

Ofgem's Corporate Strategy and Plan 2005-10

Response by E.ON UK

Summary of main points

- Ofgem's focus on "value for money" is welcome and recognises the importance of industry investment in delivering energy policy objectives.
- We also welcome Ofgem's continuing efforts to implement better regulation, in particular by seeking to improve the consultation and impact assessment processes.
- There are some areas where more progress could be made. For example, while Ofgem is examining the scope for lighter touch regulation through its supply licence review, Ofgem should examine the scope for more self-governance in industry codes and should define its own role more precisely.
- We welcome the emphasis on transparency and accountability; the transparency of the Authority's decision making processes would be improved by publishing Authority minutes
- There is a continuing need to promote the principles of better regulation at a European level.
- Following agreement on DR4, it is important that work on the development of robust resilience output measures is progressed so that network resilience investment can be delivered on time and at an efficient cost that customers are prepared to finance.
- We are highly supportive of research to examine issues relating to energy efficiency and fuel poverty and believe this research is most efficient if conducted in full consultation and co-operation with industry.

Key challenges ahead

1. We support the views expressed in the introduction to the document and also in Ofgem's presentation to licensees. Specifically, Ofgem has identified the challenge in terms of investment of moving towards a low carbon economy, whilst at the same time ensuring security of supply and reducing fuel poverty. Ofgem's view that it exists to provide value for money for the consumer and that the best way to do this is through a stable and predictable regulatory framework (e.g. paragraph 2.3) recognises the role industry has to play in attracting and delivering investment efficiently that will meet the policy challenge. In our response we suggest ways in

which regulatory stability and predictability may be developed over the plan period.

2. We welcome recognition in paragraph 2.5 of the need to provide greater transparency and ensure due process, although it will be important to ensure that Ofgem's processes do not become too bureaucratic and retain flexibility. Regulation should encourage industry to seek innovative solutions to delivering policy goals. We would encourage Ofgem to identify and explain environmental, economic and social policy trade offs and improve transparency in decision-making, Publishing minutes of Authority meetings, would help improve transparency and accountability.

Specific comments on themes

Creating and sustaining competition

Ofgem's role in the industry self-governance process

3. We welcome the review of supply licences that Ofgem is currently consulting on. We also note that Ofgem's Corporate Plan aims to "conclude review of electricity generation conditions" by Q2 2005. This review should be referred to in the Corporate Strategy document itself. Given Ofgem's views on the respective maturities of the wholesale and retail markets, we would expect Ofgem to conclude that a number of conditions in the existing generation licence have become redundant.
4. We continue to believe that Ofgem should reduce its involvement in code modification processes. A clarification of Ofgem's precise role is needed. It is, of course, Ofgem's role to take action where there are barriers to effective competition or the market is not working. Equally, Ofgem has a role to play arbitrating on issues where the industry cannot reach agreement.
5. However, Ofgem should not be pursuing projects where the consumer benefits are not certain, or not properly assessed and where the market is working satisfactorily. Ofgem could also be quicker to drop projects where the feedback is clearly negative.
6. Each of the modification procedures for the various codes is designed to allow users, and in some cases customer group representatives, to bring forward proposals to deal with issues as they arise. Save for wide-reaching market reforms

such as BETTA, changes to market rules should be driven by market participants through the code modification process and not by Ofgem. Rather than reducing its involvement, Ofgem seems to wish to promote ideas through its consultation and review processes, rather than rely on users to bring forward modification proposals. The recent cash-out review is an example of the sort of issue which we believe should be handled by self governance processes rather than being the subject of a formal Ofgem consultation process.

7. Once the mechanism for appeals to Authority modification decisions is established, we believe Ofgem should avoid promoting its own agenda for market rule changes, through reviews, conditional licence conditions etc. given that such actions may be seen to prejudice or interfere with industry modification procedures and any recommendations made by the Authority as part of such processes. The recent best endeavours obligation on Transco and buyers to bring forward enduring offtake arrangements by 1 September 2005, as a condition of the sale of gas DNs is a case in point

Impact Assessments

8. We welcome Ofgem's continuing evaluation of its impact assessment (IA) process. In our response to the guidance document on IAs we highlighted how we believed there was a case for reviewing the use of formal IAs in the industry code modification processes. We continue to believe that, although final, formal IAs are important, the extensive examination of code modification or amendment proposals prior to a formal IA by Ofgem, will in most cases remove the need for some or all of the detailed IA consultation process.

Transparency of upstream gas information

9. We support greater emphasis on information transparency of offshore data in the gas market. Again market participant are best placed to bring forward suitable amendments.

