

6<sup>th</sup> March 2006

Sir John Mogg  
Chairman (Gas and Electricity Markets Authority)  
Ofgem  
9 Millbank  
London SW1P 3GE

**Ed Gallagher CBE**  
*Chair*

**Allan Asher**  
*Chief Executive*

Dear Sir John

## **Ofgem Corporate Strategy and Plan 2006-2011**

### **Introduction**

energywatch welcomes the opportunity to respond to the issues raised in Ofgem's proposed Corporate Strategy and Plan for 2006-2011. As you know from our response to Ofgem's initial letter on Corporate Strategy issued in August 2005, energywatch supported the broad thrust of Ofgem's approach to deliver the greatest benefits to consumers over a range of activities. We are now providing detailed comments below which align with the seven themes in the current paper which we hope you will include in Ofgem's final Strategy and Plan.

We remain concerned by the continuing rise in gas and electricity prices, and consumer detriment arising as a result, particularly so after the latest price rises announced since the turn of the year. The immediate effect of these significant rises is that Ofgem's goals for reducing fuel poverty are now significantly harder to attain and we anticipate that a substantial increase in fuel poverty, particularly amongst vulnerable consumers, has become inevitable. Given this background, and the equally negative impact on all business consumers, we believe that there is substantial evidence of a lack of real competition in wholesale energy markets. In Britain, there is a significant concentration of market power amongst a few suppliers, specifically in domestic energy supply. In Europe, existing market structures, with substantive control exercised by large vertically integrated businesses, is also adding to supply and price pressures to which the unprecedented recent rises for consumers can be attributed. Ofgem should seek to make full use of its current powers to monitor and investigate market practices and act where necessary to ensure that prices to all consumers are cost reflective, and that there is a genuinely competitive market. That said, we appreciate the action you have taken personally in the European arena.

A number of key decisions affecting security of supply are due soon, not least the outcome of the Government's Energy Review. We believe that Ofgem must demonstrate to consumers that it is taking effective action to encourage the development of sufficient infrastructure, through, for instance, further appropriate investment signals in price controls,

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which would alleviate recent tight gas supply conditions and the resulting adverse price effects on consumers. Arguably, the lack of response to market signals from key players in the past has created these conditions and Ofgem must intervene to establish effective markets if market players show reluctance to act. We agree that a diverse fuel mix is the best way to deliver reliable, affordable and sustainable energy supplies to consumers in the long term.

We share Ofgem's view that liberalisation of European energy markets must be accelerated. It is the lack of competition in those markets and the concentration of market power amongst a small number of players, some of whom are also significant players in the British energy market that necessitates an impetus to move deregulation much higher up the agenda. Security of supply considerations in the British energy market are also dictated, to an extent, by Continental gas supplies, Ofgem, therefore, has a key role to play, particularly as president of the Council of European Energy Regulators, in influencing developments at European level. We believe that Ofgem should report regularly on its activities in this role, the initiatives it intends to take, and what progress has been made, to provide consumers with confidence that effective action is being taken.

Whilst energywatch generally supports Ofgem's intention to promote better regulation, we are keen that Ofgem interprets this in the context of its wider statutory duties to protect the interests of energy consumers. Better regulation does not just mean a slimmer rule-book but an effective, 'joined-up' regime where Ofgem can provide confidence to consumers that they enjoy effective protection either under the general law or through current licences. It also means effective use of Ofgem's enforcement powers to deal with licence breaches. Where there is a risk of gaps appearing in protection, or some other imbalance which favours suppliers in comparison to consumers, we consider that Ofgem should retain, and even strengthen, existing licencing provisions. In the current climate of price rises, consumers, particularly the most vulnerable, expect Ofgem to reflect appropriately their concerns and take effective enforcement action through licencing or other arrangements if there are actual failures in the competitive market.

## **Creating and sustaining competition**

We believe that this theme is particularly relevant in view of recent developments in wholesale and retail energy markets. Not only have all consumers been subjected to sustained increases in prices, but a significant number of small players have exited the market. This does not signify effective operation of the market, especially as there were originally few new entrants, even when prices were much lower than now. We believe that these developments have arisen because of real issues with market structures which, we consider, adversely affect genuine competition. We are concerned about two particular aspects of existing market structures, namely, concentration of ownership amongst a few players which makes vertical integration almost a requisite element for survival, and the lack of transparency and timely availability of market data which stifles liquidity and response to market signals.

