



Legal, Regulation and Compliance

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Friday, 27 February 2009

Andy McFaul
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By E-mail: Andrew.macfaul@ofgem.gov.uk

Dear Andy,

Re: Ofgem Corporate Strategy 2009-2014

Thank you for the opportunity to comment on the above document. This non confidential response is on behalf of Centrica plc excluding Centrica Storage Ltd. We are happy that Ofgem place this response on their website and in the Ofgem library.

We have addressed the questions under the same chapter headings as those used in the document.

Chapter 1: Creating and sustaining competition

Question 1: Does this theme remain valid?

Centrica agrees that the theme itself remains valid.

Question 2: Have we identified all the relevant issues within the theme?

Ofgem has broadly identified the relevant issues within the theme, we offer the following comments:

1. Smart metering provides a massive opportunity to transform industry processes, reducing cost and improving service to customers. Smart metering also provides a platform to help customers reduce consumption, and for future smart grid developments – both areas may contribute to Britain's energy security of supply. We understand that Ofgem requires a clear mandate from DECC in order to take a more active role in this area. However it is critical that Ofgem recognises the potential improvement to our industry arrangements that smart metering can achieve. Ofgem must be able to mobilise swiftly further to any

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mandate from DECC, as well as facilitating initiatives by ERA or individual suppliers. We are concerned at the lack of resources available to Ofgem in this area and are keen to see preparation start now in anticipation for a more active role in this area.

2. We are pleased that Ofgem has now committed to action to help address the costs and risks that energy theft poses to consumers. Theft costs paying consumers, including the fuel poor, up to £440m per annum. We look forward to Ofgem delivering on its commitment in 2009.
3. The removal of inappropriate allocations of industry charges to suppliers remains essential so as to ensure that undue cross subsidies between supplier, market sectors and consumers are removed, for example, the allocation of all gas industry imbalance costs (RbD) to domestic customers only
4. As we highlighted last year, we believe that ensuring appropriate levels of separation from the monopoly network businesses are maintained such that the competitive market is not distorted is an essential part of Ofgem's work. We would welcome greater visibility of the market assurance activity that Ofgem undertakes in this area.

Question 3: Is Ofgem's approach to the challenges ahead the right one?

Ofgem's involvement must be both timely and appropriate. We believe Ofgem should act principally in response to calls from the market and consumers for intervention, save where (after due process of consultation) it considers that broader industry reform is called for, in order to properly deliver on its statutory duties. We welcome the work being undertaken as part of the review of Code governance, but continue to believe that incremental change will produce effective results in most areas and that fundamental reform should be undertaken only where necessary.

We would welcome greater Ofgem involvement within the developmental stages of industry change. Without fettering the discretion of the regulator to decide on proposals with independence, it would be beneficial to development were there to be greater understanding of the regulatory concerns in respect of proposals under discussion; as such we believe there is merit in some of the proposals currently under consideration, provided that at the same time appropriate checks and balances are instituted. Centrica is concerned that such checks and balances are not yet sufficiently explicit in the consultation documents released to date.

Chapter 2: Regulating networks effectively

Question 1: Does this theme remain valid?

Yes, in our view, the effective regulation of monopoly networks is one of Ofgem's most important duties, since it also involves the protection of consumers and promotion of competition. We believe the theme should also extend to include other regulated infrastructure. In addition, given the clear concerns around security of supply, we would welcome greater clarity on Ofgem's corporate strategy for Storage, LNG and Interconnectors.

Question 2: Have we identified all the relevant issues within the theme?

There is a need for greater information transparency and a reduction in the information asymmetry between network companies and suppliers/other stakeholders. For example, in the recent Electricity Distribution Price Control policy paper, very significant cost increases were set out (82% network investment costs, 13% network operating costs) without sufficient insights or explanations. It would be helpful to see a more visible public debate, led by the network owners, explaining the need for these increases. Whilst we understand the requirement for substantial network reinforcement and expansion to meet climate reduction

and renewable connection targets, the case needs to be properly made and communicated to all customers and stakeholders, including government.

Improved transparency also enables better predictability of T&D charges. This has become particularly important with the growth of fixed price contract offerings, which we provide in response to customer demand (25% of our household customers are on these products). Increased transparency benefits the end customers through reduced supplier risk premiums, and enabling the competitive supply market to operate more effectively based on better quality input information.

Greater transparency of the configuration and operation of networks would also give users more understanding and confidence that this is optimal. This is of particular importance where the operation of the network is so closely related to the effective operation of the market, as is the case for National Transmission Systems.

