

Sir John Mogg KCMG  
Chairman, Gas and Electricity Markets Authority  
Ofgem  
9 Millbank Road  
London  
SW1P 3GE

29 September 2005

## **Ofgem's five year strategy 2006-2011 RWE npower's view of the challenges**

Dear Sir John,

Thank you for your letter dated 12 August 2005 inviting comments on the challenges and priorities for Ofgem over the coming five years.

We value the constructive relationship we have with Ofgem and welcome the opportunity to contribute to the development of your thinking. We would be pleased to meet to discuss any of the points in this response.

We believe that the period will provide major challenges for the majority of Ofgem's seven themes. As Ofgem has itself noted there are often linkages, as well as tensions, between themes. In many cases, the issues are by no means within the sole control of Ofgem. However, Ofgem's extensive experience and expertise give it significant influence with other key decision-makers and stakeholders across the full range of issues; it is uniquely placed to hold the ring and resolve differences where stakeholder perspectives diverge. We are keen to work with you to achieve positive outcomes. Our views on the main challenges and priorities for action are set out in detail on the following pages under the appropriate Ofgem themes. In summary:

- Delays in establishing the context for investment decisions will increase the challenge of maintaining security of supply;
- Upward pressure on energy supply costs may result in a marked increase in customer prices. Whilst assisting environmental targets, delivery of fuel poverty targets will become substantially more challenging. Ofgem will need to explore novel approaches in this area;

RWE npower

Trigonos  
Windmill Hill Business  
Park  
Whitehill Way  
Swindon  
Wiltshire SN5 6PB

T +44(0)1793/89 22 69  
F +44(0)1793/89 29 81  
I www.rwenpower.com

Registered office:  
RWE Npower plc  
Windmill Hill Business  
Park  
Whitehill Way  
Swindon  
Wiltshire SN5 6PB

Registered in England  
and Wales no. 3892782

- There are a number of steps Ofgem can take to support delivery of the challenging environmental targets including steps to kick start customer interest and to simplify delivery of environmental programmes such as the RO and EEC;
- Ofgem will need to be robust to defend competitive market approaches should administered fixes be promoted as solutions to emerging issues;
- Europe has the potential to support UK energy goals or to frustrate them. To keep European policy development on track, Ofgem will need to maintain its vigorous engagement;
- Improving the transparency and predictability of monopoly network charges is an important issue, especially to facilitate fair retail competition;
- The growing maturity of the industry, improvements in performance and the effectiveness of self-regulation provide a sound basis for Ofgem to withdraw from detailed and prescriptive regulation in favour of a higher level supervisory role.

### **Helping to protect the security of Britain's energy supplies**

Ofgem, like other stakeholders, is concerned to ensure secure supplies of energy to customers in Great Britain. Currently, there are a number of impediments to achieving this objective including:

- Lack of clarity regarding the operation of the second stage of the EU Emissions Trading Scheme (ETS) from 2008;
- Uncertainty regarding the role of nuclear power as existing nuclear stations reach the end of their design lives;
- Failure by the EU to provide a timely response to the UK government's LCPD proposals;
- Short term limitations on access to gas.

All of the first three points are political decisions, the combined effect of which is to create an environment in which the scope for investment in conventional plant and the opportunities available for different plant types are impossible to evaluate with confidence. Consequently, investment has stalled. A major challenge for Ofgem is to use its influence with decision-makers to resolve these uncertainties. In addition, a situation could develop where decision-makers seek to protect security in both electricity and gas by the imposition of inefficient quick-fixes at short notice. This risk should be mitigated by agreeing in advance what cost effective techniques would be deployed to address security issues eg by relaxing station specific emission limits.

It would also be helpful for Ofgem to use its position to explore with Government the scope for improvements to the planning regime to expedite the development of new power stations, pipelines, gas terminals and coal extraction. The lead time for new power plant projects of any kind has lengthened by 6 months to a year over the last decade due to increasing inefficiencies in the planning process.

The uncertain investment climate is also undermining the liquidity of forward markets at both the wholesale and retail levels to the detriment of customers. Without a clear basis on which to plan output, generators cannot offer forward prices to suppliers. Suppliers will be unwilling to offer forward prices to customers unless they can hedge the risk.

