

NOTICE UNDER SECTION 49A OF THE ELECTRICITY ACT 1989

In accordance with the Authority's duty to give reasons by virtue of section 49A of the Electricity Act 1989 (the Act), the following explains why the Authority has modified the restriction on self-supply special licence condition as identified in the Schedule to the notice of modification (the Schedule).

1. The Authority is modifying the electricity supply licences held by the licensees specified in the Schedule, pursuant to section 11 of the Act. The modification will remove the restriction on self-supply special licence condition as identified in the Schedule.
2. The effect of the modification is to remove the special licence condition that prevented the electricity supply licensees listed in the Schedule from entering into new electricity purchase contracts with an electricity generator which is an affiliate or a related undertaking of the licensee for the benefit of that part of the licensee's business which comprises the supply of electricity to former designated customers within the supply services areas specified in Schedule 3 of the supply licence.
3. In accordance with section 11(2) of the Act the Authority gave notice on 22 October 2003 that it proposed to make modifications to the restriction on self-supply special licence condition of the licence and required that objections or representations to the modification were made before or on 19 December 2003.
4. The reasons why the Authority is making this licence modification are set out by the Authority in the document "Restriction on Self-Supply, Final Proposals, Ofgem, October 2003". Ofgem received 8 responses to the Final Proposals document, including:
 - ◆ responses from 6 suppliers supporting the final proposals and consenting to the lifting of the restriction in respect of 12 of the 13 relevant supply licensees. Administrators for TXU UK Ltd, E&Y LLP have indicated they will not consent on the grounds that they have no customers and hence the condition has no practical effect
 - ◆ a submission from British Energy not supporting the lifting of the restriction, and
 - ◆ a submission from energywatch not supporting the lifting of the restriction.
5. Submissions and consent letters are published on Ofgem's website at www.ofgem.gov.uk.
6. Ofgem considers that the submissions arguing against the removal of the restriction on self-supply did not present relevant new information or evidence that had not previously been considered. Where new evidence was presented (eg reduced liquidity in the medium to long term wholesale market) this has not persuaded Ofgem to change its views presented in the Final Proposals document.
7. Ofgem considers that wholesale and domestic retail electricity competition is sufficiently developed to remove the self-supply restriction. Ofgem's recently published Domestic Competitive Market Review 2004 identified the continuing development of domestic electricity supply competition, including healthy levels of

switching activity, and available savings from switching away from incumbent suppliers. Inappropriate behaviour will be more appropriately tackled through Ofgem's powers under the Competition Act 1998. Ofgem considers that combining these powers of investigation and enforcement with its forward work program of wholesale and retail market surveillance will be particularly effective in tackling undesirable behaviour in the market.

8. Specifically, and in response to arguments made in submissions to the Final Proposals arguing against the removal of the restriction on self-supply:
 - ◆ In Ofgem's Final Proposals document, Ofgem reported net switching of 38 per cent at March 2003 (paragraph 4.8). This figure is now 41 per cent (as at December 2003).¹ These switching figures show that ex-PES in-area customer share continues to erode, supporting Ofgem's view that supply competition is sufficient to remove the restriction on self-supply. Ofgem also reported gross switching of 43 per cent in electricity in September 2002 (paragraph 4.21). This figure is now 51 per cent (as at September 2003)², suggesting continued high levels of overall switching activity (including switching back to ex-PES suppliers, possibly for competitive dual fuel offerings). Ofgem considers that for customers who have not yet switched there are material savings available. British Energy argues that ex-PES market shares are now stabilised at 60 per cent, and that competition is not protecting these customers. Ofgem considers that high in-area customer shares are not a concern for supply competition per se, but rather any abuse arising from these customer shares. Ofgem considers that inappropriate behaviour can be more appropriately tackled through Ofgem's powers under the Competition Act 1998. As a point of fact, although the in-area ex-PES customer share is not falling as quickly as at the introduction of competition, it continues to fall (from 62 per cent to 59 per cent between March 2003 and December 2003) and hence, on the available evidence, Ofgem does not consider that customer shares have now stabilised at 60 per cent.
 - ◆ In response to the Final Proposals, British Energy argues that there is prima facie evidence of excessive margins for in-area domestic electricity customers. British Energy argues that historically high margins are inconsistent with Ofgem's view that domestic electricity supply is sufficiently competitive to remove the restriction on self-supply. Ofgem has recently undertaken analysis of supplier margins and headroom, factoring both estimates into its overall assessment of the development of competition. Preliminary analysis found that entrants can profitably enter the domestic electricity supply market, although margins are lower for smaller suppliers. Ofgem is likely to carry out a more detailed analysis of issues surrounding supplier profitability. In particular it will continue to analyse changes to the margins being earned in the supply sector. Ofgem has extensive powers of investigation and enforcement to impose financial penalties on undertakings found to be in breach of the Competition Act 1998. Accordingly, Ofgem is not persuaded to change its views presented in the Final Proposals document.
 - ◆ Ofgem identified increases in reported traded volumes across a range of contract types (paragraphs 4.30 to 4.35 on pages 22 to 24 of the Final Proposals document) to support its contention that wholesale market liquidity had

¹ "Domestic Competitive Market Review: A review document", April 2004, 78/04, Ofgem, p. Table 6.2, p 154.

² "Domestic Competitive Market Review: A review document", April 2004, 78/04, Ofgem, p. 46-47.

improved substantially since the introduction on NETA in March 2001. British Energy has argued that reductions in liquidity for medium and long term contracts may have significant consequences for wholesale competition. British Energy has called for a full analysis of liquidity issues before removing the restriction. Ofgem recognises that over-the-counter liquidity for medium and long term trades has fallen in the months leading to December 2003. However, Ofgem is not persuaded that this development is a material consideration to the removal the restriction on self supply given that any inappropriate behaviour can be more appropriately tackled through Ofgem's powers under the Competition Act 1998. Accordingly, Ofgem is not persuaded to change its views presented in the Final Proposals document.

9. No relevant licence holder identified in the Schedule to the notice of modification has made an objection.
10. Ofgem recognises that certain ex-PES suppliers have entered into undertakings and/or assurances with the Secretary of State in respect of self-supply. It will be for those ex-PES suppliers to seek legal advice as to their position with respect to these undertakings and/or assurances.
11. Ofgem will shortly write to persons who have entered into undertakings and/or assurances with the Authority (including the then Director General of Electricity Supply) in respect of self-supply to designated customers of ex-PES suppliers, confirming that Ofgem releases relevant parties from these assurances/undertakings.
12. For the reasons set out above, the Authority is of the opinion that the licence modification is necessary and has directed that such modification be made on 23 April 2004 to be effective from 23 April 2004.