

Consultation on Ofgem's Five Year Strategy 2006-11

Comments by E.ON UK

Ofgem's priorities

1 We welcome this opportunity to comment on Ofgem's five year strategy. The commitment to full consultation throughout the strategy review process is an important contribution to understanding how the Authority intends to interpret its statutory duties.

2 We welcome Ofgem's adoption of a self imposed price control. The past year has seen completion by Ofgem of a number of substantial projects and several more are still ongoing. We believe that, if the price control model is successful, Ofgem should increasingly direct its resources at its "core competences" (e.g. network price controls) and ensuring it is properly equipped to carry them out. For example, conducting more internal analysis of DNOs, instead of employing external consultants, will help to increase Ofgem's expertise, ensure the right skills are developed and retained within Ofgem, and help prepare Ofgem to undertake DR5.

3 We hope that the need to establish priorities under its new price control will encourage Ofgem to offer a transparent and robust justification of projects against its statutory objectives and the broader framework of facilitating Government energy policy. It should also discourage projects which, while theoretically attractive, in practice create unnecessary implementation costs and complexities for the industry, for minimal benefit to the consumer. A key example of this is Ofgem's approach to reforming the gas exit arrangements as part of the DN sales process.

4 We welcome the significant progress on the 'Better Regulation' agenda (e.g. publishing of GEMA minutes and extended consultation periods). Initiatives such as 'Project Paperless' should continue to provide a real opportunity for Ofgem to ensure that it engages with all its stakeholders in the most effective and efficient manner. We believe this will require a material change in the way Ofgem conducts its consultation process and have fed these views into the review.

5 The Regulatory Impact Assessment process can be further developed to provide more confidence that these are not ex-post rationalisations of decisions. A particular area for attention is in regulation of DNOs, where a robust regulatory impact assessment is essential before decisions are taken to open up new areas to competition. We welcome the improvements Ofgem has made, but would like to see RIAs carried out much earlier in policy development.

Key industry challenges

6 Substantial industry investment will be required over the next five years and beyond to meet the Government's targets for reducing carbon dioxide emissions and to maintain security and diversity of the UK's fuel supplies. Investment will continue to be needed in networks to maintain reliability and to accommodate an increasing volume of distributed generation. Ofgem has an essential role to play in helping the industry deliver this investment efficiently, by:

- ensuring regulation is transparent, predictable and focussed only on those areas where it can add value for the consumer, both at the UK and EU level;
- ensuring that monopoly regulation is structured to attract the investment required to maintain the robust networks that will support the operation of competitive markets, security of supply and more renewable and other distributed generation;
- arguing for sensible outcomes within the new EU regulatory structures, avoiding unnecessary additional layers of regulation, proper consultation and regulatory impact assessment, and encouraging the Commission to avoid interventionist policies to achieve security of supply or other objectives.

7 Environmental legislation and policy is a major driver behind evolving energy markets. Under the Energy Act 2004, Ofgem has new secondary duties including an obligation to carry out its functions in the manner best calculated to contribute to the achievement of sustainable development. It would be helpful for Ofgem to clarify how it interprets this duty. Ofgem will need to ensure that its approach to economic regulation supports investment to meet long term environmental policy goals.

Innovation

8 An increasingly important role for Ofgem going forward will be helping to create market frameworks that encourage innovation by energy companies in response to policy challenges. Two areas stand out in particular:

Distributed Generation (DG)

Delivery of a simple regulatory framework to facilitate microgeneration and active networks capable of dealing with distributed generation will be important in supporting the government's energy policy. The framework to support DG (of all sizes) must be developed further, with appropriate sustainable incentives to encourage industry players to take action to allow DG to develop. Our response to the Government's consultation on microgeneration highlighted the need for an enduring technical and commercial framework that does not weaken incentives for industry or customers through unnecessary complexity.

Advanced Metering

'Smart metering' is attracting increasing interest from across the industry, and, if approached correctly, has the potential to benefit customers, network operators, suppliers and energy services companies. We believe that the best solution is one that recognises the mass-market element of the technology and the need to facilitate the evolution of a competitive, demand led, approach to stimulating innovation. To underpin this sensible cross-industry working, including involvement of key stakeholders and customers will be essential. The framework that is developed must provide suppliers and energy service companies with a stable environment in which they have incentives to innovate within a competitive market.

