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Your Ref:

Mr Chris Chapman
Head of Planning
The Office of Gas and Electricity Markets
9 Millbank
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Chairman's Office

14 October 2003

Dear Mr Chapman

OFGEM'S THREE YEAR STRATEGY 2004-07

Thank you for giving the Scottish Environment Protection Agency (SEPA) the opportunity to contribute to the development of Ofgem's three-year strategy 2004-07. SEPA believes that as the UK develops its energy policy in response to the Government's White Paper, "Our Energy Future - Creating A Low Carbon Economy", there is a period of opportunity to ensure that the UK creates a regulatory and incentive system that delivers its long-term energy and environmental goals.

Some of the uncertainties articulated in the foreword of Ofgem's Corporate Strategy for 2003/6 have been removed since the publication of the Energy White Paper. The publication of this document should therefore provide Ofgem with a firmer platform from which to plan its forward strategy. The Energy White Paper also makes clear that Ofgem has a major part to play in the Government's strategy to achieve a reduction of 60% in emissions of carbon dioxide by 2050, with demonstrable progress by 2020, not least in supporting the Scottish Executive's own target of 40% of electricity from renewable sources.

This response indicates several areas where greater partnership between Ofgem and SEPA could help deliver the Government's strategy. Detailed comments are provided in the attached annex, while the more strategic issues are addressed below.

Despite many of the clear signals which the Government has made in the Energy White Paper, achieving the desired reductions in emissions of carbon dioxide will be a challenge for all. One area which the Energy White Paper tends to underplay is the impact of new environmental legislation, particularly the implementation of the EC Directives on Large Combustion Plant and Integrated Pollution Prevention and Control. SEPA believes there is clearly a need for a joined up approach as energy issues are integral with environmental protection and improvement, as well as with the competitiveness and sustainable development aspects of the Scottish economy. It would therefore be entirely appropriate to see in the Ofgem Strategy a target to:

- ***Work with the environmental regulators so that environmental priorities are comprehensively addressed and adequately financed.***

SEPA believes it is important to continue to improve the dialogue between the UK's environmental regulators and Ofgem to ensure that these issues can be satisfactorily addressed. To this end, SEPA would wish to be actively engaged in any strategic processes with an environmental and/or sustainable

development dimension. In addition, we would also like to request formal SEPA involvement in Ofgem's Environmental Advisory Group.

Ofgem must continue to ensure that Scotland's concerns and issues are adequately addressed, not least because we have a small number of major players in the energy market. The issues for Scotland are not always the same as those for the rest of the UK. For instance, over and above new environmental legislation, the next few years will be significant in the development of the Scottish generating market. In particular, it is uncertain what will happen to emissions of carbon dioxide when the "must take (nuclear power)" obligations expire in 2005.

Finally, SEPA believes that there is a fundamental tension between what Ofgem sees as its core business of "protecting and advancing consumers' interests" (i.e. constantly ensuring prices are as low as possible) and the need to reduce the demand for energy (as all forms of generation have some environmental impact) and thus protect the environment. It is important that as the UK develops an overall strategy for energy generation, transmission and management, that the environmental issues are addressed and appropriate management responses play a key role. For instance, while developing a transmission and generation architecture that is both secure and minimises the generation required, it is also important to minimise the environmental impact. In some cases it may be better to trade off gains in other areas to reduce the overall environmental impact of generation.

If you require any further assistance from SEPA on this matter please contact Jane Allan (jane.allan@sepa.org.uk) or Peter Singleton (peter.singleton@sepa.org.uk) at the address below. We are, as usual, happy for this response to be placed in the public domain.

Yours sincerely

Sir Ken Collins
Chairman

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Annex

- 1. The key challenges you consider the industry faces in the short to medium term (for example, structural, social, environmental or technological), &**
- 2. What action do you consider the Authority should take to respond to these challenges?**

Greater Opportunity For Partnership With SEPA on Environmental Issues

Ofgem appears to treat health and safety issues fundamentally differently to environmental matters. In terms of the latter, they appear to let others take the lead. This may be appropriate in terms of providing targets for renewable energy sources as has been provided by the Energy White Paper. However, there are several major pieces of environmental legislation which are currently being implemented which are likely to have a significant impact on capital expenditure at individual plants using fossil fuels. Such legislation & issues include:

- The Pollution Prevention and Control Regime;
- The Large Combustion Plant Directive;
- The Emissions Trading Directive;
- The Waste Incineration Directive;
- Transco, the use of CHP as BAT, and the generation of power at GCS;
- The concentration on efficiency and high level Kyoto type commitments to the occasional detriment of other relevant statutes.