This relationship between the market and the network is a key feature in the regulation of the networks. Good examples of this are the current issues around (gas) Entry and Exit capacity. Whilst we recognise that the efficient provision and operation of the network is a central objective, this should be tempered with the consequences of such efficiency on operation of the market overall. Modest efficiencies in capacity provision have been seen to lead to distortions of a liquid market and inflated commodity prices. This cannot be in the best interests of consumers.

Centrica continues to support the development and implementation of the Offshore regulatory regime, but recognises that there are still a number of issues to be addressed. For example, the impact of the EU Third Package unbundling regulations and their application to offshore wind developers. It is important that Ofgem continues to remain flexible on some of the detail, and works with industry to ensure the success of the regime. It is vital that the OFTO process does not introduce additional costs and / or complexity to delay the development of offshore wind generation. It is also important that the regime does not introduce any additional regulatory risk that may deter investment.

A further key issue is Market Design, Ofgem needs to consider at an early date how the GB market needs to adapt to the major changes proposed to the UK electricity generation mix - with the introduction of significant volumes of renewables and new nuclear. This will result in the need for major increases in transmission access; large volumes of fossil plant to back up the winter peak to ensure security of supply low wind days; thermal plants running at part load on windy days and / or as peaking plant when there is insufficient wind; and spiky and volatile power prices due to wind intermittency. The latter may not provide the right incentives to maintain old fossil fuelled plant in the system or build new ones. It is also likely to significantly increase transmission network balancing costs.

In particular the wholesale power market arrangements (BETTA) were designed for a competitive market in primarily fossil generation and not one with up to 35% of wind generated electricity and a major renewal of nuclear power. Ofgem needs to begin a process to review whether BETTA will be fit for purpose by the middle of the next decade.

In terms of access to transmission, Ofgem needs to lead the way and ensure both they and industry are focusing on the those solutions that have some chance of tackling the GB Queue and future connections, in timescales that enable GB to meet its Renewables Obligations.

The fundamental issue is the need to build more transmission. This should be addressed as a matter of urgency and we welcome Ofgem's consultation on incentivising new transmission investment ahead of user commitment. In the meantime we feel the Transmission Owners

should be able to start the pre-construction activity to ensure both the Government's renewable targets can be met and timely connection of all types of generation.

At a more detailed level, network users require the ability to propose changes to the charging methodologies. It is unacceptable that there is no mechanism at present for users to initiate improvements or to formally dispute, vary or appeal changes proposed by the networks. Charging methodologies must be cost reflective and transparent, hence when developing charging methodologies the impact upon charges of each individual element of a proposal must be clearly and simply set out by the network.

Electricity distribution charging methodologies are of particular concern with multiple charging methodologies being developed over different timescales with varying levels of transparency. We strongly support Ofgem's proposal for a common methodology, which we believe will improve transparency and predictability of charges and benefit the end consumer through reduced supplier risk premiums. Crucially, we would expect any methodology model to be made freely available to suppliers, so that we can understand the basis for charging and estimate the impact of future rate changes and other industry developments on different categories within our customer base.

Independent Gas Transporters (IGTs) should be identified as a specific work area. The IGT Uniform Network Code has provided a foundation for improvement, but progress has been slow especially in the area of customer transfer arrangements, where different data standards, service levels and performance persist. In addition IGT charges for a number of services such as provision of estimated readings appear excessive.

Question 3: *Is Ofgem's approach to the challenges ahead the right one?*

As mentioned above, Ofgem can secure a better deal for customers in the next electricity distribution price control by engaging all stakeholders more fully and maximising the transparency of the process.

Centrica has provided detailed input over the last two years to the gas DPCR and we welcome the specific comments in the document on returning to the issue of triggers during the electricity DPCR. In terms of performance, we believe that participants are well placed to support Ofgem in the validation of Network Owner performance and incentive data, utilising feedback from customers and internal business metrics. Increased visibility of the performance of network owners and distributors, against incentive schemes, performance standards and obligations generally is needed.

We welcome the RPI-X @ 20 review. Centrica has unique perspective as the only big energy supplier without network assets and we intend to provide a full, constructive role in the debate. In our initial contributions we have already set out a number of success criteria to be considered as the review develops, namely:

- i) that rewards for networks owners should correspond much more closely to the risks they bear and the performance they deliver;
- ii) that networks bear more risk, recognising the costs to customers and suppliers of managing volatility; and
- iii) networks are rewarded for network investment based on their delivery of customer driven outputs

Chapter 3: Helping to achieve sustainable development

Question 1: *Is this theme valid?*

We agree Ofgem should have due regard to objectives related to sustainable development, and that this forms an important part of their work, hence the theme remains valid. However,

we note that in respect of Ofgem's duties, the duty to protect the interests of future consumers was already explicit.

