power. The only place where there was no incumbent electricity mark-up was for low consumption prepayment consumers, suggesting that entrants are not targeting consumers in this group. This was also the only market in which British Gas’s price was not higher than all other non incumbent suppliers. This analysis applies to charges for electricity only and not to dual fuel deals, to which many consumers switch.

4. *Consumer errors*

3.12 Switching (or its threat) disciplines the market because consumers choose suppliers who meet their needs better, usually by being cheaper for a homogenous product like electricity. However evidence from CCP questions the assumption that consumers necessarily make good choices for themselves. Even amongst those who switched electricity supplier purely to save money, consumers made surprisingly poor decisions: at most half selected the tariff that was best for them; those who switched captured less than half the available benefits; and more than a fifth switched to a more expensive supplier. This raises concerns not only for the consumers themselves, and for potential overestimates of the direct benefits from switching (if it is calculated by multiplying the number of switchers by potential benefits). But also because the discipline of switching on suppliers is likely to be less beneficial if switching is not based on the maximum benefit available to the consumer. The assessment of the benefits and the effects of competition depend partly on the nature and extent of consumer response to the incentives in the market, and in this market we can see that such response is often faulty, and the consequent discipline correspondingly lax.

5. *Does ownership of the electricity network by the incumbent hamper competition?*

3.13 Accounting unbundling and separate licensing of the incumbent and the distribution network in each electricity region has been enforced since 2000, and since then there has been separation of ownership in half of the regions (seven of the 12 regions in England and Wales). In the other five in England and Wales the incumbent supplier and the distribution wires are owned by the same company, while full vertical integration remains in the two Scottish regions. This provides a natural experiment to identify whether such co-ownership hampers the development of competition. In any one year since entry was permitted, the amount of market which entrants had managed to capture was 4% less where the incumbent was co-owned with the distribution company than where ownership was separate. Similar effects are found if Scotland (where vertical integration is more extensive) is excluded. These simple statistics suggest that co-ownership of the distribution system, even with the rigorous license and accounting separation now required in the UK, may still endow some (albeit relatively small) advantages on the incumbent in repelling entrants to its home territory. If further exploration confirms these findings, it might be appropriate to explore consider whether ownership separation should be imposed. However in this case (as compared with voluntary separation) some of the costs of separating ownership might have to be borne by the consumer, rather than shareholders, which would affect the valuation of its benefits.

— The implications of growing consolidation in the energy market;

3.14 Since the market was opened in 1999, the number of distinct retail suppliers to households has fallen dramatically, so that there are now five consolidated survivors of the previous electricity incumbents (which may reduce further, depending on the outcome of discussions about the future of Iberdrola), and one gas incumbent. Our discussion above shows that this has created conditions where tacit collusion is likely to flourish, and that other indications on prices and market share confirm this possibility.

— The interaction between the UK and European energy markets;

3.15 As a general principle, any move to a genuinely integrated single European energy market would be competition enhancing, *ceteris paribus*. However, we noted above the trend towards consolidation in ownership of the leading firms across member states. Clearly, if this trend were to continue unabated, the end result may be that the bigger integrated market is dominated by just a few large multinational suppliers. The potential problem of tacit collusion may then resurface at a supranational level.

— The effectiveness of regulatory oversight of the energy market;

3.16 Many questions were raised about the benefits of opening household retail energy markets to competition at the time, and more recently David Newbery has noted that “retail margins have widened considerably since the domestic franchise ended in 1999” (2005), indicating that the consolidated energy market is exerting less competitive pressure on the liberalised market than did the previous regulatory regime. The dilemma for the regulator is that entrants will only be attracted by high margins, and so some increase may be necessary to “kick start” a change from regulated monopoly to competition. Consumers have certainly been offered a much wider choice of tariffs since 1999. But if the market is functioning well, margins should in turn be reduced through competition. Since the regulator has itself become a champion of competition (its duties include the protection of consumers by promoting competition wherever appropriate), there is a danger that it has an incentive to defend the success of competition as a measure of its own effectiveness. We therefore welcome the announcement of OFGEM’s own probe into the energy supply markets, and the microscope which they promise to bring to the exercise.

— Progress in reducing fuel poverty and the appropriate policy instruments for doing so.

3.17 Fuel poverty depends, both in a statistical and a practical sense, on income and on energy prices. In the early years of the century, while prices fell and incomes rose, fuel poverty also fell. Since energy prices have been rising from 2004, fuel poverty has correspondingly risen. As the rise in incomes slows, as seems likely, in 2008, this counterbalance to rising energy poverty will be less effective than in the recent past.

3.18 It is very difficult to see how the government can meet its target to eliminate fuel poverty amongst vulnerable households by 2010 with the present and likely future changes in energy prices. The underlying world price of oil and the increasing importance of the environmental agenda are both relentlessly increasing the upstream cost of energy. The signals from such prices will help to curb demand and further green house gas emissions; but for the fuel poor they may depress demand below a level which is desirable from a social perspective and/or cause real hardship for households with low levels of disposable income.

3.19 The most effective way to help the fuel poor is to raise their income. Compared with offering them lower prices (for the same effect), this also has the advantage of not distorting their demand, so that they purchase “too much” energy relative to its real cost to society. Since lower income households are more responsive than average to changes in price, subsidising their prices has a larger than average effect in raising demand.

3.20 However if fuel poverty is to be addressed through lower prices, voluntary schemes are unlikely to be effective. The recent move to encourage companies to offer social tariffs to low income consumers has had little effect, and it seems unlikely that the Chancellor’s exhortations for them to increase their provision will do so. Any company which makes a significant commitment to supply one group at lower profit margins than others, puts itself at a competitive disadvantage for other parts of the market, where prices would have to be higher than otherwise in order to subsidise such offers. It is interesting that the only company which does offer significant cross-subsidies (Ebico) is a not for profit subsidiary of one of the major players, and does not pay to be included as a full participant in the “search and switching engines” which are approved by energywatch. If the government believes that low income energy consumers should be subsidised by other energy consumers, then it should mandate such schemes, so that the impact on the market (effectively a tax on other energy users) is equal across players, and does not cause further distortions. One immediate result of such a policy will be to make the subsidised consumers less attractive for companies, who, as we have seen from the history of the prepayment market, can take a number of steps to try to avoid recruiting such consumers.

APPENDICES

A: RESULTS TABLES FOR THE ESTIMATED RELATIONSHIP BETWEEN RETAIL CHARGES AND DISTRIBUTION CHARGES

(i) DETERMINANTS OF ANNUAL BILL FOR STANDARD CREDIT, DECEMBER 2006

<i>Annual Consumption</i>	<i>1650k Wh</i>	<i>3300k Wh</i>	<i>4950k Wh</i>
Constant	23194.31*** (1182.11)	35778.68*** (1817.53)	54088.27*** (2520.73)
Distribution charge	1.098*** (0.253)	1.436*** (0.222)	1.042*** (0.207)
Distribution area (km ²)	-0.036** (0.014)	-0.069*** (0.017)	-0.074*** (0.204)
Distribution customers (000)	-0.927*** (0.229)	-0.339 (0.356)	-0.612 (0.549)
Incumbent	948.71** (378.45)	2121.79*** (463.04)	3266.66*** (681.92)
<i>Suppliers</i>			
London	-4631.86*** (484.33)	-7847.52*** (592.57)	-11085.71*** (872.69)
Npower	-2731.86*** (484.33)	-3811.81*** (592.57)	-4914.28*** (872.69)
Powergen	-2453.29*** (484.33)	-3947.52*** (592.57)	-5421.42*** (872.69)
Scottish Power	-2964.10*** (480.54)	-4353.11*** (587.94)	-5816.66*** (865.87)
SSE	-5967.58*** (484.33)	-8826.09*** (592.57)	-11778.57*** (872.69)
Adjusted R ²	0.7271	0.8188	0.7918

Notes: Standard errors in parentheses.

* Significant at 10%; ** Significant at 5%; *** Significant at 1%

(ii) DETERMINANTS OF ANNUAL BILL FOR DIRECT DEBIT, DECEMBER 2006

<i>Annual Consumption</i>	<i>1650k Wh</i>	<i>3300k Wh</i>	<i>4950k Wh</i>
Constant	22939.57*** (1182.07)	34333.56*** (3914.55)	52540.69*** (2970.20)
Distribution charge	0.878*** (0.253)	1.707*** (0.479)	1.062*** (0.244)
Distribution area (km ²)	-0.029** (0.014)	-0.108*** (0.038)	-0.744** (0.029)
Distribution customers (.000)	-1.038*** (0.229)	-1.072 (0.768)	-0.878 (0.647)
Incumbent	900** (378.44)	4001.92*** (997.28)	3215.38*** (803.51)
<i>Suppliers</i>			
London	-4228.57*** (484.31)	-7264.69*** (1276.27)	-10181.87*** (1028.30)
Npower	-3278.57*** (484.31)	-3978.98*** (1276.27)	-4574.72*** (1028.30)
Powergen	-1950*** (484.31)	-3564.69*** (1276.27)	-5081.86*** (1028.30)
Scottish Power	-4592.85*** (480.52)	-7178.84*** (1266.29)	-9973.62*** (1020.26)
SSE	-5614.28*** (484.31)	-7144.69*** (1276.27)	-12517.58*** (1028.30)
Adjusted R ²	0.7236	0.5212	0.7581

Notes: Standard errors in parentheses.

* Significant at 10%; ** Significant at 5%; *** Significant at 1%

(iii) DETERMINANTS OF ANNUAL BILL FOR PREPAYMENT, DECEMBER 2006

<i>Annual Consumption</i>	<i>1650kWh</i>	<i>3300kWh</i>	<i>4950kWh</i>
Constant	21357.97*** (1398.01)	36822.46*** (1988.79)	57343.09*** (2647.43)
Distribution charge	1.451*** (0.301)	1.669*** (0.243)	1.279*** (0.217)
Distribution area (km ²)	-0.055*** (0.018)	-0.080*** (0.020)	-0.079*** (0.027)
Distribution customers (.000)	-1.033*** (0.284)	-0.351 (0.395)	-0.411 (0.580)
Incumbent	715.38 (481.00)	1910.89*** (546.24)	3112.17*** (750.78)
<i>Suppliers</i>			
London	-3453.29*** (615.56)	-9988.04*** (699.06)	-16552.61*** (960.81)
Npower	1360.98** (615.56)	-2388.04*** (699.06)	-6181.18*** (960.81)
Powergen	-1460.44** (615.56)	-6195.19*** (699.06)	-10931.18*** (960.81)
Scottish Power	-1987.91*** (610.75)	-6601.55*** (693.59)	-11280.31*** (953.30)
SSE	-2760.44*** (615.56)	-9645.19*** (699.06)	-16538.32*** (960.81)
Adjusted R ²	0.5994	0.8295	0.8592

Notes: Standard errors in parentheses.

* Significant at 10%; ** Significant at 5%; *** Significant at 1%

APPENDIX B

DOES OWNERSHIP UNBUNDLING MATTER? EVIDENCE FROM UK ENERGY MARKETS³⁷²

Stephen Davies and Catherine Waddams Price
ESRC Centre for Competition Policy, University of East Anglia
November 2007

Ownership unbundling of vertical stages in the energy sector has become a contentious topic of debate at the end of 2007. To illustrate the issues, this paper focuses on ownership separation between the distribution and retail parts of the energy supply chain, where a mixed experience has emerged in the UK. Ten years ago both the national gas incumbent and all the electricity incumbents (monopoly suppliers before the markets were opened to competition) in each region shared ownership with the local pipes/wires (though accounting separation had been imposed some time earlier). In 1997 the incumbent gas supplier voluntarily disinvested the pipeline business, and seven of the fourteen regional electricity companies have followed suit since then, once separate licenses for the distribution and retail functions were introduced. If co-ownership confers advantages on the incumbent, higher incumbent market shares would be expected in regions where there had been no separation. This paper explores the evidence for such exploitation of integration, but first considers the general issues involved and the structure of the UK energy industry.

ARGUMENTS FOR AND AGAINST INTEGRATION

The debate around unbundling in energy concerns the separation between parts of the industry which have an element of natural monopoly (national transmission and regional distribution) and those where there are no obvious economic reasons why the market should not be competitive (generation and retail). There are four vertical stages to the energy industry: generating the fuel (from exploiting gas deposits or imports for gas, from a variety of sources for electricity); transmission (generally at high pressure or voltage over fairly long distances); distribution (more local transportation of energy at lower pressure/voltage, generally to customers' houses or premises); and the retail function of selling and billing to the final customer, which generally includes obtaining the fuel and necessary transportation en route. Most energy industries have a history of vertical integration over at least some of these functions, and of established monopolies, so introducing effective competition may involve some separation of different vertical (and perhaps horizontal) elements. The essential arguments in principle can be identified by focusing on this boundary between distribution and retail, but they should be broadly applicable to other parts of the supply chain.

³⁷² Published in December 2007 edition of *Intereconomics*.

In a general model of an upstream natural monopoly and a potentially competitive downstream market, there are three possible patterns, each of which has different implications for integration. If the upstream monopoly is not regulated and the downstream market is competitive, the upstream distribution company will extract all the monopoly rent, the downstream retailer is constrained by competitive pressures, and the outcome will be the same whether or not the company is integrated. However if the downstream retailer has some monopoly power (for example from incumbency advantages) there is a danger that if they are separated both the unregulated distribution company and the retailer will try to raise price, resulting in so called “double marginalisation”, and a higher price for the end consumer than if the company were integrated. In this case of market power in both parts of the supply chain, the perhaps counterintuitive conclusion is that it would be better both for consumers and for overall economic welfare to integrate the two parts of the chain. The third situation is the most common in practice and relevant to the current discussion. This involves a regulated monopoly distribution company, and an incumbent who retains some market power in the retail market. In this case there is concern about whether a vertically integrated company can influence the effectiveness of the regulation and so “lever” its monopoly advantage to deliver (or protect) market power in the downstream market.

Whereas regulation can in principle ensure that the regulated distributor does not confer any advantage on a co-owned retailer, the integrated company has an incentive to increase the price of the monopoly product and lower the downstream price, thus raising its rivals’ costs in the downstream market, and making its own retailer more relatively attractive (Bradley and Price, 1991, Noll and Owen, 1994). Much regulatory theory and practice has been concerned with addressing such issues. The efficient component pricing rule (originally developed for the telecoms market, Baumol and Sidak, 1994) identifies ways of ensuring that an upstream distributor with monopoly power levies a price which allows efficient downstream entry but deters inefficient entry. In general, regulators responsible for such integrated entities require accounting separation between the two functions, to minimise the chances of exploitation by reducing the inherent information asymmetry in such situations. Nevertheless while common ownership persists, so does both the incentive and the ability to distort prices. The latter can be achieved by the allocation of costs disproportionately to the regulated function to raise the charges in that sector. If such costs are in some sense “common”, it is difficult for the regulator to detect or correct such “biases”. The main concern about allowing common ownership in such cases is thus that the firm has both the incentive and ability to distort emerging competition in the downstream market.

However there are counterarguments which may indicate that integration is better. The natural monopoly of the distribution pipes means that the efficient price to charge for this element is below the average cost, and some cases of vertical integration might enable this. Such pricing would be the reverse of the incentives to raise the distribution costs discussed above. Nevertheless there are cases where it would be more efficient to keep the firm integrated, if the access charge for using the network is (positively) related to the degree of entry downstream (de Fraja and Waddams Price, 1999). Proponents of integration also often argue that common ownership can deliver important sources of efficiency gain. One example is the transactions costs which arise in cases where it is very difficult to specify complete contracts between the different parts of the industry, and so it makes sense to bring these “in house”. Some commentators (BBC, 2006) suggest that such difficulties account for some of the problems experienced by the segregated privatised British rail system, where responsibility has sometimes been difficult to attribute. There may also be information efficiencies from integration; here the general rule is that decisions should be made where the information lies. If information is needed about retail customers, for example for safety purposes, by gas and electricity distributors, can such information really be effectively hidden from the retail activities of the same company? “Chinese walls”, designed to separate such activities, are notoriously difficult to seal in practice, particularly when the employees on each side of the wall are former colleagues.

Policy makers also need to take into account any “one off” costs of changing from the current situation. If these are imposed on unwilling firms, who will bear the costs? Here the experience of the UK is of some interest. Since divestiture between the distribution and retail function has been voluntary, the costs have been borne by the shareholders. However if separation is imposed by regulators or governments, shareholders might argue that they should not bear the costs, but that these should be passed on to consumers.

In the UK, the story of separation is associated with that of privatisation, but not in a clearly deterministic sense.

THE UK ENERGY SECTOR AND INTEGRATION

One of the major criticisms of the 1986 privatisation of the UK gas industry, which had been nationalised since 1949 and a national monopoly since 1972, was that the opportunity for both horizontal and vertical separation was missed: the privatised incumbent proudly announced that it was responsible for gas and its delivery “from beach head to meter”, ie for the last three stages in the supply chain. By the time the electricity industry was privatised four years later some vertical separation was imposed in England and Wales (between generation and transmission) but the distribution and retail function remained integrated under a single license for another 10 years. In Scotland two fully vertically integrated companies (one serving the north and one the south of the country) were created, each providing generation, transmission, distribution and the retail function. Throughout Great Britain (ie excluding Northern Ireland), the electricity industry

retained its nationalised structure as fourteen separate companies (distributors and incumbent retailers) in distinct regionally defined markets. Despite these initial integrated positions, over the last 10 years the gas incumbent and seven of the fourteen regional electricity incumbents (table 1) have voluntarily separated themselves from the associated distribution function. In the case of the gas incumbent this was under some regulatory pressure, but the mixed result in the electricity case shows that both common and separated ownership are chosen outcomes. It is this range of ownership patterns that enables a test of whether integration adversely affects the development of downstream competition.

Government ministers had rejected a recommendation by the Monopolies Commission in 1993 that the gas industry should be vertically separated before retail competition was introduced, and instead enacted primary legislation to introduce competition from 1996 while the incumbent supplier was still vertically integrated with the transmission and distribution provider. The regulator sent clear messages that the retail function of the company would fare better if it was separately owned, and in 1997, in the midst of market opening, the company itself divested the distribution and retail functions. Commentators at the time believed that the retail arm would not prosper, and that the separation was partly to protect the assets invested in distribution and transmission from the much riskier retail function. In practice the retail arm has retained almost half the gas market, and is now the largest single electricity retailer, supplying about a quarter of the market (Ofgem, 2007).

Table 1

THE UK ELECTRICITY SUPPLY REGIONS AND OWNERSHIP OF INCUMBENT AND DISTRIBUTION WIRES IN 2007

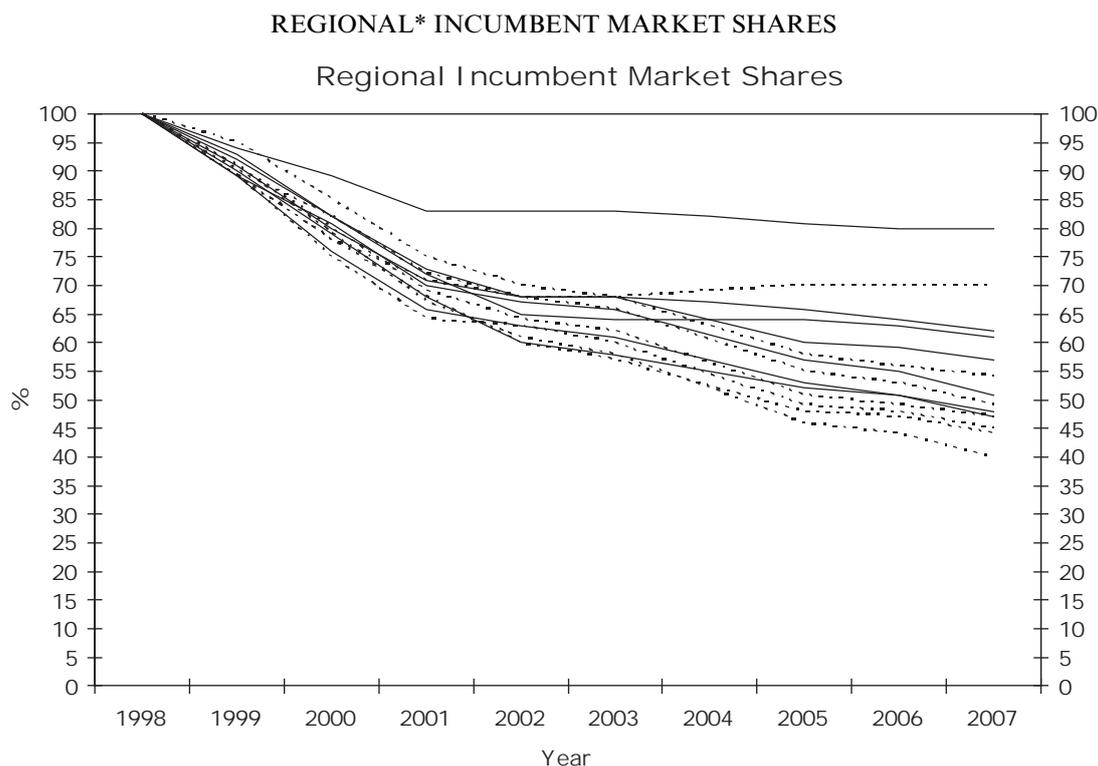
<i>Area</i>	<i>Distribution Wires Owners</i>	<i>Incumbent Supply Owners</i>	<i>Same Ownership?</i>
East Midlands	Central Networks of E.ON	PowerGen of E.ON	Y
East England	EDF Energy	PowerGen of E.ON	N
London	EDF Energy	EDF Energy	Y
Merseyside, Cheshire & North Wales	Scottish Power	Scottish Power	Y
Midlands (west)	Central Networks of E.ON	Npower of RWE	N
North East England	CE Electric	Npower of RWE	N
North West	United Utilities	PowerGen of E.ON	N
North Scotland	Scottish and Southern Energy	Scottish and Southern Energy	Y
South Scotland	Scottish Power	Scottish Power	Y
South East England	EDF Energy	EDF Energy	Y
Southern England	Scottish and Southern Energy	Scottish and Southern Energy	Y
South Wales	Western Power Distribution (WPD)	Scottish and Southern Energy	N
South West England	WPD	EDF Energy	N
Yorkshire	CE Electric	Npower	N

The retail market in gas was opened on a regional basis between 1996 and 1998, and in electricity across all regions in 1998 to 1999. From May 1999, therefore, all energy consumers have been able to choose between a range of suppliers. All the incumbents entered each others' (gas and regional electricity) markets, and since then there has been considerable consolidation in both retail and distribution, so that there are now six main retailers (five consolidated regional electricity incumbents and the national gas incumbent) and seven distribution company owners. Of these, four are also major retailers. All companies were required to impose accounting separation between their distribution and retail functions. In its review of electricity distribution companies in 1999, just as competition was starting in the retail market, the regulator, Ofgem, intervened in the company attributions, and reallocated over a fifth of companies' costs from the distribution to the retail function. One company was told to transfer over one third of its costs. This action by the regulator suggests that the companies both had incentives to load costs more heavily onto the distribution function in anticipation of competition, and that they acted on these incentives.

During the many post-privatisation transactions in which electricity companies changed hands, a mixture of ownership patterns for the incumbent suppliers and distribution companies emerged. The original 14 regional incumbents had reduced to five through takeover by 2003, and the main suppliers, as they stand in mid 2007, in addition to British Gas, are shown in table 1, along with their ownership. One main retailer owns no distribution assets; one owns distribution assets only in (both) the areas where it is incumbent; one owns them for two of its three incumbency regions, but not elsewhere; and the remaining two own distribution assets in some areas where they are incumbent and some where they are not. In this paper the main focus is in the seven areas where there is common ownership between the incumbent and the distributor. In particular, is there any evidence that the incumbent retains higher market share in those regions where it shares ownership with the distributor?

Does integration protect incumbent market share?

Figure 1 shows the evolution of incumbent market share in the 14 regions, labelled according to the status of their joint ownership (solid lines) or not (dotted lines) in 2007. This graph provides a useful preliminary overall picture, but it is simplified because, where ownership did become separated, it happened at different times since market opening commenced in 1998. Nevertheless, it does reveal that the region in which the incumbent has retained the largest market share in 2007 (North of Scotland) is integrated, while as the regions with the four lowest incumbent market shares (Midlands, the North West, Northern and Yorkshire) are not; however, the evidence between these two extremes is mixed.

Figure 1

*Solid lines indicate regions where the incumbent and the local distributor are owned by the same company in 2007; dotted lines indicate regions where the incumbent is not owned by the same company as the local distributor.

Source: Ofgem, 2007 and predecessor Ofgem reports

Therefore, to examine this further, a least squares panel regression has been used to explore whether the market share retained by the incumbent in each year was related to whether or not it was integrated with the distributor up to and including that year. The results are shown in Table 2, in which the dependent variable is the incumbent's market share, in a given region at a given point in time, integrated is a binary dummy variable, indicating whether or not the retailer was integrated with the distributor in that year. The equation also includes a time trend, to allow for the natural erosion of market share over time, which will typically occur in any, previously monopolised, market into which new entry is introduced. However, this is modelled using a quadratic time trend (including time squared), to allow for the possibility that, as consumers become increasingly familiar with the market, the rate of switching will perhaps slow down after the initial few years. Since this is a panel model, the equation also controls for any other differences between the regions, which may remain even after taking account of integration and the time trend (for instance, consumers in certain regions of the country may exhibit more or less loyalty to the incumbent, perhaps because it has a strong regional identity).

Table 2

MARKET SHARE, TIME TREND AND VERTICAL INTEGRATION 1999–2007

<i>Market share</i>	<i>Coef.</i>	<i>Std. Err.</i>	<i>t</i>	<i>P > t</i>
Time	−9.125303	0.6835588	−13.35	0.000
Time squared	0.5128004	0.0644144	7.96	0.000
integrated	4.104698	1.664571	2.47	0.015
constant	93.93349	2.178107	43.13	0.000
sigma_u	6.1550725			
sigma_e	4.0301183			
Rho	0.69992939			

The estimated equation includes very striking, and statistically significant, results on both the time trend and the role of incumbency.

First, as expected, the incumbent's market share does indeed tend to decline over time: typically, then, incumbents lost market share year-on-year in all regions. However, the particular values and signs of the coefficients on time and time squared reveal that the rate of decline gradually slowed down over the period, so that, in the last year (2007, year 9), the annual rate of loss had almost levelled out. On average over the whole time since market opening, the annual loss of market share by the incumbent was around 4%, but at much higher rates in the opening years, and much lower rates in the later years.

Second, and most important for the current discussion this general reduction in market share, though experienced in all regions, is found to be significantly slower for companies which are integrated (as indicated by the positive coefficient on the "integration" variable.) Thus, on average, in any one year, the market share of an integrated firm has been more than 4 percentage points higher than that of a counterpart where different companies own the incumbent retailer and the associated regional distribution company.

These are the "headline" results, but the estimated equation also reveals considerable background variation between regions (not shown in the table). Five regions show similar patterns of market share reduction: Manweb, Northern, North Western, South Eastern and East Midlands. Incumbents in the other nine regions retain significantly higher market shares, even after accounting for whether or not the incumbent is integrated. In particular, the north of Scotland, whose incumbent is Scottish Hydro, shows particularly high incumbent market share, over 20% above that of the comparator regions, in addition to the higher market share attributable to its integrated status. Scottish Power, the incumbent in the southern part of Scotland, also retains a higher market share than the comparator regions. Both these companies are vertically integrated not only with distribution, but also with transmission, which is not allowed in England and Wales.

CONCLUSION

The analysis above appears to provide clear evidence that those UK incumbent electricity suppliers who remained vertically integrated with their local distributor have retained a higher market share than those where these functions have been undertaken by separately owned companies. This result is evident even after region specific characteristics, such as different levels of consumer loyalty, have been included. Competitors have been slower to gain market share where there is common ownership despite considerable intervention by the regulator. Its actions have included reallocating costs (originally attributed to the distribution function by companies) to the potentially competitive retail function, a regulatory regime for distribution which is generally regarded as robust, and constant vigilance by the regulator in the retail market.

We should stress that the above statistical model is relatively simplistic, and it should be viewed as a piece of documentary evidence—to be put alongside any other information which becomes available results. It certainly does not prove that the companies concerned have been indulging in illegal or improper behaviour. Nevertheless, the results do suggest that, even with vigilant regulation and clear accounting separation, incumbents who are vertically integrated appear to exhibit an advantage in retaining their market share against the inroads of entrant firms. As the debate about ownership separation continues in Europe, this summary of UK experience provides one piece of evidence which suggests that joint ownership of the distribution function may indeed confer competitive advantage on the incumbent.

REFERENCES

- BBC, News 5 November 2006, <http://news.bbc.co.uk/1/hi/uk/6117728.stm>, last accessed 13 November 2007
- Baumol, W J and G Sidak, *The Pricing of Inputs Sold to Competitors*, YALE J. REG. 171 (1994)
- Bradley, I and C Price (1991) Partial and Mixed Regulation of Newly Privatised UK Monopolies in W Weigel (ed): *Economic Analysis of Law—A Collection of Applications*, pp 212–221, Schriftenreihe der Bundeswirtschaftskammer, Wien, 1991
- De Fraja, G and C Waddams Price (1999) Regulation and access pricing: comparison of regulated regime, *Scottish Journal of Political Economy*, 46,(1), pp 1–16
- Noll, R G & Bruce M Owen (1994) *The Anticompetitive Uses of Regulation: United States v. AT&T*, in THE ANTITRUST REVOLUTION: THE ROLE OF ECONOMICS 328 (John E Kwoka & Lawrence J White eds)
- Ofgem, 1999, Reviews of Public Electricity Suppliers 1998–2000, Distribution Price Control Review Draft Proposals, August
- Ofgem, 2007, Domestic Retail Market Report—June

APPENDIX C

DO CONSUMERS SWITCH TO THE BEST SUPPLIER?³⁷³

Chris M Wilson* and Catherine Waddams Price**

* Department of Economics, University of Oxford

** ESRC Centre for Competition Policy, University of East Anglia

Abstract: This paper suggests that the ability of consumers to choose accurately between alternative suppliers is substantially limited even in a relatively simple and transparent market. Across two independent datasets from the UK electricity market we find, on aggregate, that those consumers switching exclusively for price reasons appropriated between a quarter and a half of the maximum gains available. While such outcomes can be explained by high search costs, the observation that at least a fifth of the consumers actually reduced their surplus as a result of switching cannot. We consider and reject several alternative explanations to pure decision error.

1. INTRODUCTION

Competition policy and other policy initiatives in markets as diverse as health and education are increasingly based on the presumption that consumers can play a positive role in generating market competition by choosing to trade with the supplier that best suits their needs. However, consumers may be unable to perform this role and competitive forces may be consequently weakened for several reasons. Consumers may be unwilling to change suppliers because of switching costs, unaware of alternative suppliers because of search costs or may face difficulties in evaluating and comparing different suppliers' offers because of cognitive decision-making costs³⁷⁴. While previous empirical research has largely focussed on identifying the effects of switching costs, this paper investigates the importance of the last two possibilities by analysing empirically the accuracy with which switching consumers choose their best available alternative supplier.

We exploit two independent datasets from the UK electricity market where consumers have been free to switch away from their regional incumbent to one of several entrants since the market's liberalisation in 1999. In such a market, we would expect consumers' switching decisions to be relatively accurate for several reasons. First, almost all households consume electricity and for many, it forms a significant part of their household budget. Second, the market is relatively simple as firms supply a near-homogenous good and at the time of our surveys each supplier effectively offered only a single tariff option. Third, the market is transparent with the industry regulator and several online price comparison services providing many forms of advice and tariff information. Yet, despite such market conditions, this paper suggests that the inaccuracy of consumers' switching decisions remains substantial. Even when focussing only on the consumers who, when asked, indicated that they had switched suppliers exclusively for price reasons, we find that across the two datasets and under a range of assumptions, only 8–19% of consumers switched to the firm offering the highest surplus and, in aggregate, switching consumers appropriated only between 28% and 51% of the maximum gains available to them. While such behaviour is wholly consistent with the behaviour of rational consumers facing high search costs, the additional finding that 20–32% of switching consumers appear to have lost surplus through their choice of supplier is not. These consumers lost an average £14–35 per year in increased bills, apart from any other switching costs they may have incurred.

³⁷³ Published as CCP working paper 07-6

³⁷⁴ See Farrell and Klemperer (2006) for a review of the market power effects of switching costs, Baye et al (forthcoming) for search costs, and Gabaix et al (2005) for cognitive costs.

Very little previous research has examined empirically the switching accuracy of consumers. As part of a much wider investigation into the effects of entry in the New York State telephone market, Economides et al (2005) suggest that 42% of consumers switched to a more expensive supplier, resulting in an average loss of \$4.32 per month. Giulietti et al (2005) suggest there may be consumer inaccuracy in the UK gas market by showing that consumers' (binary) switching decisions appear unrelated to the monetary gains available from doing so, especially for consumers who expect price differences to be transitory. A larger literature however, has analysed the widespread potential for consumers to select a non-cost minimising option from a menu of tariffs offered by the same firm. Agarwal et al (2006), for example, suggest that over 40% of consumers selected the more expensive tariff when offered the option of two credit card contracts in a market experiment by a US bank, while Lambrecht and Skiera (2006) use data from a German internet provider to estimate that around a third of consumers chose a more expensive fixed rate tariff, and over half of these paid more than double the cheapest alternative tariff. The proposed explanations for such choices fall into three broad categories. First, consumers may show a preference for certain tariff structures, such as flat-rate fees (Lambrecht and Skiera 2006). We find no support for such an explanation as the gains from switching are largely unrelated to any associated change in tariff structure. Second, in comparing tariffs, consumers may weight inappropriately the various components of a tariff or price, such as the introductory rate, shipping charge or state-tax rate (eg Ausubel 1999, Hossain and Morgan 2006, Ellison and Ellison 2006, respectively). This explanation is not supported by our data which show that the gains made by consumers who switched to suppliers offering a potentially focal "dual-supply" discount are not significantly different from the gains made by other consumers. Third, consumers may evaluate alternative suppliers' tariffs using an incorrect prediction of their own future consumption (Miravete 2003, Della Vigna and Malmendier 2004, 2006). This explanation also appears unconvincing as all results are derived from consumers' own (expenditure) beliefs and remain robust across consumption variations of plus and minus 10 percent.

Highlighted by the recent widespread allegations about such practices within the industry, one plausible explanation of the results concerns the pressurising or misleading influence of suppliers' sales activities. However we find that the accuracy of consumers' choices are not significantly related to the self-reported influence of a sales agent; nor does an increased number of regional competitors, which might result in increased sales activity, consistently reduce the accuracy of decisions. Instead, the paper concludes that consumers' switching inaccuracy is consistent with pure decision error. This finding underlines the importance of the growing research into the incentives firms may face to exploit or induce consumer confusion—see Ellison and Ellison (2004) or Armstrong and Spiegler (2007) for a further discussion.

