



13 October 2003

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

Dear Mr Chapman,

Response to the Ofgem consultation on future strategy

Entergy-Koch Trading Ltd (EKTL) welcomes the opportunity to comment on Ofgem's future strategy.

In the UK we are principally involved in the wholesale energy markets, and as such our views in this response are focussed on this part of the energy market. Our response is structured along particular themes: information and transparency, security of supply, governance and the low carbon economy.

Information and Transparency

As a trading company we are acutely aware of the role that information and transparency performs in influencing market participants and the development of a liquid traded market. Much progress has been made in increasing the amount of information available to market participants, but there is still a significant level of uncertainty, particularly with respect to the actions of transmission owners and upstream gas producers.

NGT are in a privileged position with respect to information as market participants are almost universally affected by its actions on the gas or electricity transmission network. In many cases the provision of information to the wider market is helpful in forming commercial decisions on supply and demand responses which in turn leads to effective price discovery in the markets. Trading or taking actions around uncertain information flows increases overall market risks which may manifest itself in widening spreads or a lack of innovation in risk products. Good information flows are therefore a key part of providing benefits to consumers through efficient pricing and from efficient long-term investment based on reliable prices.

We consider that Ofgem should be vigilant on how transmission owners contract in the market, and how those contracts are exposed. Our experience with National Grid contracting is that this is often opaque, particularly in respect to products such as warming contracts and PGBTs, and this is creating a degree of market uncertainty, as well as potentially adversely affecting forward prices. At this stage, Transco's actions are less problematic as it contracts close to the gas day. However, should it

increase its long term contracting, there will be a need to mirror this with greater transparency.

NGT often highlights commercial confidentiality when there are requests or pressure on information transparency. ECTL does not consider that this argument is valid in most circumstances. NGT is being encouraged through incentives to act in a commercial manner, but as it has a very strong market position there is a need to understand its actions and ascertain the potential impact on prompt and forward prices. If market participants are constantly surprised by NGT actions this will increase risk and discourage activity.

The design of incentives for National Grid and Transco can be an important in terms of how it decides to contract in the market. For example, the procurement of reserve by National Grid is based around a cost target, however there is no consideration of how the procurement itself may affect the market. If Ofgem continues to believe that incentive based regulation is the appropriate way forward, market participants must be reassured that the incentives are aligned with the best outcomes for the market and are not simply assessed against a single measure such as cost.

It is equally important to consider when the 'stick' is more appropriate than the 'carrot'. For some activities it will be more efficient to impose obligations on behaviour rather than incentives, as this will provide greater certainty on the outcomes. While we have a preference for market-based solutions, we consider that there is still an important role for well-designed obligations with good regulation and surveillance.

Ofgem should provide clarity on the NGT's role in obtaining system reserve, relative to other market players. With a finite amount of reserve available in the electricity market, NGT's long term actions can act to crowd out other market participants, and its socialising of the reserve costs effectively dampens market signals and rewards unreliable plant at a cost to reliable producers.

With respect to upstream gas information, we would welcome a stronger relationship between Ofgem and DTI to resolve this problem. We consider that this issue has been around for a significant amount of time, and as the UK supply scenarios begin to change, it is very important to better understand this key market dynamic. Without better offshore information market players have little ability to assess levels of reliability, which in turn provide efficient price discovery. For example, recent summer interruption events may have been avoidable if market players had been able to understand the risks and develop more flexible contracts, or had priced in the risks such that the opportunity cost of interruption was more visible.

We feel that the future development of trading liquidity in the gas markets is being hindered by this lack of information. At a time when there has been a reduction in market counter parties it is necessary to give greater consideration to the barriers to efficient trading. We would encourage Ofgem to continue to recognise the role of the market and to ensure that its decisions give due consideration to the future development of liquid markets.

Security of supply

Security of supply has become an important consideration in most commentary on energy market development in the UK and Europe. The phrase is often misused to promote particular points of view or to provide a rationale for often-unrelated reforms. We consider that for the most part, the market can provide the correct response to

meet supply and demand for energy. However, there is a need to ensure that the market arrangements and Government policy are conducive to this result.

The development of energy markets requires regulatory authorities to focus on creating the correct environment. Within a good environment market players will pursue efficient structures and trading. We consider that Ofgem should focus its activities on environment setting, which includes an increase in transparency of regulated companies, increased information flows, greater long term certainty in market arrangements (including explicit statements of issues such as the reliability policy), increased signalling of regulatory changes, consideration of consistency in decision making in order to lower sovereign risk, lower levels of bureaucracy and complexity in governance, vigorous assessment of the activities and charges of transmission companies, and the development of incentive arrangements that do not distort long term market signals.