Regulating network monopolies

Industry structures and cost reporting

10. We support Ofgem's view that companies and capital markets must retain the freedom to seek and adopt innovative and more efficient corporate structures (paragraph 3.32). Network business mergers have benefited customers, with

higher efficiencies achieved during DPCR 3 than would otherwise have been the case. Additionally, Ofgem was able to further reduce operating costs in DPCR4 using comparative information. The cost reporting project established by Ofgem at the end of 2004 should allow annual reporting of data on a more comparable basis. Thus, DPCR 5 will be conducted using many more observations than previously, increasing Ofgem's ability to use comparative information irrespective of industry structure.

Incentive-based regulation

11. We welcome Ofgem's continued commitment to incentive regulation as the best way of protecting the interests of consumers. Going forward, we believe the following points are important.
12. During the recent electricity distribution review, we were disappointed that the five year rolling opex incentive was removed. As the mechanism increased the incentives on companies to be cost efficient, we would urge Ofgem to reintroduce it as soon as possible, rather than wait until DPCR 5
13. We do not believe that the frontier incentive for being a "best performer" under the opex cost benchmarking approach is strong enough. We believe the current upper quartile frontier should be changed to one representing an average cost. It would be helpful if Ofgem clarified its approach to benchmarking in DPCR 5 as early as possible.
14. Whilst we support the aim and principles behind the incentives introduced to respond to the anticipated growth of distributed generation we caution that they may not be sufficient.
15. Developing new models for future charging is particularly important at a time when the growth of distributed generation means DNOs' networks are undergoing change from largely passive one-way flow systems, to much more complex systems requiring active management.

Quality of service

16. The Information and Incentives Project, introduced during DPCR 3 has been increased in DPCR 4 by setting more challenging targets and increasing the revenue at risk. However to maintain credibility, it is important that:
 - operating and capital allowances are consistent with delivering these targets; and
 - targets set are consistent with customers' willingness to pay for improvements
 - We had a number of concerns during the DPCR 4 process that these two issues were not being fully recognised by Ofgem. Going forward, it is important that

this process is improved for the next price control review

Metering competition

17. We broadly support the design of the temporary price controls that have been introduced for MAP and MOp metering activities, and in particular the principle that distributors should be protected from stranding risks arising from previous regulatory obligations. However, we strongly urge Ofgem to conduct a thorough review of the competitive state of the metering market as soon as practicable, and believe that these price controls and obligations placed upon distributors should be removed by 1st April 2007 at the very latest.

Helping protect the security of Britain's energy supplies

Network investment

18. We agree with Ofgem that there is a need for substantial increases in investment both to replace ageing assets and to improve network resilience. The 55% increase in allowed capex for Central Networks was a first stage in this process, designed to replace ageing assets essentially to maintain existing levels of resilience. However we argued during the DPCR 4 process that investment should be provided to *improve* the resilience of our network, consistent with the underlying message given by the Trade and Industry Select Committee throughout 2003 and 2004. A key area of work that we would like to help Ofgem focus on over the next two years is the development of a robust resilience output measure so that resilience investment can be delivered at an efficient cost that customers are prepared to finance.

Electricity Generation

19. We are pleased to see that Ofgem recognise some of the longer term market and environmental issues that affect the closure of old plant and investment in new plant. Going forward, Ofgem has an important advisory role to play in continuing to bring these and related issues to the early attention of Government in order to contribute to the stability and predictability of the regulatory framework.
20. In particular, we have longer term concerns about security of supply arising from the combined impact of the EU emissions trading scheme, the Large Combustion Plants Directive and the Environment Agency's approach to Integrated Pollution Control on further investment in coal-fired generation, which we see as having a continuing valuable role in maintaining supply security, as the UK becomes increasingly dependent on imported gas and the level of wind generation

increases. It is important that Ofgem takes these issues into account in the way it regulates the market, given Ofgem's need to have regard to ensuring that all reasonable demands for electricity are met and its responsibility to carry out its functions in the manner best calculated to secure a diverse and viable long-term energy supply. Clearly, this also supports the interest of consumers in receiving a reliable energy supply.

Informing the debate / JESS

21. The JESS series of reports have been useful in drawing attention to specific issues and stimulating debate. We welcome the work of JESS and its objective of ensuring that energy companies, investors, consumers and other stakeholders have access to as wide a range of information as possible. We broadly support the conclusions of the most recent document and we agree with the new indicators which the DTI and Ofgem are hoping to develop for future reports and the proposed work plan for the sixth report. We have commented to JESS on a number of ways in which the report could be improved.

