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26 September 2006

Dear Andy

OFGEM'S FIVE YEAR STRATEGY 2007–2012

I refer to Sir John Mogg's recent letter inviting views on the development of Ofgem's strategy for the next five years. EDF Energy is pleased to have the opportunity to comment.

The developments in Ofgem's strategic direction since the beginning of 2006, as cited by Sir John in his letter, are impressive and we largely welcome and support them. At the same time, of course, it remains important for the organisation to continue to focus at all levels on maintaining a high quality and reasonable process of regulation.

The current rate of regulatory change places a great burden on all market participants. So it is also important that Ofgem should seek to simplify market arrangements, reduce the rate of regulatory change, and continue to be an exemplar for other utility regulators by showing – as it has done during the supply licence review process in particular – that reducing the burdens imposed by the stock of existing regulation can actually increase the quality and effectiveness of regulation overall.

Sir John's letter sought comments on the key challenges that we consider the industry faces in the short to medium term and the actions that we consider the Authority should take to respond to these. Our specific views are attached under four broad headings:

- Renewal of the UK generation infrastructure
- Renewal of the UK electricity network infrastructure
- Making UK market arrangements work more efficiently
- Meeting the needs of UK customers

Finally, we consider it imperative for Ofgem to continue playing a leading collaborative role with other European energy regulators in facilitating the creation of a single competitive, efficient, and sustainable internal market for gas and electricity in Europe.

We hope that our comments are helpful and we look forward to commenting on Ofgem's draft strategy in due course.

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Attachment to EDF Energy's letter dated 26 September 2006

THE DEVELOPMENT OF OFGEM'S FIVE YEAR STRATEGY

This attachment sets out EDF Energy's views on the key challenges that we consider the industry faces in the short to medium term and the actions that we think the Authority should take to respond to these.

1. Renewal of the UK generation infrastructure

Estimates vary, but between now and 2016 the UK will need to construct some 25–32GW of new plant to replace planned nuclear closures, coal and oil plant closing as a result of the LCPD, and demand growth. In addition, in response to the Renewables Obligation, significant volumes of, mainly intermittent, renewable generation will also be constructed. Even with substantial growth in distributed generation, by far the majority of this new capacity will remain transmission-connected.

Coupled with a need for new capacity to deliver security of supply is the directional signal provided by government via the Energy Review and EU ETS allocations that the UK's generation sector must significantly reduce its CO2 emissions both in the short term and in the longer term to put the UK on track to deliver a 60% reduction in emissions by 2050.

We comment below on a number of areas where we believe Ofgem can assist in creating the right conditions for the required investment:

- Ofgem influences a number of important external factors relating to power station development. Short and medium term policy is important in creating the right environment for investment over longer timescales. Investment will be attracted by a stable, low risk environment. The current rate of regulatory change in the UK (for example, electricity access reform and gas exit reform) creates a perception of high levels of regulatory risk. Ofgem needs to carefully consider whether reforms brought forward at its instigation both increase market efficiency **and** create an investment-friendly climate. Many investors are multi-national and have the option of investing either in the UK or overseas.

  Ofgem must create an investment-friendly climate by reducing regulatory risk.

- Market price signals are an important, but not the only, factor in deciding to make power station investments – liquidity is at best extremely limited beyond a five-year time horizon. One mechanism for managing long-term wholesale price risks is long-term contracts. The commercial framework must enable the development of longer-term contract structures with all classes of customer.

  Long-term customer contract structures must be supported in the UK market framework.

- To accommodate the large volume of new generation, the transmission network must be reinforced in a timely fashion – long-term investment signals for transmission system owners are important. However, a balance has to be struck between the means of deriving such signals and the financial burden placed on system users through the information-gathering process.

  The production of long-term investment signals must not financially penalise system users.

- Risks should be placed with those most able to manage them. Ofgem's support for the concept of carbon contracts in its formal response to the Energy Review recognises that CO2 prices have high levels of political risk associated with them, and is therefore most welcome.

  Ofgem should continue to emphasise to government that risks must be placed with those parties best able to manage them.

- Government policy is to promote the development of renewable generation. So Ofgem must give due consideration to the impact of proposed changes on the investment climate for renewable generation when making decisions. In the recent past, however, Ofgem has made a number of decisions that quite clearly adversely impact on renewable generators (for example, P194).

  Ofgem should manage change so that it is better aligned with government policy objectives.

