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Ofgem's Five Year Strategy 2010 - 2015

Dear Andy,

We welcome the opportunity to respond to the recent Ofgem letter regarding your five year strategy for 2010 – 2015. We believe that the re-structuring within Ofgem is well timed both because of the clarity that E-Serve brings to the delivery agent but also the creation of a Sustainable Development department. We look forward to working with this new structure.

We have some general comments first, which reflect concerns we have with the relationship between government priorities, the role of Ofgem and how this impacts on the business environment and competitive markets.

We are in a period of significant change within our industry and the wider economic and environmental climate which we will be operating in. What we do and how we operate over the next three decades is being decided now, and with that responsibility we should not be looking for quick fixes that will require further fixes in a couple of years.

Over the last decade we have built an energy market that has delivered both on security of supply and competitive prices for our energy customers. This should not be thrown away, as this stable platform will allow us to build on this stability and invest to meet the challenges as we move to a low carbon future.

Government must find a balance between the short term issues created by the financial crisis where there is a temptation to take more money out of the energy companies and ensuring that the very same companies can fund the longer term aims of transitioning to a low carbon economy.

We have identified the following priorities for Ofgem, grouped into three broad areas:

1. Protecting the interests of current and future consumers

Creating and Sustaining Competition

We resolutely believe that competitive markets are still the most efficient method of delivering the lowest cost products to energy market customers, whilst delivering investment and security of supply. We believe that the current market arrangements

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can evolve to meet the challenges of the future but see potential to damage this development with well intentioned but badly designed license changes both on the supply and wholesale sides. Ofgem appear to be responding to stakeholder pressure and seeking to introduce measures that could do lasting damage to the energy markets.

A leading voice in Europe

With the coming into force of the 3rd energy package in early September and its creation of the Agency for the Cooperation of Energy Regulators (ACER), we continue to support Ofgem's work with European regulators' groups to develop a consistent European regulatory framework and in preparing for the Agency. The ERGEG Regional Initiatives Group (RIG) looking to identify synergies and promote best practice with the aim of ensuring compatibility of approaches of the gas and electricity initiatives should facilitate their development towards single markets in electricity and gas.

Liberalisation of the energy market has already brought benefits to UK customers and we continue to support market-based mechanisms wherever possible. In the case of security of supply, the latest drafts of the Gas Security of Supply Regulation reflect this position.

We support the principle of developing a framework to extend the financial services market abuse legislation for the energy sector as required. However, given that GB gas and electricity wholesale markets are the most transparent in Europe, we would urge that any new requirements are not over prescriptive and provide the flexibility to undertake an Impact Assessment on the specific markets before they are imposed. In the past, Ofgem appear to have taken measures for the sake of harmonization on gas transparency, previously considered adequate by most market participants in the UK.

We support the aim of safeguarding against the danger that overly prescriptive European proposals might undermine any benefits to consumers. We look to Ofgem to work with Government to ensure the appropriate transposition into UK law.

Helping to tackle Fuel Poverty

The profile of fuel poverty has risen significantly over the past year, not least because of the impact of the recession. Suppliers have responded positively and increased again the amount that they spend on fuel poverty alleviation initiatives and will continue to do so in the medium term at least. With the uplift to CERT and the introduction of CESP later this year, npower will spend over £100m in 2009 on helping the fuel poor.

Notwithstanding this, we do have concerns about the ad hoc and piecemeal way in which suppliers are continually expected to do more. The data-share exercise to which Government attaches a high priority has been grafted on to the voluntary social commitment at very short notice with limited regard to the knock on effects. It also overturns the previous premise of the social obligation which is that suppliers would be free to determine the allocation of their spend. Policy makers can helpfully recognize that policy stability is important for the effective and efficient operation of retail as well as generation businesses, ultimately to the benefit of customers.

Recognizing the limits to what can be achieved through suppliers (provision of financial and energy efficiency advice and measures, special tariffs), we would hope that the current fuel poverty review lays the foundations for a stable, national fuel poverty strategy. This strategy should extend beyond supplier obligations. It must consider the role of other stakeholders and government agencies in dealing with the underlying issues related to poverty in general.

2. Tackling climate change and ensuring security of supply

Helping to achieve sustainable development

We note that the Energy Act 2008 amends Ofgem's duties, adding a duty to contribute to the achievement of sustainable development. This continues the transition of Ofgem from a purely economic regulator and reflects the challenges that are articulated in the Government's UK Renewable Energy Strategy which outlines how we will achieve our share of the EU renewable energy targets.

Over the next two years it is anticipated that a Feed-in Tariff (FITs) and a Renewable Heat Incentive (RHI) to support microgeneration and renewable heat respectively will be introduced. If Ofgem are to administer either of these schemes, we would like to ensure that its systems are sufficiently robust to avoid the teething problems that arose with the administration of the Renewables Obligation.

