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## 02a/09 Ofgem Proposed Corporate Strategy and Plan 2009-2014

Dear Andy,

Please find below our response to your recently published Corporate Strategy document. We make the following observations on the GB market that relate to the investment climate. We believe that Ofgem should also consider these comments as well as our more detailed ones below.

The UK has a massive need for investment in new generation, distribution and supply infrastructure. This investment will be provided by the energy companies which, while doing so under enormous cost pressures and during the most severe economic downturn for at least a generation, are being constantly vilified from all quarters.

Regulators and lawmakers have added to this difficulty with a large number of interventions at short notice. More are in the pipeline. These developments have the potential to seriously undermine the UK's reputation as a stable and open place to do business, increasing the cost of capital and consequently diminishing the attractiveness of the UK compared to the many other locations in Europe which also badly need new investment.

It is the case, we believe, that should this uncertainty continue with the possibility of additional obligations being imposed on energy companies, in the medium term (i.e. over the period of Ofgem's corporate plan) investors will certainly look elsewhere. It is in this context that we provide our comments on Ofgem's Strategy and Plan.

### 1. Creating and Sustaining competition

The 'Creating and Sustaining Competition' theme remains valid and the relevant issues have been identified within this theme.

We welcome the positive comments on competition from the Energy Supply Probe conclusions that:

- The fundamental structures of a competitive market place were in place and that the transition to effective competition was well advanced and continuing .... There are greater levels of competitive activity and consumer switching than almost every other energy market in the world and most other service markets in the world.

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- Suppliers compete actively for those consumers who seek out the best deals in the market and have also considerably widened the range of tariffs available.
- Suppliers do not act as a cartel and their consideration of competitors' price changes is a normal feature of a competitive market.

However, we disagree with the approach taken to assist those not benefiting fully from the competitive market, disproportionately vulnerable customers according to Ofgem. Ofgem's concern with vulnerable customers would be better addressed by specific energy related social initiatives rather than by constraining energy supply market competition through the imposition of price control licence conditions. Given npower's considerable involvement in energy-related social programmes, we would be pleased to work further with Ofgem in this area. We support those remedies to improve transparency and customer engagement.

As we said in our response to the Probe, we support measures to facilitate new entry provided that they do not discriminate in favour of specific suppliers and that they protect existing suppliers from the costs arising from other suppliers' defaults. Our proposals were to: fix network and BSUoS charges in advance to reduce supplier risks; remove GS/OS as this has been superseded by the statutory complaints arrangements; and address uncertainty from further unpredictable social and environmental obligations. With regards to GS/OS, we note Ofgem's stated intention in its Corporate Strategy and Plan 2008-2013 to review their continued relevance.

We support Ofgem's remedies to further develop customer information and engagement and are actively working with Ofgem in these areas.

Furthermore, our views on debt blocking have not changed since our response to the Probe which stated that we consider that the current arrangements (other than the Debt Assignment Protocol) are working well and that there would be malign effects of allowing customers to leave debts with the old supplier. However, we are working with Ofgem on its review of the area.

We are sympathetic to measures to help small businesses become more aware of the terms and conditions of their contracts. npower has already adopted the recommendations of Ofgem's Non-domestic Working Group in this area.

As we pointed out in our response to the Probe, the current arrangements covering business objections appear to be adequate: the contractual right to object can be an efficient way to resolve risks between customers and suppliers; there are clear rules governing the objections process and the means to address and resolve issues; and any lack of clarity over arrangements for contract termination should be addressed by other remedies relating to terms and conditions. We would support the development of a code given an explanation of the motivation and its content.

npower has contributed more than its energy market share to the removal of around £500 million of "unfair premiums" from suppliers set out in Ofgem's 16 December Press Release and will maintain and extend the changes already made in our next price review. Other suppliers indicated further rebalancing in their future price changes on which some suppliers have delivered now.

We note that Ofgem intends to move forward with proposals related to the detection of theft. Suppliers have argued that their activities in dealing with theft mean that electricity distributors and others benefit at no cost to them but with a significant cost to the individual supplier. This is particularly so for supply companies without linked distribution arms. Ofgem should take this into account when formulating its proposals.

With regard to additional powers to tackle market abuse, Ofgem has not demonstrated that there is a problem which needs to be solved and nothing in the intervening years has undermined the Competition Commission's reasoning on the previous market abuse licence condition which it rejected.

