

18 February 2003

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Dear Gill,

Ofgem Proposed Corporate Strategy 2003 - 2006

Thank you for the opportunity to comment on the issues raised in your consultation on the above published in December 2002. The overall framework of energy regulation has been improved with the creation of the Authority. This has significantly de-personalised regulation and created a more balanced regulatory regime. Other positives include a continued improvement in the development and quality of Ofgem's strategy document, the structured way in which Ofgem consults and the initiatives Ofgem is taking to drive forward moves to open up competition in other European markets.

However, and against this backcloth, it is important that Ofgem does not lose sight of the fact that the energy markets and the ESI in particular have experienced unprecedented and unparalleled change in recent years. The advent of NETA and the re-shaping of the regulatory framework by the Utilities Act 2000 have had a profound impact on the commercial and regulatory environment within which companies operate. The objective now should be for a period of regulatory calm and stability. Ofgem should avoid embarking on further ambitious and radical changes unless the benefits of doing so can be clearly and unequivocally demonstrated.

The ESI is a capital-intensive industry characterised by long-term investment and planning horizons and regulatory stability is crucial to creating the right environment for new investment. Yet at a time of heightened market uncertainty and unsustainable wholesale prices, it is concerning that confidence in the regulatory system continues to be eroded. The pursuit by Ofgem of an agenda which at times appears to be driven almost exclusively by economic theory, combined with a lack of consideration for the realities of the business environment and the absence of clear justification for regulatory initiatives and decisions (including demonstrable net benefits) all contribute to this. Furthermore, there is a growing unease with the current governance arrangements and in particular the role and accountability of Ofgem in respect of code changes.

Such factors undermine investor confidence, increase regulatory uncertainty and increase the cost of capital for investment projects. In the long-term this will increase costs to customers and, if not addressed, could pose serious questions regarding the ESI's ability to provide safe and secure electricity supplies.

It is in this context that we offer the following points.

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Key Points

- **Ofgem has failed to make the case for reform to the charging arrangements for transmission access and transmission losses. Development work on the implementation of BETTA will require these arrangements to be revised again in any case. Development work should therefore be suspended until the implications of new arrangements on a GB basis are understood.**
- **A strong argument exists for a full and comprehensive review of the operation of the wholesale electricity market.**
- **The continued absence of a formal regulatory impact assessment/cost benefit analysis in Ofgem's decision making process remains a serious concern.**
- **It is disappointing that the cost of regulation has not reduced despite the fact that the energy markets are more competitive. Ofgem should better prioritise its work to deliver lower costs.**

Detailed Comments

Making Competitive Markets Work Successfully

BETTA (and Transmission Access and Losses)

British Energy fully supports the creation of GB-wide trading arrangements and welcomes the recent publication by DTI of the draft BETTA Bill. We also welcome the recognition and importance attached to BETTA by Ofgem with the identification of BETTA as one of its top priorities for 2003.

However, we have serious concerns regarding the interaction between the development of BETTA and Ofgem's determination to push through major reforms to the arrangements for charging for transmission access and transmission losses in England and Wales. We have repeatedly criticised Ofgem's failure to apply a full and rigorous regulatory impact assessment in support of its proposals and remain concerned at Ofgem's determination to push through reform in the absence of such analysis and ahead of the implementation of BETTA.

We also note the recent consultation by the Energy Minister on the implications of Ofgem's decision on transmission losses from a BETTA perspective. It is clear from this that the Minister is concerned about the possible consequences of significant E&W market reform on the implementation of GB-wide electricity arrangements and on meeting the Government's wider environmental objectives (e.g. the development of renewables).

It is for these reasons that Ofgem should postpone further development work on transmission access and losses reforms until the implications of their application on a GB-wide basis have been fully explored, assessed and understood.

Market Structure and Competition

Over the past 12 months BE has made a number of submissions to Ofgem setting out our concerns regarding the current market restructuring that is taking place and the subsequent



increase in vertical integration and market power within the sector. Furthermore, it appears that all independent generators are experiencing serious financial problems as a consequence of unsustainable low wholesale prices. In the meantime, the large VI groups are continuing to report very healthy results on the back of uncompetitively high margins in domestic supply. They are also continuing their policy of no tariff reductions - and in some cases increases - to in-area customers.

I will not repeat in this response our detailed arguments but suffice to say there is strong evidence to suggest that the dominance of the large VI players is having a distorting effect on competition in both the generation and supply markets. Therefore, a full, open and comprehensive review of the issues surrounding VI should be carried out. If Ofgem is unwilling to conduct such a review (as suggested by its consultation into PowerGen's acquisition of TXU) it should ask the OFT or Competition Commission to do so.

Governance Arrangements & Code Changes

There is growing unease within the ESI regarding the current governance arrangements and in particular the role and accountability of Ofgem in respect of code changes. The recent decision by the Authority to overrule the BSC Panel in respect of BSC modification P82 is a case in point. We are also extremely concerned regarding Ofgem's proposal to use a licence condition on NGC to force through its proposed reforms to transmission access. This is potentially a serious breach of process and one we vigorously oppose.

In our responses to Ofgem's consultation papers on the BSC and CUSC under BETTA we highlighted our concerns regarding weaknesses in the current governance arrangements, particularly with regard to the lack of accountability of Ofgem and the absence of a full and proper appeal mechanism across the full range of regulatory decisions. In our view changes to the current arrangements are needed to address these weaknesses and to bring energy regulation into line with the appeal mechanisms available in relation to the decisions of other comparable UK regulators. In the meantime, it is imperative that decisions of the Authority (and in particular those that depart from a panel recommendation) are seen to be well reasoned and justified. In part, this cannot be achieved until such time as Ofgem fully embraces and applies regulatory impact assessments as an integral part of its decision making process (see below).

Improving the Way Ofgem Works

We have continually pressed for the principles of good regulation (as developed by the Better Regulation Task Force) and for the energy regulatory regime to embody - and even lead - regulatory best practice. As indicated above, whilst Ofgem has made much progress in some areas, there are further improvements that could and should be made to adopting regulatory best practice, particularly in respect of transparency, accountability and proportionality. For example, Ofgem's application of Regulatory Impact Assessments needs considerable enhancement, particularly when considering changes to industry codes. The importance of these approaches has been recognised by a range of institutions including the Government, the BRTF and the NAO yet Ofgem has still to accept that RIAs should form an integral part of any major regulatory reform/initiative. We recognise that it is not always easy to quantify benefits. But nevertheless, where regulation imposes significant costs it is imperative that a cost-benefit analysis is carried out.



Cost of Regulation

We note Ofgem's statement that its forecast costs for 2003-04 have managed to absorb inflation without impacting the headline cost figure. This is welcome. However, the absolute level is still significantly out of line with all other European regulators. It is also disappointing that the forecast budget for 2003-04 has not changed from the previous forecast set out in Ofgem's corporate strategy document for 2002-05, particularly since 70% of the energy markets are no longer subject to regulation. Rather than being content to contain costs, Ofgem should be seeking ways to reduce its costs. One way would be for a more effective and focused prioritisation of its work-plan.

Yours sincerely,

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