Andy MacFaul
Head of Government Affairs
Office of Gas and Electricity Markets
9 Millbank
London
SW1P 3GE

Head Office
Inveralmond House
200 Dunkeld Road
Perth
PH1 3AQ

Telephone: 01738 456400
Facsimile: 01738 456415
Email:

Our Reference:
Your Reference:

Date: 4 March 2005

Dear Andy

Ofgem's Proposed Corporate Strategy and Plan 2005-2010

We welcome the opportunity to provide comments on the above document. Our overall comments are set out below, while the attached appendix provides detailed comments on each of Ofgem's strategic themes in turn.

Costs
In our response to the previous consultation on Ofgem's corporate strategy, we highlighted our strong concerns about Ofgem's continuing high level of costs and staff numbers, compared to equivalent figures for energy regulation in the mid 1990s. These concerns remain and, in our appendix of detailed comments, we refer to specific areas where we would expect Ofgem's costs to decline or where increases seem unjustified. Essentially, we believe that less regulatory resource is needed to oversee competitive markets and also in some aspects of network regulation.

Regulatory Stability
We recognise that network monopoly regulation will always require a certain level of regulatory resource to cater for price reviews, quality of service regulation and the resolution of disputes, for example. However, as we have commented before, we do not support regulatory resources being used to continually review and initiate change in market processes and, in particular, in how market participants are charged for use of the networks. Many areas of the supply chain are subject to new or "ongoing" review by Ofgem and this appears to perpetuate a need for regulatory resources to continue the reviewing. This maintains an upward pressure on the direct costs of regulation as new areas become subject to review. It also introduces indirect costs for market participants in engaging with the policy debates as well as facing the uncertainties and

potential costs of change implementation. In the case of use of system charge changes, there can also be significant impacts on the cost base of individual market participants.

In contrast, we strongly believe that there is value in regulatory stability, backed by industry-governed processes to initiate change where it is really required. In this vision, Ofgem would take a more reactive role, intervening only when industry processes had not resulted in consensus. As well as active consideration of options for deregulation, an important part of Ofgem’s agenda should be to seek to reduce the quantum of change that was to be introduced at any one time for any class of market participant.

Transparency

As discussed in the attached appendix in relation to Ofgem’s efficiency theme, we believe there is a need for greater disclosure by Ofgem of the detail of its planned work, both in scope and over time. Almost all individual areas of reported activity have increased significantly in cost compared with the budget for 2004/05. In contrast, the costs attributed to BETTA are projected to fall from nearly £5m to around £100,000, as would be expected once this major project comes to an end. It is difficult to avoid the inference that the resources devoted to BETTA in the last year or so have been spread around Ofgem’s other cost categories with no real attempt to control costs in other work areas.

I hope these comments and the attached appendix of detailed points are helpful.

Yours sincerely

Rob McDonald
Director of Regulation

APPENDIX

Ofgem's Proposed Corporate Strategy and Plan 2005-2010
Comments on Detailed Points

Our detailed comments are set out under the headings of Ofgem's different strategic themes. We consider the points made in the strategy document under these headings together with the deliverables, if appropriate, and the costs set out in the corporate plan appendices.

Creating and Sustaining Competition

We strongly believe that where competition has become established, Ofgem should withdraw from regulation and drastically reduce the considerable resources it is using for monitoring, enforcement and compliance. On the other hand, where there are issues of market structure and transparency, we look to Ofgem to take whatever steps it can to improve the operation of the market. Broadly speaking, we consider that gas wholesale markets are a specific example of the latter situation and that energy retail markets fall into the former area. We consider each of these areas in more detail below.

Gas Wholesale Markets

Ofgem mentions, in paragraph 2.6, that concentration of ownership and declining liquidity are likely to become issues in both electricity and gas wholesale markets. However, in our view, there remains the issue of the concentration of gas producers feeding in to the GB market. In the longer term, more of Britain's gas supplies will be sourced from Europe and we welcome Ofgem's willingness to engage with European regulators to promote the proper functioning of the gas wholesale markets in a European context. In the shorter term, we continue to be concerned about the high levels of gas wholesale prices (reaching £1.15 per therm in a recent peak price) and welcome Ofgem's continuing efforts to analyse the effect of maintenance patterns and contractual arrangements on prices. Ofgem rightly links this issue with that of the production and availability to the market of information from offshore gas producers. We support the planned review of the regulatory framework governing information disclosure in this context but note that it is still a matter of concern that there is still only a voluntary basis for the production of information relating to offshore gas supplies.