Regulating networks effectively

The networks will have a key role in facilitating and supporting initiatives to tackle climate change and ensure security of supply. The regulatory framework must facilitate these objectives and the TO, SO, and DNO price controls need to contain appropriate incentive mechanisms which has been recognised by the RPI-X@20 initiative. We strongly believe that regulation of monopoly electricity and gas networks should be the primary focus for Ofgem in the coming five years and that it undertakes rigorous network analysis to inform its decisions on network investment over this time.

With the decline in UKCS gas supplies and increasing share of gas-fired generation in the medium term, it will be important that the gas network is flexible enough to accommodate supplies from a range of sources. There is a need for additional infrastructure, as well as better utilisation of existing assets as supply and demand patterns change into the future.

In the short-term, Ofgem should implement short-term access CUSC amendments developed under the Transmission Access Review. They should also carefully review the substitution obligation on National Grid Gas, to minimise the potential for capacity destruction and removal of flexibility.

In the medium term, meeting the carbon emission reduction targets will have an impact on the generation mix which is likely to be both intermittent and remote. This has repercussions for networks; Ofgem should consider ways in which new grid infrastructure is planned and developed, including new incentives on TOs to invest ahead of full user commitment. Given the levels of investment required to meet the challenges of a low carbon future, it is important that network regulation provides a clear economic framework for the network companies. Ofgem must recognise that there will be a cost in achieving these measures, as there are with meeting social measures and must play its part in communicating this to customers who may find that retail energy costs actually increase at times when wholesale energy costs are falling.

Helping to protect the security of Britain's energy supplies

We reiterate our comments made in relation to Creating and Sustaining Competition that competitive markets are still the best means of delivering security of supply. Both the gas and power markets have responded well to the challenges they have faced over the last decade with investment prompted by the market delivering security of supply both in terms of capacity and diversity required. We are also seeing significant investment in a diverse range of energy sources to meet our future requirements. Ofgem has done much in the past to aid this process and must continue to promote an attractive investment climate in the future. It must continue to get the balance right between increased regulation and the impact this

could have on future investment decisions given greater regulatory uncertainty.

3. Governance

Better Regulation

In our view, Ofgem's recent adoption of "just in case" regulation is contrary to the principles of better regulation. Taking an extract from the Better Regulation Executive's website:

"The principles state that any regulation should be:

- transparent
- accountable
- proportionate
- consistent
- targeted – only at cases where action is needed."

In contrast to the Supply Licence Review, which reduced the number of Electricity and Gas Supply Licence Conditions, the number of proposed licence conditions has proliferated over recent months and the following examples are illustrative of Ofgem's approach.

- Firstly, regarding the Generation Licence, Ofgem's proposal for the Market Power Licence Condition advocated a broad solution "ensuring Ofgem has sufficient powers to address market power concerns which may arise on a forward looking basis." (6.6)
- Secondly, on Direct Debit, following an exchange between Alistair Buchanan and Peter Luff, chairman of the Business and Enterprise Select Committee (despite the fact that Ofgem acknowledges that, if a problem exists, it is one of communication, not abuse), it is proposing a Supply Licence Condition.
- Thirdly, the resurrection of licence conditions from the early years of privatization: non-discrimination and separate business accounts.

Therefore, we would welcome a return to the approach set out by the BRE where regulation is "targeted – only at cases where action is needed."

In addition, we welcome the requirement for Ofgem to produce Impact Assessments (IAs) for important proposals (introduced by the Sustainable Energy Act 2003 in s.6 into the Electricity and Gas Acts.). However, the issuing of the IA of the Energy Supply Probe's Retail Market Remedies with the statutory notice for the proposed Licence Condition is not helpful. The problem with such a late IA is indicated by the comment on the investment in systems to provide the additional information for bills and annual statements that: "Suppliers have largely advised that they are unable to provide estimates for the costs until they know the exact requirements." (2.49)

We contend that a feature of better regulation is that the regulator has regard to the intensity of resource commitment that it is demanding to effect its proposals. This is a particular concern in respect of the probe remedies package. Most of the proposals have very significant systems implications. Consequently, they will require the allocation of significant specialist resource. This resource is finite and may already be allocated to other business initiatives designed to improve the customer experience in ways which Ofgem would endorse. At the same time, Government is urging companies to participate in initiatives which draw on the same resource.

In setting the timing of the imposition of new obligations, it is important that the regulator takes into account the scale of the burden which it and government are seeking to apply.

Code Governance

We are fully engaged in the Industry Code Governance review process but our starting point is that the codes in their present form have served the industry well over the years and therefore fundamentally they are fit for purpose. We accept that there is always room for improvement, in the codes themselves but also in the roles of industry and Ofgem in making the codes work.

In conclusion, we recognise that changes in the wider economic and environmental climate will impact upon Ofgem's future priorities and strategy. Getting the balance right in terms of the amount and focus of increased regulation will be critical to the successful delivery of the required changes over the next five years and beyond.

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

Yours sincerely

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