

11 October 2005

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Sir John Mogg
Chair
OFGEM
9 Millbank
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Dear Sir John

Ofgem Corporate Strategy

I welcome the opportunity to respond to your consultation on Ofgem's Corporate Strategy. energywatch supports the broad thrust of Ofgem's approach in remaining focused on those activities that will deliver the greatest benefits to consumers and we have fleshed out, in quite some detail, our thoughts on the document. I hope your staff find these comments useful.

Currently, our key concern is the level of gas and electricity prices in the UK. The current price levels are detrimental to Ofgem's goal of reducing fuel poverty and also have a negative impact on the competitiveness of industrial and commercial consumers. All groups of consumers would benefit from reduced prices and Ofgem's key goal should be to promote market conditions that lead to prices which are more cost reflective. It is our contention that current prices bear little or no relation to those which consumers would obtain in a genuinely competitive market. With this in mind, energywatch believes that Ofgem's strategy should make market monitoring and assessments of any further market concentration a key function.

I have outlined below energywatch's priorities for Ofgem's corporate strategy. Generally we would like to see actions for the coming year set out more clearly so that Ofgem's achievements can be better judged and so all stakeholders will be well placed to understand the regulatory framework. Consumers want to know what Ofgem expects its strategy to deliver to them.

energywatch has concerns about the impact of vertical integration on the level of competition in both wholesale and retail markets. We fully support market monitoring, but this activity should also be used to inform the regulatory agenda.

Ofgem should consider sharing more widely the information it gathers - for example, data relating to electricity supply interruptions, levels of gas interruptions by region, licence breaches, etc. Although this data is available from other sources it would be easier for consumers to find if it were placed on one website with reliable data.

Industry Concentration

When looking at any further industry consolidation energywatch believes that Ofgem should be prepared to speak forcefully against any transaction which may result in a substantial lessening in competition. Any further lessening in competition will be detrimental to consumers. There have been few new market entrants in either the electricity or gas markets. This suggests to energywatch that there remain significant barriers to entry. Ofgem must consider in all its policies what the impact on new entrants may be and how barriers to entry can be removed. For example, following recent changes to the credit rules under the UNC and BSC Ofgem should monitor what impact the rules are having on costs, ultimately borne by consumers. The present costs of providing credit are a barrier to entry which could be removed without increasing costs to consumers. It is essential that Ofgem addresses issues such as this when considering its policies.

energywatch continues to have concerns about the systems and processes that sit at the heart of the electricity supply market. We are keeping in touch with Elexon on the review of the PAF and considering other changes that could be instigated. energywatch also has concerns about the lack of regulation or competition in the provision of meters and meter services, both of which are vital to the achievement of effective competition in supply. We would like to see Ofgem tackle some of these issues in the short to medium term. In its response to the Super Complaint Ofgem indicated it would consider a framework for examining how the newly competitive metering market in both gas and electricity is developing. We would welcome further action on this.

In terms of changes to the various “code” rules, energywatch believes that Ofgem must continue to ensure that any changes to the industry codes are beneficial to consumers. In particular energywatch believes that Ofgem must make sure that the enduring gas exit capacity arrangements are supported by consumers. As Ofgem is aware, we have raised our own modification to the UNC and we are considering other code changes that we believe to be in the best interests of consumers.

energywatch raised modification 006 to the Network Code to increase information about gas flows, in part as a response to Ofgem’s last corporate strategy document. It is unfortunate that the Authority has postponed a decision on this modification until next year. Ofgem should keep information provision high on its agenda as energywatch believes that transparency is vital to securing effective competition to the benefit of

consumers. It is equally vital that consumer interests are placed at the centre of all actions so Ofgem should work with the DTI to try and improve information flows from the offshore market. The increasing unreliability of gas fields and growing imports makes information more important in delivering secure supplies at economic prices.

Retail Markets

energywatch, via its Super Complaint, has raised with Ofgem its ongoing concerns about the lack of effective competition in the energy supply markets and the billing issues that consumers face as a result of persistent poor service. While we note Ofgem's response to our Super Complaint, energywatch remains of the view that consumers are suffering material detriment and that billing errors remain higher than consumers should reasonably expect. Given the way that technology allows financial institutions to track daily transactions across the world it must be possible for energy companies to send accurate quarterly bills.

Better billing is high on energywatch's work plan and we would like to see Ofgem playing a more active role in improving the service consumers receive possibly be addressed during the supply licence review. The work energywatch has been doing with the BSI on utility billing may help to inform the regulatory framework in this area, but we would like to see Ofgem act on persistent complaints about billing in terms of service standards on both content and timing of bills. There are still real concerns over the quality of customer and metering data held by suppliers, which we believe is a major root cause of many billing problems. We encourage Ofgem to act on this.

