

Ofgem's 2004-07 Corporate Strategy Consultation

Response by Powergen

Summary

The consultation draft demonstrates Ofgem's willingness to listen to its stakeholders and new arguments based on good evidence. We support strongly this open approach.

Ofgem has a key role in shaping the electricity and gas markets, and we are particularly encouraged to see that delivery of investment to meet the challenges facing the UK energy sector is a strong theme in the document.

We believe that there is more scope for companies and Ofgem to work together and to develop a constructive dialogue about how these challenges can be met.

We highlight a number of key areas where we would welcome further dialogue with Ofgem, including:

- the future shape of European energy markets and the appropriate level and role of regulation at the EU level
- the ability of the wholesale electricity market to ensure sufficient investment in generating capacity to maintain security of supply, given our view that the existing market framework does not provide sufficient incentives for investment
- the effect of environmental regulation on the wholesale market and investment in coal-fired generation
- the need to promote efficient investment in distribution networks to maintain their robustness rather than to facilitate distributed generation alone
- how the development of an energy services market can best be encouraged for domestic customers
- the removal of barriers to customer switching by improving the customer transfer process
- the role of suppliers in meeting the Government's fuel poverty targets
- the implementation of BETTA in a way which reflects the interests of all stakeholders including competitors primarily located in England and Wales
- the scope for regulatory withdrawal in competitive markets, for example from code modification processes and through removal of obsolete licence conditions

We look forward to further discussions on these issues and to addressing them in more detail in Ofgem's work programme.

Introduction

1. We very much welcome Ofgem's invitation to comment on its strategic plan for the next three years. The document shows that Ofgem is willing to listen to its stakeholders and new arguments based on good evidence. We support strongly this open approach.

2. We look forward to helping Ofgem fulfil Sir John’s desire for “continuity, coherence and predictability”, provided this also embraces a willingness to adapt to changing circumstances. This will help establish a climate conducive to efficient investment in the energy sector which will be needed if the UK Government’s energy policy objectives are to be met. Ofgem has a key role in shaping the electricity and gas markets, and we are particularly encouraged to see that delivery of investment to meet the challenges facing the UK energy sector is a strong theme in the document.
3. We believe that there is more scope for companies and Ofgem to work together and to develop a constructive dialogue about how these challenges can be met. We discuss below the seven themes raised by Ofgem, which we agree cover the key challenges facing the industry. Within each theme, we highlight the issues we believe are important to a sustainable UK energy sector, with a view to promoting further dialogue and action.

Creating and Sustaining Competition

Wholesale markets

4. Competitive markets have a key role to play in encouraging efficient investment, provided they exist within a framework of rules which provides a sufficiently high level of assurance that security of supply will be maintained. We comment on this further below.
5. We support Ofgem’s continued efforts to create a more competitive wholesale market in Scotland (paragraph 2.3¹). It is important that the DTI and Ofgem take this process forward in consultation with all market participants, with the aim of ensuring efficient and effective market processes. We attach particular importance to ensuring cost-reflective allocation of transmission costs, including those arising from losses. We believe that this is important in ensuring the most efficient disposition of investment across the system as a whole from a cost, security of supply and environmental perspective.
6. We are working actively towards effective and efficient industry governance of competitive energy markets and are pleased to see Ofgem’s continuing commitment in the consultation document to withdrawal from unnecessary regulation. We believe there is scope for more industry self-regulation of competitive markets and look forward to further dialogue with Ofgem on industry code governance (e.g. approvals of minor code modifications). We would also welcome withdrawal of obsolete licence conditions.
7. Transparency of the system operator’s actions is a fundamental part of ensuring a competitive wholesale market. We are concerned that increasingly fragmented and complex market rules, opaque incentives, and NGT’s operation across gas and electricity increase uncertainties for market

¹ This and all similar references refer to paragraph numbers in the consultation document.

participants unnecessarily. We would welcome further dialogue with Ofgem on measures to clarify the role of the system operator and improve transparency.

