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Dear Andy

### **Ofgem's Five Year Strategy 2009-2014**

I refer to the open letter of 1 August and am pleased to respond with views on the development of Ofgem's next five year strategy.

The key strategic challenges facing the energy industry in the short to medium term continue, in our view, to be those that we highlighted in our response to last year's corporate strategy consultation: **security of supply** and **climate change considerations**. In addition, we recognise that increased pressure on wholesale fuel prices is now feeding through to higher retail energy prices. This has led to heightened public and political awareness of the consequences for energy pricing, fuel poverty and reliability of energy supplies of a continuing dependence for energy needs on sources beyond the UK.

Within this context, we believe there is urgent need for the Authority to direct Ofgem to establish and maintain a more pro-investment climate for both new generation capacity and the network infrastructure which will support and enable that generation to participate fully in the market to meet the needs of suppliers and their end customers. Both generation and network capacity are long-lived assets, requiring a stable regulatory and commercial framework to reduce the risks (ultimately priced into the retail cost of electricity) of the necessary investment. There are a large number of regulatory initiatives, probes and reviews underway at present, covering every aspect of the industry supply chain. In the spirit of promoting stability and investor confidence, we would urge Ofgem to reduce the number of such regulatory initiatives going forward.

In addition, there are fundamental issues affecting the investment climate for generation, where we believe that the Authority has powers and a duty to act. These are as follows.

- Transmission access. There are currently long queues of potential generation projects seeking to establish a firm connection cost and timescale at both transmission and distribution voltage levels, where the proposed connection is affected by transmission constraints. This is leading to long delays and uncertainties in the time and cost for which a connection will be made available, which increases investor risk.
- Transmission network charging. These charges are driven by a highly volatile and unpredictable forward-looking charging methodology that weights charges onto generators in the north of Great Britain. Approximately £50 million of the transmission companies' revenue is recovered through the locational element of National Grid's generator use of system charges. This net figure masks a gross payment of +£190 million by generators in the north and a -£140 million receipt by generators in the south. The north of the country is where a large proportion of the renewable resource that is key to meeting the Government's climate change and emission reduction targets is located. The high and volatile charges in this area will clearly result in less generation capacity being built to take advantage of the local renewable resources than would be the case under a more stable and evenly distributed revenue burden across the country.
- Distribution network charging. Our concern here is that Ofgem is actively pushing for forward-looking charging methodologies at distribution level that have proved demonstrably unstable and volatile at transmission voltage levels. There is also a move to include generators connected to distribution systems prior to April 2005 within the scope of ongoing use of system charging arrangements, where they have had no such liability before - having paid what was required under "deep connection charge" arrangements. Both of these developments increase the perceptions of regulatory and commercial risk for distribution connecting generation.

In our view, in consideration of the vital role that a pro-investment climate will play in addressing the twin strategic challenges we have outlined, the Authority should take the following three steps to address the specific issues we have outlined above. These should be given the highest priority amongst the various areas of work that the Authority oversees.

- It should bring forward licence amendments for network companies that require them to provide a firm connection date for generators consistent with their development programme. For renewable generators, for example, we consider that this should be 4 years from the date of their connection application. This would be consistent with delivering the "connect and manage" approach to connections advocated in the joint Ofgem/BERR Transmission Access Review report.
- Ofgem is already involved informally in discussions on network charging methodologies and formally has a role in accepting or vetoing proposed changes to

these methodologies. We therefore believe that the Authority should direct Ofgem's efforts towards establishing a stable, uniform transmission charge per unit of energy transmitted, which tends towards compliance with EU guidelines that such ongoing charges for generation should be zero. Any required locational signals can be provided through the one-off connection charge which provides a much more certain environment for generators than trying to take into account an uncertain and varying ongoing commercial liability. The same is true for distribution-connecting generation and here, we believe that the Authority should redirect Ofgem's interest in complex forward-looking charging methodologies towards simple, stable arrangements which provide the a broad signal that it is welcome and beneficial for generation to connect at distribution levels – not least, from the point of view of local security of supply. For these generators, a guaranteed zero use of system charge liability is even more valuable than the prospect of negative charges, which under forward-looking methodologies, can quickly change to positive charges depending on the actions of other system users.

- It should require Ofgem to avoid introducing any further complexities into the regulatory and market framework affecting electricity generation. For example, there has been talk of introducing auctions into the process for gaining access to the electricity transmission system. Similar arrangements introduced into gas entry have been a failure. Instead, the focus should be on delivering quicker transmission investment coupled with a “connect and manage” approach to transmission connections, as noted above.

The Authority acts within a framework of statutory duties and guidance from the Government on social and environmental issues. We are aware that this framework is being given parliamentary consideration and that BERR is currently consulting on an update to the guidance. Any changes that emerge from these processes might adjust the Authority's framework of duties and considerations in a way that makes it easier for it to take action in the areas we have highlighted. However, we believe that it is still possible for the Authority to take the actions we have proposed within the current framework, recognising the benefit for future customers that these actions to promote security of supply and a reduction in emissions will bring.

Finally, reviewing the list of activities set out in the consultation letter, in which Ofgem has been involved over the last year, we welcome Ofgem's support for the Government's policy on the introduction of smart metering. We also recognise that there are areas noted on this list that require continuing focus by Ofgem – such as fuel poverty and the European framework. With respect to measures on the fuel poverty and social agenda, we would welcome a period of certainty and stability for suppliers on the outputs required of them. In the European theme of work, we recognise that there will be initial effort required by regulators and the industry to establish the anticipated Association for the Cooperation of Energy Regulators (ACER) and the cross-border codes that it will approve. However, with respect to the transmission-related items on the list, we believe that a more focused approach is required in order to deliver actual generator connections and actual infrastructure investment to support those connections, as discussed in our main comments above.

*Scottish and Southern Energy plc*

I hope these comments are helpful. Given the scale of the challenges facing the UK and its energy industry in the areas of security of energy supply and on climate change considerations such as the meeting the EU targets on the proportion of renewable generation and reduction in emissions, we would be very happy to contribute further to the debate.

Yours sincerely

Rob McDonald  
**Director of Regulation**