

30th September 2005

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Dear Andy

OFGEM'S FIVE YEAR STRATEGY 2006-11

British Energy welcomes the opportunity to contribute to the development of Ofgem's next five year corporate strategy as set out in the consultation dated 12th August 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 is to develop an energy regulatory 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). 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 specific questions set down within the consultation letter.

Energy Policy

Energy policy is the responsibility of Government and the Prime Minister indicated on 26th September that a review of energy policy will be conducted by Government in the New Year. British Energy considers a review of energy policy is timely. There are significant policy issues that need to be addressed by Government in order to facilitate the operation of a transparent and properly functioning market that provides appropriate signals to new entrants and existing players on investment time-scales.

Although at this stage the scope and implications of any review are uncertain it is likely that Ofgem will have a pivotal role to play in assisting the Government during any policy review. We would urge Ofgem to ensure that the Government review includes matters such as security of supply, fuel mix, market structure and the plethora of environmental initiatives. It is only when these issues are tackled appropriately and coherently can the interests of consumers be fully protected. Consequently, we consider this to be one of the key priority areas of work that will need to be tackled by Ofgem and as such Ofgem's next five year strategy will need to reflect this challenge.

Market Structure

We have long advocated an open and comprehensive review of the issues surrounding vertical integration, 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. Evidence suggests that the trend of increasing VI is having a distorting effect on competition in both generation and supply markets.

Firstly, the internal contracting by VI players is inhibiting the ability of the wholesale market to function properly. This is evidenced by continued liquidity problems and the absence of effective paper derivative markets and limited pure trader activity. As a result, the wholesale generation market has effectively been reduced to the role of a secondary balancing mechanism where trading is increasingly 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. These factors, combined with the continued absence of any meaningful traded derivatives market, make it hard for independent power producers or suppliers to trade their output or requirements and manage market risk compared to the VI entities. It also leads to a lack of confidence that wholesale prices are reflective of underlying market fundamentals.

Secondly, a consequence of the vertically integrated and illiquid nature of the market is that it will increasingly foreclose the market to new entrants. This is because new entrant suppliers will find it difficult to source the power they need on a competitive basis to enter and compete in the retail market and new entrant generators will be unable to secure the longer term 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 well into the future. It is clear that NETA is in danger of failing in both respects – the traded market is stagnant with little prospect of liquidity, especially in longer term contracts, improving and market participants are exiting rather than entering the market.

Similar concerns to those expressed above were made by Stephen Littlechild in a recent publication entitled "Smaller Suppliers in the UK Domestic Electricity Market: Experience, Concerns and Policy Recommendations" dated 29 June 2005. In particular, one recommendation of the report called for Ofgem to give substantial weight to the potential effects on liquidity and competition when appraising and advising on any potential merger/or take-over. We fully support this recommendation particularly within the current environment where there is speculation over further significant take-overs within the GB electricity market.

Transmission Charging

We consider that one of the major priorities for Ofgem to tackle during the early period of the next five year corporate strategy should be to create a more stable regulatory environment in respect of transmission charging arrangements. Our concerns in this respect are twofold.

Firstly, we have been critical of the process adopted by Ofgem in the recent GB transmission charging review. We consider that when significant regulatory proposals are taken forward, it is essential that Ofgem recognise the need for sufficient lead times to allow market participants to factor in the change. For example, suppliers require sufficient notice of any significant changes to their costs in order that such changes can be reflected in the preparation of customers offers. Decisions on proposals that have a material impact (and in particular the visibility of final values) need to be confirmed sufficiently ahead of implementation to achieve this.

Secondly, we are disappointed that Ofgem appear to have adopted a policy of seeking fundamental reviews of transmission charging arrangements on an annual basis. This continual review process is particularly damaging to market confidence and does little to improve the perception of market/regulatory risk over the longer term which ultimately is detrimental to the interests of consumers. Therefore in the absence of any significant flaws in the charging framework implemented on completion of the existing review we consider there to be a real need to draw a line under the current review process and introduce some stability and certainty into the transmission charging regime. A possible solution could be to link the timing of charging reviews with that of transmission price control reviews.

Governance

We are pleased to note that Ofgem has made some significant improvements to its governance arrangements over the past two years, most noticeably with the adoption of regulatory impact assessments (RIAs) for significant regulatory decisions, the publication of Authority meeting minutes, the development of an electronic public register and generally more openness and direct interaction with industry participants. All of these developments are welcome and go some way to achieving that aim of more transparency and accountability in the regulatory process.

However, we would urge Ofgem to continue to strive to do more in this area with a view to operating, wherever possible, in accordance with regulatory best practice. One area in which we consider there is scope for further improvements is in the production of RIAs. We consider there is a need for significant improvement in the quality of the regulatory impact assessments produced by Ofgem as some previous examples have failed to stand up to critical scrutiny and therefore achieve the improvements these are designed to bring to the regulatory process. We note that Ofgem has conducted a review and produced revised guidelines on the production of RIAs and we hope this will lead to greatly improved assessments produced by Ofgem.

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. For example, Ofgem needs to consider carefully the compatibility and consistency of the GB trading and transmission arrangements with those in the developing EU energy markets. 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.

Network Investment

A major challenge for Ofgem within the short to medium term will be the price control review for electricity and gas transmission. This will be a major task for Ofgem as for the first time all electricity and gas transmission issues will be considered together under one single review. The treatment of uncertainty surrounding the levels of investment that will be required during the control period, particularly that relating to the accommodation of a potentially substantial growth in renewable generation is, in our view, the key challenge to be addressed under the review. The latter in particular has substantial implications for the capital expenditure plans of NGC given the uncertainty of the volume, timing and location of such generating capacity. During the review it is essential that Ofgem are in a position to subject any investment proposals to transparent and rigorous regulatory scrutiny.

Metering

We are of the opinion that it would be timely for Government/Ofgem to conduct a full review into the issue of 'smart' metering. The cost of metering technology continues to fall and there is increasing evidence that the installation of smart metering has the potential to deliver real benefits for customers. These include improvements in energy efficiency, reductions in metering service costs, scope for competition and the accuracy of meter readings and the knock on benefits to settlement systems.

Furthermore, we are concerned at the way in which competition in metering services is evolving and in particular the withdrawal of many incumbents in providing metering services to independent suppliers. The introduction of smart metering has the potential to remove such concerns. Consequently, we consider it appropriate to conduct a full review of the costs and benefits of 'smart' metering and evaluate the most appropriate way of encouraging or obliging the widespread take up of such technology.

Clearly, there are some significant barriers that would need to be evaluated, such as the needed investment and meter ownership/stranded assets. On this latter point, Ofgem should review the meter ownership arrangements and explore the possibility of transferring ownership to the distribution network operators.

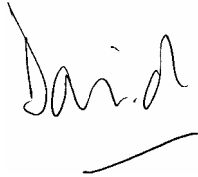
Review of Licence Obligations

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 occurred during the introduction of NETA, Standard Licences 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 for 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 proper functioning competitive markets and such a review would go some way to demonstrating the adoption of such a policy. Consequently,

we welcome the current review of electricity and gas supply licences and would urge Ofgem to conduct reviews of other licence types on completion of the current review.

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". The signature is written in a cursive style with a long horizontal flourish underneath the name.

David Love
Head of Regulation

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