Retail markets

8. We believe that retail markets are continuing to evolve in a way that will provide wider choice to customers, not simply in terms of supplier but also the range of service offerings available. Retail markets also need to evolve rapidly if the lower carbon dioxide emissions which form part of the UK's climate change programme are to be delivered in the domestic sector. If they are not it seems likely that the Government will impose increasing direct constraints on upstream emissions which will result in further increases in wholesale prices and subsequently in retail prices.
9. Electricity and gas supply markets will therefore need to change radically. This will require the active engagement of customers and suppliers. We welcome Ofgem's agreement to a trial suspension of the 28-day rule to facilitate the development of an energy services market. More generally we believe that innovation will be encouraged by shifting to lighter touch regulation supported by more self-regulation through industry agreed codes of practice.
10. We agree that Ofgem should continue to work with the industry to remove barriers to competition in the supply market and to ensure that the benefits of the market are open to all consumers. It is particularly important that customers can switch suppliers easily. We are actively supporting improvements in the customer transfer process and the review by the ERA of the compatibility of switching systems employed by individual suppliers. We also support Ofgem's intention to introduce effective and targeted regulation of energy supply marketing in discussion with the industry and look forward to further dialogue with Ofgem on this issue.

Regulating Network Monopolies

11. The consultation document sets out clearly the principles of good incentive regulation, particularly in paragraph 3.4. Throughout its participation in the DR4 process, our distribution business has been assessing the challenges to be faced and making the case for sustainable investment. In January 2004, we acquired MEB and that significant further investment is required in its network also to maintain its resilience and long-term integrity, a case already made by MEB in its own responses to Ofgem consultations. Consequently we are pleased to see the priorities laid out in paragraph 3.5.
12. Nevertheless, we would like to see a stronger acknowledgement of the general need for investment in ageing network infrastructure. This is important to support the long term sustainability of the network, including resilience to storms, and the network's ability to maintain security of supply which is central to the interests of consumers. The emphasis in the consultation document (e.g. paragraph 3.10) appears to be on facilitating environmental policy objectives by reinforcing networks for renewable and CHP generation. Powergen is an active developer of renewable projects and

micro-chp and so we recognise fully the need to ensure that barriers to connection are addressed. However, there is a danger that investment in "conventional" networks, i.e. to replace ageing assets, will take second place. Since this investment is critical to security of supply, including the successful integration of new forms of generation, it deserves fuller recognition.

13. The consultation document also discusses Ofgem's move towards regulation of outputs – giving distribution businesses more freedom to meet their objectives. On this topic, we look forward to helping Ofgem establish a well defined framework, where objective targets are set for quality of supply and similar output criteria, including the treatment of severe weather events and the objectives of IIP versus Guaranteed Standards. However, any target setting must take account of the inherent variability in network performance. Ofgem's commitment to better regulation will be important in ensuring transparency and predictability in this area of regulation. We look forward to a continuing dialogue with Ofgem on these issues in the context of DR4 during 2004 and very much welcome the arrangements for high level meetings with the Authority as the DR4 review progresses.
14. Ofgem has signalled its intention to review the structure of distribution charges over the coming years, and we look forward to working together to achieve this. The regulatory framework now and in the future needs to focus on delivering the investment needed to maintain sustainable networks with appropriate incentives for managing the level of investment and risks efficiently.

Helping Protect Security of Britain's Energy Supplies

15. We fully support the importance that Ofgem places on this subject. Chapter 4 reflects the wide level of interest in security of supply, and we welcome Ofgem's commitment to work with stakeholders on the issues involved (para. 4.13). Generation and network infrastructure are equally important factors in the debate.
16. Whilst wholesale electricity market conditions have improved somewhat in recent months, signals do not yet exist for long term investment in new generation capacity. For this to happen, companies need to have a reasonable prospect of making adequate returns, which are competitive with those available to them outside the UK.
17. No useful link can be drawn between decisions to return mothballed plant to service (referred to in para 2.8) and the higher order of expenditure required to construct new capacity in the medium to long term. Our view is reinforced by the low level of forward liquidity beyond the rolling period of 12-18 months and the uncertain impact of environmental legislation on investment returns. There is a need for continued debate, in the context of projected capacity margins and the requirement for new capacity, and we are pleased to see that Ofgem will continue to participate in this (para. 4.5).

18. While we note Ofgem's observation that it has no new evidence to support capacity payments (para 4.10), we hope that ongoing work by Ofgem will remain open to measures which can provide investment incentives for investment in plant in sufficient time to provide adequate security margins and that it does not simply await evidence to be put by others. A constructive approach to developing the effectiveness of the current market structure is more likely to be compatible with competition than a more intrusive role for the System Operator in preserving plant margins.
19. 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.
20. We look forward to more discussion with Ofgem on these issues.

