

# **Ofgem Five Year Strategy and Plan 2006-11**

## ***Comment by E.ON UK***

### **Ofgem's priorities**

1 E.ON UK welcomes this opportunity to comment on Ofgem's five year plan. 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 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 we thoroughly support the notion of creating a "centre of regulatory excellence".

3 The first priority for Ofgem must be to conduct more internal analysis, instead of employing external consultants; this will help to increase Ofgem's expertise, ensure the right skills are developed and retained within Ofgem, and help prepare Ofgem to undertake DR5.

4 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.

5 A key example of this is Ofgem's approach to reforming the gas exit arrangements as part of the DN sales process.

6 We welcome the significant progress on the 'Better Regulation' agenda (e.g. publishing of GEMA minutes, extended consultation periods, and indeed, the format of this consultation paper). 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.

7 However, during the public session to discuss this strategy, Ofgem's emphasis under the 'better regulation' agenda was on benefiting the consumer, rather than reducing the administrative burden to business. Whilst these two objectives are clearly linked, we believe that 'better regulation' should be defined as being aimed at reducing the burden of regulation on business, where this burden is not justified by the benefit to the consumer. We believe that reducing the administrative burden on business through 'better regulation' will generally lead to a benefit to the consumer, and that this should therefore be Ofgem's focus.

8 We welcome the Regulatory Impact Assessment process Ofgem undertakes, and congratulate its efforts in this area. However, we believe the process can be further developed to provide more confidence that RIA is not simply an ex-post rationalisation of decisions, and would like to see RIAs carried out much earlier in policy development. 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.

## **Creating and sustaining competition**

9 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.

10 Ofgem should not be pursuing projects where the consumer benefits are uncertain, or not properly assessed, and where the market is working satisfactorily. We also reiterate that Ofgem could be quicker to drop projects where the feedback from the majority of stakeholders is negative.

11 Particular areas of concern include Ofgem's continued insistence on implementation of radical reform to the gas exit regime (known as the "enduring offtake arrangements"), further reviews of cash-out arrangements and encouragement of fundamental changes to emergency arrangements despite extensive and controversial reform during Q4 2005.

12 In the wholesale markets area we believe Ofgem should scale down or cease many of its own working group activities that relate to changes to code market rules. The existence of such groups is not consistent with Ofgem's wish to encourage industry self regulation. In many instances such groups can undermine the industry's own code modification procedures (the formal vehicle for such changes).

13 In addition the fast tracking of modification proposals using urgent procedures (which is an Ofgem prerogative and recently very frequently exercised) following debate in Ofgem-chaired rather than industry-managed meetings, is weakening the legitimacy of Authority decisions to approve or reject such proposals.

14 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.

15 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. We would urge Ofgem to review this strategy.

16 We remain concerned that at times undue pressure can be applied to regulated monopolies to bring forward changes that can have a profound affect on competitive market participants (i.e. shippers under the gas uniform network code and generators and suppliers under electricity industry codes). There is a place for such intervention where action is clearly required to protect customer interests, but we believe it is inappropriate where a diverse range of stakeholders, including customers and market participants, are signalling that such change is not required.

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 NG/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.

### **Regulating network monopolies**

20 E.ON UK endorses the challenges laid down by Ofgem for the regulatory framework. In particular, ensuring incentives exist for network businesses to invest in a timely and efficient way in order to deliver energy policy objectives is a key issue. In practice this means refining the regulatory framework to ensure it provides long term incentives for investment.

21 This is a subtle change for the current framework which has predominantly been focused on efficiency and short-term performance. The use of the words "quickly" and "timely" in paragraphs 2.4 and 2.5 of the strategy consultation document is particularly relevant. The sheer size of networks means that investment is by and large incremental and it is only possible to renew a fraction of the network over a single price review. E.ON UK believes that any framework of incentives for investment needs to reflect a longer term view of network performance and avoid a situation where future performance suffers because the network cannot be upgraded quickly enough.

22 A shift to a longer term framework requires a re-assessment of incentives for Opex efficiency, given the progress made to date by the industry, and the likelihood that differences between companies are predominantly driven by differences in underlying cost drivers (e.g. level of capital investment being undertaken, or network topography).

23 Two areas require particular attention:

- Firstly, the diminishing opportunities for Opex reduction means that the longer savings are retained by shareholders, the more likely it is that efficiency initiatives will be introduced on economic grounds, to the benefit of customers in the longer term. In this context, the use of rolling incentives regime for Opex would ensure that there is no discrimination between making efficiency savings in the first year of a price control compared with later years of that price control. Moreover it would be supportive of efficiency saving programmes that generally incur significant upfront costs, but provide ongoing benefits to customers.

- Secondly, whilst we strongly support the objectives of standard cost reporting rules, regular review is required to ensure a sustainable approach. In particular, attention needs to be paid to the treatment of indirect costs associated with capital investment within any efficiency benchmarking. Such costs should be appropriately capitalised to remove the current perverse incentives to outsource, which, given the increasing demand for resources may not necessarily be in the longer term interests of customers.

## **A leading voice in Europe**

24 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.

25 The focus should be on effectively implementing existing EU legislation. Ofgem should encourage the Commission to avoid interventionist approaches which seek to direct investment in generation or networks.

26 E.ON UK fully supports the liberalisation of European energy markets and we seek to play an active and constructive role, especially in the regional markets initiative. At present the impact on the UK of the RM initiative is unclear. Creation of an "all island market" covering the Republic of Ireland and Northern Ireland will require careful preparation, particularly as market arrangements between the UK and Eire are diverging (Ireland moving to a pool system).

27 Ofgem through its EU roles should focus on developments that add value and further the single integrated market, but avoid promoting harmonisation for harmonisation's sake. The UK has invested heavily in its trading arrangements and they have been shown to work well; there should be no presumption that there should be one form of trading at wholesale level across Europe. The key point is to seek harmonisation of trading arrangements where they impede progress to an integrated market.

## **Helping to protect the environment**

28 Environmental legislation and policy is a major driver behind the evolving energy markets, thus E.ON UK supports a greater environmental role for Ofgem.

29 We welcome Ofgem's explanation of its duties and commend its steps to reduce its own emissions, however we would like further clarity on how Ofgem interprets its duties in regards to the environment and sustainability. Considering the environmental impacts of one's decisions should be a prerequisite for all companies and apart from this Ofgem merely seems to be administering environmental schemes on the government's behalf. More work is needed to communicate the "greening" of Ofgem in words and actions.

30 We would suggest that a useful indicator of consumer requirements and areas of interest regarding sustainability could be gained through corporate CSR reports and initiatives.

We would welcome engagement with Ofgem on how this could best be used to support Ofgem's role.

E.ON UK

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