Retail Markets

In energy retail markets, Ofgem has confirmed that "competition … has become firmly established". We agree with this and cannot stress highly enough that in consequence, there is little that Ofgem should actively be doing to "promote competition" or to promote change as discussed in paragraph 3.21. We would also argue that this continual promotion of change, for example by continuing to "seek improvements" to customer transfer processes, is actually in itself creating a barrier to entry, as suppliers have to track and bear the costs of continually changing requirements in systems and procedures. In contrast, it is noteworthy that in the telecoms retail sector, for example, it is possible for retail suppliers to enter the market easily with the minimum of regulatory requirements and oversight of the market. Ofcom, the regulator for telecoms also reports regularly on areas where it has reduced or removed regulation, which is, in our view, a useful emphasis for regulatory bodies.

We welcome Ofgem's headline commitment to withdraw from regulation where appropriate and, in particular, support the project to review supply licences with a view to removing conditions that are no longer necessary. However, there are still several comments in Ofgem's discussion of strategy in this area that imply an ongoing intention to review and foster change in various elements of the market.

In paragraphs 3.2 and 3.21, Ofgem signal their intention to seek improvements to the customer transfer programme. Ofgem and the industry have been involved in a recent review of this market process, which identified both issues and solutions. We are strongly of the view that the outcome of this review should be allowed to bed in and that industry should be allowed to manage any issues going forward.

Also in paragraph 3.21, Ofgem refer to focussing resources on aspects of the market where "<u>changes</u> would have the greatest beneficial impact on consumers". Linking with our point above on change being a barrier to entry, we are strongly of the view that it is not the function of regulatory bodies overseeing competitive markets to promote change. Rather, the regulator should be reactive to concerns, a party to whom market participants are able to appeal if they have concerns with the manner in which the industry's own governance arrangements are operating on any particular issue. This comment applies equally to Ofgem's role in the code modification process and we welcome Ofgem's willingness to adopt "lighter touch" regulation in this respect.

In conclusion, we strongly advocate that Ofgem moves from a proactive role in the energy retail market towards a situation characterised by minimal sector-specific regulation and an agenda that reacts to problems raised rather than pursues changes which appear desirable. To that end, we would urge Ofgem to produce a "roadmap" setting out its strategy for the complete withdrawal of sector specific regulation of competitve markets.

<u>Costs</u>
Bringing together the drivers for continuing regulatory involvement in the gas wholesale market and for a withdrawal of regulation in retail energy markets, we consider that a significant reduction in the resources allocated to this regulatory theme is possible over the course of the period of the draft corporate plan. It would be useful to see a forecast of this and to see a greater distinction between the resources needed for wholesale and retail market issues as the regulatory considerations and activities are, in general, very different.

In comparing Ofgem's budget for 2005/06 compared with that for 2004/05, we see significant increases for the cost categories of enforcement; consumer affairs; licensing; electricity modifications and gas modifications. Altogether, these categories now represent over £5m of costs while the equivalent figure in 2004/05 was £3.7m. However, an even more significant increase in costs has occurred over other categories. Excluding BETTA costs (which fall, as would be expected following the planned implementation of this project in April 2005), DN Sales (the costs of which now come under Networks) and Connections, the balance of costs for regulating competitive markets in 2004/05 amounted to £5m, while in 2005/06 £7.5m has been allowed. The majority of this is represented by the figure of £6m for "Consumer and Wholesale Markets". This is a new category for costs under this strategic theme and it is not clear what activities are expected to require so much of Ofgem's budget in the coming year.

