

# **Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations**

**Stephen Littlechild\***

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\* Emeritus Professor, University of Birmingham  
Senior Research Associate, Judge Business School, University of Cambridge  
sclittlechild@tanworth.mercianet.co.uk

## CONTENTS

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Executive Summary

Preface

1. The pattern of new entry into the domestic market
2. The costs and profitability of new entry
3. Experience of companies that left the retail market
4. Market structure, barriers to entry and concerns of smaller suppliers
5. Entry qualification processes
6. Credit cover
7. Quality of data
8. Meter reading and related services
9. Purchasing and liquidity
10. The restrictions and burden of regulation
11. Conclusions

Appendix 1. New entrants' costs

Appendix 2. Market entry processes

Appendix 3. Network credit cover

Appendix 4. Ofgem's review of barriers to entry

## EXECUTIVE SUMMARY

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### **New entry into the domestic market**

Smaller new entrants have hitherto supplied only about half a percent of the UK domestic (residential) electricity market. New suppliers have continually entered and grown but some of the faster growing ones have experienced difficulties and have been bought out by larger incumbent players. New entry is nonetheless important for competition in terms of price, quality of service and innovation.

### **Costs and profitability of new entry**

In some respects the potential profitability of smaller entrants seems lower than Ofgem's headroom analysis indicates. However, in other respects there may be scope for lower costs and more viable margins.

### **Experience of companies that left the retail market**

These companies incurred high initial costs, needed high working capital and were cash-negative while growing. Data transfer problems were unexpectedly severe and pervasive, and the solution was largely outside the control of these companies.

### **Concerns of smaller suppliers today**

Smaller suppliers are concerned about six main issues:

- a. the complexity and cost of entry qualification processes including accreditation
- b. the cost of credit cover
- c. the increasing difficulty of purchasing and lack of wholesale market liquidity
- d. the quality of data
- e. the lack of competition for metering and related services, and
- f. the restrictions and burden of regulation.

Not all these are very tractable problems, but in some cases steps are already being taken to deal with the problems, and in other cases action would be possible and desirable. This Report makes ten Recommendations to address these concerns.

**Recommendation 1.** In order to reduce significantly the cost, time and complexity of present entry qualification processes, market participants (specifically, the BSC parties) should introduce modifications to take forward and implement reforms to the present BSC arrangements.

**Recommendation 2.** In order to reduce the burden of network credit cover on smaller suppliers, network operators should implement provisions for unsecured credit that are no less onerous than Ofgem's proposals presently envisage. In the event of a small supplier encountering payment difficulties, network operators should deal with this sympathetically and constructively.

**Recommendation 3.** In order to help alleviate the problems with data quality, market participants should continue to work on the Customer Transfer Programme, and in due course explore the scope for further improving data quality performance.

**Recommendation 4.** In order to facilitate more competition in metering services, further steps should be taken to review, enforce and where necessary extend the obligations on incumbent providers of metering services. In particular, such providers should make available detailed information about meters to new suppliers and their agents and where appropriate to other potential metering service providers.

**Recommendation 5.** Until competition in metering services is more effective, service providers that have a dominant position in any regional area should continue to offer terms to all suppliers in that area, particularly the smaller ones, so that the latter can continue to compete in supply. Dominant providers should not exploit their positions by, for example, using their meter readers to promote their own company at the expense of other suppliers to whom they provide such services. If necessary, Ofgem should take steps to enforce such transitional protections for suppliers.

**Recommendation 6.** Ofgem should consider how best to improve the purchasing and liquidity situation faced by smaller suppliers. In particular, in considering the need for action in the wholesale market and in appraising and advising on any proposed merger or takeover, Ofgem and other policymakers should give substantial weight to the potential effects on liquidity and competition in the capital and wholesale markets.

**Recommendation 7.** The present calculation of cashout prices creates a market distortion against smaller non-integrated competitors and is not conducive to liquidity. Market participants and Ofgem should consider a modification proposal to revise the calculation of the reverse direction cashout price so as to remove or reduce the spread between System Buy Price and System Sell Price in each half-hour.

**Recommendation 8.** In order to remove an unnecessary regulation, which also restricts and distorts competition, Ofgem's present Supply Licence Review should consider removing Standard Licence Condition 43 that requires suppliers to offer a full range of payment methods to all domestic customers.

**Recommendation 9.** In order to remove another unnecessary regulation, which also restricts and distorts competition, Ofgem's present Supply Licence Review should consider removing Standard Licence Condition 46 that requires all customers to be able to cancel any contract at 28 days' notice.

**Recommendation 10.** In order to improve and maintain communication with small suppliers and new entrants, Ofgem should explore the possibility of a regular Forum for exchanging views.

## **Conclusion**

These measures will not change the situation of smaller suppliers overnight. But they will remove certain artificial or unnecessary obstacles to the ability of smaller suppliers to compete against their larger rivals. This can only be good for competition and domestic customers.

## PREFACE

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The UK domestic (residential) gas and electricity markets were opened up to retail competition some five to seven years ago. The extent of competition and the changes in market structure have been very significant.<sup>1</sup> In contrast to the experience in most other countries, retail competition in gas and electricity is widely regarded as a success, both nationally and internationally. Yet there has been relatively little new entry on a small scale by parties other than incumbents, and their market share remains very low.

Ofgem has looked at many aspects of competition and new entry in the domestic market, and is committed to removing any entry barriers.<sup>2</sup> Cornwall Consulting has recently produced a good Report on competition in the small business sector.<sup>3</sup> The present Report investigates the experiences and views of smaller suppliers in the domestic electricity sector.

The Report begins by looking at the nature and extent of new entry and identifies who the small suppliers are and what they are doing. It then examines Ofgem's analysis of the costs and profitability of new entrants. The main part of the Report documents the problems or barriers facing such small suppliers, as described by the suppliers themselves (including the experiences of some entrants that have left the market). The Report also considers what can reasonably be done to reduce these barriers.

This Report is based on about 30 interviews carried out during March 2005, mostly by telephone. About two thirds of these interviews were with present or former new entrants into the electricity supply market. The remainder were with other companies or organisations actively involved in this sector, including Ofgem and Elexon.

I should like to thank the representatives of these suppliers and organisations for the time and thought they gave to discussing this issue. I am grateful to Ofgem for supporting this work. None of the above is responsible for the views expressed herein.

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<sup>1</sup> Incumbent electricity companies have entered the gas market and the incumbent gas company Centrica has entered the electricity market on a large scale. Retail supply businesses have been actively bought and sold, not least by entrants from overseas. Customers have been able and willing to switch suppliers, and about 40 per cent of customers are now with non-incumbent suppliers. There has been competition on price, and innovation in products and services offered. Problems and complaints, mainly about the selling tactics of some companies and faults in the switching process, are increasingly being dealt with. In general customer satisfaction appears to be good.

<sup>2</sup> *Domestic Competitive Market Review: a review document*, Ofgem, 78/04, April 2004. Its work programme included "ensuring new entry is possible to all sectors, by reviewing Ofgem's regulation of supply markets, with one objective being to identify if entry barriers can be removed, to the benefit of customers".

<sup>3</sup> *Business Energy Markets 2004*, Report for Energywatch, Nigel Cornwall and Robert Buckley, Cornwall Consulting, September 2004, available at [www.energywatch.co.uk](http://www.energywatch.co.uk). There are many similarities between the domestic and small business markets, and the experiences and views of the suppliers are similar in both cases. The conclusions and recommendations of these two Reports are largely consistent, but complementary rather than identical.

## 1. THE PATTERN OF NEW ENTRY INTO THE DOMESTIC MARKET

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### 1.1 Changing market shares

The market shares of the principal supplier groups in the domestic electricity market have changed quite radically in the last seven years.<sup>4</sup> To highlight the main changes, Table 1 shows market shares (in terms of residential customer numbers, to the nearest half a percent) of the present main players in the residential electricity market at three dates: when the markets first opened in 1998, in August 2001 and at December 2004. There are also similar figures for the domestic gas market.

Table 1 Market shares (G B Residential Customers) 1996 – 2004

Company	Market Shares Electricity %				Market Shares Gas %		
	1998	Aug-01	Dec-04		1996	Mar-02	Dec-04
BGT		18	22.5		100	65.5	56.5
PowerGen		7.5	21.5			4.5	13
Npower		18.5	14.5			9	9
EdF Energy		10	13.5			2.5	5
SSE	2.5+10	14	15			5	8.5
SP	7	10.5	12.5			4	8
TXU		15.5				7.5	
Seeboard	8	5.5				2	
Other RECs	72.5						
Others		0.5	0.5			0.5	0.5
Total	100	100	100		100	100	100

Source: Ofgem

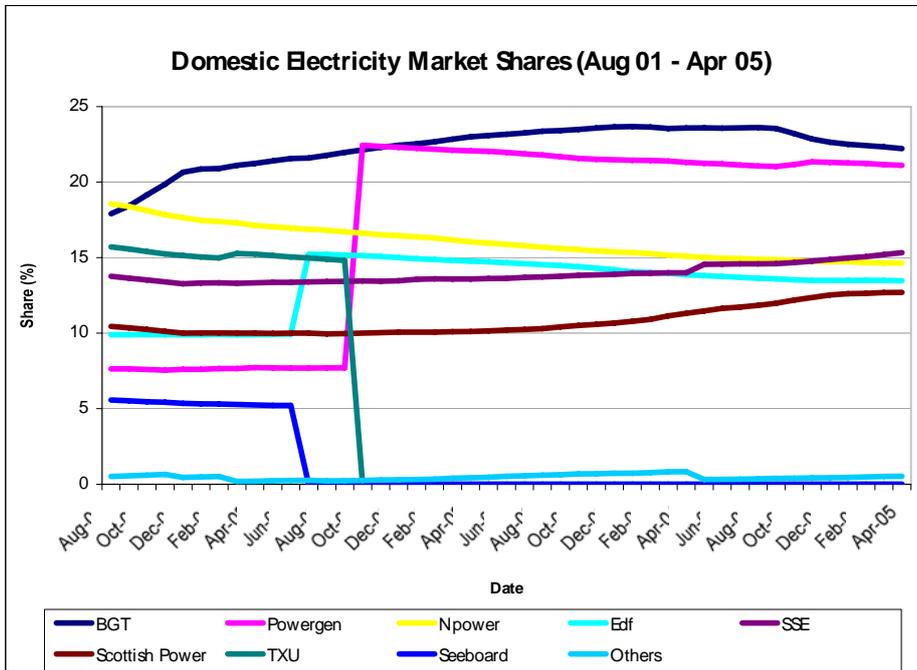
The main action has evidently been in the restructuring of the incumbents in the industry and new entry by means of merger and takeover of existing firms.<sup>5</sup> The gas incumbent (British Gas Trading, also known as BGT or Centrica) has been a major entrant into the domestic electricity industry. The result of this activity is the ‘Big Six’ vertically integrated companies: Centrica, E.On (Powergen), Npower, EdF Energy, Scottish Power (SP) and Scottish and Southern (SSE). They are of roughly equal size in terms of electricity market share, and now supply 99.5% of the residential electricity and gas customers in Great Britain. Figure 1 shows in more detail the evolution of the domestic electricity market since August 2001.

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<sup>4</sup> *Domestic Competitive Market Review*. In the UK the term ‘domestic’ is generally used where other countries might use the term ‘residential’. In the present context it does not refer to national as opposed to international or European.

<sup>5</sup> Most of the original 12 RECs in England and Wales have now been sold. BGT (British Gas Centrica) has lost 45% of the gas market but acquired 23% of the electricity market. The two main generators Powergen and Npower, now owned by German companies E.ON and RWE respectively, and the French company EdF Energy have acquired between 14 and 22% of the electricity market and between 5 and 13% of the gas market. The two Scottish electricity companies SSE and SP have built up their market shares of electricity to 13 – 15% and acquired around 8% of the gas market.

Figure 1 Domestic Electricity Market Shares 2001-2005



Source: Ofgem

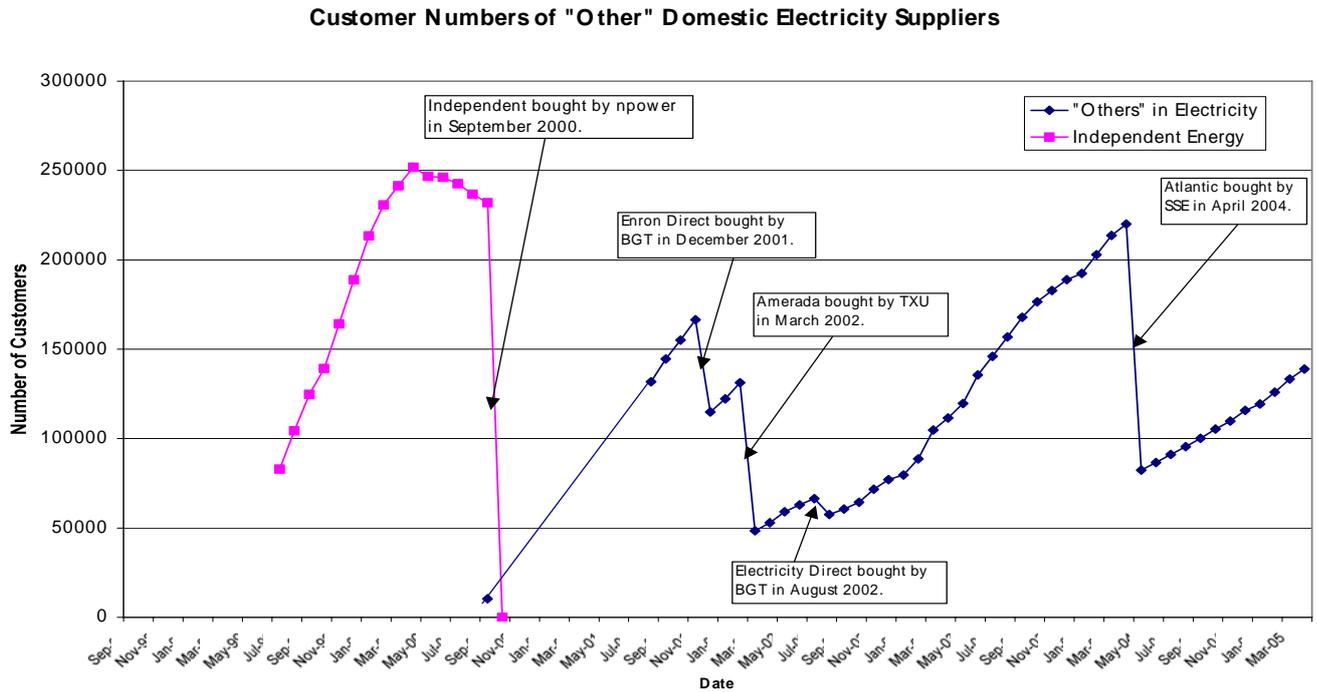
The remaining suppliers, classed as “Others”, account for only about 0.5% of residential customers, in both 2001 and 2004, and in both gas and electricity markets. Since there are about 26 million residential customers in total, this means that the Other suppliers account for a little over 100,000 residential electricity customers.

### 1.2 The rise and fall of new entrants

These snapshots at two dates do not fully indicate the experience of new entrant suppliers over this period. Customer numbers, whether individual or aggregate, have by no means remained constant over time. New entrants are continually entering the market in both gas and electricity, and attracting increased customer numbers. However, equally frequently the aggregate customer numbers are reduced as incumbent suppliers buy out the new entrants.

Figure 2 illustrates this experience in the electricity market. Ever since the market first opened in late 1998, the number of customers with new and smaller suppliers has grown at a remarkably constant rate, about 100,000 customers per year. Initially Independent Energy attracted most customers, but later there were other suppliers. At a couple of periods the number of electricity customers with Other suppliers has reached about a quarter of a million (about 1 per cent of the total domestic market). Perhaps in total Other suppliers have attracted over half a million customers over this period (about 2 per cent of the domestic market). But incumbent suppliers have repeatedly bought out the smaller suppliers: first Independent, then Enron Direct, Amerada and Atlantic. There has been a similar experience in the gas sector (indeed, many customers take ‘dual fuel’ terms).

Figure 2 Customer numbers of Other domestic suppliers



Source: Ofgem

### 1.3 The issue of new supply licences

Table 2 shows that, since 1990, 45 licences have been issued to supply the domestic electricity market. At most 19 of these licences were issued to incumbent companies in the industry and the other 26 to smaller new entrants.<sup>6</sup> The incumbent electricity companies or their acquirers obtained or renewed their present licences in 1999 and 2001.

Table 2 Issue of domestic electricity supply licences

Year of issue	Incumbents	Entrants	Total
1990	1	0	1
1996	1	1	2
1997	0	1	1
1998	1	1	2
1999	4	5	9
2000	0	0	0
2001	12	2	14
2002	0	2	2
2003	0	4	4
2004	0	10	10
<b>Total</b>	19	26	45

Source: Ofgem

<sup>6</sup> For present purposes, British Gas Trading is categorised as an incumbent. I have not been able to check whether all the licenses presently held by incumbents were actually applied for by them, or by entrants that the incumbents subsequently acquired.

Our focus here is on the licences to new entrants. The number of these has increased remarkably in the last couple of years.

#### 1.4 Who are the licensees?

Table 3a lists the 19 domestic electricity supply licences granted to date that are presently associated with the Big Six suppliers. They are not further investigated here.

Table 3a Licensed domestic electricity suppliers: incumbents

<b>Name of Licensee</b>	<b>Licence issued</b>	<b>Present supplier</b>
British Gas Trading Limited	29-May-1996	BGT
London Energy Plc	30-Sep-1999	EdF Energy
Midlands Gas Limited	08-Dec-1999	Powergen
Norweb Energi Limited	28-Jun-1990	Powergen
Npower Direct Limited	02-Jan-2001	Npower
Npower Ltd	29-Jun-1999	Npower
Npower Northern Ltd	06-Sep-2001	Npower
Npower Northern Supply Ltd	01-Oct-2001	Npower
Npower Yorkshire Ltd	01-Nov-2001	Npower
Npower Yorkshire Supply Ltd	01-Oct-2001	Npower
Powergen Retail Gas (Eastern) Ltd	25-May-2001	Powergen
Powergen Retail Ltd	01-Oct-2001	Powergen
Scottish Power Energy Retail Ltd	01-Oct-2001	SP
SEEBOARD Energy Limited	01-Oct-2001	EdF Energy
South Wales Electricity Limited	01-Oct-2001	SSE
SSE Energy Supply Ltd	08-Dec-1999	SSE
SWEB Energy Limited	01-Oct-2001	EdF Energy
TXU UK Limited	01-Oct-2001	In administration
TXU Direct Sales Ltd	23-Jan-1998	License revoked 28 April 2004

Source: Ofgem

Table 3b lists nine supply licences associated with seven new entrants that are no longer trading as such. One or other of the Big Six suppliers acquired their licences and customers. Little is known about Western Gas and Enizade, who do not seem to have been very active. Independent, Atlantic and Amerada were directly supplying to the domestic market. Enron Direct provided White Label supply on behalf of other non-licensed suppliers (see below). Economy Power Ltd, recently acquired by E.On/Npower, has a licence to supply the residential market but in practice was active only in the SME market, with a focus on nursing homes and housing associations. Like other non-domestic licensees (such as Electricity Direct shown in Figure 2) it also served domestic customers (more precisely, premises with domestic profiles) as an incidental part of its supply to commercial premises.

Table 3b Licensed domestic electricity suppliers: new entrants since acquired by others

Name of Licensee	Licence issued & SVA qualification	Maximum number domestic electricity customers	Purchased by	Activities in domestic market
Independent Energy UK Ltd	7 Mar 1996; 1 Jul 1999	c. 250,000	Npower/E.On	Domestic supplier
Enron Direct Ltd	29 Sep 1997; 9 Feb 1999	c. 34,000	BGT	SME supplier and WL provider in domestic market
Atlantic Electric & Gas Ltd	2 Oct 1998; 17 Aug 2000	c. 140,000	SSE	Domestic supplier
Western Gas Limited	8 Dec 1999; 5 Dec 2000	Very few	TXU/Powergen	WL with Amerada?
Amerada Hess Ltd <sup>7</sup>	8 Dec 1999; 5 Dec 2000	c. 90,000	TXU/Powergen	Domestic supplier
Economy Power Limited	23 Aug 2001; 14 Jun 2000	< 10,000	Npower/E.On	SME supplier
Enizade Ltd	1 Oct 2001	Very few	Aquila/Powergen	Query active?

Source: Ofgem, Elexon and licensees.

Table 3c lists seven smaller licensees presently active in supplying the residential market. In date order of acquiring their licences:

- The Renewable Energy Company Limited, trading as Ecotricity, is a wind generator that now sells to domestic customers, and has built up several thousand domestic customers;
- Good Energy Ltd, formerly known as Unit[e], is a renewable supplier that has now built up over 10,000 domestic customers;
- Utility Link is a White Label supplier for several new and unlicensed suppliers that in total have over 10,000 domestic customers;
- Opus Energy is an active supplier in the SME market and provides White Label supply to Telecom Plus in the domestic market;
- Telecom Plus is a supplier of all utility services to about 200,000 customers in the domestic market, of which nearly half take electricity: since it has not passed the entry qualification processes itself it formerly used Enron Direct and now uses Opus Energy as its White Label electricity supplier;
- Utilita and Zest4 are the latest entrants who started selling at the end of 2004 and have already acquired several thousand customers each. Utilita sells only energy efficiency packages. Zest4 aims to have the lowest priced product in the market.