Section 2 provides a brief theoretical foundation for the measures of the gains from switching that are later calculated. Section 3 introduces the market, the data and the calculation procedures. The descriptive results are presented in section 4. Section 5 proposes some potential explanations for the results and presents some further analysis to test them; section 6 concludes.

2. THEORY

To analyse the accuracy of consumers' switching decisions it is necessary to calculate both the actual gains in surplus that each consumer made through their choice of new supplier and the maximum possible gains that each consumer could have achieved by switching to their best supplier (given their demand characteristics). We now present some simple measures to form the basis of such calculations.

Consider consumer i 's decision to switch away from his old supplier, o , to a new supplier, n , chosen from his set of alternative suppliers, S_i . Assuming that consumer i cares only about the tariff offered by each supplier, equation (1) describes the approximate annual gain in consumer surplus (excluding switching costs) from deciding to switch from supplier o to supplier, n .

$$\Delta CS_i = CS_i^n - CS_i^o \approx [u_i(C_i^n) - E(C_i^n; T^n)] - [u_i(C_i^o) - E(C_i^o) - E(C_i^o; T^o)] \quad (1)$$

where the consumer surplus received at any firm j consists of the utility from consuming C_i^j homogenous units of electricity annually, $u_i(C_i^j)$, minus the associated bill expenditure, $E(C_i^j; T^j)$, which depends on firm j 's tariff, T^j . With the use of a revealed preference argument to ensure that $u_i(C_i^o) - E(C_i^o; T^o) \geq u_i(C_i^n) - E(C_i^n; T^o)$ an upper bound for the actual gains made from such a switching decision, x_i^{sw} , is constructed by comparing the expenditures that would result from consuming the level of post-switching consumption, C_i^n , at each supplier, (2). Such an upper bound is very close to the approximate change in surplus described by (1) when demand is highly price inelastic, as in the electricity market (Baker et al 1989).

$$\Delta CS_i \leq x_i^{sw} \equiv E(C_i^n; T^o) - E(C_i^n; T^n) \quad (2)$$

Similarly an upper bound for the maximum possible gains that consumer could have made by switching away from supplier, o , $x_{i,o}^{max}$, can be constructed by comparing the expenditure at i 's old supplier with the lowest possible expenditure available from the set of alternative suppliers, S_i , (3). One final upper bound measures the gains consumer i would have expected to make by randomly selecting an alternative supplier, $x_{i,o}^{mean}$. (4) compares the expenditure at i 's old supplier with the average expenditure across supplier i 's set of alternative suppliers.

$$x_{i,o}^{\max} = E(C_i^n; T^o) - \min_{k \in S_i} E(C_i^n; T^k) \geq 0 \quad (3)$$

$$x_{i,o}^{\text{mean}} = E(C_i^n; T^o) - \text{mean}_{k \in S_i} E(C_i^n; T^k) \quad (4)$$

Fully rational and informed consumers who care only about the tariffs offered by each firm would select the alternative supplier that offers the maximum reduction in expenditure, $x_i^{\text{sw}} = x_{i,o}^{\max}$. However if they are rational but not fully informed, perhaps due to the existence of search costs, switching consumers may be willing to select a supplier that does not offer the maximum reduction in tariff expenditure, $x_i^{\text{sw}} \in [0, x_{i,o}^{\max}]$. As consumers always retain the option of not switching, one should never observe switching consumers making negative gains, $x_i^{\text{sw}} < 0$.

3. CALCULATIONS

This section uses the measures constructed in section 2 to analyse the switching accuracy of two sets of consumers in the UK electricity market. After an introduction to the market in section 3.1, section 3.2 presents the data and illustrates how the UK electricity market is particularly well suited for such an analysis. Section 3.3 explains how the final calculations are made.

3.1 The Market

Since liberalisation of the UK residential electricity market was completed in mid 1999, electricity suppliers have been permitted to enter each of the fourteen regional markets to compete with the original regional incumbent. While few new suppliers chose to enter the industry, many regional incumbents took the opportunity to enter most, if not all, of the regions in which they had not previously been incumbent, as did the national gas supplier, British Gas. Consumers were free to switch away from their regional incumbent (or any subsequent supplier) with 28 days notice and no financial penalty. In the subsequent eight years about half of all energy consumers moved away from their regional incumbent.

An example of the range of tariffs on offer to consumers is displayed in Table 1. As tariffs vary by region and by time, Table 1 presents a typical snapshot of the tariffs offered within an example region, the Midlands, in June 2000. Suppliers are obliged to offer tariffs for three possible consumer payment methods—standard credit, direct debit and prepayment, but in practice, only offered a single tariff per payment method³⁷⁵.

Suppliers typically offer two-part tariffs, with some offering three-part tariffs that contain an additional marginal rate for higher levels of consumption beyond some threshold. The majority of electricity suppliers who are also active in the gas market increasingly participate in mixed bundling by offering a dual-supply discount to those consumers who choose to buy both forms of energy. While it is common for suppliers to approach consumers directly in the hope of persuading them to switch, it is rare for suppliers to use upfront discounts or incentives.

Since liberalisation, many internet-based price comparison sites have offered consumers advice in choosing between suppliers. Despite the industry regulator and consumer body endorsing the use of several comparison sites, their popularity remained limited in the period of our studies, with only 10% of surveyed consumers having used them in 2003 (OFGEM 2004).

³⁷⁵ More recently suppliers have offered a wider choice of tariffs, including “capped” tariffs, but these were not available at the time of the consumer decisions analysed here.

EXAMPLE SET OF TARIFFS (MIDLANDS REGION, JUNE 2000, IN PENCE)

<i>Electricity Supplier:</i>	<i>Payment Method:</i>			<i>Direct Debit</i>			<i>Prepayment</i>			<i>Dual-Supply Discount</i>		
	<i>Credit</i>	<i>Fixed</i>	<i>Rate1</i>	<i>Rate2</i>	<i>Fixed</i>	<i>Rate1</i>	<i>Rate2</i>	<i>Fixed</i>	<i>Rate1</i>		<i>Rate2</i>	<i>Threshold</i>
MEB (Regional Incumbent)	2159	6.72	6.52	—	2094	6.52	—	3734	6.72	—	—	—
British Gas	0	10.57	9.01	5.65	0	9.01	5.65	0	10.28	6.17	900	1460
Eastern TXU Energi	2848	6.38	6.38	6.28	1856	6.38	6.28	3713	6.72	—	2392	—
East Midland	3541	5.99	5.99	—	2491	5.99	—	5116	5.99	—	—	250
Independent	4982	5.46	5.46	—	4026	5.46	—	4497	7.77	—	—	—
London Electricity (1)	3048	5.86	5.86	—	3048	5.86	—	9202	7.80	—	—	—
Northern Electric and Gas	0	9.14	8.19	5.68	0	8.19	5.68	3990	6.52	—	1092	—
Norweb Energi	4922	5.30	5.21	—	4637	5.21	—	3734	6.72	—	—	—
Seaboard (2)	0	11.97	10.82	5.34	0	10.82	5.34	4112	6.72	—	728	—
Scottish Hydro	1873	6.08	6.08	—	1873	6.08	—	3990	6.52	—	—	—
Scottish Power	5408	5.26	5.01	—	4883	5.01	—	3734	6.72	—	—	1050
Southern	3116	6.29	6.16	—	3053	6.16	—	3990	6.52	—	—	—
SWALEC	1966	5.67	5.44	—	1886	5.44	—	3734	6.71	—	—	—
SWEB	3045	5.86	5.68	—	2954	5.68	—	4523	7.39	—	—	—
Utility Link	3595	7.25	7.25	—	2595	7.25	—	7388	7.68	—	—	—
Yorkshire	4721	5.72	5.76	—	4091	5.76	—	8669	5.76	—	—	—

Each supplier offers a tariff across three payment methods. Each tariff consists of an (possibly zero) annual fixed fee, *Fixed*, with an additional marginal rate, *Rate1* in pence/kWh, and, in some cases, a second marginal rate, *Rate2*, for consumption over and above some annual breakpoint, *Threshold* (in kWh). Dual supply discounts are offered only to credit or direct debit consumers (except by East Midland/Powergen who offer them to all consumers). Additional discounts are labelled with numbers in brackets—(1) 3% off Direct Debit if bill exceeds £10.50 (2) £8.40 off credit and direct debit.

3.2 Data

Two datasets were constructed from two independent, cross-sectional, face-to-face surveys of consumers in England, Scotland and Wales. The EA survey (Cooke et al 2001) was conducted between March and August 2000 and was intentionally biased towards low-income consumers³⁷⁶. Of the 3417 consumers surveyed, 523 had switched electricity suppliers and, of these, 373 had a full set of responses to questions relevant for the analysis. In contrast, the CCP survey, was designed to be representative of the general population and was conducted for the ESRC Centre for Competition Policy in June 2005³⁷⁷. Of the 2027 consumers surveyed, 370 had switched suppliers in the previous three years, and 245 furnished useable responses. While the presence of a low-income bias and missing information limit our ability to draw general inferences about how switching behaviour varies with consumer characteristics, we view the measurement of switching accuracy within each of these samples as informative.

A major constraint on the ability to measure consumers' switching accuracy arises from the possibility that consumers switched for reasons other than price. Whilst non-price gains are likely to be small in a near-homogeneous market like electricity, they may arise from two sources. First, although the reliability of supply is independent of the supplier (since it depends upon the vertically separated distribution function), consumers may perceive that firms vary in attributes such as customer service or environmental awareness. Second, in addition to the possible monetary benefits of being supplied electricity and gas by the same supplier, for which we account for, consumers may perceive some non-price, practical benefits from having to deal with only one supplier. To eliminate these possibilities, we restrict our analysis to a subset of consumers who stated that their switching decision was motivated purely by price. Specifically, two sub samples are created that contain 318 and 154 consumers respectively who, when asked, cited only differences in price as a reason for switching and did not mention factors such as the quality of service, the provision of "environmental" tariffs or the practical benefits of being dual-supplied. A full summary of the consumers' (multiple) reasons for switching suppliers is presented in Tables 2a and 2b.³⁷⁸

Tables 2a and 2b

REASONS FOR SWITCHING SUPPLIERS ACROSS THE TWO DATASETS

<i>Reason for Switching (EA)</i>	<i>Mean</i>	<i>Reason for Switching (CCP)</i>	<i>Mean</i>
Cheaper	0.77	Better Prices/Rates	0.86
Dual Supply Discounts	0.10	Better Service/Quality	0.19
Influence of Sales Agent	0.10	Not Satisfied with Old Supplier	0.11
"Conned"/Unaware of switching	0.03	Dual Supply	0.06
Poor Service from Old Supplier	0.03	Environmental Tariffs	0.03
Better Service	0.02	Other	0.10
No Standing Charge	0.01	n	245
Other	0.05		
n	373		

3.3 Calculating the Gains from Switching

This section provides further details of how the bound measures constructed in section 2 are used with the selected data samples to calculate consumers' switching accuracy.

³⁷⁶ The EA survey and its initial analysis were funded by the Electricity Association—an early description of consumers' choices and errors is contained in Waddams Price (2003).

³⁷⁷ The CCP survey was designed to analyse search and switching behaviour across eight different product markets as analysed by Chang and Waddams Price (forthcoming). Here, only the data from the electricity market is used.

³⁷⁸ The EA respondents were asked to provide an unstructured explanation for why they had switched, which was later coded into an exclusive list of reasons, whereas the CCP respondents were asked to indicate up to three reasons from a list of possible options. No distinction was made between price and non-price benefits of dual-supply and so all consumers who cited dual-supply as a reason for changing suppliers are eliminated from the sample.

To focus only on the accuracy of consumers' choice of supplier and not on the choice of payment method or gas supplier, all calculations are made by comparing suppliers' relevant tariffs whilst treating each consumer's known choice of payment method(s) and gas supplier as given. Specifically, the calculations are made using equations (5)–(7), where the tariff of each supplier, $T_{tr}(m,g)$, varies according to the consumer's date of switching, t , electricity supply region, r , choice of gas supplier, g , and choice of payment method, m , (both before and after switching).

$$x_i^{sw} = E[\check{C}_i^n; T_{tr}^o(m^o, g)] - E[\check{C}_i^n; T_{tr}^n(m^n, g)] \quad (5)$$

$$y_i^{swg*} = \beta_1 + agent_i \beta_2 + conned_i \beta_2 + D_i \beta_3 + x_i^{max} \beta_4 + stable_i \beta_5 + \varepsilon_i \quad (6)$$

$$x_{i,s}^{mean} = E[\check{C}_i^n; T_{tr}^o(m^o, g)] - \underset{k \in S_r}{mean} E[\check{C}_i^n; T_{tr}^k(m^n, g)] \quad (7)$$

Using a time series of the unique tariff offered by each supplier per payment method³⁷⁹, an estimate of consumption, \check{C}_i^n , was calculated from each consumer's own estimate of their average electricity expenditure³⁸⁰. Such an approach offers two advantages. First, it is probably more accurate as consumers are more likely to recall their expenditure than their consumption. Second, and more importantly, all gains are calculated in a way that is consistent with consumers' own consumption beliefs, so that any inaccurate consumer choices cannot be attributed to consumers' incorrect consumption estimates. A potential drawback, however, comes from the possibility that each consumer's expenditure beliefs may have changed in the intervening period between the time of the switching decision and the time of the survey. We take two approaches to allow for this possibility and to add further robustness to the findings. First, we identify a subgroup of the EA consumers whose survey responses indicated that their consumption was highly price inelastic, and stable over time, and demonstrate that these do not differ significantly from the rest of the sample³⁸¹. The insignificant difference supports the claims that i) the constructed upper bounds form close approximations to the true gains from switching and ii) consumption is likely to be stable between the time of switching and the time of the survey. Second, we repeat the three measurements for all consumers using consumption levels which are plus and minus ten percent of our original estimate.

Whilst the CCP dataset is sufficiently rich to provide all the required information, the EA dataset does not provide all the necessary variables directly from the survey because of uncertainty about the exact date of switching and of any change in payment method. To proceed we derive the EA calculations under the four most likely scenarios and compare the results for robustness. This leads to the specifications, Oct99nochange, Oct99change, Jun00nochange and Jun00change, which are detailed fully in the appendix.

4. DESCRIPTIVE RESULTS

Figure 1 plots the estimated actual gains from switching against the maximum gains available for all consumers (averaging across the EA specifications outlined above). Two immediate observations can be made. First, many of the consumers have not appropriated the maximum gains available, as indicated by the points located below the 45° line. This is consistent with the behaviour of rational consumers facing search costs and with experimental evidence that suggests consumers often search too little (Sonnemans 1998 and Tenorio and Cason 2002). Second, however, a significant fraction of switchers appear to have actually lost surplus by switching to a more expensive supplier, as indicated by the points below the x-axis, a finding which is inconsistent with the behaviour of rational consumers motivated to switch only by price. To explore the findings in more detail, Table 3 displays the main results derived from the original estimates of consumption and Table 4 includes the results with the alternative consumption levels.

³⁷⁹ The tariff dataset builds on that used by Giuliotti et al (2005) and was obtained by either contacting suppliers directly or downloading bimonthly tariffs from a consumer advice website, www.which.co.uk or the energy consumer body, www.energywatch.org.uk.

³⁸⁰ Consumers were asked to provide an estimate of their expenditure on a weekly, fortnightly, monthly or quarterly basis as they preferred.

³⁸¹ The subgroup of consumers indicated high price inelasticity by replying "the same" to the following questions: Q. If the cost of electricity went down would you use more electricity or use the same electricity and use the savings for something else?, and Q. If the cost of electricity went up would you use less electricity or use the same electricity?, and further indicated a stable consumption pattern by replying "No" to the following questions, Q. Has there been any change in your household's circumstance in the last two to three years that affected your fuel consumption?, and Q. Has your household's electricity ever been disconnected because of unpaid electricity bills?

Figure 1

THE ACTUAL GAINS MADE FROM SWITCHING RELATIVE TO THE MAXIMUM GAINS AVAILABLE, CCP AND EA (POOLED SPECIFICATION) DATASETS

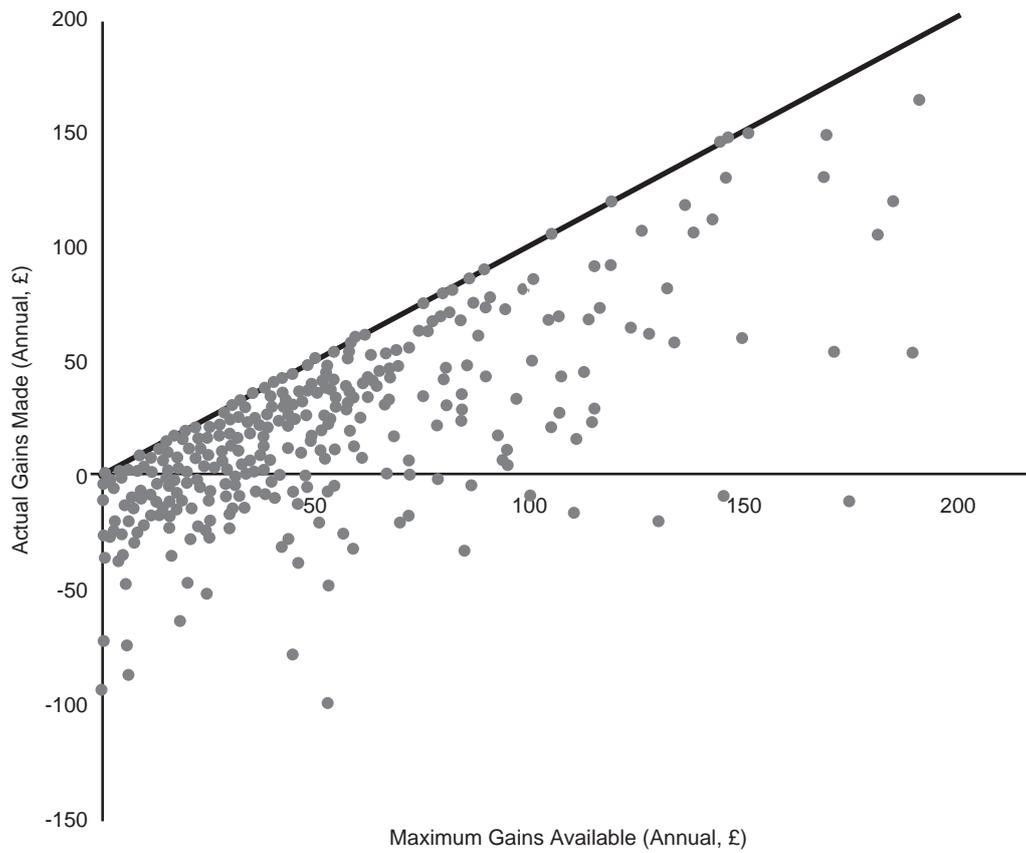


Table 3
DESCRIPTIVE STATISTICS OF THE GAIN MEASURES ACROSS A RANGE OF DATASETS AND SPECIFICATIONS

Data Specification	CCP		EA Pooled		EA Oct 99 no change		EA Oct 99 change		EA Jun 00 no change		EA Jun 00 change	
	Average	(StDev)	Average	(StDev)	Average	(StDev)	Average	(StDev)	Average	(StDev)	Average	(StDev)
Number of Switchers	154		318		318		318		318		318	
Average Maximum Gains Available (annual, £)	49.04	(39.20)	44.22	(42.65)	43.02	(42.84)	41.42	(39.91)	47.08	(42.85)	45.35	(45.00)
Average Mean Gains Available (annual, £)	11.43	(31.16)	8.80	(27.14)	8.62	(28.02)	7.01	(27.62)	10.64	(29.25)	8.92	(33.06)
Average Actual Gains Made (annual, £)	17.92	(43.18)	19.41	(38.56)	21.36	(41.57)	19.75	(38.99)	19.13	(35.61)	17.40	(38.09)
Average Mean Gains/Average Maximum Gains	0.23		0.20		0.20		0.17		0.23		0.20	
Average Actual Gains/Average Maximum Gains	0.37		0.44		0.50		0.48		0.41		0.38	
Proportion of Switchers with Perfect Gains	0.18		0.14		0.18		0.18		0.10		0.10	
Expected Proportion if Random Alternative Selected	0.14		0.07		0.07		0.07		0.07		0.07	
Proportion of Switchers with Negative Gain	0.31	(0.46)	0.25	(0.43)	0.24	(0.43)	0.26	(0.44)	0.22	(0.41)	0.29	(0.45)
Average Gain given Negative Gain	-26.96	(32.99)	-17.56	(19.16)	-16.78	(20.77)	-19.23	(19.80)	-15.76	(16.93)	-18.47	(19.14)
Proportion of Switchers with Non-Negative Gain	0.69	(0.46)	0.75	(0.43)	0.76	(0.43)	0.74	(0.44)	0.78	(0.41)	0.71	(0.45)
Average Gain given Non-Negative Gain	37.64	(30.55)	31.85	(35.29)	33.13	(39.27)	33.52	(34.53)	28.98	(33.24)	31.78	(34.10)
Proportion of Switchers with Dominated Choice	0.01		0.06		0.07		0.08		0.03		0.04	

Maximum Gains Available refers to the change in surplus that would have been realised by a switcher had they switched to their cheapest alternative supplier. *Mean Gains Available* refers to the change in surplus that a switcher would expect to gain by selecting a supplier randomly. The *Proportion of Switchers with Perfect Gains* refers to the proportion of consumers who appropriated all of the maximum gains available. This is compared to the expected probability of doing so had the consumer randomly selected an alternative supplier. The *Proportion of Switchers with Dominated Choice* refers to the proportion of consumers that switched to a tariff that could not be cheaper than their previous tariff for any level of consumption.

Table 4
COMPARING THE CALCULATED GAIN MEASURES WITH THE PERTURBED CONSUMPTION LEVELS

<i>Data Specification</i>	CCP	EA Pooled	EA Oct 99 no change	EA Oct 99 change	EA Jun 00 no change	EA Jun 00 change
	Average (StDev)	Average (StDev)	Average (StDev)	Average (StDev)	Average (StDev)	Average (StDev)
<i>Using Estimated Consumption</i>						
Average Maximum Gains Available (annual, £)	49.04 (39.20)	44.22 (42.65)	43.02 (42.84)	41.42 (39.91)	47.08 (42.85)	45.35 (45.00)
Average Actual Gains Made (annual, £)	17.92 (43.18)	19.41 (38.56)	21.36 (41.57)	19.75 (38.99)	19.13 (35.61)	17.40 (38.09)
Average Actual Gains/Average Maximum Gains	0.37	0.44	0.50	0.48	0.41	0.38
Proportion of Switchers with Perfect Gains	0.18	0.14	0.18	0.18	0.10	0.10
<i>Using Estimated Consumption - 10%</i>						
Average Maximum Gains Available (annual, £)	47.47 (37.56)	42.04 (38.00)	41.17 (41.66)	40.97 (36.27)	42.44 (38.21)	43.57 (35.85)
Average Actual Gains Made (annual, £)	20.76 (41.19)	18.51 (34.89)	20.72 (40.53)	19.27 (37.05)	17.42 (31.99)	16.64 (29.99)
Average Actual Gains/Average Maximum Gains	0.44	0.44	0.50	0.47	0.41	0.38
Proportion of Switchers with Perfect Gains	0.16	0.13	0.19	0.14	0.10	0.08
Proportion of Switchers with Negative Gain	0.25 (0.43)	0.23 (0.42)	0.24 (0.43)	0.24 (0.43)	0.22 (0.41)	0.23 (0.42)
<i>Using Estimated Consumption + 10%</i>						
Average Maximum Gains Available (annual, £)	53.30 (49.22)	53.23 (59.92)	44.12 (44.46)	43.88 (38.75)	51.81 (47.86)	73.09 (108.62)
Average Actual Gains Made (annual, £)	17.98 (52.50)	21.36 (39.39)	22.42 (42.48)	20.82 (39.27)	21.64 (39.19)	20.56 (36.63)
Average Actual Gains/Average Maximum Gains	0.34	0.42	0.51	0.47	0.42	0.28
Proportion of Switchers with Perfect Gains	0.14	0.13	0.19	0.15	0.10	0.08
Proportion of Switchers with Negative Gain	0.32 (0.47)	0.22 (0.42)	0.24 (0.43)	0.24 (0.43)	0.20 (0.40)	0.21 (0.41)

Maximum Gains Available refers to the change in surplus that would have been realised by a switcher had they switched to their cheapest alternative supplier. The Proportion of Switchers with Perfect Gains refers to the proportion of consumers who appropriated all of the maximum gains available.

The results shown in tables 3 and 4 are remarkably robust across datasets, across specifications and across consumption levels, providing support for the chosen measurement methodology. Despite including only decisions based exclusively on price, many consumers failed to switch to the cheapest supplier. Across datasets, specifications and consumption levels, the reported percentage of consumers selecting their cheapest supplier ranges between only 8 and 19%. Although consumers as a whole made positive average gains of between £16 and £22 per annum, in aggregate, consumers appropriated only between 28 and 51% of the maximum benefits available to them.

They have only achieved a little more than would have been expected by switching to a randomly selected supplier; this would have offered consumers a 7–14% chance of picking the cheapest supplier³⁸² and appropriated 17–23% of the maximum gains available.

More startlingly, even without taking into account the (financial or non financial) costs of making the switch, between 20 and 32% of consumers switched to a more expensive supplier, losing, on average, approximately £14–35 per year. Further, between 3 and 31% of these loss-making consumers actually switched to a “dominated” tariff that could not have offered them a reduction in expenditure at any level of consumption. Finally, although it is difficult to make robust comparisons given the biases within each of the samples, our data provide no evidence that switching accuracy improved over the five years which elapsed between the two surveys.

5. POTENTIAL EXPLANATIONS

The existence of search costs can explain why consumers did not select the best possible supplier, but the choice of a more expensive supplier remains puzzling. In this section we explore the validity of four possible explanations:

- i) consumers exhibited some bias or preference for particular tariff structures;
- ii) consumers were overly-attracted to suppliers offering dual-supply discounts;
- iii) consumers were influenced by misleading sales activity; and
- iv) consumers made genuine decision errors.

First, we consider the possibility that consumers’ choices could be explained by a bias or preference for different tariff structures, as proposed in the literature documenting consumers’ inaccurate tariff choices (eg Lambrecht and Skiera 2006). While the potential for such biases is limited in our market due to the narrow range of available tariff structures, we investigate the potential for consumers to have displayed a preference for tariff structures in two respects—the number of parts in the tariff (two or three) and whether or not there is a positive fixed fee. The evidence for such biases seems limited. Table A1 in the appendix indicates that the estimated switching gains are largely unrelated to the choice of a two- or three-part tariff; the only weak evidence of such a bias occurs in the EA June specification where the 40 consumers who switched from a three- to a two-part tariff made significantly less accurate decisions than other switchers. Table 2a shows that only 1% of consumers cited the existence of a zero fixed fee as a reason for switching and Table A2 in the Appendix shows that the estimated switching gains are, for the most part, unrelated to the magnitude of the chosen fixed fee. The only possibility of a bias occurs within the EA dataset where the 18 consumers who switched to a positive fixed fee made significantly worse decisions.

Second, we examine the possibility that consumers could have overestimated or have been overly sensitive to the dual-supply discount, as emphasised as an explanation in other contexts by Ausubel (1999) and Hossain and Morgan (2006). Despite excluding any consumer who cited the existence of a dual-supply discount as a reason for switching, this explanation may seem persuasive since 74% of the consumers in the sample who changed supplier switched to their gas provider. However, Table A2 in the appendix indicates that the dual-supplied switchers made, if anything, higher gains than the non-dual supplied consumers, contradicting such an explanation. This evidence also eliminates the potential explanation that consumers may have switched to their gas supplier to receive some unmeasured non-price benefit.

Third, could consumers have been influenced by suppliers’ mis-selling activity? Such an explanation is particularly plausible in the UK electricity market where there have been many allegations of mis-selling. While some complaints have been targeted at internet price comparison sites for misleading consumers by favouring certain suppliers³⁸³, most allegations have been aimed directly at the use of more direct mis-selling tactics by suppliers themselves. Indeed, the problem of aggressive or misleading “cold-calling” or doorstep selling was considered so serious that several bodies conducted investigations (energywatch 2002, OFGEM 2002 and OFT 2004) and OFGEM subsequently fined London Electricity two million pounds^{384,385}

³⁸² This figure was calculated by finding the reciprocal of the number of alternative suppliers, averaged across consumers, given their respective regions. The probability doubles to 0.14 for the later CCP dataset due to the heavy market consolidation in recent years.

³⁸³ See <http://business.guardian.co.uk/story/0,,1975484,00.html>. 19 December 2006.

³⁸⁴ See <http://news.bbc.co.uk/1/hi/business/2315115.stm>. 10 October 2002.

³⁸⁵ We find no evidence that those consumers who switched to London Electricity made significantly different gains to those who switched to other suppliers.

5.1 Potential Mis-selling

In this section we estimate whether the consumers' switching accuracy is related to two sets of test variables associated with potential mis-selling. We analyse each in turn. First, we explore whether the accuracy of consumers' switching decisions is adversely affected by the self-reported influence of suppliers' sales activity, as captured by two dummy variables from the EA survey. These correspond to consumers either reporting that they had been "conned" into switching without their consent, $conned_i$, or that a sales agent had been active in their switching decision,³⁸⁶. Consumers could cite both influences. To analyse how these variable relate to switching accuracy, two procedures are used to estimate variations of equation (6), where the gains from switching, y_i^{swg*} , are modelled as a function of the two test variables $agent_i$ and $conned_i$ while controlling for a vector of consumer demographics, D_i , and each consumer's maximum available gains, x_i^{max} .

Table 5

SUMMARY STATISTICS OF THE DEMOGRAPHIC AND TEST VARIABLES

Variable Name	Variable Definition	Mean	(StDev)
highsoc	Household social grade: A, B or C1	0.28	(0.45)
midsoc	Household social grade: C2 or D	0.49	(0.50)
lowsoc	Household social grade: E	0.22	(0.42)
highinc	Household income: £25,000 +	0.13	(0.33)
midinc	Household income: £12,500–£25,000	0.25	(0.43)
lowinc	Household income: Less than £12,500	0.43	(0.50)
incref	Income status refused	0.20	(0.40)
age	Age of respondent	44.86	(15.96)
single	The household respondent is single	0.15	(0.36)
married	The household respondent is married	0.62	(0.49)
exmar	The household respondent is widowed or divorced	0.23	(0.42)
arrears	The household has electricity arrears	0.04	(0.21)
gassw	The household has previously switched gas supplier	0.51	(0.50)
rent	The household lives in rented accommodation	0.43	(0.50)
disable	The household has some form of disability benefit	0.19	(0.47)
agent	The household cited the influence of a sales agent	0.11	(0.31)
conned	The household switched without consent	0.03	(0.18)
n	The number of regional competitors	14.75	(0.85)
	Number of Observations	318	

A further variable, $stable_i$, is included to investigate whether the measured switching accuracy of the sub group of consumers who reported highly price inelastic and stable consumption differs from the rest of the sample. This variable is later reported to be insignificantly different from zero, as discussed previously in Section 3.3. All relevant variables are described and summarised in Table 5.

$$y_i^{swg*} = \beta_1 + agent_i \beta_2 + conned_i \beta_2 + D_i' \beta_3 + x_i^{max} \beta_4 + stable_i \beta_5 + \varepsilon_i \quad (6)$$

We use equation (6) to explore how consumers' switching gains depend on a set of independent variables in two ways. In the first case, y_i^{swg*} is treated as a latent variable and we estimate the probability of a consumer making a positive gains using a probit model, and in the second case, we model the gains from switching as a continuous variable using OLS with heteroscedasticity-consistent standard errors. For robustness, the two estimations are conducted across each of the four EA data specifications and the results are reported in Tables 6 and 7.

The self-reported incidences of sales and "conning activity" have no significant effect on switching accuracy across all specifications. The estimations also indicate, in line with the findings of Economides et al (2005) and Miravete (2003), that very few demographic variables are useful predictors of the ability of consumers to make accurate decisions. Consumers living in rented property make less accurate decisions, probably because they expect to enjoy any benefits for a shorter time. Some of the specifications suggest that consumers with higher incomes (and those who declined to reveal their incomes) appropriate less of the available gains. Consumers are less likely to make a loss from switching suppliers if the maximum gains available are higher, a finding consistent with consumers having a higher incentive to make an accurate decision when the rewards from doing so are greater.

³⁸⁶ The CCP data do not include these variables

Table 6

ESTIMATIONS OF THE PROBABILITY OF MAKING A POSITIVE GAIN³⁸⁷

	June		June		October		October	
	No Method Change		Method Change		No Method Change		Method Change	
	<i>M.Effect</i>	<i>z</i>	<i>M.Effect</i>	<i>z</i>	<i>M.Effect</i>	<i>z</i>	<i>M.Effect</i>	<i>z</i>
agent	0.03	0.53	-0.16	-1.62	0.08	1.39	0.04	0.61
conned	-0.18	-1.16	-0.23	-1.24	0.07	0.79	-0.07	-0.45
gainmax	0.00	4.23**	0.01	7.16**	0.01	5.52**	0.01	7.18**
stable	-0.03	-0.55	-0.02	-0.46	-0.05	-1.04	-0.06	-1.31
highsoc	-0.01	-0.11	-0.07	-0.74	0.02	0.21	-0.08	-0.89
midsoc	-0.02	-0.39	-0.07	-1.00	-0.05	-0.79	-0.14	-2.12*
highinc	-0.24	-2.03*	-0.22	-1.78	-0.13	-1.21	-0.16	-1.37
lowinc	-0.05	-0.69	-0.04	-0.55	-0.03	-0.43	-0.09	-1.40
incref	-0.09	-1.13	-0.11	-1.21	-0.08	-1.05	-0.10	-1.17
age	0.00	0.63	-0.01	-0.83	0.00	0.30	0.00	0.21
age2	0.00	-0.71	0.00	0.78	0.00	-0.01	0.00	0.12
disable	-0.05	-0.96	-0.07	-1.25	0.00	-0.01	-0.04	-0.70
single	-0.10	-1.17	-0.08	-0.86	-0.12	-1.33	-0.21	-2.07
exmar	0.01	0.09	0.03	0.50	0.02	0.29	0.02	0.29
rent	-0.15	-2.87**	-0.16	-2.58**	-0.10	-1.93	-0.14	-2.55**
arrears	0.03	0.27	-0.01	-0.05	0.09	1.29	0.08	1.02
gassw	-0.12	-2.77**	-0.12	-2.44*	-0.05	-1.20	-0.04	-0.84
n	318		318		318		318	
Log-Lik	-141.7		-145.6		-144.3		-137.0	
LR(17)	51.90**		89.65**		58.78**		91.07**	
McF R2	0.15		0.24		0.17		0.25	

There is no evidence that previous experience improves decision accuracy. While Giulietti et al (2005) suggest that consumers are more likely to switch in a given market if they have previously switched in others, we find that a past experience of switching gas suppliers does nothing to improve (and sometimes reduces) switching accuracy.