Regulating Network Monopolies

In the regulation of the network monopoly businesses, cyclic peaks of regulatory workload occur at the time of major price reviews. With the completion of the electricity distribution price control, we accept that Ofgem will begin to turn attention to the electricity and gas transmission price controls and to the gas distribution price controls which are due to be implemented by April 2007 and April 2008 respectively. There are two other areas of work associated with network regulation that are also partly affected by the price control cycle. These are the development of incentives, which are usually implemented at the start of price control periods, and the structure of network charges, where significant changes in, for example, the boundary between connection and use of system charges are also implemented at the start of price control periods. We discuss some concerns about regulatory policy in these two areas below, followed by some observations on a number of other work areas before considering the resources that have been budgeted for this regulatory theme.

<u>Structure of Charges</u>

We have commented for some years now on our concerns about the continuing and wide-ranging reviews of use of system charges. These create a great deal of work and uncertainty, both for the network companies and for the market players who become involved in trying to influence the outcome of a debate that could substantially affect their costs. As we have argued before, stability for customers should be a policy goal for regulation in this area, particularly since there can never be a definitively "right" approach to network charging.

All methodologies involve trade-offs and the influence of other policy objectives, including those of the government of the day. It is worth noting, for example, that the use of auctions in gas entry pricing is not "cost-reflective" as the market may place a different value on the use of the assets. We would therefore caution Ofgem against too great a reliance on the principle of "cost reflective charging" as discussed in paragraph 4.14 of the document and suggest that the effect on the customer is given more prominence within policy objectives for this area of work.

Current projects in this area and our comments on these are noted below.

- Electricity transmission pricing – this has been under review since the autumn of 2002 and has still not produced, in our view, a stable and defensible set of GB transmission charges. We still have concerns about the extreme signals produced by the current methodology and advocate that, as the charging methodology evolves, parties who pay the charges are protected, as a matter of policy, by a cap on any increases in charges from year to year. There is precedent for this in the regulatory policy for distribution charges to generators.

- Electricity distribution pricing – we accept that some development of these charges is required following the development of interim charging arrangements for distributed generation. We welcome the introduction of caps on the changes in these charges, as noted above and hope that the principle of stability for those paying charges can be carried through to other aspects of the development of these charges.

- Gas distribution pricing – in our view, it is not necessary to proceed with this development until after the next gas distribution price control review. We therefore do not support the item in Appendix 1, which suggests “final proposals” in this area in quarter 2 of the next financial year.

Network Incentives

We have previously commented that incentives on network operators are becoming increasingly esoteric and complex. We therefore welcome Ofgem’s comment, in paragraph 4.11, that it will consider whether incentive arrangements around gas entry capacity could be simplified. In our view, both the arrangements for remuneration of entry capacity and the incentives around these are unhelpfully complex and moreover, no assessment has yet been made of the effectiveness of this regime.

More generally, we are not convinced that it is necessary to apply incentives in as many areas as Ofgem advocates. For example, against the background of a shallow connection policy, transmission owners have to have certainty that the reinforcement expenditure they will incur to accommodate new connections will be allowed on their regulatory asset base. At these voltage levels, investment costs are such that positive regulatory sign-on is required before these investments will be made. It is difficult to envisage a straightforward incentive scheme that would absolve Ofgem of the need to approve, on a case by case basis, major reinforcement projects that transmission owners require to undertake.

Similarly, we consider that incentives on transmission quality of service performance in Scotland will be problematic due to the inclusion of 132kV assets in the definition of transmission voltages in Scotland.

Other Work Areas

We have a few further comments on other items mentioned under this regulatory theme.

- Sale of Gas Distribution Networks (DNs) – we are fully supportive of Ofgem’s work in this area and agree with the assessments of customer benefits associated with the proposed sales.
- Distribution CUSC – we are concerned over the potential costs of this initiative and do not consider that the case has been made for any radical change. As such, we believe that other network issues should take priority over this work. Furthermore, a regulatory impact assessment addressing all governance options identified, including one of minimal change to the DUoSA, has still to be carried out for this work. In our view, it is likely to be too early to reach a final decision in this work area in the first quarter of the next financial year, as proposed in Appendix 1.
- Offshore renewables – we note that Ofgem is working with the DTI to develop the regulatory regime to apply to offshore cables. Our suggested starting point for this debate is that the transmission services areas of the existing transmission owners should be extended offshore. This would establish some certainty about which party has an obligation to invest and would not preclude other parties from becoming involved in investing in offshore assets as essentially “private networks” in future.

