ASSOCIATION OF ELECTRICITY PRODUCERS

OFGEM'S THREE YEAR STRATEGY 2004-2007

RESPONSE TO THE CHAIRMAN OF OFGEM'S INVITATION TO COMMENT

1. The Association (AEP) is the trade association for the electricity generating industry in the UK. Its membership of some 100 includes all the major generating companies and a wide range of other generating businesses. Between them, the members represent virtually all of the generating technologies employed commercially in the UK. Through payment of their licence fees, the Association's members make a large contribution to the cost of running Ofgem. The Association welcomes the opportunity to comment on Ofgem's strategy, its commitment to public discussion of its Strategy and Business Plan and the introduction of a three year planning horizon.

2. Ofgem's principal objective of 'protecting the interests of consumers, wherever appropriate by promoting effective competition' has been largely achieved. In the generating sector, wholesale prices are clearly derived from competition and any doubts about the competitive nature of the market should be considered in the light of companies going into administration, plant values collapsing, businesses being repossessed by the banks and the Government having to support British Energy. In the retail market, customers can choose between many competing suppliers and as Ofgem has stated often, millions of them are exercising that power successfully.

3. As energy regulation has developed in the UK, so has competition law. This applies as much to the energy industry as any other and is more stringent than ever before.

4. In the sector where the emergence of competition is unlikely – the monopoly networks – Ofgem now has some 12 years experience of regulation. Day to day regulation and periodic reviews, therefore, should now be more routine, with few surprises.

5. Ofgem's strategy should reflect fully the circumstances – competitive markets, tough competition law and experience of monopoly regulation - in which the Authority now operates.

6. Sir John Mogg's letter asked about the challenges facing the industry. At first sight, those challenges are fairly simple. They are to maintain and improve the delivery to UK energy users of secure and competitively priced energy. That is the very essence of the relationship between the industry and its customers. It is complicated, however, by the many political objectives (environmental, social and economic) which are overlaid on the market drivers. Those objectives seem to carry different weight at different times and they are often in conflict with each other. This makes the challenges facing the industry much more complex, particularly in relation to investment. At present, there is no sector of the generating industry in which companies can invest with much confidence. We

recognise that the Government, of course, is the main player where public policy influences the market, but, it is important that Ofgem should take account of this situation; reduce uncertainty where it is able to and at very least, avoid adding to uncertainty.

7. Sir John also asked whether Ofgem should pursue new areas of work. We note that Ofgem's Corporate Strategy 2003-2006 suggests an indicative budget of £34 million for 2005-2006, compared with £36 million for 2003-2004. It goes on to explain that additional work or new priorities '… could result in a different budget.' The current budget for some 300 staff with annual spending of £36 million is astonishingly high, particularly as: -

- generation and supply of electricity are competitive;
- competition law is stringent;
- Ofgem can now draw upon 12 years of experience in regulation of the monopoly networks;
- energywatch has been set up to protect customers and
- there are experienced trade bodies to look after larger customers' interests.

Ofgem should plan to reduce its staffing and budget substantially. Existing work should be reviewed and any proposals for new work should be addressed in the context of the comments above. The Association believes it is vital to the interests of an efficient market, and hence customers, that the thrust of regulatory development is focused, cost-effective and designed to achieve the minimum intervention necessary.

8. There are some areas of work where Ofgem could re-evaluate its role to good effect. For example, we have been concerned for some time about the Ofgem's role in industry governance, where its involvement in operational matters can be at odds with its position in making rulings. It would also be reassuring to know that Ofgem will not seek changes in the way that the electricity and gas markets operate, without a convincing assessment of the costs and benefits of doing so and more generally, it should avoid the temptation to micro manage the industry's trading arrangements. In an appendix, we attach some more detailed comments on benchmarking Ofgem within Europe, the balance of activities, and the approach to determining budgets and work areas. We have used the current Corporate Plan 2003-2006 to illustrate our comments.

9. The Association would welcome the opportunity to discuss this response with Ofgem.

David Porter
Chief Executive
Association of Electricity Producers
First Floor
17 Waterloo Place
London
SW1Y 4AR

Tel: 020 7930 9390
Email: dporter@aepuk.com

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APPENDIX: Detailed Comments based on the Corporate Plan 2003-2006

Operational Goals:

Some of Ofgem's work will arise as a result of changes in the market place and in response to the consideration of the effects of those changes by government. We suggest Ofgem should seek ways of establishing service levels and agree them with the DTI. In this way value for money can be demonstrated and a benchmark established for future downward pressure on costs.

Some of Ofgem's activities arise from its decisive role in amending industry codes such as BSC, CUSC, GC and DC. We suggest that Ofgem publish operational targets for dealing with proposed amendments. This would have the dual benefits of imposing time and cost disciplines on Ofgem, and allowing industry participants to plan the implementation of changes with better notice and therefore lower costs. Similarly, the industry would welcome a better understanding of Ofgem's reasoning when proposals for change, which have had widespread support, are rejected.

