

2nd July 2002

Iain Osborne
Director, Supply
Office of Gas and Electricity Markets
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London
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Dear Iain

RESTRICTION ON SELF-SUPPLY: INITIAL PROPOSALS

Thank you for the opportunity to comment on the important issues raised in the above consultation dated May 2002. Your initial proposals rest on both competition and regulatory process points and we have divided our comments accordingly.

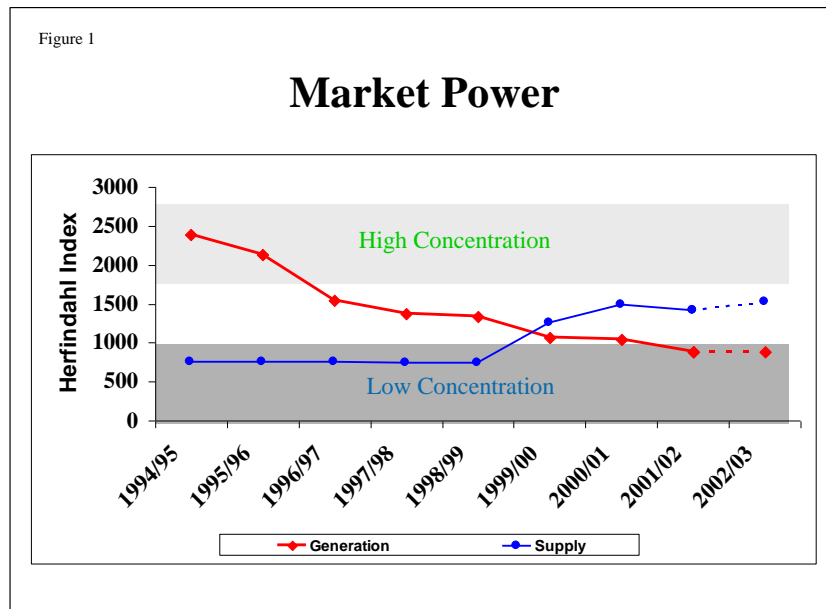
Key Points

- We oppose the abandonment of self-supply restrictions at this time. The issue should not be considered in isolation but examined in the wider context of whether some aspect of vertical integration is preventing the benefits of competition flowing to all consumers.
- There are grounds for concern over the development of competition in the domestic retail sector, such as the degree to which the ex-PESs are able to act independently of competitive pressures and the possibility of distorting cross-subsidy.
- While physical market liquidity is improving, trading in derivatives has yet to emerge and the wholesale electricity market remains incomplete. It is wrong to prejudge the outcome of the NETA anniversary review on these points.
- We are concerned that Ofgem have apparently chosen not to enforce these conditions since their introduction. The existence of enforcement difficulties does not prove that regulation is unnecessary.
- New conditions would not necessarily be required to secure compliance. We have proposed simple alternative arrangements that should be considered for all incumbents.
- We are concerned that DTI do not appear to have been involved in drawing up these proposals and it is unclear to what extent Ofgem's proposals would or could release firms from undertakings given separately to the Secretary of State in the course of merger or acquisition proceedings.