We note that Ofgem found no evidence that the lag in wholesale price to retail price changes due to hedging was no greater when prices are falling than rising.

We do not understand why our hedging strategy should be driven by customer preference rather than the risk which the company faces. If customers wish, they are able to make such choices or risks through fixed price or tracker products.

RWE is committed to enhancing liquidity in the wholesale markets as demonstrated by its work with the Futures and Options Association. However, our view is that the challenges faced by new entrants are due to low retail margins and the difficulties in proving credit-worthiness.

Given the co-operation of suppliers with Ofgem and the positive reaction by suppliers to the pro-competitive remedies to increase transparency and customer engagement in the energy supply market, we advocate that Ofgem should focus on this approach and avoid remedies which could stymie competition.

We support the view that distributed generation may contribute towards the Government's CO2 reduction targets by displacing some more carbon intensive centralised generation and cutting transmission losses.

We support the removal of barriers to the growth of distributed generation that prevent it competing with other technologies on an equitable and transparent basis but not the provision of an 'inside track'.

We played an active part in the Distributed Energy Working Group and were pleased to note that Ofgem concluded that the market for small generator output is both competitive and diverse. We have already indicated that we see no reason at this stage why we would not accept a licence amendment that would enable DE projects to obtain supplier services from larger suppliers.

## **2. Regulating Networks Effectively**

The 'Regulating Networks Effectively' theme remains valid and it could be argued that this should be the regulator's primary focus over the plan period. We welcome Ofgem's continued commitment to promote cost-reflective network charges.

This theme needs to recognise the anticipated changes to the generation mix connecting to the electricity transmission and distribution networks, both onshore and offshore, between now and 2020. There will also be changes to the pattern of flows on and off the gas network as UKCS supplies are replaced by storage, LNG and interconnectors. Ofgem has identified the key issues.

Ofgem's approach is to identify and assess whether the current technical, regulatory and commercial framework remains fit for purpose, given the relevant issues. This includes examining the current approach to incentive-based regulation, reforming access arrangements and considering how price controls can be designed explicitly to deliver both investment efficiency and sustainability objectives. Given the issues to be faced, the approach is correct. We welcome Ofgem's continued commitment to extensive consultation in these areas but we would prefer an industry-led approach where possible.

One important area for suppliers is that of being able to predict the network charges for their business planning process. It is therefore important that once set these are not changed in the interim.

### 3. Helping to Achieve Sustainable Development

The electricity generation sector is expected to play the major role in meeting the Government's 2020 and 2050 targets; this, coupled with the change in Ofgem's statutory duties, makes this a valid theme.

From a networks perspective, the relevant issues follow on from addressing the challenges identified under Regulating Networks Effectively, although in addition to economic regulation, Ofgem has responsibility for administering a range of Government programmes.

We agree that infrastructure provision will be required and endorse the possible introduction of incentives to encourage the TO to invest ahead of full user commitment, providing that the costs of stranded assets are properly targeted. On access arrangements, we disagree that a radical approach is necessarily the correct solution. Short-term access rights that facilitate sharing, together with Connect and Manage may address Ofgem's concerns and we support these as long as charges remain cost-reflective for all types of generation connected and vary by location to reflect local congestion costs. Given the requirement for significant investment in both renewable and thermal generation capacity, it is important that connectees face the correct economic signals. We also believe that the issue of correctly allocating the cost of system reserve so that the relative cost of alternative low carbon technologies can be accurately compared. We also disagree that existing generators do not make long-term commitments. The economics of investment in long-lived generation assets is predicated on long-term access to the energy market. The need to minimise the perception of regulatory risk will be fundamental to delivering the required investments, both on and offshore.

Ofgem should avoid regulatory impatience and mandating changes. The experience of introducing gas entry and exit reforms highlights that this approach can be counter-productive. Where changes to market arrangements are thought to be necessary, these need to be developed under existing governance arrangements and with appropriate timescales allowed for development and timely decision making.

At the same time, there is a continuing need to be vigilant about proposals which, rather than eliminating barriers to entry, positively discriminate in favour of certain technologies. For example, para 3.11 says: **"We will also continue to encourage DNOs to develop charging methodologies that facilitate the connection of microgenerators."** And 3.22 says: **"We support the Government's consideration in its Renewable Energy Strategy of additional measures for distributed energy and community energy, including CHP."** Whilst we recognize the case for additional support for certain "far from market" technologies, it is important that this support is transparent and not buried in non-cost reflective charging methodologies. Similarly, the outcome for the probe initiative on page 53 is stated as: **"Reduced barriers to entry thereby strengthening competitive pressures on existing suppliers"**. It will be important to ensure that reducing barriers does not spill over into policies aimed at giving advantage to particular competitors. Such policies distort competition, reduce efficiency and undermine the interests of consumers.