Table 7

ESTIMATIONS OF THE GAINS MADE FROM SWITCHING³⁸⁸

	June		June		October		October	
	No Method Change		Method Change		No Method Change		Method Change	
	<i>Coeff</i>	<i>t</i>	<i>Coeff</i>	<i>t</i>	<i>Coeff</i>	<i>t</i>	<i>Coeff</i>	<i>t</i>
agent	0.70	0.14	-2.57	-0.49	-2.10	-0.41	-3.34	-0.58
conned	0.22	0.05	-0.03	-0.01	-3.64	-0.45	-3.75	-0.49
gainmax	0.01	9.43**	0.01	11.05**	0.01	14.24**	0.01	10.55**
stable	0.93	0.31	0.79	0.27	-1.22	-0.42	-1.54	-0.54
highsoc	-4.21	-0.90	-2.98	-0.61	-2.26	-0.56	-2.28	-0.54
midsoc	-3.88	-1.00	-3.91	-0.95	-3.08	-0.85	-4.45	-1.16
highinc	-13.90	-2.21*	-13.23	-2.08*	-1.08	-0.19	-0.36	-0.06
lowinc	-5.12	-1.39	-5.80	-1.50	1.89	0.52	1.55	0.41
incref	-13.57	-3.22**	-13.73	-3.22**	-6.87	-1.57	-5.63	-1.41
age	-0.02	-0.04	-0.27	-0.51	0.39	0.81	0.27	0.55
age2	0.00	0.18	0.00	0.66	0.00	-0.25	0.00	0.04
disable	-4.87	-1.30	-4.52	-1.16	-6.53	-1.77	-6.30	-1.71
single	-5.66	-1.25	-4.94	-1.06	-0.33	-0.08	-3.25	-0.75
exmar	-0.49	-0.16	-0.33	-0.10	0.16	0.05	-0.44	-0.13
rent	-6.08	-2.17*	-4.54	-1.58	-8.40	-2.77**	-7.71	-2.46*
arrears	-8.98	-1.21	-8.22	-1.08	-4.17	-0.66	-4.48	-0.72
gassw	-3.92	-1.33	-3.44	-1.15	-4.27	-1.53	-3.32	-1.20
constant	5.28	0.38	7.29	0.52	-15.52	-1.23	-12.03	-0.92

³⁸⁷ All significant tests are indicated by * for the 5% level and by ** for the 1% level. Where applicable, all marginal effects are calculated for the average switcher relative to the base case of a consumer who is married, of low social class and with middle income.

³⁸⁸ All significant tests are indicated by * for the 5% level and by ** for the 1% level. Where applicable, all coefficients are estimated relative to the base case of a consumer who is married, of low social class and with middle income.

	June		June		October		October	
	No Method Change		Method Change		No Method Change		Method Change	
	Coeff	t	Coeff	t	Coeff	t	Coeff	t
n	318		318		318		318	
F(17,300)	10.34**		14.06**		18.37**		14.06**	
R2	0.58		0.61		0.68		0.64	

To provide a further (less direct) test of the effects of mis-selling, the estimations are repeated with the inclusion of a different test variable—the number of competitors in each consumer's regional market. While conventional theories of consumer search do not predict any negative relationship between consumers' ability to appropriate the gains available and the number of competitors³⁸⁹, it is reasonable to conjecture that mis-selling strategies may be more attractive to firms as the profits from more standard forms of competition are reduced from increases in the number of suppliers. In a related sense, recent work by Spiegler (2005) illustrates how firms face an increased incentive to obfuscate by increasing the variance of their utility offers when faced with more competitors, while Miravete (2007) offers evidence to suggest that firms are more likely to employ dominated tariff options when competition increases. To test for such an effect, we exploit the fact that the number of regional competitors varied between twelve and sixteen at the time of the EA survey³⁹⁰. If mis-selling were an explanation, consumers would make less accurate decisions in regional markets with a higher number of competing suppliers³⁹¹.

Formally, the two estimation procedures are repeated with the replacement of the previous test variables, *agent_i* and *commed_i*, with the new test variable, *n_i*, measuring the number of regional suppliers faced by each consumer³⁹². As the estimated coefficients differ very little from those previously reported, only the effects of the test variable are displayed in Tables 8 and 9.

Table 8

ESTIMATED MARGINAL EFFECTS OF THE NUMBER OF REGIONAL COMPETITORS ON THE PROBABILITY OF SWITCHING TO MAKE A POSITIVE GAIN³⁹³

	June		June		October		October	
	No Method Change		Method Change		No Method Change		Method Change	
	M.Effct	z	M.Effect	z	M.Effect	z	M.Effect	z
n	-0.01	-0.54	0.03	-0.96	-0.04	-1.43	-0.05	-1.77

Table 9

ESTIMATED MARGINAL EFFECTS OF THE NUMBER OF REGIONAL COMPETITORS ON THE ACTUAL GAINS MADE FROM SWITCHING

	June		June		October		October	
	No Method Change		Method Change		No Method Change		Method Change	
	Coeff	t	Coeff	t	Coeff	t	Coeff	t
n	-3.76	-2.47*	-3.84	-2.47*	-1.87	-0.99	-2.66	-1.36

While there is no evident relationship between the number of regional competitors and the probability of making a positive gain by switching, Table 9 suggests that in two out of four specifications, consumers appropriated relatively less of the maximum available gains in regions with a higher number of suppliers. However as much of the variation in the number of regional competitors arises, however, from the relative lack of market entry in the two Scottish electricity regions, such a finding is also consistent with the presence of some unobserved characteristic of firms or consumers within the Scottish markets. The results are therefore unclear and do not provide direct evidence that mis-selling explains the inaccuracy of consumers' switching decisions.

³⁸⁹ Indeed, for any given price distribution and cost of search, a consumer should accept any discovered price below the optimal reservation price which is defined independently from the number of firms (Kohn and Shavell 1974).

³⁹⁰ These numbers refer to the number of large firms that were patronised by consumers in the EA sample and do not include some smaller firms that also operated across all regions. Including such firms in the estimations increases the number by a constant and does not affect our qualitative results. No such variation in firm numbers existed at the time of the CCP survey due to later market consolidation.

³⁹¹ It is feasible, but unlikely given the limited variation in the number of firms, that consumer inaccuracy may also be prompted by a 'choice overload' effect from the increased complexity of the decision (eg Iyengar and Lepper 2000 and Iyengar and Kamenica 2006).

³⁹² Both the number of competitors and the maximum gains can be included as explanatory variables, since they have a negligible correlation of approximately 0.02 across specifications.

³⁹³ Significance is denoted at 5% by * and at 1% by **.

The evidence presented in this section does not indicate that consumers' poor switching choices are explained by tariff biases or suppliers' mis-selling activity. We deduce that much of the switching inaccuracy results from genuine consumer confusion and decision error.

6. CONCLUSION

Using two independent datasets from the UK electricity market our results show that the capacity of consumers, to choose efficiently between suppliers may be limited, even when switching purely for price reasons. While the results are not necessarily representative of the general population, our estimations show that, at best, a fifth of the consumers in our samples actually lost surplus as a result of switching; and that, in aggregate, switching consumers appropriated only half of the maximum gains available to them. Such a failure of consumers to compare accurately between alternative suppliers can damage their welfare, both directly in lost savings, and indirectly by delivering firms with a source of market power. Indeed, together with the well established effects of switching costs in reducing the willingness of consumers to switch suppliers, such behaviour may seriously impede the competitive process, even after a market has been liberalised or made subject to standard competition policy (as recently argued by Waterson 2003).

We have examined and rejected several explanations of consumer errors, including preferences for particular tariff structures or dual fuel supply, and misleading sales activities by firms. Instead, despite the apparent simplicity and transparency of the market, consumers' poor choices seem more consistent with an explanation of pure decision error. This finding casts doubt on the ability of consumers to generate competitive forces through accurate switching decisions and raises many important policy concerns. Future research would be valuable in understanding how competition and consumer authorities should respond to consumer errors, if at all, and in investigating the implications for current policies aiming to increase competition in less familiar markets, such as health and education.

References

- Agarwal S, Chomsisengphet S, Liu C and Souleles N S (2006) "Do Consumers Choose the Right Credit Contracts?" Federal Reserve Bank of Chicago Working Paper 2006-11
- Armstrong M and Spiegler R (2007) "Boundedly Rational Consumers" June 2007
- Ausubel L M (1999) "Adverse Selection in the Credit Market" Working Paper University of Maryland
- Baye M R, Morgan J and Scholten P (forthcoming) "Information, Search and Price Dispersion" in Handbook on Economics and Information Systems, Elsevier
- Baker P, Blundell R and Micklewright J (1989) "Modelling Household Energy Expenditure Using Micro-Data" Economic Journal vol.99 p.720-738
- Chang Y and Waddams Price C (forthcoming) "Search and Switching Across Relationship Markets" ESRC Centre for Competition Policy Working Paper
- Cooke D, Ferrari A, Giulletti M, Sharratt D and Waddams Price C (2001) "Affording Gas and Electricity: Self Disconnection and Rationing by Prepayment and Low Income Credit Consumers and Company Attitudes to Social Action" www.ccp.uea.ac.uk/publications.asp#2001
- Della Vigna S and Malmendier U (2004) "Contract Design and Self-Control: Theory and Evidence" Quarterly Journal of Economics vol. 119(2) p.353-402
- Della Vigna S and Malmendier U (2006) "Paying Not to Go to the Gym" American Economic Review vol. 96 (3) p. 694-719
- Economides N, Seim K and V B Viard (2005) "Quantifying the Benefits of Entry into Local Phone Service" NET Institute Working Paper, October 2005
- Ellison G and Ellison S F (2004) "Search, Obfuscation and Price Elasticities on the Internet" NBER Working Paper 10570
- Ellison G and Ellison S F (2006) "Internet Retail Demand: Taxes, Geography and Online-Offline Competition" Working Paper April 2006
- energywatch (2002) "Doorstep and Telephone Selling: A Guide for Gas and Electricity Consumers" Information Sheet
- Farrell J and Klemperer P (2006) "Coordination and Lock-In: Competition with Switching Costs and Network Effects" Forthcoming in Handbook of Industrial Organization Vol 3, M Armstrong and R Porter (eds), North-Holland
- Gabaix X, Laibson D and Li H (2005) "Extreme Value Theory and the Effects of Competition on Profits" Working Paper March 2005
- Giulletti M, Waddams Price C and Waterson M (2005) "Consumer Choice and Competition Policy: A Study of UK Energy Markets" Economic Journal vol. 115 p.949-968
- Hossain T and Morgan J (2006a) "Plus Shipping and Handling: Revenue (Non) Equivalence in Field Experiments on eBay" Advances in Economic Analysis and Policy vol. 6(2)

- Iyengar S S and Lepper M (2000) “*When Choice is Demotivating: Can One Desire Too Much of a Good Thing?*” *Journal of Personality and Social Psychology* vol.79 p.995–1006
- Iyengar S S and Kamenica E (2006) “*Choice Overload and Simplicity Seeking*” Working paper, October 2006
- Kohn M G and Shavell S (1974) “*Optimal Adaptive Search*” *Journal of Economic Theory* vol. 9 p.93–123
- Lambrecht A and Skiera B (2006) “*Paying Too Much and Being Happy About It: Existence, Causes and Consequences of Tariff Choice Biases*” *Journal of Marketing Research*, forthcoming, May 2006
- Miravete E J (2003) “*Choosing the Wrong Calling Plan? Ignorance and Learning*” *American Economic Review* vol. 93(1) p.297–310
- Miravete E J (2007) “*The Doubtful Profitability of Foggy Pricing*” Working Paper October 2007
- OFGEM (2002) “*OFGEM Keeps up Pressure on Suppliers to Reduce Misselling*” The Office of Gas and Electricity News, Press Release 30 January 2002
- OFGEM (2004) “*Domestic Competitive Market Review*” April 2004
- OFT (2004) “*Doorstep Selling: A Report on the Market Study*” Office of Fair Trading, May 2004
- Sonnemans J (1998) “*Strategies of Search*” *Journal of Economic Behavior and Organization* vol.35, p.309–332
- Spiegler R (2005) “*Competition Over Agents with Boundedly Rational Expectations*” *Theoretical Economics* vol. 1(2) p.207–231
- Tenerio R and Cason T N (2002) “*To Spin or Not to Spin? Natural and Laboratory Experiments from The Price is Right*” *Economic Journal* vol.112 p.170–195
- Waddams-Price C (2003) “*Spoilt for Choice? The Costs and Benefits of Opening UK Residential Energy Markets*” Working Paper December 2003
- Waterson M (2003) “*The Role of Consumers in Competition and Competition Policy*” *International Journal of Industrial Organization* vol.21 p. 129–150

APPENDIX C1

IDENTIFYING TARIFFS FOR THE EA DATASET

Two aspects of the EA dataset make it difficult to identify directly the exact set of tariffs relevant for each consumer’s switching decision. The first is the exact date of the switching decision. (Economides et al (2005) faced the same problem and were forced to assume that consumers had switched at the date of information collection.) The second problem arises from the timing of the change in payment method for the 32% of consumers who reported such a change. To calculate the gains on switching we need to know whether they, changed their payment method before, after, or at the same time as they switched suppliers. To resolve these uncertainties and to enhance the robustness of our findings we report the results over four different specifications. As the EA survey was conducted in March–August 2000, very soon after liberalisation, consumers could have switched using one of only four possible tariff sets, namely those commencing in June 1999, October 1999, April 2000 and June 2000. Consumers are most likely to have switched under either the October 1999 tariffs, as these were stable for the longest period (October 1999–April 2000), or the June 2000 tariffs, as the proportion of consumers switching suppliers was rising over the period. Using both of these time periods, the calculations are then made under two further assumptions to provide a total of four specifications. These two assumptions concern whether the 32% of consumers who had changed their payment method, changed either before they switched suppliers (the consumers traded with both their original and current supplier under their current payment method) or, perhaps more realistically, at the time of switching (the consumers traded with their original supplier using their previous payment method but traded with their current supplier under their current payment method)³⁹⁴. The four specifications are respectively labelled as Oct99nochange, Oct99change, Jun00nochange and Jun00change (see appendix for further details).

³⁹⁴ The most commonly reported method changes are moving from credit to direct debit (41%) and credit to prepayment (38%). We do not allow for the unlikely possibility that the change was made after the process of changing suppliers.

³⁹⁵ Notes for Tables A1–A3. ** and * are used to indicate a significant difference in means under both a standard t-test and a non-parametric Mann-Whitney U test at the 5% and 1% respectively.

APPENDIX C2³⁹⁶

Table A1

SWITCHING ACCURACY BY CHANGES IN CHOSEN TARIFF STRUCTURE

<i>CCP Data</i>	<i>No Change in Tariff Structure</i>		<i>Three-part to Two-part</i>		<i>Two-part to Three-part</i>	
	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	74		50		30	
Proportion of Switchers	0.48		0.32		0.19	
Average Maximum Gains Available (annual, £)	44.25	(32.46)	53.16	(44.10)	53.99	(45.35)
Average Actual Gains Made (annual, £)	14.82	(41.96)	23.18	(50.25)	16.80	(32.63)
Average Actual Gains/Average Maximum Gains	0.33		0.44		0.31	
Proportion of Switchers with Negative Gain	0.30	(0.46)	0.28	(0.45)	0.37	(0.49)
<i>EA Data (Pooled June Specification)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	169		40		109	
Proportion of Switchers	0.53		0.13		0.34	
Average Actual Gains Made (annual, £)	12.50	(29.24)	- 3.38**	(27.69)	35.14**	(41.33)
Average Maximum Gains Available (annual, £)	42.17	(36.40)	34.69	(29.29)	56.72*	(54.29)
Average Actual Gains/Average Maximum Gains	0.30		- 0.10		0.62	
Proportion of Switchers with Negative Gain	0.31	(0.45)	0.55**	(0.46)	0.06**	(0.20)
<i>EA Data (Pooled October Specification)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	226		78		14	
Proportion of Switchers	0.71		0.25		0.04	
Average Actual Gains Made (annual, £)	19.85	(43.01)	23.28	(24.11)	16.84	(32.72)
Average Maximum Gains Available (annual, £)	41.42	(42.66)	41.85	(28.43)	57.19	(47.58)
Average Actual Gains/Average Maximum Gains	0.48		0.56		0.29	
Proportion of Switchers with Negative Gain	0.27	(0.43)	0.18	(0.37)	0.21	(0.43)

Table A2

SWITCHING ACCURACY BY CHANGES IN CHOSEN FIXED FEE TARIFF STRUCTURE³⁹⁷

<i>CCP Data</i>	<i>No Change in Tariff Structure</i>		<i>Pos. Fixed Fee to Zero Fixed Fee</i>		<i>Zero Fixed Fee to Pos. Fixed Fee</i>	
	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	69		29		56	
Proportion of Switchers	0.45		0.19		0.36	
Average Actual Gains Made (annual, £)	19.46	(43.29)	19.43	(32.43)	15.25	(48.19)
Average Maximum Gains Available (annual, £)	46.97	(33.38)	55.08	(45.67)	48.46	(42.55)
Average Actual Gains/Average Maximum Gains	0.41		0.35		0.31	
Proportion of Switchers with Negative Gain	0.28	(0.45)	0.28	(0.45)	0.36	(0.48)
<i>EA Data (Pooled June Specification)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	156		144		18	
Proportion of Switchers	0.49		0.45		0.06	
Average Actual Gains Made (annual, £)	8.79	(29.44)	32.78**	(37.93)	- 15.72**	(22.08)
Average Maximum Gains Available (annual, £)	39.93	(35.04)	53.73**	(50.27)	40.64	(40.53)
Average Actual Gains/Average Maximum Gains	0.22		0.61		- 0.39	
Proportion of Switchers with Negative Gain	0.36	(0.46)	0.08**	(0.23)	0.78**	(0.39)

Table A3

SWITCHING ACCURACY OF DUAL AND NON-DUAL SUPPLIED CONSUMERS

<i>CCP Data</i>	<i>Not Dual Supplied</i>		<i>Dual Supplied</i>	
	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	29		125	
Proportion of Switchers	0.19		0.81	
Average Actual Gains Made (annual, £)	15.36	(62.37)	18.52	(37.68)
Average Maximum Gains Available (annual, £)	48.07	(49.43)	49.27	(36.66)
Average Actual Gains/Average Maximum Gains	0.32		0.38	
Proportion of Switchers with Negative Gain	0.45	(0.51)	0.27	(0.45)

³⁹⁶ Notes for Tables A1-A3. ** and * are used to indicate a significant difference in means under both a standard t-test and a non-parametric Mann-Whitney U test at the 5% and 1% respectively.

³⁹⁷ Tariffs with positive fixed fees were so common within the EA Pooled October Specification that all consumers switched to such tariffs, preventing us from testing such a hypothesis.

<i>CCP Data</i>	<i>Not Dual Supplied</i>		<i>Dual Supplied</i>	
	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
<i>EA Data (Pooled Specifications)</i>	<i>Average</i>	<i>(StDev)</i>	<i>Average</i>	<i>(StDev)</i>
Number of Switchers	96		222	
Proportion of Switchers	0.30		0.70	
Average Actual Gains Made (annual, £)	10.45**	(43.17)	23.29	(30.95)
Average Maximum Gains Available (annual, £)	46.87	(50.42)	43.07	(34.82)
Average Actual Gains/Average Maximum Gains	0.22		0.54	
Proportion of Switchers with Negative Gain	0.39**	(0.40)	0.19	(0.34)

March 2008

Memorandum submitted by the University of Greenwich

ARE THE CONSUMER PRICE INCREASES FOR ELECTRICITY IMPOSED IN JANUARY 2008 JUSTIFIED?

SUMMARY

This paper examines whether increases to published wholesale prices justify the retail electricity price increases imposed on residential consumers in January 2008. The study is based on analysis of two questions: Is the reported wholesale price a reliable indicator of the cost electricity retailers are paying to buy power; and is the corporate structure of the British electricity sector competitive?

Detailed analysis of prices shows that even in the period 1990–2002, when prices for electricity were falling in real terms, the wholesale electricity market was not working well. Large cost reductions experienced by the generating companies were not passed on to consumers as would have been expected to occur if the wholesale electricity market had been an efficient one. Experience since 2002 has demonstrated that the retail electricity market is also not efficient and has allowed the electricity companies to increase prices to residential consumers without convincing justification and not pass on cost reductions. So the current problem is not an isolated one in an otherwise successful system.

The assertion by the six electricity retail companies that the large price rises for electricity imposed in the first quarter of 2008 are justified by movements to the wholesale market price for electricity is not supported by the evidence they have given. The liquidity of the visible wholesale market is negligible and the six companies buy nearly all their own power from their own power stations or from independent power producers under long-term contracts. The connection between the cost of these purchases from their own sources and under long-term contracts, and the published price in the spot market is weak. There are strong suspicions that this is not the first time the companies have manipulated prices to their advantage. In 2002, the wholesale electricity price fell by 40% but none of this was passed on to residential consumers. In 2005–06, the companies increased their prices by 50% or more citing high wholesale prices, but when wholesale prices fell in 2006, the price reductions were minimal.

Residential consumers already face a near impossible task in trying to get the best deal for their power purchases. They have to choose a supplier knowing only the current relative prices, which in a volatile market could easily have changed even before the switch to a new supplier has been completed. They have to compete with large users to buy power and the retailers have a history of systematically allocating their cheapest power purchases to large users, presumably because of their stronger negotiating power. The companies also discriminate against poorer consumers, offering much lower prices to those that can afford to pay by direct debit and who have access to, and are confident with the internet. Pre-payment meter and standard credit (quarterly variable bills) consumers might pay a third more than direct debit consumers. The companies have provided no convincing evidence that this price differential is justified by real cost differences.

The structure of the electricity industry has become significantly less competitive and more concentrated in the past decade, with the implicit approval and sometimes at the instigation of both the government and the regulatory authority, Ofgem. Further changes are likely that will make the situation worse. In the case of the likely takeover of British Energy, which will remove the main independent power producer, the change was at least in part prompted by the government itself. This reduction in competition will give consumers even less confidence that prices are being set competitively by the market. It will leave residential consumers even more vulnerable to the market power of the oligopoly of a handful of European companies that increasingly dominate UK as well as European energy markets.

Solutions to these problems are not easy. When confronted with such serious market failures, it is tempting to recommend pro-competition measures, such as breaking up the companies, forcing greater use of visible spot markets and reducing the extent of integration of generation and supply. However, the result of such measures could be to jeopardise security of supply if, as seems likely, independent generation companies would profit more from power shortages than from investing in new capacity.

The regulator, Ofgem, has a poor record. Dubious price movements in 2002, 2004–05, 2006 passed with no serious investigation by them and their response to the latest price rises was belated. There must be suspicions that it was only prompted by public outrage and the announcement of the BERR Select Committee investigation. Ofgem’s announcement of its inquiry gives concern that Ofgem will be looking to shift blame elsewhere. It states: “We are concerned about the increased volatility of wholesale prices and we want to investigate how European and other global energy market developments are affecting energy bills in Britain”. Fundamental issues such as the efficiency of the British wholesale market and the corporate structure in Britain are nowhere mentioned. Ofgem has also consistently failed to tackle the issue, long recognised, of price discrimination amongst residential consumers which results in pre-payment and standard credit consumers paying far more than direct debit consumers.

A more impartial investigation than can be carried out by Ofgem is needed and the Competition Commission seems the most appropriate body to carry out such an investigation. The issues it would need to examine are:

- Do movements in the price actually paid for power by retailers justify the January 2008 price increases?
- What if any is the relationship between the published spot price for electricity and the price paid by retailers for power?
- Do cost differences justify the price differences between the tariffs offered to pre-payment meter and standard credit consumers, and to consumers paying by direct debit?
- Are residential consumers paying disproportionately more for their power than large industrial consumers?
- What are the costs of switching by residential consumers and, if as seems likely they are high, can these costs be reduced to more affordable levels?
- Is the structure of the electricity market competitive and, in particular, would the takeover of British Energy by one of the existing retailers lead to serious competition issues?

If the problems identified cannot be remedied by changes to the market, a return to a more strictly regulated system of tariffs may be necessary.

The problem of the ineffectiveness of Ofgem is a serious one and needs to be addressed separately. There must be doubts, given its role in designing the wholesale market and presiding over the corporate changes in the industry, whether it is now too compromised to carry out its primary duty of protecting the interests of consumers. A more comprehensive reform of regulation may be required.

1. INTRODUCTION

In January 2008, five of the six electricity retail companies supplying residential consumers in Great Britain increased their electricity prices by up to 15% (see Table 1). The sixth supplier, Scottish & Southern Energy pledged not to increase its prices before the end on March 2008 but on 20 March, it announced its prices would rise by about 14.2% from 1 April 2008.

It is estimated that these price rises will mean that 4.5 million households in Britain, about 20% of the population, now suffer from “fuel poverty”, they pay more than 10% of their household income on energy purchases, compared to about 2.5 million three years ago.

The companies try to justify the price increases by claiming that the wholesale prices of electricity and gas, which accounts for about a third of electricity generation and therefore has an impact on electricity prices, had risen sharply. This paper examines whether increases to published wholesale prices do justify these retail price increases. The study is based on analysis of two questions: Is the reported wholesale price a reliable indicator of the cost electricity retailers are paying to buy power; and is the corporate structure of the British electricity sector competitive?

Table 1

ENERGY RETAIL PRICE INCREASES FOR RESIDENTIAL CONSUMERS

<i>Company</i>	<i>Date</i>	<i>Electricity (%)</i>	<i>Gas (%)</i>
RWE (Npower)	04.01.08	12.7	17.2
EDF	15.01.08	7.9	12.9
British Gas	18.01.08	15.0	15.0
Iberdrola (Scottish Power)	01.02.08	14.0	15.0
E.ON (Powergen)	07.02.08	9.7	15.0
Scottish & Southern Energy	20.03.08	14.2	15.8
Average		12.3	15.1

Source: Press reports

2. HOW ELECTRICITY PRICES ARE SET

In order to understand movements in electricity prices, it is necessary to examine the four main elements that make up an electricity bill. For price comparisons, taxes should be excluded. This is especially important for international comparisons because the tax rate varies from country to country and comparing prices including taxes would give a distorted picture of the relative costs from country to country.

2.1 *Components of an electricity bill*

Since the privatisation of electricity in Britain in 1990, the four main components of electricity bills have been calculated by different methods (see Table 2). These four components are: wholesale electricity purchase price, supply cost (meter reading and billing etc), transmission (use of the high voltage transmission network) and distribution (use of the low voltage distribution network and purchase and maintenance of the meter). The wholesale price should be set by the market. From 1998, when residential consumers were allowed to choose their retail supplier, the supply price, which had previously been set by the regulator, should also be set by the market. Transmission and distribution are monopolies and the price for these elements is set by the regulator and, for the same service, will be the same for all generators and retailers.

Table 2

ELEMENTS OF A RESIDENTIAL CONSUMER'S ELECTRICITY
BILL—% (EXCLUDING SUBSIDIES)

	<i>Price setting</i>	<i>1991</i>	<i>2008</i>
Generation (wholesale price)	Market	54 (60)	69 (75)
Supply cost	1991, Regulated monopoly. 2008, market	6 (7)	
Distribution (inc meter)	Regulated monopoly	25 (28)	18 (20)
Transmission	Regulated monopoly	5 (6)	4 (4)
Nuclear subsidy/Environment	Subsidy/levy	10	8
Total		100 (100)	100 (100)

Source: Offer and Ofgem

There have been a number of generally smaller elements. From 1990–96, 10% of every electricity bill was paid essentially as a subsidy (the Fossil Fuel Levy, FFL) to the nuclear industry.³⁹⁸ Now, about 8% of the average bill is used to pay for energy efficiency measures including the Carbon Emissions Reduction Target (CERT).

For residential consumers, if we strip away these additional costs leaving just wholesale, supply, distribution and transmission, we can see that the monopoly elements (transmission and distribution) have fallen as a percentage of the bill from 34% in 1991, to 24% in 2008. Generation and retail combined have increased from 67% to 75%. Ofgem no longer estimates separately generation and supply costs. It provides a figure of 66% (75% if we exclude VAT and environment subsidies) that covers “energy, supply costs and margin”. When Ofgem last estimated separately the supply cost in 2005, the figure it gave was 35% of the total bill. If the price retailers pay for electricity (the wholesale price) has increased significantly and the supply cost has not changed, the supply cost, as a percentage of the overall bill would have fallen somewhat since 2005.

In practice, it is difficult to know how Ofgem can estimate the supply cost as Ofgem, as we will argue later, has no knowledge of the price retail companies pay for their wholesale supplies, so it would seem difficult for Ofgem to split up wholesale and supply. In addition, Ofgem has moved a small number of costs that were allocated to distribution in 1991 to supply so the 1991 figures are not strictly comparable with current prices. Nevertheless, it is clear that the supply cost has increased substantially since 1991. Various authors have tried to breakdown the elements of the bill more precisely, especially the supply element (see Annex 1).

2.2 *Price movements up to 2002*

The rapid movements in prices from 2004 onwards came on top of a period following privatisation in 1990 up to 2002 when prices were relatively stable falling slowly in real terms. Household electricity prices fell in real terms by about 25%. It is widely assumed that these price reductions resulted from the impact of competition in the wholesale and retail markets and from the improved efficiency of private companies compared to nationalised companies. In fact, these factors had little or nothing to do with the price reductions. It can be shown that there were two main components to the price reductions (Thomas, 2006): the removal of the FFL in 1996 (which raised about £1 billion per year), which reduced prices immediately by 10%; and reductions in the cost of the monopoly elements, which halved in that period.

³⁹⁸ A very small proportion of this subsidy was paid to renewables.

Given the collapse of British Energy in 2002 and the government's rescue package which will cost taxpayers in the order of £12 billion,³⁹⁹ it is far from clear that the removal of the nuclear subsidy was ultimately anything more than a shift of costs from electricity consumers to taxpayers.

The dramatic reductions in the cost of transmission and distribution came not from improvements in efficiency, but essentially because the electricity assets were privatised for about a third of their asset value (Thomas, 2004). The prices for these services are set by allowing the companies a given rate of return on the value of the assets they own. By selling the companies for only a small fraction of their asset value, much of the value of pre-privatisation assets was essentially written off and as a result, prices fell sharply. The reductions will be temporary and prices will tend to rise again as the written-down pre-privatisation equipment is replaced at full market cost. The price reductions were effectively paid for by taxpayers because assets they owned were sold for below their value.

The price of generation was largely unchanged in the period 1990–99. This is hard to justify given that, like the transmission and distribution assets, the power stations were sold for about a third of their asset value and the real price generators paid for coal and gas fell by 40% or more. These cost reductions appear to have been retained partly as extra profits for the privatised companies and partly passed on only to industrial consumers.

So even in the period 1990–2002, when the public, understandably, believed that privatisation was working through the impact of competitive markets and the superior efficiency of privately owned companies, the reality was different. Markets were not working well and there was no strong evidence that the privately owned companies were more efficient than the nationalised companies.

2.3 Price movements from 2004–07

The price increases in the first quarter of 2008 come on top of very steep price increases imposed by electricity retailers from 2004–06 (see Table 3).⁴⁰⁰ Like the 2008 price increases, the companies tried to justify them by claiming large increases in wholesale prices. From mid-2006, wholesale prices fell but price reductions followed only slowly (see Table 4) and, except for British Gas, these reductions were more than wiped out by the price increases of 2008. On average, electricity prices have increased by over 60% since the beginning of 2004.

Table 3

PRICE RISES (%) IMPOSED BY UK ENERGY SUPPLIERS FROM JANUARY 2004
TO DECEMBER 2006 (mm/yy)

Company	1	2	3	4	5	6	Total
B Gas	9.4 (08/04)	14.2 (09/05)	22 (02/06)	9.4 (07/06)			66.7
EDF	6.7 (02/04)	3.8 (08/04)	5.4 (01/05)	10.7 (07/05)	4.7 (02/06)	8.0 (07/06)	46.0
RWE (NPower)	5.8 (01/04)	7.6 (09/04)	13.6 (11/05)	13.4 (03/06)	9.9 (09/06)		61.2
E.ON (Powergen)	6.9 (01/04)	8.9 (11/04)	7.2 (07/05)	18.4 (02/06)	9.7 (08/06)		62.1
Scottish Power (Iberdrola)	9.0 (09/04)	5.0–8.0 (10/05)	8.0 (02/06)	10.0 (06/06)			36.0–39.9
Scottish & Southern Energy	4.0 (06/04)	6.7 (02/05)	8.9–12.0 (11/05)	9.4 (03/06)			32.2–36.0

Source: Author's research

Notes

1. Dates shown are when the price rise was announced.
2. Scottish Power's and Scottish & Southern Energy's gas and electricity price increases have varied according to the region (whether it was their former home region) and method of payment.

Table 4

PRICE REDUCTIONS (%) IMPOSED BY UK ENERGY SUPPLIERS FROM JANUARY
TO DECEMBER 2007 (m/y)

			Total price change 1/04 – 12/07	Total price change 1/04 – 2/08
B Gas	11.0 (2/7)	6.0 (4/7)	39.5	60.4
EDF			46.0	57.5
RWE (NPower)	3.0 (2/7)		56.3	76.2
E.ON (Powergen)	5.0 (2/7)		54.0	68.9

³⁹⁹ Commission decision of 22 September 2004 on the State aid which the United Kingdom is planning to implement for British Energy plc. Official Journal of the European Union. L/142 26–80.
<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2005:142:0026:0080:EN:PDF>

⁴⁰⁰ It should be noted that these figures should not be taken as an indication of which is the cheapest supplier. The companies that show relatively small increases might have been expensive suppliers at the start of 2004.

		<i>Total price change 1/04 – 12/07</i>	<i>Total price change 1/04 – 2/08</i>
Scottish Power (Iberdrola)	5.5 (5/7)	28.5–32.2	46.5–50.7
Scottish & Southern Energy	5.0 (4/7)	30.6–34.2	49.1–53.3

Source: Author's research

3. CHOICE OF ELECTRICITY SUPPLIER FOR RESIDENTIAL CONSUMERS

3.1 *Special features of electricity*

Intuitively, most people would assume that being supplied by a competitive market will inevitably be preferable to being supplied by a monopoly supplier. However, a number of factors in combination mean that choosing an electricity supplier is a very different and far more difficult choice than most other consumer decisions they have to take. This may mean that consumers would be better off being supplied by a well-regulated monopoly. These factors include:

- Electricity is a standard product.
- Consumers must commit to buy a product without knowing the price they will pay.
- Residential consumers are in competition with large consumers to get the best deal from the retailers.
- In a competitive market, retailers will target the most profitable customers; they cannot be given social obligations without compromising the efficiency of the market.

