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Dear Andy

Ofgem's Five Year Strategy 2007-2012

I refer to the open letter of 1 August and am pleased to respond with views on the strategic choices for the Authority in the coming years.

Reviewing the list of actions, set out in the consultation letter, which the Authority has taken since the beginning of 2006, we clearly welcome those of a de-regulatory and/or cost reducing nature. In particular, we are encouraged that Ofgem continues to outperform its RPI-3 cost reduction target and that the review of supply licence conditions has resulted in proposals from Ofgem to reduce the number of standard conditions significantly. The establishment of an energy supply ombudsman is also a promising way forward to provide an efficient complaint-handling resource for customers.

However, in our view, much remains to be done to reduce the level of Ofgem's costs towards the levels seen across the separate offices of Offer and Ofgas in the mid 1990s. In money of the day, these costs held steadily at around £13m until the increases associated with the full opening of the market began to be seen. Across all of Ofgem's stakeholders, we believe there are many voices calling for Ofgem to slim down its cost base still further and to withdraw from active initiation of change across the markets that it regulates. These twin objectives can be achieved by Ofgem reducing its headcount and taking a more reactive role in relation to the markets that it regulates. This is particularly the case for the competitive markets but even for the regulated monopolies, where the setting of price controls and other regulatory duties require more active engagement with the industry, we believe that reductions in Ofgem-led projects could be achieved.

For example, in the review of the supply licence conditions, we believe there is scope for Ofgem to go further in reducing the number of conditions and their regulatory burden on supply licensees. Similarly, the current review of industry codes compliance provides an opportunity for Ofgem to develop a plan to withdraw from direct regulation of these codes and for the industry to achieve greater autonomy in this area in the longer term. In response to the recent consultation, we have argued that Ofgem should develop a detailed plan for this and, as a first step in this long-term plan, withdraw immediately from routine approval of all changes that are proposed by the industry.

The other major areas, where Ofgem's pro-active initiatives cause us significant concern, include the promotion of change in network pricing methodologies and the increasing complexity of network incentive schemes. We discuss the former area in some detail in the following section of this letter and a current example of the latter is the proposed exit reform in the gas market.

Key challenges to the industry in the short to medium term

We see the following areas as key challenges for the energy industry over the next few years.

Gas Prices
The level and volatility of wholesale gas prices continues to give significant cause for concern to customers and the industry. We therefore welcome Ofgem's lobbying of the European authorities on this issue. We continue to believe that there are aspects of the UK offshore market that would merit further investigation by the UK regulatory authorities and also that more information about this market would increase transparency and equity in the downstream onshore gas market. We recognise that the recent modification "006" to the Unified Network Code should increase the availability of offshore information, which is welcome, and would support further initiatives in this area.

Growth of Renewable Generation
This continues to be a major challenge and uncertainty for the electricity network businesses in the next few years. During the current transmission price control review, Ofgem has a responsibility to set parameters such that the infrastucture investments required to accommodate the demand for renewable generation connections is delivered in a timely manner on the transmission networks. These parameters include the assessed cost of capital for the transmission businesses and the mechanism developed to fund uncertain future generation-led reinforcement requirements. The latter mechanism is of key importance in delivering an acceptable investment framework for the transmission licensees and, in our view, an important component of this should be a commitment from Ofgem to react in a timely manner to unforeseen infrastructure investment needs. Furthermore, the mechanism that is developed should be flexible to changes in, for example, access arrangements, security standards or charging methodologies.

A specific subset of renewable generation is that wishing to connect offshore, which has brought its own specific regulatory issues such as offshore transmission licensing arrangements. We welcome the setting up of the Offshore Transmission Experts Group (OTEG) following the government announcement earlier this year that offshore electricity transmission would be regulated by a licensed price control. Ofgem and the DTI have committed to a "go live" date of July 2008 for these licensing arrangements. This is a challenging deadline and we would encourage Ofgem to prioritise this work so that the links with other areas of work (such as use of system charging methodologies and network security standards) can be considered in appropriate detail before the new licensing arrangements are finalised. Uncertainties in this area are also relevant to the price control mechanism for funding unanticipated reinforcement requirements discussed above.