Ofgem acknowledges that there is significant vertical integration in energy markets. We believe this creates a real barrier to competition. Ofgem should proactively monitor market developments, taking action to investigate, either directly or through Competition Act referrals, whether barriers are being created for new entrants and whether incumbents, through the exercise of market power, are affecting market operation in a way that makes new entry unattractive. energywatch remains vigilant of market abuses and we will continue to raise such issues with Ofgem as part of our remit. Ofgem should be aware that domestic and small business consumers now have limited choices in a market where prices are on an upward curve due partly to irrational responses to market signals, and that the recent exit of small suppliers has exacerbated the situation. We do not believe that current market structures provide fertile ground for significant self-regulation in the retail market in particular, although we will work with Ofgem and the industry to find areas of common ground where appropriate. Ofgem should work closely with other agencies, including the European Commission, to identify whether the preponderance of a few large vertically integrated players is disrupting underlying supply and demand conditions, and take firm regulatory action where the evidence demonstrates that this is the case.

It is undoubtedly the case that high wholesale gas prices during this winter have played a significant role in the demise of some small players, as well as increasing price pressures on all consumers. Arguably, it is the demand-side response of some of the largest consumers which has kept the lights on this winter. However, Ofgem has only recently considered it worthwhile to undertake more extensive monitoring of movements in prices and their correlation to events around gas supplied to Great Britain. energywatch has been prompting Ofgem for some time, through modification UNC006 to the gas Uniform Network Code, to increase information transparency on a timely basis to ensure that the market can respond accordingly and secure gas supplies. We note that Ofgem is still consulting on UNC006 but would urge a prompt decision in favour, as the provision of information undoubtedly helps in raising market awareness of events impacting on gas supply and would provide market signals to participants and the system operator of the action required to secure sufficient supply to meet demand. We believe that Ofgem could use the mechanism proposed through UNC006 as an important tool for improving the flow of market information, which is a key element of effective markets and not an optional extra. We look forward to working with Ofgem to monitor the effectiveness of UNC006 in the future.

Ofgem recently sought views on the need for a review of the non-domestic supply market to which energywatch contributed. We remain of the view that small business consumers face many of the same issues as domestic consumers regarding the lack of a competitive market, but do not have the same protection afforded to domestic consumers, thereby disadvantaging them. The key problems continue to be insufficient market monitoring to root out mis-selling, and a lack of confidence that contracts on offer represent best practice or best value for money while energy costs rise. Ofgem relies on anecdotal evidence to claim that there is real competition in the small business market, which is insufficient as a

measure of the depth of competition and whether there are enough suppliers to provide a vibrant market. Only a definitive review of the state of competition will allow small business consumers to have confidence that they have a real choice of supplier. Ofgem should be prepared to revisit this issue over the next year.

In the consultation, Ofgem has highlighted the introduction of British wholesale electricity trading arrangements (BETTA) from April 2005. We are keen that Ofgem undertakes a review of BETTA in due course, and we would consider that a review after two full years of its operation (from April 2007) would be a sufficient point at which to allow consumers to judge whether the promised benefits of reduced prices, particularly in Scotland, have been achieved and, if not, what further changes to market structures are required.

Ofgem indicates that it will be considering metering, and competition in metering services in 2006. energywatch will be fully engaged in Elexon's review of smart metering and considers more extensive introduction of smart metering as a critical means to compliment further improvements to the accuracy of consumer bills, and also to improve data quality in the settlement processes in the retail market, which we believe would reduce additional costs for consumers (hence our 'Get Smart' campaign). Ofgem should be proactive in promoting smart metering given the potential benefits to consumers, and the further possible by-product of improvements in energy efficiency from the household sector which may result.

We acknowledge Ofgem's response to energywatch's supercomplaint on billing. In Ofgem's view, there are a 'relatively small proportion' of consumers who are affected by inaccurate and uninformative bills. Ofgem should note that energywatch is only one consumer group which receives complaints about suppliers' billing practices. In addition, complaints made directly to suppliers may not be recorded rigorously and so the true number of complaints may be quite significant. Poor billing practice is a major source of consumer detriment which neither Ofgem nor the industry can ignore. We note the action taken to date on dispute resolution arising from poor billing practices, but we would encourage Ofgem to support a more preventative approach which encourages the industry to take effective action, through rigorous application of a robust code of practice, independently approved, to produce accurate (based on actual readings regularly obtained) and informative bills for all consumers. Consumers should not have to wait for a potentially long-term roll-out of smart meters to give effect to improved billing practices.

energywatch has made a full contribution to the Supply Licence Review to date and looks forward to ensuring that robust conclusions are drawn from this process, which provide real protections for consumers. energywatch believes that better regulation translates into effective and fair regulation, and appropriate, independently guided, self-regulation where necessary. The latter remains untested in many respects, specifically whether governance processes are sufficiently robust under industry codes to provide real sanctions against errant suppliers. energywatch has highlighted its concerns in this area on several occasions. The industry must prove that effective self-regulation works not just for incumbents but also new entrants while the existing licence obligations remain in place. Ofgem must be prepared to maintain robust supplier licences, and enforce their provisions, where there is a risk of potential gaps in the protection of consumers, particularly the most vulnerable, and not seek to withdraw from regulation purely as a 'paper-cutting' exercise.