In paragraph 3.9 you talk about the impact of different tariff structures, including rising block tariffs; it is difficult to see how a rising block tariff is consistent with a competitive market as tariff structures typically have the opposite profile. And competition drives price structures to reflect cost structures. For this reason, it is also difficult to see how rising block tariffs would be aligned with Ofgem's current emphasis that price differences between tariffs should reflect cost differences.

We agree that energy efficiency must form the basis of any sustainable development strategy. Energy saving is by far the most economically efficient means of meeting the ambitious targets of the UK Renewable Energy Strategy.

We support the continuation of the RO as the prime support mechanism for large scale generation. Any fundamental policy change would create a hiatus in the development and build of projects.

The Renewable Heat Incentive and Feed-in Tariffs must be consistent both with each other and the RO regime in order to avoid perverse incentives. If these are designed correctly and also available for capitalisation, they will provide a platform for the emergence of retail energy services products.

#### **4. Helping to Protect the Security of Britain's energy supplies**

The 'Security of Supply' theme remains valid and most of the relevant issues have been identified within this theme.

We support the Ofgem approach and the commitment to use market solutions where appropriate, as we believe that this is the best way to deliver security of supply and to deliver the lowest cost solution for consumers.

Whilst we don't see major issues in terms of the supply demand balance on both gas and electricity over the plan period, the next few years are critical to ensuring that security of supply is delivered in the period 2014 to 2020 and beyond.

Whilst DECC has a major role to play in determining policy we look to Ofgem to re-iterate that competitive markets remain the means to deliver security of supply over this period and not to undermine markets with the introduction of licence conditions that could impact on investment decisions. Over the last two years there have been a number of interventions that are damaging to investors, these centre around CERT, windfall taxes, CESP and licence conditions. This is damaging because of the unpredictability of the interventions which changes the investment climate.

We support the roll out of SMART metering as soon as possible as we believe the demand side has a major role to play in delivering security of supply.

#### **5. A Leading Voice in Europe**

The 'Leading Voice in Europe' theme remains valid and the relevant issues have been identified within this theme.

We continue to support Ofgem's work with European regulators' groups to develop a consistent European regulatory framework including, in the coming years, regulatory oversight at EU level and a workable relationship between the Agency for the Cooperation of Energy Regulators (the Agency) and the Energy Network Transmission System Operators (ENTSOs) with effective stakeholder involvement. We agree that regional markets are a required step towards single markets in electricity and gas and support further work on the regional market initiatives. We emphasize the need for all stakeholders to be able to interact with the Agency and so support Ofgem work on developing an effective consultation process, although this need applies to the whole market development process.

We would hope that as Chair of the regulators' Sustainable Development taskforce you would be able to highlight the inconsistencies between promotion of the competitive market and a market-based approach

to sustainability through EU ETS with the “very challenging” Renewables Directive’s electricity generation targets for the UK.

Whilst we would generally support measures that improve security of supply, we would have expected much greater reference to competitive markets in the Second Strategic Energy Review. We would advocate continued support for the position that strategic gas storage is not mandated as the competitive market is able to resolve the issue more efficiently and affordably.

Liberalisation of the energy market has already brought benefits to UK customers. We support Ofgem’s aim of guarding against the risk of measures being implemented that adversely affect competition and consumers in British energy markets, although in the GB context Ofgem’s proposed price control licence conditions are likely do just that.

We look to Ofgem to work with DECC to ensure the appropriate transposition into UK law of the Third Package. As previously stated we would expect any new legislation to be implemented in accordance with the principles of better regulation. Therefore, we would emphasise the need for reporting for transparency purposes to relate to GB wholesale energy markets being flexible and risk-based.

We support Ofgem in ensuring that retail and consumer proposals are workable in the context of the competitive British energy markets. We welcomed the view from the 1<sup>st</sup> meeting of the Citizens Energy Forum that there was not a need for a binding charter as the rights already enshrined in EU directives are binding and the strong support for well functioning retail markets.