3.1.1 Electricity is a standard product

Electricity is an entirely standard product. Changing supplier cannot give the consumer “better” or more reliable electricity. Billing should be an entirely routine business (unfortunately, it appears not to be given the large number of complaints) so service quality should not be a factor and consumers should only have price by which to judge the different offers.

3.1.2 Consumers must commit to buy a product without knowing the price

When consumers are investigating the prices offered, all they have to go on is the current price (assuming the price comparison sites are up-to-date). Given that most consumers are unlikely to want to go through the process of establishing which company is the cheapest and then switching supplier (a process that can be very time-consuming and frustrating if things go wrong) more than, say, once every two to three years, the chances that relative prices will remain the same over that period are negligible. In today's volatile price climate, it is not unlikely that relative prices will have changed before the switch is completed and the consumer will not even start with the cheapest deal. Anyone who finds that large savings are to be made simply by switching supplier (not changing payment method) is likely to be with a company that has just raised its prices and the cheap company will be one just about to increase its prices. There is also evidence that while consumers that switch are generally attempting to move to the cheapest company, they are often not successful. In a detailed behavioural study, Waddams-Price (2004) found that, amongst a sample of about 400 consumers who switched supplier, 42% of those switching ended up paying more, 14% were paying the same, while only 44% actually made savings. These percentages were calculated based on the time the choice was made, not when the switch was completed.

3.1.3 Residential consumers are in competition with large consumers

In a market, the best prices go to buyers with the most buying power. Unlike most products, residential consumers will have to compete with very large users, eg, aluminium smelters and chemical works with annual bills of millions of pounds, to buy power. Residential consumers do not have anything like the buying power or expertise of such companies, which can employ specialists to negotiate the price they pay.

Now that electricity retail is a free market for all consumers, the regulator has no knowledge of the wholesale price retailers buy their power at. Large consumers buy their power on confidential contracts, the details of which are only known to the two parties, so it is difficult to provide current evidence for the existence of the likely distortions noted above arising from the buying power of large companies.

However, in 1997, the regulator, then Offer, published evidence that the retailers had systematically allocated all their cheapest power to large consumers. The large consumers were then able to choose their electricity supplier, while residential consumers still remained captive to their local retailer. This meant that the generation element of a residential consumer's bill was about 30% higher than that of a large consumer (Thomas, 2006). While the retail, distribution and transmission elements of the bill for a large consumer are

legitimately lower for a large consumer than for a residential consumer, it costs no more to generate a kWh for a residential consumer than for an aluminium smelter. The electricity retail companies were simply taking advantage of the inability of residential consumers to switch.

Offer did nothing about this abuse, assuming, naively, that the introduction of retail competition would mean that retail companies would not be able sustain this unfair allocation of costs. In fact, the evidence is that introducing retail competition allowed retail companies to increase the differential between the generation price they charged large consumers and the price they charged residential consumers. From 1999–2002, the price large consumers paid for generation fell by 22% while the price paid by residential consumers actually increased by 5% (Power UK 2002), so opening up the market to competition actually exposed residential consumers to greater exploitation. In this period, as in 2007, large price reductions in the wholesale market were not passed on to residential consumers.

The National Audit Office (NAO, 2003) in an investigation into NETA [New Electricity Trading Arrangements, the then name for the wholesale market] found:⁴⁰¹

“Prices paid by industrial and commercial customers have fallen sharply since NETA was implemented. Consumers who switch supplier can see substantial reductions. However, prices that domestic consumers pay for electricity have not fallen much since NETA was implemented, although they have fallen broadly in line with the trend in suppliers’ overall costs since 1998. The prices that industrial and commercial consumers pay for electricity have fallen by 18% since the start of NETA, and by 30% since April 1998. Prices for domestic consumers have fallen little since the start of NETA but by 8–17% since April 1998, reflecting the much higher costs of supplying domestic consumers which have been rising due to new environmental costs and the substantial costs of processing changes of supplier”.

3.1.4 In a market, companies will target the most profitable customers

There is much clearer evidence of discrimination between different classes of consumer within the residential sector. Specifically, there is a large and consistent difference between the prices charged to consumers on pre-payment meters and standard credit terms (quarterly bills that are settled when they are issued) compared to the prices charged to those paying by monthly direct debit. There is no evidence that these price differentials reflect differences in costs and there must be strong suspicions that companies are simply targeting the more profitable consumers.

Pre-payment meters (PPMs) have played a key role in dealing with low-income consumers since privatisation of the electricity industry in 1990. In no other developed country are pre-payment meters used by a significant proportion of consumers. After its privatisation, British Gas adopted a much tougher stance towards consumers that could not pay their bills, and the number of consumers cut off increased markedly, bringing the process of privatisation into disrepute. To avoid this recurring with the electricity industry, pre-payment meters operated with “smart cards” individual to each consumer were introduced. Consumers facing difficulty paying their bills had little choice but to move to a PPM and the number of consumers paying by such meters increased from about 1 million to more than 3.5 million by 1995 (about 15% of consumers). The number of consumers using PPMs fell slowly to about 3 million by 2003, but the increase in electricity prices since then has led to a substantial increase so that by 2006, the number was 3.8 million and has continued to rise since then.

In 1992, the Regulator capped the extra cost that could be passed on to PPM consumers requiring that they pay no more than 5% more than standard rate consumers. This cost cap did not concern the retail supply companies because any costs not recovered from PPM consumers could be passed on to other franchise consumers. For the pre-payment meter consumer, there were significant advantages with this system. It allowed them to continue to receive a supply of electricity even before they had paid off their debts. They also did not need to fear receiving a bill of unpredictable size once a quarter. So PPMs helped with low-income consumers with budgeting but it imposed extra costs on them and if they really could not afford their bills, a PPM was no help to them.

PPMs also had an important advantage for retail electricity supply companies. The meters were set up to use a proportion of any payments to buy more electricity to pay off existing debts. The retail companies did not incur the expensive and politically damaging cost of cutting off consumers that could not pay their bills. Consumers that could not pay their bill disconnected themselves. They also meant that debts to them were paid. The extent of the fuel poverty problem was masked. There is no ready way to accurately determine the extent of self-disconnection. A survey by the Electricity Association found that about 24% of PPM consumers self-disconnect and about 1% (about 36,000 consumers) chronically disconnect (more than 20 times per year) (Electricity Association 2001, pp 22–23).

Nevertheless, PPMs have proved popular with consumers. They are generally aware that they are paying a higher price for their power, but, in the same way as pre-payment mobile phones are popular despite high call charges, consumers value the extra control over tight household budgets that the PPM gives them.

⁴⁰¹ National Audit Office (2003) “The New Electricity Trading Arrangements in England and Wales” Report by the Comptroller and Auditor General HC 624 Session 2002–03: 9 May 2003.

Once retail competition had been introduced in 1998, prices were set by the free market and the companies were no longer required to maintain the 5% differential and the gap between PPM prices and those of other payment plans, especially direct debit plans, has widened. This issue has been continually been highlighted by consumer groups such as Energywatch and the National Right to Fuel Campaign, but Ofgem has taken no effective action. However, in its 2008 Budget, the government announced that it was going to work with the companies to find new ways to help the poorest consumers, with the threat that legislation would be introduced if a satisfactory agreement could not be reached. It remains to be seen how effective this new initiative will be.

Table 5

PRICES OF ELECTRICITY BY PAYMENT METHOD AND ACCOUNT TYPE (£/YEAR)

	<i>On-line direct debit</i>	<i>Direct debit</i>	<i>Standard credit</i>	<i>Pre-payment</i>
SEEBOARD	306	359	387	390
London	312	372	400	402
Southern	327	372	401	405
South West	336	394	420	422
North West	321	385	396	404
South Wales	356	409	441	448
Eastern	316	362	387	389
Midlands	338	375	400	406
East Midlands	322	368	392	398
Manchester/N Wales	321	369	396	404
Northern	332	382	411	420
Yorkshire	326	370	397	408
South Scotland	336	390	417	426
North Scotland	342	386	409	418
Average	328	378	404	410

Source: http://www.energywatch.org.uk/help_and_advice/saving_money/index.asp

Notes:

1. Rates were calculated for 21 February 2008 and represent the average for the six suppliers for a “medium” consumer, ie, 3300kWh/year.
2. Note, EDF does not offer on-line direct debit terms.

Table 5 shows that, on average a pre-payment meter consumer now only pays a little more than a standard credit consumer, but 11% more than a direct debit consumer and 25% more than an on-line direct debit consumer. This seems to represent a worsening from the position five years ago, before on-line tariffs were widely offered. Then, Thomas (2004) found that for the London region, the price for those with pre-payment meters was about 3% more than standard credit and about 8% more than direct debit. A detailed analysis of prices on offer in the London region (see Box) shows that PPM consumers that have not moved from the original monopoly supplier are now paying 27% more than the cheapest offer, an on-line direct debit dual-fuel account.

The picture has changed in the past five years. Then, the most expensive suppliers were almost invariably the incumbents, presumably because the companies could assume a high proportion of their existing consumers would never switch and the companies could exploit this inertia. Now, there appears to be no such relationship because the proportion of consumers willing to switch might be high enough to ensure that companies cannot rely on this inertia. There was also then a significant differential between PPM and standard credit consumers. This differential no longer exists. How far this is due to a change in the expected costs of supply and how far it is down to other factors is impossible to know. However, five years ago, there was significant criticism of companies for the high cost of PPMs. Companies can now legitimately, but disingenuously, claim that their prices for PPM consumers are now in-line with their standard credit consumers.

The companies claim there are additional costs for supplying pre-payment meter consumers. While it is plausible that the system of topping up is more expensive than sending out bills, there are off-setting cost savings. No meter-reading and billing is required, payment is in advance, and there is no possibility of the consumer not paying their bill.

Unless convincing and independently authenticated evidence is provided to show that these high prices reflect real additional costs, the companies must be seen as guilty of exploiting the classes of consumers, pre-payment and standard credit, that contain the most vulnerable and disadvantaged consumers. If the differential does reflect real cost differences, there is a need for government or regulatory action to ensure that vulnerable and disadvantaged consumers are not in such a poor position for the purchase of an essential public service.

Ms A's Energy Purchases

Ms A is a single, working mother known to me. She has had problems with previous debt to energy suppliers, not incurred by her. Her limited budget and this bad experience mean she values very highly the assurance pre-payment meters (PPMs) gives that unaffordable bills will not be incurred even though she is aware that PPMs are not the cheapest method of paying. She is also reluctant to experiment with untried energy providers. She lives within London Electricity's catchment area and buys her electricity from the previous monopoly supplier, London Electricity (EDF) and her gas from British Gas (Centrica) using pre-payment meters (PPM). If we assume she is a "medium user" (3,300kWh/year of electricity and 20,500kWh of gas per year), the price she currently pays and her options are shown in the Table. She has five basic payment options: pre-payment meters; standard credit (SC) terms (a variable quarterly bill); direct debit (DD) under which a fixed sum is taken monthly from her bank account; and on-line DD under which her account is a paperless one operated via the internet. For all options except PPM, a dual fuel offer is available offering a small discount over buying the energy under separate accounts. For clarity, dual-fuel prices are only shown for the cheapest way of paying, on-line DD.

Care needs to be taken interpreting the Table as Scottish & Southern Energy (S&SE) is almost invariably the cheapest supplier for any given class of payment, but the prices shown here were calculated before it announced a price rise of 14.2% effective from April 2008. This means that in most cases it is not now the cheapest supplier.

Table**COST OF PURCHASING ENERGY IN THE LONDON REGION**

	<i>PPM</i>	<i>Standard credit</i>	<i>Direct debit</i>	<i>On-line DD</i>	<i>On-line DD dual-fuel</i>
EDF/B Gas					
Electricity	401	401	393	393*	n/a
Gas	617	656	588	565	n/a
Total	1,018	1,057	981	968	n/a
Dearest					
Electricity	440 (NPower)	429 (S Power)	402 (Npower)	320 (NPower)	
Gas	676 (E.ON)	656 (B Gas)	633 (NPower)	595 (NPower)	
Total	1,116	1,085	1,035 (NPower)	915 (NPower)	876 (S Power)
Cheapest					
Electricity	353 (S&SE)	350 (S&SE)	329(SS&E)	285 (NPower)	
Gas	579 (S&SE)	535 (S&SE)	503 (SS&E)	462 (S&SE)	
Total	932	885	832	747	744 (E.ON)
Cheapest (ex SSE)					
Electricity	393 (E.ON)	393 (E.ON)	357 (S Power)	285 (NPower)	
Gas	617 (B Gas)	642 (E.ON)	580 (S Power)	565 (B Gas)	
Total	1,010	1,035	937	850	744 (E.ON)

Source: http://www.energywatch.org.uk/uploads/PriceComparison_london_21February2008.pdf

The Table shows a number of important features:

- On-line Direct Debit dual-fuel, is 27% cheaper than paying by PPM with the incumbent utilities.
- There is little to be saved within PPM suppliers. Now that S&SE has increased its prices, the available savings are negligible.
- Standard Credit terms are now generally little if any cheaper than PPMs and if Ms A remains with the same supplier and switches to SC, her bills would actually increase.
- Significant savings are available if Ms A switched to paying by Direct Debit. The savings would be only about 4% if she remained with her existing suppliers, but if she switched to the cheapest, excluding S&SE, she would save 8%.
- However, the big pay-offs arise when on-line DD are considered. Switching to the cheapest supplier (excluding S&SE) would save 17%.
- Switching to the cheapest supplier with on-line DD and a dual fuel offer would increase savings to 27%.
- Now that S&SE has increased its prices from April, anyone following Ofgem's advice in January and February to switch is likely to have found that by the time the switch was complete, S&SE was no longer the cheapest supplier and their effort was wasted.

3.2 *Switching rates and price differentials*

Switching rates, that is, the proportion of consumers that change supplier each year, are frequently used as an indicator of the health of the retail electricity market, while a clustering of prices is claimed to be an indicator that markets are not operating competitively. In both cases, these assertions are misleading.

A market that has little switching because the process is so onerous or because companies are not actively competing is clearly not healthy. Equally, if the market is operating efficiently, competing companies would know they would quickly lose market share if their prices were significantly higher than their competitors. In such a market, there would be no need to switch because consumers would be assured that their supplier would follow closely the price movements of the market. So a market with a low switching rate and closely clustered prices could be operating efficiently.

From another perspective, if the market is working well, prices should cluster. If we look at the components of an electricity bill, including tax and environmental costs, 35% is accounted for by elements that are standard for all suppliers, for example, the transmission charge. Of the rest, about two thirds is the generation cost. If the wholesale market is working efficiently, it should be very difficult for one retailer to buy power more cheaply than another. If we look at most commodity markets, all buyers pay essentially the same cost for the commodity. This leaves the supply cost. If one retailer was, say, 20% more efficient than its competitors, this would allow them to offer power about 6% cheaper than their competitors, hardly a major incentive to switch for residential consumers. So the existence of major price differentials is more likely to be an indication of a malfunctioning wholesale market than an indicator of a healthy retail market.

3.3 *Retail costs in a competitive market*

It is generally assumed for most products that competition is a “free good” (or negligible costs) with only benefits from competition. It is difficult to know what the retailers’ costs are but it is clear they are up to four times as high as when retail was a monopoly. Some of the additional costs include:

- Marketing.
- Switching costs.
- Higher profits.

3.3.1 Marketing

Marketing costs range from product advertising in mass media and sponsorship of sports, to door-to-door and telephone marketing. These costs are likely to be substantial will inevitably be passed on to consumers.

3.3.2 Switching costs

The systems to allow retail switching were hugely expensive to build and are expensive to operate. Ofgem estimated allowed the companies to recover £850 million from consumers to pay for the building of the systems and operation over seven years from 1998 (Thomas, 2006). The NAO (2003) wrote of “the substantial costs of processing changes of supplier”. In May 2005, the British energy minister, Brian Wilson, said: “The benefits of price falls must not be restricted to those who switch, not least because if everyone starts to switch, the costs of administering this will outstrip the savings”. No reliable estimate of the average switching cost per consumer exists, but it is unlikely to be less than about £40. This cost legally cannot be charged to the switching consumer so is borne by consumers in general. While not charging consumers to switch will result in higher switching rates than if they were charged the real cost they were incurring, it does mean that consumers that do not switch are not only not receiving the potential benefits of switching, they are having to pay for the benefits switching consumers receive.

If all consumers switched as regularly as Ofgem advocates and sufficiently to ensure they were generally on the lowest tariff, this is likely to require them to switch up to twice a year. Even if the switching systems were able to cope with this, which seems unlikely, the annual costs would be in the order £2 billion. Ofgem’s standard response when complaints are made about prices, that consumers should switch to cheaper suppliers is therefore ill-thought out and likely to result in extra costs far above any potential savings from greater competition.

Ofgem should be required to re-estimate the annual cost of switching so that sensible advice can be given to consumers on switching.

3.3.3 Higher profits

It is now difficult to see whether energy retailers are making excessive profits. Four out of six of the energy companies are subsidiaries of foreign companies and do not publish audited accounts of their UK businesses. The other two companies, Centrica (which trades as British Gas in the UK) and Scottish & Southern Energy offer both gas and electricity, and are also integrated into electricity generation and, in the case of Centrica, gas production. So it is difficult to know where their profits come from. In February 2008, Centric reported profits for 2007 of £571 million compared to £95 million in 2006.

4. IS THE CORPORATE STRUCTURE COMPETITIVE?

The corporate structure for the electricity industry, with six major companies is much more competitive than most countries in Europe. Nevertheless, using the standard measure of market concentration (the Hirschmann-Herfindahl Index, HHI), the market would still be categorised as moderately concentrated (an index of 1,500). However, the market is still highly regionalised with the former monopoly supplier for each region still holding perhaps 50% of the residential market, with British Gas holding about 30% of the residential market. This would give an HHI of about 3500, well above the level (1800) that is the threshold for a highly concentrated market. However, while the fact that, a decade after the introduction of retail competition, these measures are still so disturbing does provide ample grounds by itself for the need for a Competition Commission Inquiry, the issues are more complex than is suggested by these simple statistics.

4.1 *Vertical integration of generation and retail*

When the electricity industry was privatised in 1990, there seemed a clear desire by the government to maintain a corporate separation between generation and retail. The reason for this was clear. The rationale for the new structure was to force generating companies to compete with each other “every half-hour of every day”. At that time, generation accounted for over half the cost of electricity. Most of the rest of the cost was made up by activities that would remain monopolies, so it did not seem likely the new structure would lead to major cost reductions in these activities. The benefit to consumers would come from the operation of an efficient electricity wholesale market, which would force generators to continuously force their costs down to the minimum they could achieve. The prices in this market would also act as investment signals, stimulating new investment when the price was high and ensuring that investment in new capacity kept pace with demand.

If generation and retail had been allowed to integrate, the majority of power would have been produced by generators and sold directly to their retail customers, bypassing the wholesale market. With low liquidity, the wholesale market would not have been an arena where independent generators and retailers could risk trading a significant proportion of their power and would not provide reliable investment signals.⁴⁰²

The logic of the need to separate generation and retail was so compelling that in many countries that copied the British structure, it was illegal for the same company to generate power and sell to final consumers. However, while the British government did try to maintain a separation between the generators and the 14 privatised retail companies, it caved in to pressure from the generators in 1998 and very quickly, the 14 separate and competing retail companies were taken over by five large generation companies. Annex 2 gives greater details on the history of this change.

The most recent development concerns the one remaining major independent generator that does not have a retail business, British Energy, the privatised nuclear company. British Energy did buy a retail company (SWALEC) in 1999, but sold it a year later. This may have contributed to its collapse in 2002. Eventually it was rescued by government at huge cost to taxpayers in a deal that effectively gave the government 65% of the shares. In June 2007, the government sold 30% of the shares and in March 2008, it announced it was looking to sell the remaining 35% of the shares and would not exercise its Golden Share which allowed it to veto any company owning more than 15% of the shares. Separately British Energy announced that it was in talks with a number of companies about a full takeover. The likelihood seems to be that British Energy will be partly or fully taken over by one of the six integrated generator retailers.

Investment in new generation in Great Britain continued after privatisation because of the failure of the wholesale market to bring down prices (the so-called “Dash for Gas” in 1991–92 and a second “Dash for Gas” in 1997–98. New generators could produce power at well below the market price and it seemed that investing in new plant represented a low risk. After the wholesale price fell in Britain in 2002, new investment would have become much riskier if the generation and retail had been separate because there would have been little assurance that a new entrant could produce at lower than the market price. However, the market is now dominated by a handful of integrated companies so investment risk is low because the companies are selling direct to consumers that cannot easily switch rather than into a half-hourly market. The risk that

⁴⁰² The first design of wholesale market, the Power Pool required generators to bid all the plant they wanted to operate into the Pool with only successful bidders allowed to generate. However, hedging contracts were allowed that meant that the price generators bid into the Pool bore no resemblance to the price they were actually paid and bids were little more than a charade.

there will be insufficient generating capacity may also be lower. Integrated companies will tend to ensure they have enough capacity to supply their own consumers reliably. So supply security may be improved by integration, but the price will be much reduced competition.

However, the intuitive conclusion that if integration of generation and retail is destroying competition, this form of integration should be prevented is dangerous. As stand-alone businesses, both generation and retail supply are highly risky businesses. Investment in new power plant will be seen as highly risky if the plant owner has to sell the output into a competitive market in which the prices and volumes sold will not be predictable from one hour to the next. For a standard product like electricity, retail suppliers will quickly lose their market share if they cannot match the cheapest prices on offer. The evidence from California and Brazil, where integration was not allowed and investment in new generation collapsed after liberalization, is not encouraging.

4.2 *Emergence of five dominant European players*

These changes in the UK must be seen in the context of changes in the corporate structure of the electricity industry in Europe. Like the UK, the European Union has been pursuing a policy of liberalisation of electricity markets but, ironically, the result of the attempt to introduce competition has been a massive process of corporate concentration and the emergence of an oligopoly of about five major players present in several countries. Thomas (2003) wrote about the Seven Brothers in 2003, examining the proposition that seven or eight companies would dominate European electricity markets.

Of the eight companies considered by Thomas as candidates, three were then already significantly larger than the other companies. These three companies, EDF, E.ON and RWE, were the first European companies to enter the UK and remain very powerful throughout the rest of Europe as well as in their home markets and the UK. Of the other five possible companies identified by Thomas: ENEL (Italy) is in the process of taking over another of the companies, Endesa (Spain); and Electrabel (Belgium/France) is in the process of merging with the gas equivalent of EDF, GDF. However, Vattenfall (Sweden) appears not to have the scope for further expansion and Iberdrola (Spain) has taken over Scottish Power, but is now under threat of takeover by EDF. The five dominant companies likely to emerge from this process, EDF, E.ON, RWE, ENEL and Electrabel/GDF are comparable in size and would have the resources to take over either of the two remaining British integrated companies, Centrica and Scottish & Southern Energy as well as the nuclear generator, British Energy.

4.3 *Prospects for new entry*

The Energy Minister, Malcolm Wicks expressed concern in February 2008 about the lack of new entry to the retail market since 2003 saying he wanted to raise the issue with Ofgem.⁴⁰³ However, the prospects for potential new entrants are now very poor and the reason for this is the actions of Ofgem and the government itself in allowing integration of generation and retail. New generators will only be able to enter the market if they can obtain a long-term contract to sell their power to one of the integrated companies. Such deals will contribute little to competition in generation. A new retailer will find it difficult to obtain wholesale supplies because generation is dominated by integrated companies. If, as now seems likely, British Energy, the only large independent generator left, is taken over by one of the six integrated companies, the proportion of capacity not owned by these six companies will be even smaller.

US companies moved rapidly into the UK market as soon as the “Golden Share” provisions that allowed government to veto takeovers of the privatised companies expired in 1995. However, many exited within a year or two, while the UK subsidiaries of those that remained after 2000, almost all went bankrupt. Experience by these US companies in other markets was generally little if any better, and virtually all the US companies have now withdrawn from all non-US markets after suffering heavy losses. The prospects that any US utilities will try to enter the UK market again in the next decade or so seem slim. Investment organisations, such as Macquarie Bank and Ontario Teachers’ Pension Fund and SE Asian companies have invested in UK utilities, but they seem only interested in regulated network activities, where the commercial risk is much lower than for electricity generation and retail.

A particular issue for prospective small new entrants is the so-called balancing market for power. This is a complex mechanism. Essentially retail companies have to forecast the demands of their consumers a day ahead and generators have to declare which power stations will be used so that the system operator (National Grid Transco) can check the compatibility of these plans with the transmission network and with their own (more accurate) forecast of demand. Inevitably, the retailers’ forecasts will not be precisely accurate and the system operator will, an hour ahead, have to buy additional generation or pay for a generator not to generate so that supply and demand do balance precisely. The price in the balancing market to generate extra power at short notice has proved to be highly variable and is often very high. For a large integrated company, this risk is manageable. For a small new entrant retailer, if their forecast is, say, 10% too low at a time when the balancing price to buy extra power is, say 10–50 times the normal market price, the company could easily be bankrupted.

⁴⁰³ Power UK, “Wicks to raise entry issues with Ofgem” Issue 167, January 2008, pp 57–58.

So new entry to the UK only seems likely from European companies with only the five emerging, dominant players having the size to move into the UK market or expand their existing position here. EDF, RWE and E.ON will probably remain strong forces in the UK market. The other three UK integrated companies (Centrica, S&SE and Scottish Power) and British Energy must be seen as takeover targets for these three companies or the other two major European companies, ENEL and Electrabel/GDF that have yet to establish a position in the UK. The latter company has already bought a major UK power station in 2008 signalling its intention to move into the UK market.

5. IS THE REPORTED WHOLESALE PRICE A RELIABLE PRICE INDICATOR?

5.1 *The Pool and NETA/BETTA*

As discussed earlier, from 1990–2002, the wholesale market for England and Wales was the Power Pool, which was a market all generators and retailers had nominally to operate through. In practice, the allowing of hedging contracts meant that the prices bid into the Pool had little or no impact on price-setting in the wholesale market. However, the terms and prices of the contracts were mostly known to the regulator at least up to 1998 because residential consumers were still captive to their regional company and the regulator had to be assured that the companies were only passing on to their captive consumers the costs they were actually incurring.

The Pool was replaced by a new spot market, the New Electricity Trading Arrangements (NETA), which in 2005 became the British Electricity Trading and Transmission Arrangements (BETTA), when Scotland was integrated into the England & Wales market. NETA/BETTA is a voluntary market and generators and retailers are free to sign confidential contracts outside the visible spot market. Whilst NETA/BETTA is immensely complex in detail, for these purposes, as we will argue, the fact that power can be bought and sold on confidential contracts outside NETA/BETTA is the key point.

The justification provided by energy retailers for the price increases of 2004–06 and for 2008 was that they were forced to pass on wholesale price increases to consumers. This begs the question: is the published wholesale price from BETTA a reliable indicator of the price retail companies pay for their power? Statistical analysis of day-ahead wholesale prices and retail prices found no correlation between these suggesting that there is no statistical basis for this claim (Waterson *et al*, 2008). But on a number of practical grounds, it is clear that the wholesale price is not a reliable indicator.

5.2 *The day ahead market is not liquid*

The only market for which prices are published is the “day-ahead” market for each 30-minute period. This is essentially a market used by the companies for fine-tuning their purchases, buying additional or selling surplus power. The volumes traded are minimal and the prices fluctuate dramatically from one period to the next. For example, in December 2007, the highest half-hour price on this spot market was £400/MWh, while the lowest was £15/MWh. The total turnover for the month was 857GWh. Total demand for the month was of the order 40,000GWh. So it can be seen that only a very small proportion of wholesale sales pass through the day-ahead market.

5.3 *All retailers can cover a large proportion of their sales from own capacity*

All six major companies are able to cover 50% or more of their power needs from their own coal- and gas-fired plant. The transfer price from the generation to the retail division of this power is not known and, if the fuel used to generate this power is bought on long-term contracts, the price of this fuel may not be strongly related to spot market gas and coal prices.

5.4 *The rest of the purchases are on medium- or long-term contracts*

There remain three significant independent power producers that do not have retail businesses, International Power (2.8GW), Drax Power (4GW) and British Energy (10.8GW). These companies own about a quarter of British generating capacity and supply a somewhat higher proportion of British power needs (their plants are used more intensively than average). All three companies are potential takeover targets for the six integrated companies. These independent generators were selling their power through short-term and spot sales in 2002 and British Energy and Drax Power (then owned by a US company, AES) both collapsed financially when the short-term price fell sharply. They now sell their power primarily via medium- and long-term contracts to the six major retail companies. The terms of these contracts are known only to the two parties involved and are highly unlikely to have a systematic relationship to electricity spot market prices.

6. CONCLUSIONS

Detailed analysis of prices shows that even in the period 1990-2002, when prices for electricity were falling in real terms, the wholesale electricity market was not working well. Large cost reductions experienced by the generating companies were not passed on to consumers as would have been expected to occur if the wholesale electricity market had been an efficient one. Experience since 2002 has demonstrated that the retail electricity market is also not efficient and has allowed the electricity companies to increase prices to residential consumers without convincing justification and not pass on cost reductions. So the current problem is not an isolated one in an otherwise successful system.

The assertion by the six electricity retail companies that large price rises for electricity imposed in the first quarter of 2008 are justified by movements to the wholesale market price for electricity is not supported by the evidence they have given. The liquidity of the visible wholesale market is negligible and the six companies buy nearly all their own power from their own power stations or from independent power producers under long-term contracts. The connection between the cost of these purchases from their own sources and under long-term contracts, and the published price in the spot market is weak. There are strong suspicions that this is not the first time the companies have manipulated prices to their advantage. In 2002, the wholesale electricity price fell by 40% but none of this was passed on to residential consumers. In 2005-06, the companies increased their prices by 50% or more citing high wholesale prices, but when wholesale prices fell in 2006, the price reductions were minimal.

Residential consumers already face a near impossible task in trying to get the best deal for their power purchases. They have to choose a supplier knowing only the current relative prices, which in a volatile market could easily have changed even before the switch to a new supplier has been completed. They have to compete with large users to buy power and the retailers have a history of systematically allocating their cheapest power purchases to large users, presumably because of their stronger negotiating power. The companies also discriminate against poorer consumers, offering much lower prices to those that can afford to pay by direct debit and who have access to, and are confident with the internet. Pre-payment meter and standard credit (quarterly variable bills) consumers might pay a third more than direct debit consumers. The companies have provided no convincing evidence that this price differential is justified by real cost differences.

The structure of the electricity industry has become significantly less competitive and more concentrated in the past decade, with the implicit approval and sometimes at the instigation of both the government and the regulatory authority, Ofgem. Further changes are likely that will make the situation worse. In the case of the likely takeover of British Energy, which will remove the main independent power producer, the change was at least in part prompted by the government itself. This reduction in competition will give consumers even less confidence that prices are being set competitively by the market. It will leave residential consumers even more vulnerable to the market power of the oligopoly of a handful of European companies that increasingly dominate UK as well as European energy markets.

Solutions to these problems are not easy. When confronted with such serious market failures, it is tempting to recommend pro-competition measures, such as breaking up the companies, forcing greater use of visible spot markets and reducing the extent of integration of generation and supply. However, the result of such measures could be to jeopardise security of supply if, as seems likely, independent generation companies would profit more from power shortages than from investing in new capacity.

The regulator, Ofgem, has a poor record. Dubious price movements in 2002, 2004-05, 2006 passed with no serious investigation by them and their response to the latest price rises was belated. There must be suspicions that it was only prompted by public outrage and the announcement of the BERR Select Committee investigation. Ofgem's announcement of its inquiry gives concern that Ofgem will be looking to shift blame elsewhere. It states: "We are concerned about the increased volatility of wholesale prices and we want to investigate how European and other global energy market developments are affecting energy bills in Britain". Fundamental issues such as the efficiency of the British wholesale market and the corporate structure in Britain are nowhere mentioned. Ofgem has also consistently failed to tackle the issue, long recognised, of price discrimination amongst residential consumers which results in pre-payment and standard credit consumers paying far more than direct debit consumers.

A more impartial investigation than can be carried out by Ofgem is needed and the Competition Commission seems the most appropriate body to carry out such an investigation. The issues it would need to examine are:

- Do movements in the price actually paid for power by retailers justify the January 2008 price increases?
- What if any is the relationship between the published spot price for electricity and the price paid by retailers for power?
- Do cost differences justify the price differences between the tariffs offered to pre-payment meter and standard credit consumers, and to consumers paying by direct debit?
- Are residential consumers paying disproportionately more for their power than large industrial consumers?

- What are the costs of switching by residential consumers and, if as seems likely they are high, can these costs be reduced to more affordable levels?
- Is the structure of the electricity market competitive and, in particular, would the takeover of British Energy by one of the existing retailers lead to serious competition issues?

If the problems identified cannot be remedied by changes to the market, a return to a more strictly regulated system of tariffs may be necessary.

The problem of the ineffectiveness of Ofgem is a serious one and needs to be addressed separately. There must be doubts, given its role in designing the wholesale market and presiding over the corporate changes in the industry, whether it is now too compromised to carry out its primary duty of protecting the interests of consumers. A more comprehensive reform of regulation may be required.

REFERENCES

- Cornwall Energy Associates, 2008, “Gas and electricity costs to consumers”, Paper for the National Right to Fuel Campaign and Unison prepared by Cornwall Energy.
- Electricity Association, 2001, “Affording Gas and Electricity: Self Disconnection and Rationing by Prepayment and Low Income Credit Consumers and Company Attitudes to Social Action”, Electricity Association, London.
- I Lang, 2002, “Blue Remembered Years”, Politico’s, London.
- National Audit Office, 2003, “The New Electricity Trading Arrangements in England and Wales” Report by the Comptroller and Auditor General HC 624 Session 2002–03: 9 May 2003.
- Power UK, 2002, “Prices fall for some but stay the same for others”, No 97 (March 2002), 27–8.
- S Thomas, 2003, “The seven brothers” Energy Policy, vol 31, 5, pp 393–403.
- S Thomas, 2004, “Evaluating the British Model of electricity deregulation” Annals of Public and Cooperative Economics, vol 75, 3, pp 367–398.
- S Thomas, 2006, “The British Model in Britain: failing slowly” Energy Policy, vol 34, 5, pp 583–600.
- M Waterson, M Giulietti & L Grossi, 2008, “The missing link” Power UK, issue 167, January 2008, pp 60–66.
- C Waddams-Price (2004) “Spoilt for Choice? The Costs and Benefits of Opening UK Residential Energy Markets”. CCR Working Paper 04-1. Also published as University of California Energy Institute Working Paper CSEM WP-123.

Annex 1

A DETAILED BREAKDOWN OF SUPPLY COSTS

Cornwall Energy (2008), in a paper commissioned by UNISON and the National Right to Fuel Campaign has tried to establish a more detailed breakdown of the current cost of power for residential electricity consumers (Table 7). If we include system losses with generation, the generation element makes up 35% of the total cost (excluding taxes and subsidies); distribution (including metering) comprises 21%; transmission 3%; leaving 41% to cover the supply cost and profits.

