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Ofgem's Five Year Strategy 2007-2012

Dear Andy,

Thank you for your letter dated 1st August 2006 inviting comments on the challenges, actions and priorities for Ofgem over the coming five years.

We value the constructive relationship we have with Ofgem and welcome the opportunity to contribute to the development of your thinking. We would be pleased to meet to discuss any of the points in this response.

We believe that the period will provide major challenges for the majority of Ofgem's seven themes. As Ofgem has itself noted there are often linkages, as well as tensions, between themes. In many cases, the issues are by no means within the sole control of Ofgem. However, Ofgem's extensive experience and expertise give it significant influence with other key decision-makers and stakeholders across the full range of issues; it is uniquely placed to resolve differences where stakeholder perspectives diverge. We are keen to work with you to achieve positive outcomes. Our views on the main challenges and priorities for action are set out on the following pages under the appropriate Ofgem themes.

Helping to protect the security of Britain's energy supplies

We welcome Ofgem's commitment to markets delivering security of supply and therefore the imperative to resist the temptation to interfere with market solutions. We believe markets are responding well to the challenge of providing secure gas supplies by pursuing various large investments in import infrastructure assets, which will provide the UK with a broad variety of gas supply routes. We therefore currently do not see any need for strategic gas storage, as this would:

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- Introduce uncertainties as to when the strategic reserve would be used;
- Distort the market for commercial storage and reduce incentives for its development; and'
- Burden energy consumers with potentially significant additional costs for a level of security that they might not value.

Electricity market participants value fuel diversity but will factor other risks and relative capital costs into generating build decisions. To this end, current environmental legislation and planning processes clearly favours gas-fired plant, resulting in only Combined Cycle Gas Turbine (CCGT) projects being progressed. The result of this “business as usual” scenario is that the UK would be highly dependent on gas-fired generation and on imported gas.

Now that we have the Government’s Energy Review document, Ofgem, industry and Government need to work together in delivering the long term energy policy and regulatory policy to ensure that the market can choose from the widest variety of options to deliver a diverse fuel mix similar to that currently enjoyed by the UK. This would be the most effective way to remove any concerns over achieving security of supply.

Helping to tackle fuel poverty

As in last year’s submission, upward pressure on prices creates challenges for fuel poverty targets. We largely support the views expressed by Ofgem on this issue.

The long term solution to eradicating fuel poverty will be achieved mainly through continued improvement in the UK housing stock, supplemented with new technology. In the short term though, support will be required to increase income and reduce fuel costs. Critically, the balance between short and long-term needs must be met. Addressing fuel poverty should be a shared responsibility between Government departments (DTI, DEFRA, DWP, DH and ODPM) and local authorities. Government bodies and agencies are best placed to identify the fuel poor, enabling fuel poverty to be evaluated and tackled in a more effective way. The supply industry should continue to offer products and services aimed at those most in need through their Corporate and Social Responsibility programmes. This could be supplemented with further spend made available through the decoupling of fuel poverty from the carbon saving goals within EEC. This will ensure proper focus on both targets and therefore we were disappointed that there was no commitment to this in the Energy Review Report. We will continue to press for this and will work with Ofgem in tackling fuel poverty.

Helping to protect the environment

There are a number of areas where Ofgem can and does lend its support:

Reducing electricity demand through energy efficiency measures – Broadening the concept of energy efficiency to recognise the potential of measures to influence consumer behaviour such as smart metering and real-time displays. There needs to be an industry-wide solution for smart metering, with agreed standards, protocols and timetables. We urge a solution where there is a standard base unit with agreed core functionality and communications protocols, allowing flexibility for different supplier provided display devices. We welcome Ofgem’s commitment to ensuring that smart metering cannot be used to promote exclusionary behaviour in the retail energy market.

Micro generation units - such as solar panels, domestic and small commercial micro-CHP units and small scale wind turbines, could usefully contribute to reducing CO₂ emissions by displacing more carbon intensive centralised generation and cutting transmission losses. However, there remain significant

barriers hindering the growth of micro generation, particularly in the areas of settlements and metering. Ofgem has taken a lead here with the newly established micro generation forum and we look forward to working with you on this.

Carbon pricing mechanism – In order to promote diversity in the longer term we are seeking a robust policy and consistent framework which underpins a value for CO2 emission reductions and strongly support continuation of the EU ETS into phase 3 with an allocation period of 15 years. In addition, effort must be focused on ironing out the wrinkles which became apparent towards the end of phase 1. We note that Ofgem takes a similar stance.

Renewables – Although renewable generation will not by itself be able to fill the anticipated generating capacity gap, it has an essential and increasing role to play both in securing diversity in generation and carbon reductions. We support the Renewables Obligation and believe it should be retained as a long-term stable framework to maintain value in existing projects, but also to stimulate investment in new viable renewable energy generation. Whilst we are not in favour of banding we recognise that the RO must deliver in terms of value for money. Investor confidence in the RO is critical therefore we welcome the statements in the recent Energy Review that:

- changes will be introduced following a notice period and then for new projects only;
- Future changes to banding will be limited and will not apply to projects that are operational before those changes.

