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Dear Andy

### **Ofgem's 5 year Strategy 2006-11**

I write in response to Sir John Mogg's letter of 12 August. We appreciate the opportunity to engage in discussion on your future plans, and are pleased to provide answers to the three questions raised.

#### **1. Key challenges facing the industry in the short to medium term**

As last year, one of the most obvious challenges to the industry is the rapid increase in wholesale prices, which is currently feeding through to retail customers. Although the immediate driver of these increases is the world market price for oil and gas, there are underlying concerns over the need for future investment at each stage of the energy supply chain. The continuing increase in demand for energy must also be seen alongside growing concerns on climate change and the increasing pressure to move to a lower carbon future.

This suggests that the real challenge is how to secure a sustainable energy sector, which will provide what customers want, at prices they are prepared to pay, without doing undue harm to the environment. This single sentence encapsulates a whole range of issues that need to be addressed by government, the industry and its regulator.

#### **2. What action is needed from Ofgem?**

Ofgem's key role is to ensure that markets are working effectively to deliver outcomes that meet both consumer expectations and broader Government policy objectives. This extends to both intervening where markets left unregulated would fail to meet these objectives and contributing to broader debate on energy policy. We can therefore see areas for actions under a number of headings:

- 2.1 Government policy reviews – Ofgem should continue to provide input to reviews of Climate Change policy and energy policy to ensure that rational decisions are taken for the long term future of the electricity and gas industries. This should include contributing to debate at the European level and to ensure that successful market reforms in the UK are not undermined by conflicting initiatives from Brussels.
- 2.2 Creating an attractive climate for investment – the utility infrastructure continues to need investment to replace and supplement existing assets. It is essential that investors are attracted to the energy sector by the returns that can be expected. In the case of network companies this requires regulatory settlements that continue to encourage investment. We would expect to see a consistent approach emerging from the transmission and gas distribution reviews, so that the next electricity distribution review can adopt well-established practice to incentivise investment.
- 2.3 Establishing customer requirements – a greater level of understanding of customers' expectations of utility networks would assist in future investment planning. A more coordinated approach to research, perhaps in partnership with energywatch, would provide background material for future price control reviews, and could be supplemented with specific input from government where they are able to specify additional requirements based on a broader view of the need for resilience and reliability. It would also be possible to overlay any other social and environmental policy objectives to create a more complete picture of what the industry is expected to deliver.
- 2.4 Modelling efficient costs – the network price control reviews will challenge Ofgem's ability to use comparative data to establish efficient levels of cost. There are less comparators than were evident in electricity distribution and more divergence in scale. We would like to see work continue on the tools available for comparative analysis, using data from the RRP in electricity distribution. This would allow Ofgem to return to the unfinished assessment of both total cost modelling and the opportunities to assess value for money by incorporating service levels into the comparisons. We would also like to see formalised the treatment of 'singleton' companies in sectors where multiple licence ownership has become the norm.

In our submission to the corporate strategy consultation in March, we observed that the proposed strategy had little detail beyond year one. Whilst Ofgem have to react to events and market developments, it is important that a proactive agenda beyond 2006 is developed. We would hope that some of the issues identified above could be timetabled for further development across all years of your plan.

### **3. Priorities**

Our consistent theme in response to previous consultations has been to try and focus on a smaller number of key projects that will help to provide better services to customers at an appropriate cost. We have repeatedly emphasised this point in the context of the Distribution governance debate. We welcome the review of supply licence obligations and we hope this can be extended to the connections and metering activities. We have recently written to Martin Crouch suggesting a review of the metering licence obligations in line with our previous comments that Ofgem should withdraw from regulating these activities.

We have welcomed your efforts towards better regulation, and in response to Alistair Buchanan's letter in April, John Roberts replied stressing the importance of value for money. It should be a continuing theme within all your work to focus on the high value issues. This is one of the reasons why we support continued use of Regulatory Impact Assessments to establish the true worth to society of any proposals for new projects within Ofgem.

I hope you find these comments helpful. I would be pleased to join in further discussion on the issues raised.

Yours sincerely

Mike Boxall  
Electricity Regulation Director

cc Sir John Mogg