As of April 2005 these suppliers in aggregate supply some 128,000 domestic customers. In addition, non-domestic suppliers such as Economy Power, Bizz Energy and others serve nearly 11,000 domestic customers in aggregate as an incidental part of their supply to commercial premises. In total, some 139,000 domestic customers are supplied by suppliers other than the 'Big Six' integrated retail suppliers.

<sup>7</sup> Amerada Hess Ltd had three domestic licenses that were subsequently reissued in the name of TXU Europe Ltd, and are presently held by Powergen.

**Table 3c Licensed domestic electricity suppliers: new entrants**

<b>Name of licensee</b>	<b>Licence issued &amp; qualification</b>	<b>Status</b>
Renewable Energy Co Ltd (Ecotricity)	24-Jan-1996; 2 Nov 1999	active supplier
Utility Link Limited	15-Jan-1999; 21 Oct 1999	active WL provider
Opus Energy Ltd	28-Aug-2002; 14 Oct 2002	active SME supplier; WL provider
Good Energy Limited formerly Unit[e]	22-Jan-2003; 19 Mar 2003	active supplier
Telecom Plus PLC	26-Mar-2003	active supplier; WL by Enron Direct then Opus Energy
Zest4 Electricity Limited	09-May-2003; 19 Feb 2004	active supplier
Utilita Electricity Limited	06-Nov-2003; 19 May 2004	active supplier
Affinity Power Limited	27-Sep-2002	not yet active supplier
R S Energy Limited	04-Feb-2004	not yet active supplier; consultancy
Utilitease Limited	09-Feb-2004	not yet active supplier; consultancy
730 Energy Limited	17-Feb-2004	not yet active supplier
SME Energy Limited	17-Feb-2004	not yet active supplier
Pan-Utility Ltd	19-Feb-2004	not yet active supplier
Powerrelate Limited	27-May-2004; in process	not yet active supplier; consultancy
Primary Connections Limited	28-Jun-2004	not yet active supplier; consultancy
Abingdon Energy Limited	10-Nov-2004; 19 Jan 2005	not yet active supplier
Banbury Energy Limited	10-Nov-2004; 19 Jan 2005	not yet active supplier
Cherwell Energy Limited	10-Nov-2004; 19 Jan 2005	not yet active supplier

Source: Ofgem, Elexon and licensees

The remaining eleven supply licenses are not yet being exercised. Four of the licensees offer consultancy services at the moment, mainly to companies entering or considering whether to enter the market. Three of the licensees have systems that have recently qualified under the entry processes, on behalf of other potential suppliers. In practice, most of the licensees would consider using their licence to enter the market (or to facilitate entry by others) if there were to be a demand for this.

### **1.5 White Label supply and affinity deals**

From time to time a number of organisations have marketed electricity to domestic customers in conjunction with a licensed supplier. Often these have been large existing organisations with established brand names, such as Lloyds TSB, Virgin, Tesco and Sainsbury. They have typically worked in conjunction with one or other of the Big Six suppliers. However, some new suppliers have also emerged, whose main function is to sell electricity and gas, and often they have contracted with the newer and smaller suppliers.

The arrangements between the brand name organisation and the supplier seem to vary considerably. Differentiating factors are the extent to which each party determines certain crucial decisions such as pricing, who the customer is perceived as contracting with, and what happens in the event that the initial agreement is discontinued. Two commonly used phrases are ‘White Label’ supply and ‘affinity deal’, though again the content of each type of agreement varies.

With a pure ‘White Label’ arrangement, the customer contracts with the brand name organisation, and in a sense ‘belongs’ to that organisation. The brand name organisation contracts with the licensed supplier to provide certain defined supply services including switching and settlement, and it may also contract

with other organisations to provide other services such as billing and customer liaison. A widely cited example is Lloyds TSB Ideal, which initially obtained White Label services from TXU and later from SP. Sainsbury's arrangement with SP also perhaps falls in the White Label category.

Other brand name organisations have used an 'affinity deal' arrangement whereby the customer is attracted via the brand name, and may even deal directly with it, but in fact contracts with the licensed supplier. Tesco has this kind of arrangement with Powergen, as do a variety of other brand name organisations with other main suppliers, including Age Concern, the AA, and the RSPB. Other organisations have had such arrangements in the past, including the Daily Telegraph and Saga, and when these arrangements ceased the customers were retained by the licensed supplier. Similarly, Virgin Home Energy had a joint venture arrangement with EdF Energy, and the customers stayed with EdF Energy when the agreement ceased.

A few new companies, not themselves licensed or with leading brand names, have set up arrangements to supply electricity using the services of licensed suppliers. In the past these included Cambridge Gas and Electricity (initially White Label from Enron Direct then purchased by SSE) and Servista (initially White Label from Powergen, now absorbed into Powergen). Other new non-licensed suppliers with ongoing arrangements with licensed suppliers, and their distinctive features, include

- Union Energy, 'the only company dedicated to providing cheaper domestic energy to trade union members and their families in the UK', supplied by SP;
- Ebico, 'a not-for-profit company whose aim is to harness the power of 'the market' to tackle real issues of social justice, with a bias towards those on low incomes and stewardship of resources, consistent with those of the Christian Gospel', supplied initially by Southern Electric and now by SSE;
- Basic Power, offering 'competitively priced electricity that does not penalise customers for wishing to pay in a more conventional way' hence 'lower priced electricity at the same price to all types of customers, independent of payment method', supplied by Utility Link;
- Countrywide Farmers 'supplying the farming and rural communities with energy products since the early 1950's', supplied by Utility Link; and
- Green Energy UK offering products with 10 per cent or 100 per cent British renewable sources, supplied by Utility Link.

It is difficult to estimate the numbers of customers supplied by these various White Label arrangements, affinity deals and new suppliers. Industry records do not identify them separately from customers of their host suppliers. Some arrangements involve only a few thousand customers, but the largest involve over one million. At a guess, between 2 ½ and 5 million customers would be on such arrangements – that is, between 10 and 20 per cent of all domestic customers.

The number of customers involved in these arrangements is thus an order of magnitude greater than the number served by the new and smaller suppliers. Such arrangements are clearly a potentially significant form of new entry and competition. In principle they can harness the selling power, credit rating, low costs and retailing experience of leading brands to the energy purchasing experience of the licensed suppliers, and thereby enable leading brands to enter the domestic energy market with minimal cost and disturbance. They can also facilitate the entry of new and inexperienced suppliers into niche areas.

However, whether White Label and affinity deals will continue and grow, and whether they will constitute effective competition to the Big Six suppliers, is less clear. While some of the Big Six are evidently interested in acting as White Label suppliers, most seem to regard it as unprofitable and not worthwhile. They see a danger of 'cannibalisation' whereby the partner brand simply takes the host's

customers rather than attracts new ones. Hence the incumbent suppliers prefer to manage as much as possible of the partner brand's end product. But some incumbent suppliers have found it difficult to control the marketing and sales activities of the partner brand.

Affinity deals are more attractive to the licensed supplier insofar as the partner brand simply attracts customers to the host supplier. In this case prices are typically set by (or by agreement) with the licensed supplier. If the deal ceases then the customers stay with that supplier. However, such deals are of less interest to a branded company wishing to enter the market and control its own product. And while affinity deals with an incumbent supplier may intensify competition among the Big Six, they do not necessarily provide an alternative to the Big Six.

### **1.6 Is new entry important?**

New smaller suppliers thus account for only about ½ per cent of domestic electricity supply. In aggregate they have grown quite rapidly, but incumbent suppliers have bought out the faster growing ones, not least because they have run into difficulties of various kinds. Other organisations have entered by means of White Label and affinity deals, perhaps amounting to 10 to 20 per cent of the market. Whether this form of competition will continue is unclear, and is outside the focus of this study.

If new entrants supply such a low proportion of total output, do they have any significant effect on the market? Is it really worth doing anything about the paucity of new entry?

Ofgem has already given a good answer on this point. The lower the entry and expansion barriers, the more likely it is that new entry will prevent incumbent companies from persistently raising prices above competitive levels. Put another way, the higher the entry and expansion barriers, the more easily can the incumbents increase prices, put aside innovation, and enjoy a more comfortable life at the expense of domestic customers.

The price in any market tends towards the cost of new entry. If new entry is infeasible or costly, incumbent firms are likely to charge correspondingly high prices. Quality of service and variety of product will also suffer. Facilitating new entry is therefore necessary in order to ensure competition, and to protect customers in the longer term.<sup>8</sup>

The smaller new entrants have a greater impact on the competitive market than their market share suggests. It is typically a smaller new entrant that offers the lowest price for the majority of services. For example, at the time of writing, the lowest offer in my own postcode area for domestic electricity supply at an average of 3300 kWh per year is by a smaller new entrant. It offers a discount on the incumbent price that is one third bigger than the discount offered by any Big Six competitor. For a domestic customer using 6600kWh the discount is two thirds bigger than any Big Six discount, and a second new entrant also offers a better discount than any Big Six company.

Price is not the only consideration. In several cases the new entrants offer differentiated products for niche markets, often reflecting particular social values. They claim, at least, to offer better and more personal customer service by virtue of being smaller and more specialised. They also tend to innovate. This is consistent with experience in the Nordic countries, where smaller entrants rather than incumbents have pioneered the introduction of competition for residential customers, not least by offering innovative

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<sup>8</sup> The presence or otherwise of independent suppliers also has implications for new entry in generation, but this aspect lies beyond the present report.

fixed price contracts.<sup>9</sup> Of course, as in the Nordic countries, incumbent suppliers themselves have often initiated or responded with products in some of these categories.<sup>10</sup> However, the richness and variety of competition is enhanced by the presence of new independent suppliers. It is therefore important to understand what determines the rate of entry of smaller suppliers, and whether this is constrained by economic factors or by artificial barriers to entry.

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<sup>9</sup> See section 10.4 below.

<sup>10</sup> E.g. *Review of domestic gas and electricity competition and supply price regulation: Conclusions and final proposals*, 16/02, Ofgem, February 2002, Appendix 4.

## 2. THE COSTS AND PROFITABILITY OF NEW ENTRY

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### 2.1 Ofgem's headroom analysis

Is the domestic electricity market sufficiently attractive and profitable to attract and sustain smaller new entrants? Ofgem last year estimated the costs and revenues of operating in the supply business as a new entrant, and deduced the level of 'headroom' between revenue and cost. In part this was a response to suspicions by others that retail margins were too high.<sup>11</sup>

Appendix 11 of Ofgem's *Domestic Competitive Market Review* set out the main elements of cost per customer per annum over the range of all 14 ex-PES regions. Table 4 below takes the midpoint of the ranges for a standard rate customer with average consumption (3300 kWh).<sup>12</sup> The numbers are rounded to the nearest pound. The first column below gives the figures for paying by standard credit. The figures for other payment methods are the same except for revenue, supply business costs and metering costs. The revenue figures are based on the tariff of the in-area incumbent on 1 March 2004. The headroom figure gives the calculated margin by which the entrant could undercut the incumbent at that time.<sup>13</sup>

Table 4 Ofgem's headroom analysis (simplified)

<u>Cost item</u>	<u>Standard Credit</u>	<u>Direct Debit</u>	<u>PPM</u>
Revenue	£256	£246	£264
Electricity costs	78		
DUoS costs	58		
Supply business costs	60	37	57
Acquisition costs	20		
Meter provision & maintenance	4	4	9
TNUoS costs	7		
Renewables obligation	4.5		
Energy Efficiency Commitment	4		
Total costs	235	212	251
Headroom (£/customer/yr)	20	34	13
Headroom (per cent)	8	16	5

<sup>11</sup> "The Public Accounts Committee has recently suggested that the domestic retail market has been less competitive than the industrial and commercial sector and has recommended that Ofgem carry out a review to determine whether the suppliers are acting in an anti-competitive manner to the detriment of domestic customers." (Ofgem 2004, p. 133) In addition, some parties have raised the question "whether adequate incentives exist on ex-PES or BGT suppliers to compete more aggressively, given that they have these established and large scale businesses".

<sup>12</sup> One entrant has commented that the average customer uses much more than 3300kWh per year, perhaps more like 5000 kWh. It is true that 3300 kWh is now on the low side. However, it has long been a common point of comparison for pricing that is now used by (e.g.) energywatch and the Advertising Standards Authority. Attempts to calculate an actual average have proved difficult, not least because of regional variations.

<sup>13</sup> Table 4 reflects averages and mid-points whereas the underlying data varied considerably from one region to another and Ofgem gives ranges. For example, the average headroom on a prepayment meter customer ranged from -2 to 15 per cent, a spread of 17 percentage points compared to the average of 5 per cent. This presumably explains, for example, why Ofgem's calculated average headroom for direct debit customers is 16 per cent while in Table 4 herein the £34 midpoint of the headroom range is only 14 per cent of the £246 midpoint of the annual revenue range.

Ofgem calculated that the weighted average headroom (with an average mix of customer types) was about 11 per cent. It rightly cautioned that its estimates were sensitive to many assumptions. It nevertheless concluded from this headroom analysis that “entrants could still profitably enter the retail supply market although supply margins for a new entrant are relatively low for smaller suppliers”. (p. 135) It suggested that new entry was not being deterred, but was being constrained to certain forms e.g. “to enter on a large scale based on an existing brand and/or distribution channel”. (p. 135)

## **2.2 Need for further investigation**

These calculations are helpful in indicating the relative magnitudes of the main costs of the supply business. However, they largely reflect the costs and experience of incumbents, since little was then known about the costs of new entrants. This suggests a need to look at the actual costs of new entrants, and in more detail than given in the calculations.

In addition, the calculations are based on the supply costs associated with about one million customers. Ofgem’s Figure 5.2 (p. 138) shows how the electricity headroom varies according to scale, ranging from just under 10% at 0.5 million customers to nearly 25% at 15 million customers. But with the exception of the incumbent gas supplier Centrica, which has reached about 5 million electricity customers, none of the electricity entrants has yet approached even the lowest end of this range. The largest new suppliers to date (Independent and Atlantic) reached about 0.3 million customers each, including both gas and electricity, before they exited the market. Only one or two other suppliers seem to have exceeded 100,000 gas plus electricity customers. The number of electricity customers with Other suppliers in December 2004 is little over 100,000 in aggregate among half a dozen suppliers. Even on Ofgem’s calculations, the headroom percentage seems likely to tail off significantly at such small customer numbers.

Even if a new entrant can eventually aspire to 1 million or more customers, it is evidently necessary to consider the interim period when it might have 1000, then 10,000 then 100,000 customers. Moreover, not all entrants do aspire to 1 million customers or more. Some entrants seek to fill smaller niches in the market by offering different products and services. For such suppliers, 100,000, 10,000 or even 1,000 customers might be an ultimate aim rather than an interim stage.

It is therefore important to look at the costs actually incurred by smaller new entrants and at smaller sizes than 1 million customers. Three elements of Ofgem’s Table 5 are most relevant in terms of differential costs of new entrants: electricity costs, supply business costs and acquisition costs. The following sections do not purport to be definitive, but rather to indicate the general implications of what entrants have experienced.

## **2.3 Electricity costs**

Ofgem says that ‘electricity wholesale costs were based on annual April 2004 baseload and peak prices over the period 9 June 2003 to 30 January 2004. It was assumed that peak prices represented ten per cent of the total electricity wholesale cost.’ Leaving aside any changes in wholesale price levels since March 2004, was this the right basis for calculating energy costs?

One licensee commented that his modelling also assumed a 10 per cent weighting for peak prices, but that Ofgem did not seem to have factored in any allowance for risk premium. The extent of this would depend on arrangements with the energy provider: this licensee’s assumption was that 15% should be added for risk premium. In addition, allowance should be made for imbalance charges or very short term

trading, including the costs of a trading team. In practice, some small suppliers have had to buy all or much of their energy in the balancing mechanism.

If the average annual energy purchase cost is £78 per customer, then a 15% allowance for risk would add about £12, and an allowance for imbalance charges could increase this to at least £15. Two small suppliers suggested that if anything this was an underestimate.<sup>14</sup>

## 2.4 Customer acquisition costs

Ofgem estimated annual customer acquisition costs at £20 per customer. This is based on an acquisition cost of £53.33 discounted over three years using a long-term risk free rate of 5 percent.<sup>15</sup>

These assumptions may be plausible for an incumbent. Some incumbents have paid considerably more to acquire customers by takeover of existing REC businesses, generally in the range £100 to £300 per customer.<sup>16</sup> This presumably reflects various factors, including the high margins that could be obtained when the wholesale markets were low, the high proportion of profitable 'in area' customers that are 'stickier' on average, and potential efficiencies from combining existing businesses.<sup>17</sup> BGT seems to have incurred losses totalling about £100 per customer to build up its electricity business.<sup>18</sup>

However, smaller new entrants have typically not been able to afford such acquisition costs, and moreover would not be able to finance them at a risk-free rate of 5 per cent. Discussions with such entrants (see Appendix 1) suggest acquisition costs in the range £20 to £50 per customer, or discounted say £10 to £20 per year. This is for an electricity only customer: it would be worth paying more to acquire dual fuel customers. Note, however, that these methods and costs might not be sufficient to attract the volume of customers necessary for an entrant that planned to grow fast, particularly to achieve a level of 1 million customers. And note that these costs would need to be incurred repeatedly since 'less sticky' customers are more likely to leave. For present purposes, assume the acquisition cost would be £10 per customer per year for a small business, £15 for a medium-sized one and £20 for a large one.

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<sup>14</sup> One commented that smaller players tend to purchase 'shapes' rather than blocks of peak and off-peak, particularly as the 'domestic shape' at smaller volumes does not lend itself to combinations of such blocks. This results in higher premiums for risk and for third party costs. The other suggested that the risk premiums referred to were appropriate in previous years. There was a long period of falling wholesale electricity prices during which the risk being taken by new entrants (indeed all suppliers) was low because any unhedged sales could usually be purchased on the day at lower than the hedged price. However, such risk premiums would be inadequate in today's market of rapidly escalating wholesale prices, when any under hedging would prove to be very expensive and risky. The obvious solution of over-hedging and selling back into the market what was not needed was not easy for the smaller player, since the wholesale and trading markets are still not readily accessible to such players.

<sup>15</sup> This acquisition cost is in turn based on "the average marketing and advertising costs of the incumbent gas and electricity suppliers, which are given in the data monitor report *2002 UK Residential Review*, plus the cost of acquiring a customer given in the Datamonitor report *Reducing the cost to acquire*". *Domestic Competitive Market Review*, Appendix 10, pp. 86-7.

<sup>16</sup> *Domestic Competitive Market Review*, Figure 5.3, p. 140.

<sup>17</sup> Atlanta Energy had a different customer base and was in financial difficulties when SSE acquired it, but even so the reported price was £50 per domestic customer. Datamonitor 1 April 2005.

<sup>18</sup> BGT's accounts show a series of losses on the electricity business over the period 1997 – 2000: £25m in 1997, £86m in 1998, £167m in 1999 and £107m in 2000, totalling £385m. By this time BGT had acquired 4 m customers. On this simple basis the average cost per customer was £96. There was a profit of £40m in 2001, after which time separate figures were not given for electricity.

## 2.5 Supply business costs

Ofgem assumed supply business costs of £60 per standard credit customer. This is understood to cover the normal costs of such a business, including meter reading, call centres, billing and collection, bad debts, and so on. Two modifications seem appropriate for smaller entrants.

First, while the Ofgem estimate includes an allowance for working capital, it is not clear that it reflects the costs of credit cover that a small entrant would incur. For such players, credit cover is a particular burden, as the interviews reported below make clear. Their costs are likely to be higher than that of incumbents or large established companies. Rough calculations (see Appendix 1) suggest that an additional cost of, say, £2 to £6 per customer per year might be allowed for this, depending on size of business.

Second, while Ofgem's calculations cover the ongoing costs of an existing supply business, it is not clear that they include the initial costs of setting the business up in the first place. These costs are substantial, and include the costs of IT and billing and settlement systems, the costs of the new entry qualifying process, and other initial costs such as legal fees and initial marketing. Discussions with entrants suggest that such costs might range from about £300,000 for a small business aiming at between 1000 and 10,000 domestic customers, £700,000 to £1 million for a medium-sized business aiming at 10,000 to 100,000 customers, and £3 to £8 million for a large business aiming at 100,000 to 1 million customers.

Assume that these initial costs would have to be covered over the first five years, assume optimistically that the business might achieve an average of half its maximum capacity size over this period, and include interest charges at a modest 12 per cent. This implies an average cost of £17 per customer per year in a small business, £5 in a medium-sized business and £3 in a large business. The lowest cost requires that about 1 million customers could be attained in about 5 years. This is a rather challenging target – with the exception of BGT none of the other new entrant suppliers has reached more than a quarter of that level.