There appears to have been a four-fold increase in profits from 2003–06 and, if Centrica’s profits for 2007 are a guide, the percentage of the price made up by profits will have increased again sharply in 2007. Marketing costs are likely to have fallen given that most of the companies are no longer employing major door-to-door and telephone marketing efforts.

While distribution and transmission have fallen as a percentage of the bill, they are increasing, reflecting extra costs associated with integrating renewables, but also, as argued in section 2.4, the fact that the industry was sold at a small fraction of the asset value and the pre-privatisation assets are now having to be replaced.

Table 6

COSTS OF SERVING RESIDENTIAL CONSUMERS—£m (%)

	2003	2006	% change 2003–06
Fuel costs	1,815 (25)	3,020 (27)	66
System losses	499 (7)	878 (8)	75
Distribution charge	1,610 (23)	1,734 (16)	8
Metering	526 (7)	543 (5)	3
Transmission charge	190 (3)	298 (3)	57
Suppliers' cost to serve	903 (13)	908 (8)	1
Profits	557 (8)	2,635 (24)	373
Residual	1,020 (14)	983 (9)	–4
Total (exc tax and environmental)	7,120 (100)	10,999 (100)	54
Energy efficiency commitment	97	182	
Renewables obligation	148	256	
Total	7,365		

Source: Cornwall Energy Associates

Annex 2

INTEGRATION OF GENERATION AND RETAIL

The British government has been inconsistent about integration of generation and retailing electricity. Because of strong opposition in Scotland, from across the political spectrum (Lang 2002), to the break-up of the two nationally-owned Scottish electricity companies, these were privatised intact as two fully vertically integrated companies. However, the Scottish electricity industry has now been absorbed into that of England and Wales.

In England and Wales, the 12 regional retail supply companies were allowed to build their own power plants and the generators were allowed to supply directly the large consumers who were able to choose their electricity supplier. The situation became more confused in 1995 when Scottish Power was allowed to take over a regional company in England and Wales (Manchester and North Wales Electricity Board). At that time, Scotland was commercially separate from England and Wales but physically interconnected. Improvements to the interconnections were underway and it was clear that Scottish Power would be able to operate as an integrated company in England and Wales. A regional company, Eastern, had bought the plant the Regulator had forced the two large privatised generators, National Power and Powergen, to sell in 1995, also creating a large integrated company. However, the proposed take-over in 1996 of regional companies by both National Power and Powergen caused government to think again.

These two companies still had immense power in the generation market and allowing them to take over regional companies would have been a risk to competition and the take-overs were prevented. Only two years later, renewed take-over bids by the duopoly were allowed. It is not clear why the government changed its position on vertical integration. What had changed was that the market share of National Power and Powergen in generation had fallen and the government required, as a condition, that the duopoly sell more of its plant to new entrants. National Power and Powergen were also experiencing financial difficulties because long-term gas contracts they had signed had proved to be over-priced. Between them, the two companies had to write off about £1.5 billion in 1998–99 on these contracts. The government may have been concerned that these problems had so weakened the companies they would have been vulnerable to foreign take-over. Allowing them to integrate appeared likely to give them more strength. In fact, this protection was ineffective. In 1999, National Power had to split itself into a UK business and an international business. The UK business of National Power was taken over by RWE in 2002 while Powergen succumbed to E.ON in 2001.

The decision on vertical integration of National Power and Powergen opened the floodgates to integration and by 2002, the 14 retail businesses of Great Britain (12 in England and Wales and two in Scotland) had all been taken over by generators. Now five integrated companies dominate generation and retail supply. RWE, E.ON, EDF and Scottish & Southern Energy each own three regional companies, and Scottish Power owns two. A sixth company, Centrica (trading as British Gas), has made significant inroads into the retail market for residential consumers and owns a significant amount of plant. There is every prospect that, in the next year or two, further mergers and take-overs will leave just three or four dominant companies.

The risks of this form of vertical integration to consumers were soon apparent. 40% of Britain's generating capacity was in serious financial difficulties at the start of 2004. Some was for sale at distress prices, some had been repossessed by the banks that lent money to the owners and the nuclear plants were owned by companies that were only able to continue to trade because of government support. This 40% of capacity was owned by non-integrated generators. The integrated companies get most of their power from their own plant or under long-term fixed price contracts and are little exposed to the markets. When the

wholesale electricity price as measured by the wholesale market price fell, the integrated companies did not pass on the reduction to consumers (National Audit Office 2003). The non-integrated companies, most of whom had only bought their plants in 2000–01, were much more seriously exposed to the price reduction and began to lose money heavily.

While this form of integration significantly reduces the risks to electricity generators and retailers, it is not a guarantee against failure. In Great Britain, by about 2000, TXU, a Texas-based electric utility held about 4000MW of generation and supplied to two regions and was widely seen as having a very strong position in the British market. However, it contracted too much power at a high price from an independent power producer, sustained heavy losses and was bought out by E.ON in 2002.

March 2008

Memorandum submitted by Utilita

My company, Utilita (www.utilita.co.uk) is a relatively new entrant in the energy supply market. Unlike most new entrants we have targeted the residential sector for both gas and electricity, and do NOT specifically sell a renewable or “Green” product. We are the 7th largest dual fuel supplier in Great Britain, basically because there is no one else after the Big 6 (British Gas, RWE, Eon, Iberdrola, Scottish & Southern, and EdF). As a small company we seek to exploit our advantages in technology vis-à-vis the Big 6, and are currently launching a new pre-payment product based on smart metering which we believe is the biggest smart metering project in the residential sector and the only smart meter project focused on pre-payment. This product is priced to be competitive with incumbent supplier direct debit prices, rather than at a significant premium.

We have not been invited to give evidence to the select committee, and are not particularly looking to give oral evidence, however, we would like to ensure that the committee is aware of the evidence that we have submitted to Ofgem as part of their review of the retail market. In particular the points we have focused on are:

1. **Predatory pricing**—whilst pushing through big increases to their incumbent customer base several of the Big 6 suppliers have continued to cut the prices they offer to new customers. Obviously as a new entrant we have to compete with their discounted prices and believe that these are therefore preventing competition. Furthermore it should be noted that much of the cost to serve for utility customers is in winning and losing customers, both in terms of internal costs of setting up and closing accounts and external costs of commission payments. These same companies often apply even higher prices to pre-payment customers. On the surface it certainly seems that they are cross-subsidizing their new customers from their inert and/or pre-payment customers. This is a barrier to entry.
2. **Credit cover**—Sometime ago, Ofgem reviewed the credit cover arrangements that were being imposed by the monopoly electricity distribution businesses and came to the conclusion that these were a barrier and that there were more efficient ways to manage bad debt. They subsequently introduced changes to the standard terms of business that removed the credit cover requirements, however, they failed to translate the same principles onto the gas distribution companies, and as a consequence there are still onerous and unnecessary credit cover arrangements being imposed by the gas distribution companies. The same applies to NGC Meters, a company that essentially operates a near monopoly in the provision of gas meters and that was fined by Ofgem earlier this year, but there has not changed the onerous credit cover arrangements that they impose. This is a barrier to entry.
3. **Balancing prices**—because a supplier cannot predict exactly how much gas or electricity its customers will use on a day, but at the same time there is a physical need to ensure the systems remain in balance, both markets have a “balancing mechanism”. These are markets that come into play after the event to balance out the differences between what a supplier bought in advance (based on what he thought his customers would use) and what his customers actually used whether more or less. Obviously for these to work there needs to be a mechanism for determining the price at which these balancing trades are performed, in fact there are two prices, one that applies if you are short, and a lower price that applies if you are long and need to sell back the excess. The differentials in these prices between the two markets is enormous, in the gas industry typical spreads are around $+/- 2\%$, but in the electricity industry they can be $+100\%$ (or more when we need to buy) and -50% (when we are selling). This leads to differential wholesale costs between big and small suppliers because we both trade in the same markets ahead of time where there is a minimum granularity in the products we can trade and smaller suppliers therefore cannot hedge as accurately in percentage terms as bigger suppliers. This is a barrier to entry.

We did have concerns about smart metering. We are currently rolling out a fully commercial product that both delivers smart meters and addresses the fuel poverty issue by reducing prices to pre-payment customers. We would not wish to see any measures being imposed on the industry (primarily on the Big 6) that had the effect of removing a critical element of one of the few competitive advantages we have over our much larger competitors.

4 June 2008

Memorandum submitted by Welsh Power
INQUIRY INTO UK ENERGY MARKET

INTRODUCTION

Welsh Power Group Limited is a dynamic independent power company, which aims to build an integrated multi-asset European energy business using a buy and build strategy.

Welsh Power Group is the owner and operator of Uskmouth Power, a 363MW coal fired power plant in South Wales. Uskmouth is one of the most efficient and flexible coal plants operating in the UK and being fitted with FGD is also one of the cleanest plants. Welsh Power has a subsidiary Severn Power Limited who is developing an 850MW gas-fired power station on the brown-field site next to Uskmouth Power.

In January 2007 Welsh Power launched Haven Power, an electricity supply company providing predictable electricity prices and straightforward contracts tailored to the individual needs of business customers. In June 2007 the Company commenced the development of a 49.9MW biomass plant at Newport Docks through its wholly owned subsidiary Nevis Power Limited. This development is being managed by Carron Engineering & Construction our specialist power engineering business. Carron Energy Limited is the commercial and trading arm of the Group managing its trading and energy management functions, coal, CO₂ and gas trading.

As one of the few new market entrants in the last few years, Welsh Power Group has experienced first hand the barriers to entry to the GB power market. We believe that the market is fundamentally broken and in need of a more radical solution than recent Ofgem initiatives, such as the cash-out review, have examined. Outlined below are our key concerns and some proposed solutions.

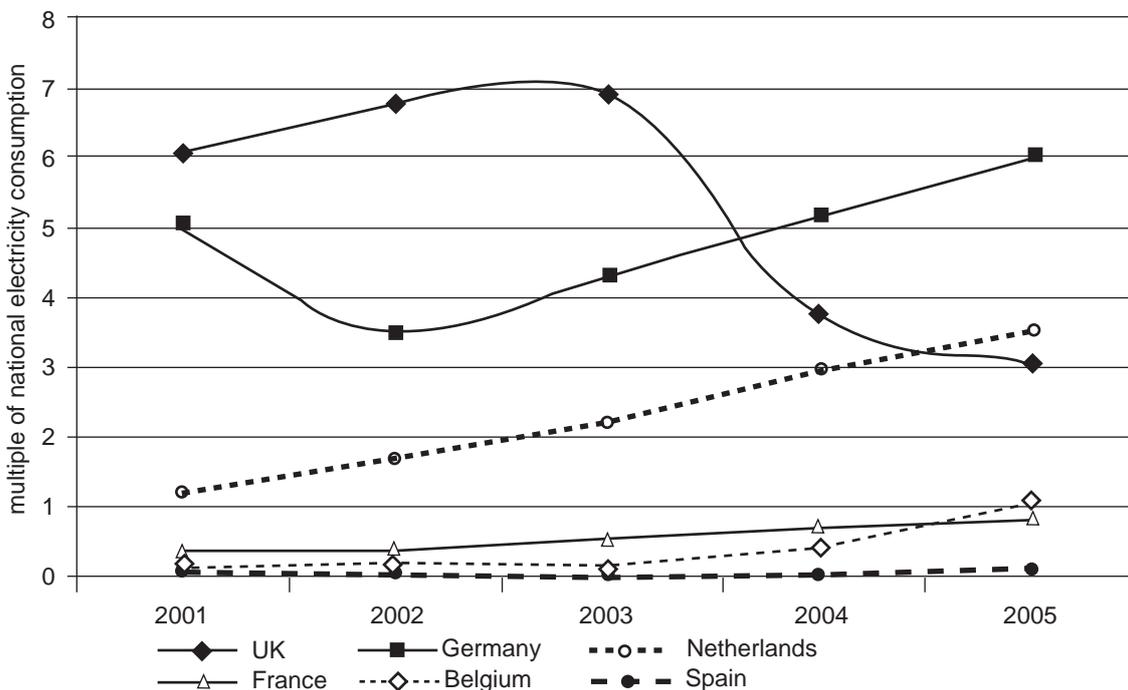
MARKET DESIGN CONFERS A SIGNIFICANT ADVANTAGE ON INTEGRATED PLAYERS

The integrated players, owning both generation and supply businesses, do not have to effectively participate in the wholesale market. Their position allows them to pass generation costs straight to their supply arms, via internal power sales, and on to customers. This has three impacts:

The European Commission's 2006 report into the EU electricity sector pointed out that the UK was the only power market with falling liquidity (see graph 1 below). Since their report in 2006, data from the power exchanges show that liquidity in the wholesale market has continued to fall with monthly volumes almost halving in the past two years. Graph 2, illustrates the falling liquidity for the year 2007 based on data from the London Electricity Broker's Association (LEBA). This lack of trading means that the market is not working efficiently with the less economic plant, in terms of cost and environmental performance, being dispatched as the market does not trade into an efficient outcome. A very large proportion of all the electricity sold is not traded in the wholesale market. This thinness of the market, making prices increasingly volatile, makes it very difficult for suppliers (other than the large integrated suppliers) to offer competitive prices to their customers.

Graph 1

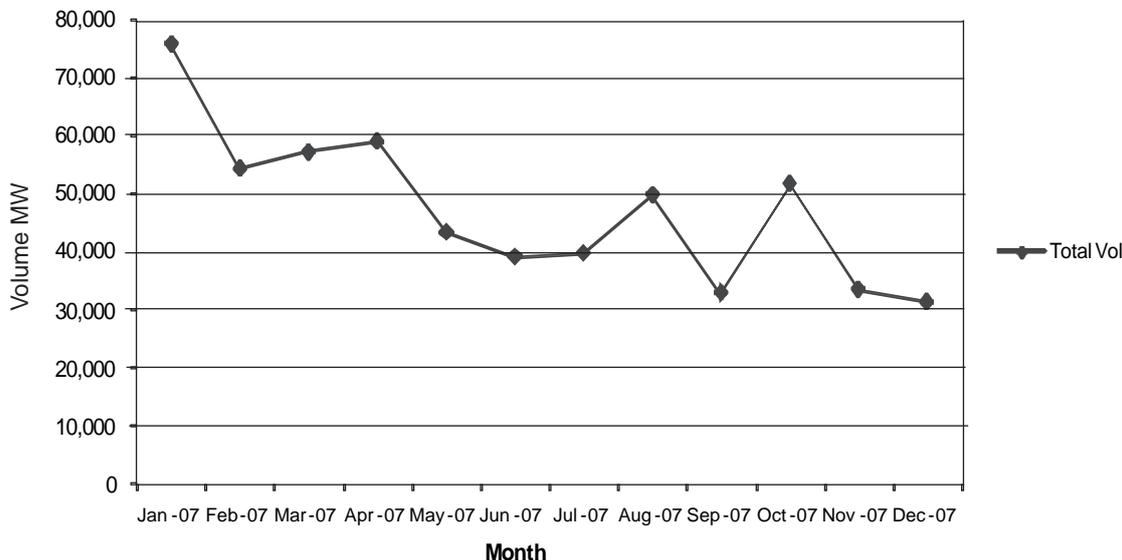
Forward trading has developed differently across countries
 Development of total volumes on OTC forward markets as a multiple of national electricity consumption



Source: European Commission, Preliminary Report into the Electricity Sector, February 2006

Graph 2

LEBA Total Traded MW Volume Per Month



Customers switching between integrated players face increased costs as their suppliers are not adopting an economic purchasing strategy. Incumbent suppliers face very limited competitive pressure from the threat of new entrants as the lack of a liquid wholesale market means new market entrants cannot purchase necessary power at economic rates.

The integrated players see their supply portfolios alter, but their general supply levels remain large enough to support their own generation portfolios. Switching numbers for customers are coloured by some customers being regular switchers, but the general level of change in the smaller end of the market is, we believe, overstated. These “sticky” customers pick-up the cost of expensive generation through inflated tariffs.

SOLUTION

There are several ways to mitigate the market power that the integrated players have:

The generation licences could be altered to require generators to sell all of their output via the wholesale market, rather than to their supply arms. This could be monitored by Ofgem. The new EU electricity Directive proposes reporting on power trades, and the UK could develop reporting requirements to allow Ofgem to monitor the position of the integrated players. For example all OTC trades and exchange trades would have to be notified to Ofgem and a market reporting service to stop generators from concealing trades and this may lead to a requirement to licence all BSC signatories.

Alternatively, if this was felt to be difficult to police, a divestment of generation, or full financial separation of generators from all other larger energy businesses (along the lines applied to monopoly networks) could be used. Under this scenario back to back trades between related companies should be banned and financial penalties, under competition law, should be applied to any parties found to be in breach of the law.

BARRIERS TO ENTRY

As well as the lack of liquidity, there are a number of other barriers to entry to both the electricity retail and wholesale markets:

The market itself is very complex, with physical players having to sign a number of multi-party contracts, with a variety of different governance regimes. The market rules are subject to regulatory risk with Ofgem signing off all changes to the market rules and also able to raise its own policy initiative driven changes that can lead to fundamental changes to the market structure.

The balancing mechanism at the heart of the market arrangements imposes further uncontrollable costs on smaller players. The larger a portfolio the lower the demand forecasting risk and the more likely you are to have embedded generation, all of which reduces your exposure to imbalance prices and this lowers your costs. A number of modifications to the BSC⁴⁰⁴ have been raised that aim to reduce the level of imbalance cash-out prices. However, changes to cash-out in themselves will not resolve the structural issues.

Since the advent of NETA/BETTA the credit and financial requirements for market participation have grown enormously. Whilst some of this can be traced to supplier failures the level of credit and security required to buy and sell electricity is now so great that it represents the most difficult (and potentially expensive) step for any new entrant. In addition the larger integrate players tend to have investment grade credit ratings which means that they are not subject to the same credit constraints and their overall purchase costs are significantly lower as a result.

For generators, there is currently a significant queue to get transmission capacity to connect new plant. Welsh Power has recently requested a connection in the South West only to be told that the earliest connection data would be 2020. We are extremely concerned that the Transmission Access Review (TAR) is looking at ways to allocate scarce capacity, including the removal of the firm access rights on which generators made investment decisions. The Government and the regulator need to focus on ways to get National Grid as the transmission owner to build the capacity that generators are willing to pay for. We are in danger of missing out on the benefits of a competitive wholesale market as new generators will not be able to come to the market and existing generators will have their transmission rights removed and given to more expensive, intermittent renewable generation.

SOLUTIONS

Ofgem is currently carrying out a review of the industry Codes. We are hoping that this may streamline the number of codes and the way that they are governed. The gas market arrangements would create a good template for improving the power market, with only one key code and a more flexible and streamlined governance process. The regulatory risks would also be reduced if Ofgem withheld from undertaking fundamental reviews of market structure unless prompted to do so by change proposals raised by market participants. Such reviews take up resource and only the largest players are resourced to participate.

A levy on larger suppliers could be used to meet the credit requirements of those new entrants that had demonstrated some competency in their operation. This could work in a similar way to the current High Distribution Cost Area levy which is used to subsidize distribution costs in the North of Scotland.

On transmission access, National Grid must be allowed to progress significant investment in new capacity under its price control. Ofgem's concern over costs to customers must be weighed against the costs that the customers will face if effective competition in generation is eroded still further. New entrants should expect to be offered firm connection rights within a reasonable (say 4 years) timeframe if the generator is willing to underwrite the costs. To encourage new entrants the calculation of the amount to be underwritten (shallow verses deep connection costs) could reduce the costs to generators. However, delivery of firm physical rights is vital. A copy of a confidential letter sent to Ofgem, in Annex 1 (not printed here), explains

⁴⁰⁴ Balancing & Settlement Code.

how transmission access is impacting investments today. Alternatively some mechanism could be found to introduce more competition into the provision of transmission services; this could involve a break up of National Grid.

WHY PRICES WILL CONTINUE TO RISE

Welsh Power believes that the Government, and the country as a whole, needs to face up to the fact that energy prices are likely to go on rising. A more competitive energy market would be better able to absorb some of these costs, but generally costs faced by generators are increasing:

Renewable energy targets (under the EU Renewables Directive and the Government's own targets) are expected to add in the region of £200 to each household bill. We expect that it will be higher than this as the technologies are expensive, and thus subsidized, but also the amount of wind results in intermittent generation that requires additional reserve generation is held by the system operator.

Global fuel prices are rising sharply. Gas and oil have risen 135% and 90% respectively in the past year. Biomass fuels are also going up in price. For those needing landfill to dispose of waste those costs are also increasing, along with freight and shipping charges. For those looking to undertake new build generation, equipment prices are increasing significantly with global demand and availability is very limited. All of these factors combine to increase the price of delivered power.

EU ETS is a real cost for generators, all of whom are theoretically short under phase II, and under phase III of the scheme the Government has said that it will auction all permits for the generation sector. The cost of buying carbon contributes to generators costs and ultimately prices.

Environmental policy, such as LCPD and NECD,⁴⁰⁵ are pushing up costs to generators. They either require installation of new equipment, further monitoring and reporting, more expensive (lower emissions) fuel, reduced running hours or closure. The Commission is already moving forward on environmental legislation that will continue to add costs to the generation sector. It is also easy to aim policy at generation, so where policy aims to reduce one type of pollution and the government is missing its targets, it is easy to require generators to act rather than other sectors, such as transport. The use of the generation sector as the main tool for all clean air policies, despite the most economic improvements already being made, simply adds to the costs of generation.

SOLUTION

While the Government controls some of these policies, if its policy framework is fixed it must find an economically efficient way to help the fuel poor and educate the rest of the population so that the price rises that are coming are not a surprise and all customers can prepare and/or budget for them. Attempts to use the energy suppliers as a vehicle to implement social policy have not been inefficient as suppliers cannot identify target groups easily. For example customers on pre-payment meters are often students and not pensioners.

This Committee can kick start this process by reporting that the price rises currently look inevitable and that the promotion of energy efficiency, along with tackling vertical integration, will help all customers to adapt to the change as well as reducing emissions.

1 April 2008

Supplementary evidence from Welsh Power

I hope you and the BERR Select Committee found our evidence interesting and relevant.

I was interested to hear the views of SSE, RWE and E.ON about the volumes that they trade through the market; I can't reconcile this with our experience perhaps we also need to define the "wholesale market" better. Ready access to power and reporting of traded volumes and prices is critical and the wholesale market reporting should cover trades of all descriptions. Given the "Big 6"'s apparent enthusiasm for wholesale trading, the proposals that we made should be quite acceptable to them.

I was also interested to note that a number of the "Big 6" (SSE and E.ON) were against further consolidation. If things have got this far it strongly reinforces the need for action!

I thought it would be helpful to set out our views of the sensible remedies for the liquidity and new generation entry issues as we got through a lot of material in quite a short time.

⁴⁰⁵ Large Combustion Plan Directive, National Emissions Ceiling Directive.

LIQUIDITY

- 100% of generation to be sold on the wholesale market.
- Ban on self supply.
- Requirement to sell on a “no worse” basis across the market and not just to a “closed shop” subset of the market. Care would have to be taken to ensure that credit terms were reasonable.
- Given that the “Big 6” all told the Committee that they do trade their power via the wholesale market we would not expect any of them to have any problems with our proposals. This means that a change to the generation licences could be secured quickly as it requires only a majority to agree to the change. Once the largest agree, the change can come into force in a matter of months. This makes it a timely solution, but it does rely on Ofgem to take a proactive stance on monitoring.
- An alternative would be for Parliament to use their legislative powers to require plant divestment. We would propose that no supplier can be related to a generation company that could generate, and thus supply, more than 50% of their supply requirement. In order to help the market in a timely manner, the legislation would have to require divestment in a relatively short timeframe, say one year. While this is tight, it is an achievable timeframe and could have a backstop that plants not sold through a bi-lateral process would be auctioned.

GENERATION ENTRY

- WPG has only succeeded with Severn Power its new generation plant because it absolutely meant to build it.
- WPG does not have an investment grade credit rating and has to lodge collateral with eg National Grid so there is real money at stake. Other players are able to use their credit ratings to book transmission capacity which keeps it away from the rest of the market, but they may choose not to build while they assess and rank alternative projects in a number of markets (eg Germany, Spain, France etc). This creates a low cost option to build and makes it more difficult and expensive for competitors to build new generation. A good example is Pembroke which is on the National Grid list for connection in April 2009—we understand that construction has not yet started and this is making the construction of new plant in the same grid area correspondingly more expensive.
- WPG wants to build a further two plants but needs more certainty over the process. The consents take too long to get (it took two years and we still don’t have the pipeline consent).
- Planning processes need to offer certainty on timetable at present they are open ended.
- The current work on transmission access may well backfire and make new entry much more difficult, especially if Ofgem approves the auctioning of entry rights and the removal of existing rights the generators have built business on. It is very unlikely that banks will fund new plant under this sort of regime.

PRICES TO END USERS

We mentioned to the Committee that the Big Six claimed to be losing money on supply while still appearing rather profitable. It may be useful to understand that their current wholesale supply portfolio gives them a cost of supply that is not directly connected to the current high prices. All players will try to lock-in power for the customers that they have committed to supply. The “shape” of the contracts will depend on the type of portfolio supplied, but the supplier will try to match their longer term contracts to their forecast yearly, monthly and then daily requirements.

For the integrated players they can internally “contract”, allocating their generation output to their own supply. These internal contracts would have a price of generation associated with them, without one they could not then price their retail supply. These generation prices may relate to longer term fuel contracts, the price of carbon, etc. . . The deals done, either internally or externally, are unlikely to give you the “right” output for each given day, so as demand forecasts are known each company must fine tune their generation requirements by trading either day ahead and on the day. We believe that it is the trading to fine tune positions that forms the bulk of the trading in the current wholesale market. This is truly a marginal activity.

The fact that the market is simply fine tuning means that “Big 6” are not currently saving their customers a huge amount of money. The cost of actually supplying their customers is made up of the price of contracts they signed in the past, plus the costs of the fine tuning. However, they should be offering terms today that will have an element of locking in current supplies and thus current wholesale prices.

We would be happy to provide any further information that you require. We would also be able to provide information on competitor offers that are below wholesale cost but before doing so I would like to understand how public this would be as it will contain individual customer information and we may need to obtain customer consent.

27 June 2008

Memorandum submitted by Professor Michael Waterson, Professor of Economics, University of Warwick

**INVESTIGATION INTO POSSIBLE ANTI-COMPETITIVE BEHAVIOUR
IN THE UK'S ENERGY MARKET**

1. EXECUTIVE SUMMARY

Together with other academics, I have investigated the linkages between domestic electricity retail prices, wholesale prices and prices of the underlying fuels over the period since 2001, following reforms both in the retail supply market and in wholesale market trading arrangements. We find that despite these reforms, there is significant price dispersion between suppliers in their offers to domestic consumers. Surprisingly, we also find rather little observed linkage between retail and wholesale prices for electrical power. To this extent, the operation of what is intended to be a competitive market is somewhat opaque.

2. BRIEF INTRODUCTION

I am Professor of Economics at the University of Warwick, a post I have held since 1991. My specialist research area is Industrial Economics and I have recently been working on topics in the area of domestic energy supply, in partnership with various other scholars. This area interests me academically because the UK is in the vanguard of moves towards competition in generation and in supply. I have a paper in the *Economic Journal* (2005) with two other scholars on consumer switching in the gas industry (funded by the Leverhulme Trust) and am currently working on pricing behaviour in domestic electricity supply, focusing on firms' strategies. This latter work is funded by the ESRC and is joint with Monica Giuliotti, an academic at Aston Business School (and has been assisted by a visiting statistician, Luigi Grossi). The conclusions I summarise above, and the more detailed comments below, relate in large part to our current (and somewhat preliminary) work on investigating trends in domestic supply prices and on linking domestic electricity supply prices and wholesale energy prices. We have not been working on retail gas prices at this particular stage. I should also make clear that we are interested in the topic as independent academics engaged in a study of markets and, in particular, we are not engaged by OFGEM, or any of the energy supply companies, nor any similar parties.

3. POINTS ON WHICH I FEEL I CAN COMMENT

Below I make comments in several areas relating to the bullet points in the announcement of inquiry, where these link with our investigation. I do this in the order of the points that you make, but I can comment more fully on some than others. Where I write retail below, I refer only to domestic retail.

4. You ask whether the current market structure encourages effective competition in the retail markets for gas and electricity. Certainly it has been designed to do that. In my opinion, it does so imperfectly. However, whether an alternative system would do better is I think a moot point. To elaborate somewhat, the current structure certainly leads to a very large amount of switching between suppliers; approximately 20% of consumers switch supplier in any year. A good deal of this switching appears to be what might be described as "churn" and a substantial minority of consumers appears uninterested in switching supplier. Our analysis of pricing trends in the market has suggested that substantial percentage price differences between suppliers can coexist in the market, despite the seeming homogeneity of the product. In particular, an incumbent supplier (the firm that would be your supplier had you never switched) has historically been able to command around a 10% price premium over the average of other suppliers. However, there is some evidence that this premium is declining. Within the set of other suppliers, significant price differences appear, up to 30% at times, although these commonly do not persist for long periods (that is, there are commonly these differences, but any one company is not consistently a "best buy" for long). Why do I say that it is a moot point whether an alternative system would be better? Other academic studies on pricing dispersion more generally (with different products) show that pricing differences across suppliers are very common, and that the percentage magnitude of these differences is not out of line with the results above. Nevertheless, it is perhaps unusual considering the importance of electricity in many peoples' budgets.

5. I would say that the workings of the wholesale market are somewhat opaque. I have obtained from Platts, one of the three main data supply companies in this area, price data for wholesale electricity and gas. However, these data refer only to rather short-dated supply, up to one month out. Platts tell me data for less prompt contracts are not readily available. However, I have also been told by an industry representative

that the majority of contracts they engage in are for much longer dates than those for which I have price data. Since these are bilateral contracts, whose terms are only known by the two parties themselves, it is difficult to get a view of how the market as a whole is operating. As with any commodity, it is normal in order to reduce the risk inherent in an energy portfolio for the energy company to hold a set of contracts diversified as to maturity. What is somewhat surprising is that the short term signals do not necessarily reflect what the supply companies tell us are underlying movements in the longer term market. In addition, so far as I am aware, there are no third parties providing liquidity.

6. One intriguing aspect of the current market is the consolidation amongst suppliers. So far as domestic electricity supply is concerned, independent operators seem to have been squeezed out of the market. Since these operators tended to have the most financially attractive tariffs, price pressure on the bigger companies may have been lessened. As to why the independents have been squeezed out, I conjecture that one consequence of the replacement of the Pool system by NETA was that it became more difficult for independents to obtain adequate cover against market price risk. In contrast to independents, the major suppliers are all significantly vertically integrated and therefore have significant cover against price risk on the supply side. Having said this, I do not feel there is any intrinsic reason why a market with six suppliers and active consumers should be markedly uncompetitive.

7. My remarks on the relationship between wholesale and retail markets for electricity should be prefaced by a point made above. We have price series for wholesale electricity, but only on a day-ahead and month-ahead basis. We also have price series for retail prices (over a standard set of contracts), collected from the energywatch website. We have examined the relationship between these series of wholesale and retail prices for the time period 2001- February 2007. Expressed in terms of returns (as one would in comparing say the movements of one particular share against a market portfolio), there is essentially no statistically significant relationship between the two series. "In sum, these simple cross-correlation experiments suggest no strong link between the relatively shortdated wholesale prices for which market data are available, and retail prices. This is not because retail prices are simply a smoothed version of wholesale prices. Rather, the series show quite different characteristics". (a quote from the article in Power UK I wrote, attached to this memorandum). I find this a most surprising result. In my opinion, it does put the onus on the supply companies to explain where they view the underlying cost pressures as arising. We may also note here that the other elements of cost are unlikely to be of the magnitude, nor the variability, to provide the missing explanation.

8. I am not able to comment in any detail on the interaction between UK and European energy markets.

9. The main regulator, OFGEM, has in my opinion focused on developing the prerequisites for competitive operation of the generation and supply markets, rather than on micromanagement of these markets. It therefore focuses on market-driven solutions to perceived problems in supply. It has also eagerly embraced the NETA and BETTA arrangements it devised for trading electricity. In part because other European nations have more of a "command and control" approach to energy supply, the UK may be more exposed to price movements in the market.

10. I am not able to comment on the issue of fuel poverty, save to note that the proportion of consumers of electricity who are on Prepayment terms is quite high.

March 2008

Memorandum submitted by Dominic Whittome

CONTRACT PRICE FIXING

Since August last year, forward gas prices in the wholesale market have risen by over 70%. This is in spite of an abundance of gas in Northern Europe. The increase has had little to do with "security of supply" because forward North Sea gas reserves estimates have not altered in this short period. Yet wholesale prices of *long-dated* gas deliveries are continuing to rise as major gas producers continue to fix their long-term contract prices to oil. This contractual fix has driven forward prices to levels much higher than would otherwise have been the case. Consequently, North Sea gas and UK electricity prices have been driven higher by the price of OPEC crude.

In recent years, gas producers and importers appear to have *aligned their wholesale supply policies*. Forward price rises in the wholesale market have been *exaggerated* as a result. A full examination of company trading policies will reveal signs of *co-ordinated behaviour* in the wholesale market. Gas producers have acted collectively in gradually curtailing their forward trading activities. Instead, producers have marketed an increasing and disproportionate percentage of their principal gas volumes on secret, off-market, long-term contracts.

Many, though not necessarily all, of these long-term contracts involve contractual indexation to crude oil and petroleum products. But, *whether the gas price in these long-term contracts is indexed to oil or not*, the dominance of off-market trading undermines the influence of open trading in wholesale market.

This adverse effect on forward pricing competition transgresses into power generation, where output electricity prices are driven by input gas prices. The effect then feeds down to the commercial and retail markets for both gas and electricity.

SECRET CONTRACTS

The long-term contracts in question are negotiated bi-laterally between large users, utilities and international producers. They effectively *seal the gas out of the* forward market for contract terms ranging generally from 10 to 20 years.

Today over 80% of the gas initially sold into the UK and 90% on the Continent is contracted under long-term, off-market contracts. Not only does this action withhold forward price and volume information from market participants but the predominance of long-term contracts also “crowds out” forward gas trading that would otherwise take place; where the “trading multiplier” make the market impact considerable.