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energywatch would be somewhat concerned if Ofgem views merger and acquisition activity as a key driver of market efficiency. Any further mergers and acquisitions can only concentrate market power further in fewer hands and Ofgem should assess the efficiency of such activity on its merits and not assume that efficiency will automatically result. We would support rigorous market surveillance by Ofgem and a willingness to take action against parties which are involved in anti-competitive activity against the consumer interest.

Perhaps one aspect of the current market which evidences the challenge facing Ofgem in regulating an effective competitive market is compliance and enforcement issues in relation to day-to-day activities. For example, energywatch has brought mis-selling practices to its attention through formal referrals, most recently late last year. We will continue to formally refer practices, backed by substantive evidence of consumer detriment, to Ofgem and have an expectation that action will be taken as appropriate. We believe that Ofgem should undertake the appropriate investigations and enforce under the powers afforded by the Enterprise Act 2002 where mis-selling or other breaches of consumer protection law have been shown to exist.

We note Ofgem's watchwords of coherence, consistency and predictability, and have highlighted instances above where it is necessary for Ofgem to apply those principles to produce competitive and effective energy markets. It is critical, if Ofgem is to meet its principal duty to protect consumers, that markets are regulated effectively where there are inherent weaknesses, transparency produces competition and choice for consumers, and market rules are applied in a holistic, coherent and consistent manner so that market players are well aware of how they add to consumer detriment and how they should respond to remove these problems.

## **Regulating network monopolies**

We will support Ofgem in the next few years in developing appropriate incentives and mechanisms through price controls for transmission networks and gas distribution networks. We will also work with Ofgem to identify fair, innovative and cost reflective charging structures for electricity distribution networks, given the challenge of effective active management of these networks in the event that significant volumes of distributed generation are connected in future. Ofgem should ensure that network operators take account of the changing shape of the network and the need to encourage distributed generation, and that cost reflective messages are passed on to consumers to realise the full benefit of the new arrangements.

We also support Ofgem's intention to continue development work to ensure that policies are delivering benefits for consumers, including competition in connections, innovation schemes and quality of service targets. These must be meaningful, and provide distribution companies with a real incentive to engage with consumers and manage their concerns appropriately.

In relation to price control proposals, a key element must be that efficiency savings are shared with consumers who otherwise bear the costs of further investment in networks. Consumers must have assurance that investment will be economic, efficient and timely, particularly when current network infrastructure requires renewal to maintain both security and quality of supply.

Interactions between gas and electricity network investment must be managed efficiently between transmission networks and between transmission and distribution networks. While connection of offshore generation should boost security of supply, the timing of other new connections of equal merit, which help to minimise network congestion and are sufficiently firm, should not be unnecessarily delayed. We support Ofgem's intention to protect consumer interests in this respect.

Ofgem is aware of our concerns regarding charging by suppliers for independent gas transporter (IGT) connections which are relatively few but disadvantage a significant number of consumers disproportionately, both in terms of costs and ability to switch. We will highlight these issues in detail to Ofgem in due course but believe that Ofgem must look into the problems raised, and act to reduce consumer detriment which is clearly discriminatory for a small number of consumers in comparison to the overwhelming majority.

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

We have already noted that security of supply is being adversely impacted by anti-competitive market practices, some related to European markets, which dampen signals for efficient investment and prompt response to market activity. This can be rectified in part through rigorous market monitoring by Ofgem. However, Ofgem can also encourage response in other ways, for example, by having a more orderly regime for demand-side response by large consumers when demand outstrips supply. This can be facilitated through prompt access to market information but also through appropriate mechanisms by which the system operator is able to use demand reduction to effect efficient balancing actions. The recent development of a gas balancing alert, issued by National Grid Gas under system stress conditions, is a useful start, but further work may be necessary to create commercial products for which large consumers can contract with the system operator, particularly if tight gas supply conditions seen this winter are replicated in 2006/07. We hope that Ofgem will learn from the experience of this winter and monitor the market more effectively, encourage participants across the supply chain to release market information promptly, and explore, with the Demand-Side Working Group, proposals for mechanisms which allow orderly reduction of demand in tight supply conditions.

