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Dear Andy

### **Ofgem's Five Year Strategy 2007-12**

I write in response to Sir John Mogg's letter of 1 August. We appreciate the opportunity to engage in discussion on your future plans, and are pleased to provide the following comments. Before responding to the specific questions you have posed, it is worth reflecting on the significant improvements in your published plans in recent years. It is helpful that you have identified themes which remain consistent from one year to the next and that your plans are intended to extend over a five year period. This is less evident in practice as there continues to be a strong emphasis on the first year. To some extent this reflects the need for you to respond to external pressures, but we would support any further efforts to improve the balance between the immediate future and the rest of your plan period.

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

As last year, the most obvious challenge to the industry in the short term is the rapid increase in wholesale prices, which has fed through to retail customers. Behind this is the longer-term question of security of supply, which formed an important element of the recent Energy Policy Review and the increasing pressure to move to a lower carbon future. Whilst there are signs that wholesale prices are starting to fall as new infrastructure comes on-stream and the price of oil decreases, it is important that Ofgem maintains strong pressure on the relevant parties to ensure that customers benefit from the changing circumstances and that customers' faith in the competitive market does not diminish.

However there are two other themes which we believe need to be drawn out in your plans. The first is the growing recognition of the importance of investment planning. The gradual replacement of energy network assets needs to be planned over a substantial period and it is important that managing investment is not limited to five year price control windows. The industry needs to collaborate to establish a longer

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term vision for asset replacement, taking account of both emerging technologies and the risk of service failure if too much reliance is placed on aged assets.

Our second issue concerns the better regulation agenda. We have commented recently in response to consultations on industry governance and supply licences, emphasising the distinction between better regulation and less regulation. There is a danger that the current enthusiasm for cutting red tape increases the risk to customers. The industry must share the challenge to ensure the regulatory framework continues to operate in the interests of customers and that useful regulatory controls are not swept away in the enthusiasm to reduce the size of regulatory documents.

## **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. We see a number of areas for actions during the coming years under the headings below:

### **2.1 Energy policy review**

The results of the review will need to be pursued through future legislation and we note that Ofgem are to be involved in several workstreams arising from the review. We are particularly interested in the future work on the review of distributed generation and we hope Ofgem will be consulting industry participants on this area of work. If Government targets are to be met, the need to ensure that the growth of distributed generation is effectively managed is paramount. We also note that gas security of supply is to be an area of work and we would suggest that electricity security of supply should also be on the agenda and broader network resilience issues.

### **2.2 Distribution price control review (DPCR5)**

We hope that a consistent approach will emerge from the current transmission and gas distribution reviews so that the next electricity distribution review (DPCR5) can be built on established practice. Companies are already making initial plans for DPCR5 and it is important that Distributors can see in the current reviews appropriate messages for the future on issues such as future network investment. It is essential that investors are attracted to the energy sector by the returns that can be expected and the results of the current reviews will send out important messages to potential investors. We also hope that DPCR5 will build on the improved data set available from the RRP to re-examine the modelling of efficient costs. This work does not need to wait for the formal price control review process to start and we would be pleased to engage in early discussions based on RRP output.

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### 2.3 Metering and Connections

Striking the balance between competition and regulation is essential and we hope that, in these areas where competition has been fostered in recent years, Ofgem will be able to reduce the obligations on licensees. We expect the DNO obligations in respect of metering services to fall away in April 2007 and in connections we hope the focus will remain on making the existing market for contestable services more effective across the whole country. In our view, this will deliver greater benefits to customers than trying to extend the scope of competition before the current market is operating effectively.

### **3 Priorities**

Our consistent theme in response to previous consultations has been to try and focus on a smaller number of key projects. Neither the industry nor its regulator has the resources to tackle too many projects simultaneously, and to do so also adds to the risk of unintended interactions.

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

Yours sincerely,

Mike Boxall  
Director of Electricity Regulation

cc Sir John Mogg