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Dear Andy

### **OFGEM'S THREE YEAR STRATEGY 2005-08**

I write in response to Sir John Mogg's letter of 5 August. We appreciate the opportunity to engage in discussion on your future plans, and are pleased to provide answers to the three questions raised.

#### **1 Key challenges facing the industry in the short to medium term.**

At present the most obvious challenge to the industry is the rapid increase in wholesale prices, which is feeding through to retail customers. Behind this is the longer-term question of security of supply, which formed an important element of the recent Energy Policy Review.

The Government's review also identified the environmental impact of our industry, and the need to strike a balance between lower costs and other societal benefits. This challenge is intensified by the pressure on retail prices, and the growing recognition of the impact of carbon emissions on the environment.

To these fundamental market issues, we would add two regulatory challenges - the growing significance of European regulation (and the risk it may undermine the substantial improvements in UK markets over the past fifteen years), and the opportunities created by the sale of gas distribution networks to improve the framework of gas regulation.

#### **2 What action is needed from Ofgem?**

Ofgem's key role is to ensure that markets are working effectively to deliver outcomes which meet both consumer expectations and broader Government policy objectives.

We see great merit in the development of Regulatory Impact Assessments that allow proposals to be tested against clearly specified objectives. This implies a significant element of work to understand customers' requirements, and where necessary, the potential conflict with other policy goals. With this assessment as background, RIAs can more effectively compare options with each other, rather than just against the status quo.

You will no doubt continue to review security of supply jointly with the DTI. This work will inevitably focus primarily on wholesale market issues and sources of raw energy, but the role of networks in assuring delivery must not be neglected. We hope

that measures of network resilience can be developed and suitable incentives be applied to network owners, reflecting customers' service expectations.

We would also expect you to continue to work with Government towards a low carbon future, providing incentives across the gas and electricity markets to encourage efficient use of resources and assistance to low carbon sources of energy.

Sir John indicated, in last year's strategy review, the need for the industry to take a greater interest in the development of European regulatory standards. Ofgem can help inform the industry of key areas of debate and help to support existing UK market practices where these are serving customers well.

We would also hope to see the lessons learnt from the current electricity distribution price control review applied to the forthcoming gas distribution review. It will be important to ensure, in both sectors, that comparative analysis is used appropriately and that smaller players are not disadvantaged compared with owners of multiple network Licensees. There is also a case to review the growing complexity of incentives, to ensure that they will still lead to appropriate behaviour from companies. There is a risk that the most important issues for customers are lost in an increasingly complicated framework of interacting incentives.

### **3 Priorities**

Our consistent theme in response to previous consultations has been to try and focus on a smaller number of key projects. Neither the industry nor its regulator has the resources to tackle too many projects simultaneously, and to do so also adds to the risk of unintended interactions.

In our view you should seek to concentrate resources on the areas that :

- a) matter most to customers – based on research that must be done
- b) will have a significant impact – as demonstrated through draft RIAs.

These guiding principles should help to reduce the overall workload without jeopardising customer interest. In particular we continue to urge you to step back from potentially competitive markets (such as metering and connections) and leave the market participants to develop detailed mechanics within a framework that is applied consistently across the country.

I hope you find these comments helpful. I would be pleased to join in further discussion on the issues raised.

Yours sincerely

**Mike Boxall**  
**Head of Electricity Regulation**

CC: Sir John Mogg