We fully support Ofgem's review of supply licences and the backstop billing proposal. However, Ofgem must be ready to make wider market changes (such as licence changes on other players) in order to deliver a better market to consumers. energywatch will take a full and active role in the licence review process and hope that we can help Ofgem get the best value for consumers out of this significant piece of work. We would ask that Ofgem try to run the consultation and development process in such a way as to maximise input from consumers.

energywatch also expects the industry, with Ofgem's help, to work towards better performance of the non-half hourly electricity market. It is difficult for non-experts to contribute specifically to some of these developments, still we remain extremely concerned by the complexity of the market and the performance of some parties to SVA arrangements. While altering the licence regime may address some issues, energywatch would like to see Ofgem undertake a wider review of the market to see if it is time to make more fundamental changes (more timely cash-out for example). There is a balance to be struck between trying to correctly allocate energy flows and the costs and barriers created by the complexity of the allocation processes. In addition, we note

that a shorter settlement period would reduce the overall cost of credit in the settlement arrangements.

Ofgem will be aware that energywatch has recently published a paper on “smart” metering. energywatch believes that the market for meters and metering services is not competitive, is creating a barrier to market entry and is failing to deliver the metering required to address the billing and energy management requirements of the future. This is an ideal time for Ofgem to press suppliers to improve performance on bills issued against actual reads (manual meter reads). This would have the double benefit of improving billing and making the economics of smart metering easier to cost justify. We hope that some of these issues may be addressed during the supply licence review, but Ofgem must make sure that it monitors closely the availability of meters and meter services to all suppliers and ultimately consumers. energywatch has raised with Ofgem this year our objection to the separation of National Grid’s gas metering business. Without intervention, which we believe is necessary, Ofgem will have no choice but to regulate the provision of meters through distribution licences and we will be looking to see the protection of consumers’ interests extended under the next DN price controls.

Network Regulation

The sale of some of the gas networks raised concerns for energywatch particularly in terms of the benefits for consumers. “Benefit sharing” should be the goal and energywatch looks to Ofgem to ensure this is the case. energywatch feels Ofgem has worked hard to increase consistency, align controls and continue to push for efficiency gains. We recognise that there are challenges ahead, notably in relation to the development of new generation technologies and associated distribution networks. energywatch also sees opportunities from the DN sales to deliver greater benefits to consumers from these service providers via the price control process.

energywatch’s key concern in relation to future price controls is that Ofgem does not introduce too many complex incentives. Incentives on some activities appear to offer extra revenue to monopolies for undertaking functions we believe are their responsibility and their core business. For example we are concerned by the SO incentives as these may lead NGET and NGGT to taking balancing actions in such a way that they may distort the market. energywatch has been made aware that some participants have concerns about Transco taking large trades late in the day. It is not clear to us how Ofgem can audit the operation of these incentives and their complexity and interaction with the codes and licences makes them difficult to change. Greater transparency about how the incentives are set would be welcome in order to allay some of our concerns in this area.

Standards of service are a good way to ensure that consumers benefit from increased services. energywatch fully supports Ofgem in seeking to extend services and to make standards higher, notably where those service levels directly impact consumers. We would like to see the impact of incentives on service standards closely monitored to ensure that performance is improving.

While we appreciate Ofgem's attempts to offer longer term investment signals to monopolies, energywatch does not feel that there is evidence that the long term auctions in gas have delivered any meaningful signals to Transco. Consumers need to be reassured that Transco is still investing to meet a 1 in 20 winter, basing its investments on its relatively robust planning process. Recent modifications relating to the QSEC auctions and the review of UCAs makes the capacity market look unstable. Equally, the underlying framework seems to rely on Ofgem signing off investment, a job for which they do not seem well qualified. Signals may have a role to play in informing investments, but the main responsibility should lie with the network operators who are the only ones who really know their systems and their business interests rely on them facilitating energy throughput.

Finally, Ofgem and the DTI must be cautious about the way they accommodate the growth in renewables, notably offshore wind farms, and Ofgem must not be seen to favour one specific technology. Further, if the government wishes to provide additional support for renewable generation, including its connection costs, this should be funded via tax payers not electricity consumers. Subsidies from consumers will mean some of the poorest in society pay proportionally more which cannot be in line with policy to reduce fuel poverty.

Security of Supply

Much has been discussed about the low level of gas stored in the run up to winter and Ofgem must recognise and address falling consumer confidence in this area. energywatch like Ofgem is encouraged by the new investment that has been occurring to deliver gas to the UK in the coming years. We also note the announcements with regard to new generation build and hope that new storage facilities will also be developed. Ofgem should continue to ensure that barriers to entry are minimised and that the regulatory regime is stable and predictable.

