



taking care of the essentials

Ofgem's Five Year Strategy 2006 - 2011

A Centrica response

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1 INTRODUCTION

Centrica welcomes the opportunity to contribute to the development of Ofgem's future corporate strategy. As an active market participant, we have a keen interest in the development of the strategy and the interplay among energy, social, environmental, and competition policy in Great Britain and the EU.

We broadly support the issues identified by Ofgem in its letter: improving consultation processes, a greater emphasis on European affairs, the supply licence review, and ensuring appropriate network regulation.

Our response covers the following issues: European affairs, security of supply, network investment, environmental matters, social policy, technology, and streamlining regulation. With respect to each of these issues, the response sets out: a) the key challenges that, in our view, face the industry in the short and medium term, and b) the actions that, in our view, the Authority should consider taking to address these challenges.

2 EUROPEAN AFFAIRS

Centrica supports Ofgem's strengthened focus on European markets. Those markets are increasingly important to the UK energy industry and to the Authority's strategy in a number of areas. Firstly, as the UK becomes a net importer of gas, interconnections with Continental Europe and access to trans-European networks are key issues to be considered in the context of security of supply. As imports are sourced from markets ever further afield, Ofgem should also consider how it addresses the operation of the market not only in a European context but also on a global basis. Secondly, the lack of effective gas market liberalisation on the Continent is contributing to upward pressure on the level of wholesale gas prices in Great Britain. For these reasons we support Ofgem's ongoing engagement in discussions and deliberations regarding the pace and direction of market reform within Europe.

We wish to highlight several areas of particular importance:

- In our view Ofgem plays an important role within CEER/ERGEG. We expect those organisations to be of growing importance in developing consistent EU-wide approaches to the implementation of EU Directives and Regulations, and to the compliance with Guidelines. Ofgem's experience with the liberalisation of energy markets in Great Britain and the supporting institutional and contractual arrangements will be invaluable to this process.
- As Great Britain becomes more interconnected with the Continental market, the need for better and clearer cross-border regulatory co-operation increases. This is especially true, as regards those Continental European markets (e.g. France, Belgium, Netherlands) with which Britain is physically connected.

We would encourage Ofgem to engage more regularly with GB stakeholders regarding European issues. For instance, our view is that Ofgem would benefit from discussion with such stakeholders regarding ERGEG's agenda and Ofgem's input into ERGEG's deliberations. Input from market participants could equip Ofgem with valuable commercial insight relevant to the particular issues under consideration, which would

enhance its contributions within ERGEG and other fora. This could be through regular discussions with individual stakeholders as well as through hosting regular seminars.

3 SECURITY OF SUPPLY

As Britain becomes more dependent on imported fuels, securing energy supplies becomes an ever higher profile subject. Whilst we do not advocate that Ofgem should engage in any form of integrated resource planning, the impact on security of supply should be considered across a range of regulatory debates. The favoured approach is to maintain regulatory consistency and avoid intervention in the market that might compromise investor confidence.

Maintaining plant margin is crucial for security of electricity supply, and the continuity of regulatory approach is an important component to investments in new and enhanced facilities. For example the implementation of the Emissions Trading Scheme rules could alter decisions about investing in a new generation of CCGT plants. When assessing changes – through impact assessments – Ofgem should consider how it will ensure and monitor that identified benefits are realised, and furthermore how any unexpected costs which may reduce these benefits are addressed and included in future learning.

4 NETWORKS

Within the timeframe covered by the strategic review, the industry will face challenges with respect to both the electricity and gas networks.

With respect to the electricity network, Ofgem has recognised that the increased levels of small scale and embedded generation investment will require changes in the operation and design of the networks. Centrica recommends that any consideration of those changes be broadened to include the network impact of microgrids. Microgrids are small scale networks embedded within larger networks, designed to provide electricity for small communities, such as isolated rural areas, housing estates, business parks or academic campuses. In linking small generators located close to end users, microgrids are reported to have lower operational costs, a reduced environmental impact and greater system reliability.

With respect to the gas network, as Britain becomes a net importer of gas, fundamental investment will also be required. Hitherto the focus has been very much on the long term; the core changes to the industry have now commenced, and thus require attention by Ofgem.

The recent structural change of gas distribution networks sale was expected to benefit customers. Ofgem needs to ensure that the anticipated value is delivered and must be cognizant of any additional costs which may materialise as a result of required industry adjustments.

The development of new gas import infrastructure, both pipelines and LNG, will have a significant impact on the pattern of gas flows within the NTS. That pattern of flows has been relatively stable for many years. Participation in the long term process of acquiring System Entry Capacity has been founded upon the continuance of this stability. Existing charging models are based around the cost of accommodating marginal increments to

existing gas flows and set Unit Cost Allowances and reserve prices on that basis. These models are inherently ill-suited to the significant and dynamic changes which we now face over the period to 2011. Adjusting to these changes in gas flows in the NTS could have a major impact on matters such as access pricing and entry capacity auctions. Moreover, the possible introduction of a parallel regime for exit arrangements would compound the issues to be addressed.