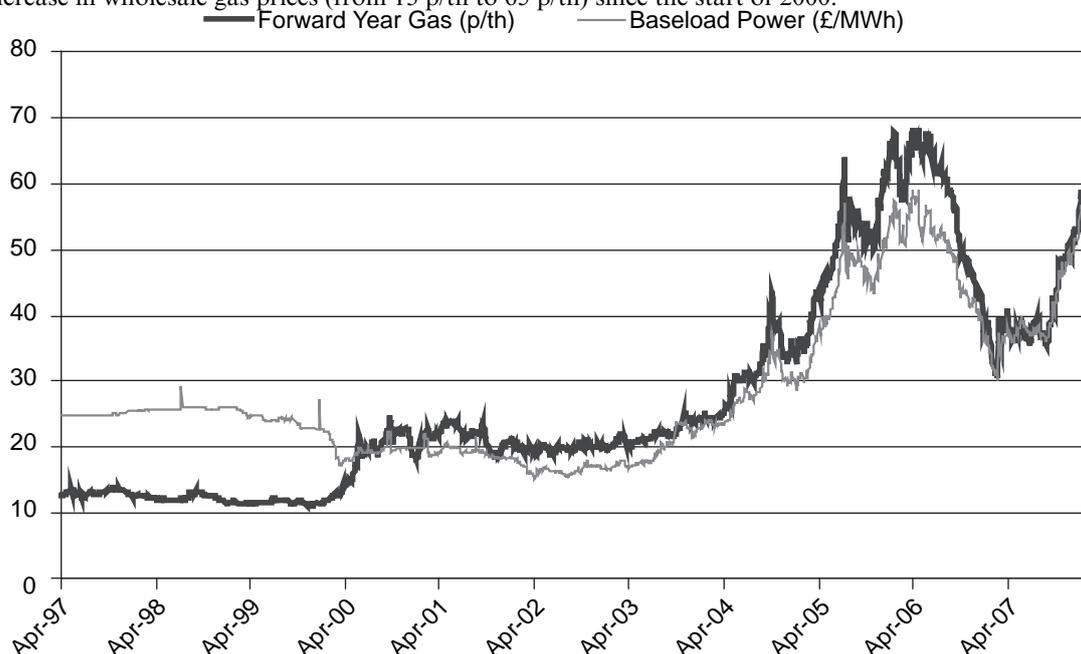
A proper investigation should expose the fact that, over the past seven or eight years, gas majors and importers have been selling an ever reducing fraction of their *long-dated* gas volumes, ie dated one year forward or longer, on the forward market and selling a correspondingly higher fraction on long-term contracts.

The disproportionately high volume sold off-market is a major problem from the point of view of efficiency. Consistently higher-than-optimal prices may not be the result of decisions made by individual traders but by the gas producing companies who—wittingly or unwittingly—having synchronising their policy decisions.

COPYCAT STRATEGY

The convergence of wholesaling policies has had *the effect* of greatly constraining liquidity in the long-dated wholesale market. The dearth of forward trading in large volumes has reduced wholesale price transparency (where posted long-dated prices are indicative, estimated or non-existent). It has also increased market volatility, which in turn has significantly increased the price premium, ie on top of the already exaggerated forward prices, which the producing supplier can levy on gas consumers who need to fix their price one year forward or more. Consequently, some gas buyers will purchase a swap from a merchant bank, although that is a further unnecessary cost they then incur.

The inquiry must identify what the individual wholesaling policies of major gas producers are; assess the extent to which these company policies coincide; and ascertain whether these policies have been converging. In short, are we witnessing copycat behaviour in the supply policies of the producers. In the background, we have seen in a 180% increase in forward-year power prices (from £21/MWh to £59/MWh) and a 400% increase in wholesale gas prices (from 13 p/th to 65 p/th) since the start of 2000.



CORPORATE MOTIVES

Duplicative gas supply policies, which promote off-market contracts as the principal (or only) platform for selling forward have *the effect* of supporting long-dated prices posted in the wholesale market. Higher wholesale gas prices not only boost the immediate profits of producers, they also *serve to safeguard the contractual integrity* of their long-term contracts. Restricting the liquidity in forward trading reduces the danger of any wide price discrepancy evolving between long-dated wholesale prices and long-term contract prices. Allowing these prices to get out-of-kilter would trigger calls from consumers and possibly regulators for some contracts to be re-negotiated, which producers should want to avoid at all costs.

TACIT COLLUSION

If we not concern ourselves—at least for now—about “price fixing” between individual gas traders, we should be concerned about any alignment of producer policies. Above all, the inquiry should explore the unwillingness of producers to sell a significant proportion of their gas openly, on the long-dated, forward market. In most cases, this proportion could be below a third and in some cases below 5%, quite possibly zero in one or two cases.

In the final analysis we may see a textbook example of tacit collusion whereby producers are not fixing prices directly but simply *acting rationally*; recognising in common the commercial interest in copying the other’s behaviour, *which replicates the effect of a price-fixing cartel*.

This *de facto producer boycott* of the forward market when it comes to selling gas on a long-dated basis will partially explain why wholesale gas prices have soared to the unprecedented levels that we see today, far above the levels that would otherwise be achieved in an efficiently-operating market, where actual gas supply and demand fundamentals will determine the forward price.

ELECTRICITY MARKET IMPACTS

A proper inquiry should find evidence of producers reverting to long-term contracts for practically all their forward selling, trading only residual gas volumes on the wholesale market to support these long-term contracts’ flexibility commitments to the buyer. The consequential constraint on liquidity in the forward gas market has also affected electricity trading, where liquidity collapsed over the past two years. Only a minuscule percentage of power volumes are now traded more than six months forward on the UK Power Exchange as a result.

Despite Britain’s head start over its EU peers in terms of energy market liberalisation, forward liquidity in the Nordic and German power markets has already overtaken the UK’s and other European countries are closing in. Even in gas, industry insiders see the Dutch Title Transfer Facility replacing our own National Balancing Point (NBP) as the principal trading hub in North West Europe.

This meltdown in liquidity in our gas and especially power markets has coincided with weaker price transparency, soaring volatility and record “risk premiums” (ie over short-term delivery prices) in the forward market.

VICIOUS CIRCLE IN THE WHOLESALE MARKET

Constraints in forward trading have had multiple impacts on traded prices. First, reducing the availability of long-dated gas supplies posted for sale on the forward market puts buyers into a position where they have to compete (what appear to be) “scarce supplies”. This *tightens the market* generally and leads to higher prices than would otherwise be the case. Second, higher volatility and weak price signals make new entrants (eg large consumers, independent generators and energy merchants) wary of posted prices which deters them from entering the market. This reduces forward trading further and the liquidity problem becomes self-reinforcing. (Mergers between producers and exit of US merchants added to the problem of market concentration). Third, with the market is more volatile and allegedly “riskier” to trade in, the incumbent producers are then able to charge a higher “risk premium” to buyers, although producer policies contributed to this situation. A similar pattern may be prevalent in the power market, but as gas prices affect electricity and not vice-versa, the root problem with producers of gas needs tackling first.

PROFITS IN PERSPECTIVE

Today we see a widening gap between the pre-taxes supply cost of gas delivered into the UK (at 15 p/th \pm 30%) and the wholesale price (at 65 p/th), which suggests a *nominal and pre-tax* profit margin of around 50 pence per therm.

To put the producers’ profits into perspective, we can make a back-of-an-envelope calculation by simply estimating the total profits of producers who just supply gas as far as the wholesale market viz. the beach terminal and no further. We can exclude the cost of flexible volume or “swing gas” for which producers will charge a premium. Assuming the UK consumes on average 130 million th per day in a year, the nominal profit shared by the handful of producers = 130, 000,000 th/d x 365 days x 50 p/th = £ 24 billion gross.

This rough estimate shows just how high the stakes are and the sensitivity of producers to any change in the status quo. This same is probably true of any Exchequer in light of the high tax take involved. At the moment however, supra-normal profits for the club of producers who export gas to the UK is assured; nearly all the equipment is in place and is operating, as are the long-term contractual arrangements which provide the income stream outlined above. Producers have no commercial incentive to advocate changes or foster the development of a wholesale market that may facilitate price discovery and expose any discrepancy with long-term contract prices. So this market is unlikely to correct itself without a proper investigation that would show that a problem exists.

CONCLUSION

The most recent charge in the wholesale market has seen gas and power prices rise by 300% and 200% respectively versus five years ago. Long-term supply & demand fundamentals alone should not explain increases of this magnitude. Two main factors are responsible for this anomaly. First, the fixing of gas prices to oil in most long-term gas contracts agreements and second the adverse effect on liquidity in the forward market caused by long-term contracts generally, by their oil-indexed or not.

These two anti-competitive practices might be resolved jointly, by obliging producers to release pre-contracted gas into the open market, albeit at the expense of gas tied up under legacy long-term contracts. In addition, wider measures to promote free-market trading of gas on an over-the-counter basis could be introduced, so more gas is sold on standard, re-tradable contracts. Such remedies, which a Competition Commission investigation should be equipped to identify, will be key to resolving the problems which still exist in the wholesale gas and power markets, some 15 years after privatisation.

It is odd perhaps to see so much attention placed on the retail gas market, where profit margins per therm are comparatively small (possibly negative in the case of some utilities) and where prices are ultimately dictated by the wholesale market. Further, the question of competition *within the wholesale market* itself is not included in the terms of reference of the Ofgem inquiry although it is to be covered by the BERR inquiry.

Whatever motive, design or co-incidence explains the policies of gas producers towards the wholesale market, seemingly synchronised behaviour is having *the effect of a price support operation*. Because of the complexity of the long-term contracts in question and the cartel-type impact on competition, the multinational producers concerned should be referred to the Competition Commission. A start can then be made to identify why we are seeing exaggerated gas and electricity prices posted in the wholesale market.

The Competition Commission is the appropriate body to act, having been set up specifically to deal with such cartel questions under the Enterprise Act. Due to numerous energy mergers and acquisitions in recent years, the final number of gas producers in question may be comparatively small. However, all the companies concerned will have UK gas shipper licences and many will also be UK domiciled. In either case, English law applies to them just like any other entities selling goods and services within the UK.

Whatever producer practices are distorting market competition, householders and industry are in urgent need of answers. A fully independent investigation by the Competition Commission will deliver this and it may well throw light on some early market remedies as well.

April 2008

Memorandum submitted by Professor Philip Wright and Dr Ian Rutledge

WHY THE RE-INTRODUCTION OF PRICE CONTROL REGULATION IS THE ONLY REMEDY WHICH WILL WORK FOR DOMESTIC ENERGY CONSUMERS

SUMMARY POINTS FROM EVIDENCE

Our first conclusion responds to the Committee's questions about the competitiveness of the UK's retail energy markets. We believe that our evidence demonstrates two main points: (a) that the market structure which has evolved is anti-competitive and (b) that any amount of switching by retail consumers has and will fail to change this. In particular, litmus tests for the anti-competitiveness of the market structure are not only concerned with market concentration. As we demonstrate in considerable detail, the companies involved in the market have arranged their affairs so that they can sustain high and rising profits *whatever the level of their final prices to households and small businesses*. Corroboration of this and of the ineffectiveness of switching is that companies can be observed to make more money with lesser number of customers—hardly a punishment for causing their customers to switch.

A second conclusion addresses the Committee's concerns about wholesale markets. Our evidence demonstrates how UK households are paying higher gas and electricity prices as a result of the increased uncertainty which liberalised wholesale gas markets entail and reflect, imposing an insurance premium on

consumers which is highly sensitive to the actual and perceived risks of shortfalls in supply over winter months. Moreover, policy has contributed to this problem by failing to ensure that sufficient gas storage be built in a timely fashion.

Our third conclusion identifies areas of regulatory oversight. Apart from the anti-competitive structure of the UK's domestic gas and electricity markets, there is also evidence of actual anti-competitive *behaviour*. There is evidence of both gas prices to households being raised by more than might be justified by increasing wholesale prices and of electricity consumers being discriminated against. While this evidence is from one company, this is only because there is only one company which discloses sufficient information to consider these issues. All companies have the ability to vary the mark-up on wholesale, transportation and supply costs, according to market conditions and specifically, to discriminate between gas and electricity customers in order to protect the overall margin; only lack of company-sourced data prevents us from ascertaining how frequently other supply companies exercise this option.

Our final conclusion is that it is the domestic consumer who is most vulnerable to the deployments of companies' market power which we have identified—the domestic consumer is at the end of the chain and thereby the ultimate recipient of price risk as it is passed down the chain. However, this does not also mean that we see a remedy in the break up of the portfolios which companies have built up in order to manage their risks. Indeed such a break-up could have serious consequences for prices if it increased uncertainty and undermined the capacity of supply companies to contract for eg the large volumes of imported gas which the country will increasingly require. Instead we would propose the re-introduction of price control regulation as the only way of ensuring that households and small businesses are not exploited. Moreover, it may well be, bearing in mind the large investments in electricity generation capacity which companies are being supplicated to undertake, that rate of return regulation would be a better option than the previously favoured price-cap form of price control regulation.

WHY THE RE-INTRODUCTION OF PRICE CONTROL REGULATION IS THE ONLY REMEDY WHICH WILL WORK FOR DOMESTIC ENERGY CONSUMERS⁴⁰⁶

This evidence directly addresses the first 6 out of the 7 questions posed by the committee. It only addresses fuel poverty policy by way of the remedy suggested for addressing market structure and market power.

1. THE SYMPTOMS OF PROBLEMS IN THE UK'S ENERGY MARKETS

Rising Consumer Expenditure on Gas and Electricity

Between January 2003 and December 2006, the expenditure by UK households on electricity and gas increased by 71.7% whereas over the same period the consumption of these domestic fuels fell by 4.2% (Table 1). Since then, price reductions during 2007 have been followed by further increases in early 2008 and it therefore seems likely that total expenditure will have increased further since the publication of the data in Table 1.

Table 1

EXPENDITURE ON AND CONSUMPTION OF ELECTRICITY AND GAS BY UK HOUSEHOLDS

	<i>Expenditure £m</i>			<i>Consumption GWh</i>		
	<i>Electricity</i>	<i>Gas</i>	<i>Total</i>	<i>Electricity</i>	<i>Gas</i>	<i>Total</i>
2003	7,660	6,260	13,920	115,761	386,486	502,247
2004	9,120	8,285	17,405	115,526	396,411	511,937
2005	10,205	9,195	19,400	116,811	384,009	500,820
2006	12,375	11,520	23,895	116,449	364,555	481,004
% Change 2003–06	61.6	84.0	71.7	0.6	–5.7	–4.2

Source: Digest of UK Energy Statistics, Tables 1.1.6, 4.2 and 5.2

The onset of this rapid increase in the burden of household expenditure on fuel which has pushed an additional 2.5 million households into “fuel poverty” (*Financial Times* 2008a) has broadly coincided with the final removal of all domestic price regulation (April 2002). In short, full “competition” has been accompanied by rapidly rising fuel prices. Moreover, there are strong indications that household expenditure on electricity and gas is likely to increase further as we move into the next decade, with even more serious implications for household fuel poverty—an issue we shall return to briefly in the concluding section of this evidence.

⁴⁰⁶ The domestic market for energy supply is variously described as “retail” (of which it is a part), “household” or “residential”. In our evidence we use “domestic” to refer to the residential or household sector of the retail market (the other part of the retail market consists of small businesses and other organisations paying posted retail tariffs)—except when quoting company documents where we retain their original vocabulary.

Gas and Electricity Prices Rise Faster than Inflation

Figures 1 and 2 subtract the annual rate of inflation from the annual increase in gas and electricity prices and the black-shaded columns therefore show the extent to which gas and electricity prices have been rising faster than inflation. Since the complete deregulation of all domestic gas and electricity prices the story has mainly been of these prices rising faster than inflation (rising in “real terms”): whereas the previous regulatory regime generally resulted in consistently falling real prices. Let it also be said at this stage that any solace which OFGEM and BERR may take from any one of the possible country rankings (permutations in euros, purchasing power parity, with or without various taxes, for particular groups of consumers) of UK domestic gas and electricity prices in EU league tables is misplaced: in particular, unlike most other EU states our gas has mainly been supplied from our own offshore resources not imported by pipeline from Siberia and by ship from other places more distant than the UKCS. We should therefore expect to have gas among the cheapest in Europe. As far as domestic electricity prices (excluding taxes) are concerned the UK is consistently more expensive than the “unliberalised” markets of France and Greece, and the latest Eurostat data place the UK above the EU average.

Figure 1

UK DOMESTIC GAS PRICES AND INFLATION

FIGURE 1: GAS PRICES TO DOMESTIC CONSUMERS 1986 - 2007

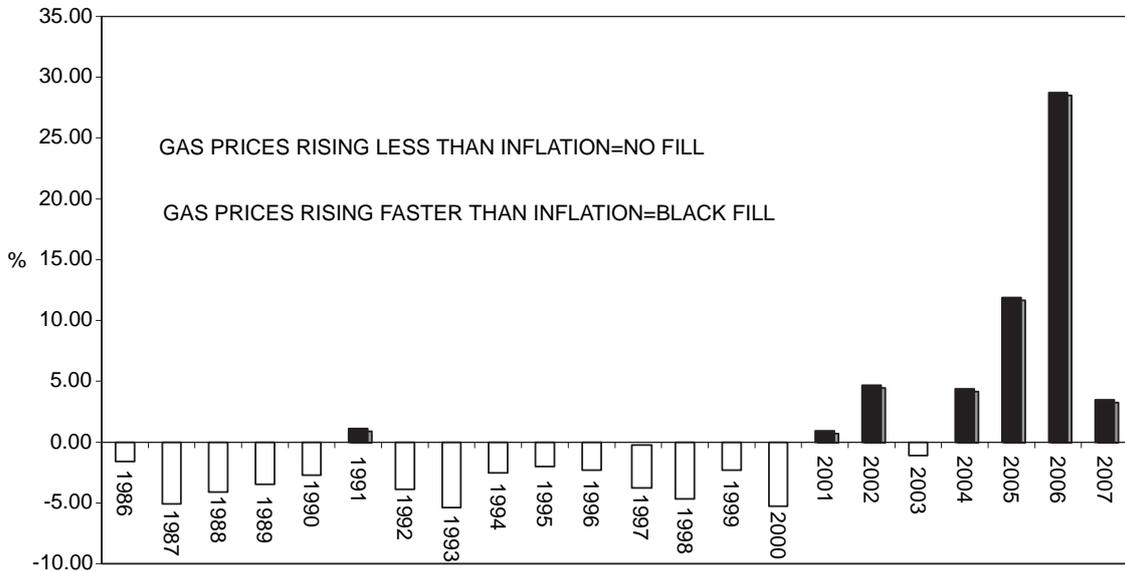
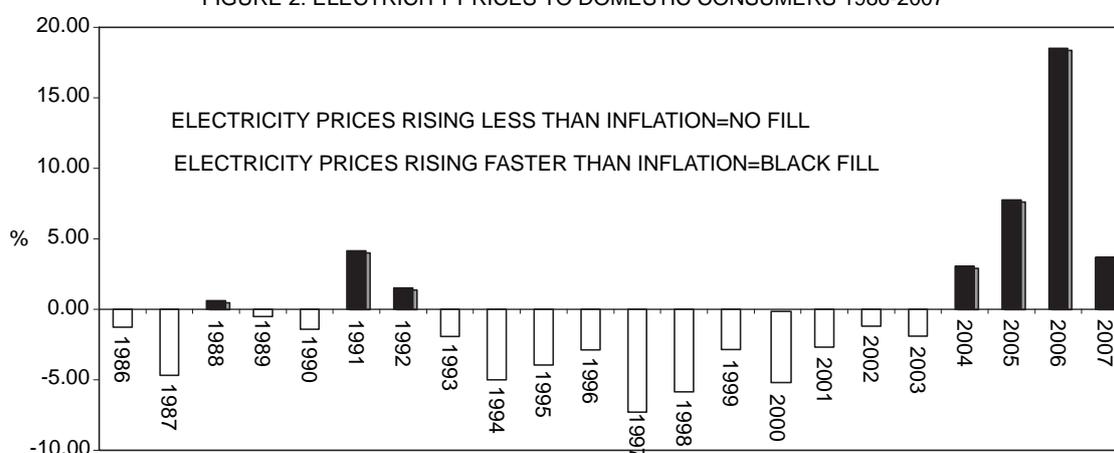


Figure 2

UK DOMESTIC ELECTRICITY PRICES AND INFLATION

FIGURE 2: ELECTRICITY PRICES TO DOMESTIC CONSUMERS 1986-2007



Source for Figures 1 and 2: *BERR Quarterly Energy Prices*, Table 2.1.1

Note: the gas and electricity prices used in constructing these Figures are the RPI fuel components exclusive of VAT

Company Profits Increase Despite Flat Demand

While consumers have been experiencing the pain of these price increases, energy company profits have been growing strongly (Table 2). Moreover, while some companies possess regulated gas and electricity transmission and distribution businesses, it is profits from their non-regulated businesses in the “competitive” part of the market which have been growing most rapidly (Tables 3 and 4).

Table 2

TOTAL OPERATING PROFITS OF THE DOMESTIC ENERGY SUPPLY COMPANIES FROM ALL THEIR UK ENERGY BUSINESSES, 2003–2006/07

	2003	2004	2005	2006	2007
Centrica plc	872	989	1,335	1,198	1,745
EDF Energy plc	517	521	587	647	n/a
E.ON UK plc	583	642	741	710	778
RWE npower	496	411	299	348	496
Iberdrola (Scottish Power)	495	597	739	955	n/a
SSE plc	680	790	887	1,081	n/a
Total	3,643	3,950	4,589	4,939	n/a

Sources for Tables 2, 3, and 4: see Appendix for sources and methodology

Notes: As with all the succeeding tables containing company-sourced information, the data have been aligned so that there is maximum overlap between the different financial years used by the companies: data from those companies with financial years ending in March have been aligned with data from those whose financial year ended the preceding December, eg the year ending March 2007 is aligned with the year ending December 2006.

Table 3

OPERATING PROFITS OF THE DOMESTIC ENERGY SUPPLY COMPANIES FROM THEIR REGULATED BUSINESSES, 2003–2006/07

	2003	2004	2005	2006	2007
EDF Energy plc	394	392	415	484	n/a
E.ON UK plc	155	323	350	334	349
Iberdrola (Scottish Power)	394	416	525	524	n/a
SSE plc	318	325	373	349	n/a
Total	1,260	1,456	1,662	1,691	n/a

Table 4

OPERATING PROFITS OF THE DOMESTIC ENERGY SUPPLY
COMPANIES FROM THEIR NON-REGULATED BUSINESSES, 2003–2006/07

	2003	2004	2005	2006	2007
Centrica plc	872	989	1,335	1,198	1,745
EDF Energy plc	126	164	151	117	n/a
E.ON UK plc	402	499	539	586	522
RWE npower	496	411	299	348	496
Iberdrola (Scottish Power)	101	181	214	431	n/a
SSE plc	363	466	523	740	n/a
Total	2,360	2,709	3,061	3,420	n/a

Between 2003 and 2006, the total operating profits from UK energy operations of the 6 domestic energy suppliers increased by 35.6%. For the three companies for which 2007 data is available the increase between 2003 and 2007 was 54.7%. Operating profits from regulated operations (electricity and gas distribution) increased by 34.2% between 2003 and 2006 while operating profits from non-regulated operations (gas production, electricity generation, gas storage, energy trading, energy supply to all customers, energy-related services), increased by 44.9%.

Relating these substantial increases in operating profit to the post-tax, post-net interest earnings attributable to the companies' shareholders is more difficult. Only three of the above companies provide sufficiently comparable data on this subject. Moreover data for the year 2007 is currently only available for one company (Centrica). Since such data relates to *all* the companies' operations including foreign and non-energy operations we can only interpret the figures with considerable caution. With these caveats in mind, Table 5 displays post-tax "adjusted" earnings per share ("adjusted"—as with the operating profit data shown above—meaning before exceptional items and re-measurements of certain derivatives) and the proportion of their total operating profits contributed by UK energy operations.

Table 5

ADJUSTED EARNINGS PER SHARE (PENCE) AND PROPORTION OF TOTAL
OPERATING PROFIT ATTRIBUTABLE TO UK ENERGY OPERATIONS, 2003–07

	2003	2004	2005	2006	2007
Centrica	16.80p (80.4)	20.00p (80.6)	18.20p (88.2)	19.40p (83.1)	30.60p (89.5)
Scottish Power	36.40p (43.0)	36.20p (89.9)	44.10p (88.7)	47.17p (85.7)	n/a
SSE	55.30p (88.2)	62.80p (88.5)	72.90p (89.8)	92.50p (89.5)	n/a

Source: Annual Reports and Accounts of Centrica plc, Scottish Power Ltd, Scottish Power plc and SSE plc
Note: The data in parentheses are the proportions of total operating profits contributed by UK operations.

From this data we can conclude that aggregate earnings per share for the three companies in question increased by 46.6% between 2003 and 2006, while Centrica's EPS increased by 82.1% between 2003 and 2007.

2. EXPLANATIONS FROM OFGEM AND BERR

In response to the substantial real price increases experienced by UK domestic consumers and in particular the evidence that "Britain's vaunted competitive energy market—often held up to other EU states as a model—is not serving all parts of society". (*Financial Times*, 2008b) OFGEM and the Department for BERR have, in a variety of different documents over the past few years, advanced the following propositions:

- (1) The UK's domestic energy market remains highly competitive as evidenced by customers switching suppliers (OFGEM, 2006a; 2006b) and the fact that, measured by a range of additional structural indicators (regulated third party access to transportation infrastructure, transparent wholesale markets etc) the UK has the "most competitive" energy market among the EU and G7 countries (BERR/OXERA, 2007a; 2007b). By implication therefore, *the steep rise in domestic energy prices cannot be attributed to any particular structural features of that market or the exercise of market power on the part of the supply companies.*
- (2) While certain environmental charges have necessarily been added to the retail price of gas and electricity, *the primary cause of fuel price inflation has been the substantial increase in wholesale electricity and gas prices* with the rising gas price feeding through to electricity prices via gas-fired electricity generation (OFGEM, 2006a). We are therefore invited to infer that the companies which supply gas and electricity to domestic customers are themselves the "victims" of these wholesale price increases, a proportion of which they reluctantly pass-on.

- (3) *UK wholesale gas prices only increased because they became linked to “unliberalised” oil-price indexed prices* in mainland Europe as a result of the physical linkage of markets via new pipelines and the fact that the UK has recently become a net gas importer (OFGEM, 2006a).

Bearing in mind these explanations we shall now investigate the issues of concern to the BERR Committee enquiry, starting with the fundamental question of the nature of competition in the UK’s energy markets. To what extent has the structure of the UK domestic energy supply industry become intrinsically uncompetitive and is there evidence that this structure has resulted in actual uncompetitive behaviour?⁴⁰⁷

3. MARKET STRUCTURE AND COMPETITION IN THE DOMESTIC MARKETS FOR GAS AND ELECTRICITY

Initial Expectations

At the time when the UK domestic energy supply industry was moving from regulation to competition (1996–2002) it was generally envisaged that the market would become dominated by a large number of independent “pure” supply companies,⁴⁰⁸ and that prices would continue to fall and generally, remain low in historical terms. The business would be intrinsically a risky one for the competing companies, but they would be able to hedge their purchases and sales in what was expected to be a deep and liquid futures and forwards (OTC) market. In the event this “deep and liquid” secondary market failed to materialise, partly because of the disappearance of the “mega-BTU marketers” like Enron and TXU who would have constituted the substantial counter-parties required, had they survived. Nevertheless, competition in the UK’s domestic energy supply business did appear to deliver decreasing real gas and electricity prices during the years 1997–2002. However, the extent to which competition *per se*, was responsible for these exceptionally low prices has been greatly exaggerated; these were also years of excess energy supplies worldwide and the specific characteristics of energy privatisation and liberalisation in the UK led to a massive over-production of gas during the earlier part of this period (IEA, 1998) and a massive over-capacity in electricity generation in the latter part (Rutledge, 2007). The “asset-sweating” regulation of transmission and distribution was also responsible for delivering a large part of the reductions in prices which domestic consumers experienced at this time.

However, this transient success from a consumer perspective also drove a company response concerned to create an industry structure which would mitigate the risks associated with the combination of over capacity, extreme exposure to price risk and very low (and volatile) wholesale market prices. This new structure “could not be described as anything other than a vertically-integrated oligopoly” (Helm 2003, p 311).⁴⁰⁹ As we shall see, this characterisation by Helm has become even more appropriate since 2003. More important though is how it has functioned to the detriment of domestic consumers.

The Development of Oligopoly since 2000

Oligopoly—the domination of a market by a small group of companies—developed in the UK energy supply industry over a relatively short period of time (2001–04). In 2000 there were 28 gas suppliers licensed to operate in the domestic market of Great Britain, 16 of which were said to be “active”. Similarly there were 20 licensed electricity supply companies of which 13 were “active”. (OFGEM, 2001a).

Commenting on this relatively happy state of affairs and having observed that, “the number of competing suppliers and changes in the number can be a useful indicator of the degree of competition”, OFGEM noted that:

“Since October 2000, the number of licences granted to . . . suppliers has increased significantly. This can be mainly attributed to the entrance of new companies into the market, which will effectively serve to aid the development of competition”. (OFGEM, 2001a, p 61)

However within a mere three years, a dramatic industry concentration had taken place. According to one industry source, by 2004, just six supply companies served 95% of the domestic and small business electricity sector, while the same six companies served 99% of the domestic (only) gas and electricity sectors. The same source described the market as “highly concentrated” (EDF, 2004). Today those same six companies dominate the totality of the domestic gas and electricity markets.

⁴⁰⁷ In this respect we adopt the traditional “structure-conduct-performance” paradigm of industrial economics, see Sawyer (1985).

⁴⁰⁸ A “supply” company is one that simply buys energy wholesale and sells retail without having any other midstream or upstream energy operations. Sometimes the term “marketing company” is used as an alternative.

⁴⁰⁹ Although, the originally state-controlled energy monopolies were broken up (or encouraged to break-up) in the years after privatisation it was highly predictable, according to “transaction cost” theory, that such an industry would soon seek new modalities of concentration and re-integration; see Rutledge (2007).

Table 6

NUMBER OF ACTIVE DOMESTIC ENERGY SUPPLIERS
IN GREAT BRITAIN 2000–06

	2000	2006
Active Gas Supply Companies	16	6
Active Electricity Supply Companies	13	6

Source: OFGEM (2001a), OFGEM (2006b)

Since, as we have noted, OFGEM regards “the number . . . and *changes in the number*” (our emphasis) of supply companies as “a useful indicator of the degree of competition”, it is difficult to see how OFGEM or anyone else can avoid the logical conclusion that the UK domestic energy supply business has become much less “competitive” than it was in eight years ago.

From this we cannot conclude *a priori* that the six UK domestic energy supply companies are able to use market power to raise retail prices above levels which are putatively competitive. There are four potential constraints on oligopolies exercising such market power. Firstly, if the market for the particular commodity being supplied is price-elastic (a percentage increase in price results in a larger percentage fall in demand) the incumbent companies would be constrained from raising prices by the expectation of lower total revenues. Secondly if there are few barriers to entry, even a small dominant group of companies might fear that raising prices—and profits—will attract new entrants who would drive prices back to lower levels. Thirdly, if each company in the oligopoly has reason to believe that if it unilaterally increases prices the other companies will refrain from following and it will consequently be “left out on a limb” losing significant market share (and profit), this *individual* company fear will inhibit the oligopoly *collectively* from exercising its potential market power. Finally, a fourth potential constraint on the exercise of market power by an oligopoly is the government and its agencies: if the companies have reason to believe they will be punished—whether by some kind of “windfall tax” or price control—if they increase prices above levels which are generally considered by society to be “reasonable”, they will obviously refrain from doing so.

Unfortunately, in the case of the UK domestic energy supply industry none of these four constraints apply. Firstly, domestic consumer demand for gas and electricity is highly inelastic—we all require a certain minimum level of heating, warmth and light whatever their prices: there are no substitutes for these “commodities”. Neither can we hedge by switching between the different fuels: if electricity were to suddenly be offered to us at a much lower price we cannot switch our gas central heating systems or gas ovens to electricity except in the very long-term.⁴¹⁰

Secondly, in today’s highly concentrated domestic supply industry there are formidable barriers to entry: the six incumbent companies have spent considerable sums investing in the latest technology to handle millions of customers (Centrica’s bill for this was around £200 million). In order to compete with the incumbent six companies a new entrant would have to make the same kind of investment virtually overnight while at the same time offering retail prices which were substantially below all the existing suppliers. This kind of scenario can reasonably be discounted.

With respect to the third caveat, on every occasion that one of the companies has raised its domestic electricity and gas prices the others have, sooner or later, followed. They may have raised prices by different amounts and at slightly different times, but this herd-like behaviour is now so well institutionalised that none of the companies has any fear that by raising prices it will become isolated and thereby lose *significant* market share.

Fourthly, so far, and based on previous experience, the companies would appear to have absolutely no reason to fear that the State will intervene if they raise prices. Such an intervention has only occurred once (the 1997 Windfall Tax) and this was primarily a response to the manner in which the energy companies had been sold off cheaply at privatisation. It should also be noted that since then, the Government, OFGEM and BERR have repeatedly eulogised the UK’s *laissez faire* energy industry model. They are deeply committed to it as an ideological project. Any intervention in the market by these bodies would therefore be interpreted as an acknowledgement that the model has failed. This view seems to be confirmed by the failure to announce any serious attempt to restrain domestic energy prices in the March 2008 Budget.

Gas Storage

Some final remarks should be added regarding the market structure of natural gas storage. This sector was originally regulated as part of British Gas Corporation plc, and subsequently BG plc but in 2000, gas storage (with the exception of LNG storage) was de-regulated in the erroneous belief that the sector was potentially competitive. (It wasn’t because the three existing storage facilities had very different technical profiles such that they can not compete with one another). In 2000–01 OFGEM required the two largest facilities, Rough and Hornsea, to auction their storage space and at the time the prices received at the auctions were exceptionally low. Subsequently BG plc sold both facilities which by 2002 had passed into the

⁴¹⁰ We discuss the price elasticity of demand for individual supply companies below.

hands of Centrica and SSE respectively. By the following year, these two facilities accounted for around 88% of total UK gas storage space (Wright, 2006, p 31) but in reality, Centrica (Rough) controlled 100% of long-term (seasonal) storage space while SSE (Hornsea) controlled 69% of mid-term storage space. In effect the former was now a monopoly and the latter the dominant player in a market which contained only two other very small players, Scottish Power (Hatfield Moor) and EDF (Hole House). Once it became evident that the UK's own gas supply was rapidly depleting and the country was becoming dependent on imports, storage prices more than trebled. In short, this sector remains almost totally uncompetitive and the consequent rapid rise in storage prices has contributed to the upward movement of domestic natural gas prices.

Oligopoly plus Vertical Integration

Responding to the extremely difficult market conditions experienced by the UK energy industry in the years 1997–2001 as described above, by 2002 a wave of disposals and acquisitions had largely taken place which resulted in an industry which was highly integrated both horizontally and vertically. By 2007 this had produced an industry structure as illustrated in Figure 3.

