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Telephone: 01738 456400
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Dear Andy,

Ofgem's Five Year Strategy 2008-2013

Thank you for the opportunity to comment on Ofgem's next Five Year Strategy.

Before I comment on the main strategic point SSE wishes to make this year, I would like to take this opportunity to recognise the most positive developments of the past 12 months. We welcome successful implementation of the new supply licences and we are hopeful that the new slimline approach is a sign that Ofgem recognises the maturity of a competitive energy supply market which is delivering higher standards of service to customers. We consider the reform of the supply licences as a great opportunity for SSE, as the market leader in customer service, to raise our sights even further and deliver additional improvements to our sector leading Customer Charter.

We hope the reform of the supply licences is the start of a lighter touch regime throughout the industry, and we look forward to a slimmer licence in distribution in the short term, and in generation, transmission and gas distribution in the longer term.

SSE appreciates the constructive way in which Ofgem has handled the Government's request for it to review suppliers' voluntary initiatives to help vulnerable customers. We acknowledge the need for suppliers to do more to help customers living in fuel poverty, and SSE will respond to the Government's challenge positively. We also recognise that Ofgem is likely to have a role in scrutinising those efforts on an ongoing basis and we welcome that.

Unlike our contributions to previous open consultations, SSE this year wish to make a single overarching strategic comment.

The key strategic challenges facing the UK's energy industry are spelled out in the current Government White Paper. With one third of existing GB generating capacity potentially coming to the end of its life by 2015 and very ambitious targets for renewable generation, **security of supply** and **climate change** are by far the greatest challenges facing the energy industry in both the short and long term.

In our view, the greatest obstacle to the industry meeting those challenges is the uncertainty surrounding network use of system charging, in particular, the electricity transmission system.

The theoretical and economic case for the existing transmission charging regime was constructed at a time where the challenge for the UK energy sector was the effective transition from a nationalised industry to a market one. As you know, SSE have always disagreed with the methodology for transmission charging, believing the methodology established did not meet best market principles and we believe our arguments for stability, certainty and proportionate cost reflective charging still stand.

Whilst putting that past debate to one side, SSE believes there is now an even greater imperative to reform the UK's transmission charging regime.

Above all else, SSE believe the time has come to consider whether the use of system charging regime for electricity transmission is able to meet the complexity of these twin challenges of security of supply and climate change.

In short, with almost every aspect of use of system charging continuing to be under review, the lack of clarity about when matters will be resolved creates significant uncertainty. That uncertain environment is not conducive to making tough business decisions that need to be taken to meet the twin long term challenges of security of supply and climate change.

A) Security of Supply

Our case on security of supply is demonstrated clearly by the following two examples.

1. The current charging methodology is producing charges which are extreme. The tariff for generators located in the north of Scotland is currently £21.59/kW and for generators located in the south-west of England is -£8.57/kW. There is no justification for this greater than £30/kW difference between south and north and we can see no correlation between these tariffs and the costs of the transmission system. For example, how can it be cost-reflective for a single generator in the north of Scotland to pay 60% of the costs of the local transmission owner? *This extreme methodology is by definition unstable.*

2. Secondly, the transmission charges are highly volatile and unpredictable year-on-year. For example, between 06/07 and 07/08 SSE's generation sites saw a change in tariff of between -25% and 130%. The most extreme year-on-year change was in south west Scotland. In 2006/07 the transmission tariff gave a strong signal to build in south west Scotland (£5.61/kW). More generation has, in fact, located in this area and as a result the equivalent tariff in 2007-08 increased to £13.02/kW, a near threefold increase in a single year.

These examples of the volatility of TNUoS tariffs underline the fact that the current charging regime does not provide a meaningful locational signal to which generators can credibly respond. Future charges are unpredictable – even within the timescale of less than a year. For example, National Grid's Publication of Long-Term Tariffs indicated on 13 September 2006 that the 2007-08 generation tariff for the southwest

Scotland area would be £9.40/kW. The final tariff, as described above, was revealed four months later to be £13.02/kW. If there is no certainty over charges on this timescale, how can a potential investor gain the certainty necessary in the medium to longer term to commit to the substantial investments required in new GB generation capacity?

These examples demonstrate that uncertainties on use of system charging undermine the market's ability to deliver additional capacity to meet the **security of supply challenge** in re-planting Britain ahead of 2015.

B) Climate Change

Transmission use of system charges are also, in SSE's view, working against government climate change objectives.

The current regime significantly rewards business decisions that locate power stations close to centres of electricity demand. If electricity generators are located far from the centres of demand, there is clearly a cost associated with the transmission of that electricity from the generator to the consumer. That cost should, and can be, proportionately reflected within existing mechanisms, such as the connection charge and (possibly) losses. In any event, for the reasons outlined above we do not believe that the current methodology is cost reflective. Furthermore, it is arguable given government objectives, whether generation companies also require an additional 'market signal' as to where to locate new electricity power stations.

In the new policy framework, it is in our view no longer of prime importance to provide strong locational signals for generation and demand to locate together. The main renewable technologies available today are onshore and offshore wind. These power stations, by their very nature, cannot be expected to locate in or close to centres of demand. Most of this generation capacity will connect at remote points of the main interconnected transmission system.

The current transmission charging methodology directly and deliberately targets generation away from those less populated areas where there is an abundance of natural renewable resource such as the North of Scotland and the Scottish Islands. By continuing with a charging regime that has this principle at its core cuts across the ability of the industry to deliver the Government's climate change targets.

Conclusion

In conclusion, we would like to propose the following action by the authority to respond to the issues we have raised on network changing.

- **Transmission charging should be 'front and centre' of the Transmission Access Review.** The Review is welcome, and should be the first priority for the Authority in the short term. However, putting transmission charging to one side in the transmission access debate, distorts that debate and will result in the failure of the industry to meet the twin challenges of security of supply and climate change.

- All **further development of network charging methodologies** in electricity distribution and gas distribution that give aggressive locational signals to the market **should be put on hold**.

I welcome this opportunity to contribute to the strategic plan and given the scale of change that faces the UK's energy industry in the years to come, I look forward to contributing further to these discussions.

Yours sincerely,

Rob McDonald
Director of Regulation