Question 2: Have we identified all the relevant issues within the theme?

Overall, the key points have been identified, in addition, please refer back to our comments under chapter 2.

Question 3: Is Ofgem's approach to the challenges ahead the right one?

We broadly support Ofgem's sustainable development agenda. However, Ofgem should play a more proactive role in achieving consistency of policy across Government departments and providing clear leadership for industry.

On microgeneration, Centrica believes that Ofgem has underestimated the importance of some issues in relation to the need for technological support, and reform of industry systems such that export can be properly credited to the supplier.

Chapter 4: Helping to protect the security of Britain's energy supplies

Question 1: Does this theme remain valid?

A combination of competitive markets and effective regulation of monopoly networks is essential in maintaining security of supply. The price of carbon will have an increasing impact on future investment plans, feeding through energy prices; we agree that greater certainty is required with respect to future phases of the EU ETS.

Question 2: Have we identified all the relevant issues within the theme?

The major issues have been identified, but in some cases insufficient emphasis is given. For example, last year Ofgem noted that National Grid would be encouraged to develop blending services to enable continental gas imports; however, we have seen no evidence of this and we continue to have serious concerns that Ofgem's approach in this area may not deliver the most beneficial outcome for consumers as a whole.

Question 3: Is Ofgem's approach to the challenges ahead the right one?

Ofgem should continue to use its influence via ERGEG and maintain its efforts in Europe to ensure full and effective competition is in place across member states and to support pro-competitive solutions to issues as they arise. The operation of the GB market is healthy and in our view requires limited regulation. This reduces demands on Ofgem resources, allowing them to be used to good effect on such wider aspects which also affect the British market.

We welcome Ofgem's assurance of light touch regulation for new infrastructure providers, and believe that this positive approach should be more widely applied.

Chapter 5: A leading voice in Europe

Question 1: Does this theme remain valid?

Ofgem correctly assesses the importance of this theme, which must continue to be a key focus of Ofgem's work in the coming period. There are an increasing number of regulatory developments at a pan European and regional level where it is crucial that Ofgem's voice is heard if energy markets in North West Europe are to function effectively on behalf of consumers in Great Britain and more widely. At the same time, with Britain and Europe's growing import dependency, the lack of effective competition across many European energy markets will have an increasingly significant impact on British energy markets and the interests of energy consumers in this country.

Question 2: Have we identified all the relevant issues within the theme?

Among the issues identified by Ofgem, we would highlight the third legislative package and the resulting market code developments, the Strategic Energy Review (SEER2) and the development of regional markets in gas and electricity.

Central to the successful implementation of the third package is effective unbundling, which will assist the provision of transit and transportation across Europe and so enhance security of supply for Britain's consumers. Another cornerstone of the third package is the development of harmonised network codes, which will require close cooperation between national regulators as well as between national network companies. ERGEG has stated that it will commence this work during 2009 in anticipation of the new Agency's establishment. We look forward to working alongside other market participants and contributing to this process.

There are major challenges in the coming months and years to ensure the successful implementation of the third package. At a European level there is the need to develop an appropriate form of regulation to oversee increasingly integrated/interdependent energy markets. Whilst the establishment of an Agency for the Cooperation of European Regulators goes part way, due to its limited formal powers there will continue to be a need for national regulators to work closely to ensure improved EU and regional regulatory cooperation. This will be essential for an effective and consistent implementation of the package across all Member States, leading to a co-ordinated European framework, where enhanced powers for national regulators are combined with the coordination and advisory role of the proposed Agency.

In the area of interconnection between Great Britain and other European networks, Ofgem has a specific involvement in ensuring that effective regulation supports the operation of the market. The work of the regional market initiatives must continue and keep pace of new market developments, for example the continued expansion of day ahead market coupling in North West European electricity markets. We would urge Ofgem to study the implications of this market development on the GB market as interconnection with the Continent increases.

Within the period of this plan, we strongly support Ofgem's engagement in ERGEG and CEER work on monitoring implementation of legislation, revising and establishing new and extended guidelines and the commencement of work on network code harmonisation. All of this is essential to maintain the momentum of present initiatives. Through ERGEG, and, in due course, the Agency, Ofgem is well placed to address the risk of developments in continental Europe or at EU level which could undermine at least some of the benefits of liberalisation in Great Britain.

