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24 September 2007

Dear Andy

OFGEM'S FIVE YEAR STRATEGY 2008–2013

This is EDF Energy's response, set out below and in the paper attached, to Sir John Mogg's letter of 6 August 2007. We are pleased to have this opportunity to comment on the development of Ofgem's strategy and priorities.

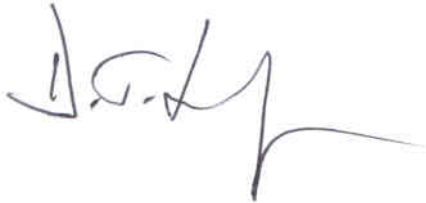
The differences of emphasis in the direction of the Authority, cited by Sir John in his letter, are impressive and we largely support them, while noting that it is important for the organisation to continue to focus at all levels on maintaining a high quality and reasonable process of regulation (including in enforcement activity, on which we comment later).

However, there are two high-level points that we should like to emphasise here in view of their importance at a time when UK energy policy is under profound review (to use Sir John's own words). Firstly, it is not clear to us that the pursuit of competition in energy markets will always necessarily be consistent with the emerging primacy of carbon emissions reduction and security of supply in the government's policy objectives. As we note in the attachment, the current legal framework for the Authority's activities does not require it to treat competition as a regulatory objective in itself, but only as a preferred means to support the overarching objective of consumer benefit.

This is not a call for the abandonment of a reliance upon market mechanisms to secure energy policy objectives. However, we do think that Ofgem will need to strike a more appropriate balance in future between the promotion of competition and the promotion of other objectives, and must aim for a more considered interaction and integration of its own regulatory proposals with the complete portfolio of existing energy policy instruments.

Secondly, and more briefly, Ofgem should, in our view, listen more to the industry and not proactively initiate change, particularly in competitive wholesale and retail markets, that as little or no support. While we expect Ofgem to be a bold and innovative regulator, we do not expect it to impose fundamental rule modifications to which market participants are actively opposed.

Yours sincerely

A handwritten signature in black ink, appearing to read "D. Linford".

Denis Linford
Director of Regulation

Attachment to EDF Energy's letter dated 24 September 2007

COMMENTS ON THE DEVELOPMENT OF OFGEM'S STRATEGY

This attachment sets out EDF Energy's comments on the letter of 6 August 2007 received from Sir John Mogg, chairman of the Gas and Electricity Markets Authority, inviting our views on the Authority's future strategy and priorities.

1. Wholesale Energy Markets

Ofgem should aim for stability in the regulation of UK wholesale power markets. This is essential in an environment where so much major new infrastructural investment and renewal is required. The candidate investors are mainly international firms which have comparable investment opportunities overseas. Other things being equal, their capital will be deployed, by rational choice, in the most stable regimes.

Clearly, if not enough energy investment takes place in the UK, because an excess of proactive regulatory change increases the perceived risk of investing and hence the industry's cost of capital, security of supply will be jeopardised and price volatility will increase, with obvious adverse consequences for consumers.

In any event, the UK's wholesale energy markets are the most liberalised in the world, and are now relatively mature. Ofgem's resources should therefore best be directed to ensuring that there is not wholesale market abuse, for example in the gaming of certain long-standing and major energy transmission constraints, rather than to the kind of "perpetual revolution" in the fundamentals of market design that all too often characterises Ofgem's current interventions.

Indeed, given recent and current increases in some of the costs we face arising from the market, we would like to see evidence of more investment of Ofgem's resources in investigating market abuse, and less in market tinkering.

2. Retail Energy Markets

The highly competitive nature of energy retail markets means that suppliers are increasingly differentiating themselves through the development of innovative products and services, including those designed to help customers save or make the best use of their energy. Service competition is likely to play a bigger role over the next five years and should not be stifled by prescriptive regulation.

We would expect Ofgem, having completed its ground-breaking Supply Licence Review, to now fulfil its earlier commitment to review the guaranteed and overall standards of supplier performance. The original purpose of these performance regimes was to counter the perceived risk that cost-cutting pressures generated by price controls on the then monopoly suppliers might prejudice the quality of their service delivery. Clearly, these obligations are no longer necessary.

Fuel poverty is undoubtedly one of the major challenges facing government and the energy industry in the short to medium term. Although it is clear that fuel poverty arises from a combination of low incomes, poor property conditions, and rising energy prices, the impact of volatility both in the price of energy and in the overall economic framework has exacerbated the issue, and energy suppliers can clearly play a strong role in helping to deliver the government's statutory targets to end fuel poverty.

While EDF Energy has committed substantial resources to support our fuel poor customers, we also believe that the opportunity for the EEC (now renamed CERT) programme to assist vulnerable customers generally is being significantly under-utilised. Suppliers invest huge amounts in delivering energy efficiency measures to Priority Group households of people in receipt of benefits. For EDF Energy alone, the additional cost of delivering such measures to the relevant households for 2008–11 is likely to be around £28 million.