- Ofgem should produce and publish a clearer indication of its interpretation of the environmental guidance provided to the Authority by the Secretary of State. In terms of shaping the UK energy sector, this is most important with regard to long-term investment signals for plant and infrastructure renewal – there is only a limited potential for CO2 emission reductions in the short term. Assessment of environmental effects in regulatory impact assessments for major decisions is essential for robust policy-making.

  Ofgem should provide clarity on its methodology for assessing environmental impacts and focus such assessments on proposals that affect long-term investment decisions.

- Large-scale investment is required to deliver security of supply. In recent years we have seen major investment in gas import and storage infrastructure and a large power station project pipeline now exists, including both renewable and conventional technologies. Except in the case of renewables, this actual and prospective investment has been delivered by the market in response to market signals and without the need for capacity mechanisms. We endorse this high-level non-interventionist regulatory framework that Ofgem has used in relation to security of supply, and support its continuation. Ofgem has, however, exerted its influence in terms of more detailed rules relating to storage and electricity cashout prices. The value of such interventions, often opposed by the majority of market participants, is debatable in contributing to longer-term security of supply and creates much short-term uncertainty.

  Ofgem should maintain a light-touch regime and rely upon an effectively functioning market to deliver security of supply.

2. Renewal of the UK electricity network infrastructure

With increasing evidence that climate change is occurring at a faster pace than previously thought, there is an urgent need to ensure that our energy infrastructure facilitates and encourages low carbon technologies. With regard to electricity networks, this means:

- Taking a long-term view of network asset replacement to ensure that the once-in-a-lifetime opportunity is taken to incorporate new technologies and designs so as to avoid a piecemeal like-for-like replacement of the 1960s networks.

- Maintaining and developing incentives for network companies to facilitate the connection of low carbon electricity generation, including reinforcement ahead of need where appropriate.
- Continuing to rebuild lost research and development capabilities within network companies, equipment suppliers, and universities through greater emphasis on schemes like the Innovation Funding Incentive and Registered Power Zones.

Ofgem should reduce its emphasis on cost-cutting and give companies more intellectual incentive to think and innovate to meet the challenges ahead.

Much of the distributors' stock of underground cables is over 50 years old and replacing them will be a massive and disruptive undertaking for our society. Ofgem needs to continue to fund research and development and to work with companies to understand how such a long-term programme can be managed in a way that minimises disruption to both energy customers and highway users while maintaining security of supply.

3. Making UK market arrangements work more efficiently

Demand-side participation in response to market price is limited within the UK gas and electricity markets, particularly so in the latter because of the operation of the current TRIAD charging mechanism. While peak demand may be an indicator of high prices when coincident with low system margin, it does not automatically trigger demand-side response in all instances of low system margin (for example, in the summer). With increasing intermittency in the UK generation fleet as more wind plant is constructed, peak demand will become an increasingly poor predictor of low system margin.

To increase the efficiency of the market arrangements, electricity demand response must be triggered in response to low system margin rather than peak demand.

The findings of the recent EC investigation have shown that the UK has probably the most transparent market information arrangements in Europe. Recent developments (such as the approval of UNC modification 006) to further improve transparency are very welcome. However, a number of deficiencies have been identified, and there are also certain areas where NG's actions as system operator (for example, in relation to balancing services contracts and interconnector operations) remain opaque to market participants. Fuller information transparency will improve the functioning of the UK market.

Ofgem should ensure that remaining information transparency defects are addressed.

System operator incentives must be structured to draw out real investments to improve the operation of the system in the longer term. The current situation, in which NG has no external balancing cost incentive scheme in place, is unacceptable. Multi-year schemes should be developed, if necessary incorporating price indexation or utilising scorecard measures of NG's efficiency, to expose NG to only those elements of cost that are within its own control.

Ofgem must ensure that system operator incentive schemes are in place that create long-term investments.

Ofgem should identify areas currently governed by the Authority in which self-governance by the industry could be achieved. There is a perception that Ofgem all too often ignores the views of industry participants and experts (for example, the high number of Ofgem decisions that reverse BSC Panel recommendations). The conclusions of code governing bodies draw on a wealth of practical experience of operating in the UK market and the rejection of industry advice should be the exception rather than the norm.

Ofgem should give greater weight to the decisions of industry governing bodies.

In addition, a programme of secondments both into and from Ofgem could enable the development of better mutual understanding between the industry and its regulator.

