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Sir John Mogg
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Our Reference:
Your Reference:

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Dear Sir John

Ofgem's Three Year Strategy 2005-8

I refer to your letter of 5 August and am pleased to respond with views on the strategic choices for the Authority in the coming years.

We welcome the opportunity to engage in the Authority's review of strategy and believe that consultation on the Authority's strategic direction and detailed workplan has been a helpful recent development in regulation. We set out our comments under different headings below, reflecting the specific questions raised in Sir John's letter.

Firstly, however, I thought it would be helpful if we reiterate our continuing concern over Ofgem's costs. Although reported costs have fallen slightly in recent years to the £37.3m noted in Ofgem's 2003/04 annual report, they are still very much higher than the combined levels of costs of the former regulatory offices of Offer and Ofgas in the mid 1990s. This represented a busy, but relatively stable period in regulation before the opening of the retail markets to competition and the work to introduce new electricity trading arrangements. In our view, once the current structural developments in the energy markets (gas LDZ separation/sale and the introduction of BETTA) have been achieved, it would be appropriate and desirable for Ofgem's costs and underlying staffing levels to fall towards these earlier levels.

The issue is not really Ofgem's costs per se, but the level of activity from the staff numbers that these costs represent. In many areas, some of which we discuss in more detail below, initiatives from Ofgem provide a substantial indirect but non-optional workload and cost on industry participants in responding to information requests, consultations and attending workgroups related to the development of regulatory policy. In addition, extended periods of uncertainty arise for industry participants when the subject of these initiatives could result in significant changes in their costs and/or revenues.

In this context, it is worth noting that the Government, in its response to the House of Lords Select Committee Report on the Accountability of the Regulatory State emphasises the importance of "regulatory certainty" which it sees as linked to the ability of the regulated sector to attract private finance. It also notes that "stable operating environments [are] important for the development of competition". In our view, regulatory stability would contribute much to the attainment of a stable operating environment for the energy industry.

Key challenges to the industry in the short to medium term

We see the following areas as key challenges for the energy industry over the period of Ofgem's three-year strategy.

Gas Price Movements
There is significant national concern about the continuing high level of gas prices. In our view, the situation merits thorough investigation. While we are fully supportive of Ofgem's work to date to investigate high wholesale gas prices, we believe that there is a growing body of evidence to suggest that there are fundamental issues with the wholesale gas market.

We suggest that the scope of the current investigation should be widened to include trading for the coming winter period, given the potential impact on security of supply. Furthermore, we regard it as vital that a lack of information does not hinder the present investigation. We appreciate that Ofgem has to operate within the constraints of its powers to gather information in this sector. However, we consider that Ofgem and the other regulatory authorities concerned should not hesitate to put the investigation on a more formal footing, if this is necessary in order to obtain the information necessary for a full understanding of the dynamics of this particular market.

Restructuring of the Gas market to facilitate the sale of LDZs
We acknowledge that there has been significant progress on the required regulatory arrangements surrounding the proposed sale of LDZ assets by NGT. Much remains to be done to ensure the outline timetable is met and indeed we remain concerned that the substantial scale of reform envisaged by Ofgem may delay completion. We would therefore urge Ofgem to bring forward a detailed project timetable. As part of that, we would also urge Ofgem to limit any changes to the absolute minimum to facilitate the sale, with more detailed reforms to follow later. SSE is committed to playing its part in facilitating these reforms.

Growth of Renewable Generation
Ofgem and the industry have already recognised the challenges, particularly for electricity networks, of the Government's targets for renewable generation. With regard to the impact on distribution networks, Ofgem has developed a new scheme, as part of the distribution price control, to incentivise distribution network operators (DNOs) to connect distributed generation (DG). However, in our view, there is still much to be done to ensure that the necessary network upgrades take place at transmission level to accommodate DG and directly connecting renewable generation. Fundamental to all network investment decisions is the cost of capital, which Ofgem sets in network price control reviews. If this figure is inadequate, then a corresponding low priority will be placed on such enabling investment.

Implementation of BETTA
Much has been achieved in laying the foundations for the introduction of BETTA in April 2005. However, we still have strong concerns over the process governing the establishment of GB transmission pricing and the charging arrangements that are currently proposed.

It is also clear that Ofgem's methodology for the "132kV discount" for generators connecting to the 132kV system is Scotland is flawed since it relies on a number in NGC's charging methodology that is itself very volatile. Ofgem should therefore ensure that generators connecting to the 132kV transmission system face stable charges that correctly reflect the benefits of connecting to the 132kV distribution system in E&W.

The fundamental point going forward is that transmission charging, like other use of system charging methodologies, should be put on a stable, long-term footing as soon as possible. Transmission users should not be subject to significant swings in liability for transmission charges from year to year. In our view, once the GB charging methodology is implemented, capping the level of permissible increases in charges from year to year would go some way to removing these uncertainties but is no substitute for a genuinely stable methodology.

Finally, we understand that Ofgem has indicated that it has now completed its work on the BETTA project with the finalisation of the necessary industry documentation. We welcome this stance and would expect that the significant staff numbers and costs (£4.8m in Ofgem’s 2004/05 budget) associated with this project could therefore rapidly be reduced from Ofgem’s overall totals.

European Issues
The impact of legislation at European level continues to be felt in the detail of UK legislation affecting the energy market. We would urge the Authority, in engaging with the European authorities, to seek to minimise any unnecessary burden on the energy industries in the UK.

