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Date: 27 February 2009

Dear Andy

Ofgem's Proposed Corporate Strategy 2009-2014

We welcome the opportunity to provide feedback on Ofgem's proposed strategy and plan for the next few years. Our detailed comments are set out in the appendix to this letter and our main area of comment and concern is discussed below.

For many years, we have been arguing in our bi-annual input to Ofgem's corporate planning process (amongst other areas) about the need for Ofgem to promote and develop regulatory and market stability for investment in both generation capacity and network infrastructure. The current emphasis on climate change considerations underline the importance of these transforming investments, which feed directly into Ofgem's themes of security of supply and sustainable development. Many of the issues that, in our view, undermine the required stability are related to network charging and Ofgem's involvement with and promotion of inherently unstable charge structure models in both transmission and distribution charging. As argued in our response to Ofgem's initial consultation in the autumn of 2008, we believe the Authority should redirect Ofgem's interest in complex forward-looking charging methodologies towards simple, stable arrangements with ongoing charges for generation tending towards zero, consistent with EU Guidelines for transmission charges for generation.

Thus, our level of concern about network charging has been high for a number of years and we have sought to make constructive suggestions through Ofgem's corporate planning process on how a more stable framework could be achieved. It is disappointing, therefore, that no flavour of this concern appears in Ofgem's own summary of responses in Appendix 1 of the current document. However, the recent publication on Ofgem's website of an open letter to National Grid (NG) about managing constraints on the transmission system has raised our level of concern about the lack of stability in network charging frameworks even further. Constraint costs feed in to Balancing Services (BSUoS) charges, paid by generators and demand customers in a similar manner to transmission network use of system charges. Ofgem has requested that NG produce a revised methodology for BSUoS in the space of barely seven working days. Given the very significant consequences and uncertainties for generators that would flow from revisions to

BSUoS arrangements, we are astounded by the timescales proposed for this work and extremely concerned about the potential effects of this initiative.

We have already spoken directly to Ofgem and will respond formally to the letter and the proposals from NG that it calls for. However, we wish to put on record our extreme concern about Ofgem's handling of this subject. It represents a further de-stabilising of the climate for generation investment and runs directly counter to Ofgem's stated objectives to support security of supply and sustainable development.

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 2009-2014 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.

1. Creating and sustaining competition

We understand that many of Ofgem's planned activities under this heading reflect the output of the recent Probe into the British energy supply markets. There have been and are still planned a number of further consultations on specific areas arising from Ofgem's Probe findings. While we are in accord with the general direction of Ofgem's further work, we would urge Ofgem to guard against the imposition of too many prescriptive obligations on suppliers. Remedies should adhere to the principles of Better Regulation and avoid restricting competition and innovation in the sector.

In relation to wholesale markets, we welcome Ofgem's continuing attention to EU and global gas markets with a view to ensuring that there is sufficient transparency and that these markets operate without resulting in artificially high gas wholesale prices in Great Britain.

On metering, we support Ofgem's continuing involvement in the smart metering project. We have a major concern in this area with the development of Government thinking on the details of the planned roll-out and this relates to inter-operability.

We believe that a mandatory functionality and interoperability standard is critical to the success of the market beyond the initial rollout programme and that this should be mandated in the developing licence conditions. Without inter-operability and standards, Ofgem will be aware of the problems that can ensue on change of supplier, where the incoming supplier does not support the particular form of metering already fitted by the outgoing supplier. These issues, which undermine the efficient working of the competitive supply market, are already causing some problems in the niche market for advanced metering for larger businesses. We would hope that Ofgem could bring some influence to bear on Government to avoid this situation spreading to the mass market through the roll-out programme. Since we believe that all suppliers recognise how vital interoperability is to ensure a well-functioning competitive market, we believe a workable form of interoperability arrangements could be agreed upon across the industry in a matter of months.

We recognise that distributed energy is an important area on the sustainability agenda going forward. We welcome Ofgem's consideration of the appropriate regulatory framework for energy service companies which we agree with Ofgem will be an important element of a sustainable approach to local energy. 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.

2. Regulating networks effectively

We agree that Ofgem has identified the major areas affecting networks over the short to medium term. We have comments across a number of the topics raised in this section.

The RPI@20 project is rightly considering whether any changes in the approach to network regulation are appropriate, given the importance of the sustainability agenda and of tackling climate change. Both of these factors are likely to drive different patterns of investment and risk compared with the current paradigm. One area that we believe deserves serious consideration in this context would be to allow the network companies to invest in demand reduction projects and see that investment allowed on their regulated asset base in a similar manner to investment in assets to meet increasing demand. This applies equally to all the network businesses but the first opportunity to develop a framework where demand side management is allowed and encouraged as a network investment in tune with sustainability objectives is in DPCR5.

