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Dear Chris

OFGEM PROPOSED CORPORATE PLAN 2004–07

Thank you for inviting us to contribute to the formulation of Ofgem's corporate plan for the three years to 2007. When you consulted on Ofgem's corporate strategy document, setting out the Authority's strategic ambitions for the same period, we commented that we found it to be clear, well presented, and helpful. We consider that the same is true of the corporate plan, and that Ofgem is to be complimented on the general clarity and presentation of the document.

The projects and resources which are set out in detail in the plan are broadly consistent with the key themes identified in the strategy document. To that extent, therefore, you may take it that the detailed points that we made in our February response to the Ofgem strategy document are equally applicable to this corporate plan. So, this letter focuses on a small number of issues which continue to give us concern. These are mainly issues where we feel that our previous comments are not sufficiently reflected in the draft plan.

Principles of better regulation

While we welcome Ofgem's commitment to the principles of better regulation, it is not clear that this will always be reflected in Ofgem's regulatory practice. In fact, the promise given in the plan to actively examine how Ofgem can further withdraw from regulating the energy industry is inconsistent with the industry's current perceptions of increased activism by Ofgem in both wholesale and retail markets. The appropriate regulatory role in those markets should increasingly be one of monitoring and ensuring ex-post compliance with licence conditions and competition legislation.

We continue to believe that the opportunity should be taken, in Ofgem's plan, to restate the role of truly independent regulation for the energy sector now that fully competitive markets have been created in the United Kingdom. It is not appropriate, for example, that Ofgem in its market governance role should be

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able to impose fundamental rule modifications that the market participants do not support and may have actively opposed. There is plenty of unexplored scope for greater industry self-regulation of competitive markets. So we would expect to see a more vigorous effort by Ofgem to reduce work and expenditure in these areas – particularly after the implementation of BETTA next year.

Regulating network monopolies

The draft plan places significant emphasis on the need to maintain an incentive framework for Ofgem's ongoing review of distributors' price controls (DPCR4). While this approach remains correct in principle, and is supported by us, it is not clear from the plan that Ofgem is yet sufficiently alert to the sharper pressures arising now from the network asset replacement cycle and, as a consequence, the heightened importance of the financial health of network operators. We are concerned that previous price control reviews may not have taken adequate account of the longer-term requirements of networks and of the need to secure maximum continuity of regulatory principles from one period to the next.

The challenge for Ofgem, therefore, is to ensure that this DPCR4 process will successfully overcome the shortcomings of previous reviews. Our own three distribution companies, in particular, need an outcome which ensures that they are able to meet effectively the imminent demands of both asset replacement and workforce renewal, while continuing to be able to finance their activities and comfortably maintain their investment grade status. Given the nature of the challenges which they and other distributors face, it is imperative to execute a price control review which incentivises behaviours that are compatible with good performance in both the short and the long term. We would like to see a stronger acceptance of this in the language of Ofgem's plan.

Ofgem as a leading voice in Europe

We support Ofgem's aim to influence and shape the direction of the regulatory debate about energy policy in Europe. However, we remain concerned about the scale of the expertise and resources which Ofgem proposes to devote to this. It is not clear that such work falls squarely within the scope of Ofgem's statutory duties. We wonder, for example, whether it is an appropriate activity of Ofgem to ensure that reports are prepared by the Council of European Energy Regulators (CEER) on the effectiveness of network unbundling. The target of ensuring that 90% of CEER documents are delivered on time and reflect Ofgem's views is equally odd. It does not seem sensible to select an indicator for Ofgem which measures not Ofgem's performance but that of another body.

It is common ground that European energy markets and European energy and environmental legislation will have an increasing influence on the UK energy markets. We agree with Ofgem that European developments should in principle favour the swiftest possible evolution of market mechanisms, and that Ofgem should be involved in lobbying for these. However, this particular work area in Ofgem's plan should not be allowed to expand at the expense of expertise and resources that could be better deployed on UK regulatory activity. Indeed, the most effective stimulant for good European developments should come from Ofgem setting the best possible standards of regulatory practice in the UK.

Organisational and financial issues

A particularly welcome theme of the corporate strategy was its greater emphasis on Ofgem's cost control and organisational effectiveness. We note that a key objective of the recent restructuring of Ofgem was to enhance the organisation's ability to accommodate new issues and prioritise its workstreams. However, to judge from the contents of the plan, and particularly the nearly 60 deliverables listed for the first year of the period alone, there is clearly still a long way to go before Ofgem can claim to be a regulatory body whose whole attention is fully focused on a smaller number of major work items. Ofgem remains a very busy regulator, with little apparent ability to prioritise its activities and withdraw from less important work. This is reflected in the degree of slippage evident in a significant number of key deliverables for the year just ended.

Costs also remain high, despite the recent commitment to a 6% budget cut for 2004–05 (which, on inspection, turns out to be illusory, since the net budget figure of £34 million has not changed from the figure presented in each of the previous two corporate plans). And while the idea of publishing performance indicators is a good one, none of those selected by Ofgem seems particularly rigorous and some appear inadequate. We have already mentioned the European indicator that appears actually to measure another body's performance. But there is also a target to investigate competition law compliance "in accordance with statutory timescales" and another one to "follow published procedures for all modifications". These do not appear to reflect an attempt to measure performance meaningfully.

Our final concern under the organisational heading is the failure of both the plan and the accompanying strategy to clarify and introduce some transparency into the relationship between Ofgem and the Authority. The latter is effectively the board of Ofgem, with its own rules of procedure, and power to reserve matters to itself for decision. However, its decision-making process is largely opaque. The Authority meets in private, no agendas or minutes are published, and the non-executive members' contact with the industry is not encouraged. Improving this situation would assist towards more competent and accountable regulation.

We are committed to working constructively with Ofgem, and hope that you will find these comments helpful.

Yours sincerely

A handwritten signature in black ink, appearing to read 'D. Linford', written in a cursive style.

Denis Linford
Head of Regulation