

4th March 2005

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Dear Andy

OFGEM PROPOSED CORPORATE STRATEGY AND PLAN 2005-2010

British Energy welcomes the opportunity to comment on Ofgem's proposed corporate strategy and plan as set out in the consultation published in January 2005.

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).

We consider that there is now an opportunity for a full and timely review of the existing arrangements with the aim of creating a new enduring market framework. 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 proposed five year strategy and plan set down within the consultation paper. A number of these views we expressed in our response to the earlier consultation. However, in instances where Ofgem has made specific comments on these issues we have repeated our views for clarity purposes.

Vertical Integration

British Energy has on 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. Consequently, we are disappointed with Ofgem's response set out in paragraph 3.33 whereby it states that effective market monitoring and its enforcement powers under competition legislation protect consumers against potential problems with vertical integration. In addition, Ofgem states that the absence of barriers to entry is one of the most important contributors to effective competition.



We consider that vertical integration has directly or indirectly introduced a number of market imperfections detrimental to the interests of consumers that should be of concern to Ofgem. These include the existence of barriers to entry particularly in the domestic market. The existence of these barriers together with the possibility of tacit collusion between the existing players means that true competition is unlikely to develop and excessively and uncompetitively high margins will continue to be gained without regulatory intervention.

Furthermore, the asymmetric response of suppliers to variations in their input costs, and in particular the speed with which they have increased tariffs relative to changes in their cost base since 2003, suggests that Ofgem's previous response¹ to arguments were wrong and/or misguided and that competition in supply is not sufficiently established or effective enough alone to protect the interests of consumers.

Market Liquidity

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 and is acting as a further barrier to entry. One of the main consequences of this is that within the generation wholesale market there has been an overall and worsening trend in wholesale market liquidity. The earlier growth in market liquidity has reversed such that it has now fallen to below 2001 levels.

As a result, the wholesale generation market has effectively been reduced to the role of a secondary balancing mechanism where most trading is focused on the fine tuning of very short-term (within day/day ahead) power requirements as opposed to the trading of longer term positions. This has resulted in a more volatile wholesale market where relative low levels of traded activity, both in terms of the number and volume of trades executed, are resulting in significant swings in market prices. Compared to the VI entities these factors, combined with the continued absence of any meaningful traded derivatives market, makes it harder for independent power producers or suppliers to trade their output or requirements and manage market risk. It also suggests a malfunctioning and immature wholesale market, where wholesale prices are not reflective of underlying market fundamentals.

A further consequence of the vertically integrated and illiquid nature of the market is that it has helped to foreclose the market to new entrants. This is because new entrant suppliers find it difficult to source the power they need to compete in the retail market and new entrant generators are unable to secure the contracts they need to underpin their financing arrangements. We note that a key cornerstone of the New Electricity Trading Arrangements ("NETA") introduced in March 2001 was the creation of market conditions that would attract new entry. Key to this was the emergence of deep and liquid wholesale markets in which a diverse range of derivative products would be traded. It is clear that NETA is failing in both respects – the traded market is stagnant with little prospect of liquidity improving and market participants are exiting rather than entering the market.

This is not in the interests of consumers, for without the prospect of new entry the stranglehold of the six major VI groups is likely to remain unchallenged. Moreover, the extent of VI and the way in which the wholesale markets have developed suggests that

¹ Electricity Supply Competition – An Ofgem Occasional Paper (83/02), December 2002



Ofgem's decision in October 2003 to remove the self-contracting restrictions on the VI entities that limited the level of internal contracting between their generation and supply businesses was ill-timed and ill-judged.

In light of the above, we welcome Ofgem's acknowledgement in paragraph 2.6 that greater concentration in ownership and declining liquidity are key issues and 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.

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. With this in mind we welcome the confirmation that Ofgem intends to engage fully in influencing and shaping the European debate.

However, we are still concerned that Ofgem does not appear to consider the compatibility and consistency of the GB trading and transmission arrangements with those in the developing EU energy markets to be an important issue. 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 increasingly and better 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. On this issue we welcome Ofgem's acknowledgement that there are important public policy issues for the Government to tackle if it considers new nuclear generation may have a contribution to make in terms of delivering low carbon energy sources.

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.

Governance

We welcome the fact 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 have been extremely disappointed to find that some of the regulatory impact assessments (RIAs) published by Ofgem (e.g. in respect of GB charging methodologies) have failed to meet the expectations of



the industry in respect of the production of such assessments and the improvements these are designed to bring to the regulatory decision making process. On this point we note that Ofgem has instigated an external review of its impact assessments. We welcome such a review and look forward to contributing and to ensuring improvements are made in this area.

We consider that there is scope for further improvements within this area of governance which could improve investor confidence and increase regulatory certainty. For example, there is a need for more transparency 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 or published. This is not conducive to open and transparent regulation. We would therefore urge the Authority to publish more information regarding its proceedings including meeting agendas and a (non-confidential) summary of the minutes of meetings and also to consider the possibility of adopting open Authority meetings on occasion.

Regulating Monopolies

When significant regulatory proposals are taken forward, it is essential that Ofgem recognises 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 they can factor in such changes in time for the contracting rounds and in the preparation of customer offers. Decisions on proposals that have a material impact (and in particular the overall level of end-customer charges) 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 an all too 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.

With respect to the recent GB charging review we have been critical of the consultation review process adopted by Ofgem for the very reasons stated above. Consequently, we are disappointed to find that in concluding the latest charging review Ofgem has obliged NGC to review aspects of the charging regime again over the first two years of operation. This continuing review process damages confidence in the market and does little to improve the perception of market/regulatory risk over the longer term.

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 have occurred during the introduction of NETA, the implementation of a Standard Licence regime under the Utilities Act 2000 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 properly functioning competitive markets and such a review would go some way to demonstrating the adoption of such a policy. Consequently, we welcome the recent announcement by Ofgem of its proposed review of electricity supply licences. However, we are concerned with Ofgem's justification for such a review i.e. that the supply licences are currently a "formidable barrier to entry". We do not in any way concur with this view and would much rather see Ofgem justify the review on grounds of efficiency and good regulatory practice. As described above, we consider there to be other significant barriers to entry in supply and would urge Ofgem to focus on these under the theme of "creating and sustaining competition". A more appropriate place within the Ofgem Plan for the supply licence review would be perhaps under the theme of "Ofgem's efficiency and effectiveness".

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 plan period. However, given that BETTA introduces some significant new arrangements (e.g. SO-TO code) it would be prudent for Ofgem to plan for a first annual review and consultation of the GB arrangements to ensure that these are operating as expected and in the interests of all users and customers. We note that within the proposed Ofgem plan there is currently no intention to conduct such a review. We request that Ofgem considers performing such a review.

Electronic Public Register

We are pleased to note that Ofgem is finally putting in place an electronic public register. We consider this to be an important tool and will improve the transparency and efficiency of the regulatory regime.

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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