Chris Chapman
Head of Planning
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415

Our Reference:
Your Reference: jm37-03lpl

Date: 13 October 2003

Dear Chris

Ofgem's three year strategy 2004-7

I refer to Sir John Mogg's letter of 1 September and am pleased to respond with views on the strategic choices for the Authority in the coming years.

We welcome the opportunity to engage in the Authority's review of strategy and believe that consultation on the Authority's strategic direction and detailed workplan has been a helpful recent development in regulation. We set out our comments under different headings below, reflecting the specific questions raised in Sir John's letter.

Firstly, however, I thought it would be helpful if we set out our fundamental concerns over the high costs of energy regulation and its growing emphasis on detailed issues. Despite the withdrawal of regulation from many areas which were directly regulated at the time of privatisation, Ofgem's operating costs have grown significantly since that time, particularly in the years just prior to the Offer/Ofgas merger and the introduction of NETA. Taking out these particular costs, overall costs have risen from about £10m in 1990/91 to about £37m in 2000/01 (as noted in the HM Treasury report on the efficiency of regulators). They have continued at this sort of level since then. This is in marked contrast to the regulated costs of the privatised companies, which have been driven down though the RPI-X mechanism.

It is also worth noting that recent analysts' research comparing staff numbers involved in electricity regulation in different European countries provides the following estimates:

United Kingdom	> 300
Italy	80
France	75
Belgium	60
Portugal	50
Netherlands	50
Germany	0

Against this background, we would expect to see the direct cost and staffing levels of Ofgem reducing rapidly from the pre-NETA and immediate pre-merger levels which have persisted in recent years. As many areas that were directly regulated in the early post-privatisation years have now been opened to competition, we see no reason for large amounts of staff and resources to continue to be applied to areas that are now competitive.

<u>Key challenges to the industry in the short to medium term</u>
The key challenges for the industry, in our view, include those set out below and we would urge Ofgem to concentrate its resources in these areas.

Implementation of BETTA
British Electricity Trading and Transmission Arrangements are due to be implemented via primary legislation on 1 April 2005. It is absolutely vital for the smooth transition to these new arrangements that there is clarity, as soon as possible, on some of the major structural issues. In particular, urgent clarity is necessary on the status of the 132kV network in Scotland and the specific GB transmission charging arrangements that will apply under BETTA. If these final policy issues are not resolved soon (and certainly before primary legislation is brought forward), we believe that the April 2005 deadline for BETTA will not be met.

Growth of Renewable Generation
The Government's targets for renewable generation will create significant challenges for the industry, particularly for the electricity networks, as Ofgem has already recognised. In our view, it is vital to create a framework that establishes with certainty that capital expenditure by distribution network operators (DNOs) to accommodate distributed generation (DG) will be remunerated by earning a return on the regulatory asset base at least equal to the basic cost of capital. The incentive scheme that Ofgem has proposed for DG might be capable of providing, as implied, an incentive for DNOs to actively seek out new opportunities and ways of working with DG. However, the incentive effect would be undermined if the basic requirement for certainty of adequate return on investment is not fulfilled. It would lead DNOs to delay making unforeseen DG-related investment between price reviews and substantial capability for accommodating DG will inevitably be delayed in these interim periods.

The commercial framework for DG is also an important consideration. We are firmly opposed to the proposed introduction of generator distribution use of system charges (GDUoS) from April 2005, which is creating its own set of additional risks and uncertainties for the industry. The valid policy objective of encouraging the connection of further quantities of renewable generation to meet government targets can, in our view, be achieved without the introduction of GDUoS. One approach would be to allow the current “deep” connection charge for generators to be annualised over a number of years (which would also preserve some locational signals). An alternative would be to put all the costs of accommodating new generator connections into the DuoS charges which are currently applied to demand. Between these two options, there is a third alternative that would involve determining a “shallowish” connection charge that a new generator would pay, possibly on an annualised basis, with the remaining “deep” reinforcement costs supported by DUoS charges levied on demand. In our view, even a substantial level of network investment would not add materially to the base of charges already seen by demand and furthermore, to the extent that they do become significant in certain parts of the country, a GB funding mechanism could then be considered.

