



Andy MacFaul  
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4 October 2005

Dear Andy

### **Ofgem's Five Year Strategy 2006-2011**

The Energy Networks Association (ENA) is the trade body that represents gas and electricity transmission and distribution companies in the UK. We welcome the opportunity to contribute to the development of Ofgem's next five year corporate strategy to 2011.

This letter sets out ENA's views on the appropriate priorities for Ofgem in the light of the challenges facing the industry over the next five years and beyond. ENA's comments are confined to those themes which will directly impact on the energy networks sector, in particular those relating to the regulation of network monopolies.

We acknowledge Ofgem's continuing commitment to consult widely on its future work programme and recognise the progress that has been made in terms of both its internal organisation and in its relationship with the network companies, which was particularly evident during the recent regulatory review of the distribution network operators. We therefore look forward to contributing constructively to the development of Ofgem's five year strategy over the next few months.

#### **1. KEY CHALLENGES THE INDUSTRY FACES IN THE SHORT TO MEDIUM TERM**

The Government's review of energy policy will have profound implications for the energy networks industry in ensuring long term supply security and supporting the expected growth in renewable generation arising from the Government's environmental objectives.

***well connected***

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Changes to the energy environment brought about by new sources of energy supply allied to the increasing need to replace substantial parts of the nation's energy network infrastructure will present the energy network industry with a number of important challenges. Climate change itself may also have implications for the construction of networks.

All of these developments will impact upon the commercial operation of the network companies. It will be necessary for Ofgem to ensure that the regulatory framework in which the companies will be operating is adapted to this changing environment, providing clarity and transparency to ensure that they continue to deliver what their customers want at a price that they are willing to pay.

A further challenge facing the industry is the increasing influence of new European legislation and Ofgem can play an important role in influencing developments and policies emanating from Brussels and minimising any unnecessary burden on the energy industries of the UK arising from new European legislation. Ofgem can also play a part in lobbying at the European level to ensure markets are opened to competition. As you know ENA has already set up a committee with both DTI and Ofgem membership which is very successfully working together to influence policy within Europe.

## **2. ACTION OFGEM SHOULD TAKE TO RESPOND TO THESE CHALLENGES**

ENA believes that an important role for Ofgem is to ensure consistency between Government and Ofgem initiatives. Ofgem has an influential role in advising Government on the practical implications of policy proposals, as well as in developing the more specific incentives that should ensure delivery of these objectives.

### **2.1 Price Review Timetable**

A feature of the period to 2010 is the three price control reviews that Ofgem will be undertaking. In conducting these reviews it will be important that Ofgem establishes some key regulatory principles at an early stage of the process to ensure consistency throughout. This will do much to enhance both the predictability and stability of the regulatory environment into the longer term and hence provide a business environment responsive to the investment needs of the industry.



## **2.2 Development of Renewable / Distributed Generation**

The development of renewable and distributed generation will form an important background to these reviews. Ofgem has already addressed DNO incentives to connect distributed generation in DPCR4 and will need to consider the related matter of transmission upgrades in the current TPCR. NGC's TSO control has already had to be adapted to reflect the increasing uncertainty about future levels of investment due to the increase in renewable generation, and DTI/Ofgem are now consulting on the future regulation of Off-shore transmission. As new generation continues to be developed, operating practices will also change and the output required from DNOs may be transformed from passively facilitating the supply of electricity from the Grid to final consumers to active system operators managing power flows across their networks. The increasing penetration of micro-CHP will also bring fresh challenges.

## **2.3 Incentives for Investment**

Ofgem has characterised the next five years as a period when the emphasis will shift away from squeezing further savings from operating expenditures towards the increasing need for investment to replace the existing networks and to support new energy supply sources.

Companies require a stable and predictable business environment which encourages investment into the sector. In this context, the levels set for the companies' WACC in the forthcoming reviews will be very important. The process for determining the WACCs must be transparent and the mechanisms used consistent. It will not be satisfactory for Ofgem to wait until the very end of the review process, as occurred at DPCR4, to set the WACC at future reviews.

In both the transmission (and subsequent distribution) reviews the mechanism for encouraging the right level of investment will be a key feature. Ofgem has indicated a desire to move to a more market related approach to determining investment in the electricity network industries, similar to that used in the gas industry. However, the ENA believes that it is essential to allow the changes within the gas industry to settle down and be proven to be effective before any such change is considered for electricity.

Finally, throughout all of the forthcoming reviews, it is to be hoped that Ofgem heeds the constructive suggestions made by stakeholders in its own consultation on the DPCR4 process. One example is the need for greater involvement of Ofgem's technical team during price control capex assessments and hence a reduced reliance on external consultants.



## **2.4 Customer Aspirations**

A key question for the future development of networks is the extent to which customers will be prepared to pay for improvements to their quality of service and how these aspirations will be satisfied within the evolving regulatory framework. It will be important that Ofgem continues to canvass the views of customers in this regard to ensure that the companies have clear incentives to invest to deliver the appropriate quality of service. The current incentive and penalty regime however does not necessarily address the question of the long term integrity of the networks (security of supply) and much work is required to establish the key drivers of long term network performance.

## **2.5 Market Governance**

If Ofgem is intent on implementing significant change to the governance of the electricity distribution commercial arrangements, it will be essential to ensure that such reforms are implemented in a realistic timescale with the full involvement and support of the industry.

Also, ENA is aware of an unprecedented level of modifications to the new Unified Network Code (UNC) in the gas market. Whilst some of these modifications will be consequential to changes in documents that are not subject to UNC governance, all have a commercial impact on the market. It is difficult to avoid the impression that many changes are being rushed through without the safeguard of due and thorough consideration by market participants. In this area, the ENA would urge Ofgem to work with the industry in reviewing the level of modifications currently being progressed through the governance structure and to consider restricting the volume of change that can be considered within the same timeframe.

## **3. PRIORITY AREAS OF WORK**

While many of the issues mentioned above are broadly addressed in Ofgem's existing corporate plan there is a need for Ofgem to prioritise them in any future work programme for the regulation of the energy networks industry. It will also be important in this plan for Ofgem to extend the work programmes and key deliverables for the full five years rather than just for year one, in order to provide clarity about its long term objectives.



In summary ENA believes that Ofgem's overriding driver should be the promotion of a stable, transparent and predictable regulatory framework. In this context, it should:

- Ensure that the forthcoming reviews of the gas and electricity transmission and distribution companies are consistent, based upon sound and agreed regulatory principles, and are flexible enough to adapt to a rapidly changing energy environment.
- Create a regulatory and commercial climate in which the necessary network investment is forthcoming and the rewards to both investors and customers are in both their long term interests.
- Withdraw from areas where regulation is no longer needed and minimise the impact on companies of the increasing legislative burden.
- Set out its key priorities over the five year plan period.

I hope you find our comments helpful.

Yours sincerely

A handwritten signature in black ink that reads 'Andy'. The signature is written in a cursive style and is underlined with a single horizontal stroke.

Andy Phelps  
Head of Regulation