



ScottishPower

Andy MacFaul
Head of Government Affairs
Ofgem
9 Millbank
London SW1P 3GE

1 October 2004

Dear Andy

Ofgem's three year strategy 2005-08

We are writing on behalf of ScottishPower in response to Sir John Mogg's invitation to comment on Ofgem's strategy for the years 2005-2008. We welcome this opportunity to give our views on the appropriate priorities for Ofgem over this period in the light of the challenges that it faces. We recognise the positive steps taken by Sir John Mogg and Alistair Buchanan in reviewing Ofgem's strategy and organisation and in placing Ofgem under an RPI-X cost control regime from April 2005 to be determined and monitored by GEMA's Audit Committee.

We believe that many of the themes set out in Ofgem's three year strategy 2004-07 document remain valid. We continue to support the emphasis on incentives for efficient investment and cost-reflective charging. It is critically important that a robust regime for delivering efficient investment to support the Government's targets for renewable generation is put in place.

A number of major initiatives are due to be implemented from 2005 including BETTA go-live, the potential sale of a number of gas distribution network businesses and the distribution price control, which in itself includes new incentive structures for distributed generation, quality of supply and losses. A transmission price review is also due to commence in 2005.

As such, we believe it is now time for Ofgem to delay introduction of any further significant new initiatives in order to allow enough time for these changes to be effectively implemented within the businesses and their outputs fully considered and analysed.

ScottishPower believes that Ofgem's key priorities over the next three years should be:

- ***A fair and equitable commercial and contractual framework for GB trading and transmission arrangements;***

The current proposals for the commercial and contractual framework for GB trading and transmission arrangements to be implemented from 1 April 2005 incorporate a transmission charging methodology which will result in market participants facing volatile changes in their costs. Ofgem has an important role in setting up these arrangements to ensure they are proportionate and non-discriminatory and then allowing the industry to develop the market.

- ***A framework that encourages investment in a mix of generation to ensure security of supply and achieve environmental targets;***

While there are strong incentives to invest in particular forms of renewable generation the situation regarding gas and coal-fired generation is very uncertain with volatile fuel prices and uncertainties in the legislative treatment of plant. Ofgem has a key role in reducing legislative uncertainty while allowing the market to work. Retail prices need to rise to reflect wholesale cost pressures, environmental costs, and energy efficiency costs. Regulatory policy must allow the market to bear the costs and energy companies to earn sufficient returns to ensure investment in reliable, cleaner, and more efficient power and gas supplies for the future.

- ***A framework for transmission price control that addresses the ageing network asset;***

Improved asset management techniques have been effective in maximising the benefit that can be extracted from existing assets. Where these techniques now highlight the need for increased investment the regulatory framework must recognise this and provide funding accordingly.

- ***Funding arrangements for investment necessary to accommodate the impact of renewable generation.***

For some time the industry has recognised the need to invest in networks to facilitate renewable energy. As the renewable energy market develops and network investment solutions are proposed it is essential that funding arrangements can be quickly agreed to avoid unnecessary delays.

1. Key challenges for the industry in the short to medium term

The key challenge remains ensuring consistency between the Government's broader energy and environmental objectives and the price control regime, which promotes cost efficiency and energy price reduction, while maintaining reliable supplies of gas and electricity.

Fuel price and wholesale price volatility increase the challenges facing the industry. Customers cannot be immune to the volatilities of the market and a market framework that encourages fuel diversity is key.

Measures based on emissions reductions are vital and fuel security is also a key issue which in certain circumstances may have CO2 implications. Renewable energy and energy efficiency are fundamental areas for expansion and energy efficiency is a critical part of tackling fuel poverty, particularly at times of increasing wholesale and retail prices.

A robust regime to deliver electricity infrastructure investment to support renewable generation targets is vitally important. This must incorporate an incentives framework which will encourage efficient investment, recognise relevant system security considerations and allow price controlled companies to earn an adequate return.

The period following BETTA go-live will involve significant challenges for companies, particularly in Scotland, as they learn to work with the new arrangements for transmission charging and for system operation and planning. In distribution, significant new incentive arrangements covering embedded generation, quality of supply and losses are due to be implemented in 2005. It is important that these changes are given time to settle down before further changes in these areas are considered.

