

24th September 2007

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Dear Andy

PROPOSED CORPORATE STRATEGY & PLAN 2008-13

British Energy welcomes the opportunity to contribute to the development of Ofgem's next five year corporate strategy and plan as set out in the consultation dated 6th August 2007.

The primary aim of Ofgem's existing and future strategy should be one that seeks to achieve its principal objective of 'protecting the interests of consumers'. However, energy policy in the UK is currently going through an extensive review driven predominantly by the need to tackle the issues of climate change and ensuring the security of energy supplies. Although energy policy is the responsibility of Government, Ofgem has a pivotal role to play in assisting the Government during the current and any future policy review. With this in mind, Great Britain requires an energy policy and regulatory framework that balances security, diversity and care of the environment with competitive markets and price stability. The continuing challenge for Ofgem is to develop an energy regulatory framework that satisfies the public interest test by striking the right balance between these priorities whilst operating in accordance with best regulatory practice. Furthermore, it is important that the industry understands the way in which Ofgem balances these priorities when developing regulatory policy in order to create the right environment for new investment.

Regulatory Climate:

The promotion of competition by Ofgem in the energy markets combined with the operation of network price controls has brought historic benefits to consumers. Although lower prices can be in the interests of consumers and could potentially increase the competitiveness of UK businesses in the short-term this should not become an aim in itself. There is a need for urgent and sustained action to implement a large scale investment programme in infrastructure including new

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generating capacity to address a looming capacity gap. Given the electricity industry is a capital intensive industry characterised by long-term investment and planning horizons, regulatory certainty and stability is crucial to creating the right environment for new investment. Ofgem's objective should be to facilitate a fully functioning market with competitive and transparent prices that delivers the required investment to underpin security of supply.

Competitive markets evolve over time so some form of regulatory oversight is required to ensure that the interests of consumers are protected. However, significant regulatory intervention in competitive markets should only be contemplated when a clear benefit to consumers has been demonstrated. Interventions based on text-book economic efficiency which at times ignores the reality of the market undermine regulatory certainty and investor confidence.

Government quite rightly takes no role in the day to day operations of Ofgem. Whilst we fully support this independence it is vital that the decisions of Ofgem do not conflict with overriding Government policy. There is therefore a question of how independent of Government Ofgem should be given the need to ensure a coherent policy and regulatory framework and in light of the important role Ofgem plays in helping to deliver the Government's energy, social and environmental objectives. Unfortunately, instances have arisen where the regulatory framework has not achieved this objective (for example Ofgem's recent 'minded to' decision on zonal transmission losses and the impact on the Government's policy on renewables development). Effective scrutiny of how and to what extent Ofgem's policies are consistent with and complement the framework of energy policy set by Government is required.

Europe

European energy markets and EU regulatory and competition policy have an increasingly important impact on the UK's energy markets and consumers. Consequently, Ofgem clearly has an important role in shaping the development of European policy in energy markets in order to protect the interests of GB market participants and ultimately all consumers. We consider that Ofgem takes this role very seriously and through its participation in CEER and ERGEG it is clearly engaged in promoting and developing competitive energy markets and effective network regulation across the EU.

Although it is well recognised that the UK has one of the most developed liberalised energy markets in Europe there is still a need to carefully consider the compatibility and consistency of the UK market arrangements with those in the developing EU energy markets. In the context of competitive single European energy market, it would be neither appropriate nor efficient for there to be significantly different, more complex or more burdensome arrangements in the UK. The EC in a report earlier this year on the internal market commented that "Britain can no longer be regarded as an isolated, self sufficient market for electricity and gas. Regulatory decisions need to be strongly co-ordinated with neighbouring jurisdictions. If not there is a continuing risk that inconsistent regulatory frameworks will create perverse incentives for energy companies".

One potential barrier to trade that has been identified by the France, UK & Ireland (FUI) regional market initiative is differing approaches to transmission charging (including transmission losses) arrangements. This issue needs to be tackled urgently if an effective FUI regional market is to be developed and UK competitiveness is to be maintained. For example, major differences in transmission charging levels (including for losses) across the region need to be removed (although absolute levels do not necessarily need to be identical) and transmission charging methodologies (including for losses) need to be harmonised.

It is possible that Ofgem's current statutory powers constrain its ability to co-ordinate its regulatory decisions with neighbouring jurisdictions. We note that the EC has recently published its Third Liberalisation Package which includes amongst other things proposals on policy objectives, duties and powers for regulatory authorities. Clearly these proposals need to be fully assessed by Ofgem and what impact they may have on the GB regulatory arrangements. However, consideration could also be given to amending the statutory duties of Ofgem and the Secretary Of State. The appropriateness of a new 'secondary' duty that obliged Ofgem and the Secretary of State in carrying out their functions under the Electricity Act to act in a manner which, where possible, facilitated EU market integration should be considered.