## 2.6 Net modifications to headroom

Table 5 brings together these calculations. They also acknowledge that the Energy Efficiency Commitment (EEC) is not applicable to businesses with fewer than 15,000 customers. The implication is that entrants' costs would be some £20 to £24 higher than Ofgem estimated. Ofgem calculated headroom of £20 per year for a standard credit customer.<sup>19</sup> The calculations therefore suggest that modifications to reflect the actual costs of entrants would essentially remove the headroom on Standard credit customers for large and medium sized entrants, and render it negative for the smallest ones. The same modifications applied without further investigation of costs suggest that, for all sizes of entrant, there would still be some positive headroom for direct debit customers but negative headroom for prepayment customers.<sup>20</sup>

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<sup>19</sup> Strictly speaking, Ofgem's figures applied to Large suppliers with about one million customers, hence the square brackets in the table around the Ofgem figures for Small and Medium suppliers.

<sup>20</sup> One small supplier questioned whether the differential between standard credit and direct debit customers would be as great as Ofgem's calculated £23. There was not such a great differential between the cost of processing direct debits and the cost of processing cheques since a similar percentage of direct debits are 'cancelled by the bank' or 'referred to drawer' as are cheques. This supplier suggested a differential of around £5.

Table 5 Modifications to Ofgem’s headroom analysis

Size of new entrant supplier	Small	Medium	Large
Ofgem headroom Standard credit	[£20/yr]	[£20/yr]	£20/yr
Possible adjustments:			
Electricity purchasing (risk)	-15	-15	-15
Credit cover	-6	-4	-2
Customer acquisition	+10	+5	0
Other initial costs	-17	-5	-3
Energy Efficiency Commitment	+4	0	0
Total adjustments	-24	-19	-20
Revised headroom Standard credit	-£4	£1	£0
Ofgem headroom direct debit	[£34/yr]	[£34/yr]	£34/yr
Revised headroom direct debit	10	15	14
Ofgem headroom prepayment	[£13/yr]	[£13/yr]	£13/yr
Revised headroom prepayment	-£11	-£6	-£7
Ofgem average headroom			11%
Possible revised average headroom	0-2%	4-5%	3-4%

Ofgem calculated that the weighted average headroom for a large entrant was about 11 per cent. This assumed proportions of customers of different types approximately equal to the national average (45 per cent standard credit, 40 per cent direct debit and 15 per cent prepayment). Table 5 assumes customer proportions more in line with those of new entrants (40 per cent standard credit, 57 per cent direct debit and 3 per cent prepayment). Even so, the weighted average headroom is only 3 to 5 per cent for medium to large entrants, and barely positive for small entrants.<sup>21</sup>

These calculations are evidently very rudimentary, and the components may well change over time. Nevertheless, to the extent that weight can be placed on them, the calculations suggest that new entry into residential supply may be less profitable than Ofgem’s headroom analysis implied, especially for the smallest entrants. So the relative lack of entry, or at least lack of outstanding profitability and growth so far, is not entirely surprising. More encouragingly, however, the figures suggest that entry on a medium scale may be as viable as on a large scale, although it would be necessary to reexamine all the other cost elements (particularly associated with credit cover and purchasing ability) before drawing that conclusion.

## 2.7 Financial backing

The figures are consistent with the suggestion that the minimum efficient scale is between about 100,000 and 1 million customers. This assumes an initial outlay of at least £1m, and more likely around £5m. Moreover, the experiences of those companies that exited the market, as well as those of the new entrants set out below, suggest that the initial investment is not recovered immediately. Rather, it is

<sup>21</sup> The lower ends of these ranges reflect direct debit headroom percentages as calculated in this table; the higher ends reflect the 2% higher average headroom reported in Ofgem’s table.

followed by a cash-negative period of several years duration, during which the business needs to put up additional cash to build up customers.

This seems to confirm the view that only entities with significant financial backing are viable. There are no bankable contracts for future outputs, so the prospects for bank lending are remote. The financial backing is more likely to come from a venture capital fund, or from a larger parent company.

A venture capitalist might look to double its money within 3 to 5 years. It would not look to a longer-term investment. Therefore, within 3 to 5 years the business should be saleable, or at least it should be possible to replace some of the venture capitalist's equity by debt. This would normally require the business to be cash-positive and to have gone some way to paying off the initial costs.

## **2.8 Other routes to profitability**

Those who wish to enter the market, especially those without such extensive financial backing, will naturally look for ways to reduce some of these costs. Several possibilities were suggested to me.

An initial expenditure of several million pounds might be avoided by entering on a small scale. £0.5m was generally regarded as the minimum required for new entry. However, an initial cost lower than that is not impossible. For example, the entrant might accept a very rudimentary system (at least initially), or secure lower costs by virtue of the entrant's own expertise, or negotiate a special deal with equipment or service providers, or share costs with other entrants or suppliers, or accept greater outsourcing, or defer some of the initial outlays over time to relate them to the rate of growth of customers, or accept a subsequent growth rate very constrained by availability of cash. A combination of several of these factors might reduce costs even further. Such an entrant might be forced to live from hand to mouth for some time, but this would not necessarily preclude eventual success.<sup>22</sup>

A second possibility is that, for new entrants, other supply business operating costs might be significantly less than the £60 per customer per year assumed in the headroom analysis. One entrant suggested that this could indeed be the case. A new system could be significantly more efficient than the incumbent systems. It might have lower staffing and overheads. It might also be more flexible, amenable to different kinds of products than the legacy systems of the incumbent suppliers.<sup>23</sup>

A third possibility, already noted above, is that new entrants might focus on more profitable customers. Specifically, the headroom on a direct debit customer is higher than on a standard credit customer, which in turn is higher than on a prepayment meter customer. Table 5 in section 10.2 below shows that most of the smaller entrants have in fact specialised in this way.

## **2.9 Comparison of new entry conditions for generation and retail**

It is of interest to compare the conditions of entry in the residential sector of the electricity retail market with that of generation, where there has been significant new entry, including on a small scale. What are the similarities and differences between the two sectors?

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<sup>22</sup> However, one entrant argued that it was very difficult and costly to start with a small system and then migrate to a larger one. He suggested that Independent and Atlanta had perhaps experienced problems by starting with systems designed to accommodate tens of thousands of customers and then having to convert them to accommodate hundreds of thousands.

<sup>23</sup> Datamonitor has in fact carried out studies showing lower supply costs, but it is not clear that these cover all the items included in Ofgem's calculation.

In both cases, entry is possible at about one per cent of the market – say a 600 MW CCGT generation plant or 250,000 residential customers. There is evidence that new entry in generation is possible and successful at a wide variety of sizes – new plants have been constructed at anything up to about 3 per cent of the total UK market. It is not yet clear what size ranges of entry in retail supply are viable over an extended period of time.

The initial cost of a ‘one per cent entrant’ would be very significantly lower in retail, perhaps of the order of £5m suggested above, compared to about £265m for a 600 MW generation plant (at £275/kW). On the other hand it would take about twice as long to get to target size in retail – say about six years compared to three years for the generation plant. And the retail operation would be cash-negative for all or most of this period, whereas the generation plant would be cash-positive from the time it started operation.

There are risks in both businesses but those in retail are less well known and less easy to lay off than those in generation. For example, it is possible to contract for fuel purchases and electricity output for several years ahead, whereas the difficulty or impossibility of contracting far ahead for residential customers render anything more than short-term hedging difficult.

## **2.10 Conclusions on profitability of new entry**

To summarise, some of the initial costs of entering and operating in the domestic electricity supply business may well be higher than Ofgem’s headroom analysis estimated. Certainly a cash-negative period of several years seems to be necessary. As a result, the headroom available to a new entrant may well be less than Ofgem estimated, perhaps even zero or negative in some cases. This could help to explain why new entry has been relatively limited, especially at the residential level, and in some cases unsuccessful. It is not in itself a sign that supply competition has failed, but rather that the market is gradually responding to the underlying costs of operation.

On the optimistic side, there may well be ways in which new entrants can reduce their costs, especially if they are established organisations or brands with lower costs of capital.<sup>24</sup> And although the initial costs of entry may seem high, they are small compared to the costs of entering the generation sector.

The next part of this Report looks at the problems as perceived by the new entrants themselves, beginning with the accounts of entrants that have since left the market. With respect to each problem the Report looks for ways in which the barriers to entry and associated costs might be reduced.

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<sup>24</sup> Other means of entry including variants of White Label operation could also be attractive, and could lead in due course to the brand names becoming separate suppliers in their own right, but are beyond the scope of this Report.

### 3. THE EXPERIENCE OF COMPANIES THAT LEFT THE RETAIL MARKET

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About a dozen companies have entered the energy supply market and subsequently left it.<sup>25</sup> The reasons for this may assist an understanding of the problems facing new entrants. I have not explored the case of TXU Europe, the owner of an incumbent business (Eastern Electricity) that was placed in administration in 2002 and whose contracts Powergen acquired. Nor have I looked at primarily gas suppliers. The following notes supplement Ofgem's summary of the experiences of Independent Energy and Enron Direct<sup>26</sup> and provide an account of Maverick and Atlantic. These accounts reflect the views of senior managers of those companies.

#### 3.1 Independent Energy

Independent Energy was incorporated in 1995 with oil and gas interests in the UK. It decided to move into electricity in order to capitalise on its small gas fields. It became active in the half-hourly electricity market in 1996 and later expanded into the designated (domestic and small business) market after 1998. In the period 1996 to 2000 the company raised various amounts on the AIM and NASDAQ markets, including one offering of £99m in March 2000. At that time its share price valued the company at £1.4bn. At its peak in April 2000 it supplied over a quarter of a million domestic electricity customers and employed over 200 staff.

From Independent's perspective, billing systems and accreditation for the half-hourly market were not a problem, and for larger customers the business worked well. The company aimed at 10 to 15 per cent of that market and achieved it. There was a good process for gathering and processing consumption data. Administrative and billing costs were low, requiring only 2 to 3 people for 2-3000 customers.

When the company entered the designated (non-half-hourly) market it needed to grow rapidly in order to cover the high initial setup costs (additional IT systems, billing and accreditation). Working capital requirements were much higher because the company was paying daily for power but not getting paid until 30 to 60 days later. Distribution companies required credit cover for use of network charges that they did not require for the half hourly market. Working capital was therefore a massive issue and burden, for Independent and for other smaller suppliers that did not have a credit rating.

Direct selling was not a great problem, although sales agents needed to be strictly managed. Revenue collection was no worse at Independent than at any incumbent company where accurate bills were produced, and the receivers later collected the bulk of the monies owed.

The biggest problems lay in the processing of data in this market. This was erratic, and not consistent as between distribution companies despite testing and accreditation, and despite the delay in opening the designated market in order to prepare the existing systems. In the absence of data problems, outsourcing customer service was not intrinsically a problem, and could be sensible for a new supplier. However, it introduced an inflexibility that caused difficulties in dealing with the data problems that had not been expected given the accreditation process and the industry-specified data flow standards. The incumbent companies experienced similar data problems when attracting customers from out of area, but were not

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<sup>25</sup> Cornwall Consulting, *Business Energy Markets 2004*, Table 8.1. This includes all sectors of the gas and electricity market, not just the domestic sector.

<sup>26</sup> *Arrangements for gas and electricity supply and gas shipping credit cover*, consultation document, Ofgem, 11 March 2002, Appendix 2.

subject to the same credit costs (since they had investment grade credit rating) and their legacy customer base provided a massive financial buffer.

Data processing and consequent revenue collection problems led to Independent's exit from the market. In May 2000 the company agreed with Ofgem a special licence condition on customer service performance, and the company agreed not to market to or attempt to register any new designated electricity customers until it could meet the agreed specified standards for billing customers. The company took the view that it could have worked its way out of these problems, but banking issues led to the sale of the business. On 8 September 2000 the company asked the banks to appoint receivers and on 14 September 2000 Innogy purchased Independent Energy's supply assets for £10m. At this point the company had about 232,000 domestic electricity customers, over 3000 large industrial customers and about 80,000 gas customers.

A former executive's view is that, in retrospect, it would have been more sensible to defer entering the designated (including domestic) market until the data problems had been resolved, or to have left immediately they became apparent. There was no collective willingness in the industry to solve these problems, given the position of the established players with their legacy systems and customer bases. Until these problems are solved, an entrant needs to recognise that data collection is an issue in the designated market, and to budget for revenue collection to be delayed and for additional customer service costs to be incurred as a result.

### **3.2 Enron Direct**

Enron began electricity trading in 1994. Its subsidiary Enron Direct Limited obtained an electricity supply licence in September 1997. Enron found the new entry and accreditation process tortuous: at that time there was no knowledge of the process, and Enron underestimated the magnitude of it. In addition, the process was alien to its own approach, too formal and unduly based on existing PES systems.

Nonetheless Enron Direct appears to have been a successful business. It supplied gas to approximately 12,000 non-domestic sites and electricity to approximately 149,000 non-domestic sites and 34,000 domestic sites. It served the domestic sites as a White Label supplier to other companies. Some of these companies subsequently obtained White Label supply from other licensees.

In September 2000 Enron Corporation reached a peak stock market valuation of \$66bn. On 31 October 2001 the SEC launched a formal investigation. Enron Corporation filed for bankruptcy on 2 December 2001. Enron Direct Ltd was put into administration on 4 December 2001, and Centrica purchased certain assets and liabilities for £96.4m. The decision to put Enron Direct into administration seems to have been due to the parent company's bankruptcy rather than to incapable trading or problems in the supply market.

### **3.3 Maverick Energy**

Maverick Energy was founded by a group of executives that had been buying power for groups of schools at the time of privatisation. There was a particular demand for this activity after the over-100kW market was opened to competition in 1994. The executives became aware of the lack of customer care in this sector of the market, and decided to set up a business to offer more customised billing to multi-site customers. Maverick Energy was established with private finance in June 2000, and obtained a supply licence in November 2000. Suitable IT and billing systems and accreditation were all difficult and very costly. Marketing and attracting customers were not a problem since the multi-site customers

appreciated a better product. The company grew to an annual turnover of over £50m by June 2003, supplying some 12,000 sites.

The main problem that the company faced involved data communications: data came in different formats not matching the standard format. It was not possible to halt supply in order to sort out these problems, since the customers needed a continued supply of electricity, so the problems compounded. At the same time the company needed to sell power in order to pay back borrowed money.

With the change from the Pool to Neta in 2000/1 there was a period of uncertainty about credit mechanisms. In June 2003 the company's overseas source of finance (Sempra) decided to tighten its credit stance, call in receivers and sell the company's contracts to Atlantic, which it part-owned.

In retrospect, a former executive's view is that it was risky to get involved in a regulated industry where so many of the activities were outside of the company's own control. It could not move quickly to solve any problems, and there was little incentive within the industry to solve the communal data problems. The company might have decided to grow more slowly, but there was a strong demand for its service. And this demand came in chunks: if a customer had 700 sites the company could not simply take 30 of them.

### **3.4 Atlantic Electric and Gas**

Atlantic Electric and Gas was set up in early 2000 and acquired a supply licence in July 2001. It planned to build up a volume business quickly (between 0.5m and 1m customers) in order to recover money spent in the early years. In contrast to the other new entrant suppliers the original aim was to sell out within 4 to 5 years. The US utility group Sempra funded the company.

IT systems and accreditation were difficult, time consuming and expensive, but this was expected. There were no suitable billing systems: the company eventually bought a US system designed for incumbent utilities that had inadequate facilities for frequent change of customer base, and modifying this system took longer than expected.

Doorstep selling and telesales were necessary to acquire large volumes of customers quickly. The company understood the problems of managing the sales agents. However, there were problems throughout the industry with European Sales Agency regulations that gave sales agents significant power in relation to the principals. (This came to a head in 2001/2 when one of the incumbent suppliers settled out of court with one of the sales agents.)

Purchasing energy was not a problem: this was done by Sempra's trading arm, which also provided credit cover. Enormous amounts of working capital were required, since revenues were collected about two months in arrears of cash outflows. Customer service was done at an in-house call centre, which was large and expensive. Billing caused some problems because of the inadequate systems for data transfer within the industry. The problems were exacerbated by competition in metering, which added to the complexity, errors, costs and billing delays.

In 2003 Maverick Energy was having billing and collection problems. Atlantic's part-owner Sempra was also Maverick's biggest creditor. In June 2003 Atlantic agreed to take over Maverick's customers in order to maximise recovery of these revenues. This also added to Atlantic's customer base. The company eventually grew to about 260,000 domestic gas and electricity customers plus another 70,000 non-domestic customers (that is, sites), and was claimed to be the most successful new entrant company.

The increase in wholesale prices in 2003 was a problem: the company had typically not hedged all of its sales because there was a high premium in the forward market and forward prices typically fell as the actual date approached. This, coupled with incumbent competitors' prices based on their vertically integrated structure rather than on current wholesale market prices, put a squeeze on retail margins and forced a sale of the company in April 2004, a little earlier than planned. The purchaser SSE required a 'pre-packed deal' that involved the company being put into voluntary receivership in order to prevent sales agent liabilities passing across to the purchaser.

### **3.5 Main problems for companies that exited the market**

The experiences of those companies that exited the retail suggest a variety of different problems. There were high initial costs and a need for very high working capital for credit cover (for energy purchases and network charges). As long as the businesses were growing, they were cash negative. These aspects might have been foreseen. On the other hand, the data transfer problems, which impacted on operating costs, customer service, billing and revenue collection, were unexpectedly severe. The solution to them (as opposed to managing the consequences of them) was largely outside the control of the companies.

Opinions will no doubt differ on how well these companies anticipated and managed these problems. However, subsequent new entrants presumably have to cope with essentially the same problems. An aim of the present Report is to ascertain whether the present new entrants perceive the same problems or whether the problems have changed, and to consider what if anything could and should be done to reduce these problems.

## 4. MARKET STRUCTURE, BARRIERS TO ENTRY AND SMALL SUPPLIERS' CONCERNS

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### 4.1 The determinants of market structure

There are at present six major and similar sized vertically integrated suppliers in the domestic electricity sector. Is this the most efficient structure of the industry, the result of competitive market forces? Or has it been distorted and protected by artificial or unnecessary barriers to entry and expansion? Depending on the answers to these questions, further steps to assist new entry and small suppliers would either be uneconomic and costly, or would be necessary to reduce or remove such barriers in order to secure a more efficient industry.

Certain economic factors tend to favour larger and established suppliers. These factors include economies of scale, good credit ratings for purchasing power, established brand names and customer bases, experience in the industry, the high up-front costs to competitors of new entry and growth, and so on.

New entrants see themselves as willing and able to meet and overcome these factors – for example, by lower costs of operation, greater flexibility, lower prices, better quality service, more innovative products and faster reactions in the market. In this way, entrants envisage achieving sufficient scale, credit rating, brand name and experience to compete successfully with the incumbents, whether this be in volume or in various niche markets.

However, entrants also see other factors as conferring additional largely artificial advantages on incumbents, and unreasonably holding back new entry and expansion. Energy regulators Offer, Ofgas and Ofgem have taken steps to remove such barriers, as each sector of the market was opened to competition. Yet several such barriers are still perceived to exist. One respondent – not a small or new supplier - commented “The market is completely stacked against new entrants.”

### 4.2 Ofgem’s analysis of barriers to entry

Ofgem has periodically assessed the market situation. In November 2001 it examined potential barriers to entry and expansion in the domestic retail supply market.<sup>27</sup> It took a broad definition of a barrier as anything that might deter entry or expansion, and that it might be appropriate for Ofgem or others to take action to change. In April 2004 its *Domestic competition market review* examined the barriers identified in 2001 and discussed the findings of a more recent exercise. It explained the changes that had taken place since 2001 in six main features that might present barriers to entry. It then presented the results of talking to actual and potential new entrants in order to assess the potential impact of barriers to entry and expansion, and outlined its findings and conclusions. Appendix 2 summarises that review document.

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<sup>27</sup> *Review of domestic gas and electricity competition and supply price regulation: evidence and initial proposals*, 71/01, Ofgem, November 2001

### 4.3 The concerns of new entrants

Ofgem's review might suggest that all potential barriers to entry are now dealt with or are in hand. This was not the view of the smaller new entrants into the domestic electricity sector. Although a great deal has been achieved, especially with the fundamental separation of distribution and supply businesses, such entrants have numerous outstanding concerns. As discussed in the previous section, those companies that have left the sector as a result of takeover feel most strongly about the poor state of data quality. For those entrants still in the sector, the following six were generally held to be the most serious:

- g. the complexity and cost of entry qualification processes including accreditation
- h. the cost of credit cover
- i. the increasing difficulty of purchasing and lack of liquidity in the wholesale market
- j. the quality of data
- k. the lack of competition for metering and related services, and
- l. the restrictions and burden of regulation.

This is not an exhaustive list. Other concerns were certainly mentioned.<sup>28</sup> But the above six were the main concerns. This is not to say that smaller entrants claim that all their problems are due to entry barriers. They accept that larger and more established companies have certain advantages, and that some smaller new entrants have suffered from lack of experience. However, the above six factors do cause them serious concern.

Other factors were costly and often took up a great deal of management time, but did not seem to be perceived as major barriers to entry and expansion, at least on a continuing basis. For example, many suppliers commented that there was very limited choice of suitable IT and billing systems.<sup>29</sup> Perhaps some lack of choice here is to be expected given the (at present) relatively limited extent of supply competition worldwide. Some newer entrants feel that they have now developed better systems.

