energywatch
bringing power to gas and electricity consumers

Tuesday, 09 July 2002

Iain Osborne
Director, supply
Office of Gas and electricity Markets
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London
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Dear Iain,

RE: Restriction on Self-Supply Initial Proposals

Thank you for the opportunity to respond to the above consultation paper. Our key considerations are set out in the paper below.

energywatch considers that there is enough evidence to justify retention and proper enforcement of the self supply licence condition. We also consider that the conditions could be applied to the integrated firms that do not have them at present.

If you wish to discuss any of the issues raised in this paper please do not hesitate to contact me on 020 7799 8362.

Yours sincerely

Lesley Davies

CONSULTATION ON THE RESTRICTION ON SELF SUPPLY INITIAL PROPOSALS

Introduction

The introduction of self supply restrictions was founded on legitimate fears concerning anti-competitive resulting from changes to the industry's market structure. We will argue that the conditions prevailing in the current market have not changed sufficiently enough to warrant their removal. Therefore, energywatch supports the retention of the self supply licence conditions.

The response will question the view that where first tier customers continue to be charged higher prices by the incumbent supplier this is leading to a rapid erosion of the incumbent's market share. Despite the higher prices offered by the incumbent suppliers they continue to retain high first tier market shares. We question the analysis Ofgem has undertaken to support its view that the benefits to consumers from retaining the restriction would be small. Finally the response will consider the usefulness of the Competition Act as a means to adequately address the harmful effects of vertical integration.

Vertical integration and market power

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. We believe this is the case in both gas and electricity:

- it may allow firms to extract *full monopoly profits* from the market as a result of control throughout the supply chain;
- *cross subsidy*. Vertical integration can facilitate cross subsidy between the generation and supply business and between first and second tier tariffs;
- *price discrimination*. A vertically integrated firm can offer different prices for the same product when the production costs are basically the same;
- *as a means to create a barrier to entry*. A vertically integrated firm can deter new entrants by effectively increasing the costs of entry throughout the supply chain; and
- *relative immunity from competition law*. Competition law is not normally applied to integrated firms but more usually vertical agreements that restrain competition.

energywatch accepts that there is nothing wrong with vertical integration *per se*. Vertical integration can create efficiencies where

managerial costs are lower than going to market for a raw material or service. Vertically integrated firms can also reduce uncertainties of the supply of raw materials by guaranteeing supply. However, energywatch would point to some factors that make energy different from other supply chains. Domestic consumers in the energy market have a low cross elasticity of consumption between fuels. It is unlikely that a domestic consumer will change from gas to electricity for heating without a considerable increase in gas prices over a sustained length of time. In electricity, it is unlikely that consumers could survive without electricity and still function in the modern world. Consumers can only realistically turn to generating electricity themselves if they do not want to use electricity from the grid. This is not a realistic option for most consumers. In other markets consumers could expect to choose between close substitutes and so offset any incumbent's market power.

We would also note that demand for fuel in the short term is inelastic and the cost of outage extremely high. Consumers have no choice other than to use energy as and when they require it and it is at these times consumers are particularly vulnerable to dominant firms extracting monopoly rent.

Rigidity, market shares and switching rates

Section 3.1 of the document outlines a number of scenarios illustrating the problems associated with vertical integration and market rigidity. However, the Ofgem survey has provided ample evidence that long term rigidity is allowing suppliers to charge higher prices to their first tier customers. Ofgem's research into the development of competition demonstrates the power of the incumbents brand and the low recognition of the new entrants. It was stated in the most recent MORI survey that "*despite the fact that awareness is improving, a quarter of electricity customers are still unable to name more than one supplier (presumably their own)*."

The document assumes that competition is working effectively and that market shares will decline. However, evidence from gas suggests that incumbent market share has stabilised at around 65 per cent of the market. The incumbent supplier is still continuing to charge first tier domestic customers higher prices and there has not been a rapid erosion of the market share that would be expected if the market were truly competitive. In electricity, the incumbents continue to retain a large share of first tier customers. The average incumbent continues to hold a market share of over 65 per cent in electricity. This indicates that first tier customers still constitute the majority of electricity customers. Therefore, Ofgem should continue with as much protection as possible.

