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Dear Andy

### **Ofgem's Five Year Strategy 2007-2012: consultation letter**

energywatch welcomes the opportunity to respond to the issues raised in the consultation letter. This response is non-confidential and we are happy for it to be published on the Ofgem website.

#### **Introduction**

energywatch has always sought to work positively and constructively with Ofgem to find solutions to issues arising in the development of energy markets which impact on consumers. energywatch has played an active part, alongside Ofgem, in tackling the areas of work identified in page one of Sir John's letter. Our contributions include:

- seeking to increase transparency in the gas market through modification UNC006 to improve security of supply in gas and power markets and our current work to extend that transparency to include gas storage levels at LNG facilities;
- working with Ofgem and the industry to develop supply licences which retain essential protections for energy consumers while allowing suppliers to compete effectively;
- supporting work towards the wider roll-out of smarter metering in order to eradicate the worst aspects of billing problems which are a significant source of consumer complaints and to assist in altering consumers' behaviour to improve energy efficiency in line with the recommendations in the Government's Energy Review.

These will be ongoing issues and should form part of Ofgem's next five-year plan.

The impact of higher prices on the most vulnerable has been significant. Numbers of consumers in fuel poverty have grown and will remain a challenge for everyone, including Ofgem, for the period 2007 – 2012.

That said, consumers' expectations about the delivery of energy supply go beyond the issue of energy prices. Consumers expect supplies to be reliable, secure and safe and there is increased interest in using 'greener' forms of energy, and in energy efficiency. Consumers expect the delivery mechanisms for supplies to be efficiently and economically operated, with savings in costs passed directly to them in the form of lower prices. Ofgem's principal statutory duty to protect the interests of consumers must be interpreted to ensure a consistent approach in meeting these expectations across the range of activities, whether competitive or regulated.

In setting out our views on the challenges and priorities facing Ofgem, we refer to the themes which Ofgem developed as part of the last corporate plan (2006 – 2011).

### **Creating and sustaining competition**

Ofgem is aware that energywatch is concerned that the structure of the energy market does not provide maximum benefit to consumers. That the energy retail market is contested is clear and not in question. However, we feel that there is a real and serious question whether or not the vertically integrated model of competition restricts serious new entry and constrains the actual benefits of competition to consumers. In light of the terms of reference for the sector review in Europe in which Ofgem has played a leading role, we believe these and other questions of market structure should be subject to closer scrutiny by Ofgem or a body such as the Competition Commission.

We believe that improved transparency in competitive markets is a necessary ingredient to allow wholesale energy prices to reflect all the market information that can be made available. Rational prices ought in time to feed into lower consumer bills hence our raising of MOD UNC006 and we hope to see the benefits of increased availability of market data in due course. We are also seeking to bridge further gaps in information transparency, especially regarding gas storage levels at LNG importation facilities. This work follows Ofgem's own enquiries about the effectiveness of third party access arrangements at such facilities. Ofgem recognises that improved transparency provides a real and effective step towards stable pricing in wholesale and retail markets. Ofgem should continue to press for further openness within GB markets to allow this aim to be achieved.

Additionally, Ofgem can lead work on cash-out pricing within the residual power market to improve the pricing mechanism and provide more effective signals to market participants. This would allow them to balance their positions or manage their risks better, avoiding further exiting of players from the market. Ofgem is aware of outstanding issues with the pricing mechanism; especially the pollution of energy prices by system balancing actions and can facilitate solutions to outstanding issues.

We do not, however, advocate that Ofgem takes an excessive regulatory role in markets. energywatch recognises that effective competition can provide real benefits to consumers. However, Ofgem can mix 'light touch' regulation which removes unnecessary barriers to entry with effective market monitoring and a much stronger enforcement remit where genuine breaches of transparent market rules are occurring. This provides the best guarantee to consumers that Ofgem is meeting its principal statutory duty.

