

1st October 2004

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Dear Andy

OFGEM'S THREE YEAR STRATEGY 2005-8

British Energy welcomes the opportunity to contribute to the development of Ofgem's next three year strategy and plan as set out in the consultation dated 5th August 2004.

The primary aim of Ofgem's existing and future strategy should be one that seeks to achieve its principal objective of 'protecting the interests of consumers'. With this in mind, Great Britain requires an energy policy and regulatory framework that balances security, diversity and care of the environment with competitive markets and price stability. The continuing challenge for Ofgem, and indeed the Government, is to develop an energy policy framework that satisfies the public interest test by striking the right balance between these priorities whilst operating in accordance with best regulatory practice as espoused by the Better Regulation Task Force (BRTF). The achievement of such an aim will lead to greater regulatory certainty and stability which in turn will create the right environment for long-term investment.

With the above aim in mind, we would offer the following views in respect of the specific questions set down within the consultation letter.

Security of Supply

The promotion of competition by Ofgem in the electricity and gas markets combined with the operation of price controls has brought historic benefits to consumers in the form of greater choice and lower prices. Although lower prices can be in the interests of consumers this should not become an aim in itself. The objective should be fully competitive prices in a market which delivers security of supply.

The operation of a transparent and properly functioning market that provides appropriate signals to new entrants and existing players on investment time-scales is crucial to ensuring security of supply and hence protecting the interests of consumers. However, since the introduction of NETA, concerns have been expressed about the ability of the market alone to deliver security of supply. In particular, whether the current arrangements provide appropriate incentives for generators to maintain spare capacity on the system and thus achieve the plant margin deemed necessary by NGT. This suggests that there needs to be a review of how and whether generators are sufficiently rewarded and whether additional



incentives and/or solutions are required to maintain an appropriate level of generation capacity.

Vertical Integration

British Energy has on a many occasions expressed concerns to Ofgem regarding the developments in market structure and in particular the significant increase in vertical integration and market power within the sector. Evidence suggests that this trend is having a distorting effect on competition in both the generation and supply markets. Over a three year period prior to 2004 all independent generators experienced serious financial difficulties as a result of the unsustainable low wholesale prices that occurred during this time. However, throughout this period the large VI Groups continued to report healthy results primarily on the back of uncompetitively high margins in domestic supply. Indeed, domestic tariffs rose during this period without ever noticeably reflecting the significant fall in wholesale prices. This is contrary to the current position where wholesale prices have started to recover with price rises filtering through to domestic customers very quickly as large increases in domestic tariffs are announced by all the major vertically integrated domestic suppliers.

The degree of VI raises other issues including the extent to which internal contracting by VI players is inhibiting the ability of the market to function properly. This is evidenced by continued liquidity problems and the absence of effective paper derivative markets and pure trader activity. These are essential for a fully competitive and properly functioning market and their relative absence serves to reinforce the position of VI players. Furthermore, acquisitions by the VI groups will only serve to exacerbate the liquidity problem and make it more difficult for new entrant generators to secure the contracts they need to underpin their financing arrangements.

Consequently, we again urge Ofgem to conduct an open and comprehensive review of the issues surrounding VI, including an examination of the effects of increasing VI on competition in generation and supply markets and whether this is, or is not, in the public interest.

British Electricity Trading and Transmission Arrangements (BETTA)

It is expected that the BETTA project will be delivered by April 2005 i.e. the beginning of Ofgem's three year plan period. However, given that BETTA introduces some significantly new arrangements (e.g. SO-TO code) it would be prudent for Ofgem to plan for a first annual review of the GB arrangements to ensure that these are operating as expected and in the interests of all users and customers.

European Regulation and Market Liberalisation:

Ofgem clearly has an important role in shaping the development of European policy on energy markets in order to protect the interests of market participants, and ultimately all consumers, in Great Britain. It is imperative, therefore, that Ofgem allocates sufficient resource to this work area.



In particular, we are concerned that Ofgem needs to consider more carefully the compatibility and consistency of the GB trading and transmission arrangements with those in the developing EU energy markets. In the context of a single EU market, it would be neither appropriate nor efficient for there to be significantly different, more complex or more burdensome arrangements in the UK. Regulatory policy in the UK must be consistent with that adopted by the European Commission. For example, rules for transmission charging and third party access should be aligned.

Environmental Policy

We recognise that it is Government's responsibility to develop environmental policy and targets but since power stations account for over a quarter of UK CO₂ emissions Ofgem also has a key role to play. In particular, Ofgem should assist the Government in developing environmental policy including by reviewing the existing policy instruments to ensure they are consistent or complimentary, efficient and in the long term interests of consumers. From a broader perspective, and in order to avoid unnecessary regulatory risk and uncertainty, it is essential that Ofgem's own work programme and policy initiatives remain consistent with, and where possible reinforce, the Government's wider policy initiatives and goals and it should strive to ensure that it reacts appropriately to these.

Notwithstanding the above, we are concerned that the electricity market arrangements are being modified in order to provide subsidies to certain market participants, primarily the renewable players, with the effect that the remaining market players pick up additional unjustified costs without receiving any benefit. We consider that such subsidies, if they are appropriate, should be dealt with outside the market arrangements so as to avoid any potential to distort competition. For example, the proposals for the investment in the transmission network to accommodate new renewable capacity is driven by government policy rather than market signals. We consider it essential that these costs are ring-fenced, firstly to ensure transparency and secondly to allow for the recovery of such costs from either the new connectees or the demand side. In no event should existing generators bear any of the costs or the risks.

Governance

We note that Ofgem has made some improvements to its governance arrangements over the past year, most noticeably with the adoption of regulatory impact assessments for significant regulatory decisions. However, we consider that there is scope for further improvements within this area which could improve investor confidence and increase regulatory certainty. Firstly, we consider there is a need for more information to be published in respect of the proceedings of the Authority. Apart from information regarding the composition of the Authority and the general Rules of Procedure, no other meaningful information is available. This is not conducive to open and transparent regulation. We would therefore urge the Authority to publish more information regarding its proceedings including perhaps dates of meetings, meeting agendas, attendance and a (non-confidential) summary of the minutes of meetings.



Secondly, when significant regulatory proposals are taken forward, it is essential that Ofgem recognise the need for sufficient lead times that allow market participants to factor in the change. For example, suppliers require sufficient notice of significant regulatory changes in order that it can factor in such changes in time for the contracting rounds and in the preparation of customers offers. Decisions on proposals that have a material impact (and in particular the visibility of final values) need to be confirmed sufficiently ahead of implementation to achieve this. This is particularly relevant in respect of decisions taken on transmission charging arrangements whereby significant reforms are being made on a regular basis. Only by creating a more stable regulatory environment will suppliers feel able to innovate and take a longer-term view of the market to the benefit of customers.

Review of Licence Obligations

The structure and competitive nature of the electricity market has developed significantly over time. However, the way in which each market sector is directly regulated via licences has essentially not changed over this period. While significant changes to electricity licences occurred during the introduction of NETA, Standard Licences and to a certain degree BETTA, these changes focussed on those that were deemed to be essential to implement these new arrangements. At no point was a review of the continuing need of existing licence obligations conducted throughout this period.

We consider there to be need for a comprehensive review of the electricity licensing regime and in particular a review of each licence obligation contained in all of the electricity licensees with a view to ensuring that there is continuing need for each explicit obligation. Ofgem should be adopting a policy of withdrawing from direct regulation of proper functioning competitive markets and such a review would go some way to demonstrating the adoption of such a policy.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely

A handwritten signature in black ink that reads "David". Below the signature is a horizontal line.

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