

12th May 2004

Pamela Taylor
Ofgem
9 Millbank
London
SW1P 3GE

Dear Pamela,

**Scottish and Southern Energy's acquisition of Atlantic Gas Limited: A
consultation paper**

We recognise that there were unfortunate circumstances with regard to this merger. It was far more preferable to have Atlantic's consumers acquired by a trade sale than to have to deal with the consequences of Supplier of Last Resort. However, we also need to recognise the vital function that Atlantic had within the market as a new entrant competing on price and gaining market share largely by organic growth.

As Ofgem is aware, energywatch has long held concerns about the high levels of concentration in the regional domestic supply markets and the subsequent reduction of choice of supplier for consumers. In response to the last acquisition consultation, we noted that non-domestic consumers are becoming increasingly concerned over consolidation in supply.

Consolidation in supply

Section 2 of the consultation document provides a summary of Ofgem's assessment of concentrations on a GB-wide basis using the Hirschman-Herfindahl Index (HHI). The document suggests that a rise of over 100 points is often viewed as potentially raising competition concerns. energywatch notes that 'the OFT is likely to regard any market with a post merger HHI in excess of 1800 as highly concentrated, and any market with a post merger HHI in excess

of 1000 as concentrated' (Ch.4 p23 Mergers: Substantive Test Guide). Table 1 of the consultation document indicates that in the domestic sector the HHI is 4053 in gas and 1780 in the domestic electricity market post merger which we would argue is cause for concern in itself.

There are of course many other inequality measures which Ofgem could have used in its assessment of this merger, for example the GINI co-efficient of variation or the variance of logarithms of firm size. We recommend that Ofgem show, in its decision document, the reasons for choosing HHI over any other method and the extent to which this measure is a better indication of market concentration.

The analysis of the merger has placed great emphasis on market shares that can change over time. We note that they are only a snap shot of the market at any one point in time. Some economists argue that we should be looking at the efficiency of firms in the market over a period of time. We request that Ofgem provide evidence that you have considered and rejected such alternative analysis.

Role of new entrants in the energy market

The role of new entrants in the energy market has an important impact on the competitive dynamics of the supply market. Firstly, Atlantic aggressively competed on price and therefore was used as a marker price by which the established firms had to base their pricing strategy for those customers actively seeking the cheapest. Secondly, new entrants tend to be more innovative. Atlantic was the only supplier to develop a bespoke tariff for consumers in Scotland with dynamic teleswitching (DTS). The future of these bespoke DTS tariffs are likely to be discontinued.

Conclusion

As we have previously argued, we would hope that in the near future Ofgem develops a sophisticated competitive analysis of oligopoly pricing strategies for a six firm oligopoly that has now developed in the GB energy markets as a means of ensuring that the market continues to deliver consumer welfare.

If you would like to discuss any aspect of this response please do not hesitate to call me on 020 7799 8368.

Yours sincerely

Sebastian Eyre
Policy Advisor
energywatch