Clean coal – As part of a balanced package to deliver the twin objectives of security of supply and carbon reduction, we support research into carbon capture and storage projects. Resolution of significant regulatory and legal issues (for example, carbon transport and storage infrastructure, treatment of carbon capture and storage under EU ETS and international agreements, ownership of long-term liabilities, etc.) will be required.

Creating and sustaining competition

A continuing challenge over the coming years will be to defend and extend the application of market principles in activities as diverse as energy balancing, energy efficiency and services and renewables. If adverse circumstances materialise in any of these areas, pressure could arise for inefficient, administered solutions. We know Ofgem is a supporter of market solutions where appropriate and we will continue to work with you to deliver these.

A leading voice in Europe

We continue to be encouraged by the role that Ofgem is undertaking in Europe but the implementation of European regulation is a particular concern. Whilst government and Ofgem have started to make simplification efforts, there is a continual flow of new Directives and Regulations from Brussels and these will continue. We are concerned that the UK may adopt a gold plating approach to implementation of these directives and we would emphasise the importance of applying the learning points raised by the Davidson Review when it reports by the end of the year.

In addition, there appear to be potential tensions emerging between harmonization initiatives across Europe and the impact on the operation of the Great Britain market. We would expect each case to be reviewed carefully on its own merits.

Regulating network monopolies

The range of future electricity generation scenarios raises the prospect of significant changes to the way gas and electricity networks are developed and managed. In addition to any requirement to provide new infrastructure there is also an attendant need for investment to replace existing ageing transmission and distribution assets. However, making investment in new infrastructure ahead of certainty about which new generating projects will proceed could lead to stranded investments and higher costs to customers. Managing the operation of the transmission system, including the resolution of transmission constraints and electrical losses, has an annual cost burden that is almost half that of the annual costs of investing in, operating and maintaining the transmission assets. Together the aggregate of these costs for electricity transmission in Great Britain is in the region of £1.5 billion per annum. The implication for the medium and longer term development of the transmission network should therefore consider not only the investment and asset related costs of the network but also how any future asset investment would impact the costs of operating the system in a secure fashion. Similar considerations should apply to the electricity distribution networks where the annual asset-related costs are in the region of £3 billion.

For gas networks the comparable annual costs at present are in the region of £2.4 billion per year for the national gas transmission system, and £1.9 billion per annum for the gas distribution networks.

It is our firm view that users of the transmission and distribution networks should be encouraged by the charges for the use of those networks, to contemplate their investment and operations in a manner that is economically optimal for both their own investment and the networks they use. This argues for appropriate pricing signals to be incorporated in all network charges such that they better reflect the costs or benefits a user imposes on the system. Locational signals in transmission network charges are well developed but these do not currently extend to distribution networks. Their application to the higher distribution voltages, especially the 132KV network, is highly desirable to ensure economic siting signals are given to distributed generation. Locational signals in charging for transmission losses would influence both generation investment and its operation. This should result in reduced carbon emissions through more efficient use of the existing infrastructure.

The lack of capacity for all the renewable generation that wishes to connect in Scotland has led to significant 'queuing' of projects. There are a number of projects in the queue that are unlikely to proceed but are preventing other more viable projects from progressing.

We note Ofgem's response to 'Our Energy Challenge' dated 8th May 2006 states 'we support abolition of Final Sums Liability in its current form, and its replacement with an alternative which acts as less of a barrier to connection of renewable generation'. We also note similar sentiments expressed in Ofgem's covering letter that accompanied the report of the Access Reform Options Development Group. Given the flexibility of the current arrangements, it may be worth considering a number of pre-emptive changes to the current arrangements that recognise these sentiments. In summary these are:

- Amendment of the existing Final Sums arrangements so that commitment is more closely linked to project milestones. This could be achieved by amendment to the Construction Agreement;
 - A more proactive approach by NGET in its relationships with developers;
 - Greater transparency of the process for establishing clusters either by establishing a "cluster methodology" for approval by Ofgem or incorporating appropriate amendments into the CUSC;
 - There may be some merit in the provision of enhanced information to the market place;
 - Any reallocation of capacity rights should recognise those projects that have the necessary consents in place to enable construction to commence;
 - The opportunity for provision of Non-TEC rights appears limited but should be investigated further;
- In the event that a new Final Sums methodology is adopted, revised offers should be issued to any

projects that have declined offers based on the existing arrangements.

Better Regulation

The maturing of the competitive energy markets provides a golden opportunity to refocus regulatory responsibility on existing organisations that are best suited to the role. Ultimately, we believe the energy industry should move to a position where it is regulated similarly to other sectors, with Ofgem focussing its activities on monopoly network regulation and access.

We welcome the direction of the Supply Licence Review, in particular its objective of removing sector specific regulation where this duplicates competition and consumer law. Ofgem has expressed optimism that specific regulation can be rolled back further as self regulation continues to operate successfully. The ERA billing code of practice and Energy Supply Ombudsman are recent examples and we are keen that they should be given every opportunity to deliver further service improvements, to reduce the risk of premature and disproportionate intervention. We hope that Ofgem will be bold in recommending the removal of unnecessary licence conditions and withdrawal, where sensible, from industry codes.

Yours sincerely

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