A leading voice in Europe

22. We are encouraged to see Ofgem taking an increasingly more prominent role in Europe, given the increasing interaction between UK and continental European energy markets and the more active role that the Commission is taking in developing energy and regulatory policy.
23. We very much support Ofgem's sentiments, expressed in paragraph 6.8, that legislation should not undermine market driven investments and measures delivered within liberalised competitive markets. We also support Ofgem's arguments in paragraph 6.13 concerning the need for EU legislation to complement and not hinder the development of competitive markets. Ofgem/DTI's interpretation of the requirements surrounding interconnectors is a good example of appropriate "light-touch" regulation designed to encourage efficient investment.
24. Paragraphs 6.10 and 6.11 make the point that EU legislation should not undermine domestic markets (presumably as a result of disproportionate intervention) and that integration should be progressive and carefully thought out and at the minimum level sufficient to facilitate cross-border trade. We believe that these objectives are best served through the promotion of the "Better Regulation" agenda at an EU level. This is particularly important given the lack of transparency

of ERGEG and the limited accountability of the Commission .

25. We support the views of Better Regulation Task Force’s report on simplifying EU Law¹, in particular the need for new proposals to contain “*a holistic review of all relevant legislation applying to the activities to be regulated, and an explanation of how the new proposal will fit with the existing regulatory regime.*” In practice, we believe that this will require a review of energy and environmental policy development and regulation at an EU level to ensure it is contributing to the Lisbon competitiveness agenda (a view expressed by Eurelectric.) We believe that this is in the best interests of consumers as it would help to ensure that costs of compliance are optimised and that unnecessary barriers to efficient investment or innovation are identified and removed.

Helping to protect the environment

Environmental impacts of energy policy

26. We support Ofgem’s assessment in paragraph 7.3 that its overall goal is to assist the industry to achieve environmental improvement as efficiently as possible and we are glad to see that Ofgem wishes to take a prominent role in discussing the most efficient ways of delivering a low carbon sector (7.4). An important element of developing an efficient approach is the elimination of regulatory overlap or conflict that can increase uncertainty and costs of compliance and reduces the scope for companies to seek least cost routes to deliver policy targets. As Ofgem’s environmental role is expanding, a need will arise for more effective and transparent co-operation and interaction between Ofgem and the Environment Agency. Interaction under the existing memorandum of understanding should be reviewed to ensure that Ofgem’s goal can be achieved effectively.

Delivering a low carbon future - distribution network losses

27. We welcome Ofgem’s decision to increase the distribution losses incentive (paragraph 7.6) by incorporating the social cost of carbon. However even at this marginal incentive rate, we believe that it needs further strengthening to change fundamentally procurement decisions. This is an area that Ofgem will need to monitor continually to assess the impact of its new scheme.

Promoting efficiency and limiting demand

¹ Make It Simple Make It Better - Simplifying EU law - December 2004; <http://www.brtf.gov.uk/reports/simplifyeu-law.asp>

28. In its responses to the EEC II consultation, the industry cautioned against an overly restrictive approach to accrediting qualifying measures. In particular, concern was raised over the ability of the insulation production and installation industry to deliver the volumes expected over the period. With this in mind, we welcome Ofgem's commitment to work with suppliers to examine how behavioural change might be stimulated and whether this would lead to a long term reduction in consumption. We look forward to being able to work on this subject together.
29. This is an area where more "real-life" research is needed to help the industry, the Regulator and Government understand how this issue should best be tackled. Suppliers are most likely to be able to assist if incentives exist to encourage innovation in product offerings, rather than changes being mandated which may not deliver the results expected. Specifically, and as a matter of some importance, the issue of how "soft measures" such as this can be part of EEC accredited schemes needs to be resolved.

Administering the Government's environmental programmes

30. Effective and efficient administration of environmental programmes is important for licensees for two reasons. Firstly, they expect value for money for their licence fee and secondly, inefficient or poor management of the schemes can have a direct commercial impact. Recent problems and uncertainty with the ROC register, co-incident with the introduction of the REGO register system may lead some observers to question whether these sorts of activities are not best handled by a suitably qualified specialist third party (e.g. Elexon). If this were the case, licensees would at least have the security of contractual service level agreements to fall back on in the event that serious commercial losses were incurred as a result of system failure.