It is essential that network users and customers realise benefits from the sale of gas distribution network businesses. The sale should only proceed on the basis of significant and verifiable benefits for customers with a framework to ensure that the claimed benefits are indeed realised.

The implementation of new EU legislation for electricity and gas, including the new regulatory framework established by this legislation at the European level, represents a further challenge for Ofgem and the industry. Fair and equitable implementation across Member States is key to UK companies and their ability to compete in the emerging European market.

2. Actions the Authority should take to respond to these challenges

While these challenges are being recognised and addressed by Ofgem under its existing strategy there is a need to concentrate on key priorities over the next few years. We believe Ofgem should not be diverted from these priorities by administrative work which could be carried out by industry bodies. Much of the work Ofgem currently carries out in relation to Renewables Obligation Certificates and Levy Exemption Certificates could be carried out by industry bodies such as the Non-Fossil Fuel Purchasing Agency allowing Ofgem to concentrate on its core tasks.

It is important that Ofgem in all of its work, including Regulatory Impact Assessments, fully adheres to the principles of better regulation, namely proportionality, accountability, consistency, transparency and targeting, and recognises the fundamental requirements for measures to be proportionate and applied in a non-discriminatory manner.

Regulation has been successful thus far in promoting competitive energy prices, securing efficiency gains and assisting in early market developments in renewables and energy efficiency. We are supportive of open and transparent markets for energy and also for emissions trading. Regulation will, however, require to be developed and refined in order to continue to deliver the diverse demands of energy policy addressing such needs as fuel poverty, renewable technology development, and fuel security.

If energy efficiency is to achieve its target levels then barriers to successful implementation in a competitive market must continue to be tackled. Energy services contracts and sound customer relationships are essential if these targets are to be met since energy efficiency products and services need a long term framework within which to evolve.

We agree that Ofgem should work to influence Member States' implementation of important European legislation and regulation to ensure there is effective access to continental gas and electricity markets. Ofgem must work closely with the DTI to ensure that UK customers, industries and power companies are not disadvantaged by differential application of European legislation. However, DTI represents the UK on the decision making Regulatory Committee and thus is the leading body representing the UK in the new regulatory machinery being created at European level. DTI will continue to have a more direct input to European regulatory decisions than Ofgem and this must be recognised when determining how best to allocate UK resources for maximum impact. We are particularly concerned in areas where Ofgem's and DTI's views differ. Ofgem should not be advocating proposals in Europe which are contrary to DTI's views.

We believe that the Authority and Ofgem could take further steps to improve the policy making and consultation process, in order to build on the steps set out in last year's strategy document. The recent flow of policy initiatives has stretched the capacity of interested parties and, possibly, Ofgem also, to deal with these in a timely way and ensure that relevant issues are adequately addressed. Changes to consider should include:

- Greater prioritisation of policy initiatives.
- A more transparent link between impact assessments and policy making, so that concerned parties can better understand how policy choices have been made.
- Allowing more time for responses (the Cabinet Office recommendation of 12 weeks should be taken into account here)

3. Priority areas of work

We support the themes for driving Ofgem's work over the next three years as set out in the three year strategy 2004-07 and see these continuing to set the framework to 2008. Ofgem should continue to promote effective competition through replacing traditional regulation with a greater reliance on competition powers. We believe that securing Britain's gas and electricity supplies should be a priority in the short term.

Ofgem has recognised that retail prices will need to rise to meet the costs of transformation to a lower carbon economy. Ofgem intervention should therefore be focused on situations where there is clear prima facie evidence of anti-competitive behaviour.

From an infrastructure perspective, the issue of investment for renewables should be a high priority. Some policy initiatives should be postponed or cancelled, if necessary, in order to ensure that a robust regime to deliver this is put in place.

Ofgem should continue to make it a key priority to improve its efficiency and effectiveness and we look forward to the results of the cost audit and the resultant RPI-X cost control regime under which Ofgem will operate from April 2005. The costs of Ofgem and energywatch are significantly greater than the costs of their predecessors, and much greater than the costs of other European energy regulators. We would expect Ofgem costs to reduce significantly after BETTA is introduced and the distribution price control review is completed.

Yours sincerely

CHARLES A. BERRY
Executive Director UK

RONNIE E. MERCER
Group Director Infrastructure