Ofgem has a major part to play in ensuring that necessary environmental improvements arising from this legislation are addressed adequately by the companies they regulate. There is a greater need therefore for Ofgem and the principal environmental regulators to work in partnership, as outlined in the Energy White Paper.

The Importance Of Providing For Embedded Generation and Intermittent Operation

SEPA was pleased to see that the Energy White Paper recognises the need for developing the national grid in such a way that it can cope with embedded generation with an intermittent generating pattern, primarily to assist the exploitation of renewable energy. This would also assist the development of other smaller generating capacity such as waste-to-energy plants which may have a significant part to play in meeting other environmental targets such as those in the Landfill Directive. SEPA therefore considers that this area of work should be a priority for Ofgem. Moreover, the transition from large generating capacity to smaller embedded units is novel and would be an area in which Ofgem could lead research. Closely coupled to this would be the need to research means of storing electricity which would help even out peak demands without having to resort to back-up generating stations using fossil fuels. The latter was identified as an important issue by the Royal Commission on Environmental Pollution in their 22nd Report.

The Importance of Energy Efficiency & Storage

Ofgem could develop its role in energy efficiency to ensure that energy is saved (or the need for energy is avoided) throughout the supply chain (some examples of the difference between energy efficiency and energy saving are given in Lord Marshall's report on the business use of energy). It is unlikely that this can be achieved by improvements in energy efficiency while there are few incentives for investment in energy efficiency measures due to the current low cost of energy. Ofgem must recognise the real cost of energy including its externalities, as it has started to do by ascribing a monetary value to the cost of methane leakages from the gas transmission network. Arguably this leads to more sustainable forms of generation and use. This represents a potential "win-win" for the environment, generators and consumers alike. By reducing the demand for energy, through better building design or by exploiting

measures such as passive solar gain, it is possible to reduce the need to consume fossil fuels and to reduce the need for ever greater capacity distribution systems. The latter helps reduce the cost of energy to the consumer and in the specific case of building design do much to alleviate fuel poverty.

Energy storage is an essential requirement if the UK is to rely on greater generation of energy from renewable sources, which in the short to medium term will be dominated by wind power. Ofgem should investigate how energy storage can be incorporated most effectively into the electricity supply system and into the market, and should develop operating rules to ensure the maximum environmental benefit. It should also address questions such as:

- what is the best location for storage - near the generator or the user;
- can the market be used to achieve the best environmental outcome and what mechanisms would be needed; and
- how can the market address the inherent inefficiencies of storing energy, including the potential decay of energy?

Energy Services

Ofgem could be instrumental in encouraging more radical thinking about the definition of energy services. At present, customers purchase a commodity, such as gas or electricity, which they then have to manage. An energy service provider could determine the best option for an individual installation, which could include improved insulation or installation of passive solar water heating to meet the needs of a household. New ways of packaging and selling energy services are required from suppliers. Ofgem should investigate how these services can be made available to the domestic customer and what mechanisms are necessary to provide the financial security for service providers to invest in energy efficiency measures that may have a long pay back time.

Research

SEPA would welcome discussions on more integrated and holistic research. This could partly be addressed by discussions with the Scotland and Northern Ireland Forum for Environmental Research (SNIFFER) and the Environment Agency (EA), (some joint work with EA is already under way on power station emission trends).

3. Are there new areas of work that, you believe, should be set in train and what degree of priority should they be given?

It is clear from the Ofgem Strategy for 2003/6 that carbon trading has been anticipated, primarily as a mechanism provided under the Kyoto Treaty. The Energy White Paper had also much to say on the importance placed by the Government on the EU Emissions Trading Scheme. However, the possibility of a National Plan under the Large Combustion Plant Directive, underpinned by a "cap and trade" system, does not appear to have been recognised in either the Energy White Paper or the earlier Ofgem Strategy. Similarly, specific improvements in environmental performance are likely to be sought under the new PPC regime. In the light of these developments, a further role in which Ofgem could play a lead part is ensuring the coherence of various regulatory regimes. Ultimately this would lessen the regulatory burden on industry which would, in turn, help minimise energy costs to consumers. This is again an area where greater partnership between SEPA and Ofgem would be beneficial.

4. Is there existing work that could be given greater or lesser priority or even stopped?

SEPA is not aware of any areas of work that Ofgem conducts on the environment that should be stopped.

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