### **Regulating network monopolies**

The GB electricity and gas transmission networks require significant investment to facilitate further connection of renewable generation and other supply sources – LNG supply for instance - which should provide more reliable and secure flows of gas and power for the benefit of consumers, as well as promote a sustainable energy agenda. Consumers are in no position to manage the risks of this investment and it is vital that Ofgem assesses the investment plans of transmission operators rigorously to ensure investment approved under the next price controls is based on actual requirements, is efficiently and economically incurred and avoids stranded asset risk. Incremental increases in price control allowances need to be fully justified and granted only on the basis that there is a tangible benefit to consumers.

We are keen to see the development of microgeneration and other sustainable sources of energy, including renewable generation, which we believe will provide consumers with an enhanced choice of options for their supply. Distribution companies' ability to manage and develop their networks in a responsive manner to facilitate the progress of new technologies will need to be reflected in Ofgem's review of the next price controls to apply from 2010 onwards. Future network investment must be undertaken on an efficient but forward-looking, basis.

We look to Ofgem to develop suitable proposals as part of enduring gas distribution price controls which encourage increased connections of off-gas communities to the network. Fuel poor and vulnerable consumers will benefit from having economic access to a reliable source of fuel for heating and cooking and the incentives and investment should be reflected in the price controls which are being developed with the support of energywatch and the industry. Equally, the price control process provides Ofgem and others with a unique opportunity to explore other ways for off gas consumers to reduce their energy bills through innovation such as microgeneration or smarter metering.

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

As Great Britain moves towards being a significant importer of gas it is important that those sources of supply are reliable, safe and provided economically and we have already alluded to action Ofgem could take to assist in rational price discovery. Another significant issue is the quality of gas entering the GB transmission network. Potentially, without blending of lower quality gas from imported sources, which is a more economical solution for GB consumers than mass conversion of appliances, there is a real risk of supply constraints. Ofgem should progress, with the help of the

industry, potential solutions to tackle this issue which clearly impinges on safe, reliable and secure supplies to consumers.

Alongside considering whether consumers are receiving value for money, Ofgem will also need to determine whether the environmental objectives for some of this investment are being achieved. In view of the issues raised in the Energy Review, there is further potential impact from the development of a more diverse fuel mix, including possible new nuclear build and renewable generation development. This will also affect the level of investment in electricity transmission networks which Ofgem should regulate effectively. In addition, the industry needs to consider its role in dealing with global warming. Ofgem needs to understand and develop its own position, including its interactions with other regulators and agencies, as well as ensuring that the correct balance of cost sharing between companies and consumers is achieved overall.

### **A leading voice in Europe**

We have alluded to the significant power of incumbents in European markets, across national boundaries, even as those markets are opened to further competition. The opaque nature of some markets in Europe constitutes a significant barrier to entry to new players in all energy markets and creates protection for incumbents which is anti-competitive and can hinder price transparency under the guise of commercial confidentiality.

In addition, there is further significant consolidation occurring amongst incumbent players across national boundaries, which may eventually lead to control of markets by a few market participants. We expect Ofgem to take a lead in pushing for more reform of European energy markets, working with other regulators through EGREG and with European energy companies with interests in the GB markets, to remove barriers and ensure that vertical integration does not result in reduced competitiveness, increased prices to consumers and potentially restricted supplies.

Action at European level is increasingly vital since EU legislation currently requires full liberalisation of energy supply markets from 1 July 2007, and transparency of data is a key feature of fully liberalised markets.

### **Helping to protect the environment**

Ofgem must provide clarity of its own role in sustainability before looking at the actions it and others should be taking. It is difficult to see how Ofgem can play its full part post the Energy Review without this. In providing clarity Ofgem must also seek to ensure transparent processes for the work it is carrying out. We are aware of the Microgeneration Forum referred to in Ofgem's initial letter and welcome the work intended by this group. In addition we would like to see a formal action plan to accompany Ofgem's Sustainable Development Report which clearly highlights which actions Ofgem will take to meet its regulatory responsibilities in this area.