We note Ofgem's comments on cash-out arrangements and efficient balancing actions by system operators which reduce costs to the market and, ultimately, to consumers. We look

forward to definitive conclusions from the work of Ofgem's Cash-out Review Working Group. We also consider that cash-out arrangements are only one aspect of a much more complex issue, and that lack of liquidity in energy markets and market rules restricting the flow of energy have a strong bearing on security of supply and anticipate Ofgem will take action to address the problem.

energywatch is concerned to ensure that consumers continue to receive safe supplies of energy and that gas quality regulations provide consumers with the assurance that their gas appliances will operate safely if lower quality gas is supplied to Britain. We will work with Ofgem and the DTI to ensure that gas safety and emergency arrangements operate effectively and in the best interests of consumers.

In the long term, given that Britain will become a net importer of gas and that there will be a knock-on impact on electricity generation, we would encourage Ofgem to take a global view of the delivery of gas supplies to ensure sufficient supplies are available to consumers. There is a real risk of suppliers being driven purely by price considerations, in the global LNG market for instance, in their choice of delivery location. This may result in shortages of gas to Britain, regardless of whether there is infrastructure in place to receive delivery. Ofgem must work with all relevant agencies at all levels to ensure optimal use of storage and other infrastructure, if necessary by firm regulation of third party access and 'use it or lose it' arrangements.

## **A leading voice in Europe**

Gas imports from Europe and elsewhere already play an increasing role in meeting Britain's energy needs and so energy security depends on access to open, liberalised European energy markets. We have noted concerns above about recent market developments in Europe, and Ofgem's enhanced ability to influence the debate through the presidency of the Council of European Energy Regulators. These concerns are reflected in the recent preliminary report of the European Commission's Competition Directorate into EU gas markets, which has highlighted the concentration of market power and vertical integration in both wholesale gas and electricity markets, thereby deterring new entrants; the lack of transparency of available data to the market which fails to provide appropriate price signals for efficient and economic investment in networks and infrastructure; lack of liquidity in wholesale gas markets which dampens market activity which would enhance competition; and an overall lack of liberalisation in European energy markets when compared to Britain.

We would urge Ofgem to use the opportunity to take a real lead in pushing for reform in European energy markets, setting out its objectives, the activities it is undertaking, and reporting back on progress. We also expect Ofgem to support the European Commission where it seeks to take action against some of the practices identified in its preliminary report. Ofgem can make a real difference for British consumers at a time when some of the problems they face are exacerbated by the European dimension, and we will support Ofgem in moving the debate forward.

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## **Helping to protect the environment**

energywatch remains supportive of Ofgem's remit to provide protection for the environment through the development of sustainable markets where the appropriate balance is struck between the needs of consumers to have safe, secure and affordable energy supplies and real reductions in environmentally damaging emissions levels. Work is continuing to promote energy efficiency measures in conjunction with the industry and we will continue our support for the Energy Efficiency Commitment. We also believe that smart meters have a role to play in raising the awareness of all, but particularly domestic, consumers regarding their consumption and how best they can contribute to energy efficiency. We would urge Ofgem to proactively engage in this debate to ensure that smart meters become a regular feature in British energy markets, with the potential to reduce costs and allow consumers to contribute effectively to Government environmental targets.

We will continue to work with Ofgem on initiatives which enhance the contribution of renewable generation to the overall fuel mix and to Britain's energy security. However, we would urge Ofgem to consider whether the application of connections policy post-BETTA needs to be reassessed to allow those renewable projects which will enhance supply and which are well advanced, to be given greater priority over those which are less developed. There may be benefits to the consumer if this approach enhances efficient and economic development of networks and limits the problems of network constraints, which add to the costs of operation and are ultimately passed to the consumer.

## **Helping to tackle fuel poverty**

energywatch is not optimistic, given recent price rises, that targets to reduce fuel poverty will be met by 2010 and in fact see a distinct trend in the opposite direction. We would urge and support Ofgem to redouble its efforts to protect the most vulnerable consumers by engaging both with energywatch and suppliers to push forward a series of measures which we believe would provide real benefit to those consumers at this time. There are a number of such measures, including the wider development by suppliers of social tariffs; improved discounts to low income consumers allowing them to meet their energy needs at a time when the proportion of their incomes spent on energy is rising; improved reporting from suppliers (and active appraisal of, and follow-up action, by Ofgem as appropriate) regarding the actions they are taking to meet social obligations, which picks up on best practice and applies it across all suppliers as a minimum threshold (including the removal of duplicate or unused reported data to provide a clear focus on suppliers' handling of debt, disconnection and billing issues); and additional or enhanced targeted protection through licence conditions as identified in the Supply Licence Review. It is not in the interests of consumers to have these protections reduced through licences at this time, as 'proportionate protection for vulnerable consumers' should not equate to dilution of that protection. We will continue to work with all suppliers to ensure that consumers are made aware of all available means by which they can reduce their bills and limit the damage of recent price rises. We will also liaise with consumers about how effectively suppliers' social obligations meet their needs.

