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Dear Chris Chapman

OFGEM'S THREE YEAR STRATEGY 2004-07

Sir John Mogg's letter of 1 September invited Prospect's comments on OFGEM's three year strategy for 2004-07. This brief response focuses on the specific questions highlighted in that letter, though Prospect has prepared a series of more detailed submissions to Government and Parliament which we would be happy to share if that would be useful.

As Sir John indicated, it is both logical and sensible for OFGEM to plan its future work to address the key challenges facing the industry.

Security of supply and reduction of CO₂ emissions are, in our view, linked priorities for future energy policy. Diversity and flexibility of supply are key features in ensuring security, though recent experience serves as a timely reminder that most supply disruption stems from some form of network failure and that networks have become increasingly vulnerable. Furthermore, although Prospect supports the 10% target for electricity generated from renewables by 2010, we are not convinced that it will be achieved.

The adoption by some regional electricity companies to introduce "green" tariffs should assist technologies that are near to achieving market competitiveness. Even so business commitment to renewable sources will hinge on economic factors and this may mean that in the short term a financial incentive is required. Such a mechanism should explicitly support new renewable generation capacity.

However, achievement of the Government's energy policy objectives will require a move to large-scale generation from renewable sources. This will pose both major engineering and financial challenges for generation, transmission and distribution, including distributed generation systems. There may also be environmental implications, especially if power lines are required from remote locations to population centres and grid connections are not local.

We agree with the Energy Futures Task Force that the "The goal should be a system that, as far as is practical, is neutrally designed to be capable of accepting generation close to the

points of demand as well as offering opportunities for remote generation from large plants that may have been sited to take advantage of local resources". In practice, this means that distribution and potentially transmission network operators will need to be incentivised to send micro-generated power to and from where it needs to be. In addition, there will be a need to strengthen and, in some cases, build new networks to meet the needs of new renewable generation. All of this has implications for pricing regimes and operating expenditure, particularly for distribution network operators.

More broadly, the uptake of renewables could be greatly enhanced by the promotion of Corporate Social Responsibility (CSR) principles, with businesses encouraged to engage in activities that support local communities.

In response to these challenges, we believe that there is a case for strategic review of the electricity supply system including:

- The consequences of regulatory action on long-term supply strategies;
- The role of generators in long-term strategic planning, including new build;
- The role played by transmission and distribution companies in securing cost reductions and passing on savings to consumers.

Undoubtedly the distribution price control review will be an important focus for OFGEM's work in the period ahead. The existing skewed market conditions are certainly causing significant problems. Market mechanisms based on short-term cost criteria, such as the New Electricity Trading Arrangements (NETA), militate against investment-led plans and decision-making. This needs to be addressed both to strengthen existing networks and to meet future infrastructure requirements. Evidence submitted by the Electricity Supply Trade Union Council (ESTUC) to the Trade and Industry Select committee on the 1999 Review serves as a timely reminder of the consequences of getting it wrong. The ESTUC evidence noted that "In reality, the distribution companies have already absorbed price cuts of 33% and shed 40% of their labour Customer service will decline but worse, the security of the system, its robustness under pressure, will decline also".

It is clear to Prospect members working in the industry that financial pressures often result in decisions that are sub-optimal from the perspective of service delivery. For example, the network is increasingly operating with inherently insecure radial feeds because of pressures to provide the cheapest new connection costs, but there is no will to join up these radial feeds in order to provide a more secure distribution network. Similarly, under-investment in the national grid system is resulting in more, and sometimes conflicting, outages. This results in the system being denuded for longer periods, in order to try and catch up again. The challenge is clear: A period of infrastructure renewal is now necessary and the current five-year segments must be extended to allow for a major investment programme.

Prospect has welcomed the Government's initiative in re-examining OFGEM's terms of reference. It is essential that the social and environmental guidance that emerges encourages a new era of investment-led planning. The key challenge is to move away from a very short-term focus to a broader longer-term approach.

Prospect would support a requirement on all energy companies to publish clear corporate and social responsibility objectives within a national framework. These might include, for example, support for research and development, training and skills transfer in low carbon

technologies and services. Effective and transparent mechanisms would be needed for setting, measuring, recording and reporting the outcomes of CSR policies.

Finally, we support the more open approach now being taken by OFGEM to its work, including the acceptance that assessment of future costs will be explained, though we do think that this process should be open to public scrutiny.

Yours sincerely

A handwritten signature in black ink, appearing to read "Paul Noon.", with a stylized, cursive script.

Paul Noon
General Secretary