A remaining issue in relation to renewable generation is, in our view, the stability of electricity transmission and distribution pricing. We discuss this in more detail below.

Stability in Network Pricing

We strongly believe that the Authority should be aiming to promote the stability of network charging arrangements. A climate of instability and uncertainty in this key area has several undesirable effects. Firstly, promotion of change by Ofgem in this area entails an element of direct regulatory cost and a significant level of indirect cost for the network companies in responding to the proposals, providing information and analysis, and attending workgroups. Secondly, the players in the competitive markets who see these charges as input costs, will also have to devote resources to understanding and trying to influence the outcome of proposed changes. Thirdly, these parties will factor in risk premia in their competitive offerings if there is significant uncertainty in the level and likely path of future charge liabilities, which in turn feeds into higher prices for end-customers. Finally, the hurdle rates for new competitive projects – for example, potential new renewable generation projects – will be higher than they would be against a more stable charging background.

It is this latter point that has a direct link to the above discussion on the growth of renewable generation. In our view, that potential growth will be adversely affected by continuing uncertainties in electricity network pricing. We look in turn at transmission and then distribution level below.

At transmission level, we note that NGET has not developed solutions to the issues raised by Ofgem when conditionally approving the current charging methodology at BETTA "go-live". While NGET has complied with the conditions by consulting on each issue, it has treated each one in isolation and concluded in each case that it cannot make any feasible amendment to its current methodology. Not only is this insufficient to clear the issues that were raised, but we also believe that if NGET took a holistic approach to reviewing all the issues raised, it would be able to see charging methodology amendments that would address the common concerns underlying all the issues raised. This is particularly relevant to the issue of intermittent generation since this also impacts on non-firm connections in the transmission price control review and encompasses potential changes to: the GBSQSS; the charging methodology; and the calculation of revenue drivers in setting allowances in the price control.

For electricity distribution, we are concerned about the disruptive effect that Ofgem's promotion of long run marginal costing models is likely to have on distribution use of system charges. In our view, there are significant flaws and instabilities in these models: not least the lack of any auditable cost-reflectivity when a high proportion of final charges to system users depends on modelling of <u>future</u> (rather than actually incurred <u>historic</u> costs). There is also a significant issue affecting existing generation connected to the distribution networks, which is the matter of whether they are brought within the charging base for generator-related use of system charges. In our view, such generation has paid all that was required in the way of connection charges at the time of its connection. To suddenly require such generation to pay an ongoing use of system charge is both unacceptable to the generators concerned and sends an adverse signal about regulatory risk to current generation developers, many of whom will be looking to develop renewable resources.

In relation to gas network charges, we have similar concerns about stability and the promotion of change in gas transmission charging. Proposals for the development of exit charging are increasingly complex and it would be useful, in our view, for the Authority to consider a "post investment appraisal" of the reforms for gas entry capacity charging before driving a similarly ambitious change in exit charging. On the other hand, in relation to gas distribution charges, we are encouraged that Ofgem has taken a simplifying approach and that debate in this area is now drawing to a close.

In conclusion, therefore, our hope would be that the Authority would put a high priority on simplification and stability in network charging in the years ahead. We believe the time is right for the Authority to assess the costs, benefits and risks associated with its involvement in charge structure developments across the energy networks and to actively promote stability in network charging.

European Issues

There is no doubt that European energy markets and regulatory policy are increasingly influencing those in Britain. We are concerned about increasingly detailed levels of regulation from this source and see a key role for Ofgem in engaging with the European authorities in order to minimise the regulatory burden on the liberalised energy markets of the UK. We would expect Ofgem to guard particularly against any gold-plating of EU requirements within its own sphere of influence. We therefore agree that European issues should continue to be a key priority for the Authority and we welcome Ofgem's work to date in this area, particularly in relation to market opening. However, we believe Ofgem should continue to push for liberalisation across the EU, but at the same time ensure that any new legislation in this area has no adverse implications for the UK's competitive markets.