## **Helping to tackle fuel poverty**

Upward pressure on prices is likely to come from a number of quarters over the next five years:

- The growth of emerging nations will maintain pressure on fuel prices;
- The tightening of the EU ETS is likely to raise the price of carbon allowances;
- The cost of achieving the Government's renewables targets is likely to rise as existing technologies reach saturation point;
- The cost of modifying transmission and distribution systems to accommodate renewables will be substantial;
- The cost of EEC could rise if the new obligation increases targets and as existing lower cost solutions become exhausted;
- The need for returns to rise to levels which adequately remunerate the required new investment.

The combined effect of these pressures may increase prices to end customers substantially. Whilst, this is in itself an instrumental policy goal to the extent that it will promote energy efficiency measures, it will present major challenges for the achievement of the Government's objectives for vulnerable customers. The radical steps required go well beyond the resources available from suppliers and their limited ability to identify those in need. We believe there are a range of actions which Ofgem needs to take over the coming years to respond to the challenges:

- Continue its focus on liberalizing European gas markets and access to those markets;
- Press the Government to make early decisions regarding both the cap and allocation allowances under EU ETS 2 so that companies can respond efficiently;
- Work with Government and other stakeholders to reduce the barriers to the effective utilization of cost-effective technologies such as co-firing with biomass. Apply discretion where possible, propose amendments where not;
- Press the Government to cast the net of carbon allowances more widely so that the energy sector does not bear an inefficiently high share of the burden;
- Facilitate social policies by supporting the introduction of smart metering at an accelerated level and in an economic and equitable manner;
- Improve the cost effectiveness of EEC by separating social obligations from energy efficiency obligations;
- Identify and promote changes to legislative and institutional arrangements, which will enable social action to reach a wider base more cost effectively. For example, community workers and social workers may be best placed to be set and achieve targets in identifying and reducing fuel poverty;
- Investigate and promote novel approaches to vulnerable customer support which are capable of generating the higher level of funds required in view of rising prices eg hypothecation of RO receipts of NFFO generators and/or a levy on distribution charges.

## **Helping to protect the environment**

It is acknowledged by Government that achieving its environmental targets will be a challenge. Some of the actions which Ofgem can take to promote environmental goals also contribute to other objectives and have already been noted. These include:

- Taking a pragmatic approach to renewable generation regulations eg biomass;
- Relaxing the requirement to target EEC measures on the fuel poor regardless of cost effectiveness;
- Pressing for early decisions on emissions regulations and trading schemes such as the LCPD and EU ETS phase 2;
- Promoting wider scope for the industries covered by ETS and ensuring that all sectors take a fair share of the burden of reducing emissions.

Other steps include:

- Promoting continuity and consistency in the RO regime in order to maintain investor confidence and willingness to purchase ROCs on a long term basis;
- Maintaining a stable and consistent UK-wide market in ROCs by opposing banding including initiatives such as the Scottish Executives proposals for multiple ROCs for marine technologies;
- Exploring means of supporting emerging renewable technologies, such as offshore wind, at least cost to the consumer eg the offering of contracts for differences on ROC prices to remove the regulatory risk;
- Encourage consumer interest in energy efficiency by promoting the adoption of measures which provide tangible benefits for the implementation of energy efficiency measures eg council tax reductions, stamp duty reductions. These would help kick start the market for energy services which has more potential in the long run than the EEC. The key difference being that the EEC restricts initiatives to those approved by Ofgem whereas an energy services market is driven by the innovation and initiative shown by customers and suppliers. It is therefore potentially of much broader scope and scale;
- Promoting smart metering as a tool to raise awareness of, and response to, energy usage and its cost;
- Promoting the efficient use of capacity, infrastructure and charging developments to facilitate the expansion of renewables;
- Extension of the regulated transmission network to include offshore wind farms, thereby providing consistent treatment with conventional onshore generation.

### **Creating and sustaining competition**

Ofgem has stated that it is committed to reducing the burden of regulation on companies where possible; the supply licence review is evidence of this. There are a number of reasons why we believe Ofgem should start from a presumption that licence conditions are not needed and demonstrate robust justifications for those conditions which it believes should be retained. For example:

- General consumer protection legislation has expanded considerably since the licences were established, thereby increasing the overlap;
- The supply market has substantially matured since it was fully opened in 1998;
- Concerns have substantially diminished as the industry has demonstrated both an appetite and ability to put its house in order;
- Explicit self-regulation is proving successful and has scope to be applied more widely as an alternative to licence regulation.

