

AW/PW/097

Andrew MacFaul
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Ofgem
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Dear Andy

Ofgem Five Year Strategy 2009-2014

I am responding to Lord John Mogg's August open letter on Ofgem's five year strategy. It is helpful that the overarching themes are consistent from year to year providing a stable backdrop to energy regulation.

Northern Gas Networks welcomes the implementation of last year's strategy as outlined in the letter, in particular the leading role taken within Europe to promote liberalisation, and the launch of a number of reviews. The most important announcement was probably the RPI-X@20 project. NGN agrees that now seems an opportune time to review the principles that were established 20 years ago and have evolved to the current regulatory regime. However, it is important to recognise that this regulatory regime underpins the financing of networks and careful consideration must be given to any radical change and the impact that this might have on the financial markets, both debt and equity; in particular it is the RAB concept that provides the long term stability and enables the long term commitment of shareholders and lenders. NGN intends to be fully engaged with this project and contribute to assessing opportunities to improve the effectiveness of the current model.

The other comment that we would make on Ofgem's strategy is that pragmatic solutions may often be better than the purist economist solution and lead to lower costs for customers. One example is the reform of gas distribution interruption arrangements where there are alternatives to the tender process (such as administered prices) that are likely to have achieved the benefits proposed, led to lower costs for customers and been more straightforward and less costly for shippers and GDNs to implement.

The remainder of this response answers the questions raised in your letter focusing on gas network related issues.

1. Key challenges facing the industry

Security of supply continues to be a concern and we welcome the inclusion of this issue as a key part of the forthcoming Energy Bill. NGN welcomes the initiatives that Ofgem has taken to reduce the risk of supply issues. Nevertheless, the continuing gradual decline in UK gas production will mean that this continues to be a high priority item. We would support measures to improve the security of supply, for example to incentivise further development of gas storage facilities. Concerns were raised at the recent Winter Outlook seminar that there was a real risk to supply disruption this winter and we would welcome stronger measures by Ofgem to reduce this risk.

Wholesale gas prices continue to be volatile and market movements suggest that this is not an efficient and effective market. Consequently, Ofgem's probe into the energy supply market is welcome. The market volatility impacts gas distribution networks by making it difficult to predict shrinkage gas costs and results in unpredictable changes in transportation charges thus impacting customers.

Better regulation will continue to be important to ensure that controls on monopoly companies are adequate but that excessive costs and obligations are not imposed. Additionally, the review of electricity distribution licences has been valuable with a third of conditions removed; this follows the supply licence review that removed over half the conditions and we trust that Ofgem will review the gas transporters' licences in 2009. There are a number of redundant obligations, such as the meter supplier of last resort, that could be removed reducing the burden on companies and Ofgem and ultimately benefiting customers.

NGN supports the objective of low and stable prices for customers, but it is essential that the regulatory environment remains attractive for investors to deliver the requisite safe and secure networks. Incentive regulation has been effective since privatisation in delivering efficiency and hence lower prices, and we believe that incentive regulation to encourage the appropriate behaviours will continue to be essential for effectively regulating network companies.

2. The response the Authority should take to these challenges and the order of priority that it should give to its response

The Authority should continue to provide a leading voice in Europe and address security of supply and better regulation. Continuing to work with the European Commission (EC) is important to bring about market liberalisation which will help ease gas supply issues in the UK and should lower energy prices. NGN supports the unbundling proposals in the third energy liberalisation package. A competitive market in the UK alone is insufficient to ensure security of supply and thus further progress needs to be made in Europe.

It is essential to ensure that the climate is right in the UK for adequate investment to ensure safe delivery of gas and to effectively manage security of supply issues. This means providing sufficient allowances for companies to invest in their networks and that this investment is appropriately incentivised. Furthermore, it is important to ensure that companies are able to finance these investments and that the returns on investment are sufficient to attract investors to network utilities and to encourage companies to invest. Investors also require a stable and predictable regulatory environment.

NGN will contribute to the debate in the Code Governance Review and welcomes the opportunity to make the decision-making process more effective. However, it should be noted that many of the governance issues being discussed are in electricity and that both

shippers and networks believe that gas governance works reasonably well and that incremental rather than fundamental changes are appropriate.

NGN also notes the increasing focus on fuel poverty and climate change. However if changes in behaviour are to be encouraged then appropriate incentives need to be in place (as has happened for gas leakage) and it may need to be recognised that cross-subsidisation is required to achieve Government social objectives.

NGN fully supports comparative regulation to ensure that efficient companies are incentivised to encourage further efficiencies. The implementation of Cost Reporting for gas networks is welcome and NGN looks forward to the publication of comparative statistics between reviews as well as during price controls. In addition Ofgem should consider benchmarking non-financial areas such as customer service and safety to encourage companies to adopt best practice and to improve performance.

I hope that you find these comments helpful; I would be pleased to have further discussions on any of the issues discussed.

Yours sincerely

A handwritten signature in black ink that reads "Alex Wiseman". The signature is written in a cursive style with a long, sweeping tail on the final letter.

Alex Wiseman
Regulation Director

Cc Lord John Mogg