Even prior to the package completing its legislative process, attention is already focusing on SEER 2, and in particular the revision to the Gas Security of Supply Directive. It is essential to ensure that measures taken to improve Europe's security of supply do not unwittingly undermine the operation of the internal market (e.g. by mandating a given level of strategic storage) and recognise the growing interdependence of Member States and the need to resolve issues on a pan-national basis. Emergency measures should only engage when market mechanisms have proved inadequate and when a crisis has been formally declared.

Finally in view of the growing extent to which environmental initiatives are undertaken within a European context, we welcome the combination within Ofgem of work on European and environmental issues, in view of the growing extent to which environmental initiatives are undertaken within a European context.

Question 3: Is Ofgem's approach to the challenges ahead the right one?

As noted above, we fully support Ofgem's general approach and constructive engagement with European issues. Ofgem's experience and insights are acknowledged and widely

respected, and it must remain a key driver in the development of more competitive energy markets in Europe.

We welcome opportunities for dialogue with Ofgem on their work at EU level. We believe it would be helpful for Ofgem's planned work to be set down in greater detail within this strategy document or elsewhere, to reflect ERGEG's own work plan and the interests of the Commission.

The challenges of creating regional markets are considerable, not least in the need to develop industry rules/codes. As is often the case, the devil will be in the detail, and an appropriate level of resources and expertise will need to be given to this area.

Chapter 6: Helping to tackle fuel poverty

Question 1: Does this theme remain valid?

It is important for Ofgem to continue to build on its existing priorities around the tackling of fuel poverty, and for it to remain at the forefront of its strategy and plan.

Fuel poverty is a complex interaction of a number of factors, including quality of housing stock, household income and energy prices and as such energy efficiency can only go so far in tackling fuel poverty.

The Government cites that the increase in the number of fuel poor reflects the impact of energy price rises in recent years on the number of households in fuel poverty. However it is important to remember that the Government's existing fuel poverty strategy was published in 2001 during an era of low energy prices. With the era of cheap energy widely regarded to be over, a more sophisticated approach now needs to be taken to tackling fuel poverty which looks at how higher prices might drive the right signals in behaviour. Such an approach would encourage those who could afford to change the way they live their lives to do so while protecting those who are least able to respond to the challenges that this presents. We believe that a fundamental root and branch review of the UK's current approach to tackling fuel poverty is now necessary to ensure that there are specific and coherent programmes to tackle these three main drivers of fuel poverty. We would specifically look to Ofgem to support such a review.

Question 2: Have we identified all the relevant issues within the theme?

We recognise Ofgem's intention to facilitate efforts of Government and Industry, but look to Ofgem to provide support where needed, championing issues such as the introduction of effective data sharing and access to benefits data, which will enable industry to target CERT offers more effectively. Fuel poverty is part of a wider problem of poverty and social exclusion, which has been exacerbated by other recent pressures on household budgets. Poverty is an issue for government and requires a focus on increasing the incomes of those most critically affected and improving quality of housing stock.

We accept that suppliers have their part to play in tackling fuel poverty, suppliers cannot do this in isolation. Government has a role to play and we look to Ofgem to not only facilitate but also to actively champion such issues.

We welcome Ofgem's recognition of the contribution that suppliers are making and hope they will continue to encourage and incentivise suppliers to deliver real solutions.

Chapter 7: Better regulation

Question 1: Does this theme remain valid?

Centrica supports the principles of better regulation; Ofgem should continue to place them at the heart of their activities. Regulation should be proportionate to the maturity of the relevant market and the degree of competitive pressure on participants. Where competition is effective, a far lighter touch is appropriate and efficient. Ofgem has an important role to play in supporting good governance and must be sufficiently resourced to do so.

Question 2: Have we identified all the relevant issues within the theme?

In terms of the Code Governance review, please refer to our earlier comments. We agree that there are some issues. However, as with better regulation above, principles of proportionality and transparency should be carefully applied, particularly in the area of any actions identified. In all cases, a proposed course of action should be tested against the risks, both in terms of cost and regulatory burden. In addition, we would wish to emphasise our earlier points in respect of the checks and balances required in the area of code governance, especially in respect of Major Policy Reviews, where we believe these are not yet sufficiently explicit.

In addition, we refer to our previous responses in terms of transparency and information asymmetry. Where regulated monopoly companies exist in a regulated, price controlled environment, then the assumption must be in favour of publication of data unless in individual cases, exceptions can be justified. Where such justifications exist, they must be kept under review and tested on a regular basis to ensure they still hold.

In conclusion, we are generally supportive of the review. We believe that where adjustments are required, these are not insurmountable and will clearly benefit consumers.

Should you wish to discuss any of the points raised above in more detail, I should be happy to help.

Yours sincerely,

By e-mail

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