We believe that smarter metering has a significant role to play in changing consumer behaviour regarding energy usage. It will help drive forward energy efficiency at

domestic sector level, help government to reach targets for sustainable development and address some of the key failings in the energy billing process. Currently around one third of all bills sent to consumers are inaccurate, yet to promote effective demand-side action consumers must have accurate, comprehensive and timely information about their consumption. The absence of this information seriously undermines the effectiveness of competition in the retail markets as well as increasing costs to consumers because of the need to complain about bills, damaging efforts to encourage consumers to use energy more responsibly and inflicting needless suffering on vulnerable consumers. Smarter metering must be an important part of the competitive market but also of a responsible market and a sustainable market. This is particular area where added value can be brought through closer working between Ofgem, energywatch and external stakeholders.

If properly targeted, the fuel poor and vulnerable consumers will benefit significantly from the wider roll-out of smart meters and Ofgem is in a unique position to assess the issues and coordinate a joined-up solution.

The roll-out of smarter metering will require considerable changes which Ofgem can coordinate for the benefit of consumers. Given the complexity of industry and regulatory structures, there is a clear need for coordination and leadership to ensure that the various initiatives required are effectively linked to allow the relevant changes to take effect.

Agreed benchmarks, which must include minimum standards based on consumers' needs will be required for the smarter metering to provide benefits but not stifle innovation. The energy settlement rules, and therefore the future systems and processes which support settlement, will be significantly impacted. There may be development of increasing and flexible load management by suppliers for groups of consumers which will require active response from the network operators. The pace at which these developments take place and the management of market rule changes and system processes will require considerable planning. Ofgem is well placed to consult fully with the industry and other interested parties on how to optimise the project management of these changes.

### **Helping to tackle fuel poverty**

Ofgem will continue to play a leading role in fighting fuel poverty through proper consumer protection measures and by exhorting and incentivising companies to do more individually and collectively.

Over the coming years we would like to see Ofgem undertake active research or other work on these key issues which might help the market maximise its contribution to the fight against fuel poverty. These might include the contribution and efficacy of Corporate Social Responsibility initiatives by distributors and suppliers, communication by companies with their vulnerable customers, more information on the value and limitations of prepayment by vulnerable groups and the issues that surround data protection and the targeting of services to vulnerable consumers.

The regular Social Action Plan review group is a mechanism that could be effectively used by Ofgem to lead research projects with the active engagement of partners and stakeholders from other sectors.

### **Better regulation**

The Supply Licence Review has been a significant undertaking by Ofgem and others, including energywatch, energy suppliers and external stakeholders. While there has been vigorous debate about the process and substance of the review, those involved have been able to agree broadly on ways to ensure that essential consumer protection and effective competition are being reflected in redrafted licences. However, the publication and approval of the final licences must not be the end of the story and Ofgem has a responsibility to assess, analyse and report on how the new licensing regime is working, and take action if problems arise.

Similarly, while we have supported the drawing up of formal industry self-regulatory codes and schemes outside of the licences to provide consumers with some remedies when suppliers do not perform, the rigour and effectiveness of these self regulatory measures needs to be tested fully before Ofgem considers these as successful alternatives to licensing.

Ofgem should monitor the adequacy of these schemes, report back regularly about their performance, and take effective action if there are shortcomings in consumer protection. In light of the possible consequences of the review of consumer representation it is vital that Ofgem is vigilant not only towards the existing self regulatory schemes but also any other self regulatory measures which may come into the market. Ofgem should become much more engaged with the experience of standards and self regulatory initiatives that exist in other markets and be more proactive in taking forward best practice from other industries and bring this into the energy market. Effective self and co-regulation is an important way of adding protection to a market and Ofgem must use these tools to maximum effect on behalf of consumers.

