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Ofgem's Corporate Strategy and Plan 2006-2011

Dear Andrew,

Thank you for the opportunity to comment on Ofgem's corporate strategy and plan.

Since you first published your letter on the 12th August last year, we have seen the announcement of the Energy Review and the EC's preliminary report into European Energy Markets. Both substantial pieces of work that will have implications on the functioning of the GB market. It will be important for both industry and Ofgem to engage in these processes and ensure that any outcomes are consistent with the market arrangements in GB.

On your proposed Corporate Strategy and Plan we believe that the themes identified are still valid and the issues raised are relevant. We have some detailed comments which we have included under the appropriate headings.

Helping to protect the security of Britain's energy supplies

We agree that competitive wholesale markets will best protect security of supply and that in a properly functioning market appropriate investment signals will arise. In our earlier submission we noted a number of external impediments to bringing forward this investment. We are therefore encouraged by the comment in the last paragraph of this section that "investors will expect a stable political and regulatory environment before making investment in new capacity and Ofgem will continue to work with and advise the Government to provide stability and certainty in the long term regulatory and policy framework to facilitate this investment".

We applaud Ofgem for the work they have carried out ahead of and during this winter in the area of the "Demand-side Working Group". Not only has this work raised the profile of demand side participation in the market but has brought forward some innovative solutions from the demand side. We will continue to participate in this work going forward.

The "Demand Side Working Group" has in part of its work touched on the transition between normal market operation and that of the emergency

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arrangements, which falls into the domain of the Energy Emergencies Executive. We believe there are other areas in this transition that are worthy of exploring further, such that the requirement for using the emergency arrangements may at least be pushed back and at best not brought into play. Examples include: clarity on how National Grid would use the various tools at its disposal; a clear process by which environmentally constrained capacity could be released and the interaction between the gas and electricity markets. The Demand Side Working Group shows that these initiatives are resource intensive but can deliver real benefits.

We note that a number of the issues that fall under this heading will also feature as part of the Energy Review. Whilst the time-scales of the actual review are short there will be long term issues that come out of it which will impact on Security of Supply. Ofgem will need to build flexibility into their plan to accommodate this.

Helping to tackle fuel poverty

We agree that achieving the government target that by 2010 no vulnerable household should be in fuel poverty is going to be extremely challenging.

Whilst the bullets under the heading “The Next Two years” are valid we believe these will not lead to the delivery of the governments target and that Ofgem should consider the points made in our earlier response of 29th September 2005. For clarity we reproduce those comments below.

- 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 e.g. hypothecation of RO receipts of NFFO generators and/or a levy on distribution charges.

Helping to protect the environment

Ofgem has statutory duties relating to the environment and sustainable development and we agree that the best way of discharging these duties is by using market-based instruments and solutions that do not distort competition in energy markets.

Your plan picks up on three of the areas we highlighted in our earlier response. That of energy efficiency where we believe an energy services market has the potential to have a broader scope and scale and therefore better contribute to government targets than an energy efficiency commitment on its own. Smart metering has the potential to raise awareness of energy efficiency and therefore is worthy of being taken forward. Development of offshore wind farms has stalled because of uncertainty in how the transmission network will be funded; an early decision on this is likely to bring forward projects which again will contribute to government targets.

Creating and sustaining competition

We are encouraged that Ofgem recognises that in future there may be scope to rely more on competition rather than regulation and that the supply licence review is an opportunity to remove unnecessary licence conditions.

Ofgem suggests that the pressure on gas and electricity prices over the next two years should ease. This may well be the case but the statement could give the impression that prices will return to the levels seen two years ago. However, the emerging cost pressures mean that we are no longer in the era of cheap energy. We are no longer self-sufficient in gas, we have to fund cleaner emissions, update infrastructure and build new power stations.

A leading voice in Europe

We are supportive of Ofgem's role in Europe and the initiatives it is taking to ensure that the British consumer is not paying more for its energy than a competitive market would deliver. At the same time, there may be more scope to promote a balanced understanding on the part of UK consumers. For example, interconnection to Europe has helped offset the cost pressures noted in the paragraph above; as the Global Insight report for Centrica notes, UK prices would have been even higher had it not been for interconnection to the Continent.

The industry views very positively the regular meetings between industry, Ofgem and the DTI under the umbrella of the AEP, but not restricted to AEP members. Opportunities for this type of forum should be encouraged in all areas of Ofgem work.

Regulating network monopolies

We believe our response in September remains valid and therefore restate it here.

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.

Further comments under this section;

Ofgem should create the right investment climate and provide clarity over policy related to TPA requirements. Potential investors also need to face stable and predictable network access and charging arrangements, rather than potential uncertainty created by auction-based frameworks.

Under the current transmission price control review, Ofgem should retain status quo arrangements unless there is a compelling case for change demonstrated through an impact assessment. We believe that RPI-X remains appropriate as the main form of incentive regulation; other incentive mechanisms should be only at the margin. The need for responsive and therefore highly incentivised network monopolies should not be over stated.

We do not believe that network monopolies should receive incentives for meeting statutory licence targets and objectives as these should be remunerated under the price controlled allowance.

Better regulation

We are participating in the supply licence review which may well lead to a reduction in regulation where competition is established or self regulation is a better alternative. It may be appropriate once this review is completed to take the lessons learned and apply them to other licensing arrangements.

This is also an example of Ofgem reviewing the need for formal regulation which is exactly the point we were making in our response back in September of last year. We are encouraged by this initiative and would encourage Ofgem to explore further cases where formal regulation could be rolled back.

Yours sincerely,

David Mannering
Director of Economic Regulation