Most new suppliers did not see attracting customers as a significant problem, although some of those entrants competing other than on price do find it hard work. All were aware that there was a cost involved in acquiring customers quickly, and they had to choose the most appropriate method. Nor was staffing a particular problem, although call centre staff required training and turnover was quite high because it could be a stressful job. Some knowledge of the industry was needed at more senior level, but most suppliers had previous experience in the industry, and consultancy support was available. There may have been other concerns related to supply in the gas rather than electricity sector, but this inquiry did not probe these.

Several of the main concerns have also been noted in Cornwall Consulting's recent review of the small business market. For example, "market risk and volatility have increased markedly [and] declining liquidity is making pricing more unpredictable"; "industry data problems are constraining competition. They particularly affect smaller sites"; "Persistent regulatory change in a fixed price environment is not helpful to suppliers and ultimately their customers, especially at the smaller end of the market where

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<sup>28</sup> Some suppliers referred to the complexity of the industry agreements, and the behaviour of some incumbent suppliers and distribution companies. In particular, there was a concern that the translation of revised price controls into transmission and distribution charges was sometimes unpredictable and inexplicable, with adverse effects on retail competitors and on customers. It was suggested that there be a requirement for adequate notice and a limit of, say, 5 per cent a year on the increase in any component of such charges.

<sup>29</sup> An IT and billing system from the US was noted, but considered as better suited to a monopoly utility with stable customer base than to a competitive supplier whose customers would change frequently.

such supply terms are much more prevalent and transaction costs can be significant on a per account basis. There is also a perception that the market structure works against small players in that they are unable to provide enough resource to monitor and influence regulatory policy and the resulting market change.”<sup>30</sup>

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<sup>30</sup> *Business Energy Markets 2004*, pp. 10-11. It is also said that “market entry processes are perceived to be over-rigorous”, “governance processes in both gas and electricity markets, especially processes for making changes, are resource intensive and favour larger suppliers”, and “competition in metering and data services is introducing unnecessary system complexity, and increases the tendency for errors to occur and thus customers to suffer billing difficulties”. p. 140.

## 5. ENTRY QUALIFICATION PROCESSES

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### 5.1 Nature and merits of the present processes

Before they can act as a supplier, new entrants have to demonstrate that their systems and processes meet specified conditions. At present, Elexon<sup>31</sup> and MRASCo<sup>32</sup> carry out these scrutinies.<sup>33</sup> Elexon has usefully summarised the qualification processes.<sup>34</sup> The main elements are set out in Appendix 3 to the present Report, with an indication of the time and charges involved at each step.

Entrants recognise that the actions and capabilities of any market participant can impact on other parties. Almost without exception, they saw some merit in having some form of scrutiny of the systems and processes of new entrants.

Suppliers noted several merits of the present testing process. For example, they variously said that it brought home to new entrants the nature and complexity of the market arrangements as a whole, helped them to ensure their systems worked properly, was useful to show staff how the process works and was good training for customer services and billing staff. Entrants would need to test their own systems anyway, so that not all the time and cost of the formal BSC process could be avoided if it were simply removed. One adviser said the qualification processes were mostly clear and reasonable, although not always appreciated by their clients.

Some said that testing processes were improved from a few years ago, when they were 'tortuous'. One said that qualification was difficult and time-consuming, but not more than expected. Later entrants seemed to appreciate Elexon's increased guidance. One said that it was possible to facilitate the process by working with rather than against Elexon and MRASCo. A few entrants were broadly satisfied with the present procedures. Some said the procedures took no longer than expected. A few commented, perhaps not seriously, that, now they were through the qualification process, it was a useful barrier to the entry of further competitors. Most did not take this view, and several said that they would welcome a greater number of smaller suppliers in the market.

### 5.2 Concerns of new entrants

There were nonetheless more criticisms about the qualification processes than compliments. One supplier said that, as a result of the P62 modification, the tests were about 20% more onerous than they used to be. Another supplier said that the P62 change had cost it £300,000 in additional consultancy charges, and noted that not all the incumbents had yet complied with P62. Another

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<sup>31</sup> Elexon is the Balancing and Settlement Code Company (BSCCo) created by the Balancing and Settlement Code (BSC).

<sup>32</sup> MRASCo is the MRA service company, 'the custodian of the retail design for the UK electricity market that sets out the operational and contractual framework for registration of metering points by licensed market suppliers'.

<sup>33</sup> As it happens, discussions tended to focus on Elexon rather than MRASCo, but it may be that entrants' comments and concerns apply to both.

<sup>34</sup> *Simple Guide to Market Entry*, Elexon, version 1.9, February 2005.

said that, although there was now faster completion of testing, this was primarily due to the greater experience of consultants rather than to any simplifications introduced by Elexon.

All the entrants agreed, and most complained, that qualification was a costly and time-consuming process. Evidence from the suppliers suggests that testing now typically takes about 2 to 3 months and costs nearly £0.25 million in consultancy fees or own-staff time. Both these figures can vary: this variation may offer the prospect of a quicker and cheaper process for those that are well-prepared but also the prospect of a longer and more expensive one for those that are not. This adds to the uncertainty facing an entrant. Moreover, it was pointed out that this cost and uncertainty came at a particularly difficult time for new entrants. There were suggestions that the process and cost should be related more closely to the growth pattern of the entrant, being less onerous at first when the entrant was just starting out.

The strongest and most frequent complaint of most entrants is that much of the testing process seems inappropriate or too detailed and unnecessarily onerous, and constituted a barrier to entry. Frequent complaints were that it was focused on a series of theoretical scenarios, and did not test the systems in the conditions under which it would actually be used. For example, it assumed specified completion times for various tasks to be carried out by other parties that in practice were generally beaten or exceeded. One entrant commented that the test environment actually introduced additional risks because the theoretical test assumptions then had to be adjusted to reflect reality.

A related complaint was that the systems and tests seemed unduly related to the older systems of the incumbent PESs. One supplier constantly felt that the rules were written to keep out new entrants. A more specific example was the requirement for paper printouts at various stages to check that the processes were operating properly, whereas newer IT systems would not need this. Consequently, the test did not check how these newer systems would actually operate in practice.

The testing requirements were widely thought to be 'over the top'. Similar or even identical systems all had to go through the testing process separately. There was an overlap between the testing processes of Elexon and MRASCo, resulting in unnecessary cost and delay.

It was noted that the testing focused on the state of the system before operations began, and in the initial stages of operation. It did not provide assurances about the ongoing performance of the system. Nor did it cover other important aspects of performance that contributed to the failure of some previous entrants, such as billing competence. One supplier suggested that the focus should be adjusted to include more emphasis on billing.<sup>35</sup>

Several entrants commented that gas market procedures seemed to work well without such a qualification system, although it was recognised that the two systems had evolved in different ways.<sup>36</sup> The general view was that something should be done to reduce the onerous nature and cost of the accreditation and testing process in electricity.

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<sup>35</sup> However, billing systems are not part of the BSC settlement process.

<sup>36</sup> There was initially a single service provider in gas, hence each market participant had less requirement for assurance about the performance of others.

Several suppliers and others expressed concern in general about the rate of change and increasing complexity of institutional and regulatory obligations and provisions. As applied to the new entry qualification procedures, the concern was that changes to provisions were made frequently and were difficult to keep up with. One supplier referred to significant weaknesses in documentation in the main organisations (Elexon, MRASCo, Ofgem). The extent of complexity and change, and the lack of adequate documentation, meant that it was costly to keep up to date and to contribute to the process of debate: this made life difficult for all suppliers but worked to the particular disadvantage of new entrants and smaller suppliers.

It was suggested that qualification processes needed to be simplified and less centralised in order to reduce costs and allow more scope for innovation.

One supplier pointed out that some charges for Elexon and other services, while not an issue for larger suppliers, could be unduly burdensome on new entrants and small suppliers. It was suggested that such charges could sensibly be more tailored to the size of the market participant.

### **5.3 Addressing concerns about entry qualification processes**

New entrants are not alone in their concerns about the time and costs of the qualification processes. Elexon itself recognises that the arrangements set up to deal with the situation when the domestic market first opened are not necessarily the most appropriate seven years later. Specifically, the qualification processes were set in a market dominated by the old PES systems, and addressed the potential risks associated with new entrants or suppliers' agents that might attract millions of domestic customers, and where the procedures for customer switching were largely untested. However, these measures are not necessarily required to meet the circumstances of new entrants with new IT systems, attracting a few thousand customers in a market where switching processes are now well understood.

Elexon has recently reviewed the BSC Supplier Volume Allocation (SVA) arrangements, which are at the heart of the qualification process.<sup>37</sup> Although it finds that the arrangements work satisfactorily in many respects, Elexon refers to "pervasive problems" to do with individual metering points and suggests that the arrangements do not achieve their objectives in the most efficient way. Elexon recommends that the BSC parties consider changes that eliminate unnecessary specifications. In a subsequent review of the qualifications processes, Elexon's review group has also identified the need to tackle potential overlaps between the market entry processes of the BSC and MRA, and it is understood that MRASCo is also reviewing its processes.

It is beyond the scope of this paper to analyse in detail the strategies identified or to make specific recommendations. No doubt views differ, and one party expressed scepticism whether the 'ticking boxes' proposals would in practice reduce the burdens on entrants. Nevertheless, most suppliers saw scope for useful simplification here, and this avenue seems well worth pursuing. Small new entrants have a strong and justified concern about the cost and time and complexity of present accreditation and entry processes, there are ways of addressing these

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<sup>37</sup> *BSC Review 2004/2005: Review of the Supplier Volume Allocation (SVA) Arrangements*, Elexon, September 2004, p. 5. Appendix 3 to the present Report contains further extracts from Elexon's Review.

problems without compromising the legitimate needs of other market participants, and Elexon has proposed a set of potentially helpful reforms. However, since Elexon itself is precluded from raising a modification to implement such reform, the onus is on others to act.

### **Recommendation 1**

In order to reduce significantly the cost, time and complexity of present entry qualification processes, market participants (specifically, the BSC parties) should introduce modifications to take forward and implement reforms to the present BSC arrangements.

As regards the concern about BSC charges, the bulk of Elexon's costs are recovered from members by charges in proportion to the number of MWh generated, supplied or traded. However, there are also additional fixed charges, including a Base Monthly BSC charge of £250 per month (£3000 per year) that is described as a Membership Fee.<sup>38</sup>

These fixed charges are negligible for large participants, but they could be a burden on small suppliers. For example, a large supplier with one sixth of the total supply market might pay a usage-based charge of the order of £2m per year. In contrast, a new supplier with 1000 domestic customers might pay about £300 in usage-based charges. The Base Monthly Charge of £3000 would be nearly ten times its annual usage charge. In fact, the Base Monthly Charge would increase a small supplier's annual cost per customer by £3, and correspondingly reduce its retail margin (which according to the figures in section 2 above might be not much more than that amount).

It might be argued that £3000 a year is not a large amount, that serious suppliers ought to be able to cover it, and that Elexon staff spend considerable time with the smaller members, particularly in areas such as credit management. However, the BSC Base Monthly Charge is one of many charges that in aggregate increase the burden on small suppliers that are often particularly short of cash, and thereby hit the smallest suppliers hardest, and at the most vulnerable stage of their growth. Many other organisations have a lower membership fee for newer and smaller members in order to enable them to participate and grow. Market participants (the BSC parties) might likewise wish to consider reducing the membership fee (Base Monthly Charge) for the smallest suppliers. There would be negligible additional cost on larger suppliers.

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<sup>38</sup> *Elexon's Business Strategy and Annual Budget, 1 April 2005 – 31 March 2008*, Elexon, p. 36.

## 6. CREDIT COVER

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### 6.1 Concerns of entrants

All suppliers expressed strong concern about the costs of credit cover. They did not always distinguish between the various types of credit cover, although criticism was particularly focused on the ‘bonds’ or deposits required by distribution companies. However, there was no doubt about the strength of the views of suppliers. The credit cover requirements were variously described as “very burdensome on entirely new entrants”, “a huge problem, the single biggest hurdle”, “a serious barrier to entry and growth”, “the most significant constraint on growth” and “the biggest waste of money and the biggest barrier to entry”.

New suppliers found it difficult to fund the up-front cash requirements for energy and network charges. Growth was constrained by cash requirements. It led to ‘stop and start growth’. Suppliers would sign up some new customers, then have to put up cash to supply them, but these customers would not begin to pay their bills for a month or two. When suppliers’ cash limits were exhausted they would need to wait for the new customers to start paying before they could begin to take on more customers, and so on. Suppliers considered that the adverse effects of the network credit arrangements were disproportionate to any beneficial effects that they might have.

One supplier was concerned that arranging credit cover took so much management time. More often complaints were that the credit cover obligations for the networks were unreasonably high. One supplier said that this was because distribution networks billed 60 days in arrears, which in turn was because their old metering and billing systems could not handle billing 30 days in arrears.

Several suppliers and advisers said that arrangements worked to the advantage of established suppliers or new entrants with established brand names and creditworthiness, and that financing was difficult otherwise. Suppliers could put up a letter of credit from an approved bank instead of a cash deposit, but this route was not available to the new supplier. Or at least it offered no respite since banks would typically provide a letter of credit only if the supplier put up a comparable amount of cash with the bank.

There were different views as to whether the present system had been proved necessary in practice. Some said that the envisaged procedures were not actually called upon since other suppliers typically bought up a failing supplier’s customers. Several suppliers claimed that distribution companies did not actually lose money on previous supplier failures. Others said that this was not the case, and that distribution companies recovered only a proportion of their losses. One supplier complained at having to pay for the cost of the TXU failure that occurred before this new supplier entered the market.

One supplier commented that the monopoly distribution networks did not have to attract customers so had no incentive to optimise their credit arrangements. They were inclined to a simplistic approach that involved taking no risk at all. They were under no competitive pressure to be more sophisticated or innovative.

Many suppliers commented that new suppliers were typically so small that the effect of any failure on their part would hardly be noticed. The failure of large suppliers with reputedly good credit ratings was much more serious. One commented that credit ratings could deteriorate very fast, and that foreign ownership made exercising supervision and control more difficult.

Ofgem has been looking at the issue of distribution business credit cover since at least 2002, and has recently set out its view on the way forward. (See the next section and Appendix 4.) Views of suppliers differed on this matter. One supplier said that Ofgem ‘deserved a big tick’ for revising these provisions. Another said that credit deposits had been a big problem that might be resolved now, or at least from implementation in October 2005. However, it commented that the situation had been up in the air for over three years, and its own credit requirement was uncertain to the extent of £3m, depending on the outcome of the issue.

Other suppliers were more sceptical or critical. One was not sure that the recent Ofgem modifications had solved the problem. One commented that these changes would tend to benefit the distribution companies rather than the suppliers. Another said that they might make the situation better for entrants, but much better for incumbents, so there would be a wider disparity and new entrants would be relatively worse off. At least two parties indicated that distribution companies would now have a need, or at least a greater incentive, to ‘get tougher sooner’ with smaller suppliers that approached their cash limits.

Several suggested that it was not sensible to impose credit cover requirements on small suppliers with less than, say, 1000 sites in any network, provided they paid their bills. The impact of any failure of such a small supplier would be miniscule. One proposed that the risks should be pooled, and each supplier would pay a proportion. One pointed out that if network credit requirements were reduced, it would enable small suppliers to use their scarce cash in more efficient ways, including to finance trading and hedging in the forwards markets.

## **6.2 Ofgem’s proposals on credit cover**

Suppliers need to provide credit cover in a variety of respects. As regards the purchase of power, the generators and traders determine the requirements for credit cover pertaining to bilateral contracts. The electricity exchanges like the IPE and IPX, and the Balancing Mechanism operated by Elexon, follow similar practices to other exchanges. Suppliers’ concerns about credit cover in some of these respects are noted in the next section.

Credit cover arrangements for the use of transmission and distribution networks are in principle set out in a bilateral contract between the supplier and the network owner. In practice there has been a degree of regulatory involvement, albeit indirect since the obligations in the distribution licenses refer to the form of the contract terms rather than to the terms themselves. It is for the distribution companies to set terms on credit cover. If suppliers (or generators or other parties) find those terms unacceptable they can appeal to Ofgem.

Ofgem encouraged the industry to review and reform its policies. An industry Working Group made proposals published in September 2004. Ofgem suggested some modifications to those

proposals and indicated its thinking in the event of an appeal. Appendix 4 outlines these developments in a little more detail, and describes the debate about the arrangements for small suppliers.

This is not a straightforward issue and expert opinion differs on the Working Group proposals and on Ofgem's modifications. Ofgem's view is that the Working Group scheme had substantial advantages over the previous arrangements, in particular, by providing finer gradation of credit availability rather than the 'all or nothing' decision. However, it was not in all respects consistent with the published principles. Ofgem's modifications were designed to remove these inconsistencies, to make the proposals simpler and more practicable, and to address matters on which the work groups had been unable to reach a single view.

Ofgem was concerned in particular to ensure that small suppliers were treated fairly. It considered that the Working Group scheme had made inadequate provision for these suppliers. It considered that its proposal was more favourable to small suppliers than the Working Group's proposal would have been. On paper, its proposal was also better than the previous situation.

Whether Ofgem's proposals would be better for small suppliers in practice is less clear. Previously, it was not uncommon for distribution companies to extend more liberal credit arrangements than the basic rules provided. Insofar as Ofgem's proposed arrangements might discourage this, and force distribution companies to take a 'tough line', there is a possibility that the actual outcome for small suppliers could be worse than it was before.

Distribution companies have not yet decided whether to implement Ofgem's proposals. Of necessity, it is not yet clear what the impact might be on smaller suppliers.

### **6.3 Analysis of Ofgem proposals on credit cover [consider shifting to appendix]**

It is desirable to encourage networks to operate efficiently, including with respect to risk minimisation and revenue collection, and to minimise possible losses that customers may have to bear. It is also desirable to promote competition and new entry into supply. Insofar as smaller new entrants may pose greater risks to networks that extend credit to them, it is necessary to design arrangements to balance these two sets of considerations. What is it reasonable to expect from a network operator, with respect to the credit terms offered and the recovery of overdue payments, in the light of the relevant regulatory and statutory obligations?

Any business would naturally prefer customers with higher credit ratings. However, in a competitive market a business cannot afford to turn away customers whose credit record is less well established, or to insist on a high degree of credit cover. It must offer attractive terms not only on price and service but also on payment, and if necessary design innovative credit terms to meet the needs of its customers. By the same token, a network operator should tailor its credit terms to the needs of its newer and smaller users as well as those of its larger ones. Regulation of the network monopolies should therefore provide such users with the protection that they would enjoy in a competitive market.

Ofgem has helpfully set out principles to which it would have regard in this matter. These include the need for incentives to manage debt efficiently, the objective of a secure and stable business environment, and the protection of consumers from loss of supply. In addition, “the credit arrangements must not be unduly discriminatory, or prevent the promotion of competition”.<sup>39</sup>

In addition, under Section 9 of the Utilities Act 2000, distribution companies have a statutory duty to facilitate competition in the supply and generation of electricity. While they are not required to discriminate in favour of smaller suppliers, they must at least avoid any suggestion of discrimination against them.

This suggests that Ofgem was right to modify the Working Group proposals in order to provide for smaller and newer entrants to have access to a degree of unsecured credit that the larger suppliers already enjoyed. Ofgem’s action could be seen as removing an artificial barrier rather than as providing an artificial subsidy to new entrants.

Small suppliers were unsure whether Ofgem’s credit guidelines provide adequate protection for them. Rough calculations suggest that the guidelines envisage the possibility of granting a new entrant unsecured credit for its distribution charges while growing at the rate of nearly 100,000 domestic customers a year to nearly 500,000 customers over five years.<sup>40</sup> This may well be adequate for most new entrants, and would seem to cover the growth rates of those that have entered to date.

Some entrants and advisers suggest that, in order to be economically viable in the domestic market, an entrant has to envisage operating at around 1 million customers rather than half a million, and has to achieve that level within about 5 years. Insofar as Ofgem’s proposed guideline may hamper the reasonable activities and growth of such aggressive new entrants, some modification of the proposal deserves further consideration. There seems merit in the suggestion that the requirement of credit cover on a small supplier should not be more onerous

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<sup>39</sup> *Best Practice Guidelines for Gas and Electric Network Operator Credit Cover: Conclusions document*, 58/05, Ofgem, February 2005, p. 2. The statutory requirement to promote effective competition has not always been at the forefront of regulatory discussion. *Arrangements for gas and electricity network operator credit cover: conclusions and proposals document*, 06/03, Ofgem, February 2003, concentrated on non-discrimination and said nothing about the promotion of competition. The summary in *Recommendations for best practice guidelines for gas and electricity network operation credit cover: consultation document*, 226/04, Ofgem, September 2004, para 1.10, failed to mention non-discrimination and the promotion of competition.