Regulatory Impact and Cost Benefit Analysis

Some of the work areas are described currently in broad terms, anticipating that detailed projects will emerge during the course of the plan's term. Without some form of regulatory impact assessment and an assessment of costs and benefits arising from the intended projects, it will be difficult for Ofgem to demonstrate that these projects represent value for money. We welcome the proposal in the Energy White Paper for Ofgem to conduct RIAs for major new policy initiatives. This does not go far enough and does not recognise the usefulness of this mechanism as an internal management tool. Apart from being recommended by the Better Regulation Task Force (BRTF), it is also part of normal business activity for a commercial organisation that has aspirations to learn from its mistakes and improve its efficiency and effectiveness. Analyses and assessments of this type give a rigorous and externally defensible method for the choice of work to be pursued. Ofgem lacks normal commercial drivers and this is why RIA and CBA are important as surrogates.

At the moment, the test of acceptance for amendment to the industry codes is against sets of Applicable Objectives. In principle, any proposed change that offers an iota of improvement will be implemented. Rigorous application of cost benefit disciplines would make regulatory oversight more transparent and predictable. Ofgem should not underestimate the costs which fall on industry parties from proposals for wholesale changes – not merely from the design and implementation of them, but also from lengthy periods of uncertainty.

Prioritisation of Different Regulatory Objectives

Ofgem now has a number of different objectives: economic regulation, security of supply, social guidelines and environmental guidelines. The Better Regulation Task Force report of July 2001 set out 5 recommendations for regulators. We are not clear how Ofgem intend to achieve one of those recommendations: prioritisation of different regulatory objectives. We believe it is important that this is spelt out.

Levels of Resources

The Corporate Plan 2003-2006 comments on the 3-year target to reduce the overall costs of Ofgem and compares the total cost with the overall turnover of the industry. Whilst it is laudable that Ofgem is seeking to reduce costs, it should be noted that the resources proposed for Ofgem are still very large by comparison with other European regulators. In a recent benchmarking study for the European Council at Stockholm (Brussels, 3.12.2001, SEC (2001) 1957) the UK performed very well against the EC criteria for liberalization of both the electricity and gas markets (see tables 1, 3, Executive Summary). Unfortunately, it also had the most expensive regulator by far, its reported 2001 budget of €103m being greater than the combined budgets of the 12 other countries that reported a budget (Appendix 4, attached). Additionally, the reported staffing level of 340 was twice the size of the next nearest (Sweden 162 staff). Even allowing for the fact that 2001-2's budget may have been large because of one-off NETA costs, the proposed Ofgem budgets for the next 3 years (~€58m, €58m, €54m) are each nearly three times the next nearest 2001 budget (Sweden, €20.5m). In a situation in which Ofgem's direct contact with domestic consumers has been reduced by the split of work with Energywatch and it has shown some commitment to withdrawing regulation from certain areas, it is difficult to understand why such huge resources are required to regulate the most liberalized energy market in Western Europe.

The Association believes Ofgem should be setting a resources target consistent with the size and maturity of the UK energy market.

Balance of Resources between Areas

Currently the major areas of activity are 'making markets work' and 'regulating monopolies'. We applaud the intention that the 'making markets work' (mmw) budget is set to decline over the 3 years. This is consistent with the maturity of the competitive markets in gas and electricity. However, this will still be £18.04M, 53% of the budget by 2006, compared with regulation of monopolies £11.52M, 34%, arguably the natural business of a regulator. We would suggest that a more challenging target would be for the 'mmw' budget to be a lower percentage of the total than the 'rom' budget.

Contingency

Ofgem's Corporate plan contains a contingency of 5-8%. The need for this should be reviewed.

Summary of Ofgem Budgets

Summary Ofgem Budget	**’03-04**	**’04-05**	**’05-06**	**‘05/06 % of Budget**
Promoting Competition	21.98	18.39	18.04	53%
Regulating Monopolies	10.72	12.81	11.52	34%
Total Net Budget	36.0	36.0	34.0	

EC Comparison of Regulators’ Resources and Competences

	Ex-ante/ Ex-post	**Network access conditions**		**Dispute settlement**		**Licenses issued by:**	**Annual Budget 2001(€m)**	**Staff number**
		Gas	**Electricity**	**Gas**	**Electricity**			
Austria	Ex-ante	N	R	M	R	Ministry	7.0	37
Belgium	Ex-ante	R	R	R	R	Ministry	9.4	40
Denmark	Ex-post	R	R	R	R	Ministry	2.5	30
Finland	Ex-post	R	R	R	R	Regulator	1.2	15
France	Ex-ante	n.a.	M	n.a.	Reg.	Ministry	9.1	65
Germany	n.a.	N	N	Competition Authority		Ministry	No regulator in place	
Greece	Ex-ante	n.a.	M	n.a.	R	Ministry	4.4	10
Ireland	Ex-ante	M	R	M	R	Ministry/regulator	5.0	27
Italy	Ex-ante	R	R	R	R	Ministry	18.0	63
Luxem	Ex-ante	M	M	M	M	Ministry	na	1
Neth	Ex-ante	N	R	R	R	Ministry	4.0	33
Portugal	Ex-ante	n.a.	R	n.a.	R	Ministry	4.5	46
Spain	Ex-ante	M	M	Regulator/Regional Govt		Ministry	16.8	140
Sweden	Ex-post	R	R	R	R	Regulator	20.5	162
UK	Ex-ante	R	R	R	R	Ministry/regulator	103.0	340