A further consequence of the review of consumer representation must be the active consideration by Ofgem of the fulfillment of its duty to protect consumers in the absence of a dedicated sector consumer body and with new arrangements for consumer representation and advocacy.

Ofgem's statutory duty to protect consumers requires it to act if material and persistent breach of licence conditions has been identified and is not being remedied by the offending party but Ofgem must also be alive, through appropriate market monitoring, to other patterns of consumer disadvantage which may indicate that the competitive market is failing to deliver benefits for consumers. This evidence may not be manifested as a licence or code breach, but Ofgem should still regard it as a signal for further action.

In respect of industry codes, we do not believe that Ofgem needs to undertake a significant exercise to determine the boundaries of its compliance and enforcement powers, and if uncertainty exists, there may be simpler ways, such as code

governance arrangements, to address these issues without the burden of a full scale review. Ofgem's statutory duty requires it to take at least a residual role in these activities if code signatories are failing in their obligations and the codes lack robust processes to deal with breaches.

## **Summary**

We have highlighted a number of areas in which Ofgem can actively develop its strategic role and feel that Ofgem must recognise that these issues cannot be progressed effectively in isolation. There are clear links between smart metering, providing more accurate data to consumers and suppliers, energy efficiency, reduced demand and active management of networks, investment in which can then be determined through appropriately set price controls. More flexible demand patterns and management of energy create the need for more responsive investment in energy supply infrastructure.

Ofgem can help deliver this plan by drawing the correct balance between competitive and regulated activity to optimise the benefits for consumers. Simple cost reduction in regulation activities does not in itself signify effective regulation or even a more efficient use of resources.

The annexed table reflects the challenges and priorities which energywatch believes Ofgem must meet and undertake in the coming years.

Going forward, we will keep these issues under review and provide comment on further development of Ofgem's plan and strategy according to the timetable outlined in the letter, always considering the possible impact on consumers.

If you do wish to discuss our response further please do not hesitate to contact me on 0191 2212072.

Yours sincerely

Carole Pitkeathley  
Head of Regulatory Affairs

## Annex I

The annexed table reflects the challenges and priorities which energywatch has identified in its response.

Challenges (Themes)	Priorities
Creating and sustaining competition	<ul style="list-style-type: none"> <li>enquiry into competitiveness of retail markets by Ofgem or Competition Commission</li> <li>use of market monitoring to improve transparency</li> <li>facilitating further work on cash-out pricing</li> </ul>
Regulating network monopolies	<ul style="list-style-type: none"> <li>effective implementation of network price control review proposals and data monitoring</li> </ul>
Helping protect the security of Britain's energy supplies	<ul style="list-style-type: none"> <li>progressing solutions on gas quality</li> <li>coordination of network investment with Energy Review outcomes on new generation, sustainable development</li> </ul>
A leading voice in Europe	<ul style="list-style-type: none"> <li>working at European level on transparency, market competition issues</li> </ul>
Helping to protect the environment	<ul style="list-style-type: none"> <li>provide clarity of Ofgem's role in sustainability</li> <li>coordination of, and leadership on, wider smarter metering roll-out and energy efficiency initiatives</li> <li>formal action plan following Sustainable Development Report</li> </ul>
Helping to tackle fuel poverty	<ul style="list-style-type: none"> <li>undertake research on key issues relating to fuel poverty e.g. contribution and efficacy of CSR, communication with vulnerable consumers, value and limitations of prepayment by vulnerable groups and the issues that surround data protection and vulnerable groups</li> </ul>
Better regulation	<ul style="list-style-type: none"> <li>proactive engagement in standards and self regulatory initiatives in other markets</li> <li>effective enforcement of new supply licence conditions</li> <li>effective enforcement of all material and persistent licence breaches</li> <li>'less is more effective' as objective of better regulation policy</li> <li>monitoring self-regulatory initiatives</li> </ul>