Ofgem should therefore consider the implications of all these elements of change on the market in a holistic manner before deciding on future directions. This should be addressed through an initial review paper identifying all the possible linkages and consequences (including network planning, price controls and incentives for transmission and distribution network operators etc.) before more detailed consultations can be carried out.

5 ENVIRONMENTAL AFFAIRS

A low carbon economy is a key government policy, its goals closely linked to the energy industry. The effect of this policy on existing infrastructure and operational practices needs to be assessed as policy mechanisms themselves are reviewed. These include:

- Offshore electricity transmission networks and connections required for renewable generation investments, and efficient grid reinforcement to ensure the success of the renewables obligation;
- The regulation of distributed generation, including micro CHP and issues such as feed in to local electricity networks;
- The impact on the wholesale electricity market of requested revisions to the emissions trading scheme, e.g. allowances for new plants;
- Regulatory aspects of other potential environmental solutions, e.g. carbon capture and storage and possible new nuclear plants.

There is a need to encourage new generation through equitable treatment for new entrants compared to incumbent in the issue of emissions trading certificates, thereby enabling investment decisions in cleaner CCGT plants and avoiding the continued use of higher carbon emitting coal and oil fired plants. As older stations are closed and decommissioned, the wider implications on plant margin must be balanced with the way in which Ofgem administers environmental policy.

We support the use of market mechanisms to minimise the impact and cost of delivery of environmental policy mechanisms. At the same time we would urge Ofgem to review the administrative burden on companies of proving compliance with environmental programmes, particularly in view of the growing scope and size of these programmes, e.g. the amount of hard copy evidence suppliers were required to furnish in EEC reports. We would encourage Ofgem to attempt to reduce the burden of regulation by streamlining the processes. We suggest that Ofgem could widen the scope of Project Paperless, to assess its potential benefit in a range of existing reporting requirements, and to consider alternatives, e.g. scanned evidence, electronic responses, etc.

In considering future environmental policy mechanisms in the energy market, Ofgem should challenge any significant increases in targets and whether they place a disproportionate burden for delivery on energy market participants compared to other sectors, e.g. transport and in particular aviation.

Ofgem should also avoid undue complexity in balancing the need for the separation or overlapping of schemes in the areas of renewables, carbon emissions, energy efficiency, co-generation, carbon capture and storage, and nuclear energy, challenging demands for grouping mechanisms together simply because they all address a related environmental policy goal.

6 SOCIAL POLICY

On the social agenda, Ofgem's work to support vulnerable customers and the fuel poverty agenda should include more detailed research to explore cross industry solutions thus helping to facilitate the targeting of supplier led initiatives. Indeed, further work in developing a better understanding of the correlation between fuel poverty and vulnerability would greatly benefit suppliers.

7 TECHNOLOGY

We believe that the industry itself is best placed to assess and therefore drive innovation, and we would encourage Ofgem not to directly champion any single technology, but rather allow competitive pressures to make these decisions. There are a number of market based examples where a wholly different outcome may have been the result had government influenced technological innovation, for instance, would the mobile telephony market be as advanced today had regulation set technical standards? In metering technology developments, for example, it is unwise for Ofgem to try and predict what might be the best solutions for the market to adopt, given the increasing pace of change. We suggest that Ofgem should concentrate on enabling technology and ensure that the industry avoids being locked in to a technological solution that might need to be reviewed in only a few years. Ofgem needs to lobby at a European level for market based solutions, and to consider the impact of adjustments required by technological advancements on industry processes, e.g. the impact of automatic meter reading on data flows, or balancing and settlement.

8 STREAMLINING REGULATION

To aid further market development, Ofgem should resist the urge to micromanage and help ensure that industry governance arrangements are effective and efficient, and furthermore allow for progressive deregulation, where complexity and cost can be reduced without adversely affecting competition or consumers. The supply licence review is an example of such an opportunity, where Ofgem's role can be transformed from that of an active regulator to a monitor of markets and competition.

Improvements in regulation can also result from giving greater consideration to the degree of prioritisation, improving the use of Regulatory Impact Assessments, considering the connections between overlapping issues, and giving due consideration to the results of phased consultations. Revising the priority given to less important issues, would allow Ofgem to improve its performance to targets, and hence enable market participants to manage their resources more successfully.

In its March 2005 report that Better Regulation Taskforce stated that the total cost of regulation across all sectors was equivalent to ca. 10% of GDP. Thus a reduction of 10% in

the administrative cost to industry could improve GDP by 1% in the medium term. In setting out its strategy, Ofgem should outline the steps it shall take to reduce the burden of regulation on the energy industry and its customers. More regular publication of Ofgem's Deliverables and Performance Indicators would also improve the transparency of Ofgem's achievement of its performance targets.

We would welcome the opportunity to discuss any of the issues addressed in this letter in more detail, and look forward to continue working with Ofgem in the development of its future strategy.

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