Ofgem's principal objective is the protection of customers' interests by the promotion of competition where appropriate. And Ofgem has demonstrated its commitment to competition and markets. An important challenge over the coming years will be to defend and extend the application of market principles in activities as diverse as energy balancing, energy efficiency and services and renewables; if adverse circumstances materialize in any of these areas, pressure could arise for inefficient, administered solutions. (For example, we continue to have concerns regarding the potential for distortions to the energy market arising from the system operator's interventions in forward markets.) We would particularly welcome the opportunity to discuss our ideas with you on these issues.

### **A leading voice in Europe**

The key challenge is to ensure that the EU strikes the right balance between consistency and subsidiarity. We need sufficient pan-European consistency to promote an effective single market in energy, but enough subsidiarity to avoid imposing unnecessary and costly uniformity. Many of the points made in last year's five year plan continue to be relevant. We are encouraged by the commitment which Ofgem has shown to influencing the European dimension and urge you to keep up the momentum. Success on this front will be vital if the UK is to avoid obligations stemming from Europe which impose costs whilst providing little benefit to UK customers. UK arrangements have evolved over many years and, in general, work well to support efficient and competitive arrangements. Substantial changes would be a concern if these were simply to promote EU harmonisation. Ofgem must continue to promote the better regulation agenda in Europe including the application of robust impact assessments to proposals. Ofgem needs to apply regulatory best practice to the development of EU proposals and to transposition of EU law and its implementation into UK law, working closely with the lead government departments. For example, full advantage must be taken of the "appropriateness" test in the draft Energy End-use Efficiency and Energy Services Directive to evaluate the benefits of provisions relating to billing.

We look forward to continuing and expanding the co-operation between Ofgem and the industry on European issues.

We also welcome Ofgem's commitment to resolving European gas issues, given the implications for UK security of supply noted above.

### **Regulating network monopolies**

An important issue for suppliers, particularly those without the potential hedge of a distribution business, is the risk of unforeseen price movements in transmission and/or distribution prices. In the context of customers with fixed priced contracts lasting several years, these unforeseen movements can be substantial in relation to the supply margin. In our view, regulated monopolies are far better placed to carry under or over recovery of allowed revenues than are suppliers to absorb fluctuations. Allowed monopoly revenues could easily be reconciled at the next review. We would therefore urge Ofgem to explore the scope for facilitating supply competition by introducing mechanisms that ensure use of system charges are smoothed and predictable. One possibility might be to fix forward transport prices for, say, three years. Restrictions should also be placed on the rights of transporters to fine tune tariff structures without giving similar notice. And pricing structures should be consistent across transporters at least at the distribution or transmission level.

We support Ofgem's aim to provide efficient locational signals for network monopolies. In our view, Ofgem has secured the right balance with its current approach to electricity transmission.

In view of widespread industry reservations, a key challenge for Ofgem will be to conduct a full regulatory impact assessment of the success of gas transmission entry auctions and the pro's and con's of applying auctions more widely before making final decisions in this direction.

### **Improving Ofgem's efficiency and effectiveness**

A number of points have been identified under other themes. In particular, we believe there is scope for Ofgem to use more discretion to apply the regulations it administers more pragmatically in order to promote important wider objectives.

The industry has matured, performance has improved and self-regulation is seen to be working well; we would hope that Ofgem will now take the opportunity to review the scope for withdrawing from detailed prescriptive regulation through codes and licenses, whilst recognising that monopoly networks will always need regulatory oversight.

Consumer representation arrangements are likely to evolve significantly over the review period: following the super-complaint review, a billing complaints ombudsman will be established and Government has signalled the possibility of a combined utilities watchdog. We see an important role for Ofgem in checking that each organisation (including itself) has a clear, distinct and sustainable remit. If Ofgem concludes that new structures do not meet these requirements, we would look to Ofgem to take the lead in resolving issues, taking account of affected parties' views.

As requested in your open letter, an electronic copy of this response is being sent to Andy MacFaul, Head of Government Affairs.

Yours sincerely,

Andrew Duff  
CEO, RWE npower

Cc Andy MacFaul, Ofgem