A further area of uncertainty is recovery of the costs associated with the Renewable Energy Transmission Study (RETS) in respect of the work needed on the Scottish / GB transmission systems to accommodate renewable generators. Currently, significant works that will be needed to accommodate renewable generation risk being delayed unless there is certainty on recovery of the associated costs. Any delay would have an increasingly adverse effect on achieving the government’s targets for the output of renewable generation. We would therefore urge the Authority to resolve the outstanding funding issues, at least for the first phase of this work, as a matter of urgency.

There are thus several areas where the Authority could clarify and stabilise the commercial and regulatory framework surrounding the accommodation of renewable and distributed generation.

European Issues

The growth in regulation of the sector at European level is becoming increasingly important. We therefore welcome the Authority’s engagement in the European dimension. In particular, we would urge the Authority to seek to minimise any unnecessary burden on the energy industries of the UK arising from new European legislation. We also agree that the Authority has a role to play in lobbying at the European level to ensure that markets on the Continent are opened to competition and that other EU countries are able to take advantage of any efficiencies in regulatory approach arising from the UK experience.

Emissions Trading
The introduction of emissions trading is a significant development in the electricity generation market. We are firmly opposed to the proposal to hold back a proportion of the allocation for the electricity generation sector and provide this instead to installations in other sectors (the so-called "indirect allocations"). Such an approach would significantly increase the costs to the generation sector of complying with the Emissions Trading Scheme, which could have implications for the financial viability of some plant (particularly coal). It would also involve discrimination between consumers who were granted indirect allocations and those who were not, thus exposing the national allocation plan to legal challenge. We therefore seek the Authority's support on this issue in the consultation process by DEFRA on implementation of the Emissions Trading Scheme.

Governance of Industry Codes
We are concerned about the amount of involvement that Ofgem has in the development of the industry codes. Instead of being routinely involved in every single modification, the industry should be allowed a much greater degree of self-governance and Ofgem's role should be that of an appeal body for any market participant feels strongly about a proposed modification. Such an approach would be consistent with the declared aim of withdrawal from regulation of competitive markets. Furthermore, as indicated by the work of the Better Regulation Task Force, we believe there should also be an independent appeals process, available to market participants, for all decisions made by the Authority.

Gas Issues
The formulation of retail gas supply governance arrangements is an essential step towards clarifying supplier interactions with Transco. We have supported the introduction of the Supply Point Administration Agreement (SPAA) but have been very firmly of the view that this agreement cannot have the desired effect unless Transco is also a signatory to the SPAA. Transco owns and operates the core registration processes and hence any change control mechanism that excludes them is meaningless. It is also, in our view, imperative that the new governance arrangements are in place before (and incorporate the governance of processes relating to the operation of) new gas metering arrangements. This is because Transco's own Supply Point Administration process is an integral part of the new metering arrangements. We therefore believe that Ofgem should bring further pressure to bear on Transco to achieve their involvement in SPAA, as ultimately, the Authority could modify Transco's licence to achieve this objective.

A major structural issue for the industry is the separation of regulatory arrangements and potential sale of the Local Distribution Zones (LDZs). There has been constructive discussion and consultation so far in this area, and we would look to the Authority to finalise the regulatory structural arrangements as soon as possible.

Security of Supply
There is a growing awareness in the industry about the interaction between gas and electricity markets, particularly in the area of security of supply. In this respect, we have significant concerns over the operation by Centrica of the Long Term Interruptible gas contracts. There is evidence that these contracts are being used to interrupt the supply of gas to power stations at times when capacity margins in the electricity market are already being put under pressure due to demand peaks or specific reductions in available generation capacity. This is a structural issue in the energy market that is, in our view, validly within the powers of the Authority to address. We would welcome the opportunity to explain our concerns in this area in more detail.

<u>Action by the Authority to respond to the challenges above</u>
We have given our views on actions that the Authority could take in relation to the specific issues we have raised above. In summary, we look to the Authority for early regulatory clarity when structural changes are proposed and being implemented together with timely and appropriate intervention on issues of market structure, when the Authority's powers and influence can bring about changes of benefit to the energy markets. We do feel that the Authority should reduce the resources it commits in some areas, consistent with the withdrawal of regulation from competitive markets, and to that end, we have noted (in the relevant section below) some specific areas where Ofgem's involvement could readily be reduced.