Costs

We are disappointed to note the overall increase in costs for this area from £10.8 to £13.7m. Within this total, we accept that new categories of work for the gas price controls and for “costs and outputs” are required, assuming the latter reflects the cost reporting project that Ofgem has initiated as part of the distribution price control review. We can also understand why more resources are budgeted for gas distribution policy in the coming year given the attention that this is currently receiving as part of the DN sales process. However, we do not understand why there is a significant increase in costs for financial issues, why almost £2m is budgeted for incentives and structure of charges, and why over £1m is needed for the (electricity) distribution price control review which has just finished.

In some areas, it is difficult to track the path of costs due to changing categories for the costs. For example, there are headings for gas and electricity transmission in the 2004/05 budget information but no mention of “transmission” at all in the 2005/06 budget. Instead, new categories of “incentives and structure of charges” and “policy development and special projects” have appeared, accounting for some £3.5m between them. In our view, a great deal of work has been carried out on structure of charges to date under the previous set of cost headings and there is no justification for bringing in new categories to cover these costs, if costs under the previous headings are not decreasing. In fact, “policy” cost headings have increased from £2.4m to £4.4m between the two years. This situation illustrates all three of the points made in our cover letter.

Security of Supply

We support Ofgem’s emphasis on this regulatory theme and recognise that it has interactions with work in the other regulatory themes. Our greatest concern in this area is the structure of the wholesale market for gas, as discussed in more detail above. We have also expressed concerns that the extreme pricing signals for the north of Scotland zone that emerge from the currently approved transmission use of system charging methodology might lead to the closure of otherwise efficient generating plant. In our view, this could have an adverse effect on security of supply in Scotland, which we do not believe that Ofgem have robustly assessed.

Europe

We agree with Ofgem that European energy markets and regulatory policy are increasingly influencing those in Britain. We welcome Ofgem’s involvement with European regulatory bodies and agree with Ofgem’s policy to promote liberalised competitive markets. In this respect, the development of European gas markets will be particularly important, as discussed above. We also hope that Ofgem can protect the open, British markets from intrusive regulation targeted at less competitive European markets.

Transmission issues are also significant in the European arena and we appreciate that this might be another force for change in relation to transmission charging structures. We are not against some degree of harmonisation in this area, subject to the comments made in our covering letter on the pace of change.

Environment

We suggested in our response to last year’s corporate plan that Ofgem might like to consider setting their own environmental objectives and, to that end, we provided a copy of SSE’s targets for 2004/05. Our own targets for 2005/06 have not yet been finalised, but will be published as part of our environmental annual report in due course.

In relation to costs, we note the significant increase in the budget allocated to this regulatory theme. We see no justification for this, even allowing for some more work associated with a planned review of the Renewables Obligation in 2005.

Fuel Poverty

Ofgem has specific duties in relation to tackling fuel poverty and we also recognise that there is a role for the energy industry to play. SSE has been proactive in coming forward with innovative approaches to the treatment of vulnerable customers and will continue to make efforts in this area. We do feel, however, that the energy industry cannot be expected to have a significant impact in this area if it is working in isolation. Coordinated action by government is also required, for example in the interaction between energy billing and benefit schemes.

We are also somewhat concerned that Ofgem's own costs are budgeted to increase by 50% in this area, as there has been no case made that previous levels were inadequate for the level of projects and workload that Ofgem has been undertaking in this area.

Ofgem's Efficiency and Effectiveness

We welcome Ofgem's moves towards a greater emphasis on cost reduction with the introduction of the RPI-X mechanism and also to the development of the performance indicators set out in Appendix 2. We note that, as indicated in last year's plan, Ofgem's performance and updated targets have been made available on the website in the corporate planning area of work and we welcome this transparency. However, we consider that the overall transparency of Ofgem's planning process could be significantly improved in a number of areas and discuss these in turn below, followed by some specific comments on other issues relating to this chapter of the document.