<sup>40</sup> Ofgem’s proposal envisages that a distribution business should have a maximum credit limit of 2% of its RAV, so a distribution business with an RAV of £1bn would have a credit limit of £20m. Ofgem’s proposal further envisages that an unrated supplier should have a credit allowance starting at 0.4% of the maximum and increasing at 0.4% a year to a maximum of 2% after five years of perfect payment history, so an unrated supplier would be allowed £400,000 of unsecured credit after five years. Assume that an average distribution bill is £58 per customer per year, or £5 per month. Assume the supplier is held responsible for 2 months’ credit, that is £10, then the five-year allowance of £400,000 covers about 40,000 customers. This is the allowance with each of the 14 distribution companies. Thus the new supplier is theoretically limited to  $14 \times 40,000 = 560,000$  customers after five years without having to put up more credit. Since customers are not evenly spread over all 14 distribution companies, there would be more customers in some areas than others (and probably also some small business customers with higher average distribution charges), so the achievable total over five years within the credit limit would probably be under 500,000.

than on a large supplier, as long as that supplier continues to demonstrate an acceptable performance on payment of bills. I understand that this is consistent with Ofgem's position.

What about the concern that Ofgem's proposed approach would in practice be less liberal than it seems? The concern is that, because the approach is firmly anchored on the principle of prompt payment, a network operator would need to crack down hard at the first sign of payment difficulties, and thereafter would not offer the same liberal facilities because of the threat of losing the ability to pass through any losses incurred.

There is a parallel here with an issue that arose when the gas and electricity supply markets were opened to competition. Some domestic customers have always had difficulty paying their bills. The regulators Offer and Ofgas did not accept that failure to pay meant automatic disconnection, but at the same time did not wish to compromise the principle that customers should pay their bills. The regulators therefore required that any supplier, before disconnecting a customer for non-payment of debt, should take steps to understand the particular circumstances of that customer, and to work out a practical and achievable and mutually agreed timetable for repaying any debt.<sup>41</sup> In addition, the companies were allowed to install prepayment meters that enabled the customer to avoid incurring the debt in the first place; for the most part customers appreciated such meters, which facilitated their budgeting. In these ways the potential problem of disconnection was substantially avoided, at least in electricity, and disconnections almost disappeared in some companies.

Thus, it should not be assumed that Ofgem expects network operators to take a 'tough line' with small suppliers. On the contrary, the operators should respond to the situations of the suppliers that depend on their services. In the event of a supplier encountering payment difficulties, the network operators should deal with this sympathetically and constructively, consistent with their statutory duty to facilitate competition in supply.

There is some concern that the cost of doing this would not be consistent with the price control. However, the cost of failure of a small supplier would not be large – some have calculated under £2 per customer per year.<sup>42</sup> To date, the cost has been rather less than that, perhaps only 40 pence per year.<sup>43</sup> Neither of these seems an inordinate amount to pay to facilitate new entry in the domestic supply market by removing a barrier that does not apply to incumbent suppliers. It is difficult to estimate the benefits of removing this barrier, in terms of facilitating competition in price, quality of service and innovation. But is it a less appropriate or worthwhile expenditure for

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<sup>41</sup> Standard Supply Licence condition 35 refers.

<sup>42</sup> The small suppliers have calculated (see Appendix 4 section A4.2) that if 10 per cent of small suppliers were to fail in any year, the rise in end user prices would be only 0.0075%. For an average standard rate domestic customer with an annual bill of about £257 (per Ofgem's headroom analysis), this would amount to under £2 per year.

<sup>43</sup> The most serious default of a new entrant so far is that of Independent Energy in 2000, with some 240,000 electricity customers. Distribution companies were owed £19m in charges, of which they recovered over 80% from the receivers, leaving under £4m. The network operators were held entitled to recover between 80% and 90% of that from distribution use of system charges. Suppose that other domestic supplier failures over the period 1999 – 2004, apart from Independent, were in aggregate such as to double this cost. This amounts to under £6.5m. Averaged across the 2.6m domestic customers in the UK, that is an average of about £2.50 per customer, and averaged over the six years that represents about 40 pence per year. Admittedly the cost could have been higher if no credit cover had been required.

domestic customers than the annual costs of £3.60 for the energy efficiency commitment or £4.50 for the renewables obligation? In other words, the setting and enforcement of the network price controls should allow for the afore-mentioned constructive policy by the network operators.

#### **6.4 Addressing concerns about credit cover**

To summarise, network operators need to put in place sound billing and collection procedures, and all suppliers should pay their bills. Nevertheless, consistent with this, the arrangements for extending credit to new entrants in the supply business should take full account of the statutory duty on distribution companies to facilitate competition in supply, and of the importance of discovering, understanding and meeting the needs of the smaller new suppliers. Despite some uncertainty at present about their likely effect, Ofgem's proposals seem the best way forward, provided they are properly implemented.

#### **Recommendation 2**

In order to reduce the burden of network credit cover on smaller suppliers, network operators should implement provisions for unsecured credit that are no less onerous than Ofgem's proposals presently envisage. In the event of a small supplier encountering payment difficulties, network operators should deal with this sympathetically and constructively.

## 7. QUALITY OF DATA

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### 7.1 Concerns about data quality

Most new entrants expressed concern about the quality of data in the industry. One described it as ‘shocking’. Existing suppliers often provided poor quality data about the level of consumption of existing customers, which was very costly to clean. The number and identification of registers was often incorrect. For example, there were different conventions between companies, and from one type of meter to another, as to whether the day rate consumption or night rate consumption was listed first. This led to error and confusion. Several commented that problems with data quality were only flushed out when a customer changed supplier. Some referred to the massive complexity of the industry systems leading to the incorrect data. One said that data inaccuracies were ‘the biggest frustration in day-to-day management’, and that 15 per cent of its staff were devoted to tidying up industry data.

Some said there was little interest in cooperation from distribution companies, especially those owned by incumbent suppliers. In some cases other meter readers were not able to get the data because incumbent meter operators resisted. Incumbents were slow to change and to sort out the problems.

Incumbent suppliers said that they recognised the problems of data quality, which were undesirable and costly from their own perspective too. They noted that the extent of the problem was now relatively small, and that the situation was improving. They said that the Customer Transfer Programme was working to deal with these problems. When that was implemented it would also be possible to identify more clearly which parties were providing poor service, and to take appropriate remedial action.

Some smaller suppliers thought that the Customer Transfer Programme was long overdue. Others thought larger incumbents might be unduly confident or complacent about it. One commented that the incumbents might not be particularly concerned if poor data quality led to a general slowdown in customer transfers. Most felt there was a lack of motivation or industry ability to improve the situation, and felt vulnerable to industry performance (or lack of it) that they could not control. Several urged a more innovative approach. One suggestion was to hold customer data centrally, another was to give the customer ownership of the data rather than the network operator or supplier.

### 7.2 Addressing concerns about quality of data

Customers, Ofgem, energywatch and market participants have had long-standing and justified concerns about the quality of data. New suppliers are particularly hard hit in two respects.

- a. First, an important part of the problem is not of the new suppliers’ own making. Many problems seem to lie in the way the data has hitherto been recorded or conveyed by incumbents, rather than in the way in which new suppliers treat it.

Some new entrants have been the subject of customer complaints and have attributed the deficiencies in their performance to problems with industry data, as have some incumbent suppliers. All new suppliers suffer from some aspects of data quality, whether their own procedures are efficient or not.

- b. Second, all the customers of new entrants are exposed to the imperfections in data quality, whereas for the incumbent suppliers this is a problem only at the margin. On average the incumbent suppliers still have 40 per cent of the in-area customers. This means that failure to improve data quality is a much more serious problem for entrants than for incumbents.

Data quality problems have unfortunately proved rather intractable. The reasons are several-fold, including databases and procedures designed for a pre-competition world, lack of precedent in designing processes for supply competition, and the coincident introduction of competition in metering. Customer transfers have often identified inadequacies in the data, but in some cases have introduced additional errors (for example, the inability to read handwriting from door-to-door sales calls). It is not easy to identify responsibility for errors at different stages of the transfer process, and the cost of introducing stronger incentives and penalties relating to data quality has hitherto been held to outweigh the benefits.

The Customer Transfer Programme (CTP) has been designed to improve the data quality situation at relatively low cost. The principal proposals are expected to be implemented in March 2006 although market participants have already begun to take action. The situation is improving over time. For example, only one in a thousand transfers now leads to a complaint to energywatch.<sup>44</sup> Of course, only a small proportion of those transfers that involve data quality problems lead to formal complaints to energywatch. How far the final stage of the CTP will deal with the outstanding problems remains to be seen. The thrust of the CTP is to give new suppliers available data directly upon notification of a change of supplier, in parallel with the present industry process. This will not in itself improve data quality, but will give new suppliers an earlier chance to check it and to take action where discrepancies are detected. It may in due course facilitate the identification of poor performance and thereby improve it.

More radical technical solutions are available, that might in due course yield faster and more accurate data transfer. These might be comparable to the standards reportedly achieved elsewhere.<sup>45</sup> However, they would probably require greater centralisation of databases, would be difficult to reconcile with competition in metering, would not in themselves improve the quality of existing data, and would necessitate expensive new IT systems. An alternative approach involves smart metering, as discussed in the following section, but this is not an immediate solution.

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<sup>44</sup> The number of transfer complaints fell by 60 per cent from (April 2002 – January 2003) to (April 2003 – January 2004). *Energywatch Annual Report 2003-4*, pp. 10-11. In the subsequent year, the number of transfer complaints has fallen from about 2 to 1 per thousand transfers. [www.energywatch.org.uk](http://www.energywatch.org.uk).

<sup>45</sup> A recent report by Capgemini is cited as commenting that “it is possible to implement models that are effective and efficient, quoting an example of a market where a Change of Supplier transaction costs less than £1, and completes in minutes”. *Deregulation: Meeting the Delivery and Sustainability Challenges?*, 2004 Report from Capgemini, as cited in *BSC Review 2004/2005: Review of the Supplier Volume Allocation (SVA) Arrangements*, Elexon, September 2004, fn 4, p. 20. The market in question is understood to be in Australia.

It is thus difficult to identify a further specific step that can usefully and economically be taken at present. New suppliers therefore have to allow for the costs of cleaning up erroneous data, although these costs should be declining over time. It would be sensible to complete the Customer Transfer Programme, and to assess how the newly-available information can be used to improve performance further, not least by better identifying responsibility for inadequate data. A programme of data quality monitoring is being implemented as a result of the CTP, and the results may lead to a clearer case for reforming data management arrangements, or for the further development of smart metering.

### **Recommendation 3**

In order to help alleviate the problems with data quality, market participants should continue to work on the Customer Transfer Programme, and in due course explore the scope for further improving data quality performance.

## **8. METER READING AND RELATED SERVICES**

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### **8.1 The concerns**

Most new entrants, and some incumbent suppliers, drew attention to the increasing problem of obtaining meter readings at reasonable rates and with a good quality of service. There was a widespread view that the quality of service had reduced and that the costs had increased, and that the problem would get more serious. One supplier said that agent performance was the main problem at present and going forward.

Although there was intended to be competition in the provision of data collection, meter operation and related services, this was not yet effective. Many suppliers noted that some of the incumbent companies were withdrawing the provision of services such as data collection and meter operation. This was causing real problems. It left few alternative suppliers in that area, often only one. These alternative suppliers did not have the same size and coverage in that area as the incumbent. Because volume and density is important in this activity, these other companies were generally not in a position to offer comparable service.

In addition, the small suppliers were not able to offer a significant number of customers. They felt that they were at a significant disadvantage to other suppliers, particularly the larger and incumbent ones, in negotiating rates and service contracts. It was not feasible for most suppliers to set up their own data collection agencies. Arranging backup reads to meet licence obligations was particularly problematic. There would be a massive increase in data collection costs, even if suppliers could collect data at all.

One supplier commented that competition in metering had exacerbated the already serious problems of data quality. It added to complexity, errors and costs, and led to further billing delay. While the new suppliers were generally not opposed to competition in metering, they considered that competition was not yet adequate to provide good service to non-incumbent suppliers, certainly not smaller ones. Nor was it likely to be effective in the immediately foreseeable future. Some commented that Ofgem did not seem able or willing to recognise this.

### **8.2 Suppliers' suggestions for improvement**

Several suppliers said that agents needed to treat all suppliers alike in terms of price and quality of service. Incumbent and vertically integrated companies should not be allowed to withdraw service to other suppliers. One supplier suggested that the most important need was for clearer business separation in respect of these services, and more rigorous enforcement of separation obligations on the incumbent companies. This would include Chinese walls to prevent the passing of information. One supplier went further, to suggest that suppliers should be barred from having in-house meter reading activities, or vertically integrating into such service activities. Another suggestion was that the vertically integrated suppliers should be either required or encouraged to open up their systems to act as hosts for other suppliers. They should

provide not only metering services but also trading and management of wholesale risks and renewable obligations, in return for appropriate remuneration.

One supplier said that small suppliers could not control the service providers, there was insufficient competition to provide alternatives, and it was unrealistic to expect a small supplier to take a service provider to court over poor service. It would be more sensible to introduce the concept of an 'accredited data collector' under the MRA. Then, a service provider in breach of its obligations would have to do something about it. More generally, there was very little transparency in this area, and it would be better for a central agency rather than the supplier hub to manage the situation. There was some sympathy for a central bank of information that all service providers could access.

### **8.3 The views of integrated companies**

The vertically integrated companies withdrawing data collection services said that Ofgem had decreed that this should be a competitive sector rather than a regulated one. They were complying with licence obligations on meter provision and operation, but there were no such obligations on meter reading and related services. Their policy was to use their meter reading businesses to their own benefit, including by making the meter readers the visible and badged face of the company in the customers' houses and premises.

Moreover, their understanding was that this would take forward Ofgem's policy on competition in meter reading services, and indeed was an inevitable consequence of it. There were already other service providers in the market. Their own policy of taking meter reading services back in-house would provide the incentive for other service providers to emerge and develop, and speed up the process of transition to a competitive market. To impose regulatory restrictions on these developments would be a retrograde step.

### **8.4 Experience and analysis of meter-reading and related services**

When the retail markets opened to competition, the question arose whether to extend competition to metering services. There were pros and cons. The potential advantages were that competitive pressures and choice would be extended to a larger proportion of the cost of providing electricity, which would be conducive to efficiency and innovation. Several suppliers argued that having a greater proportion of the costs under their control would enable them to compete more actively in supply. Against this were potential disadvantages of added complexity, and uncertainty about how long it would take for effective competition in metering services to develop.

Offer and Ofgas decided that on balance it would be desirable to allow competition in metering services, including in data collection and transfer, but also to provide for transitional obligations on incumbent businesses while competition developed. Ofgem has continued and developed this policy of promoting competition in metering services. These services have indeed been opened up to new entrants, and some meter manufacturers have entered the market. Some of the companies have sold off their meter-reading activities into separate companies. The former British Gas meter reading activities now trade under the name Accuread, and cover data collection and transfer for electricity too.

Competition and choice in data collection and transfer has thus begun to develop. However, such competition is not yet fully effective. It seems to be generally agreed that the costs of data collection depend crucially upon volume and density of customers in each region. It is misleading to look at the national market alone. The incumbent meter reading business in each region has a great advantage over entrants in at least two respects: familiarity with the local situation and large volume of meters to read. The situation varies greatly depending on the circumstances, and some competitors were reluctant to indicate a particular level of local market share as being critical. However, one suggested that 40% market share in any region was necessary in order to compete effectively.

At present, no meter reading company other than the incumbent is anywhere near this figure in the electricity market. Although competing suppliers may in aggregate have about 40% market share in any region, this is split among the remaining five major suppliers (other than the incumbent) and the new entrants. Moreover, other suppliers have hitherto frequently chosen the incumbent's data collection and transfer business in order to minimise problems. All the arguments and evidence put to me was that other providers were not in a position to offer comparable service to non-incumbent suppliers, in terms of either price or quality of service.

In these circumstances, withdrawal of meter reading services by some incumbent suppliers is a serious matter for all other suppliers, particularly but not only the smaller ones. In the absence of other comparable service providers in the immediate future, it imposes significantly higher costs on these other suppliers, thereby reducing their ability to compete in the supply market. It is difficult to believe that incumbent suppliers are not aware of this adverse effect on competition, and do not see it as yielding a competitive advantage to themselves.

It might be argued that the companies withdrawing their services are themselves vulnerable to the same difficulties in other regions, and therefore would not follow this policy if they believed they could not appoint satisfactory agents in other regions. However, if all major suppliers followed this policy, the outcome could be a steady reduction in competition in all regions, to the consequent benefit of incumbent suppliers in their own regions. Competition in supply could wither away, at least for domestic and small business customers. The incumbent suppliers would then have no effective market constraint on their prices and quality of service.

It is difficult to see how it can be justified to allow vertically integrated incumbents to exploit their inherited position in this way. The economies of scale in metering services especially meter reading, and associated specialised knowledge, seem to give the incumbents a market position in each area that is almost as great as control of the network itself, at least in the short term. To allow these companies to withdraw the provision of metering services before that market has adequately developed seems to be inconsistent with the underlying principle of allowing retail competitors non-discriminatory access to the basic input services required to enable effective retail competition to take place.

## **8.5 Addressing the concerns about meter-reading and related services**

Some would suggest that the solution is to abandon competition in metering services. This would be too pessimistic. It is evidently taking longer than expected for competition in metering services to develop, and the transitional protection has proved insufficient. But this is not to say that there are no benefits from competition and choice in metering, or that it would be sensible to reintroduce regulated monopolies.

Others suggest that some kind of advanced (or 'smart') metering is the solution, and that DTI and Ofgem need to bite the bullet of the cost involved. Advanced metering is indeed worth exploring, and may have advantages in terms of efficiency, customer awareness and responsiveness, innovation, scope for competition, accuracy and cost of meter-reading, avoidance of metering disputes, overcoming problems with market power in metering services, and so on. However, it would require a substantial investment and a considerable debate on whether to implement it and how best to do so consistent with competition in metering. It thus raises issues beyond this paper and will not solve the immediate problem.<sup>46</sup>

A policy to address present concerns needs to have two main components: further steps to facilitate effective competition in metering services, and further steps to protect all suppliers, including smaller ones, during the transition to effective competition in metering.

As regards the first component of policy, incumbent metering businesses in each area have a detailed knowledge of the types of existing meters in each area. Other potential providers of these services do not have such knowledge, and there are weaknesses in the industry data that are passed to the new provider. As a result, competitors have difficulty in instructing their meter readers how to proceed (for example, which dial on a multi-rate meter indicates which service in which premises). This means that competitors have to incur higher costs and cannot provide such effective service. Industry arrangements (BSC and MRA) were intended to ensure the transfer of all relevant meter technical details. Further steps may be necessary to enforce or extend these arrangements. For example, one suggestion was for more accurate or detailed meter mapping, specifying not only the protocol for each PES area but also for each meter.

### **Recommendation 4**

In order to facilitate more competition in metering services, further steps should be taken to review, enforce and where necessary extend the obligations on incumbent providers of metering services. In particular, such providers should make available detailed information about meters to new suppliers and their agents and where appropriate to other potential metering service providers.

As regards the second component of policy, the main concern is that all suppliers, however small, should be able to obtain adequate metering services at an acceptable price in order to enable them to continue to compete in retail supply. This could be expressed formally in terms of

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<sup>46</sup> However, in the case of SME customers, there could well be a strong case for an early lowering of the level of compulsory smart metering below the 100 kW maximum demand level.

allowed charges, non-discrimination provisions, separation of businesses, and other measures to prevent a dominant position and associated information being used anti-competitively. Various routes would be open to Ofgem to deal formally with the situation, including via a competition inquiry or a licence amendment. More radical solutions involving separate ownership or operation of metering businesses should not be ruled out. Admittedly these routes could be time-consuming, the formal obligations would not be straightforward to draft, and the prospect of increased regulation could deter the growth of competition in metering services. It would therefore seem preferable that the incumbent suppliers recognise that the present and immediately prospective situation with respect to withdrawal of metering services is untenable. Transitional arrangements need to be put in place until competition in metering services is more fully developed. If necessary Ofgem should take steps to secure a satisfactory outcome.

### **Recommendation 5**

Until competition in metering services is more effective, service providers that have a dominant position in any regional area should continue to offer terms to all suppliers in that area, particularly the smaller ones, so that the latter can continue to compete in supply. Dominant providers should not exploit their positions by, for example, using their meter readers to promote their own company at the expense of other suppliers to whom they provide such services. If necessary, Ofgem should take steps to establish and enforce such transitional protections for suppliers.

## 9. PURCHASING AND LIQUIDITY

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### 9.1 Concerns about purchasing and liquidity

All suppliers said that purchasing had become more difficult than it used to be. Most small suppliers saw the lack of liquidity as a serious problem. One mentioned the very big brokerage margin and said that it could only buy in cooperation with other suppliers. Another said that it was too small to trade in the market, since no-one was interested in trading under 1 MW and the cost of using brokers was too high. It therefore had to buy in the Balancing Mechanism or under the cashout process.

Another supplier said that the changing structure of the market presented its biggest challenge at the moment. Vertical integration plus Neta had meant less liquidity in the market, there were also fewer traders, and this meant that the supply market was less viable for smaller players. Another company mentioned the difficulty of getting counterparties to trade power in the market and the lack of liquidity, which was particularly problematic given the present volatility in the market. A supplier said that not only were there fewer traders now but they were also less imaginative, and operating in the market was more risky. One supplier said that three years ago it could choose from 15 to 20 sellers, now there were only three, so power purchasing had become a real problem.