Helping tackle fuel poverty

31. E.ON UK is committed to continuing to identify innovative ways of meeting the needs of vulnerable customers and we wish to play a full part in enabling the Government to meet its target of removing vulnerable customers from fuel poverty by 2010. Although not mentioned in the plan, we welcome the consultation on pre-payment meter (PPM) use following the changes introduced by the Energy Act. Allowing PPMs to be used to recover charges for energy efficiency measures, for example, will help suppliers to target energy efficiency improvements more easily at the vulnerable or fuel poor.
32. We want to support Ofgem in researching and tackling the issues explored in this chapter, especially as regards energy efficiency, consumer behaviour and targeting

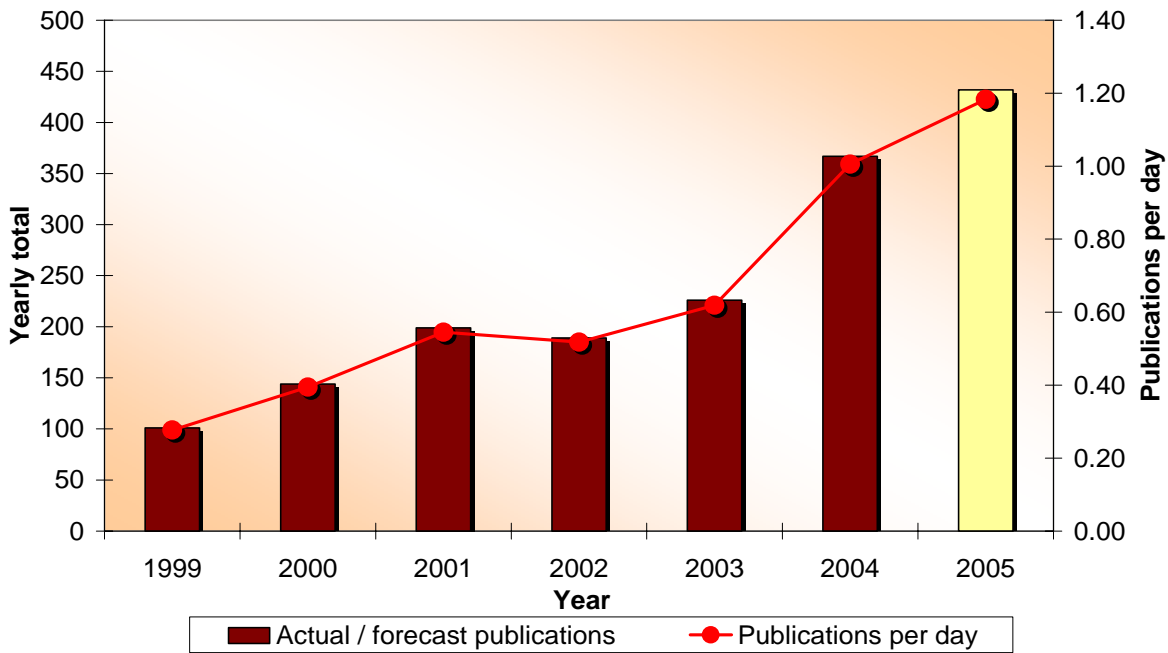
vulnerable customers. As we have already mentioned, this research is most efficient if conducted in full consultation and co-operation with industry. Our experience of the debt management review leads us to believe that such research should not be left until the last minute.

Improving Ofgem’s efficiency and effectiveness.

Improving the consultation process

- 33. Ofgem has stated its intention to provide value for money for consumers in an environment of increased investment. We welcome this approach and also the moves Ofgem has taken to assess the value for money of its own activities for licence payers and ultimately consumers.
- 34. We have already highlighted areas where we believe Ofgem can and should reduce or remove the degree of direct regulatory intervention, thus reducing costs or freeing up resources for use in other areas.
- 35. We are pleased to see that Ofgem recognises the indirect costs it imposes on our industry. In our response last year, we provided a chart showing the growth in Ofgem documentation produced. Figure 1 below is an updated version of this chart.

Figure 1 - Rate of growth of publications



36. The total for 2005 is a forecast based on the average number of publications per day to date and we would expect that post BETTA, this average rate would tail off. We are highly supportive of Ofgem's continuing efforts to make best use of the consultation process particularly by improving the quality of consultation papers. However, care must also be taken not to confuse transparency and value for money with the amount of publications, or even the number of new regulatory initiatives that are produced or proposed each year.
37. We recognise that the balance between ensuring due process is observed, that all stakeholders' views are considered, and that regulation is cost effective, is a difficult one to achieve. Measures such as the self imposed price control and review of impact assessments are important steps towards this.

E.ON UK

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