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Dear Andy

### **Ofgem's Proposed Corporate Strategy and Plan 2008-2013**

We welcome the opportunity to provide feedback on Ofgem's proposed strategy and plan for the next few years. We are encouraged by the various references in the document to planned projects and reviews that are likely to have a de-regulatory effect and to Ofgem's support for a self-regulatory approach in the competitive retail energy markets. We continue to believe that Ofgem should be able to achieve significant cost savings, based on reductions in compliance and monitoring costs going forward. Our detailed comments on the proposed plan are set out in the appendix to this letter.

We are restricting our main comments, on this occasion, to our fundamental disagreement with the policy approach that Ofgem has and is continuing to take in relation to the structure of network use-of-system charges. We comment on the GB electricity transmission charging arrangements in particular but note in passing that we have similar concerns about Ofgem's drive to see forward-looking marginal cost models adopted in other areas of network charging such as electricity distribution charging.

#### Transmission Use of System Charges

We have grave concerns about the negative impact of transmission network use of system (TNUoS) charges on the GB electricity industry. Our response to Ofgem's invitation in August last year to comment on its five year strategy majored on this topic and we believe that the situation has become even more pressing in the light of recent commitments to source 20% of energy requirements from renewables by 2020. In simple terms, we believe the current TNUoS charging regime, with its extreme locational signals and volatility, runs directly counter to Government commitments and developing EU legislation on encouraging the development of new renewable generation.

There have been some encouraging developments in the period since our last response: Ofgem and Government have initiated a review of transmission access arrangements in GB; and Ofgem has initiated a review of industry code governance, which proposed that charging methodologies

are moved within the scope of the appropriate industry code. We support the latter proposal and consider that the immediate focus should be on bringing transmission level charging methodologies within the scope of industry codes.

With respect to the Transmission Access Review (TAR), whilst we strongly support the need for a review of this nature, we are concerned that it is not focussing on the right areas. The structure of electricity transmission charges is not mentioned in the recently published interim report from this review and, from this report, it appears that the main focus is on procedural and process issues rather than the substantive areas of concern that we highlighted in our response, including major points on charging methodology. Overall, we believe that an opportunity to address the perversity, instability and continuing uncertainty over the development of TNUoS in GB is in danger of being lost.

In summary, our major concerns with the current approach to transmission charging and Ofgem's policy with respect to it are:

- Current charging structures based on forward-looking marginal cost models produce extreme charging signals in peripheral areas (e.g. £21.59/kW north of Scotland versus - £8.57/kW south west of England);
- These forward-looking models are intrinsically not cost-reflective as they rely on uncertain and varying views of future marginal costs, not current costs;
- These same models produce highly volatile and unpredictable year-on-year changes, as different views of future, marginal costs are developed and other users react to pricing signals (e.g. south west Scotland charge 2006/07 £5/61/kW, indicative 2007/08 charges in September 2006 £9.40/kW, final tariff set January 2007 £13.02/kW) – this undermines any claim to cost reflectivity of charging as underlying network costs are highly unlikely to change so dramatically in the short term;
- These uncertainties in use of system charging over just a single year demonstrate the problems that potential new investors in generation (not to mention existing market participants) have in forecasting their liabilities going forward – this runs directly counter to Ofgem's acknowledgement in successive corporate plans that “investors require a stable ... regulatory environment before making investment in new generation capacity”;
- We believe Ofgem is failing to provide that regulatory stability by not using its influence to determine a pragmatic balance between cost-reflectivity, stability and predictability of charging methodologies that avoids such barriers to entry – in fact it appears to use its influence to drive changes to charging to make models more unpredictable not less so;
- This runs counter to Ofgem's theme of security of supply and the Government's commitment to this broad policy goal;
- The current transmission charging methodology also produces high charges for areas where there is significant potential for renewable generation – particularly in the north and west of Scotland (see first bullet above) – we believe this “signal” or “penalty” again cuts across Government's objectives and targets for increased amounts of renewable generation, large volumes of which will have to connect in these areas;
- We are also of the view that this approach is against the letter and spirit of recent amendments proposed at EU level to the renewables directive, which are again aimed at encouraging the development of new renewable generation – we expand on this point in the appendix under the “Europe” theme.

*Scottish and Southern Energy plc*

We believe that transmission charging should be “front and centre” of the TAR as any discussion of transmission matters that sets aside this important topic distorts the debate and risks failure to achieve UK and EU objectives for security of supply and promotion of renewable generation. In our view, some simple changes could be made to the existing charging methodology that would provide more stability of transmission charging for generators and we have made detailed comments on this in our TAR response.

I hope these comments are helpful. Given the importance of this single issue and the scale of challenge that is facing the UK’s energy industry, I look forward to contributing further to this particular debate.

Yours sincerely

Rob McDonald  
**Director of Regulation**

## **Ofgem's Proposed Corporate Strategy and Plan 2008-2013 Detailed Comments**

We continue to support the framework of themes that Ofgem has used to group its prospective future activity and welcome the consistency of this approach from year to year. We agree that the themes are all valid and that, overall, Ofgem has identified the relevant issues within the themes. Our main comments are set out in our covering letter and below we comment on some more detailed issues under each theme.

### **Creating and Sustaining Competition**

We welcome Ofgem's comments on the highly competitive nature of the energy market and the spur that this has given to product innovation. We also welcome the emphasis on self-regulation and the potential scope for further withdrawal of formal regulation that is mentioned at paragraph 1.17 and also specifically in relation to potential withdrawal of energy supply-related standards of performance at paragraph 1.28. We agree with Ofgem that wholesale and retail energy markets should become increasingly like normal commodity and service industry markets without the burden of significant sector-specific prescriptive regulation.