Several suppliers felt that the large vertically integrated companies were not interested in trading with the smaller suppliers. One said that several of these companies took a more cautious view than their predecessors and demanded more creditworthiness, perhaps reflecting a continental European approach. Several respondents other than small suppliers confirmed that there was now less willingness to deal with smaller players, who were now seen as more risky. It was variously said that trading limits were more vigorously enforced since Enron's demise, and that the vertically integrated companies were tightening their own credit policies to unrealistic levels that effectively prevented them from trading with smaller counter-parties.

One supplier was concerned that the large vertically integrated companies were squeezing smaller players on both sides of the market, by establishing an artificial price gap in the market between buying and selling prices. Another supplier suggested that the larger vertically integrated companies either did engage in market manipulation or had the scope to do this. They had long contracts and own generation and thus could self-balance. They were not as exposed to the spot price, whereas the smaller suppliers had to respond to the spot price. One respondent suggested that the integrated companies found it convenient at present for their generation arms to have lower contract prices with their retail arms, but to maintain the wholesale market price at a high level by restricting their sales to other parties. Another supplier was not convinced that the vertically integrated companies were deliberately manipulating the market, since this would be difficult to achieve. However, there was an increased aversion to risk at present, liquidity was a fraction of what it had been, and the integrated players had less need to trade in the market.

Others suggested that structural changes in the market now favoured the larger players. Neta was more complicated than the Pool. Dual cashout and the Balancing Mechanism made it more

expensive for the smaller suppliers, who were less able to predict their demand and to cover it at more competitive prices.

One supplier linked the problems of liquidity, volatility and credit cover. Because the philosophy of mark-to-market now applied, suppliers who had bought forward had to put up more credit if the wholesale price rose. This was true even if they had struck back-to-back deals to sell the power at a profit. Small suppliers were therefore subject to very expensive credit calls in a volatile market. Whereas they could once have negotiated credit terms as part of the deal, in the less competitive wholesale market they now had no choice.

## **9.2 Addressing concerns about liquidity**

The major incumbent companies tended to see nothing amiss with the market. In contrast, smaller suppliers were very conscious of problems with wholesale markets and liquidity. Evidence was put to me of how the situation had worsened. For example, in 2001/2 Heren typically reported some 8 – 11 TWh traded daily. By the end of 2004 this had fallen to under 2 TWh. Again, load shape 44, with equal base and peak hours, is a crude proxy for the needs of smaller customers, a benchmark product, and crucial for small suppliers. 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 only 22 occasions; for the 2-year product this happened on only 2 occasions and for the 3-year product not at all.<sup>47</sup>

There was no unambiguous diagnosis of the reasons why the situation was worse than it used to be. Many possible explanations were put forward, including the introduction of Neta, the increase in vertical integration, other changes in market structure, rising energy prices, the impact of previous supplier failures, the different risk attitudes of different owners, the failure of financial traders and speculators to enter the market in a significant way, and so on. There was some feeling that Ofgem had allowed the wholesale market to become less competitive, particularly by allowing so much vertical integration and perhaps by not publicly reporting on it. But none of the suppliers had an easy answer to the problems of liquidity, and there was no obvious single step that could be taken to make the market more competitive.

The large vertically integrated companies have less need to trade than do smaller non-integrated ones. It is difficult to justify breaking up the larger companies simply in order to create more trading for the benefit of smaller suppliers and generators. However, the formation of larger and more integrated companies has had an adverse effect on liquidity in the market, which in turn impacts on the feasibility of new entry. Whether larger and more vertically integrated companies are indeed more efficient than smaller ones is not yet a settled issue. If some obstacles to smaller suppliers were removed or reduced, there could be a greater role for such suppliers, and the same may apply to small generators. Greater numbers of smaller suppliers and generators would in turn make it more worthwhile for traders to deal with them and provide greater critical mass for consolidators to enter the market.

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<sup>47</sup> *Report into liquidity of UK OTC Energy Trades*, Bizz Energy, 2 April 2005.

If there is evidence that larger players are discriminating against smaller players, then the existing non-discrimination obligations<sup>48</sup> may need to be more strongly enforced or strengthened. It might be necessary to oblige larger players to sell to other parties on the same terms as they sell to themselves. In the meantime, it is important to ensure that the competitive situation does not get worse. These considerations should be taken into account in determining policy.

### **Recommendation 6**

Ofgem should consider how best to improve the purchasing and liquidity situation faced by smaller suppliers. In particular, in considering the need for action in the wholesale market and in appraising and advising on any proposed merger or takeover, Ofgem and other policymakers should give substantial weight to the potential effects on liquidity and competition in the capital and wholesale markets.

## **9.3 Cashout prices, wholesale prices and liquidity**

The extent of liquidity is influenced not only by the market participants but also by the calculation of cashout prices. At present there is a dual cashout price: a System Buy Price (SBP) that is in principle distinct from the System Sell Price (SSP) in each half hour. This was not a necessary concomitant of Neta, but the result of a separate decision as to how cashout prices should be set.

A dual cashout price impairs liquidity and introduces a bias against smaller players in two respects.

- First, traders find it helpful to have a marker against which to price their contracts. The dual cashout price does not provide such a marker.
- Second, the difference between the two cashout prices is in effect a tax on buying and selling uncontracted electricity. Since small suppliers have to purchase a greater proportion of their energy via cashout than do larger ones, the tax falls most heavily on them. The same is true for small generators.<sup>49</sup>

When cashout prices were introduced, it was argued that they should reflect the costs to the System Operator (National Grid) of balancing the market. Market participants would then decide how far to balance their own positions, and how far to buy at cashout prices, depending on the relative costs involved. In this way, cost-reflective cashout prices would ensure the most efficient extent of central balancing. This would minimise the total costs to the market as a whole, and to customers.

The cashout price in the main direction (reflecting whether the system as a whole is short or long) is indeed based on the costs incurred by the System Operator in the Balancing Mechanism.

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<sup>48</sup> E.g. in Condition 17 of the generation licence and Condition 12A of the electricity supply licence.

<sup>49</sup> Cashout prices should be seen in context, and one supplier in the SME market noted that they accounted for only about 1 per cent of its energy costs. However, this may be because the risk of being short has encouraged participants to unduly over-contract so as to avoid payment of cashout prices (and instead to accept receipt of System Sell Price to the extent they are over-contracted). Cashout prices are likely to be a larger and less predictable component of the costs of a smaller supplier to the domestic sector.

In contrast, the calculation of the cashout price in the reverse direction has varied over time, and is now set equal to a market-based spot price. This is self-evidently not a reflection of the costs incurred by the System Operator. Those costs would presumably reflect the savings from not having to act so extensively in the main direction. In other words, cost-reflective pricing would seem to indicate a single cashout price in any half hour, with those in a short position paying it and those in a long position being paid it.<sup>50</sup>

There might nonetheless be various possible reasons for adopting a dual cashout price. These would include a view that encouraging parties to balance their own positions is desirable in its own right, or desirable as a means to enable the System Operator to balance the system in a short time-scale. These are not irrelevant or unreasonable considerations, particularly when the practical operation of the system is unknown. However, it is not clear that they are still sufficiently persuasive to justify maintaining a significant spread between the buying and selling cashout prices.

As noted, a main argument against a dual cashout price instead of a single price is that it distorts the market because it increases the balancing costs of smaller suppliers relative to larger ones. It also leads over time to the accumulation of an imbalance surplus or deficit.<sup>51</sup> This is paid for disproportionately by smaller market participants to the extent that their imbalance volume constitutes a larger proportion of their total electricity purchases, but it is returned to all participants pro rata to size on the basis of their metered volume. Both features thereby encourage larger and more vertically integrated players than would otherwise be the case.

The extent of this distortion could be significant. SBP was on average over twice as high as spot price in 2001 and 2002. SBP has tended to decline over time, partly as a result of various rule changes and partly in response to parties becoming more attuned to market operation under Neta. In particular, SBP has significantly reduced since modification P78 set the reverse cashout price equal to a market-based spot price. Even so, in baseload periods SBP was on average 29% over spot price in 2003 and 15% over it in 2004. The ratios were higher in peak periods.<sup>52</sup> This is one measure of the higher energy costs that smaller suppliers have to incur.

It is understandable that a smaller supplier might have to resort more frequently to short-term trades on the exchanges or in the Balancing Mechanism, and ultimately to use of the cashout mechanism. When the system is short it would expect to pay a higher price. But when the system is long – which has typically been the case<sup>53</sup> – it is not clear why the supplier should have to pay spot price instead of the lower SSP. The dual cashout policy thereby handicaps smaller suppliers in their energy purchasing. By the same token, it also handicaps smaller generators by reducing the amount they are paid for surplus energy at times when the system is short.

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<sup>50</sup> The cashout price would not necessarily be equal to, or even close to, the market spot price: typically it would be above or below that depending on whether the system as a whole was short or long.

<sup>51</sup> The Residual Cashflow Reallocation Cashflow (RCRC) or 'Beer Fund'.

<sup>52</sup> Peak SBP was 65% over spot price in 2003 and 38% over it in 2004. I am grateful to Prof D M G Newbery for these calculations.

<sup>53</sup> And still seems to be the case, about three quarters of the time from December 2004 to February 2005. Source: *Elxon Trading Operation Report*, February 2005, Table 2.6.

The spread between SBP and SSP narrowed over the first three years of Neta, largely as a result of various modifications to the calculation of the balancing prices.<sup>54</sup> But it has tended to increase somewhat in recent months.<sup>55</sup> It has always been a significant proportion of the spot price and has recently increased, from just over one quarter of spot price in February 2004 to 35 per cent of spot price in the last six months. This is another measure of the artificial premium on balancing that is paid disproportionately by small suppliers.

A single cashout price would thus remove a distortion against smaller players that artificially favours vertical integration. It would have other advantages too. It would encourage parties to look more to the short term forward markets instead of relying on cashout. It could increase liquidity by providing a marker against which traders could price their contracts. (As one respondent put it, “a single price should translate into a reference price allowing contracts to be settled against it, leading to a standardisation of trading.”) In addition, it would remove any incentive for parties to influence the determination of spot market prices in order to influence reverse cashout prices.

Although the basis of calculating cashout prices has been modified over time, the dual nature of the cashout price has not been reconsidered. Dual cashout has been the most controversial and criticised feature of the new trading arrangements. Perhaps surprisingly, Ofgem’s present review of cashout prices is looking at many aspects of the prices except this. However, it now seems too late to include dual cashout prices in that review.

That does not mean there is no opportunity to reconsider the calculation of cashout prices. It would be possible to improve the basis of the reverse price without changing from dual to single cashout. For example, the price in the reverse direction could be set equal to halfway between the spot price and the cashout price in the main direction. This would reduce the extent of the present distortion and make the reverse price more cost-reflective. Over time, and provided there was no adverse impact on the System Operator’s ability to balance the system, the reverse price could be set closer to the main price and eventually equal to it.

### **Recommendation 7**

The present calculation of cashout prices creates a market distortion against smaller non-integrated competitors and is not conducive to liquidity. Market participants should consider raising a modification proposal to revise the calculation of the reverse direction cashout price so as to remove or reduce the spread between System Buy Price and System Sell Price in each half-hour.

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<sup>54</sup> The average monthly spread between SBP and SSP was £69.80 in April 2001, £21.99 in February 2002, £14.40 in February 2003 and £5.52 in February 2004. *Domestic Competitive Market Review*, Appendix 19 para 1.21.

<sup>55</sup> Compared to £5.52 in February 2004 the spread was £10.81 in February 2005 and averaged £10.15 in the six months to May 2005. Source: *Elxon Trading Operation Report*, Table 2.5.

## 10 THE RESTRICTIONS AND BURDEN OF REGULATION

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### 10.1 Obligations on payment methods

Standard Licence Condition 43 in the electricity supply license concerns the contractual terms and method of payment for suppliers to the domestic market. It requires that all licensees shall have available (and shall publish) forms of domestic supply contract that provide for payment through a prepayment meter; payment by different methods including by cash or cheque; and payment at a reasonable range of intervals including twice-monthly or more regularly or monthly or quarterly in arrears. Licensees must also process all requests for a supply of electricity to domestic premises without undue preference or undue discrimination.<sup>56</sup>

For some suppliers, the obligation to offer all types of payment methods was not a concern. Some planned to attract as many customers as they could and recognised that they would need to offer the full range of payment methods. Some saw their niche market as offering methods of payment or supplying customers that other suppliers found less attractive.

For other small suppliers, however, this condition presented a problem. One said that the obligation to offer a full range of services was onerous, especially with respect to prepayment meter terms. Another said that the obligation to offer the whole range of terms was an additional cost that bore relatively heavily on smaller suppliers. A larger supplier said that having to offer prepayment meter terms was a concern because of the many different systems across companies and the extent of misdirected payments. A small supplier said that the Standard License Conditions increased the barriers to supply competition and deterred new entry.

A supplier in the small business market said that it had considered entering the domestic market to supply direct debit customers. However, it decided not to enter because of the obligations to serve all customers. This would have necessitated putting in place additional staff and IT systems, going through additional qualification processes, and securing that the systems and staff could deal with the whole range of customers and payment types. This would render the domestic market unprofitable, even though the direct debit sector of it would have been attractive. The supplier had considered setting less attractive terms for other domestic customers, to avoid some of the costs of domestic supply, but feared that if it did so Ofgem would take steps to remove its supply licence.

Another supplier said that it was considering an innovative package involving renewable generation that would apply in certain geographic regions. But it was worried that if it did so it might be held in breach of licence obligations.

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<sup>56</sup> In retailing contexts the obligation to offer the whole range of terms is referred to as ‘full-range (or full-line) forcing’: a manufacturer requires a retailer to stock the whole range of the manufacturer’s products if the retailer wishes to be allowed to supply them at all. Economists have debated the efficiency and competitive implications of this practice.

## 10.2 Addressing concerns about obligations on payment methods

Standard Licence Condition 43 derives from the time that the domestic market was first opened to supply competition. There was an initial fear that, in the absence of such obligations, new suppliers (even if they emerged) might not offer prepayment terms to the more vulnerable customers. Incumbent suppliers might then increase their prices to such customers, or indeed withdraw their provision of such terms. For social reasons, there seemed to be a need to impose an obligation to offer all methods of payment.

Those conditions no longer obtain. It is now apparent that the incumbent suppliers are continuing to offer the whole range of terms, and finding it profitable to do so, both in their own areas and in other areas. Moreover, some of the new entrants have explicitly specialised in offering the whole range of terms, from a deliberately social perspective. There is therefore no longer a need for an obligation on suppliers to offer all kinds of payment methods.<sup>57</sup>

The obligation has in any case not led to all suppliers competing equally actively for all types of customer and payment method. All six incumbent suppliers including Centrica have proportions of different payment methods that reflect the national average quite closely. But Table 6 shows that the new smaller suppliers have attracted more direct debit customers than the national average and fewer of other types of customer. One new supplier supplies no customers (or a negligible proportion) on standard credit terms. Three supply only 1 per cent of their customers by prepayment. Interestingly, two of the suppliers offer about twice the national average of 'other' payment methods. This may indicate a greater element of innovation, or a greater willingness to tailor their arrangements to the needs of customers.

Table 6 Electricity customers by payment method (%)

Supplier	Stand. credit	Direct debit	Prepayment	Other	Total
National average	42	39	15	4	100
Telecom Plus	0	96	1	3	100
Atlantic	39	53	7	1	100
Unit Energy	39	51	1	9	100
Utility Link	35	58	1	7	100

Source: *Domestic Competitive Market Review*, Table 6.5, p. 159

There is now evidence from the interviews with new suppliers that the obligation to offer a full range of payment methods is not merely unnecessary but is also positively harmful in some respects. It has increased the costs of new suppliers. It has deterred at least one supplier in the small business market from competing in the domestic market, since that supplier feared it would not be allowed to appeal to direct debit customers alone. The restriction may have restricted the growth of other new suppliers, since the payment method is so critical to the ability to finance and grow the business and obligations to offer less preferred methods can be unduly costly to

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<sup>57</sup> It might be suggested that Standard Licence Condition 43 is there to support Standard Licence Condition 32, which imposes a duty to supply domestic customers. This condition too seems to be no longer needed, since in practice all incumbent suppliers as well as several new suppliers have demonstrated their willingness to supply all types of domestic customers.

small suppliers. The restriction may also have discouraged the development of innovative and beneficial products – an example being the product involving renewable generation in certain geographic regions.

The obligation to offer a full range of payment methods thus seems to be unnecessary nowadays, and to have restricted and distorted competition in the domestic market. In the first instance, direct debit customers have suffered most from this restriction. Over the longer term, however, discouraging new entry into direct debit may also have harmed other domestic customers. If a new supplier could establishing itself in the direct debit part of the domestic market, that could enable it to move more easily into other parts of that market. Even if the supplier stayed in the direct debit part of the market, this would help to build up a greater market share for small suppliers in the domestic market, and this in turn would contribute to a more liquid market for small suppliers generally.

Ofgem has initiated a review of the Supply Licence, and indicated its intention to remove unnecessary or outdated restrictions. SLC 43 is a good candidate for removal.

### **Recommendation 8**

In order to remove an unnecessary regulation, which also restricts and distorts competition, Ofgem's present Supply Licence Review should consider removing Standard Licence Condition 43 that requires suppliers to offer a full range of payment methods to all domestic customers.

### **10.3 Concerns about the 28 day rule**

Standard Licence Condition 46 requires that a domestic customer shall be able to terminate any contract at 28 days' notice. Any termination fee must be reasonable, and a termination fee may not be charged for a contract of less than one year.

One non-supplier that advised on available offers argued that fixed price contracts for more than 12 months, supported by a termination fee, could prevent customers from switching for a considerable period of time and thereby dampen competition. In the past, some new entrants have been associated with this view.<sup>58</sup> One new entrant in the present survey did at first mention such a concern, but then admitted it could see advantages in the ability to offer fixed-price fixed term contracts. All other new suppliers took the view that the 28 day rule was unhelpful.

One new supplier said that the 28 day rule would have been an absolute barrier to offering energy efficiency terms, which were impossible to deliver without contracts for a period of years. This supplier would not have entered the market at all unless the 28 day rule had been temporarily lifted. Another supplier said the 28 day rule would have been a problem if it had wished to offer energy efficiency products.

Several suppliers said that they had simply accepted the 28 day rule, and had therefore not given thought to the range of products that they could offer in the absence of the 28 day rule. However, they could see the advantage of removing it. For example, one said that contracts would provide more certainty over the size of its customer base. The 28 day rule allowed a supplier's customers

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<sup>58</sup> *Domestic Competitive Market Review*, p. 184.

to just disappear, and therefore made the market less attractive to suppliers. Another supplier said that in the absence of the 28 day rule it could offer a wider range of contracts (for example, ranging from 3 months to a year), and could also hedge its position more effectively. A third said that the rule would be a barrier if it wanted to offer new products such as improved metering. The rule was not conducive to widening the market. Two suppliers said that the 28 day rule was very confusing and tended to be abused by incumbents or used for other commercial reasons.

#### **10.4 Addressing concerns about the 28 day rule**

Like Standard Licence Condition 43, Standard Licence Condition 46 reflected conditions that obtained at the time of opening the domestic market. It was feared that incumbent suppliers would induce their customers to sign up to long contracts before competitors could offer better terms. This could be to the disadvantage of those customers, and could restrict the emergence of supply competition. Given the inexperience of domestic customers with respect to choice in the energy market, and the overwhelming dominance of incumbent suppliers and uncertainty as to whether new entrants would emerge, Offer considered it prudent to require that any domestic customer should be able to exit a supply contract with 28 days' notice.

The situation that obtained at the opening of the market no longer obtains. Customers are now very aware of the concept of competition. More than half of them have actually changed supplier at least once. If they signed up to a fixed-term contract it would be in awareness of what the alternatives might be. On the competition side, domestic customers are no longer faced by a monopolist incumbent supplier with no competitors. The incumbent has only 60 per cent of the market on average, and there are half a dozen other suppliers more or less well known to the customer.

There is thus no longer a need for the 28 day rule to protect either customers or competition. Indeed, the rule is now positively harmful. It precludes competitors from offering a greater variety of contractual terms, such as fixed-price fixed-term contracts. In the Nordic countries, where there is no such limitation on contracts, the range of fixed terms is now from 3 months to 5 years, with many intermediate variants including spot price and capped spot-price products. In Sweden, nearly 50 per cent of domestic customers have now voluntarily chosen a fixed term contract, either with their incumbent supplier or with another supplier.<sup>59</sup>

Until it was suspended, the 28 day rule precluded suppliers from offering energy efficiency options that would need to be paid for over a period of time. It may also limit the development of more advanced metering options.

It is true that incumbent suppliers will find it attractive to try to 'lock in' their customers for fixed terms. But they can only do this by offering better terms than their rivals offer – that is, by competing more effectively. Suppliers are able to reduce their costs and risks by signing customers to fixed term contracts. In a competitive market the benefits will flow to customers.