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One specific issue which adversely impacts on prepayment meter (PPM) consumers is the lethargic recalibration of token PPMs. In a period when prices are rising, suppliers should be encouraged to speed up the recalibration of PPMs so that consumers can work with their suppliers to deal more effectively with debt issues before these become critical. It is in the mutual interest of suppliers and consumers to understand why debt problems may be arising and how to mitigate the impact on the consumer before more drastic action, such as the relatively unchecked area of self disconnection, may be required.

In supporting smart metering elsewhere in our response, we are acutely aware that it allows consumers to avoid self-disconnection - a phenomenon which itself creates consumer detriment and fails to deal effectively with the root causes of debt build-up. As stated elsewhere, the development of a coherent, consistent and predictable approach across the areas of fuel poverty and smart metering would help the most vulnerable consumers and we would urge such an approach.

energywatch also welcomes the increased focus on how network companies can help their vulnerable customers, and looks forward to further input on the discretionary reward scheme for electricity network operators. Ofgem must tackle implementation of this scheme carefully, and conduct an ongoing review of progress to ensure that it provides real benefits to consumers, encouraging innovation and best practice amongst operators. energywatch also supports Ofgem's intention to address the extension of the network to off-gas communities as part of GDPCR.

Whilst energywatch has highlighted a number of specific initiatives above which Ofgem could pursue as part of the Social Action Plan, there are clearly wider market initiatives, also alluded to elsewhere in our response, regarding improved market mechanisms, which will benefit all consumers, promote a real competitive market, and lower the costs of operating networks through efficient and economic means. All these initiatives are part of a coherent, consistent programme which Ofgem should pursue, with immediate action to help the fuel poor a particular priority.

## **Better regulation**

energywatch has actively supported Ofgem in the Supply Licence Review in seeking to identify areas of the supply licences which would preserve protection of the interests of consumers whilst removing unnecessary conditions which create burdens on suppliers. However, our impression is that Ofgem is not yet clear about where the correct balance lies between protection of consumers and reduced regulatory burdens. We have stated elsewhere in this response that better regulation is as much about a coherent, consistent and predictable framework of licences and other rules which provide fair and effective regulation, and is not purely about reducing the size of these documents. Re-writing licences may involve strengthening some licence conditions as well as discarding others which have outlived their usefulness or original purpose.

We would urge Ofgem to adopt principles of better regulation to ensure that the rules are applied proportionately, consistently and transparently in a targeted manner. It is not the purpose of better regulation to merely reduce the administrative costs of the regulator if this leads to the failure of the regulator to undertake its duties effectively. Ofgem has itself highlighted the problems associated with the current state of energy markets and action which it believes needs to be taken to enhance competition.

Whilst it would be beneficial if the solutions to current problems were market driven (perhaps through codes of practice agreed with consumer groups and adhered to voluntarily by market participants) where intervention is clearly required, Ofgem should be willing to take effective enforcement action. There is nothing in the Plan about using enforcement action to address licence breaches, any criteria by which such action would be triggered, or the type of sanctions to be applied where necessary. The Ofgem Budget for 2006/07 makes only modest provision for delivery under the 'Creating and Sustaining Competition' theme, which suggests that Ofgem has only limited ambitions in terms of effective regulation of licences, and investigation and action where markets may be operating sub-optimally. We do not believe that self-regulation has yet been proven to work in the energy markets and so a role for Ofgem, particularly the ability to enforce rules effectively, remains necessary. To this end energywatch would like to see a section dedicated to the description of the use of

Ofgem's enforcement powers, including the criteria for use and how these will be monitored and reported.

We note and support Ofgem's wish to ensure that consumer input to its consultations and assessments is given due consideration. We also agree that Ofgem should maintain a drive to deliver regulation efficiently and cost effectively, using best practice from elsewhere to enhance the quality of its work.

I hope these comments are helpful in setting your strategy and plan. If you do wish to discuss our response further please do not hesitate to contact Carole Pitkeathley, energywatch Head of Regulatory Affairs on 0191 2212072.

Yours sincerely



**Allan Asher**  
**Chief Executive**