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Dear Chris

Ofgem's Three Year Strategy 2004-07

I write in response to Sir John Mogg's letter of 1st September.

We welcome the chance to contribute to the development of the Ofgem Corporate Strategy. This is a particularly important time with Sir John Mogg and Alistair Buchanan taking up their new positions. We look forward to meeting them both in the coming weeks. Your plan is a valuable document that, once finalised, should explain your priorities and provide advance notice of the projects in which we may wish to participate.

I will structure our reply to follow the specific questions posed in Sir John's letter:

Key challenges facing the industry in the short to medium term

In our view, the key challenges can be captured under the single label 'developing and implementing energy policy'. Our perspective reflects the scope of our businesses, which include both electricity distribution and renewable generation. For both, there is a need to clarify Government objectives and the policy instruments by which they will be delivered.

To be more specific, I would identify a number of areas where attention should be focussed.

1. Security of supply – the Energy Policy Review raised the question of security of supply. Recent events, internationally and in the UK, have added to the prominence of this debate. To the extent that this is an issue of network resilience, it is important that public expectations are clarified in good time for the impact to be assessed within the Distribution Price Control Review (DPCR).
2. Environmental policy – the Energy Policy Review also reviewed targets and aspirations for a low carbon future. However the delivery mechanisms associated with these objectives appear inadequate. There is widespread doubt over the achievability of targets for 2010 on both renewable generation and CHP. For renewables, in particular, there are problems that extend beyond the Renewables Obligation market support mechanism (though this also has its problems). Potentially successful projects are also deterred by the difficulties of achieving planning consents and the problems related to connection to networks which were not designed to take large energy inputs.

3. Market restructuring – the energy markets continue to change, reflecting the effects of developing competition and the restructuring of services. Where such change is beneficial it should be encouraged, but there will continue to be a role for regulation to prevent the abuse of dominant positions or to specify minimum service standards.
4. Distribution Price Control Review – the price control review provides a new opportunity to construct a coherent framework of incentives. In our view, it is as important for incentives to encourage appropriate behaviour as it is to promote cost efficiency.

What action is needed from Ofgem in response to these challenges?

We recognise that many of the areas of concern require clarity of government policy objectives. This is true both on security of supply, where the standards expected of twenty first century networks should be specified clearly, and on distributed generation, where government aspirations need to be converted into more manageable targets. We believe that Ofgem have an important role in advising Government on the practical implications of policy proposals, as well as in developing the more specific incentives that should ensure delivery. For the latter, it is important to recognise the timetable of the DPCR and therefore Ofgem need to press the government for clarity of objectives, where this does not already exist.

We hope that the price control review process will develop clear links between allowed income and the delivery of services that meet the needs of customers and Government. This must include a recognition of the linkage between investment levels and supply quality, risk and network resilience. We believe that Ofgem should work with energywatch to identify customers' requirements and also consider whether there is a separate public interest that reflects Government social policy. Once standards have been set, network operators can be incentivised to consistently meet those levels of performance. This is not an easy area, but recent events indicate that the public debate will continue until there is greater clarity over both standards and the means of measuring performance.

Similarly in the area of distributed generation, whilst we accept that many issues can only be resolved through Government action, Ofgem can play a major role in advising Government of what is needed and in suggesting detailed solutions to particular problems. This should include the difficulties faced by renewable generators, uncertain over the long term future of ROCs and the network related issues arising from both planning and connection difficulties. We are pleased to see that Ofgem have begun to develop an incentive regime aimed at accelerating the connection of distributed generation, but remain concerned that the proposals to date still bear the hallmark of a regulator concerned to avoid additional cost. The immediate need is to achieve a step change in the rate of development. This is likely to require commitment to construct infrastructure able to accept increasing volumes of new generation. This inevitably involves some speculation. The risk needs to be shared with society, in recognition of the environmental benefits that are expected to emerge in the longer term.

More generally the price control review must allow companies sufficient funds to operate. We hope that Ofgem will devote sufficient resource to the development of more appropriate means of inter-company comparison and financial modelling that takes full account of the requirements of the capital markets on which we depend for future funding. We appreciate

the open and constructive dialogue that has already been established with companies and will continue to comment constructively on these issues in forthcoming consultations on price controls.

Are there new areas of work that should be started and what priority should they be given ?

In general, we believe your plans embrace all significant topics and we would not wish to see any further expansion of your workload nor any upward pressure on licence fees.

Is there existing work that should be greater or lesser priority or stopped ?

We have commented before on Ofgem's tendency to take on too many tasks simultaneously. This not only causes resource problems for you but also makes it difficult for us to do justice to the many issues upon which we wish to comment and contribute. We continue to believe that Ofgem should focus its attention on a smaller number of major items of work. In our view your current priorities should reflect the key challenges discussed above. We suggested last year that you should review your work priorities after the Energy Policy Review was published and we trust that this is taking place in parallel with this consultation.

Furthermore, it may be worth making a couple of observations on Ofgem's ways of working. We believe there can be a tendency for projects to run on too long. Once an issue has been raised it is important that it is dealt with promptly, removing uncertainty for customers and companies alike. We can think of recent examples, such as the treatment of DUoS bad debts, where this has not been the case. As a general principle it would be helpful to see quicker decisions and more obvious precedents being set, with guiding principles clearly evident.

Finally, we would also wish to comment on the way that Ofgem have handled emerging competition. In some cases, such as both connections and metering, the focus has not always been on removing regulation to allow the competitive market to flourish. Such an approach would also release more resources for other projects within Ofgem's plan. There is an understandable tendency to intervene with market rules that may or may not be consistent with the way competition is developing. Again it may help if guiding principles could be established, which describe Ofgem's priorities as the market changes. If a market is to become competitive it is essential that all players face equal obligations. There continue to be examples, in metering, connections and network ownership where this is not the case.

I hope you find these comments helpful. We would be pleased to discuss them further if this would be of assistance.

Yours sincerely

Mike Boxall
Head of Electricity Regulation

CC: Sir John Mogg