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<sup>59</sup> Stephen Littlechild, "UK Domestic Energy Contracts: the 28 day rule and experience in Sweden", Cambridge Working Papers in Economics CWPE 0431, CMI Working Paper 45, 26 May 2004, available at <http://www.electricitypolicy.org.uk/pubs/wp.html>. A revised version "Residential energy contracts and the 28 day rule", 22 February 2005, is forthcoming in *Utilities Policy*, available on request.

They get the degree of security that they want. There is now evidence in the UK as well as Nordic countries that customers actively want protection in terms of price caps for varying periods of time. (And in Nordic markets neither customers nor suppliers have shown any inclination to sign up for excessive contract durations that would make 'lock-in' a concern.) It is therefore appropriate to facilitate this form of competition instead of restricting it. SLC 46 is thus another suitable candidate for Ofgem's policy of removing unnecessary regulation.

### **Recommendation 9**

In order to remove another unnecessary regulation, which also restricts and distorts competition, Ofgem's present Supply Licence Review should consider removing Standard Licence Condition 46 that requires all customers to be able to cancel any contract at 28 days' notice.

Many entrants referred in general terms to the complexity and burdens of licence conditions that weighed more heavily on smaller suppliers. They commented that regulatory risks were a particular problem for small suppliers, not least the risks of changes in regulation. Some instanced energy efficiency obligations in this context. Ofgem itself has noted concerns about the impact of the Renewables Obligation (RO), and whether this favoured large suppliers.<sup>60</sup>

Taken alone, the energy efficiency and renewable energy obligations might not be an undue burden on small suppliers. But these obligations are not alone. They are just two of many licence obligations that contribute to the complexity and burden on newer and smaller suppliers, and reduce the attractiveness of new entry into the domestic market.

The present market share of new suppliers in the domestic market (about half a percent) is very small. Removing the obligations on small suppliers would not compromise any targets in both these areas. They would usefully ease the burdens on these suppliers. Ofgem might therefore consider removing from small suppliers the Standard Licence obligations with respect to energy efficiency and renewable energy. Where the line is drawn is for consideration, but a reasonable definition of small suppliers here might be those with less than 1 per cent share of the domestic market.

### **10.5 Concerns about regulation in general**

Several suppliers commented in passing on the role of Ofgem. There was appreciation that the process of acquiring a licence was not onerous. One supplier was particularly grateful for Ofgem's work on revising credit cover provisions. Some members of Ofgem staff were considered to be particularly knowledgeable and helpful.

In general, however, there was a feeling that Ofgem did not understand the problems faced by new and small suppliers, and was not particularly interested in them. One thought that Ofgem was beginning to understand these problems. But suppliers would have appreciated greater recognition within Ofgem of the problems in the market place. One wondered whether Ofgem staff did not recognise the significance of some electricity supplier issues, particularly data flow problems, because they had seen fewer problems on the gas side.

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<sup>60</sup> *Review of domestic gas and electricity competition and supply price regulation: evidence and initial proposals*, 71/01, Ofgem, November 2001.

Most suppliers complained of the heavy and increasing burden of regulation, not least in competitive sectors. This was a particular problem for new entrant suppliers. Such suppliers experienced the licence obligations and the reporting requirements and requests to provide information as onerous burdens on them. For example, Ofgem had recently asked for many pages of information to be supplied each quarter. One said that Ofgem published more consultation papers in 2004 than Ofcom, Ofwat and ORR combined. It was difficult for smaller players to contribute to all the discussions.

One commented that major changes such as REMA or BETTA had significant cost consequences for all market participants, particularly with respect to systems. These weighed particularly heavily on smaller participants, unless they were to be held neutral against them. In fact, the risks associated with regulatory change and development were so significant that they made funding of their businesses difficult. This lack of fluidity in the market was in the interests of incumbent players and in due course would allow them to increase their margins.

One said that Ofgem's Supply Licence Review itself caused uncertainty among new entrants, particularly given the pressure from some parties including energywatch for more obligations on suppliers. This might incline potential competitors to defer their entry decisions until they could see what licence changes were involved.

Several smaller suppliers said that they could bring a different and useful perspective to industry discussions that involved potential changes in industry codes and regulation. This was potentially important because the outcomes of these processes were often unhelpful to smaller suppliers. However, it was very costly for smaller suppliers to participate because they could not devote scarce staff time to this. They also felt that the larger suppliers would outvote them so there was not much point in participating. In other cases industry procedures were unduly cumbersome and costly.<sup>61</sup>

There was a feeling, often expressed most strongly by respondents other than small suppliers, that Ofgem's recent decisions had tended to favour the larger players, particularly the incumbent distribution companies. Hence, it was not surprising if Ofgem was perceived to have a bias against smaller suppliers. One suggested that Ofgem had taken its eye off the ball, and allowed too much consolidation and vertical integration.

One supplier commented that Ofgem and energywatch were not coordinated on Codes of Practice. Energywatch seemed to be under great strain with respect to resources, and took a long time to respond. Another supplier felt that energywatch tended to create its own problems and demonise the situation: the organisation took time, cost and effort to deal with and was generally unhelpful.

As to what might be done to improve the situation, some suggested that Ofgem should provide more help to potential entrants – for example, in terms of guidance as to what was to be done.

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<sup>61</sup> For example, BSC procedures prevented them from suggesting amendments to proposed modifications if they were outvoted by larger players, and required them to propose modifications of their own, whereas CUSC procedures were more flexible.

Several said that Ofgem could usefully consider how to make the burdens of regulation less onerous for small suppliers. One suggested that Ofgem could run a small suppliers' Forum, so as to understand better the issues facing small suppliers and to improve mutual communication. It was difficult for small players to know where and how to put their views. There was a need for someone in Ofgem who understood the problems faced by small suppliers. Moreover, given the strength of lobbying by the larger incumbents, there needed to be some representation of future players that were not there at present. One suggested that industry panels should have funding to appoint advisers that would be independent of the interests of the larger players.

### **10.6 Addressing concerns about regulation**

In general, Ofgem has taken a pro-competitive stance, and several of its actions have assisted smaller suppliers. It has ensured that obtaining a supply licence is a relatively straightforward procedure. It has maintained the policy of setting licence fees in proportion to the business of each supplier (in MWh), thereby not imposing an undue burden on newer and smaller suppliers. In at least one case it has sought to protect smaller suppliers from onerous agreements proposed by network companies.

However, it is unfortunate, but undeniable, that new and smaller suppliers generally feel that Ofgem does not fully understand and sympathise with the situation that they face. In some cases, Ofgem is seen as failing to take sufficiently firm action to deal with their legitimate grievances. In other cases it is unwittingly increasing the regulatory burden upon them.

Any regulatory body faces many conflicting pressure groups, most of whom no doubt feel under-appreciated and ignored. Ofgem is not obviously worse than other regulators in this respect. Nonetheless, there seems to be some substance in the concerns raised by new and smaller suppliers.

The present Report has recommended various specific measures for alleviating the burdens and distortions that tend to operate against smaller suppliers. Ofgem should therefore seriously consider and seek to implement them. Many of these measures are consistent with Ofgem's declared aim to reduce the burden of regulation where possible, and all are consistent with its duty to promote competition.

In addition, it would be in the interest of Ofgem, as well as the smaller suppliers, to build up a better mutual understanding. To this end, it would seem helpful to establish some mechanism to improve the flow of information and understanding on a continuing basis. Ofgem's present arrangements with the Large Users Group (LUG) and Small and Medium Users Group (SMUG) may be a useful precedent.

#### **Recommendation 10**

In order to improve and maintain communication with small suppliers and new entrants, Ofgem should explore the possibility of a regular Forum for exchanging views.

## 11. CONCLUSIONS

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Smaller new entrants have hitherto supplied only a very small proportion of the UK residential electricity market. New suppliers have continually entered the market and grown, but some of the faster growing ones have run into difficulties and have been bought out by larger incumbent players. New entry is nonetheless important for competition in terms of price, quality of service and innovation.

In some respects the potential profitability of smaller entrants seems lower than Ofgem's headroom analysis indicates. However, in other respects there may be scope for lower costs and more viable margins.

Smaller entrants are concerned about a number of barriers to entry and growth. Not all these are very tractable, but in some cases steps are already being taken to deal with the problems, and in other cases further action would be possible and desirable.

As regards the steps already underway:

- Elexon has proposed ways in which parties could propose reforms to reduce the cost and complexity of new entry qualification processes;
- Ofgem has made proposals to reduce the burden of network credit cover on smaller suppliers;
- The Customer Transfer Programme is in progress to facilitate the identification and remedy of errors in the quality of data.

As regards action that would be possible and desirable:

- Steps should be taken to facilitate more competition in metering services and to protect all suppliers, especially the smaller ones, until such competition is more effective;
- It is important that the liquidity and purchasing situation should not get worse, and a revised calculation of the reverse direction cashout price would remove or reduce the distortion against smaller suppliers and be conducive to more liquidity;
- Present license obligations to offer a full range of payment methods and to incorporate a 28 day notice period are unnecessary and restrict competition, so they could usefully be removed as part of Ofgem's Supply Licence Review;
- Ofgem should consider how best to improve and maintain communication with small suppliers and new entrants, perhaps via a regular Forum for exchanging views.

These measures will not change the situation of smaller new entrants overnight. But they will remove certain artificial or unnecessary obstacles to the ability of smaller suppliers to compete against their larger rivals. This can only be good for competition and domestic customers.

## APPENDIX 1. NEW ENTRANTS' COSTS

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### A1.1 Acquisition costs

Incumbent suppliers have tried a variety of acquisition methods. TV advertising is too expensive. Affinity deals are relatively cheap but do not deliver a great volume of customers.<sup>62</sup> The same applies to mailshots.

Doorstep selling is more effective in delivering volume of new customers. However, it is relatively expensive (on average about £30 commission for each new customer). It has typically been carried out on an agency basis, with associated reputational risk, and one supplier commented that rates for the better agencies were driven up to £50 to £60 per customer by demand from the larger companies. It has encountered or caused a variety of problems, it is difficult to supervise, and has led Ofgem to impose fines on the supply companies of up to £2m. It has run into legal problems under European regulation. And it does not deliver the highest quality customer. At one point incumbents were reducing their use of this selling mode, but they may now be increasing it again.<sup>63</sup> Telemarketing is becoming more popular among entrants, and delivers a higher quality customer. But it too is quite expensive, especially for smaller operators.

Entrants often use internet websites that compare the prices charged by different suppliers and arrange to switch a customer to his or her preferred supplier. Typically these websites charge a commission of about £25 to £35 per switch. Detractors say these less personal routes are not so successful at delivering volume. Proponents say that the method delivers the best customers: there is a very high chance of securing them since they have actively chosen the supplier, they have good quality data and they are typically from high demographic groups. Use of the internet has increased significantly in the last two years, and some 10 – 20% of energy company sales are now said to be via the internet.

Other and cheaper methods include recommendations from family and friends and industry associations, though these bring in fewer customers. Entrants therefore suggested that acquisition costs could vary in a range of about £10 to £35 per customer, depending on the method used.

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<sup>62</sup> Financial institutions such as banks, building societies and insurance-related businesses have a ready customer base. However, there are many demands for the attention of customers and branches. The marketing of energy has to compete with the marketing of mortgages and insurance, which are typically more profitable products. So there is an internal transfer price to pay.

<sup>63</sup> “British Gas is recruiting a new army of door-to-door salesmen to win back the 1m customers who deserted it last year. It plans to increase the size of its direct-sales force by 400 – to 1,300 – by the end of the year. Its telephone sales team will also double, to 600, in that time. // EdF Energy, which lost about 400,000 domestic customers in 2004, also plans to double the number of door-to-door salesmen, to 600. // Door to door selling is the most aggressive form of marketing. With staff paid bonuses for the number of contracts for gas or electricity supply they sell, companies expect to make one sale for every four doors opened.//... Both companies [not clear to which companies this refers] rely on employment agencies for the bulk of their sales force. The use of agencies has led to accusations of customers being mistreated by salesmen seeking to boost their commission.” Dan Box, ‘British Gas hots up direct selling’, *Sunday Times*, Business Section, 2 April 2005.

This acquisition cost does not include the cost of processing the customer – that is, entering the customer into the supplier’s database and carrying out any other necessary processes. One supplier estimated these costs in the range £10-£15 per customer.

Including these costs would bring the typical new entrant acquisition costs to £20 to £50 per customer. Discounted over three years at 5 per cent this would amount to about £7.50 to £19 a year, but in practice smaller new entrants cannot borrow at this rate. In fact, they are typically short of cash. A range of £10 to £20 a year is more plausible. The mid-point of this range is about £5 lower than the £20 assumed by Ofgem. It probably reflects the lower acquisition costs that entrants are prepared to incur, though they often incur additional ‘costs’ in terms of price discounts. In addition, one supplier commented on the importance of attrition rate: a loss of 20-30 per cent per annum is not unusual and this has to be taken into consideration by a new supply operation when analysing the cost of acquisition.

Lower cost methods suit the smaller entrants planning on (or limited to) a cautious growth rate. However, these methods might not be sufficient to attract the volume of customers necessary for an entrant that planned to grow fast. Such an entrant – particularly one assumed to achieve a level of 1 million customers - might well need to incur acquisition costs at the level assumed by Ofgem.

## **A1.2 Credit cover**

Ofgem’s assumptions make no explicit mention of credit cover. Unless they have a letter of credit from their bank, suppliers have to put up credit cover roughly in proportion to the number of their customers and to the costs of DUoS, TNUoS and energy purchases associated with these customers. Some suppliers commented that, even if they could get a letter of credit, their bank would require them to put up cash as security for such a letter. In consequence, they have no alternative but to put up cash in one form or another.

The amount of the credit cover depends on the amount of cost at risk. One supplier suggested that it had about £10 per customer tied up in credit cover for distribution and transmission networks alone. In the case of energy the amount at risk depends on the time of year as well as upon the level (and volatility) of wholesale prices. Another supplier estimated that total credit cover (including networks) varied between £30 and £50 per customer, depending on the time of year.

Moreover, the amount of cash required for credit cover is very volatile because the credit that suppliers demand reflects their policy of ‘mark to market’. To illustrate, suppose a supplier purchased 1 TWh (= 1m MWh) of power at the going wholesale price of £30 per MWh and locked in a sale to a customer at £33 per MWh. The supplier would put up credit cover against the total purchase price of £30m. Now suppose that the wholesale price falls by 10% to £27/MWh. If the supplier defaults on the contract the energy seller stands to lose the difference of  $1\text{m} \times £3/\text{MWh} = £3\text{m}$ . Hence the supplier is required to put up increased credit cover immediately to cover the energy seller against this increased £3m risk.

Credit cover is not money that is totally lost. It is more in the nature of a forced loan. Arguably it might be included in annual cost calculations at the annual cost of borrowing that money. That is typically much higher than the risk-free rate assumed by Ofgem in discounting acquisition costs. New entrants typically cannot borrow at that rate, if indeed they can borrow at all. One commented that, notwithstanding the cost, there is also an issue of availability. Small operators without large parents have to provide this credit cover as cash, and although it is not money that is 'spent' it still has to be found and investors require the same return on this idle money as on the working money. New entrants' sources of funding vary, and often include venture capitalists. One claim put to me is that such investors look for returns in the order of 45%. Such a rate may not be typical. However, given the high premium on cash within all new supplier businesses, and bearing in mind the volatility of the required cover, it may not be unreasonable to put an annual value on credit cover at, say, 25% of the amount of that cover. If credit cover is of the order of £30 to £50 per customer, then the annual cost of credit cover might be about £10 per customer.

### **A1.3 Working capital**

Working capital is needed to finance the initial period of operation including customer acquisition costs, customer processing costs, credit cover on energy purchases and network charges. The cost depends on many factors including the entrant's business plan (notably the planned customer base and rate of expansion) and the size and nature of the entrant (including, importantly, its credit reputation). As noted, costs of credit cover will also vary by time of year and by the level and movement of wholesale energy prices. It is difficult to know what amounts most entrants have put aside for working capital, but figures up to £2.5m have been suggested for a large entrant with plans for fast growth – say 100,000 in the first year. Pro rata, one might envisage £250,000 for an entrant aiming at 10,000 customers, £25,000 for one aiming at 1000 customers.

Assuming working capital of £25 per customer, the interest on this at a conservative 12 per cent (see comments above) would be about £3.

Discussions with new entrant suppliers and others involved in this part of the industry suggest the following orders of magnitude for the various elements of the initial cost of entering the market.

### **A1.4 IT systems**

Cheapest off-the-shelf system capable of accommodating hundreds or a few thousands of customers: minimum £50,000. More sophisticated off-the-shelf systems for tens of thousands of customers: in the range £100,000 to £250,000. Customised IT systems capable of handling up to 1 million customers including business customers: £1m to £2m. Some earlier entrants incurred higher costs.

### **A1.5 New entry processes**

In the early days, costs of around £0.5m were incurred for the new entry process for a smaller system for domestic customers, and up to £2m for larger systems capable of handling business

customers. Nowadays, with systems and procedures better understood, charges in the range £150,000 to £200,000 are cited for simpler well-known systems operated or advised by experienced personnel. Larger customised systems are likely to take longer to complete the testing processes, and to cost say £300,000 or more. Almost all these costs are those of consultancy fees or own-staff time.<sup>64</sup> BSC charges collected by Elexon are indicated in Appendix 3.

### **A1.6 Billing and settlement systems**

Billing and settlement systems vary in sophistication, with costs perhaps of the same order of magnitude as those of the corresponding IT systems. (An alternative is to outsource this work to a service provider. Proponents say that this can be quicker to establish and reduces the up-front cost. Critics say that it is not straightforward to specify the initial contract so as to allow sufficient flexibility to respond to changing circumstances, and that outsourcing increases the ongoing cost and means less knowledge and control of the supplier's own customers.)

### **A1.7 Other initial costs**

Entrants need to incur legal fees and hire various kinds of expertise or consultancy advice (other than accreditation). One adviser commented that the complexity of the contractual nexus – including balancing and settlement code, network code, various transmission and distribution agreements, metering contracts, outsourcing and IT contracts – means that organisations without the necessary degree of experience and sophistication to enter into and manage their risks are going to be at a disadvantage and at risk. They can hire staff or consultants, but both involve a significant cost and cash outlay. Other possible costs include hardware, call centre setup and training, branding and initial marketing (for which item alone one supplier cited £0.6m), and allowance for contingencies. The sum of these costs could vary widely, depending on the expertise and business plan of the entrant – say in the range £50,000 to £3m.

### **A1.8 Total initial costs**

The above figures are set out in Table 7. This gives, in round figures, a total cost of about £0.3m for a small and simple system, up to £1m for a medium-sized and more sophisticated system, and £3 to 8m for a large and sophisticated system capable of handling some small business customers too. If anything, these total initial cost figures are on the low side, relative to the figures mentioned by entrants.

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<sup>64</sup> One supplier questioned whether the costs of qualification would vary to the extent shown in the table, since the process is the same irrespective of the number of customers. However, the supplier acknowledged that scalable IT systems would be more expensive and that larger players might recruit more expensive consultants to assist with the process.

Table 7 Estimated initial costs of setting up a new electricity supply business (£)

Cost item/Size of business	Small	Medium	Large
IT system	50,000	100-250,000	1 - 2m
Qualification processes	150,000	200,000	300,000
Billing and settlement systems	50,000	100-250,000	1 - 2m
Other	50,000	300,000	1 - 3m
Total	£300,000	£700,000 - 1m	£3.3 – 7.3 m
Capacity in number of customers	1000 – 10,000	10,000 – 100,000	100,000 - 1m
Initial cost per customer	£30 - £300	£7 - £100	£3.3 - £73
Annual equivalent of initial cost*	£17	£5	£3

\*Mid-point of initial cost averaged over half maximum capacity and recovered over 5 years at 12 per cent interest rate.

Nonetheless, the implications of these figures are quite striking. The small system referred to would cost £30 per customer to set up, even at its ‘design capacity’, and ten times that for fewer customers. To recover that cost over 5 years would cost about £17 per customer per year. For medium and large systems the comparable costs would be £5 and £3, respectively.

## APPENDIX 2. OFGEM'S REVIEW OF BARRIERS TO ENTRY

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In November 2001 Ofgem examined potential barriers to entry and expansion in the domestic retail supply market.<sup>65</sup> In April 2004 it reviewed the barriers identified in 2001 and discussed the findings of a more recent exercise.<sup>66</sup> It explained the changes that had taken place since 2001 in six main features that might present barriers to entry.

- 1) Prepayment meter infrastructure – there was no evidence that this was being used in a discriminatory way, and Ofgem had facilitated unbundling and competition.
- 2) Separation of electricity distribution and supply – the Utilities Act had required greater separation, and Ofgem was to complete research on brand independence.
- 3) Scottish electricity trading arrangements – BETTA was to be introduced in April 2005, a system that would treat all suppliers alike.
- 4) Dynamic teleswitched heating loads – most suppliers' billing systems were not designed to deal with this, so Ofgem reminded all suppliers of the duty to offer terms to all domestic customers; it acknowledged that suppliers have difficulty getting relevant information, and undertook to work with the industry on this.
- 5) Competition in metering – there were concerns that this would increase costs for suppliers and in turn for customers, the Review of Electricity Metering Arrangements (REMA) introduced new procedures to facilitate competition in metering services in May 2003, some suppliers had appointed alternative providers, and Ofgem had issued a survey in March 2004 as part of a competitive market review.
- 6) Debt blocking – Ofgem was working with suppliers to prevent objections to transfers on grounds of debt, an industry protocol was in force from February 2004, and Ofgem had imposed financial penalties on some suppliers for incorrect objections.