On the shorter timescale of DPCR5, Ofgem notes that it expects the role of DNOs to evolve in response to changes in network use. We are certainly happy to consider an evolving role for our DNOs but, in our view, in order for a development of the DNO role to be successful, the new activities will have to be clear, the funding for them adequate and, where appropriate, well designed incentives put in place to encourage the desired activity and outputs from the DNOs. We also support the developing incentive framework for DNOs but believe there is a need for Ofgem to be flexible in the development of these - for example in the continuation of the innovation incentives, keeping them adaptable for changing circumstances. Similar points apply for any future development of the role of GDNs; we support Ofgem's intention to refine the regulatory framework for developments such as biogas entry and believe that this type of innovation will need some initial support from networks in order to prove feasibility.

We welcome Ofgem's intention to streamline regulatory reporting. The regulatory reporting pack (RRP), developed at the time of the last electricity distribution review, was justified partly by the promise that it would simplify and reduce information requirements at the time of the next review – i.e. DPCR5. However, we have in reality had to produce even more information for business planning questionnaires in DPCR5 over and above and in a different format from the RRP. This is very disappointing and we hope that this situation can be remedied following Ofgem's review. In our view, this is the major topic on the deregulation agenda for the DNOs. For the GDNs, on the other hand, the top priority for reducing the regulatory burden would be to start the review of the gas transporter licence that Ofgem mentions in the plan as soon as feasible.

We also strongly support Ofgem's comments early in this section about applying "simple solutions where they are likely to be effective". However, we continue to find Ofgem's approach in pressing for unstable, forward-looking marginal cost models in network charging to be completely inconsistent with a simple, pragmatic approach.

A particular project mentioned in this section of the plan is that for the common charging methodology in electricity distribution. For this, the DNOs are continuing to work on a common

distribution reinforcement model (DRM) based charging model for HV and LV connected customers. Along with revised governance, we believe that the DRM-based approach will provide a simple, transparent and predictable framework for distribution charging that is responsive to the needs of all interested parties and which covers over 99% of connected customers. We therefore also believe that this is a proportionate and practical approach to meeting Ofgem's objective of "promoting more sustainable efficient investment in networks over the longer term"; it does not need, in our view, also to encompass the complexities of EHV charging to have a beneficial effect. Furthermore, with respect to pre-2005 generation, we continue to reject Ofgem's proposals to attempt to bring these generators within a new use of system charging regime.

Finally, for transmission networks, we believe it is evident that substantial investment in transmission networks is needed in the short to medium term to accommodate the volume of generation wishing to connect. However, as these developments take time to plan, complete and commission, one possible consequence of the continuing uncertainty on the form of transmission charging is the potential to undermine the investment case for particular transmission upgrades, which could result in further delays to their progress. Against the background of all the current uncertainty over the long term charging mechanisms for transmission access, we believe it is imperative for the transmission network owners to be given sufficient confidence to progress with current planned investments to support current projections of the pattern of generation and demand. The essential threat, if the network owners are not provided with this confidence, is to the overall security of supply in Great Britain in the medium term and therefore, in our view, this issue merits a place in Ofgem and the Authority's top priorities for 2009/10.

With regard to the development of the offshore electricity transmission networks, we believe that there is an opportunity to progress the forthcoming "round 3" developments on a more sustainable, environmentally-friendly and economic basis than the line by line auctioning approach that has characterised the framework for "round 2". We understand that Crown Estates will grant Strategic Development Areas in round 3 and, in our view, such an approach would fit well with extending the existing onshore licensed transmission areas offshore so that strategic and holistic network management development can be applied by the network licensees. We believe that this approach has the support of other transmission licensees and is also supported by other stakeholders such as conservation and environmental bodies, equipment manufacturers and potential offshore generators. As well as the environmental benefits which follow from an overall coordinated approach, we believe that this would be a more cost-effective approach than line-by-line auctioning. For example, it would avoid increasing the administrative burden on Ofgem to manage the competitive tenders, which section 3 of the plan states is already anticipated to cost around £4.8 million in 2009-10 for the small number of transitional "round 2" projects, where assets are already designed and built.

3. Helping to achieve sustainable development

We have recently responded to Ofgem's sustainable development report, which covers most of the themes in this chapter. In that response, we emphasised the need for investment levels in the necessary energy system plant and infrastructure to be maintained in order to bring low carbon energy onto the system in a timely fashion and allow it to be transported securely to where it is needed. As noted elsewhere in this response, we believe that Ofgem has an important role in developing stability in order to encourage the required investment to take place - from short term actions to encourage clarification of renewables-related obligations to longer term consideration

of appropriate forms of sustainable network development through the RPI@20 project. Stability and simplicity in network charging structures remains a recurring theme under this heading as discussed in our covering letter and elsewhere in this response.

