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Dear Andy

Ofgem's Five Year Strategy 2006-2011

I refer to the open letter of 12 August and am pleased to respond with views on the strategic choices for the Authority in the coming years.

We welcome the regular opportunity to provide input to the Authority's development of strategy. This, together with the subsequent, more detailed consultation on the proposed strategy and plan has developed into a rolling annual framework within which stakeholders are able to see that they can inform the Authority's thinking on these matters. We are aware that Ofgem's finalised strategy documents in recent years have responded to industry comment, for example with the emphasis on European affairs that you refer to in your letter. We have also seen a number of recent initiatives from Ofgem on the better regulation agenda, all of which are clearly welcome. I thought it would be worth commenting on these Ofgem initiatives in more detail before providing the specific views you seek in relation to future strategy.

Ofgem initiatives

- RPI – X control on Ofgem costs. This focus on cost control is clearly welcome and we look forward to Ofgem out-performing its target handsomely!
- Project Paperless. This was announced a few months ago and we have since participated in discussions with the consultants Ofgem have retained to develop policy in this area. We look forward to seeing the results of this work, specifically a reduction in and better co-ordination of the volume of consultation papers arising from regulatory policy initiatives. For example, for more focussed and complex issues, a simple open letter to regulation managers of relevant companies would be sufficient, rather than a full consultation exercise. These letters should still form part of Ofgem's overall count of consultations.

- Supply Licence Review. We welcome this timely review and are participating in this process. We believe that a significantly smaller set of licence conditions can be achieved for this competitive activity.
- European information site. This is a useful general guide to the European regulatory framework. However, we have not yet seen any regular European update on the website as mentioned in Ofgem's last corporate plan and we would also welcome specific notification from Ofgem of consultations issued by the European regulatory bodies of which Ofgem is a member.
- Electronic Register. This is a helpful development and over time we would hope that easier navigation and greater consolidation of actual licences might be possible.
- Publication of reports of Authority meetings. This is a welcome step in the transparency of the Authority's decision-making process.

Key challenges to the industry in the short to medium term

We see the following areas as key challenges for the energy industry over the next few years.

Gas Prices

The level and volatility of wholesale gas prices continues to give significant cause for concern to customers and the industry. We therefore welcome Ofgem's continuing involvement in the various investigations at UK and European level into this issue. We urge Ofgem to continue to use its influence within the European arena to press for the widest possible scope of investigation into the factors underlying the continuing high forward prices for gas. However, we continue to believe that there are aspects of the UK offshore market that would merit further investigation by the UK regulatory authorities.

Growth of Renewable Generation

Ofgem and the industry have already recognised the challenges, particularly for electricity networks, of the Government's targets for renewable generation. With regard to the impact on distribution networks, Ofgem has developed a new scheme, as part of the distribution price control, to incentivise distribution network operators (DNOs) to connect distributed generation (DG). We also welcome the Transmission Investment for Renewable Generation incentive that has been agreed in advance of the main transmission price control review (TPCR).

However, in our view, there is still much to be done to ensure that the necessary network upgrades take place at transmission level to accommodate DG and directly connecting renewable generation. Fundamental to all network investment decisions is the cost of capital, which Ofgem sets in network price control reviews. In particular, this issue will form a major part of the TPCR that is now underway. If the cost of capital is inadequate, then a corresponding low priority will be placed on such enabling investment.

A remaining issue in relation to renewable generation is, in our view, the stability of transmission pricing and I comment on this under our next heading below.

Structure of Network Charges

This is an area of concern to many market participants and individual customers. We have made comments to Ofgem on several occasions about our concerns over the continuing and wide-ranging reviews of use of system charging methodologies. These reviews entail costs for the industry and uncertainty for parties liable for use of charges. In many areas, the uncertainties continue over extended periods of time, which in our view is not conducive to a pro-investment climate. Current projects in this area, along with our associated comments, are noted below.

- Electricity transmission pricing – NGC started a project to review its charging methodology in autumn 2002. The uncertainty over the final arrangement of charges under the new model has lasted for over three years and still continues, with the review that Ofgem has required NGC to undertake following the implementation of BETTA now underway. One of the most pressing issues, apart from the general stability that is needed by all parties liable for transmission charges, is the treatment of generators connecting at the 132kV voltage level throughout Great Britain.
- Electricity distribution pricing – while we accept that some development of distribution use of system charging is appropriate, given the creation of the DG incentive revenue stream, we still have concerns about the ongoing regulatory input to the development of charge structure in this area. In our view it should be the distribution licensees, as set out in the licence conditions, that control the process and scope of change to charging methodology, with due regard to the stability of charges for their customer base.
- Gas transmission pricing – we welcomed Ofgem’s recent decision to delay the implementation of enduring NTS offtake arrangements and the recognition that this matter is fundamentally linked to other issues that will be considered as part of the NTS price control. In the meantime, we consider that the interim arrangements appear to be a pragmatic solution for the short to medium term.
- Gas distribution pricing – it appears that this work is approaching a conclusion and we hope that stability can be maintained in this area with minimal change going forward.