We support Ofgem's work within ERGEG and CEER - the two energy regulatory bodies within Europe - and would find it helpful for Ofgem to signal the consultations and forward programme for these bodies, perhaps via a dedicated area on Ofgem's website or the e-mail notification service. We also believe that Ofgem should seek to move the UK towards the "G = zero" principle of transmission tarification that has been proposed by ERGEG's own Guidelines. This, together with a similar approach in electricity distribution charging would help to alleviate some of our concerns on network charging discussed above.

Environmental Issues

Following on from the above, it is clear to us that increasing environmental legislation, much of which is at European level, is driving an increase in costs for many players in the energy market. While we recognise that Ofgem's direct role might be limited in this area, the effects of such legislation on the cost base of energy network companies and, potentially, on security of supply, fall firmly within Ofgem's remit.

Fuel Poverty
This is still a significant issue for energy supply companies and for government. We therefore believe that this should remain a key priority for Ofgem.

<u>Action by the Authority to respond to the challenges above</u>

We have tended to cover this question in our comments above. A common theme in our view of what the Authority should be seeking to achieve in the next few years is withdrawal from active direction of and involvement with the energy markets, where this is feasible. Such a strategy would still allow the Authority and Ofgem to take the role of appeal body, for example in relation to industry code governance, but would result in less regulation of the competitive markets, backed by appropriate and transparent governance mechanisms. Rather than seeking to keep up with an Ofgem-led agenda of development, we believe it is important for the competitive markets to set their own priorities for development and discussion.

In contrast, where concerns are expressed across the whole market, for example, in relation to the transparency of continental and offshore wholesale gas pricing, then we believe it is right for the Authority to become involved in seeking any structural changes that appear to be necessary to remedy market concerns. Our overall vision is for Ofgem to become a reactive rather than a proactive regulator in relation to competitive markets.

In relation to regulation of the network monopolies, we recognise that there is a need for an ongoing programme of regulatory activity such as price controls and ad-hoc requirements such as determination of disputes. Nevertheless, our concern here is also to keep the regulatory burden to the minimum that is consistent with the Authority's statutory duties.

We have already noted the work involved for network licensees when Ofgem drives an agenda for development of network charging policies. Other areas of increasing workload that we would mention include developments in the cost reporting regime for electricity distribution and the recently issued further round of consultation on competition in connections. With respect to the latter area of work, there have been a number of extensions to the contestable areas of connections work in recent years, without the benefit of any regulatory impact assessment. We believe that this area should be allowed to consolidate within the present framework, with any further proposed extension of contestable work subject to a rigorous analysis of the costs and benefits to relevant parties. On the cost reporting project, we remain concerned about the increasing levels of detail being sought through this process.

Priority of future areas of work for the Authority

Looking to the future, in the light of the challenges we have identified above, we consider that the following areas should be a priority for the Authority in the years ahead:

- establishing a clear plan for further withdrawal of sector-specific regulation of the competitive energy markets, starting with a reduced involvement for Ofgem in routine code modification business;

- continuing Ofgem's involvement in the issues of fuel poverty;

- Europe - Ofgem's work to lobby for opening of other continental energy markets is useful and should continue, but it is also important to guard against the cost to the UK of increasingly prescriptive regulation aimed at solving issues in other energy markets;

- developing a plan for providing regulatory and commercial stability in energy network pricing;

- gas wholesale pricing should remain a priority area of work;

- The other significant areas of work will continue to be the transmission price control review and the gas distribution price control review now both currently underway. In these reviews, the preservation of incentives to invest is important, against the background of substantial likely changes in the pattern of network flows. Where incentives are felt to be necessary, these should be kept as straightforward as possible for reasons of ease of implementation, transparency and minimising the risk of unintended consequences.

I hope these comments are helpful.

Yours sincerely

Rob McDonald
Director of Regulation