4. Meeting the needs of UK customers

Fuel poverty: We remain fully supportive of the government's commitment to eradicate fuel poverty and think that Ofgem should keep this theme at the forefront of its strategy. However, as Ofgem is well aware, the problem of fuel poverty is primarily linked to a customer's income level. Existing sources of income support that could in many cases relieve fuel poverty are often under-utilised. Political leadership is therefore required to co-ordinate a programme of initiatives by government departments, energy companies, and support agencies to tackle the issue of fuel poverty effectively and sustainably.

Ofgem should consider whether there are wider sectoral lessons to be learnt from EDF Energy's lead on social tariffs.

Energy efficiency: EDF Energy will continue to play an important role in delivering energy efficiency improvements. However, we believe that all levels of society need to be fully engaged if we are to change entrenched behaviour relating to energy consumption. We think that this can be achieved through a combination of information, incentives, and in some areas compulsion, such as the introduction of new product standards.

While this may not be its direct responsibility, Ofgem should do more to promote the significant contribution that consumers can make to the reduction of CO2 emissions through energy efficiency.

Smart metering: In addition to prompt resolution of the government's strategy for smart metering, an early indication from Ofgem that it will introduce an effective governance framework to support the work of the Energy Retail Association and other industry parties in this area will be necessary. The framework will need to capture the fact that some suppliers have a dual fuel strategy and others have a single fuel strategy.

In the context of the smart metering debate, the synergies of having smart metering for both electricity and gas provide an additional challenge. A further issue to be addressed is that, for a single consumer, the gas meter and electricity meter are usually owned by separate entities, and it is highly unlikely that both of these meters will require routine replacement at the same time.

Full interoperability of metering systems, file formats, and data protocols will be needed before there can be a large scale rollout of smart metering. The risk must be minimised that assets may be stranded simply because gas suppliers or metering service providers have adopted differing technical standards.

Ofgem should do everything it reasonably can to facilitate and lead an industry-wide interoperability group for smart metering.

Energy Services Directive: Article 13 of European Directive 2006/32 on energy end-use efficiency and energy services sets new requirements for metering and informative billing of energy consumption. We need to know and understand Ofgem's (and government's) interpretations of the Directive's provisions as soon as possible. While we are looking forward to receiving Defra's detailed transposition plan and expect to participate in the stakeholder advisory groups, we are concerned that government departments may have greater expectations of smart metering than can be delivered.

Ofgem should aim to ensure that Defra and other relevant government departments fully understand the limitations of smart metering (particularly that it cannot be guaranteed to change consumer behaviour) and are properly aware of the actions that the industry has already taken to deliver better billing arrangements.

Microgeneration tariffs: The Climate Change and Sustainable Energy Act empowers the government to amend electricity distribution and supply licences to ensure that suppliers offer to acquire any excess electricity exported to the distribution network by their customers from microgeneration units. While this power of amendment is a unilateral power, subject only to consultation with licensees, it can only be used within a two-year period beginning 12 months after the Act's commencement.

Ofgem should discuss these matters with the industry as soon as possible and take an open working approach to the setting of an appropriate market rate for export tariffs and the detailed mechanics of the process.

Green supply: Ofgem currently provides guidelines under which green supply should be developed. There are, however, no set rules laid out to ensure transparency in the market place. All suppliers determine their own product differentiators, which are all linked to 'additionality'. Differing interpretations of this concept make it difficult for consumers to make informed decisions on the best product for them.

Ofgem should provide more guidance on the development of green supply, including the use of carbon offset products, to ensure transparency in the market place.

Energy Supply Ombudsman: EDF Energy was involved in the development of the Energy Supply Ombudsman from the outset and we are fully committed to this dispute resolution process. The scheme should enable us to deliver a better service to our customers and also show that self-regulation can work. However, following implementation, it will be important to monitor the impact and effectiveness of the scheme to ensure that this approach meets customers' needs.

Ofgem should plan to review the general effectiveness of the scheme, in particular by examining end-user satisfaction and also by undertaking a comparative analysis of the operation of similar schemes, such as those operated by the Ofcom Ombusdman and the Financial Services Ombudsman.

Educating consumers: We have already touched on the need to fully engage consumers if we are to change entrenched behaviour relating to energy consumption. In the same way, we believe the government needs to develop a long-term campaign to communicate the outcome of the Energy Review and educate consumers about the energy challenges that we face in the UK. Addressing issues in isolation will not provide consumers with the big picture, as the whole will be greater than the sum of the parts.

Ofgem should consider the important educational role it could play in this area.

EDF Energy
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