Figure 3

UK ENERGY INDUSTRY COMPANY PORTFOLIOS 2007

Company	Companies with Domestic Supply Operations								
	Upstream			Mid-Stream			Downstream		
	Gas Production	Electricity Generation	Wholesale Trading	Transmission	Distribution	Gas Storage	Non-Domestic Supply	Domestic Supply	
Centrica (British Gas)	g	e	g e			g	g e	g e	
SSE		e	g e	e	g	g	g e	g e	
Iberdrola (Scottish Power)		e	g e	e	e	g (minor)	g e	g e	
E.ON UK	g (minor)	e	g e		e	g (Minor)	g e	g e	
RWE npower		e	g e				g e	g e	
EDF Energy		e	g e		e	g (minor)	g e	g e	
Company	Companies without Domestic Supply Operations								
	Upstream			Mid-Stream			Downstream		
National Grid				g e	g	g			
British Energy		e	e				e		
Drax Group		e	e(minor)				e		
International Power		e	e				e		
Others	g	e	g e		g		g e		

Source: Author research. "Others" includes major upstream gas producers, small electricity generators and independent suppliers to non-domestic customers

Note: g indicates ownership of gas assets; e indicates ownership of electricity assets

The principal exceptions to this trend were British Energy plc (nuclear power) and National Grid plc (formed out the merger of BG Transco (gas transmission) with the National Grid Company (electricity transmission). National Grid is prevented by its licence from owning energy supply companies (and visa-versa) and this has been the only form of vertical integration proscribed by the Government, OFGEM and BERR. It is argued that such "ownership unbundling" allows fully effective third party access to the transmission sector which in turn enables vigorous supply competition to take place. As we shall see, this confidence in the creation of a hypothetically competitive industrial structure for the UK's energy market has been entirely misplaced.

If one wishes to understand the working of the UK domestic energy market and the prices emanating from that market then the crucially important form of vertical integration is not that between transmission and supply but between "upstream" (gas production and electricity generation) and "downstream" supply as we shall now demonstrate.⁴¹¹

Table 7 shows the extent of "physical" integration between these two segments for Centrica, the only company which is a significant gas producer while Table 8 shows the extent of physical integration between electricity generation and small customer supply for each of the six domestic electricity suppliers.

⁴¹¹ The BERR/OXERA report referred to above which affirms that the UK has the "most competitive" energy market in the EU/G7 countries virtually ignores the question of vertical integration. Only a brief reference to the subject suggesting practical difficulties in obtaining data is included in Section A3.3 of the report (BERR/OXERA, 2007a, p 72).

Table 7

RATIO OF OWN GAS PRODUCTION TO DOMESTIC GAS SUPPLY VOLUMES (CENTRICA), 2003–07

	2003	2004	2005	2006	2007
Centrica	0.50	0.53	0.46	0.31	0.42

Source: Centrica plc, *Annual Reports and Accounts*

Table 8

RATIO OF OWN ELECTRICITY GENERATED TO DOMESTIC AND SME ELECTRICITY SUPPLY VOLUMES, 2003–2006/07

	2003	2004	2005	2006	2007
Centrica	0.34	0.46	0.47	0.61	0.86
EDF Energy	n/a	n/a	n/a	1.28	n/a
E.ON UK	n/a	1.2	1.31	1.32	1.32e
Scottish Power	n/a	n/a	n/a	0.90	n/a
RWE npower	1.51	1.44	1.50	1.64	1.52
SSE	n/a	n/a	n/a	1.77	n/a

Sources: see Appendix

Notes: SME = Small & Medium Enterprises

Supply volumes for Centrica: domestic customers only

Supply volumes for EDF: domestic and SME customers

Supply volumes for E.ON: domestic customers only

Supply volumes for Iberdrola: all customers (excluding “exports” to England)

Supply volumes for RWE npower: domestic and commercial customers

Supply volumes for SSE: domestic and SME customers

From Table 7 it can be seen that Centrica can supply between 31 and 53% of its “British Gas” domestic gas consumers. However, there is some indication that Centrica is finding it harder to satisfy this sector from its own resources and the company is known to be searching for additional gas reserves through acquisitions.

Table 8 shows the extent to which the companies’ own electricity generation operations can cover the requirements of their domestic and SME customers. In the case of both Centrica and E.ON UK, by 2006–07 the in-house generation assets of these two companies could supply 86% and 132% respectively of the requirements of their domestic (only) electricity supply customers. With respect to the remaining four companies, the supply data relate to both domestic and SME customers but since the percentage of their domestic and SME customers’ requirements covered by the companies equity generation ranges from 90% to 177% it seems fairly clear that they can easily serve the needs of their domestic customers alone from their own generation.

That the companies see this kind of vertical integration as being very important is evident from remarks taken from company documents. For example, referring to its UK operations in 2004, EDF Group states that its strategy was:

“to develop a vertically-integrated operation by acquiring an electricity generating capacity which would fully cover its residential clients, seeking to optimise the total margin between Sales Revenue and Production”. (EDF, *Document de Base 2004*, p 136)

By 2006, it had achieved this objective, stating:

“The output from EDF Energy’s generation plants broadly covers the customer demand from EDF Energy’s SME and residential customers, while demand from large business customers . . . is covered through wholesale market purchases”. (EDF, *Document de Reference, 2006*, p 72)

Similarly, although it has clearly not reached the degree of vertical integration achieved by EDF, Centrica states that:

“Upstream we will continue to pursue the ideal integration position to support a business with our levels of demand in gas and electricity”. (Centrica, *Annual Report & Accounts, 2005*)

Indeed, all six of the UK energy supply companies have, on various occasions, stated that vertical integration is their objective.

Using Vertical Integration to Control Profit Risks

The motivation for this kind of vertical integration is clear: in the absence of sufficiently deep and liquid financial hedging markets, the companies have resorted to physical hedging instead—vertical integration provides that physical hedge as the companies themselves have stated. Thus for, example, in 2003, having recently acquired Powergen, E.ON stated:

“Powergen’s exposure to low wholesale electricity prices in the UK is partially hedged by the balance provided by its recently expanded retail business”. (E.ON AG, *Annual Report on Form 20-F*, 2003, p 76)

However, two years’ later, with market conditions considerably changed, the company notes that, “E.ON UK’s exposure to [rising] wholesale prices in the UK is partially hedged by its retail business”, while on the same page stating,

“In response to these increases in wholesale prices UK suppliers including E.ON increased their retail electricity prices a number of times during 2005”. (E.ON AG, *Annual Report on Form 20-F*, 2005, p 62).

In similar vein, EDF states that:

“Due to the vertically integrated nature of the Group, the electricity demand from the retail business provides a natural hedge for the electricity procured from the generation business. (EDF Energy plc, *Annual Report & Accounts*, 2005, p 27)

while in the same report EDF UK states:

“Despite exceptional rises in the energy market prices in 2005, the Group has managed to limit the rise of its energy costs to 29% compared to a market rise of 67% in gas and 70% in electricity on year (price rises based on average day ahead prices on the spot market between 2004 and 2005). The Group has achieved this through vertical integration and a hedging strategy implemented together with EDF Trading, a sister organisation of the Group”. (EDF Energy plc, *Annual Report & Accounts*, 2005, p 2).

Taking this “textual” evidence together, we can draw the following conclusions:

- (1) When wholesale electricity prices are falling steeply (as in 2002) vertically integrated companies can increase the profits of their supply businesses by maintaining retail prices to domestic customers at existing levels, or perhaps lowering them only after a considerable lag, or by only a small proportion of the wholesale price decline. The latter also appears to have been the case with Centrica and falling wholesale gas prices in the first part of 2007.
- (2) When wholesale prices are rising steeply, companies can pass on all or part of this burden to their retail domestic customers who are effectively, “captive” for a period of time. (And since all or most of the companies are raising their domestic prices, customers will be uncertain as to whether to “switch” and which supplier is likely to remain the most attractive for the foreseeable future.)
- (3) While companies may quote public domain wholesale prices in justifying their retail price increases, they may not actually be paying these prices (cf the above EDF quotation.). Indeed, in general, wholesale prices today, this week or this month do not reflect the cost of gas delivered today, this week or this month. Suppliers contract for their gas years and months ahead of the gas delivery day and also use different contracts for different supplies. This means the cost of the gas delivered today is the weighted average cost of a contractual portfolio of gas prices stretching into the past—and this may bear no relationship at all to current wholesale prices.

However, even where companies appear to be increasing retail prices to domestic customers less than might be considered “justifiable” in the light of the wholesale price increase—*indeed even if they may claim quite honestly that their retail businesses are making a loss*, as a consequence—as was recently claimed by the Chief Executive of E.ON UK plc, (*Financial Times*, 2008d)—vertical integration of the kind described above may enable the company as a whole to profit from such a situation as we shall now demonstrate.

Vertical Integration in Action (1): An Example from Electricity

As we have seen, it appears to be the objective of all the companies supplying the domestic electricity market to be able to achieve 100% vertical integration with their generation operations: in other words if their domestic supply market is 25 TWh per year, they require (and indeed, have mostly achieved) upstream capacity capable of generating 25 TWh per year. Any excess of electricity generation over this level can be sold into the considerably more competitive industrial and wholesale markets where they have less market power.

Table 9

PROFIT PERFORMANCE OF COMPLETELY VERTICALLY-INTEGRATED DOMESTIC
ELECTRICITY SUPPLIER c 2005

<i>Generation Segment</i>		<i>Supply Segment</i>	
Electricity Generation	24,544,320MWh	Electricity Supply Sales to Domestic Customers	24,544,320 MWh
Sales to Supply Business			
	<i>Millions</i>		<i>Millions</i>
Revenues	£928.6	Revenues @ 75.36/MWh	£1,849.7
Fuel Cost	£539.5	Wholesale Costs	£928.6
Other Costs	£180.9	Transportation Cost	£493.0
Operating Profit	£208.2	Supply cost + profit	£428.1
Margin %	22.4	Supply cost	£400.4
		Total Costs	£1,822.0
		Operating Profit	£27.7
		Margin % =	1.5

Source: Drax Group plc Annual Report & Accounts 2005 (for generation segment data), Centrica plc, Annual Report & Accounts 2005 (for supply segment data).

Note: in 2005, the net electricity generation of the Drax Group (23.2 TWh) was broadly similar in magnitude to the electricity volume of Centrica's domestic supply business (25.4 TWh). In the circumstances we have not felt it necessary to make any proportional adjustments to the Drax-based data for revenues, costs and profits as these would be unlikely to make any material difference to the argument.

In this theoretical company (but where the figures are based on industry data) the supply segment purchases all its wholesale electricity from the Group's generation segment; visa-versa the generation segment sells all its output to the supply segment. We believe the profit margins are more or less typical for the industry at this time—22.4% for generation and 1.5% for Supply. Total Profit is £208.2 million + £27.7 million = £235.9 million with an overall margin on external revenue (that of the supply segment) of 12.8%.

We now assume a 30% rise in all wholesale prices. The charge for electricity by the generation segment to the supply segment increases to £1,207.2 million while, at the same time, the fuel costs of the generating segment, rise from £539 million to £701.4 million (we assume the other costs remain as before). Since the wholesale electricity cost charged to the supply segment only originally accounted for 50.2% of the supply segment revenues (£926/£1849.7), the maximum "justifiable" increase in the domestic retail price would be $30\% \times 0.502 = 15.06\%$.⁴¹²

However, let us also assume that, in the interests of public relations the company decides that its supply business will raise retail prices by only 12%. Then the profit performance is as shown in Table 10.

Table 10

PROFIT PERFORMANCE OF COMPLETELY VERTICALLY-INTEGRATED DOMESTIC
ELECTRICITY SUPPLIER c 2005 AFTER 30% INCREASE IN WHOLESALE PRICES

<i>Generation Segment</i>		<i>Supply Segment</i>	
Electricity Sales	24,544,320 MWH	Electricity Sales	24,544,320 MWh
	<i>Millions</i>		<i>Millions</i>
Revenues	£1,207.2	Revenues	£2,071.7
Fuel Cost	£701.4	Wholesale Costs	£1,207.2
Other costs	£180.9	Transportation Cost	£493.0
Operating Profit	£324.9	Supply Cost + profit	£371.5
Margin %	26.9	Supply Cost	£400.4
		Total Costs	£2,100.5
		Operating Loss	-£28.9
		Margin % =	-1.4

Since the prices (and revenue) of the supply segment have only increased by 12% while the cost of the wholesale electricity charged to the supply segment has increased by 30% (and assuming the other costs remain as before), the supply business records a loss of £28.9 million while the supply segment margin has fallen from 1.5% to -1.4%. However the total operating profit of the vertically-integrated operation has actually increased from £235.9 million to £296.1 million (£324.9-£28.9) while the total margin on external sales has risen from 12.8% to 14.3% (£296.1 x 100/£2,071.7).

⁴¹² The question of what is a "justifiable" pass-through of wholesale to retail price is discussed further in Section 5 of our evidence.

It must be emphasised that this example is an “ideal type” used for explanatory purposes; it does not represent a real company. Nevertheless it demonstrates very clearly how vertically integrated companies can benefit from the same rising wholesale prices which they blame for “loss making” in their downstream business.

Other things being equal, we would expect a company which has many levels of vertical integration to have more opportunities to follow this strategy than those which have fewer or no such vertical structure. Certainly the evidence that non-integrated energy companies are at a disadvantage in this respect is illustrated by Drax Group whose operations comprise one very large coal-fired power station which is totally exposed to the vagaries of the wholesale markets and in 2007 was caught by falling electricity prices and rising coal costs such that its operating profit (before exceptionals and re-measurements fell by 16% (from £548 million to £462 million), (Drax Group, *Preliminary Results*, 2007) while the operating profits of the three other companies which have published 2007 results (Centrica, E.ON UK and RWE npower) all saw their profits increase.

Vertical Integration in Action (2): Centrica plc

Given the number of vertical integration tiers in Centrica’s portfolio of UK energy businesses (see Figure 3), we should expect it to have the more possibilities for successfully controlling its profit risk. This expectation is fulfilled.

Table 11

CENTRICA’S OPERATING PROFITS FROM UK ENERGY OPERATIONS, BY SEGMENT, 2001–07

<i>Financial Years ending December £million</i>	<i>Centrica’s Profits from its UK Energy Businesses (Operating Profit before Exceptional Items and Remeasurements)</i>						<i>Total UK Energy Operating Profit £ million</i>	<i>% Increase in Operating Profit</i>
	<i>British Gas Residential Gas & Electricity</i>	<i>British Gas Homes Services</i>	<i>British Gas Business</i>	<i>Wholesaling & Trading</i>	<i>Gas Production</i>	<i>Gas Storage</i>		
2001	-46	n/a	44		573	n/a	571	
2002	218	61	65	72	447	1	864	51.3
2003	136	84	51	81	480	40	872	0.9
2004	249	95	64	-61	573	69	989	13.4
2005	90	111	77	-117	1,020	154	1,335	35.0
2006	95	102	87	-178	864	228	1,198	-10.3
2007	571	151	120	234	429	240	1,745	45.7
Total Profit 2001–07	1,313	604	508		4,417	732	7,574	

Source: Centrica plc, *Annual Reports & Accounts*

How Centrica’s portfolio works for the company is illustrated in Table 11, which shows the locus of profits moving between its different energy businesses. In 2005, for example, a year of high gas prices, Centrica made very large profits from its gas production and relatively little from its domestic customers. In 2007, in contrast, upstream profits were much lower and these were exceeded by a 500% increase in profits from domestic customers as falling wholesale prices were not passed on to consumers. In between, 2006 might appear to be an exception, a year in which the upward surge in profits faltered. However, in 2006 Centrica reduced its gas production by 37% due to “management decisions to carry out remedial work on South Morecambe’s cooler units during an extended summer maintenance period and our decisions to switch off the field in response to low intraday gas prices especially in the fourth quarter of the year” (Centrica Annual Report & Accounts 2006, p 15). If production had been maintained at 2005 levels profits could have been as much as £1,370 million. In addition Centrica has clearly benefited by adding an increasingly important “midstream” segment to its business—gas storage. Remarkably, profits from this essentially monopolistic segment (see our previous remarks) actually made twice as much money for Centrica in 2007 than the company’s energy sales to businesses.

Nevertheless, although Centrica has *more vertical integration tiers* than the other five domestic energy suppliers, we have also noted that *extent of vertical integration between those tiers* is less than the others (See Tables 7 and 8). Indeed, although it is the only company with a substantial gas production tier, in 2007 its own gas supplies only provided 42% of the volumes required by its domestic customers while its own generation volumes, having increased substantially during the past few years, still only covered 86% of its domestic customers demand. This suggests that the company may have more to gain by increasing its final energy prices and preserving its domestic segment margins than other companies which are better positioned to take advantage of the kind of scenario illustrated in Tables 9 and 10. On the other hand, Centrica also emerges as more of an upstream company than a gas and electricity supply company: 68% of its accumulated profits between 2001 and 2007 came from its upstream and midstream operations.

Switching as Countervailing Power for Domestic Consumers?

It has already been noted that OFGEM and BERR believe that in spite of the development of oligopoly the gas and electricity industry which serves domestic customers remains highly competitive because there is evidence of considerable customer switching between the six suppliers.

In fact, other things being equal, the UK domestic fuel market *ought to be* highly competitive: because although there are no substitutes for the products sold by the domestic fuel supply *industry* as a whole and therefore we would expect the *industry's* price elasticity of demand to be very low, this is not the case for each *individual supplier*. Here we see the exact opposite: there are perfect substitutes for each individual company's product and we should therefore expect the price elasticity of demand for each company's products to be very high indeed.

In other words—and this is the narrative which OFGEM and BERR would have us believe—each company will raise its gas and electricity prices above those of its competitors at its peril: if it does so it will rapidly lose its customers (because a perfect substitute is available), sales volumes will fall as will revenue and profits.

Unfortunately we only have data from two companies, Centrica and E.ON UK, which are sufficiently detailed and disaggregated to examine the validity of the OFGEM/BERR narrative. Table 12 provides data on Centrica's domestic gas market revenues, sales volumes, customers and prices and the annual changes in these variables between 2001 and 2007.

At first, the data look broadly consistent with the OFGEM/BERR narrative. In 2002 the gas price increases by 7.6% over the year compared with the average for 2001, the company loses 4.5% of its gas customers, sales volumes fall by 12.3% and revenues by 5.6%. The responsiveness of demand for the company's gas to the change in price (% change in sales volume divided by % change in price) is moderately elastic: a 1% increase in price results in a 1.63% fall in sales volume. However, the following year (2003) the pattern begins to change: an average annual price increase of 1% only results in a 0.8% fall in sales. Thereafter, until 2007, the pattern is completely inconsistent with the OFGEM/BERR narrative: the price elasticity of demand falls well below unity and as low as 0.26 in 2004. In that year the price increases by 11.8%, the company loses 6.5% of its customers; however sales volume only fall by 3% and revenue actually increases by 11.4%. The same pattern broadly continues for the succeeding two years. Indeed, in 2006, Centrica's gas price increases by a massive 28.6%, but customers and volumes only fall by 7.8 and 7.9% while revenues increase by a substantial 15.2%. Only in 2007 does the pattern revert to the Ofgem/BERR narrative: a very small annual increase in price (part of which is actually a price reduction) is accompanied by a 2.4% fall in customers while both volumes and revenues fall by 11.1%. The only problem with this account is that this was the year in which the company made a record profit of £571 million from its domestic gas and electricity business.

Table 12

CENTRICA, DOMESTIC GAS MARKET DATA AND PRICE ELASTICITY, 2001–07

	2001	2002	2003	2004	2005	2006	2007
Revenue from domestic sales £m	4,029	3,805	3,742	4,170	4,196	4,832	4,296
Domestic gas sales TWh	260.6	228.4	226.6	219.7	194.8	179.3	159.4
Domestic gas customers (000s)	13,451	12,839	12,590	11,771	11,131	10,263	10,018
Weighted average domestic gas price p/therm	43.80	47.12	47.57	53.16	61.16	78.66	79.26
Annual change in domestic gas revenue %		-5.6	-1.7	11.4	0.6	15.2	-11.1
Annual change in domestic gas sales (TWh) %		-12.3	-0.8	-3.0	-11.4	-7.9	-11.1
change in number of domestic gas customers (000s)		-612.0	-249.0	-819.0	-640.0	-868.0	-245.0
Annual change in domestic gas customers %		-4.5	-1.9	-6.5	-5.4	-7.8	-2.4
Annual change in domestic gas price %		7.6	1.0	11.8	15.0	28.6	0.8
Price Elasticity of Domestic Gas		1.63	0.85	0.26	0.76	0.28	14.56

Sources: Centrica plc, *Annual Reports and Accounts 2001–06*, Centrica plc *Preliminary Annual Accounts 2007*

Notes: The price changes shown are simply changes in the average annual price disclosed by Centrica: in reality price changes did not occur at year-end but took place (sometimes more than once) within the calendar year. The price elasticity of demand is given as: $-(\Delta q/q \times 100) \div (\Delta p/p \times 100)$ where p is the

average annual domestic price, q the quantity of gas sold and Δ the change in price and quantity; the minus sign is added in the formula because it is conventionally assumed elasticity should have a positive value whereas it is also conventionally assumed that an increase in price is associated with a decrease in quantity sold (a downward sloping demand curve).

Indeed when we compare the pattern of change in Centrica's total customer numbers (gas and electricity) with the change in operating profit from domestic sales throughout the whole period 2001–07 we observe no particular relationship whatsoever (Table 13).

For example, in 2002 Centrica lost 1% of its customers but its operating profit increased by 1,047%; in 2003 it gained 0.8% more customers but its operating profit fell by 37.6%; and in 2004, when the company registered its second biggest drop in customers (5.6%) its profits increased by 83.1%. In other words, as a profitability “driver” customer numbers (and hence the significance of “switching”) appear to have been almost totally irrelevant for this company.

Table 13

CENTRICA: CHANGES IN DOMESTIC CUSTOMER NUMBERS AND DOMESTIC ENERGY SUPPLY OPERATING PROFIT, 2001–07

	2001	2002	2003	2004	2005	2006	2007
Domestic gas customers (000s)	13,451	12,839	12,590	11,771	11,131	10,263	10,018
Domestic electricity customers (000s)	5,374	5,795	6,189	5,950	5,920	5,759	6,019
Total domestic customers	18,825	18,634	18,779	17,721	17,051	16,022	16,037
Annual change in total customers (000s)		-191	145	-1,058	-670	-1,029	15
Annual change in total domestic customers %		-1.0	0.8	-5.6	-3.8	-6.0	0.1
Domestic energy operating profit £m	19.0	218	136	249	90	95.0	571.0
Annual change in domestic operating profit %		1,047.4	-37.6	83.1	-63.9	5.6	501.1

Source: Centrica plc, *Annual Reports & Accounts*

Although the disclosure of E.ON UK's market data is considerably less detailed than that of Centrica, the same pattern of extremely low price elasticity of demand is also clearly apparent (Table 14).

Table 14

E.ON UK: DOMESTIC GAS AND ELECTRICITY MARKET DATA AND PRICE ELASTICITY, 2003–06

	2003	2004	2005	2006
Domestic gas sales TWh	51.2	51.5	54.1	52.4
Domestic electricity sales TWh	30.0	29.2	28.4	26.5
Domestic gas customers (000s)	2,527	2,673	2,656	2,649
domestic electricity customers (000s)	5,397	5,380	5,148	4,956
Annual change in domestic gas sales (TWh) %		0.6	5.0	-3.1
Annual change in domestic electricity sales (TWh) %		-2.7	-2.7	-6.7
Annual change in gas customers %		5.8	-0.6	-0.3
annual change in electricity customers %		-0.3	-4.3	-3.7
Annual change in domestic gas price %		18.5	11.9	47.0
Annual change in domestic electricity price %		16.4	7.2	30.0
Price elasticity of demand (gas)		-0.03	-0.42	0.07
Price elasticity of demand (electricity)		0.16	0.38	0.22

Sources: E.ON UK plc, *Annual Report & Accounts*, E.ON AG. *Strategy & Key Figures*, various years.

Note: Where, as in this case, there are two years where the elasticity value is negative this indicates a situation where a price increase is associated with an increase in the quantity sold. For 2003, only the combined sales volumes for Domestic and SME customers are disclosed by the company. We have assumed that domestic sales volumes would be the same proportion of the combined (Domestic + SME) total as in 2004.

In 2004 a substantial increase in the company's gas price (18.5%) is associated with an increase in both customers and sales volumes, while in 2005 another gas price increase during the year (11.9%) results in only a very small fall in customers but quite a large increase in sales (5%). And in 2006, huge increases in both gas and electricity prices are accompanied by proportionately much smaller falls in volumes sold. Throughout the whole period, the responsiveness of demand to price increases is highly inelastic.

The answer to this apparent conundrum of very low price elasticity of demand in an industry where the “competitors” are each selling a perfect substitute is fairly straightforward. Firstly, during the period in question, all suppliers have been increasing their prices making it difficult for consumers to understand (using OFGEM’s favourite metaphor) precisely “where to shop”. In any case, when OFGEM urges domestic consumers to “shop around” for cheaper suppliers, (as though buying domestic fuel supplies is like purchasing the family’s weekly vegetable requirements) it is using a totally inappropriate metaphor given that the transaction costs of time, trouble and legitimate fear of billing problems mean that customers are unlikely to “switch” more than once per year at most. Therefore, when a consumer commits to a particular supplier he/she is locking himself/herself into a an indeterminate price: the customer has no knowledge whether the price to which he/she has committed will remain constant or whether it will remain the best bargain. The position is not much better if the customer chooses to accept a fixed price contract where, again, the customer is having to gamble on whether the contract will remain the best one for the foreseeable future. Furthermore, to complicate matters for the consumer the supply companies are now beginning to offer additional non-energy price inducements (typical of oligopolistic “competition”): for example EDF Energy now offers its customers free “Nectar Points” for use at Sainsbury’s. It is therefore hardly surprising that consumers are confused and anxious when considering whether or not to switch supplier and that consequently price changes have only a limited impact on the volume of switching and sales volumes. Indeed, according to a recent study by Davies *et al.*, so confused were electricity consumers in 2000 that almost a third of switching consumers moved to a supplier that actually charged more than the incumbent; and by 2005 matters had barely improved: in that year only an eighth of consumers who switched to get lower prices chose the supplier who gave them the best deal (Davies *et al* 2007)

4. WHOLESALE GAS MARKET AND PRICES TO CONSUMERS

Turning now to wholesale markets, while we restrict our attention to wholesale gas markets these are of course also relevant to the electricity market via the use of gas in the UK’s gas-fired power stations.

A Home-Grown Problem

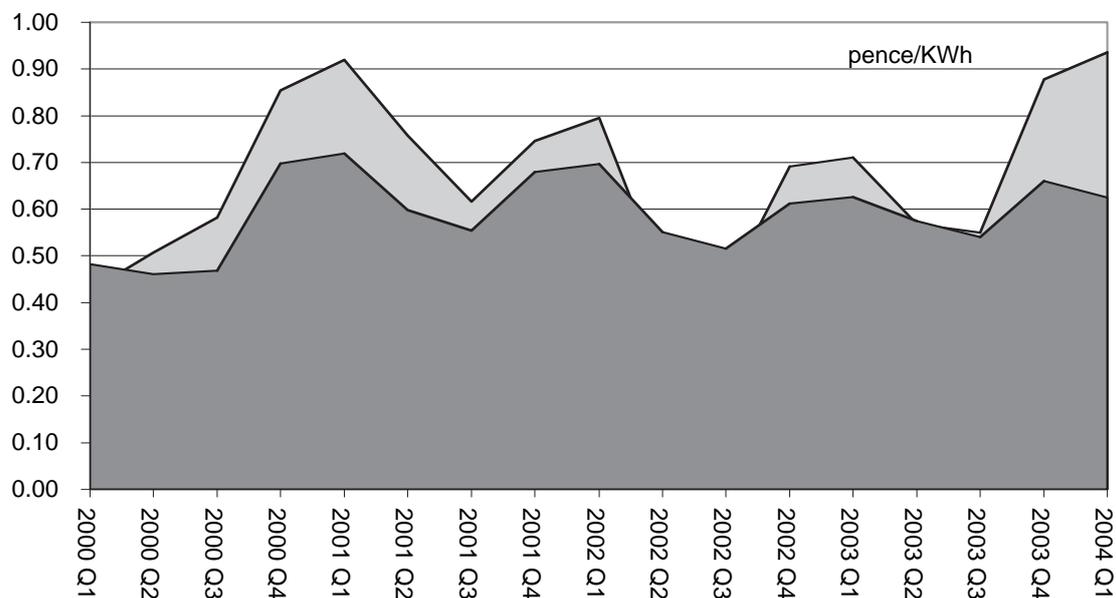
An oft-repeated contention of Ofgem and BERR is that the pricing of gas on the UK’s wholesale markets is deleteriously affected by the lack of liberalisation in continental Europe, in particular via the oil-indexed contracts which have been prevalent in the contracting for imported gas on the continent. A first point which may be made with respect to this contention is that there is a considerable body of research evidence that gas prices trend upwards with oil prices in liberalised markets without any linkage to “unliberalised” ones (Barcella, 1999; Serletis & Herbert, 1999; Asche *et al.*, 2006; Panagiotidis & Rutledge, 2007). These findings confirm the intuitive conclusion that gas prices are unlikely to spend long periods lagging behind movements in oil prices—*ceteris paribus*, producers are likely aspire to achieving prices in a similar range on a per joule basis and are not therefore likely to sell their gas at a discount to oil for any length of time.

These points mean that in order to explain the volatility and high levels of UK gas prices we have to look to more home-grown causes. Our view, explored at length by one of us in *Gas Prices in the UK* (Wright 2006), is that the behaviour of the UK wholesale gas prices is logically linked to the liberalisation of the UK market, which has at times delivered prices in excess of both the oil equivalent price and the price of gas on continental markets. Why this is the case has four basic ingredients: (a) the gas industry is frequently afflicted by physical disruptions in supply caused by breakdowns and other random events (b) in a liberalised market these everyday disruptions have immediate and dramatic reflection in wholesale market prices, not just because of the consequent shortfall in aggregate production, but also because market participants take positions to profit from the difficulties of the supplier or suppliers most affected by the disruption (c) because another aspect of gas market liberalisation has linked an increasing proportion of UK wholesale gas deliveries to these volatile short-term markets—contracts are increasingly “gas-indexed”—the prices signalled by the relatively small volumes traded in short-term markets therefore price much larger volumes of gas being sold into the market (d) because of the potential cost to individual suppliers of physical disruptions, particularly if they occur during the winter or just before the winter as stocks are being built up, futures prices can soar to dramatically high levels.

This last point, the cost of insuring prices in a liberalised gas market, is indicated in Figure 4. The figure is stacked with the blue-shaded area representing the “beach” or “upstream price” (average unit price received by producers of gas), while the red-shaded area shows the premium over the beach prices registered by the most commonly used index price for UK gas deliveries futures market—the Month-ahead price.

Figure 4

THE IMPACT OF FUTURES MARKET COSTS ON THE PRICE OF GAS



Source: adapted from Wright (2006, Figure 6.2, p 140)

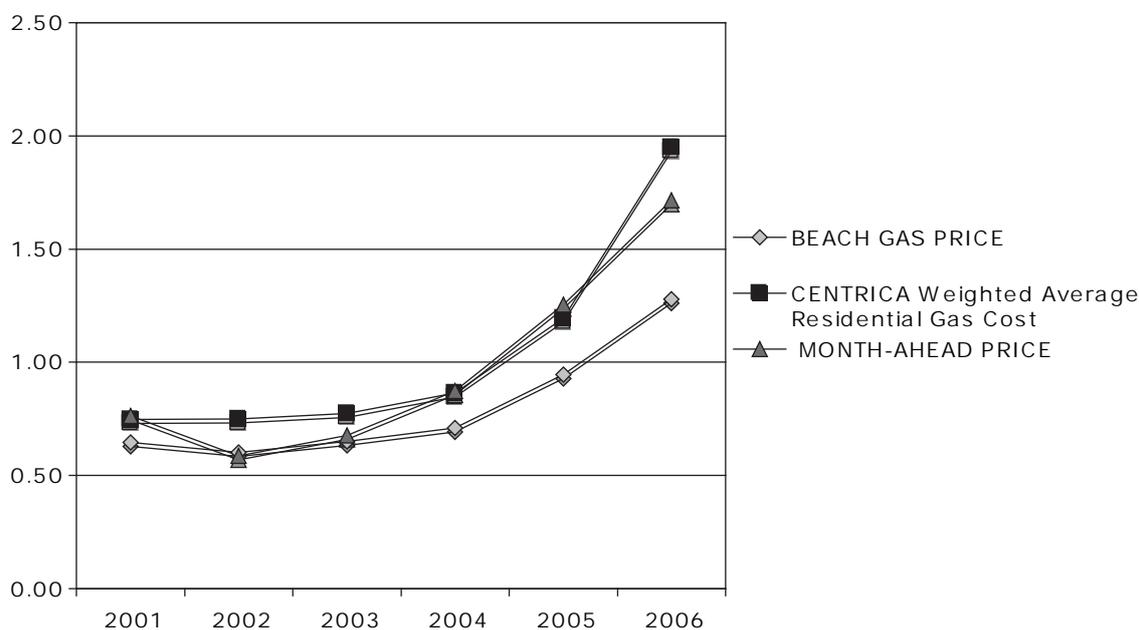
While a small part of the difference between these two price series may be explained by entry capacity charges (the Month-ahead price is for delivery to the UK's notional National Balancing Point—NBP—and therefore includes these charges for transportation), most of the difference reflects the additional costs imposed on consumers by liberalised gas wholesale markets. Traders buy and sell the risk of delivering the right amount of gas at the right time and this is reflected in a risk premium which increases the price. As well as providing traders with a source of profit, this premium also clearly escalates in winter months as both the risks of securing supply, and the costs of failing to do so, increase.

Another conclusion which may be drawn from Figure 4 is that at least until the first quarter of 2004, upstream producers were not responsible for driving the trend in UK gas prices in an upward direction—this was a function of the wholesale markets.

The fact that Figure 4 does not extend beyond the first quarter of 2004 is because BERR ceased to provide a quarterly beach/upstream price figure after that time. Subsequently, there is only an annual beach price to work with. Using this in Figure 5 it is compared with (a) the Month-ahead futures price and (b) the weighted average cost which Centrica states that it pays for gas to supply its domestic customers. While during the period beyond the beginning of 2004, the upstream price received by producers was clearly now playing a role in pushing UK gas prices upwards, the behaviour of the futures price was adding to this effect to a steadily increasing extent as the risk premium commanded by wholesale markets increased. Moreover, Centrica's gas costs, which comprise a portfolio of contracts with different time profiles, are shown to be similar to and sometimes exceeding the Month-ahead price.

Figure 5

WHOLESALE PRICES TO SELLERS AND BUYERS COMPARED



Sources: BERR, *Quarterly Energy Prices*, Table 3.2.1; Centrica plc, *Annual Reports & Accounts*; Heren Energy

5. RELATIONSHIP BETWEEN WHOLESALE AND RETAIL GAS PRICES

If the behaviour of wholesale markets already spells difficulties for consumers, these are compounded by the way the relationship between wholesale and retail prices may be manipulated.

