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Dear Chris

OFGEM'S THREE YEAR STRATEGY 2004-7

British Energy welcomes the opportunity to contribute to the development of Ofgem's next three year strategy and plan as set out in the consultation dated 1st September 2003.

The primary aim of Ofgem's existing and future strategy should be one that seeks to achieve its principal objective of 'protecting the interests of consumers'. With this in mind, Great Britain requires an energy policy and regulatory framework that balances security, diversity and care of the environment with competitive markets and price stability. The key challenge for Ofgem, and indeed the Government, is to develop an energy policy framework that satisfies the public interest test by striking the right balance between these priorities. The achievement of such an aim will lead to greater regulatory certainty and stability which in turn will create the right environment for long-term investment.

With the above aim in mind, we would offer the following views in respect of the specific questions set down within the consultation letter.

The Key Challenges facing the industry in the short to medium term and the action needed from Ofgem to respond to these challenges.

Security of Supply

The promotion of competition by Ofgem in the electricity and gas markets combined with the operation of price controls has brought historic benefits to consumers in the form of greater choice and lower prices. Although lower prices can be in the interests of consumers this should not become an aim in itself. The objective should be fully competitive prices in a market which delivers security of supply.

The operation of a transparent and properly functioning market that provides appropriate signals to new entrants and existing players on investment time-scales is crucial to ensuring security of supply and hence protecting the interests of consumers. However, since the introduction of NETA, concerns have been expressed about the ability of the market alone to deliver security of supply. In particular, whether the current arrangements provide appropriate incentives for generators to maintain spare capacity on the system and thus



achieve the plant margin deemed necessary by NGT. These concerns are highlighted by the fact that NGT have been expressing concerns about the generation plant margin for periods of the forthcoming winter due to the removal of generation from the system following the decline in wholesale prices. Whilst prices have recovered somewhat recently, only a limited amount of mothballed capacity has returned, or has been signalled for return, to service. This suggests that there needs to be a review of how and whether generators are sufficiently rewarded and whether additional incentives and/or solutions are required to maintain an appropriate level of generation capacity. This should be Ofgem's top priority.

Vertical Integration

We have previously made a number of submissions to Ofgem setting out our concerns regarding the developments in market structure and in particular the significant increase in vertical integration and market power within the sector. Evidence suggests that this trend is having a distorting effect on competition in both the generation and supply markets. Over the last three to four years all independent generators have experienced serious financial difficulties as a result of the unsustainable low wholesale prices. However, throughout this period the large VI Groups have continued to report healthy results primarily on the back of uncompetitively high margins in domestic supply. Furthermore, contrary to the views expressed by Ofgem in its last review of supply competition¹, domestic tariffs have risen without ever noticeably reflecting the significant fall in wholesale prices over the last three to four years. The degree of VI raises other issues including the extent to which internal contracting by VI players is inhibiting the ability of the market to function properly. This is evidenced by continued liquidity problems and the absence of effective paper derivative markets and pure trader activity. These are essential for a fully competitive and properly functioning market and their relative absence serves to reinforce the position of VI players.

Consequently, we again urge Ofgem to conduct an open and comprehensive review of the issues surrounding VI, including an examination of the effects of increasing VI on competition in generation and supply markets and whether this is, or is not, in the public interest.

Implementation of British Electricity Trading and Transmission Arrangements (BETTA)

BETTA will deliver benefits to consumers both North and South of the border – primarily by creating a larger, more transparent market. However, it is vital that if the benefits to consumers are to be delivered in a timely manner, the work associated with the BETTA project needs to remain a key priority for Ofgem throughout 2004. We consider the implementation date of April 2005 is achievable subject to the necessary legislation and effective leadership and prioritisation by Ofgem. However, it is essential that the project focuses on putting in place practical and deliverable arrangements within clear timescales. With this in mind, the temptation to implement fundamental reform of the existing transmission arrangements in the absence of justifiable benefits to consumers should be avoided.

¹ Electricity Supply Competition - An Ofgem Occasional Paper - December 2002



European Regulation and Market Liberalisation:

Ofgem clearly has an important role in shaping the development of European policy on energy markets in order to protect the interests of market participants, and ultimately all consumers, in Great Britain. It is imperative, therefore, that Ofgem allocates sufficient resource to this work area.

In particular, we are concerned that Ofgem needs to consider more carefully the compatibility of the GB arrangements with those in the developing EU energy markets. In the context of a single EU market, it would be neither appropriate nor efficient for there to be significantly different, more complex or more burdensome arrangements in the UK. Regulatory policy in the UK must be consistent with that adopted by the European Commission. For example, rules for transmission charging and third party access should be aligned.

Environmental Policy

We recognise that it is Government's responsibility to develop environmental policy and targets but since power stations account for over a quarter of UK CO₂ emissions Ofgem also has a key role to play. In particular, Ofgem should assist the Government in developing environmental policy including by reviewing the existing policy instruments to ensure they are consistent or complimentary, efficient and in the long term interests of consumers. In this context we welcome Ofgem's response to the Government's Energy Policy Consultation² where it concluded that the existing policy framework "risks significant inefficiencies through a multiplicity of schemes, each with multiple objectives". Furthermore, we concur with Ofgem's view that a single broader policy instrument that has the effect of internalising external costs such that all greenhouse gas emitters bear the full costs of their emissions would be a much more efficient policy instrument and would better serve the long term interests of consumers. Consequently, we would like to see a fundamental review of all the options in respect of environmental policy and would urge Ofgem to play a central role within such a review.

From a broader perspective, and in order to avoid unnecessary regulatory risk and uncertainty, it is essential that Ofgem's own work programme and policy initiatives remain consistent with, and where possible reinforce, the Government's wider policy initiatives and goals and it should strive to ensure that it reacts appropriately to these.

Energy Bill

It is possible that an Energy Bill will be presented to the House in the next session of Parliament. Consequently, the resource implications of such a Bill should be fully accounted for in the development of Ofgem's next three year plan so as to ensure timely implementation of the Bill is achieved in those areas directly affecting Ofgem.

² Ofgem response to Government's Energy Policy Consultation - August 2002



New Areas of work and the priority to be applied/Existing work to be given greater/lesser priority

Governance

As indicated above, the promotion of competition by Ofgem and its predecessors, combined with the operation of price controls has brought historic benefits to consumers in the form of greater choice and lower prices. However, the growing unease with the current governance arrangements (in particular the role and accountability of Ofgem in respect of industry code changes) and the way in which the Authority arrives at policy decisions is undermining investor confidence and increasing regulatory uncertainty. In the long term this increases the cost of capital for investment projects and hence to consumers. If not addressed, such issues could pose serious questions regarding the industry's ability to provide safe and secure energy supplies over the longer term.

There is clear need for improvement in the transparency and accountability of Ofgem's decision making process. Whilst we note that Ofgem has apparently adopted the use of regulatory impact assessments for major policy issues we consider there is a need for a more widespread adoption of these assessments when market changes are proposed. This will ensure that changes are only implemented where a clear benefit to consumers has been demonstrated and not solely on the grounds of text-book economic efficiency which at times ignores the reality of the energy market.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely

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