Distributed energy is mentioned in this section and we are aware of Ofgem's further specific consultation on this topic. We welcome Ofgem's continuing involvement in this area as we are of the view that a clear and stable regulatory framework in this area will support the development of innovative energy services-based supply offerings, which will also be relevant to Ofgem's theme of sustainable development. One area that is key to such developments is that of the management of local heat resources and we would welcome any encouragement that Ofgem can provide to the relevant Government departments to establish stable ground rules in this area going forward.

### **Regulating Networks Effectively**

We welcome all Ofgem's efforts to make price control processes more transparent, predictable and able to provide a stable long-term framework for investment in long-lived network assets. We look forward to engaging with Ofgem's further consultations on this topic in due course, particularly as work on the electricity distribution price control gathers pace.

Our main concerns on Ofgem's approach to network charging are set out in the covering letter.

### **Security of Supply**

We recognise the forward-looking considerations that Ofgem has highlighted in this section. In the context of the main comments in our covering letter, we would like to highlight that it is in this section (paragraph 3.6) that Ofgem regularly gives recognition to the fact that investors in generation "will require a stable ... regulatory environment before making investment in new generation capacity."

## **Europe**

We continue to support Ofgem's involvement in Europe via its links with ERGEG, CEER and the European Institutions – in particular where Ofgem can push for enforcement of existing obligations in other European states without entailing additional regulatory burdens for the open, British energy markets.

However, we disagree with Ofgem's approach to the challenges, particularly regarding Ofgem's pursuit of full structural/ownership unbundling of transmission networks across the EU. We do not believe this is a practical objective and note that ERGEG's response to the Energy Policy for Europe recognised the practical concerns about intrusive interference with the property rights of companies. Instead, we believe that Ofgem should pursue effective unbundling rather than full structural unbundling which would allow a range of options depending on the circumstances in each Member State. In our view, regulators' insistence on ownership unbundling risks becoming an impediment to successful delivery of the new energy package. We are firmly of the view that an independent ISO model (such as that used in Scotland) together with the some other measures in the package - such as stronger independent regulators - would bring the desired benefits more quickly and with a greater degree of acceptance by Member States.

Our other point under this heading links in with our major concerns about transmission charging in GB. We are aware that the Commission is seeking to develop Regional markets as a first step towards a pan European market. However, large transmission tariff discontinuities at borders of member states form a barrier to such market integration. The extreme locational charges provided by National Grid's current charging methodology is a prime example of such a discontinuity and distorts trade both from GB to other areas and from these areas to GB. We urge Ofgem to address this issue of compatibility between GB transmission charging arrangements and those of the adjacent Member States.

Further to the concerns set out in our covering letter, we believe that the clear requirement, in addressing this issue of compatibility, is for a fundamental change to the GB transmission charging arrangements. In this context, we note that the direction of development of EU thinking on these matters is highlighted in the changed wording of the draft renewables directive which now requires (Article 14 paragraph 7):

Member States shall ensure that the charging of transmission and distribution fees does not discriminate against electricity from renewable energy sources, including in particular electricity from renewable energy sources produced in peripheral regions, such as island regions, and in regions of low population density.

## **Sustainable Development**

We support Ofgem's continuing work under this heading, recognising that much of this involves reviewing, reporting and facilitating developments without specific direct powers. We welcome the "self-regulatory" approach where initiatives are developed in relation to the competitive energy wholesale and retail markets and accept that the sustainable agenda will be part of Ofgem's considerations in setting network price controls.

As discussed in our cover letter, however, we do have concerns about continual change in network charging methodologies and/or adoption of marginal cost methodologies which can both

lead to large changes in the liability of individual market participants for network charges. We believe that such instability in pricing undermines the objectives of sustainable networks in the longer term.

Finally, on the subject of administering environmental programmes, we note that Ofgem is in discussion with Government about future funding arrangements. Currently, we understand that while some of this cost is paid by Government, the net cost to Ofgem (expected to be £1.2m in 07/08) is outside the RPI-3 cap on Ofgem costs. We believe there should be a clear discipline on controlling these costs going forward – now that these have become more established following recent investment. We believe there would be merit in subjecting these costs to an overall RPI cap along similar lines to the cap that covers Ofgem's other costs.

### **Fuel Poverty**

In this area, we agree there is scope for action by Government, Ofgem and energy companies and we generally support the range of activities that Ofgem has set out in this section. However, we do not believe there is a case for recycling funds raised through auction of carbon allowances to help tackle fuel poverty. We note the additional question that Ofgem has posed in relation to debt blocking – the ability of a supplier to block switching by customers in debt. This issue was discussed during the supply licence review and we do not believe that this issue needs to be revisited so soon after that debate.

### **Better Regulation**

We welcome Ofgem's emphasis on the principles of better regulation, the promotion of alternatives to conventional regulation (such as self-regulatory approaches in the competitive retail energy market) and the willingness to review regulatory burdens on licensees. Recognising the significant reduction in the length of the supply licence, following the recent review of this, we look forward to similar reductions in the distribution licence as part of the review that is currently in progress and, in due course, from the output of similar reviews of the generation, transmission and gas transporter licences.

We also welcome Ofgem's work on impact assessments and the projected review of industry code governance. We have responded to the initial consultation on this latter topic and continue to believe that a significant reduction in Ofgem's day-to-day involvement with code modifications could be achieved.

We support the development of a simplification plan and believe it is useful to draw together the various projects that Ofgem proposes to simplify existing regulation and, where appropriate, to remove regulation and to reduce Ofgem's involvement in the day to day running and development of the energy markets. With regard to the format of this, we suggest it would be useful to separate out the new initiatives from those that have been mentioned before (such as the supply licence review) and which are either a completed initiative or an ongoing project, to which some "update comments" have been added.