Gas Quality

A future issue which will face consumers is the gas quality changes. We very much support the DTI's work in this area, but Ofgem is aware of the time that the market takes to implement any significant changes and we would therefore urge Ofgem to push the DTI towards timely changes where they are needed. energywatch is particularly concerned that changes to appliances will need to be coordinated well in advance and that the poorest consumers will be extremely vulnerable if changes are not correctly phased in.

Europe

energywatch appreciates that liberalisation of European markets will help secure supplies for the UK in the future. The Commission's energy market investigation is important and energywatch would ask Ofgem to try and get the Commission to focus on vertical integration, third party access to transmission and storage and long term contracts.

Environment

Ofgem's role on environmental issues is shaped by its duties and the lead roles of other departments, notably DEFRA and the Environment Agency. One area where energywatch feels Ofgem could make a greater contribution is in making suppliers provide more detail on environmental issues, such as clearer environmental tariffs, the proportion of green energy on each bill, advice on energy efficiency, etc.

energywatch believes that consumers would be better able to manage their consumption with better information. We therefore believe that work on environmental issues should go hand in hand with better billing and a move towards smart meters. Should persuasion fail, there may be a need to provide more licence obligations on suppliers to inform customers more about their energy use and ways to reduce bills. Such messages, combined with rising fuel costs, may lead to a greater take up of efficiency investments in the short term.

Fuel Poverty

For energywatch, priority consumers remain a key concern. The rises in energy prices, and increasing debt, may lead to more disconnections. Ofgem must continue to monitor the performance of companies under the debt and disconnection guidelines, which we believe provides some valuable protection to the poorest consumers. Suppliers need to come forward with more functional indicators of vulnerability and put in place robust processes to protect these consumers.

energywatch would also like to see Ofgem remove suppliers' rights to block customer transfers for reasons of outstanding debt to enable people to seek out the best deals. Price increases may prompt consumers to try and switch suppliers and it is vital that when they try to use the competitive market they can achieve a timely and hassle free transfer to the supplier of their choice. energywatch is willing to work with Ofgem to encourage suppliers to offer more "social" tariffs and ensure that suppliers offer vulnerable consumers advice on more efficient use of energy.

energywatch also believes that more robust processes need to be developed by suppliers and distribution companies to identify the most vulnerable consumers and ensure that they are not disconnected, especially during the winter months. A central

record of such consumers, updated by suppliers, may form a useful tool to ensure that all parties in the supply chain are aware of priority customers and offer them appropriate services. It is essential that those on this central record are classified in order of priority so that the needs of the most vulnerable are met at the appropriate time. The Priority Services Register should also be extended to offer help with energy efficiency improvements.

Ofgem's Efficiency

energywatch welcomes Ofgem's commitment to better regulation. To this end we suggest that Ofgem tries to keep its consultation documents shorter to help consumers better participate in the regulatory debate. Less consultation may not be a good thing if it results in regulatory uncertainty, but short focused documents would be helpful. We would also hope that Ofgem can attract more staff with private sector experience to allay concerns that economic theory is sometimes promoted at the expense of pragmatic business solutions. Ofgem must keep sight of the fact that they are experts, but many of the consumers they seek to help are not, nor should they need to be.

Ofgem should also try not to let regulatory decisions end up with last minute changes. energywatch was particularly concerned that the decisions on transmission charges under BETTA were left so late in the process. Such last minute regulatory decisions will lead suppliers to put a risk premium into consumers' bills to manage their exposure to monopoly prices. The regulated section of the market should offer stability against the volatility associated with energy not add to it.

Business consumers

We note there is no specific section within the strategy for dealing with business consumers. Below we outline the areas we feel should be included:

- Give serious consideration to the lack of competitiveness in the business market – views on this are well documented – and carry out a full review with a commitment to act upon its conclusions
- Recognise the lack of protections and service provided to small businesses by suppliers and be prepared to reinforce regulation in these area – the review of the supply licence is concentrating on the domestic market so small business consumers will not be included.
- Address the need for uniform, comparable measures of service provided by suppliers (to business consumers) which would then enable business consumers to compare performance and make decisions on factors other than price. This is essential if business are to have a realistic possibility of influencing the market by selecting suppliers on the basis of overall quality.

I hope these comments are helpful in setting your strategy. If you do have any comments or questions on detail please do not hesitate to contact Carole Pitkeathley, energywatch Head of Regulatory Affairs, on 0191 2212072

Yours sincerely

A handwritten signature in black ink, appearing to read 'Ed Gallagher', with a long horizontal stroke extending from the bottom of the signature.

ED GALLAGHER
Chair