A Leading Voice In Europe

21. We agree that European energy markets and EU energy and environmental legislation and regulation will have a growing influence on UK energy markets, because European companies have invested substantially in acquiring UK businesses, the UK will increasingly be integrated into a single European energy market, and because the UK will become increasingly reliant on European gas networks for access to gas, particularly from Russia. We support the additional resources Ofgem intends to devote to this area.
22. It will be important to identify where regulation at the EU level adds value. It has an important role in ensuring that market rules support the development of an efficient and competitive EU internal market, but it needs to avoid intervention where there is no clear need or where regulation is most effective at the national level. This will simply increase regulatory uncertainty. For example, we are concerned at the Commission's unnecessarily interventionist approach to incentivising transmission investment and interconnections between systems in its proposed Directive on Electricity Security of Supply and Infrastructure Investment. With this in mind, we welcome Ofgem's commitment in paragraph 5.5 to ensuring full consultation by the Commission's advisory group of energy regulators.
23. Competitive European markets can help deliver low prices and encourage innovation and diversity of market participation. However, given the future dependence of the UK on gas imports, Ofgem will need to provide advice to the Government and the Commission on how to ensure that the markets support the large infrastructure developments required to maintain secure gas supplies.

24. Gas storage is also likely to be a key issue both in Europe and increasingly the UK, as gas imports rise. Effective third party access to storage facilities will be important at the EU and UK level.
25. We are developing our own approach to these issues within the E.ON group and look forward to a constructive dialogue with Ofgem to help understand and shape European energy markets.

Helping protect the Environment

26. Paragraph 6.11 recognises that better demand side response can improve environmental performance and, to a limited extent help with short term supply security. We would be interested in exploring with Ofgem the options for increasing demand side participation in wholesale electricity markets. However, on the domestic front, fiscal incentives from Government will be needed, before more expensive options, such as half hourly metering, apparently favoured by the European Commission², can begin to be considered.
27. We have commented above on the need to facilitate the development of an energy services market. We would welcome more discussion with Ofgem on how domestic consumers can be encouraged to take up energy efficiency measures and Ofgem's continuing involvement in our Energy Monitor research, which last year explored in detail customer attitudes to energy and its more efficient consumption.

Social Objectives

28. We are committed to continuing to identify innovative ways of meeting the needs of vulnerable customers and wish to play a full part in enabling the Government to meet its target of removing vulnerable customers from fuel poverty by 2010. We have a wide range of initiatives which address the needs of vulnerable customers such as our Staywarm tariff, our partnership with Age Concern, and our contract with DEFRA to manage the Warm Front scheme. We also support measures to improve customers' access to competitive markets provided this is done in ways which do not act as disincentives on suppliers to seek their business.
29. Energy efficiency measures have an important role to play in eliminating fuel poverty. In the context of the Energy Bill, we believe there is a good case for changes in legislation to enable prepayment meters to be used for recovering the cost of energy efficiency measures and some other debt, subject to regulation by Ofgem, and would welcome further dialogue with Ofgem on this issue.

Ofgem's Efficiency and Effectiveness

30. We look forward to Ofgem's draft corporate plan (paragraph 8.7), which should be structured to enable stakeholders to assess Ofgem's efficiency

² COM (2003) 739, Article 13

and effectiveness. We will comment on costs when this document is published, although we would expect to see costs for management of incremental changes to market rules decrease as Ofgem fulfils its commitment to withdraw from unnecessary regulation.

31. With regard to Ofgem's approach to the consultation process, we welcome acknowledgement of the indirect costs placed on business, and that "less can be more". By reducing the volume or length of consultations, interested parties should have more time to respond to critical documents, for example those issued during the current distribution price control review.
32. In particular, we are pleased to see the recognition in paragraph 8.6 that RIAs need not be improved by increasing their length, but by ensuring early involvement of those who are best placed to judge quantifiable data. Although no "magic formula" exists for a good RIA, it should act as a credible yardstick for assessing regulatory options, rather than justifying retrospectively any particular decision.
33. Finally, we recognise the careful balance that has to be established between resources, costs and the areas of competence that Ofgem is involved with. We agree with paragraph 8.7's comments on the need to prioritise. In some cases this may mean abandoning projects which, although desirable, are less important in their impact. For example, we would caution against further alignment of transmission price controls without considering the strain on Ofgem's resources and impact on the quality of analysis.

Powergen
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