Detailed Competition Points

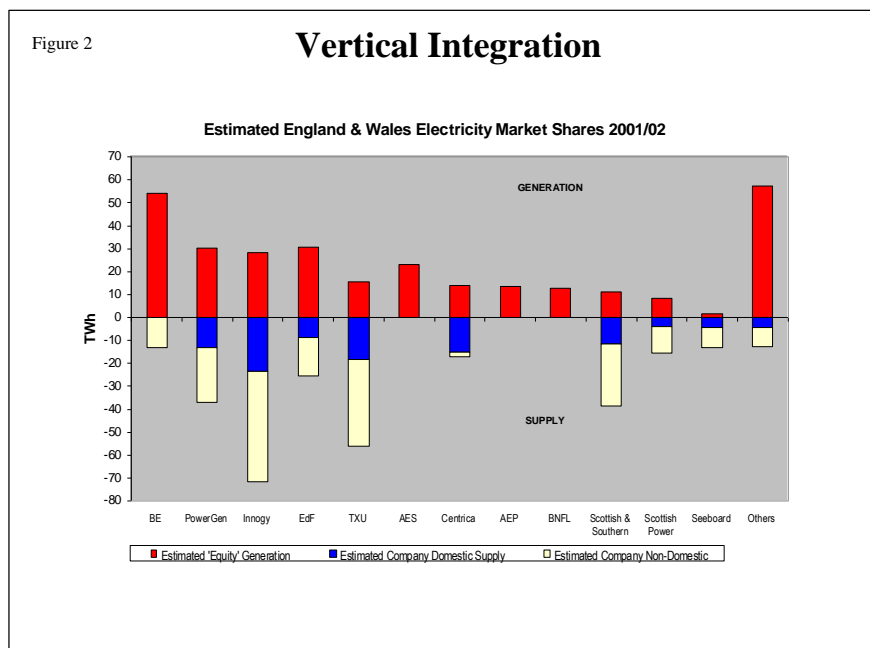
While generation is fiercely competitive, competition is clearly not as firmly established in domestic retail supply and certainly hasn't developed well enough to warrant scrapping the restriction at this time. This is reflected in the Herfindahl Indices trend for competition in generation and supply (Figure 1):



Moreover, there is prima facie evidence of excessive margins in first-tier domestic supply. In this context we note that *no* ex-PES reduced their standard credit prices in April 2002 and two actually increased prices, even though wholesale purchase cost reductions massively offset the predictably small increases in environmental costs (ROCs and EECs). The persistence of unexplained high margins is inconsistent with Ofgem's assertion of a fully established competitive market. Indeed, no comprehensive analysis of first-tier domestic margins has been forthcoming from Ofgem. This is a significant weakness in Ofgem's case and the concerns raised by energywatch and others warrant serious analysis and debate.

We agree that incumbent market shares have eroded but if the trend were to follow that experienced in gas this erosion might well now tail off with incumbent market shares stabilising at around 65%. The existence of long-term rigidities in retail supply cannot therefore be dismissed by simply measuring switching rates at a point just before any flattening off might appear. It would be premature to remove restrictions before clear evidence on the future path of switching had emerged and the issue of rigidities was settled. The scenario of distorting cross-subsidy painted by Ofgem at paragraph 3.10 remains credible and worthy of proper analysis (as perhaps shown by the partial closure of Deeside).

We agree that liquidity is a key consideration. Physical contract liquidity is developing but a year into NETA traders remain cautious and derivative contract trading is yet to emerge. Ofgem's assertion that liquidity is satisfactory thus ignores the fact that the market remains incomplete while making no attempt to assess (for example) the possible impact on liquidity of increased vertical integration within the sector (Figure 2 shows our current VI estimates).



Detailed Process Points

It is premature to make these proposals now before the NETA anniversary review has been concluded and published. For example, since liquidity concerns underpinned the introduction of the restrictions Ofgem should wait until an analysis of liquidity issues under NETA is available to inform the debate. Ofgem are putting the 'cart before the horse' and appear to be pre-judging the outcome of the NETA review.

We also note that these conditions were required by the Secretary of State and OFT to remedy concerns about the negative impacts of vertical integration. We understand that most parties subject to the condition also made parallel undertakings to the Secretary of State. It is not clear to us to what extent DTI has been involved in this consultation. In particular, does Ofgem have the power to release affected firms from these undertakings? If not who will be responsible for enforcing the undertakings to the Secretary of State and how will they discharge that responsibility?