For example, it is likely that successive price controls have reduced the level of 'gold plating' in transmission networks. Ofgem will now have to ensure that the price controls and associated incentive arrangements provide the correct focus on long term investment. There is a risk that price controls have an inbuilt degree of short-term thinking as they are traditionally framed around a particular timeframe. Also the regulatory objectives on consumers may focus too much on reducing charges when sometimes the opposite should occur as a reflection of the need to increase flexibility and security of supply. We would encourage close working arrangements within the different areas of Ofgem that look at market arrangements, price controls and environmental issues.

With an environment conducive to the development of a traded market we would expect to see the further development of liquidity. This is essential if markets are to take the next step towards commoditisation. Commoditised markets allow for greater risk diversification through the development and use of tools such as derivative products. With a range of risk products, costs can be reduced through the entire value chain. Lower risks and costs will encourage greater investment and development in physical infrastructure that will increase the flexibility of existing systems and will also encourage more innovative contracting arrangements.

Governance

The existing electricity governance arrangements create a significant level of complexity and increase the risk of developing barriers to entry. The level of fragmentation in codes and licence statements means that it is very difficult to consider many policy issues as a whole. There is a reliance on Ofgem to ensure that policy development is not held up by requisite changes to other documents.

We have no wish to see the electricity arrangements repeated in the gas market, as we feel that the existing reliance on licence statements outside of the usual network code arrangements is already a step too far. Fragmentation in governance arrangements will only act to slow the development of policy at a time when responses to changing market conditions and structural changes require more streamlined processes. Further, fragmented governance arrangements act to disenfranchise industry participants and raise the charge that policy development is becoming a private dialogue between Ofgem and the regulated monopolies.

Maintaining an independent regulatory authority where the decisions are made based on rational policy objectives helps the effectiveness of policy decision-making. In the past, we have expressed strong views against having decisions made by industry

groups (such as the BSC panel) or for appeals processes to be introduced for non-process issues. As a participant in many European markets we recognise the value of independent regulation where there is sufficient power provided to pursue agreed objectives. This model is best suited to liberalising markets as it gives an equal voice to all players and we would encourage Ofgem to defend its current position and to promote this role throughout other EU member states. Maintaining broad industry participation in the policy development process should be a key aim of the governance process. This will be aided by finding a balance between dogmatic and pragmatic policy solutions, where Ofgem is always willing to engage in the debate and retest previous decisions and views. An evolving policy environment requires flexible thinking by all participants.

Low carbon economy

The Government has made a reasonably clear position on its aspirations with respect to developing a low carbon economy. A key element of this will be the development of renewable energy resources to enhance generation capacity and in some cases to replace existing 'dirty' capacity.

Our concerns with respect to the development of renewable energy are primarily focussed on the need to maintain market efficiency. We recognise that many renewable technologies are unable to compete with other generation technologies in terms of price and reliability but the efficient pricing of pollution will help in some way to bridge this gap. However, the small scale of these projects and the reliance on natural forces (such as wind) mean that these technologies are difficult to fit within a dynamic traded market.

The solution is often to exempt particular generation from a variety of charges or risks (such as the cost of imbalance). This subsidy approach provides some recognition of the positive externalities from low carbon intensive generation and to the extent that the existing costs of pollution are not borne fully by other technologies, it is appropriate. However, there is a question of how these subsidies should be accounted for, as there is a need to measure the actual cost of mitigation. Our preference would be for an explicit subsidy paid by the Government rather than smearing the costs through industry charges. However if industry charges are considered the best way to fund the subsidy then we consider these could be reported so that it is obvious how much other firms have to pay to contribute financially to carbon reduction. This will also help Ofgem to explain why energy costs may rise as a result of the Government policy.

If Ofgem is put in a position to encourage the development of renewable energy, this should be done in a way that has the least impact on the efficient allocation of resources and the working of the traded market. Explicit transparent subsidies are less likely to distort resource allocations than hidden charges on system users and market participants.

Conclusion

We consider that the strategic priorities for Ofgem should be:

- Increasing the level of transparency and information flows from all market participants.
- Increasing scrutiny on how the actions of the regulated monopoly businesses affect the operation of the market, particular in respect to long-term investment signals.

- Creating an environment conducive to the development of traded markets.
- Increasing activities in European fora with the aim of encouraging faster effective liberalisation.
- Giving greater consideration to how governance arrangements can affect the efficient delivery of policy changes.
- Ensuring that objectives such as the promotion of renewable energy are pursued in a manner that makes the costs transparent and are not detrimental to the functioning of the wider market.

I can be contacted on 02073378448 if you require further explanation of the points raised in this response.

Yours sincerely,

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