European Union Regulation

9 In taking a lead in the development of regional markets, Ofgem should support sensible regulatory outcomes which create the conditions which allow competition to develop further but which are also practicable, avoid unnecessary regulatory risk, and do not disrupt investment. The focus should be on implementing effectively existing EU legislation. Ofgem should encourage the Commission to avoid interventionist approaches which seek to direct investment in generation or networks.

10 At present the impact on the UK of this initiative is uncertain. The implementation of a regional UK-Ireland market will require careful definition and preparation, particularly given that the emerging market arrangements in the Republic of Ireland is diverging from those in Great Britain. It is important that all the affected market players are involved in the process going forward. We therefore welcome the broader approach to the 'mini-fora' outlined at the last Florence Forum and look forward to co-operating with Ofgem on these issues.

Detailed comments - network regulation

Structure of Charges

11 We see value in developing new models for future charging, both in terms of encouraging efficient use of the network and facilitating its future development. This is particularly important at a time when the growth of distributed generation means DNOs' networks are undergoing change from largely passive one-way flow systems, to much more complex systems requiring active management.

12 The Implementation Steering Group has generally agreed that there is a need for change in the charging framework, and that there should be more commonality between DNOs' methodologies, but has produced very little agreement as to what the longer term framework should look like. We hope further clarity will emerge, and that a more detailed set of principles can be agreed. Ofgem should reconsider its plan to relinquish leadership of the project if a timely and focussed approach is to be achieved. The aim in taking this project forward should be to strike a balance between methodologies that are aligned and an environment in which innovation can continue to flourish.

Distribution Governance

13 We support this work, and are active on a number of working groups. We believe this is an important area for the industry, but that to date Ofgem has been a little remote from the work that is being done. There is a danger that, without a clear set of objectives, constraints and timescales, progress may be slow and agreement hard to reach. We believe that in this area, as for the structure of charges review, Ofgem should set out a clear framework for the work, and monitor progress against this.

Detailed comments - competitive markets

14 Ofgem should reduce its involvement in code modification processes, although we recognise Ofgem has a legitimate role in taking action where there are barriers to competition and in arbitrating on issues where the industry cannot reach agreement. Clarification of Ofgem's precise role is needed. Ofgem should not be pursuing projects where the consumer benefits are uncertain, or not properly assessed and where the market is working satisfactorily. Ofgem could also be quicker to drop projects where the feedback from stakeholders is clearly negative.

15 Each of the modification procedures for the various codes is designed to allow users, and in some cases customer group representatives, to bring forward proposals

to deal with issues as they arise. Save for wide-reaching market reforms such as BETTA, changes to market rules should be driven by market participants through the code modification process and not by Ofgem. However, rather than reducing its involvement, Ofgem seems to wish to promote initiatives through its consultation and review processes, rather than rely on users to bring forward modification proposals.

16 Ofgem should avoid promoting its own agenda for market rule changes, through reviews, conditional licence conditions etc. given that such actions may be seen to prejudice or interfere with industry modification procedures and any recommendations made by the Authority as part of such processes. The 'best endeavours' obligation on Transco and buyers to bring forward enduring offtake arrangements by 1 September 2005, as a condition of the sale of gas DNs is a case in point.

17 The role of back-up distillate fuels is likely to be an important issue over the next few years, given the strength of interactions between the electricity and gas markets. Ofgem should give serious consideration to improving incentives for companies to invest in back-up fuel infrastructure, either as part of the revised transmission price control or NGC/Transco's balancing incentive schemes.

18 Notwithstanding pressure on coal, oil and gas prices, retail costs and prices are likely to rise over time to reflect the impact of the Government's market interventions to achieve carbon reduction targets. It is important that suppliers are able to offset these effects through marketing energy efficiency services. We want to continue to work with Ofgem to establish how this can best be achieved.

19 We support Ofgem's continuing efforts to remove barriers to competition in the supply market (e.g. by reviewing supply licences) and to ensure that the benefits of the market are open to all consumers. E.ON UK will continue to identify innovative ways of meeting the needs of low income or other vulnerable customers.