## **6. Helping to Tackle Fuel Poverty**

In the present economic climate, the issue of fuel poverty remains high on all interested parties’ agendas. We agree that the numbers of households in the UK defined as being in fuel poverty by Government have risen above the 3.5 million estimated in 2006. Ofgem estimates the figure as 5 million in paragraph 6.12. We do not demur.

As noted, there are continuing upward pressures on prices coming from environmental costs as well as the need to fund new investment. Although these pressures may be tempered in the immediate future by the economic slowdown and a fall in wholesale energy costs, they are likely to be more than offset by the associated reduction in incomes.

The commitment to meet the UK’s carbon emissions targets and suppliers’ increased expenditure to help meet these all add to what has become a potent mix. As a result, the Government’s 2010 fuel poverty target appears ever more challenging even with the additional assistance, announced last year, being provided by suppliers and generators.

Suppliers have committed to spend significant sums on helping to alleviate fuel poverty through an enhanced CERT; CESP; and social tariffs. This is in addition to existing industry and Government sponsored programmes such as Warm Zones, Warm Front and npower’s own Health Through Warmth. We estimate the total financial commitment in carbon reduction/energy efficiency and fuel poverty alleviation measures by suppliers and generators over the next three years to be around £4.1billion.

Presently, CESP and CERT, which are primarily environmental obligations, do also have a strong social component. Similarly, social obligations against which Ofgem measures suppliers’ social spend, aimed primarily at alleviating fuel poverty also increase energy efficiency; we believe the obligations should be split into fuel poverty and environmental targets and allowing those initiatives which contribute to both objectives to get recognition under both.

We believe therefore that the scope of Ofgem's social spend reporting ought to be reviewed to take the above into account.

Related to energy efficiency, and the generally accepted view that this is the sustainable long-term way to alleviate fuel poverty, is the move from CERT to the Supplier Obligation (SO) post-2011. While Government leads on the policy, the importance of Ofgem's role in administering the transition to the SO will be crucial, particularly so if the move is from the ex-ante arrangement of CERT to an ex-post energy services market.

On issues relating to the proper working of the retail energy market, thus ensuring that all customers benefit fully from competition, we agree that the focus should be on measures to ameliorate fuel poverty. Any measures proposed ought not to disadvantage all customers in the round by increasing their bills unnecessarily. A measure which may add to a supplier's costs, such as, for example, when customers with debt seek to change supply, must be subjected to, and satisfy, a full and rigorous cost-benefit analysis before introduction.

As regards helping customers manage their bills and also dealing with customers in debt, we agree that identifying and assisting, earlier in any follow-up process, those who may be struggling will deliver the best outcome. However, a new paradigm may be required in this time of recession and economic downturn. Fuel poverty cannot be considered in isolation; it has many elements and should be treated as such.

Linked to this, while there is mention of network involvement in getting more off-grid gas customers connected to the mains (paragraph 6.13 refers), Ofgem ought to look at the wider role network operators might play in dealing with fuel poverty. Because of their monopoly position and having regulated asset bases, essentially, in the public interest, giving DNOs and GDNs additional responsibility for addressing fuel poverty should be explored.

The next few years look like they will be increasingly difficult for the UK - its citizens and its businesses. In the case of energy supply, suppliers are cognisant of their responsibilities and obligations, given the essential nature of the product and services they provide. The industry is also making significant investment to meet the challenges from Government, which in turn will help it meet its international obligations.

Sharing best practice and exploring issues in a bipartisan way is we believe the right way to move on. However, suppliers must have a degree of certainty as to what to expect as a result of any initiative, so that they can plan their resources accordingly.

## **7. Better Regulation**

We are actively involved in the Code Governance Review process and will be sending detailed responses to the consultations that are presently live; however we have some general observations we wish to make.

It is our view that the codes have served the industry well in its development over a number of years and whilst it is right to ensure that they remain fit for purpose for the challenges to come, we believe this should be incremental rather than substantive change.

Our main concern is the proposal for major policy reform where we could see Ofgem's role as;

- Instigator of a major policy review

- Scoping out the review
- Leading the review
- Writing any resultant modifications
- Writing the legal text
- Deciding on whether to allow the modification or not

We recognise that there will be industry engagement during the process and under limited circumstances we have a right to appeal, but the process as outlined does not strike us as good regulatory practice.

If you wish to discuss any aspect of our response, please do not hesitate to contact me.

Yours sincerely

Alan McAdam  
Wholesale Economic Regulation Manager