

CONSULTATION ON OFGEM STRATEGY 2004 – 2007

Response by Powergen

1 We very much welcome this opportunity to comment on Ofgem's three year strategy which, as Sir John comments in his letter, will need to be developed against the background of the Government's Energy White Paper, and developments in energy and environmental policy in the European Union as a whole. The commitment to full consultation with interested parties throughout the strategy review process is also very welcome and an important contribution to understanding how the Authority intends to interpret its statutory duties.

2 The Government has set a number of energy policy objectives of equal weight: reducing carbon emissions; maintaining the reliability of our energy supplies; promoting competitive markets; and ensuring that every home is adequately and affordably heated. While the White Paper was clear about the objectives, it was less clear about how the competitive market framework could provide the right incentives to deliver the investment needed to meet them in a balanced and sustainable way. Similarly, it did not clarify how it would ensure that the pursuit of some objectives, such as reducing carbon emissions, would not put at risk other objectives such as affordable prices or security of supply. In particular it does not set out the process by which the inevitable trade offs will be determined

3 This creates an investment climate which is subject to significant political and regulatory uncertainty as well as market risk. If the industry is to deliver the investments needed to enable the UK's energy policy objectives to be met, durable and stable policy mechanisms will be needed which are designed robustly to ensure that specific targets can be met and which provide companies with a reasonable prospect of making adequate returns, and returns which are competitive with those available to them outside the UK.

4 Ofgem has an important role to play in helping the UK shape its markets to help industry achieve these objectives efficiently, preserving competitive market structures. We see this as entirely consistent with the Authority's principal objective of protecting the interests of consumers, wherever appropriate by promoting effective competition. This means that economic regulation of energy markets needs to focus increasingly on creating a sustainable environment for long-term investment and on supporting the Government in achieving the same goal. The following paragraphs identify the key issues in this context:

electricity generation market

Plant margins

5 We have made clear, both to the DTI and to Ofgem, our concerns about the ability of the wholesale electricity market to provide strong or early enough economic incentives to ensure that mothballed or new

generating capacity is made available in sufficient time to maintain an adequate level of security of supply. We believe that Ofgem should actively keep under review the effectiveness of the current market structure, and, in the light of experience, consider the case for changes. This approach is more likely to be compatible with the pursuit of competition than a more intrusive role for the system operator in preserving adequate plant margins.

The role of coal-fired plant

6 We have longer term concerns about security of supply arising from the combined impact of the EU emissions trading scheme, the Large Combustion Plants Directive and the Environment Agency's approach to Integrated Pollution Control on further investment in coal-fired generation, which we see as having a continuing valuable role in maintaining supply security, as the UK becomes increasingly dependent on imported gas. It is important that Ofgem takes these issues into account in the way it regulates the market, given its responsibility to carry out its functions in the manner best calculated to secure a diverse and viable long-term energy supply, and the interest of consumers in receiving a reliable energy supply. We would be concerned if Ofgem adopted a negative approach to coal plant, in light of the social and environmental guidance it receives from the Secretary of State, which does not address security issues.

Scotland

7 We support Ofgem's continuing efforts to create a more competitive wholesale market in Scotland and its continued advocacy of cost-reflective transmission charging, which will help ensure the economic location of generation and demand, deliver environmental benefits through lower transmission losses, and reduce the net costs to consumers of Government policy intervention to deliver renewable capacity.

Distribution Networks

8 Adequately funded networks are essential to meet the increasing expectations on Distribution Network Operators to provide the robust networks which are needed to maintain supply security, to enhance resilience to external shocks, to support the development of low carbon forms of distributed generation, and to underpin the operation of competitive markets, in line with the Government's energy policy objectives. This will require higher levels of investment, given the ageing state of much of the UK's distribution assets and recent funding levels.

9 RPI-x frameworks have delivered significant improvements in cost efficiency and consequent benefits for both customers and consumers. However, this framework now needs to focus on delivering the investment needed to maintain sustainable networks through the use of 'smart' asset management processes both to identify and fund long term needs. The framework can then provide for accurate identification and allocation of the risks associated with network operation and investment, and

appropriate incentives and rewards for managing these risks, including correct funding mechanisms. The aim should be to incentivise efficient investment in networks whilst ensuring that clearly identified objectives for network operators are met.

10 We appreciate the need to develop robust incentives to facilitate meeting the Government's target on renewables and to enable fair competition in generation. The transition from lowest cost operation of a passive network to active operation to meet environmental as well as economic and quality of supply objectives will take several years, if not decades. In the extreme, active management of high volumes of unconstrained distributed generation may require investment substantially above current levels.

11 Distribution networks are also subject to regulation by the DTI Engineering Inspectorate and the Health and Safety Executive in respect of technical, performance and safety standards and this has implications for DNO investment which is in turn regulated by Ofgem. We would welcome more clarity in respect of the different roles and a more co-ordinated approach by Government agencies to minimise investment and regulatory risks for DNOs.

Supply

12 Electricity and gas supply markets will need to change radically if the UK is to secure the levels of carbon savings it hopes to achieve from domestic energy efficiency measures. This will require the active engagement of customers and suppliers and the development of a market which is focussed on wider criteria than price. We welcome Ofgem's agreement to a trial suspension of the 28-day rule to facilitate the development of an energy services market.

13 Retail costs and prices are likely to rise over time to reflect the impact of the Government's market interventions to achieve carbon reduction targets, and to provide adequate incentives for investment in generation and in distribution networks. It is important that suppliers are able to offset these effects through marketing energy efficiency services.

14 We support Ofgem's continuing efforts to remove barriers to competition in the supply market and to ensure that the benefits of the market are open to all consumers. Powergen, for its part, will continue to identify innovative ways of meeting the needs of low income or other vulnerable customers, working with the grain of the competitive market.

European Union Issues

15 We fully agree with Sir John's recent comments that the UK is no longer an island in energy terms, as it becomes increasingly reliant on imported supplies. In the UK and EU context, efficiently operating competitive markets throughout the EU can deliver lower prices, and support security of supply objectives by encouraging innovation and diversity of market participation. However, the market must be capable of

supporting substantial investments which require long pay-back periods. Ofgem can provide advice to the UK Government and the Commission on how best to achieve this balance and in particular to support the large infrastructure developments needed to maintain secure gas supplies for the UK and North Eastern Europe as a whole.

Withdrawing From Regulation

16 Ofgem should continue to look for opportunities to withdraw from regulation of competitive markets. For example, we believe there is scope for Ofgem to reduce its role in the management of trading arrangements (which, excluding BETTA, currently accounts for about one quarter of its annual budget) and the approval of Code modifications in particular, and to encourage greater industry self-governance. It should also identify opportunities to eliminate superfluous licence obligations, such as the restriction on self-contracting.

Powergen
October 2003