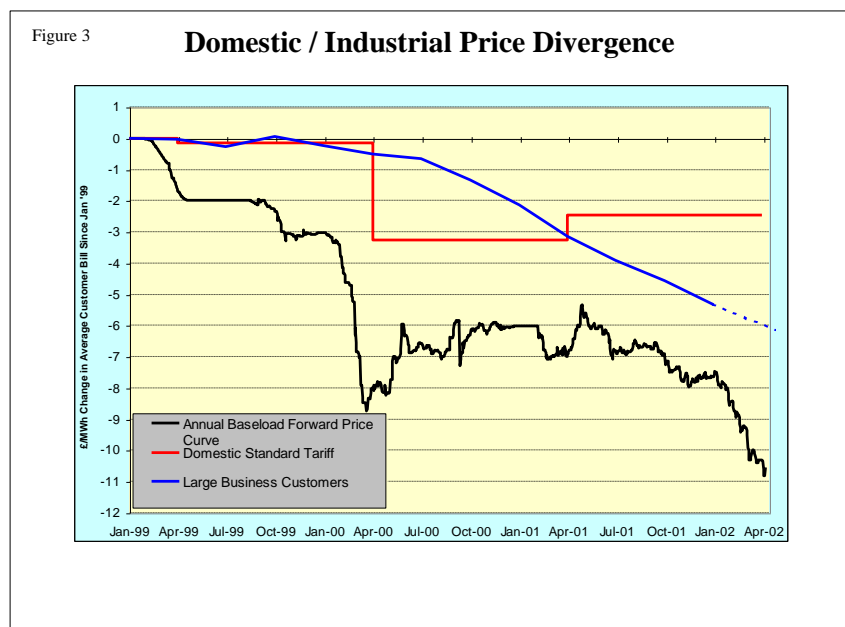
The existence of the condition in some but not all ex-PES licenses may risk distorting competition, but Ofgem ignores the obvious solution of extending the condition to all those similarly placed parties. Only 2 of the 12 'first-tier' suppliers in England & Wales do *not* have the condition, and it is surprising that Ofgem have not considered the strong case for standardising the condition across *all* first-tier suppliers. That Centrica (or other new entrant electricity suppliers) do not have the condition is of no concern as Centrica has never been a first-tier supplier of electricity. They have acquired all their electricity customers competitively and are therefore clearly not in the same position as the ex-PESs.

Ofgem's statement that the information needed to enforce the condition is not available seems to imply that the condition has not been enforced since it was first introduced, or at least since NETA go-live. Ofgem should explain why they have apparently done little to correct this unacceptable state of affairs earlier. The suggestion that new licence conditions



would be required to allow Ofgem to enforce the condition is simply not the case; Standard (Supplier) Licence Condition 19, for example, contains a general power to seek information from licensees necessary for Ofgem to discharge its duties.

Ofgem's suggestion that suppliers contract on a single-portfolio basis and that hypothecation of contracts is effectively impossible is inconsistent with the observation that vertically integrated players have apparently passed through wholesale price-cuts to their industrial customers but not to their in-area domestic customers (Figure 3). This discriminatory behaviour would be consistent with a particular hypothecation of high-priced, historic contracts to domestic in-area customers, contrary to the principles established by Ofgem when setting previous supply price controls. Alternatively, if hypothecation were not practised the difference in treatment could be explained by the relative strength of competitive pressures in the two sectors. Either way the growing divergence between suppliers' offerings to their in-area and out-of-area customers poses a serious challenge to Ofgem's views.



The fact that VI players may have options available to bypass the restriction means that the form of restriction may need to be revised. It is not in itself a valid argument for all restrictions to be abandoned and it would be illogical to do so without any proper analysis.

We have suggested simple alternative approaches before, without response from Ofgem. For example, requiring ex-PES suppliers to demonstrate annually that they have purchased sufficient volumes through the market to meet their in-area requirements would undoubtedly promote liquidity whilst imposing minimal compliance and monitoring costs.

If you would like to discuss any of the points raised here, please do not hesitate to contact me. Because of the potential interaction with the undertakings on self-supply given to the Secretary of State, I am copying this to Joan MacNaughton at DTI.

Yours sincerely,



A handwritten signature in black ink, appearing to read 'David Love', with a long, sweeping underline.

David Love
Head of Regulation

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