Market Structure

British Energy has on a many occasions expressed concerns to Ofgem regarding the developments in market structure and in particular the level of vertical integration and market power within the sector and its effect on liquidity in wholesale markets. We consider that these concerns remain valid. For example, a highly vertically integrated market increasingly forecloses the market to new entrants. This is because new entrant suppliers will find it difficult to source the power they need on a competitive basis to enter and compete in the retail market and new entrant generators will be unable to secure the longer term contracts they need to underpin their financing arrangements.

With this in mind it is important that Ofgem closely monitor/review the wholesale and supply markets with a view to examining the effects of vertical integration on competition in these markets and whether this is, or is not, in the public interest. As a minimum Ofgem should monitor customer prices against wholesale and other market costs and publish its analysis on a routine basis, particularly given the current market where falls in wholesale prices are not being passed on to customers. We note that energywatch has very recently expressed its concerns regarding the development of supply competition including commissioning an independent report¹ on the matter. We consider that this report raises some significant concerns which must be addressed by Ofgem.

The independent electricity and gas watchdog energywatch will soon be merging with the National Consumers Council. However, it is clear that energywatch's existing role and responsibilities will not be fully transferred to the new Council.

¹ An assessment of competition in the energy market, A report for energywatch, Professor Stephen Davies, Centre for Competition Policy, University of East Anglia, 11 July 2007

Consequently, Ofgem need to consider in the interim period how this gap will be filled in order to ensure that the interests of all consumers continue to be fully protected.

Better Regulation

Generally speaking over the last three to four years Ofgem has made significant improvements in its effectiveness and working practices. This has predominantly been brought about by the adoption of the Better Regulation Principles. However, we consider that significant improvement can still be made in a number of areas which are described below.

Regulatory Impact Assessments:

It is vital that the production of RIAs is not divorced from the policy making process. RIAs should not be just a box ticking exercise but should be a fundamental part of policy making. There is still the impression that policy is made and RIAs are crafted to justify the policy decision. For example, the recent impact assessment published by Ofgem in respect of a number of BSC modifications seeking to introduce zonal losses was deeply flawed. The use of out of date data plus an over reliance on independent analysis (produced for a different purpose) in coming to a decision which it knew would be highly contentious is clearly inappropriate and does little for promoting confidence in the regulatory regime.

Furthermore, a fundamental problem that undermines the use of RIAs is that Ofgem is only really involved at the end of the decision making process as is the case with modifications to the industry codes. In addition, there is also a mismatch in the impact assessments conducted by the code governing bodies and that of Ofgem. Ofgem is obliged to consider their wider statutory duties whereas the code governing bodies are limited to the code's defined applicable objectives. Ofgem together with the industry should consider reviewing these arrangements with a view to determining whether they are efficient and appropriate.

There are a number of comprehensive reviews that have been commenced by Ofgem over the past 12 months that have the potential to have a significant commercial impact on the industry. It is vital that as part of the review process a robust and comprehensive impact assessment is produced and consulted on. For example, Ofgem/DBERR has recently commenced a review of the transmission access arrangements and as part of the review it is looking at new approaches to sharing transmission capacity between different forms of generation. A number of options have been identified some of which significantly alter the existing access arrangements. We consider that any fundamental change to existing users rights should not be implemented without an overwhelming and rigorous cost benefit analysis.

Targeted Regulation

Further strides could still be made particularly in the areas of targeted and proportionate regulation. In particular, Ofgem should demonstrate that it is withdrawing from direct regulation of competitive markets (leaving this to be

regulated under competition legislation) and focussing instead on regulation of the monopoly businesses. A roadmap of how Ofgem plans to withdraw from directly regulating competitive markets should be drawn up along with the conditions it believes need to be satisfied in order to obtain this objective. This in turn would allow for some form of independent scrutiny of Ofgem's performance in this area.

We fully supported and are actively participating in Ofgem's review of electricity and gas supply licences. This is a significant and timely project that was part of package of 'better regulation' initiatives commenced by Ofgem. Given this particular review is drawing to close we see no reason why Ofgem should not be planning similar reviews of the licence conditions of other licence types with a view to ensuring that these licences also meet the better regulation principles.

Prioritisation

We believe that Ofgem needs to be more transparent in the way it which it prioritises its aims and objectives and how it allocates resources to these. This should include identifying and justifying the work it is planning to do in the short-term, plus the work that has been identified as required but given less priority (i.e. a 'wish list'). Developments in this area will promote regulatory certainty and stability.

Transparency

Whilst we recognise that Ofgem has made progress in the area of transparency further improvements could be made. Most significantly, we consider there to be a need for Ofgem to explain its decisions in a more comprehensive manner and to provide greater justification and reasoning for its conclusions rather than simply relying on assertion.

Currently, the Authority minutes are published in final form approximately 8 weeks following the meeting. We believe that these would be much more informative and relevant to the industry if published much earlier. One solution would be for Ofgem to publish draft minutes that had been subject to participant's comments within a week of the meeting. These could then be finalised and agreed at the following meeting and then republished. Further, in the interests of transparency we see no reason why Authority meeting agendas are not published in advance.

I trust you will find these comments helpful I would be happy to clarify any aspect of our response with you should you wish.

Yours sincerely



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