In conclusion therefore, we believe that Ofgem should seek to conclude the review of electricity transmission prices and reduce its involvement in other reviews of use of system charging in the interests of regulatory stability.

European Issues

There is no doubt that European energy markets and regulatory policy are increasingly influencing those in Britain. We are concerned about increasingly detailed levels of regulation from this source and see a key role for Ofgem (as well as the industry) in engaging with the European authorities in order to minimise the regulatory burden on the liberalised energy markets of the UK. In our view, a key priority for the EU Commission should be ensuring

compliance with existing Directives, before seeking to impose yet more regulations on the energy sector.

In relation to recent European initiatives, our view is that the implementation in the UK of the fuel mix disclosure requirements represented a reasonably pragmatic outcome while the gas storage guidelines, for instance, were unreasonably prescriptive and onerous.

We are also aware of the regulatory debate in Europe about the development of regional markets. We are not in favour of this and believe that individual regulators should concentrate on local market issues.

Environmental Issues

Following on from the above, it is clear to us that increasing environmental legislation, much of which is at European level, is driving an increase in costs for many players in the energy market. While we recognise that Ofgem's direct role might be limited in this area, the effects of such legislation on the cost base of energy network companies and, potentially, on security of supply, fall firmly within Ofgem's remit.

Fuel Poverty

This is still a significant issue for energy supply companies, government and for Ofgem.

Action by the Authority to respond to the challenges above

We have tended to cover this question in our comments above. However, in general terms, we look to the Authority and Ofgem for early regulatory clarity when structural changes are proposed and being implemented. Also we advocate that the Authority makes timely and appropriate intervention on market issues when this can bring about changes and transparencies that support the energy markets. Beyond these active roles and those associated with the carrying out of core regulatory functions such as price control reviews, we suggest that the Authority should seek to be more reactive than pro-active in its agenda. In particular, as we have stated before, we strongly believe in the value to the market of regulatory stability, backed by industry-governed processes to initiate change where it is really required. In this vision, Ofgem would respond to the issues that are raised by the participants in and customers of the energy markets rather than seek to pursue changes which appear desirable to the Authority but which have not necessarily been raised as problems.

While the stages up to the implementation of major structural reform inevitably involve significant commitment of Ofgem's resources, this is no longer a requirement once the reforms have bedded in. We continue to believe that, across the industry, market governance should be in the hands of the industry through the operation of appropriate codes. Within the current environment, Ofgem should avoid putting forward its own views on how the codes should develop and, as far as possible, restrict its involvement to that of an appeal body for any market participant who feels strongly about a proposed modification.

Priority of future areas of work for the Authority

In reviewing our suggested priority of work for the Authority in our comments at this stage in last year's consultation process, we are pleased to note that the key market reforms in train at that time have been successfully implemented. Both BETTA and the gas distribution network sales were completed to the planned timescales and this is due in no small measure to the hard work of the Ofgem staff involved in those projects. With respect to the first of these, there are still some BETTA-related determinations outstanding and it would be helpful if the Authority could complete its work on these as soon as possible to provide certainty to the parties going forward in the new framework.

Looking to the future, in the light of the challenges we have identified above, we consider that gas wholesale pricing remains a priority area of work for the Authority. The other significant areas of work will be the transmission price control review now currently underway, the one-year extension to the gas distribution price control and, in due course, the gas distribution price control review itself.

We believe there is an issue in relation to metering that Ofgem should address. This is the question of how to ensure that investment in new metering technology takes place within the industry. In our view, under the current arrangements, the risks for suppliers to invest in new metering technology are too high and there is currently no incentive for network operators to invest due to the risk of stranded assets. We therefore believe that it will be necessary to reconsider current regulatory and commercial mechanisms with a view to achieving greater investment in metering technology.

We also discuss below two areas where, in our view, the resources committed by Ofgem could be significantly reduced.

- Network incentives. Over the last few years, incentive mechanisms on network operators have become increasingly complex. In particular, the transmission level system operator incentives are very opaque. In our view, the Authority should not be devoting resources to continually developing these. In tune with our theme of regulatory stability, existing incentive arrangements should be allowed to bed in for a significant period, before further changes are considered.
- Structure of Charges. Following our comments on this subject above, we believe that Ofgem should be doing less to drive change to network charging methodologies.

I hope these comments are helpful.

Yours sincerely

Rob McDonald
Director of Regulation