Using switching data alone will distort the analysis necessary to make an informed decision on the removal of the licence conditions. Previously we have noted four possible reasons why the use of switching data is problematic:

1. the number of consumers who return to the incumbent supplier distort the figures;
2. there could be a rump of consumers who change frequently (multiple switchers). In this way there needs to be a *careful* distinction between figures of gross and net switching in terms of its use as evidence of competition;
3. the ownership structure means that consumers may be switching between different former PES brands, but not the actual company group; and
4. also the switching data itself may be inflated to the extent that involuntary transfers and mis-selling transfers are included in the switching figures/

Differences between first and second tier tariffs

As the provider of tariff information sheets, energywatch is concerned about the differences between first and second tier tariffs. All ex PES brands currently charge more for first tier than second tier tariffs. The average difference between bills is £23 (9%) a year as outlined in table 1. We believe that the difference provides us with empirical evidence of the scenario of distorting cross-subsidy painted by Ofgem in paragraph 3.10 of the document. This we feel raises serious concerns about the development of competition in the domestic supply market. There are no discernable differences in costs between supplying first and second tier consumers save that of marketing. This implies a cross subsidy between customer types to finance the acquisition of customers through merger or direct selling.

Table 1 Price differences between first and second tier tariffs for medium consumption standard credit payments April 2002

	Second tier (£)	First tier (£)	Difference (£)
Eastern	216	232	16
East Midlands	222	236	14
London	233	247	14
Manweb	245	268	23
Midlands	227	243	16
Northern	229	264	35
Norweb	200	242	42
Seeboard	220	241	21
Southern	233	260	27
Swalec	267	285	19
Sweb	250	269	19
Yorkshire	226	251	25
Average	**231**	**253**	**23**

Source: energywatch pricing comparison factsheets April 2002

The Competition Act as a means of compliance

The paper assumes that the Competition Act is the best regulatory route to prevent anti competitive behaviour. In fact competition policy itself is no panacea, it has been under constant pressure for reform since the 1948 Monopolies and Restrictive Practices (Inquiry and Control) Act. There has been a new piece of competition legislation on average every seven years.

Competition policy is a blunt regulatory instrument. Historically the policy has been used as a tool for the investigation of entire industries (radio valves, supermarkets and retail supply of petrol) and this is reflected in the existing case law. Even with the development of a more complaint driven competition policy, the investigating authority must continue to consider the competitive conditions in the market as a whole before making a decision.

Competition investigations are not without some important drawbacks in their application to trading aspects of the generation sector. The debate over Market Abuse Licence Condition (MALC) showed how difficult it was to police the generating sector.

Except in the most extreme situations, Ofgem cannot be complacent about its ability to protect consumers sufficiently via the Competition Act.

- Competition cases are very expensive (costs of investigation for the largest investigations have totalled over £2m) - the Regulator would only be tempted to choose the most blatant/ simple cases if they emerged, not the more marginal, technical or complex infractions. Competition assessment in the context of a four company market may need to use complex pricing theory, adding more regulatory risk.
- Competition investigations are notoriously lengthy to investigate (the longest case on record was over 12 years and some sectors have had multiple investigations) and may be over taken by events. We do not want consumers to suffer whilst a lengthy investigation takes place.
- Companies can still be exposed to high prices during the review. They may not want to risk either a predatory or excessive pricing investigation.

Conclusion

The special licence conditions were originally targeted at the most problematic mergers. energywatch agrees that it may be difficult to enforce this licence condition, but as a point of principle we do not think this warrants their withdrawal. Ofgem must have thought they *were* enforceable at one stage. The problem may be one of inclination to deploy the necessary resources to find a workable solution for these licence conditions. Further, we do not think application of these conditions should be abandoned for any future vertical mergers between suppliers and generators. To address the issue of potential discrimination between the vertically integrated companies we believe the conditions could be applied to the integrated firms that do not have them at present.

energywatch continues to hold some concerns about the development of competition in the domestic retail market and the potential for cross subsidy by integrated companies (e.g. between generation and supply or between first and second tier customers). We also recognise that high levels of vertical integration will narrow the extent to which suppliers will go to market to buy generation.

energywatch considers that there is enough evidence to justify retention and proper enforcement of this licence condition (or a variation of this licence condition).