More generally, we welcome the fact that Ofgem has recently started to produce Regulatory Impact Assessments (RIAs) for some of its major initiatives. It is, in our view, fundamental to equitable regulation that the costs to the industry are considered before regulatory projects are initiated. To support this approach, and consistent with the need to reduce regulatory costs and resources, we propose that the Authority periodically requests such assessments for ongoing projects, especially those that have never been subject to an initial RIA. In our view, this will help the Authority to re-define its priorities going forward.

<u>New areas of work that should be set in train</u>
Given our views on the need for Ofgem's costs and resources to be reduced, we would not advocate that any new areas of work are considered.

<u>Existing work that could be given greater or lesser priority or stopped</u>
There are several areas where, in our view, the resources committed by Ofgem could be significantly reduced. These are discussed in turn below.

Fundamental Review of Use of System Charging Methodologies
Ofgem have at present a number of projects underway which involve wholesale reform of use of system charging methodologies. Overall, these changes do not affect total revenue to the network operators, but they tend to drive network operator costs in design and implementation of changes as well as creating costs, uncertainty and changes in use of system liability for many industry participants.

One of the fundamental principles for use of system charges should be to maintain stability and predictability for those who pay the charges: a helpful subsidiary objective would be that no component of use of system charges should increase by more than RPI from year to year. Current projects under this heading include

- a review of **electricity distribution charges** including the introduction of charges for distributed generators. While we agree that it is necessary to move away from a "deep" connection policy in distribution to facilitate greater connection of renewable generation, we do not believe that wholesale reform of distribution use of system (DUoS) charges is justified. We are particularly opposed to the suggested new generator DUoS charge which raises substantial issues of regulatory risk and which, in turn, could challenge the financing of new renewable generation. We understand that this project is also undermining delivery of aspects of the BETTA reforms (particularly the resolution of the treatment of the 132kV network).

- proposed changes to **electricity transmission pricing** (away from NGC's current "ICRP" model). The uncertainty about the transmission charges that will apply under BETTA is one of the last remaining issues to be resolved with this major project. However, we believe that the main reason that this uncertainty has not yet been resolved is due to the reform of the existing methodology in England and Wales.

- recent proposals to review **Transco's distribution charging policy**, including reform of the exit capacity regime.

Regulatory Accounting and Statistics
We feel very strongly that the development of regulatory accounting guidelines should be a short, focussed process. Instead, it appears to have become an ongoing project for several staff which is imposing significant costs on Ofgem and the regulated companies. For example, to date, a set of guidelines for production of 2002/03 regulatory information has not yet been agreed. More generally, we have seen a significant increase in reporting requirements from Ofgem and we do not believe that the majority of information collated serves any real purpose. Some of these requirements arise from the increasingly complex set of regulatory incentive schemes (e.g. IIP), which must undermine the value of such schemes.

Metering Competition
We have been opposed to some of the recent developments in metering competition. However, now that the relevant changes have been (or soon will be) made, there should be no further significant Ofgem resource committed to this area.

Customer Transfer Processes
Ofgem has been involved in project work in this area over the last 3 years. Whilst we acknowledge that some further work is necessary, in our view, transfer processes are generally working well and existing industry change mechanisms are adequate to analyse and develop processes to cater for the few remaining areas of concern.

Significant improvements in the complaint statistics could be achieved if a number of currently poorly performing suppliers achieved the performance levels of the industry leaders, using existing systems and processes. Some changes will still then be necessary, but wholesale reform of the transfer process would not be justified.

Other Areas
In Ofgem's last Corporate Strategy document for the years 2003-2006, there are a number of other individual areas for which significant sums are budgeted, and where we see little value for the industry and its customers. These include:

- supply competition and deregulation – supply competition has been established and we would therefore expect to see Ofgem's work in this area "winding down";

- market infrastructure – we do not understand what this significant expenditure covers and, given that competition is now established, we would question whether such a large resource is required;

- customer contact – energywatch is established for this purpose;

- supplier failure and licensing – supplier of last resort arrangements have now been finalised;

- co-ordination & strategy – a more narrowly focussed programme of work would imply less need for co-ordination between different projects:

- quality of service, technical and social & environmental – these areas of work involve significant costs which are set to rise towards 2005/6 with no apparent justification.

I hope these comments are helpful.

Yours sincerely

Ian Marchant
Chief Executive