We have two other more specific points to make in response to comments in this section.

In paragraph 3.9, Ofgem refers to work it has begun to analyse the performance of the retail market in stimulating sustained behavioural change and the uptake of energy efficiency measures. We support Ofgem's research in this area and request that the results are shared with suppliers at an appropriate time.

Secondly, Ofgem asks for views at the end of the section on its approach to discharging its obligations to administer a range of Government programmes that contribute to the achievement of sustainable development. We note that the number and scope of these programmes is increasing and we welcome Ofgem's intention to make sure that explicit funding is secured from Government for these programmes rather than having them added to the costs met directly from Ofgem licence fees. If any of the costs remain within Ofgem's budget, we believe there should be a clear discipline on controlling these costs going forward by inclusion within an overall cap such as already applies to Ofgem's other costs.

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

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 of its Corporate plan that Ofgem has in the past regularly given recognition to the fact that investors in generation "will require a stable ... regulatory environment before making investment in new generation capacity." However, while providing stability in Ofgem's long-term regulatory and policy framework is mentioned at the very end of this section, it is only mentioned with reference to investment decisions by network companies. While this is clearly important (and we discuss this in our comments on section 2 above), it is also extremely important for the fundamental assurance of security of supply that investment in generation is facilitated by stable and certain regulatory and policy frameworks. We urge Ofgem to reinstate and clarify its commitment to stability in policy making affecting all aspects of the energy markets and in particular the network-charging related policies affecting investment in generation.

5. A leading voice in Europe

We continue to support Ofgem's involvement in Europe via its links with ERGEG, CEER and the European Institutions. The implementation of the third energy package and the "green" package will be key themes for the next few years. The establishment of the Agency for European Energy Regulators will be an important area of work, as will the continuing work to improve transparency and opening up access arrangements to European networks. In terms of unbundling, there will be a process to obtain Commission approval of the existing transmission unbundling arrangements in Scotland, but we do not believe that this will be a major piece of work.

The Plan mentions a number of other areas where European bodies will be developing policy affecting the energy sector – for example, on harmonising arrangements for consumer

representation and redress. We welcome Ofgem's intention to ensure that EU-wide proposals are implemented consistently with the framework already in place in Britain, without entailing any additional regulatory burdens.

6. Helping to tackle fuel poverty

We generally support the range of future activities that Ofgem has set out in this section. For example, we agree that there continues to be a need for a joined up approach from Government, industry and other agencies including Ofgem. We are fully engaged in the debate on assisting vulnerable customers in fuel poverty and note that Ofgem is considering further measures in this area. There are already multiple overlapping policy instruments (including separate measures in the devolved administrations) which intend to deliver help to customers and we strongly believe that there is scope to streamline these to maximise customer benefits. Any further measures proposed should be proportionate and avoid putting up prices for all customers.

7. 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 its willingness to review regulatory burdens on licensees in accordance with its new duty under the Regulatory Enforcement and Sanctions Act 2008.

We have comments on Ofgem's discussion about the review of industry codes governance and on the simplification plan.

We welcome Ofgem's review of the industry code governance. In our view, securing the proper treatment of charging methodologies is key to the success of the review and we strongly support the principle of opening up transmission charging methodologies to change by network users and customers by moving the charging methodologies into the existing code governance arrangements. In addition, we welcome Ofgem's proposal to introduce a self-governance process for certain modification proposals. Ofgem's analysis shows that roughly half of modification proposals are likely to be dealt with through self-governance rather than going to Ofgem for a decision. This should deliver significant cost savings to Ofgem which we would hope to see reflected as a reduction in Ofgem's budget requirements going forward. Finally, we have a number of concerns in relation to Ofgem's proposals to lead and manage major policy reform which we have outlined in our response to Ofgem's consultation paper on Major Policy Reviews. We believe that these could be addressed by the introduction of additional safeguards.

We continue to support Ofgem's work and reporting on its 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 Project Paperless) and which are either a completed initiative or an ongoing project, to which some "update comments" have been added.

The main initiatives that we hope would lead to reduced regulatory burden for licensees are:

- the review of regulatory reporting for distribution licensees (already mentioned in the Plan);

Scottish and Southern Energy plc

- an early review of the gas transporter licence following the review of the electricity distribution licence;
- similar reviews of the transmission and generation licences; and
- the removal of guaranteed standards of performance for the competitive supply businesses.