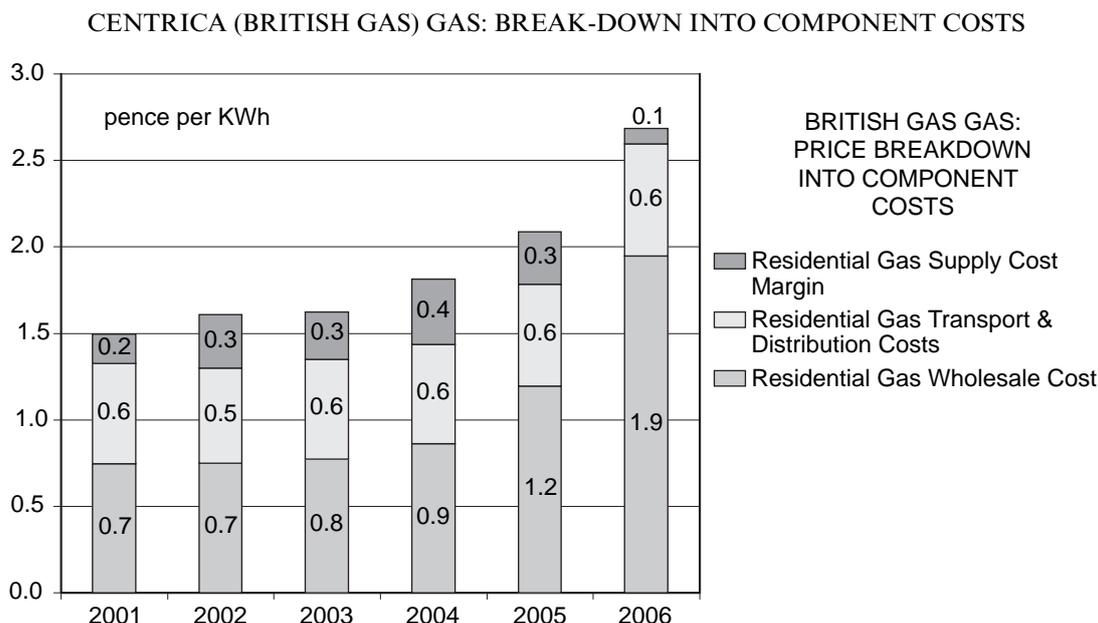
The relationship between wholesale market prices and retail prices is frequently discussed under two misconceptions. Firstly, it is suggested that if wholesale prices rise by $x\%$, then it is quite reasonable to expect retail prices to rise by the same percentage. Such an argument is implicit in a graph which appeared on the front page of the *Observer Business* section on 24 February 2008 and has also been peddled by OFGEM and recycled by the *Financial Times*.⁴¹³ In fact this supposition is entirely fallacious. Because wholesale gas prices, for example, only constitute around half of the final price of gas to domestic consumers, a wholesale price rise of say, 20%, could only be used to try and justify a 10% increase in retail prices. We say “try and justify” because if the gas and electricity retail markets were really competitive, cost pass-throughs to consumers could not be automatic. Secondly, as noted above, wholesale prices today, this week or this month do not reflect the cost of gas delivered today, this week or this month. Suppliers contract for their gas years and months ahead of the gas delivery day and also use different contracts for different supplies. This means the cost of the gas delivered today is the weighted average cost of a contractual portfolio of gas prices stretching into the past—and this may bear no relationship at all to current wholesale prices.

In order to be able to understand the relationship between wholesale prices and the final prices paid by domestic consumers knowledge of this weighted average cost of gas or electricity supplies is essential. Fortunately, one company (and only one of the Big Six) does disclose these costs and other data which makes it possible to decompose the domestic prices of gas and electricity into its three main cost components: the cost of the gas itself; the cost of transporting it to consumers; and the cost of marketing and billing for it (the so-called “supply cost”) *which also includes the company’s profit margin*.

From Figure 6 it can first of all be seen that the cost of transporting gas to households has been very stable since 2001, coming in at 0.6pence/KWh in every year apart from 2002. On the other hand, it is clearly the case that changes in the wholesale cost of Centrica’s gas have been a major driver of increases in prices. However, this is not the whole story: in both 2002 and 2004 it can be seen that changes in the supply cost (including profit margin) have also played a role. Moreover, such large increases were not caused by dramatic changes in the actual costs of marketing and billing, they were caused by increases in downstream profit margins: as price control were lifted in 2002 the profit margin on domestic energy sales was raised by Centrica from 0.4% to 4.2% and then in 2004 it was raised from 2.6% to 4.1% and according to the company’s preliminary 2007 results its profit margin on domestic energy supply has now risen to 8.8%.

⁴¹³ see OFGEM’s “Factsheet” No 66 (8/11/06), “Household Bills Explained”, later uncritically recycled by the *Financial Times* on 5 December 2006. Warwick University academics Waterson, Giulietti and Grossi also appear to be oblivious to this point in an article for *Power UK* (January 2008, p 60).

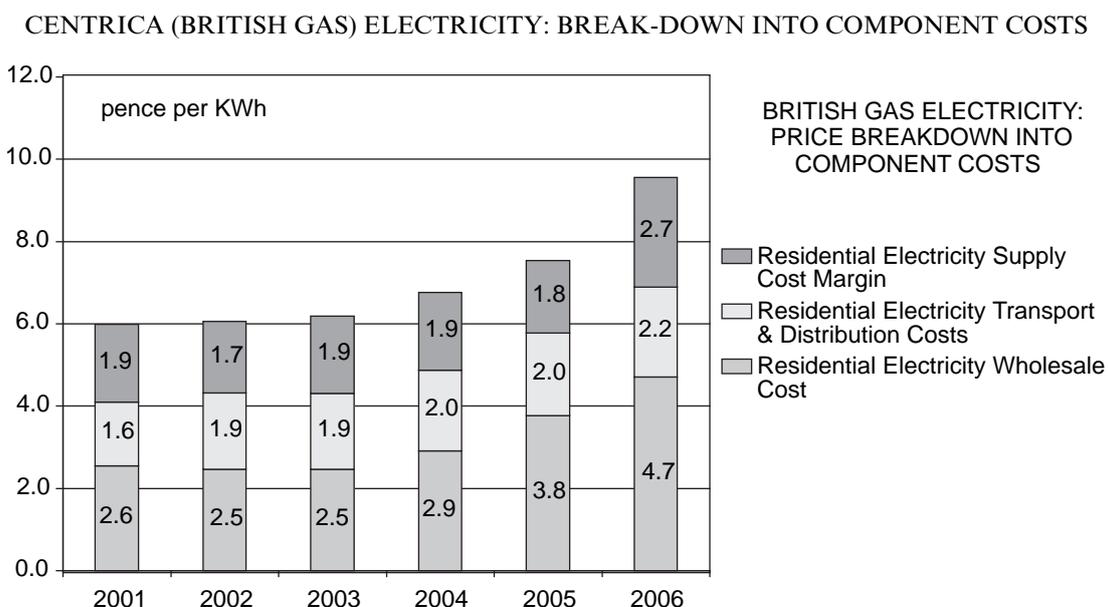
Figure 6



Source: Centrica plc, *Annual Reports & Accounts*

After 2004, in 2005 and 2006 (the data are not yet available to construct a 2007 breakdown) the gas supply margin was squeezed as increases in wholesale prices were not fully passed on to domestic consumers, particularly in 2006. However, this should not be seen as either an indicator of competitive pressure or a friendly gesture by Centrica to its customers. From Table 10 it can be seen that over these two years Centrica made £1,884 million in profits from its gas production arm, some 74% of its overall profit. Moreover, as Table 10 also shows that Centrica managed to maintain the profits from its domestic energy business roughly constant in between 2005 and 2006, a feat achieved at the expense of its electricity consumers. From Figure 7 it can be seen that the electricity supply cost margin suddenly leapt upwards in 2006, from 1.8 pence/KWh to 2.6 pence/KWh.

Figure 7



Source: Centrica plc, *Annual Reports & Accounts*

6. REGULATORY OVERSIGHT

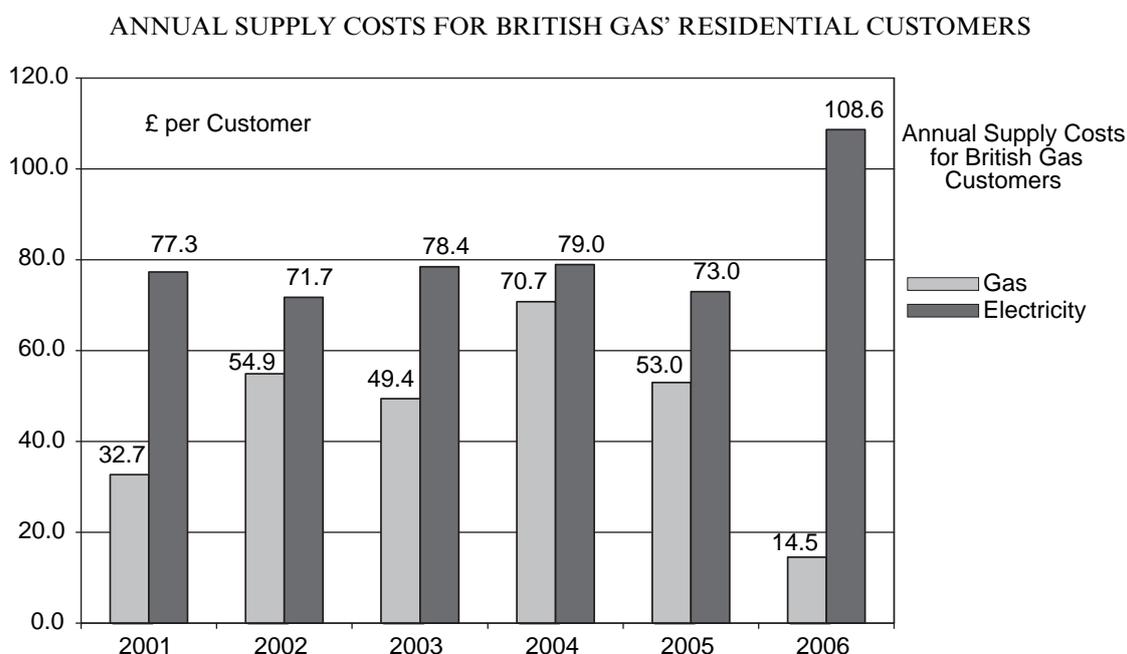
This last point also highlights an issue of regulatory oversight which Figure 8 brings into sharper relief.

While Figures 6 and 7 expressed supply cost margins for domestic gas and electricity in terms of pence/KWh supplied, Figure 8 converts these costs to an annual bill based on the average gas and electricity consumption levels of Centrica's domestic customers. This shows that the annual supply cost (marketing cost, billing cost and profit margin) of electricity had been relatively stable compared with gas supply costs between 2001 and 2006, fluctuating between about £71 and £79. Then suddenly, just as gas supply margins were facing a severe squeeze, electricity supply costs leapt to an average of £108.60 per customer.

Moreover, in this context it should also be noted that in 2001, Ofgem estimated the annual supply cost per electricity customer (excluding profit) as just £40 and £20 per gas customer (Ofgem, 2001b). Since 2001 companies have had to invest in new technology to deal with switching and other supply business demands; this may have increased the supply cost; on the other hand, the growth of dual-fuel customer billing will have worked in the opposite direction. On balance it seems unlikely that Ofgem's 2001 estimate of supply cost would have changed very much.

In other words not only do Centrica's levels of electricity and supply costs per customer seem substantially out of line with Ofgem's own estimates, but the dramatic hike in the electricity supply cost during 2006 is a levy on electricity customers constituting prima facie evidence of price discrimination against domestic electricity consumers.

Figure 8



Source: Centrica plc, *Annual Reports & Accounts*

7. UK AND EUROPEAN MARKETS: MYTH AND REALITY

To the great irritation of our European Union neighbours, who have chosen to manage the risks associated with the supply of gas and electricity to their citizens differently from the UK, Ofgem and BERR have been wont to hide behind a "blame it on Europe" smokescreen. They have also trained a small army of journalists to parrot this line of argument eg "The problem is not that suppliers are rigging their tariffs, but that wholesale prices are soaring and consumers here are forced to pay through the nose for gas imported from the Continent, where the market is opaque and uncompetitive". (*Observer*, 2008). Unfortunately, just like the view that the extent of "switching" reflects the degree of competitiveness in the market, this argument is also entirely fallacious. It is based on the non-sequitur that if the rest of Europe had more liberalised gas and electricity markets the UK's problems would evaporate, particularly because greater liberalisation would lead to the disappearance of oil-indexed contracts in the rest of Europe and therefore of the contaminating, Interconnector-delivered link with oil markets. In fact, it is highly unlikely that greater liberalisation of European markets would (a) lead to a reduction in the volume of gas covered by oil-indexed contracts many of which have only recently been signed with major producer nations and are not due to expire until the mid 2030s (Energy Charter Secretariat, 2007), or (b) even if it did, that the result would be to sever the link between oil and gas prices—as we have already noted, there is a body of research which suggests otherwise. Moreover, why would liberalisation not have similar effects in continental Europe to those which it had in the UK in 2005/6?

A separate issue affecting the relationship between the UK and continental gas markets, and which has nothing at all to do with perceived continental conspiracies to make the UK consumer suffer, is that the UK has painted itself into a corner by not building additional storage capacity commensurate with the country becoming a net importer of gas (see ILEX, 2005). The consequences of this shortcoming are starkly evident: during summer months the UK is exporting relatively cheap gas to the continent as other EU countries seek to establish winter security for their consumers, but then is being forced to buy it back at a premium when the country needs to import during the winter. If the UK had built sufficient storage it would not be exposed in this way: summer gas could go straight into storage in the UK, obviating the need to import during periods of potentially premium prices.

8. CONCLUSIONS

Our first conclusion responds to the Committee's questions about the competitiveness of the UK's retail energy markets. We believe that our evidence demonstrates two main points: (a) that the market structure which has evolved is anti-competitive and (b) that any amount of switching by retail consumers has and will fail to change this. In particular, litmus tests for the anti-competitiveness of the market structure are not only concerned with market concentration. As we have seen, the companies involved in the market have arranged their affairs so that they can sustain high and rising profits *whatever the level of their final prices to households and small businesses*. Corroboration of this and of the ineffectiveness of switching is that companies can be observed to make more money with lesser number of customers—hardly a punishment for causing their customers to switch.

Our second conclusion is that UK households are paying higher gas and electricity prices as a result of the increased uncertainty which liberalised wholesale gas markets entail and reflect, imposing an insurance premium on consumers which is highly sensitive to the actual and perceived risks of shortfalls in supply over winter months. Moreover, policy has contributed to this problem by failing to ensure that sufficient gas storage be built in a timely fashion.

Our third conclusion is that, apart from the anti-competitive *structure* of the UK's domestic gas and electricity markets, there is also evidence of actual anti-competitive *behaviour*. There is evidence of both gas prices to households being raised by more than might be justified by increasing wholesale prices and of electricity consumers being discriminated against. While this evidence is from one company, this is only because there is only one company which discloses sufficient information to consider these issues. All companies have the ability to vary the mark-up on wholesale, transportation and supply costs, according to market conditions and specifically, to discriminate between gas and electricity customers in order to protect the overall margin; only lack of company-sourced data prevents us from ascertaining how frequently other supply companies exercise this option.

Our final conclusion is that it is the domestic consumer who is most vulnerable to the deployments of companies' market power which we have identified—the domestic consumer is at the end of the chain and thereby the ultimate recipient of price risk as it is passed down the chain. However, this does not also mean that we see a remedy in the break up of the portfolios which companies have built up in order to manage their risks. Indeed such a break-up could have serious consequences for prices if it increased uncertainty and undermined the capacity of supply companies to contract for eg the large volumes of imported gas which the country will increasingly require. Instead we would propose the re-introduction of price control regulation as the only way of ensuring that households and small businesses are not exploited. Moreover, it may well be, bearing in mind the large investments in electricity generation capacity which companies are being supplicated to undertake, that rate of return regulation would be a better option than the previously favoured price-cap form of price control regulation.

The urgency of adopting some such measure to protect not just the fuel-poor but also the mass of low-to-middle income domestic energy consumers at a time when they are being squeezed by other inflationary pressures (in particular higher mortgage and food costs) is underlined by the fact that there is growing evidence that the supply companies are now anticipating a surge in wholesale electricity prices over the next five years as a result of an expected rapid decline in the capacity margin of UK electricity generation. For example, in 2006 RWE AG stated that, as a result of the shut-down of around 7 GW of nuclear capacity and 8.2 GW of coal-fired capacity (as a result of the Large Combustion Plants Directive) “a sustained increase in wholesale prices” will commence around 2011 (RWE, 2006, p 116). In 2007 the company made the same prognostication (albeit more euphemistically), anticipating that “market fundamentals” in the UK would soon lead to “a sustained return of value to the generation sector”. (RWE, 2007). It should be added that research commissioned by BERR itself points in the same direction: According to the Energy White Paper of 2007:

“In most scenarios examined, we see some decline in the amount of capacity that is in excess of expected peak demand between now and the middle of the next decade. As a consequence, we would expect to see an increase in electricity prices . . .” (DTI, 2007, p132)

However, in spite of the urgent need to address the serious social and economic problem of rapidly rising domestic fuel bills by regulatory intervention, we do not underestimate the possibility that after the years rising profits which they have enjoyed since regulation was abolished, the big six companies will strongly oppose any move back towards price control regulation for domestic consumers.

REFERENCES

- ASCHE *et al* 2006 Asche F, Osmunddsen P & Sandssmark M, "The UK Market for Natural Gas, Oil and Electricity: are they Decoupled?" *The Energy Journal*, Vol 27 No 2
- Barcella, 1999 Barcella M L, "The Pricing of Gas", *Oxford Energy Forum*, Oxford Institute for Energy Studies, May
- BERR, 2007 *Digest of UK Energy Statistics*, National Statistics, London
- BERR, 2007 *Quarterly Energy Prices*, National Statistics, London, December
- BERR/OXERA, 2007a *Energy Market Competition in the EU and G7, Final 2005 Rankings*, OXERA, Oxford, October
- BERR/OXERA, 2007b *Energy Market Competition in the EU and G7, Preliminary 2006 Rankings*, OXERA, Oxford, October
- Davies *et al*, 2007 Davies S, Waddams Price C & Whittaker C, "Competition Policy and the UK Energy Markets", *Consumer Policy Review*, Vol 17, No 1, January/February
- DTI, 2007 "Meeting the Energy Challenge", White Paper, DTI, CM 7124, May
- EDF, 2004 Electricite de France, *Document de Base 2004*, Group EDF, Paris
- Energy Charter Secretariat, 2007 *Putting a Price on Energy: International Pricing Mechanisms for Oil and Gas*, Energy Charter Secretariat, Brussels
- Financial Times, 2008a Parker G & Crooks E, Darling to curb big energy profits, *Financial Times*, 10/3/2008
- Financial Times, 2008a Pickard J & Crooks E, "Darling's voluntary energy levy seen as tax grab in disguise", *Financial Times*, 8/3/2008
- Financial Times, 2008c Crooks E, "Scottish & Southern holds prices", *Financial Times*, 19/1/2008
- Financial Times, 2008d Crooks E, "Eon chief hits out at 'myths' on profits", *Financial Times*, 7/3/2008
- Helm, 2003 Helm D, *Energy, the State and the Market: British Energy Policy since 1979*, Oxford University Press, Oxford
- IEA, 1998 *Gas Pricing in Competitive Markets*, International Energy Agency, Paris
- ILEX, 2005 *Storage, Gas Prices and Security of Supply*, ILEX Energy Consulting, October
- Observer, 2008 Sutherland R, Observer Business Section, 24 February
- Odell, 2006 Odell P R, "Britain's gas market model in radical need of overhaul", Letters, *Financial Times* 28/2/2006
- OFGEM, 2001a Review of Domestic Gas and Electricity Competition and Supply Price Regulation: Evidence and Initial Proposals, OFGEM, London, November
- OFGEM, 2001b *OFGEM's Analysis of Possible "Headroom" on Domestic Gas and Electricity Retail Supply*, OFGEM, London, 20 December
- OFGEM, 2006a "Household Energy Bills Explained", *Fact Sheet 66*, OFGEM, London, August
- OFGEM, 2006b *Domestic Retail Market Report*, OFGEM, London, March
- Panagiotidis & Rutledge, 2007 Panagiotidis T & Rutledge E J, "Oil and Gas Markets in the UK: Evidence from a Cointegrating Approach", *Energy Economist*, Vol 29
- Rutledge, 2007 Rutledge I D , New Labour, Energy Policy and "Competitive Markets", *Cambridge Journal of Economics*, Vol 31 No 6 November
- RWE, 2006 *RWE Facts & Figures 2005*, RWE AG
- RWE, 2007 *RWE Facts & Figures, 2007*, RWE AG
- Sawyer, M C, 1985 *The Economics of Industries and Firms*, Routledge, London
- Serletis & Herbert, 1999 Serletis A & Herbert J, "The Message in North American Energy Prices", *Energy Economist*, Vol 21
- Stern, 2006 Stern J, "Europe is not to blame for Britain's gas woes", *Financial Times*, 23/2/2006
- Wright, 2006 Wright P W, *Gas Prices in the UK: Markets and Insecurity of Supply*, Oxford University Press, Oxford, 2006

APPENDIX
COMPANY-SOURCED FINANCIAL AND OPERATING DATA

In constructing the tables containing company financial and operating data we have used the following sources:

Centrica plc: *Annual Report and Accounts*, 2001–2006, available:

<http://www.centrica.com/>

Centrica plc: *Preliminary Results for 2007*, available: <http://www.centrica.com/>

Drax Group plc, *Annual Report and Accounts*, 2005–2007, available:

<http://www.draxgroup.plc.uk/>

EDF Group, *Document de Base* 2004, and *Document de Reference* 2005–2006, available: <http://www.edf.fr/92053i/Home-fr/Meta-Plan/EDF-Group.html>

EDF Energy plc: *Annual Report and Accounts*, 2003–2006, available:

<http://www.companieshouse.gov.uk/>

E.ON UK plc, *Annual Report & Accounts*, 2003–2006, available:

<http://www.companieshouse.gov.uk/>

E.ON AG, *Annual Report & Accounts* 2003–2007, and *Strategy & Key Figures*, 2004–2006, available: <http://www.eon.com/>

E.ON AG, *Annual Report on Form 20-F*, 2003–2006, available:

<http://www.sec.gov/edgar.shtml>

RWE AG, *Annual Report and Accounts* 2003–2007 and *RWE Facts and Figures*, 2004–2007, available:

<http://www.rwe.com/generator.aspx/language=en/id=450/home.html>

Scottish Power Ltd, *Annual Report & Accounts* 2006–07, available:

<http://www.companieshouse.gov.uk/>

Scottish Power plc, *Annual Report & Accounts* 2003–04 to 2005–06, available as supplements to 20-F Reports at: <http://www.sec.gov/edgar.shtml>

SSE plc, *Annual Report & Accounts* 2004–05 to 2006–07, available:

<http://www.scottish-southern.co.uk/SSEInternet/>

The profit data presented in Tables, 2, 3 and 4 are for Operating Profit (profit before tax and interest payments), for UK-only energy related operations. The figures are as published at the date in question, ie we have not used the remeasured figures which are sometimes displayed where the company presents its prior-year results for comparative purposes.

As stated in the text, this data (and the operating data in other tables) have been aligned so that there is the maximum overlap between the different financial years used by the companies: data from those companies with financial years ending in March have been aligned with data from those whose financial year ended the preceding December. This applies in the cases of Scottish Power and SSE both of which have financial years ending March. Consequently financial and operating data from these two companies derived from (eg) their 2006–07 Annual Reports are placed under the column headed 2006.

The data were primarily obtained from the “segment information” notes to the accounts of five of the companies which publish consolidated accounts for their UK operations (Centrica, EDF Energy plc, E.ON UK plc, Scottish Power Ltd/plc and SSE plc). The exception is RWE npower where we have used the segment data of the German parent company RWE AG where the segment is for RWE npower’s operations and the data is for EBIT (with currency conversion from euro to sterling at the annual average rate stated by the company). EBIT is earnings before interest and taxation which means that the figure may also include some post-tax income from any associate companies or joint venture in which the parent owns less than 50%. We do not believe that the use of EBIT for RWE makes any material difference to the argument). In addition, since E.ON UK’s annual report for 2007 was not yet available, for E.ON UK’s 2007 operating profit figure we have used the EBIT figure for the company’s UK segment from E.ON AG’s 2007 Annual Report (which has been published). However, since our main argument is centred on the period 2003–06 any slight distortion arising from using EBIT for 2007 and Operating Profit for the years 2003–06 is minimal.

The choice of the year 2003 as the base line for our analysis is based on two factors (1) 2003 is the first full year after the UK domestic energy supply industry was fully de-regulated (in April 2002); (2) there were no significant acquisitions of other domestic energy supply businesses by the six companies after this date. However, both SSE and Centrica made acquisitions of generating capacity over this period and in 2004 E.ON acquired Midlands Electricity, a regulated distribution business.

Among the six companies, only Centrica discloses a detailed segment breakdown of its different business operations. However, EDF Energy, E.ON UK, Scottish Power and SSE provide separate segment data for their regulated and non-regulated operations. The RWE npower data obtained from RWE AG’s annual reports provides no further breakdown, however since we know that RWE npower has no regulated energy businesses, we have been able to include the company in both Table’s 2 and 4.

In 2005, UK companies were required to begin to use International Financial Reporting Standards (IFRS) in place of UK GAAP. This has had implications for the profit and loss account in so far as companies are now required by IAS 32 and IAS 39 to include their losses and gains on certain derivative contracts in their income statement by “marking to market” or some other method of assessing their fair value. (Derivatives which are for “own use” are exempted, however). The inclusion of these hugely volatile “paper” gains and losses is widely recognised as potentially distorting the underlying business performance of the company and the six companies whose operating profit we have used in Tables 2, 3 and 4 all provide sufficient information to either add-back or deduct the value of these volatile re-measurements.

28 March 2008

Supplementary memorandum submitted by Ofgem

I welcomed the opportunity to meet with you and other members of the Committee last month. Following our meeting, you asked us to give you some background information on new electricity generation requirements; the windfall to generators under the European Emissions Trading Scheme; the causes of fuel poverty; and the link between gas and oil prices.

NEW ELECTRICITY GENERATION REQUIREMENTS

Peak electricity demand in Britain is currently around 62 gigawatts (GW). This compares with a total generating capacity of 75GW. Of that 75GW, approximately 39% is from coal; 38% from gas; 14% nuclear; 5% oil; 2% hydro; and 2% wind. In addition there is an electricity interconnector with France which is capable of importing or exporting about 2GW.

However, Britain’s nuclear power plants are ageing and many coal and oil-fired plants will have to close as a result of the Large Combustion Plant Directive (LCPD). The LCPD requires large generators to meet stringent air quality standards by January 2008 or to opt out of the LCPD. If they opt out, they must close by the end of 2015 or after 20,000 hours of operation from January 2008, whichever is soonest. Some 12GW of coal and oil-fired generating plant falls into this opted-out category. All of this plant, some 15% of Britain’s present total capacity, will have to close by the end of 2015. In addition, according to current timetables, 7.4GW of nuclear generation capacity will have closed by 2020. Another 2.4GW is due to close by 2023. Only Sizewell B, the pressurised water reactor (PWR) in Suffolk, has a significant lifespan beyond 2020; it is due to close in 2035. However, plant life extensions should allow some delay in these closure dates.

The closure of existing plant means that there is a substantial requirement for new build. Several factors will affect the level and nature of new build:

- *Market prices and economics:* Expected levels of coal, gas, carbon and power prices are the major factor driving investment in new capacity. Higher carbon prices will tend to skew investment towards lower carbon generation plant, such as gas and nuclear. However, market participants are unable to predict the future. In addition, they value diversity, particularly if market and political signals are uncertain. As a result, generators are likely to favour a diverse mix of generating assets in the future, including some new coal.
- *Planning:* The biggest single obstacle faced by new generators and transmission owners will remain planning provisions—particularly for major electricity infrastructure. The UK Government’s Planning Bill aims to improve the planning process for major infrastructure projects, but this legislation would apply only to England and Wales, where planning delays are less acute at the moment.
- *Grid connections:* The electricity transmission networks—the wires which carry electricity from generators to customers—require investment to enable more generation to connect. New lines need to be built, especially to help connect more renewables, and better use needs to be made of existing lines. Ofgem is playing its part by allowing a 100% increase in investment in the energy networks and by reviewing the arrangements for allowing generators to gain access to the networks.
- *Skills:* The power sector has an ageing workforce and the Sector Skills Council estimates that, without a marked increase in recruitment and training, a significant shortage of skills could develop as early as 2013. Building significant numbers of new power stations and new network infrastructure would require a strengthening of the science, engineering, project management and on-site trade/technician skills base. The longer lead times for nuclear power would allow the industry more time to plan ahead.
- *Lead times:* The whole process from decision to invest through to start up can take about five years for a combined cycle gas turbine (CCGT) power station: two years for design, planning consent, project planning and permitting, two for construction and six months for commissioning. A coal-fired power station might take around seven years, of which four to five years would be needed for construction. A new nuclear power station might take around five years for construction but has

an extended licensing period that would extend the overall programme towards ten years. In addition, there could be bottlenecks in the supply chain depending on demand for construction from other sectors.

- *Subsidy*: The renewable electricity industry in Britain is supported by a subsidy through the Renewables Obligation (RO). The proportion of Britain's energy coming from renewables has increased since the RO was introduced but by far less than is required to meet the target. Other countries have different support mechanisms, eg feed-in tariffs. Whether they have more or less renewable energy than Britain will be influenced partly by the support scheme but also by other factors—such as a lack of planning constraints and the availability of spare transmission capacity.

WINDFALL TO GENERATORS UNDER THE EU ETS

The European Union Emissions Trading Scheme (EU ETS) aims to reduce emissions of carbon dioxide and combat the serious threat of climate change. It works on a “cap and trade” basis:

- EU Member State governments are required to set emissions limits for all installations in their country covered by the scheme.
- Each installation is then allocated allowances equal to that cap for the particular phase in question. The allocation of allowances is set out in the National Allocation Plan for the particular period. The first phase of the EU ETS ran from 2005–07; Phase II runs from 2008–12.
- Installations can meet their cap by reducing emissions below the cap and selling the surplus allowances. Alternatively, they can let their emissions remain higher than the cap and buy allowances from other participants in the EU emissions market in order to meet the cap. A carbon market has emerged which enables this trade in allowances to happen.

The UK National Allocation Plan has granted electricity generating companies—free of charge—a proportion of the tradeable emissions permits they need to meet their obligations under the scheme. Ofgem has long argued that these permits should be auctioned to energy companies rather than given free of charge. We are pleased that 7% are being auctioned from 2008 and hopefully that all permits will be auctioned from 2012.

Phase II of the EU ETS runs from 2008–12. Although the generators receive most of their required allowances for free, the full traded allowance price is reflected in the price of electricity traded on the wholesale market. This is because:

- the generators who need to buy extra allowances to cover their emissions will, as you would expect, factor the cost of these allowances into their price;
- the generators who hold enough allowances can sell them. They will only generate if the electricity price is high enough to compensate them for using, rather than selling, their allowances.

The free allocation of allowances therefore increases generators' profits over the five years of the phase. With carbon prices up 25% in the past year, the £9 billion windfall that Ofgem identified in January covering the period from 2008–12 is now worth in excess of £11 billion calculated at today's market prices.

It is less clear whether the full cost of allowances is passed through to end user prices. We believe that is certainly the case for the sales to large and medium industrial and commercial suppliers and largely the case for domestic customers. There is some evidence that, at times of rapidly rising prices, some of the vertically integrated power companies smooth their price increases to domestic consumers by cross-subsidising between generation and supply. The surplus generation profits from the EU ETS increase their ability to do this.

Ofgem originally highlighted this issue in its response to the Government's Energy Review in 2006. Ofgem also highlighted that by reducing the free allocation of allowances to generators to the maximum extent possible would mitigate this effect and could provide for measures to alleviate fuel poverty.

FUEL POVERTY

Fuel poverty has three main causes: low incomes, poor housing and high energy prices. After a considerable period of decline from 1996, fuel poverty is now rising and current estimates suggest that 4.5 million households could be fuel poor.

The above factors have not contributed equally to changes in fuel poverty. The Government's 2007 Fuel Poverty Annual Report stated that, “For the reduction in overall fuel poverty between 1996 and 2005, with all the changes in methodology excluded, nearly three quarters was due to increased incomes, around a fifth was due to energy efficiency measures, with the remainder due to energy price reductions.” The Scottish Household Condition Survey 2002 attributed the reduction in fuel poverty in Scotland to the following factors: 50% to increases in household income, 35% to reduced fuel prices and 15% to improvements in energy efficiency.

I have written to you separately with further information on the scale of the fuel poverty challenge; the steps to target existing measures under the Fuel Poverty Action Programme; and our view of the work that still needs to be done.

Oil and gas price link

There is a strong correlation between oil prices and wholesale gas prices. The high oil price can affect UK gas prices via two main mechanisms:

- European contract prices and their impact on Britain, via arbitrage across the interconnector; and
- any remaining British gas supply contracts that contain oil-indexation.

European contract prices

The European gas price is affected by the contractual link between oil (and a number of oil-related products) and prices for gas in contracts to supply gas into Europe. In most European supply contracts gas prices are indexed to movements in oil prices with a lag of between three and nine months. This contractual link affects GB prices due to the operation of the interconnector and the arbitrage in trading based on relative prices at Zeebrugge in Belgium and at the National Balancing Point (NBP) in Britain. This occurs in two main ways:

- Summer effect: Higher European prices during summer will tend to increase UK gas exports across the interconnector, as UK suppliers seek to sell surplus UK supplies into the higher priced continental market. This pushes up UK summer gas prices, which in turn increases the price of gas injected in to storage for use during the following winter. The cost of this higher priced gas, added to storage and cycling costs, can push forward winter prices higher to the extent that storage is expected to be the marginal source of gas on a significant number of winter days.
- Winter effect: During winter, GB gas demand is typically greater than UK Continental Shelf (UKCS) supply, with European imports, via the interconnector, and storage providing the balance of supplies. When this occurs, the price of the European gas will influence the GB gas price, either directly, when imports are the marginal source of supply, or indirectly through storage prices as outlined above.

UKCS oil-indexation

In Britain some long-term gas contracts are still linked to indices that include oil prices. However, these contracts represent a very small proportion of UK gas supplies. Since market liberalisation in the early-1990s, these contracts have not tended to influence British gas prices. When there was a significant surplus of UK supplies, gas from these relatively high-priced contracts was not required to meet demand other than on a very small number of days of high demand. As the supply/demand balance has tightened these contracts' influence on British prices will increase.

5 June 2008