An Appendix to the April 2004 review gave brief updates on six further features that presumably (in Ofgem's view) no longer presented barriers to entry and expansion. These were

- 7) a) incumbents' market position and behaviour, b) shared unmetered supply, c) competition on gas transportation networks other than Transco's, d) gas system entry capacity auctions, e) the effect of Neta and f) the Renewables Obligation.

Ofgem then presented the results of talking to actual and potential new entrants in order to assess the potential impact of barriers to entry and expansion. It classified these into five main categories. Its findings and conclusions on these were as follows.

- 8) Entry requirements
  - a. Entrants need to be party to a number of agreements (DUoSA<sup>67</sup>, MRA<sup>68</sup>, BSC<sup>69</sup>, CUSC<sup>70</sup>, Data Transfer Service Agreement, Scottish trading agreements and

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<sup>65</sup> *Review of domestic gas and electricity competition and supply price regulation: evidence and initial proposals*, 71/01, Ofgem, November 2001

<sup>66</sup> *Domestic competition market review*, at section 7. This document examined customers' experiences, assessed the extent of switching suppliers, documented price and non-price offers, estimated the headroom for new entrants and the prices paid by incumbents for existing supply businesses, looked at market shares and the degree of concentration in the market, evaluated the extent of barriers to new entry and expansion, and indicated what further work Ofgem intended to carry out.

<sup>67</sup> DuoSA: electricity Distribution Use of System Agreement.

agreements with metering agents), this is time-consuming and information is not always readily available: Ofgem has provided an information pack.

- b. Distribution companies are inconsistent in ability and willingness to negotiate: it is not clear to Ofgem why there should be such variation.

#### 9) Regulatory requirements

- a. All applicants need licences: Ofgem aims to assess applications within 12 weeks and in practice does this more quickly, does not consider this presents an undue barrier to entry.
- b. All domestic supply licensees have to comply with more standard licence conditions than in the non-domestic market, some new entrants have said these requirements place additional unnecessary burdens on them: Ofgem is likely to review these as part of its Supply Licence Review with the objective of reducing barriers to entry.

#### 10) Operational issues

- a. Domestic gas suppliers are required to offer terms to supply on non-Transco networks, which is a problem: Ofgem is likely to review this obligation as part of its Supply Licence Review.
- b. Neta makes it difficult for new entrants to protect themselves against wholesale price volatility: Ofgem considers that they can do so in a number of ways, and that Neta ensures that the cost of dealing with system imbalances falls on those suppliers that create them, and that this creates appropriate incentives to balance a portfolio.
- c. Customers incur costs in gathering information and comparing rival offers and sometimes experience problems with the transfer process or subsequent billing: Ofgem and energywatch have taken measures to reduce these costs, including free pricing factsheets, approving internet price comparison services, proposing that doorstep sales agents should provide written quotes and extensive work on the customer transfer process.
- d. Strong incumbent brands and advertising can increase barriers to entry and expansion by discouraging entrants: some new entrants have used their brands from other sectors and others have focused on price or customer service rather than brand, so these issues are not deterring credible new entry.
- e. Economies of scale or scope as a result of large fixed costs give larger suppliers an advantage over entrants: Ofgem accepts that scale affects profitability but this is not deterring new entry, simply constraining the kinds of business plans pursued.
- f. Existing suppliers could block transfers to new entrants: Ofgem was currently assessing how suppliers were implementing the newly-introduced customer requested objections, and was to publish guidance on best practice in spring 2004.
- g. The 28 day rule requires that all domestic supply contracts must be terminable at 28 days notice, but allows a termination fee for contracts over 12 months, and new entrants have expressed concern that this could prevent switching and dampen competition: Ofgem was implementing a trial suspension of the 28 day

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<sup>68</sup> MRA: the electricity Master Registration Agreement.

<sup>69</sup> BSC: the electricity Balancing and System Code.

<sup>70</sup> CUSC: the electricity Connection Use of System Code.

rule for energy efficiency measures and would consider the impact on customers' desire and ability to switch.

- h. The complexity of the customer transfer process means that a new supplier's system must be able to deal with hundreds of data flows for each transfer, and the differential ability of distribution companies to resolve problems quickly means that suppliers may need to devote considerable resources to this issue: in addition to the new entrant testing processes, Ofgem and energywatch have challenged suppliers to identify and implement solutions to the problems surrounding customer transfer, a report identifying the problems was due to be published in April 2004 and stage 2 of the exercise to identify solutions would start then.
- i. The additional costs of supplying prepayment meters means that new entrants are deterred from offering competitive rates to these customers: Ofgem's view is that suppliers can set different rates to reflect additional costs but that there are some outstanding issues, mainly to do with prepayment infrastructure.

#### 11) Financial issues

- a. new entrants are likely to require considerable financial resources to operate effectively, and in particular have to provide credit cover: Ofgem has published a document on this and industry working groups are considering how the problems could be resolved.

#### 12) Information issues

- a. obtaining information about other network costs is not straightforward as it might be, there is no central source of information about customer numbers in each area, and it is time-consuming for entrants to ascertain competitors' prices: Ofgem considers that the industry should coordinate and provide this information centrally.

## APPENDIX 3. MARKET ENTRY PROCESSES

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### A3.1 Outline of SVA Market Entry requirements

Elexon has usefully summarised the series of entry processes that are associated with new entry qualification.<sup>71</sup> The main elements are as follows, with Elexon's indication of the time and charges involved at each step.

- 1) **Accession to the Balancing and Settlement Code (BSC).** This requires filling in an Accession form signed by a director of the applicant company. It also involves payment of the Accession fee to Elexon, which is currently £500. It can typically be completed within a couple of days.
- 2) **Communication line acquisition.** This is the line required to link the supplier to BSC central systems in order to transfer data. The applicant decides between Low Grade service (using internet) or High Grade service (using dedicated lines).<sup>72</sup> There is no charge for the Low Grade service. The charges for the High Grade service are cost-reflective, and include £2,000 per month for each physical connection required. If a participant requires Tibco Software, the additional charges are £10,000 for the Software Licence (one-off fixed fee) plus £200 per month software support charge. The applicant applies to Elexon who then places the order with Logica. The lead-time for the High Grade service is stated as 60 days but may be less. In the case of a High Grade service, the physical line needs to be installed and tested.
- 3) **Authorisation.** This requires completing and filing authorisation forms in compliance with Balancing and Settlement Code Procedure 38 (BSCP 38). These need to be accompanied by a letter from a company Director declaring himself or herself to be category A authorised. This is not time-consuming and can be done in parallel with communications line acquisition.
- 4) **Qualification and Registration.** Applications must fill in and submit BSCP form 65 to register the details of the company in the central registry system (presently managed by Logica). This is a straightforward process. Once the communication lines are installed the applicant requests a qualification testing slot via form BSCP 70, to check whether the line is capable of receiving and sending data between the Participant and the Central Service Provider (LogicaCMG). This test is carried out by Logica within one day and typically takes 2 – 3 hours. The test may be waived where the supplier uses another qualified person's system. This waiving procedure is used more frequently nowadays: Elexon reports that it has had 5 or 6 requests for a waiver in the last four months. This is typically one of the services provided by White Label providers. In addition, the applicant has to register a Balancing Mechanism (BM) unit at least 30 days prior to first trading day, has to register its metering system (having appointed an accredited Meter Operating

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<sup>71</sup> *Simple Guide to Market Entry*, Elexon, version 1.9, February 2005.

<sup>72</sup> The High Grade Service provides access to all services and data through a private network communication, which gives data confidentiality and high security standards.

Agent), and has to complete registration in Market Domain Data (MDD). These processes occur in parallel and the Participants determine the timescales.

- 5) **Accreditation and Certification.** This is to ensure that all parties have developed their systems and processes to accepted industry standards and are able to fulfil the requirements of the BSC. It involves six steps: meeting with Certification Agent (PricewaterhouseCoopers) or Elexon to plan the process of certification; completion of Self Assessment Certification Return; review of same; review of evidence which may involve a site visit; report by Certification Agent or Elexon; and decision whether to accredit. The certification process involves a site visit by PwC and a fee set by the Performance Assurance Board (PAB) in the range £4000 to £8000.
- 6) **SVA Entry processes.** The Supplier Volume Allocation (SVA) entry processes are aimed at testing suppliers in conjunction with their party agents, to identify whether the supplier hub systems, business processes and operational staff can perform according to the requirements of the BSC arrangements. This test initially applied only to new entrants, but from time to time substantive modifications (e.g. P62 concerning new licensed distributors) require all existing systems to be retested to the new specifications. According to Elexon's *Simple Guide*, full entry process testing usually takes between 6 and 8 weeks for suppliers operating with agents that have previously undertaken entry processes with another supplier; testing for a new Supplier Meter Registration Service (SMRS) would typically take 4 weeks; and with new supplier agents the period would typically extend to 12 or 13 weeks.<sup>73</sup> There is no fee for Entry Process testing.

This is evidently a complex and time-consuming process. Elexon offers an initial meeting and presentation to explain the processes involved, and various forms of support during market entry, including a Customer Services Management (CSM) Team, accreditation analyst, Elexon helpdesk, market entry/exit section of the BSC(Elexon) website and ongoing support via Operational Support Managers.

### **A3.2 Elexon's review of present SVA arrangements**

Elexon has recently reviewed the Supplier Volume Allocation (SVA) arrangements set out in the BSC, which include the qualification processes. Elexon concludes that "the SVA Arrangements deal satisfactorily with the basic task of allocating volumes of energy to Suppliers; at this aggregate level the Arrangements are reliable, robust, and resilient to data and process problems in the Supplier Hub." However, "In the Supplier Hub, where the SVA Arrangements deal with individual metering points, there are pervasive problems." Elexon's view is that the present arrangements "continue to facilitate the achievement of the Applicable BSC Objectives, but do not do so in the most efficient way." It recommends that the parties should consider changes that,

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<sup>73</sup> Of the 7 parties that have been through testing for supply to the non-half hourly market in the past year, Elexon reports that one took 14 weeks, one 7 weeks, three parties in parallel 6 weeks, and two parties in parallel presently in progress are estimated to take 11 weeks. The range in this year is thus 6 to 14 weeks, the simple average is 9 weeks and the median is 7 weeks.

amongst other things, “Focus the BSC on essential requirements and the accuracy of data, eliminating from it unnecessary Agent and process specifications”.<sup>74</sup>

Among the detailed conclusions that Elexon reaches is that “Performance Assurance Framework [PAF] techniques that are of limited effectiveness should either be sharpened or abandoned. Elexon has doubts about the efficiency and effectiveness of a number of current techniques, including – Entry Processes, which were originally structured to mitigate large-scale implementation risk. Similar questions arise with Accreditation and Certification ...” (para 26 p. 24)

Amongst the strategies that Elexon proposes for consideration are

- “Strategy 2: End Central Prescription of Suppliers’ Processes. Reorient the BSC to focus only on requirements essential for Imbalance Settlement, eliminating non-essential process definitions. ...
- Strategy 6: Improve the Performance Assurance Framework. Modernise the PAF and its operation by: focussing on assuring essential BSC requirements and the accuracy of data rather than process steps ... Only pursuing non-compliances that damage other Suppliers, rather than the transgressor.” (para 6.1.2 pp 27-8)

Expounding on the details of these strategies, Elexon says of Strategy 2 “This option recognises that the efforts to centrally define in detail, monitor, and assure, processes spreading across many organisations have not ultimately been efficient or effective. Moreover, the original implementation risks, which partly prompted the mandating of a single, detailed, industry model, may not now appear so relevant. ... By focusing the BSC on essential Imbalance Settlement requirements, this strategy would remove non-essential process detail from the ambit of assurance and audit.... Elexon believes that this strategy would reduce unnecessary prescription on Suppliers, allowing increased innovation. This might be viewed as likely to increase the efficiency of the BSC, and to better facilitate competition.” (p. 30)

Regarding Strategy 6, Elexon believes that “at least the following techniques should be reconsidered and revised ... Review the market qualification techniques (Certification and Entry Processes) with a view to streamlining them and focusing on key requirements. This would reflect the fact that most new entrants now probably present a relatively low risk to other Suppliers. Consider instead a more tightly monitored and controlled probationary period of initial live operation.” (p. 35)

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<sup>74</sup> *BSC Review 2004/2005: Review of the Supplier Volume Allocation (SVA) Arrangements*, Elexon, September 2004, p. 5.

## APPENDIX 4. NETWORK CREDIT COVER

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### A4.1 Ofgem's policy on network credit cover

Before the supply market was open to competition, distribution companies would typically specify that if a supplier had investment grade credit rating (say BBB or better) then it could have unlimited unsecured credit, but if it did not have such a rating then it could have no unsecured credit. In the latter case a supplier had to provide cash cover for the amount estimated by the network to be due in DUOS charges for an average period of sixty days based on expected demand over the next six months following each semi-annual review.

Independent Energy went into receivership on 8 September 2000 following problems registering and billing its customers. It had approximately 240,000 electricity customers and 80,000 gas customers. Among other debts, Independent Energy owed approximately £19m to distribution companies.<sup>75</sup> Ofgem discovered that some distribution companies had failed to collect debts many months overdue. Independent's security cover was not enough to cover the amounts due. The receivers went on trading but refused to pay the network charges and Ofgem was reluctant to allow the distribution companies to de-energise customers in order to collect. In the event, over 80% of DUOS charges was collected from the receivers, and Ofgem allowed the distribution companies to recover a proportion of the remainder in terms of subsequent DUOS revenues. This second proportion, which varied from 80% to 90%, depended on Ofgem's view of how prudently and efficiently the distribution companies had operated their revenue billing and collection services.

Enron Direct went into receivership on 4 December 2001. It supplied gas to approximately 12,000 non-domestic sites, and electricity to about 149,000 non-domestic sites and 34,000 domestic sites. The total gross network business exposure was £16m but after deducting expected payments the estimated bad debt was likely to be around £4-8m. The proportion of this remainder allowed as pass-through by Ofgem was set out more explicitly along the following lines:

- post-insolvency debt: 100% recovery
- pre-insolvency debt not due for payment: 100% recovery
- pre-insolvency debt due for payment: a percentage based upon the age of the receivable debt.

A similar approach was taken with the subsequent failures of Maverick on 21 June 2003 and Atlantic on 28 April 2004.

In April 2002 Ofgem opened a consultation on this issue, acknowledging that current arrangements for providing credit cover present practices were no longer appropriate.<sup>76</sup>

“Ofgem does not believe that Approved Credit Ratings (ACRs) and Parent Company Guarantees (PCGs) are an acceptable form of credit cover in gas or electricity for two reasons: - they do not

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<sup>75</sup> *Arrangements for gas and electricity supply and gas shipping credit cover: consultation document*, Ofgem, 11 March 2002, Appendix 2: Case studies – Independent Energy and Enron.

<sup>76</sup> *Arrangements for gas and electricity supply and gas shipping credit cover: consultation document*, Ofgem, 11 March 2002.

necessarily provide any money in the event that the party defaults; and they introduce a cross-subsidy from those companies that do not have an ACR/PCG to those that do". (para 6.11) In the event that a company with an ACR goes into receivership, counterparties may not receive full payment of the debts owed to them, and the cost of default may be borne by the whole industry through smearing of unpaid charges, which will ultimately be passed on to customers. (paras 6.12, 13)

In simple terms, Ofgem's concerns seem to have been that present arrangements were

- ineffective (they did not protect against the actual and substantial risks of large accredited companies like TXU and Enron failing);
- over-protective against small risks (such as low turnover suppliers whose debts were negligible in the business context as a whole); and
- discriminatory (providing unlimited unsecured credit to big established suppliers, not all of whom merited it, having regard to their relative creditworthiness, and none to small new ones, at least some of whom might merit it).

Initial progress under the consultation was not rapid. In February 2003 Ofgem indicated the high level principles that should be applied and proposed that a series of industry workgroups should put together proposals for reform.<sup>77</sup> In September 2004 Ofgem published these proposals and suggested some modifications.<sup>78</sup> Ofgem then consulted on these modifications and in January 2005 published its views.<sup>79</sup> It is now for industry parties to consider these proposals and, if they see fit, to adopt them. It is then open to counterparties to accept or to object, if they wish, to whatever terms they are faced with.

Ofgem's proposed system seeks to minimise the cost of credit risk to consumers by trading off the costs of mitigation and the costs of losses, and incentivising both sides to implement and manage efficient arrangements. Briefly, the proposal is as follows. The network operators each have a notional maximum credit limit that they would grant to a riskless counterparty. The extent of this is based on 2% of the distribution company's Regulatory Asset Value (RAV). Each counterparty is accorded an unsecured credit limit that represents a specified percentage of the notional maximum credit limit, determined according to a scale (between zero and 100%) of relative creditworthiness based on the weightings adopted by the Basel Committee of the Bank for International Settlements for purposes of the revised bank capital adequacy guidelines (the so-called Basel II guidelines) promulgated in 2004.

There are further provisions as to the value of debt that has to be within these limits. This was a matter of some dispute. The proposal is that it should cover all bills issued and unpaid at any time, augmented by an allowance for charges incurred but not yet billed. The allowance is to be equal to 15 days UoS charges, calculated at the same daily rate implicit in outstanding billed

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<sup>77</sup> *Arrangements for gas and electricity network operator credit cover: conclusions and proposals document*, 06/03, Ofgem, February 2003.

<sup>78</sup> *Recommendations for best practice guidelines for gas and electricity network operation credit cover: consultation document*, 226/04, Ofgem, September 2004.

<sup>79</sup> *Best Practice Guidelines for Gas and Electric Network Operator Credit Cover: Conclusions document*, 58/05, Ofgem, February 2005.

amounts. Any supplier whose debt exceeds its unsecured credit limit must post collateral security for the excess, on which there are also guidelines.

The proposals make more explicit the provisions for a NetWork Operator (NWO) to recover irrecoverable bad debt arising from UoS charges from its future use of system revenues. Again, these depend on the extent to which it has acted efficiently with respect to billing and collecting, broadly on the lines adopted by Ofgem in respect of the failure of Enron Direct (as set out above). The NWO will have a stronger incentive to make sure its bills are paid when they fall due, and to push hard on suppliers who do not pay on time. Where this results from genuine financial difficulty, it could push the counter-party into insolvency, though that does not preclude the administrator from attempting to reconstruct and continue the supply business if it is potentially profitable. Nor does it preclude the NWO forbearing in cases where it reasonably judges its eventual total recovery will be maximised by doing so.

#### **A4.2 The debate about credit arrangements for small suppliers**

Small suppliers argued that credit cover requirements could lead to an undue barrier to entry and that the risks they presented to network operators were not material. They estimated that small suppliers (without a credit rating) accounted for around 1.5% of the power supplied in the UK. With a potential risk of 3 months' debt the potential exposure if all small suppliers failed in a year would be 0.375% of aggregate NWO turnover. Allowing for 50 per cent recovered from insolvency, the net shortfall would be 0.1875 per cent of turnover. In a more realistic case where only 10 percent of suppliers fail in any one year, the rise in end user prices would be only 0.0075%.

The small suppliers argued that the materiality of any credit failure should be a key consideration, and that "large infrequent failures may be significantly more material than smaller failures". They argued that the Workgroup proposals would increase the amount of collateral needed by two to threefold compared to the arrangements that in practice they generally enjoyed. They proposed that "small suppliers would be accorded an Ofgem stipulated minimum level of unsecured credit, and that all bad debt losses arising in respect of such suppliers should be automatically passed through allowed network operator revenues".<sup>80</sup>

The Working Group took the view that this was inconsistent with credit risk best practice in any industry. "However, the Workgroups acknowledge that free credit limits were applied in the gas industry for 2-3 years following the introduction of Transco's network Code in 1996 and that this contributed to some degree to the development of the market at that time." (paras 4.78 to 4.82)

Ofgem considered that the small suppliers' proposals had some merit (in particular in respect of the proposal to base credit limits for such suppliers solely on payment record). However, Ofgem considered that it was wrong in principle to provide a subsidy for any type of supplier. There appeared to be advantages in size in electricity supply. The goal of maximising the interests of customers would not necessarily be met by encouraging small and undercapitalised suppliers to enter the market.

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<sup>80</sup> *Recommendations for best practice guidelines for gas and electricity network operation credit cover: consultation document*, 226/04, Ofgem, September 2004, para 5.2.

Instead, Ofgem proposed that smaller suppliers that do not have credit ratings should have two possibilities. They could choose to be assessed by any one of a panel of credit rating agencies (the cost to be borne by the NWO), and potentially get up to 20% of the notional maximum limit, comparable to the bottom grade of an investment grade rating. Alternatively, they would be entitled to a formula that gives a specified amount of free credit for each year of a good payment record, up to a specified maximum. The minimum such credit was 0.4% of the notional maximum limit and it would rise by 0.4% per year for five years, to a maximum of 2.0%, provided a consistently good payment record was maintained.