<u>Action by the Authority to respond to the challenges above</u>

We look to the Authority and Ofgem for early regulatory clarity when structural changes are proposed and being implemented. Also we advocate that the Authority makes timely and appropriate intervention on market issues when this can bring about changes and transparencies that support the energy markets. In general, we suggest that the Authority’s agenda should react to the issues that are raised by the participants in and customers of the energy markets rather than seek to pursue changes which appear desirable to the Authority but which have not been raised as problems.

While the stages up to the implementation of major structural reform inevitably involve significant commitment of Ofgem’s resources, this is no longer a requirement once the reforms have bedded in. Market governance should be in the hands of the industry through the operation of appropriate codes. We welcome the recent reduction in Ofgem’s activity in promoting changes to industry codes and consider that, in maturing markets, this trend should continue towards a situation where Ofgem represents an appeal body for any market participant who feels strongly about a proposed modification rather than be involved routinely in every proposed modification.

If these two approaches are adopted, this should, in our view, help to contribute to the reduction in staff levels and costs that we have advocated above. More generally, we note that, with the introduction of the Energy Act 2004, the Authority is now required to have regard to the principles of good regulation including that under which regulatory activities should be “targeted only at cases in which action is needed”. They should also be “proportionate”.

We also note the renewed emphasis on regulatory impact assessments (RIAs) in discussions of good regulatory practice, and have recently responded to Ofgem’s consultation on the subject. The Authority now has a statutory duty to undertake RIAs in the circumstances set out in the Sustainable Energy Act 2003 and the recent House of Lords Select Committee Report referred to above contains several recommendations in the area of best regulatory practice. These include references to retrospective use of RIAs (welcomed by Government) and self-assessment by regulators of their compliance with the principles of good regulation and effective accountability.

We welcome the above developments in the Authority’s statutory duties. Taken together with an overall regulatory strategy whereby all significant regulatory decisions are subject to RIAs and existing projects similarly assessed, this should lead to a more focussed use of regulatory resources. We would hope to move towards a regulatory environment where the actions that the Authority (and hence Ofgem) takes in carrying out its duties should be prompted by proven need and be only of a scale that is proportionate to any problem that has been identified.

Priority of Future Areas of Work for the Authority

Following on from the challenges we have identified above, we consider that a priority area for the Authority is the structural development of the gas market. Areas where we believe that resources should be winding down include the work on BETTA and on the electricity distribution price control review.

However, there are a number of areas where, in our view, the resources committed by Ofgem could be significantly reduced and we discuss these in turn below.

Energy Market Surveillance

The energy retail market is one from which Ofgem claims that regulation has significantly reduced since privatisation. However, we are concerned that significant Ofgem resources are still dedicated to this area of the market. There is no justification for continuing detailed and routine scrutiny of processes within competitive markets. If this trend continues in energy markets, we consider that it will have a detrimental effect on perceptions of regulatory risk for market participants in the sector. This is likely to be reinforced by the high level of fines that have been imposed on suppliers in recent months. We would also question the wisdom of resourcing a highly staffed compliance team in this area, who will necessarily be pro-active in developing a workload for themselves.

Network Incentive Schemes
Over the last few years, incentive mechanisms on network operators have become increasingly esoteric and complex. In our view, the Authority should not be devoting resources to continually developing these. In tune with our theme of regulatory stability, existing incentive arrangements should be allowed to bed in for a significant period, before further changes are considered.

Use of System Charging Methodologies
We have made comments to Ofgem on several occasions about our concerns over the continuing and wide-ranging reviews of use of system charging methodologies. These reviews entail costs for the industry and uncertainty for parties liable for use of charges. Current projects in this area, along with our associated concerns, are noted below.

- Electricity transmission pricing – at Ofgem's behest, NGC started a project to review its charging methodology in autumn 2002. The uncertainty over the final arrangement of charges under the new model has lasted for over a year and is still continuing, with the adverse impacts on BETTA that we have identified above.

- Electricity distribution pricing – Ofgem has used the EU directive 2003/54/EC as a reason for introducing licence modification which give the Authority powers to approve connection and use of system charging methodologies. We accept that some development of distribution use of system charging is appropriate, given the creation of the DG incentive revenue stream discussed above, and the policy requirement for new distributed generators to pay use of system charges. However, we are concerned to ensure that there is protection for distributed generators from excessive volatility in the new generator distribution use of system charges (given the initially small volumes of eligible DG) and that the work to develop an enduring methodology for the period after 2010 is minimised.

- Gas distribution pricing – in our view, it is not necessary to proceed with this development until after the next gas network price control review.

Regulatory Accounting and Statistics
The development of regulatory accounting guidelines has been a long and drawn out process, which is now linked in to the development of licence modifications associated with the distribution price control review. It is an area that still has a significant annual budget of £680,000, which we would hope to see further reduced once a stable set of guidelines have been produced.

Metering Competition
We have been opposed to this development. Now that the processes required to support the policy are in place, we understand that Ofgem has disbanded the team that have been involved in developing these. There should not, therefore, be any significant resources devoted to this area of work in the future.

Other Areas
In Ofgem's Corporate Plan for the years 2004-7 there are a number of individual areas for which significant sums are budgeted, and where we see little value for the industry and its customers. These include:

- retail competition – supply competition has been established and we would therefore expect to see Ofgem's work in this area "winding down";

- consumer affairs – energywatch is established for this purpose;

- quality of service, technical policy and energy efficiency – these areas of work are notable for their particularly significant costs, without clarity on what is being achieved for the sums involved.

I hope these comments are helpful.

Yours sincerely

Ian Marchant
Chief Executive

cc: Andy MacFaul, Head of Government Affairs