Transparency of Resourcing

One of our major comments on Ofgem's proposed corporate plan for 2004/05 was that the list of stated deliverables was very far from a complete picture of how Ofgem planned to use its resources. In that year's plan Ofgem had listed 34 deliverables, some of which took the form "publish final proposals/consultation paper/report on … ". In the event, for the calendar year 2004, Ofgem published 290 documents, more than 8 times the number of deliverables. It is worth noting that for the financial year 2004/05 to date, the number of documents published has also been about 290, illustrating the continuing pace of regulatory reform. While some of the published documents would no doubt be reacting to external events and unforeseen circumstances, this discrepancy illustrates the point that a lot more is being done by Ofgem's resources than is reflected in the deliverables which are set out in the current format of the corporate plan.

In our view, it should be possible for Ofgem to establish and report, in corporate planning documents, on the major projects planned within each regulatory theme, particularly for the major themes of markets and monopolies. For these "projects" and also for the other regulatory themes, it should be possible for Ofgem to set out staff numbers, costs and the likely deliverables over the period of the corporate plan. A starting point might be the list of work areas that Ofgem uses as an index on its website. This, together with a stable classification of work activities and the information on trends across different years discussed below, would allow interested parties to observe and comment on changes in the emphasis of Ofgem's work from year to year. Ofgem could themselves provide a commentary in corporate plan documents about how, in outturn, priorities might have had to change in a particular year and the knock-on effect of this on future plans.

Transparency in the Presentation of Budget Information over Time

In earlier corporate plan documents, Ofgem has provided budget cost figures for different strands of work for the projected three years of the period of the plan. This approach was suspended for the 2004-07 plan period, due to the fact that the introduction of an "RPI-X" cost control mechanism was planned but the necessary analysis had not been carried out in order to finalise the mechanism. Now that Ofgem has announced its RPI-3 budget cap to apply for the five years from April 2005, it would be useful to be able to see budgets presented for those five years of the current plan period.

On a related point, we assume that the final corporate plan will provide a final report against deliverables for 2004/05 plus statistics on support functions, staff, accommodation and contractors. These appeared in both the draft and final corporate plans last year but are not included in the consultation document on this occasion.

Transparency in the Application of RPI-X

It would also be useful for Ofgem to provide a commentary on the various adjustments that are made in order to apply the RPI-X control. It is disappointing to note, for example, that costs to licence fee payers will see a significant rise in nominal terms between 2004/05 and 2005/06 when the headline expectation would have been for no change in nominal terms. This seems to be largely due to the pension uplift adjustment and it would be useful for licence fee payers to know what other factors, apart from RPI and X, might influence actual licence fee costs from year to year going forward.

Other Points

At paragraph 9.5, Ofgem discusses the "safety net" whereby it can seek additional budget, above the RPI-X allowance in some circumstances. This has obvious parallels with the uncertainty mechanism developed in the recent electricity distribution price control. However, we are not clear why a contingency figure (which has increased from £0.5m to £2m) is still a feature of Ofgem's budget as "contingency" amounts are generally removed during price control reviews.

It is acknowledged in the following two paragraphs that some respondents have commented that Ofgem should prioritise its workload in order to reduce the indirect burden of its work on the industry. This has been one of our own themes in previous responses. While proper consultation is an indispensable part of good regulatory process, the consultations issued do represent direct as well as indirect costs for industry since the staff time required to produce and process consultations adds to the direct resources Ofgem needs. We believe that Ofgem should actively monitor and manage the volume of consultations it produces, and seek to minimise the number that are open at any one time. Consideration should be given to deferring some areas of work. We have given some examples of these in earlier sections of this response, but it is difficult to comment more fully due to the transparency issue discussed above.

With regard to the deliverables noted under this regulatory theme, we welcome the intention to launch an electronic public register and hope that this might lead to further website developments such as the maintenance by Ofgem of electronic licences. We are also interested in the proposed establishment of a Scottish Energy Regulation Forum and look forward to further details on what it is hoped that this will achieve.