DEFRA's own estimate is that in nine years of EEC from 2002 to 2011, only some 100,000 households will have been removed from fuel poverty, whereas if the target share for vulnerable customers within the Priority Group were reduced, the savings gained could be redirected to measures which have a far greater and more direct effect on households, such as benefit entitlement checks. We believe that Ofgem should explore with suppliers this opportunity to tackle fuel poverty more effectively, and work with us to discuss this with DEFRA.

The industry also faces a major challenge to encourage, support, and deliver reductions in carbon emissions in customers' homes. The CERT programme is a central element of this work, although it is clear that the industry will need to embrace more than traditional energy efficiency measures if we are to meet the scale of the challenge. As we work with DEFRA to develop a framework for a supplier obligation beyond 2011, it is critical that we continue to explore new and more innovative ways to deliver carbon savings.

Ofgem has a crucial role to support these activities in its role as administrator of the CERT programme, and should ensure that it supports and encourages innovation through its interpretation of eligible schemes under this particular category of CERT. Without this support, the industry will be unable to make the required step change in the reduction of domestic carbon emissions.

3. Energy Network Operations

The main high-level factors which we think are most likely to affect distribution network operations going forward are the public's rapidly growing awareness of mankind's impact on the environment, and the likely effects of this in relation to the conduct and implementation of the next price control review (DPCR5) for distribution network operators (DNOs).

As with our comments above about wholesale energy markets, we would stress that investor confidence will be essential for delivering the increasing levels of investment needed in the distribution networks, particularly in cases where companies may be cash negative for sustained periods, or where they require new injections of equity. It will therefore be a significant challenge for DPCR5 to put the DNOs on a path that anticipates the direction in which society is now travelling while also incentivising them to outperform the regulatory cost of capital for efficiently delivering the outputs that customers value.

We are concerned that Ofgem's current self-imposed price control could reduce the regulatory resources available to ensure a high-quality DPCR5. In particular, it would be unfortunate if the quality of decisions relating to many £ billions of DNO investment were compromised by (relatively trivial) shortfalls in Ofgem's budget for the review. We called above for less tinkering with wholesale market design, and believe that such a shift of emphasis would allow Ofgem to keep within its overall budget while being more effective in monopoly regulation.

We also believe that the balance of resource allocation in Ofgem could be further improved on the networks side by an informed review to establish if there is any demonstrable benefit to customers from IDNO operations and IDNO performance. We cannot emphasise too strongly that competition is not, since the passing of the Utilities Act 2000, to be regarded as a regulatory objective in itself, but only as a preferred means to the over-arching objective of consumer benefit.

We say this because there are some indications, from the volume of the attention currently given to IDNO (and IGT) issues, that regulatory policy in these areas is being driven largely by the interests of developers and construction companies. Ofgem has no legal duty at all to protect the interests of these entities in that specific context. The important question, for Ofgem, is whether any commercial benefit that developers or contractors may derive from a right to be licensed to operate distribution systems is a benefit that will ultimately be experienced by consumers. This question is one that needs to be answered empirically.

4. The Enforcement Process

It is very important for Ofgem to maintain a reasonable enforcement process. We believe that there are significant defects in the way that Ofgem initiates and carries out investigations into allegations about the conduct of licensees and their compliance with their licence obligations. These observations spring from our experience, in recent years, of being on the receiving end of two protracted, disruptive, and costly compliance investigations, under section 28 of the Electricity Act 1989, each of which concluded without any findings of breach of a licence condition or a relevant statutory duty.

Two difficult features of Ofgem's compliance investigations are the low threshold for starting an investigation, and Ofgem's inability (or unwillingness) to tell the licensee what it is accused of if the complainant has requested confidentiality.

Taking the threshold issue first, we accept that Ofgem does not need to have a settled belief that the licensee is in breach before beginning an investigation. But such belief as Ofgem does have in that respect needs to be more than a mere suspicion: there has to be something that is known, or reasonably believed, about the licensee's conduct that is *prima facie* capable of justifying a decision to invoke and exercise the Authority's statutory powers. A feeling of unease, or of concern arising from a few complaints received, is not enough to justify the disruption of a licensee's business over a period of many months.

As for confidentiality, we believe that the accused has a right to know what he is accused of and that Ofgem's enforcement policy must be consistent with Article 6 of the European Convention on Human Rights. Article 6 deals with the right to a fair hearing. A licensee that is unable to know what it is accused of is placed at a substantial disadvantage with regard to its ability to defend itself and, of course, has no ability to cross-examine the complainant.

Ofgem should accordingly arrange for the procedures adopted by the Authority, in coming to any decision to take enforcement action under section 28 of the Electricity Act, to be carefully reviewed in the light of our comments.

EDF Energy
September 2007