



Scottish and Southern
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Dear Andy,

Ofgem's Five Year Strategy 2010-2015

Thank you for the opportunity to comment on Ofgem's next five year strategy.

Of all the strategies Ofgem has consulted on in recent years, the period 2010-2015 is perhaps the most critical. The GB's competitive market structure will be tested to its core by a series of factors that individually are challenging, but in coming together pose a dramatic test for the market and its regulator. We recognise that plant closures, uncertainties regarding demand levels, a wholesale shift towards intermittent renewable generation, coupled with a revolution in the way that customers are metered and manage their own energy use, are radical reforms that may introduce greater uncertainty into a market that has, to date, performed remarkably well.

For nineteen years the regulatory regime in Britain has, without doubt, delivered real benefits to UK customers and Ofgem can take credit for some of those achievements. We are struck by the success of entrenching stability within network regulation whilst at the same time bringing about improvements in quality of service, improvements in efficiencies and as such reducing charges substantially in real terms. Electricity distribution charges are down 50% since 1990, there have been nearly 8% annual reductions in operating expenditure and a 30% reduction in the duration of power interruptions between 1990 and 2005.

The danger is that because of the need for the market to respond to climate change and concerns regarding to security of supply, increased intervention in the market will result in the benefits of the competitive market being lost.

Whilst we recognise that some debates regarding the future – for example, transmission access arrangements - will take place in government and political circles, we nevertheless believe that clarity of direction from Ofgem will be very welcome to a market potentially buffeted by events.

Legacy issues in networks

First and foremost, we believe it is time to lay legacy issues from the past decade to rest. Despite the success of network regulation there are issues that have failed to find consensus in the industry and have remained contentious from the beginning. From the outset there have been serious concerns regarding the Ofgem preferred LRMC-based model for use of system charging for generators. While for SSE the model never made any sense, we believe it makes even less sense in the coming decade when there is a need to promote new generation connection and maintain existing generation.

Initiatives that further entrench locational price signals for generators – for example in transmission losses – represent an opportunity cost. At a time when there is so much more to do in tackling climate change and securing supply, we are concerned that the regulatory landscape becomes cluttered with yet more initiatives to embed price signals that were questionable in the first place. Surely time, effort and resources could be better spent elsewhere?

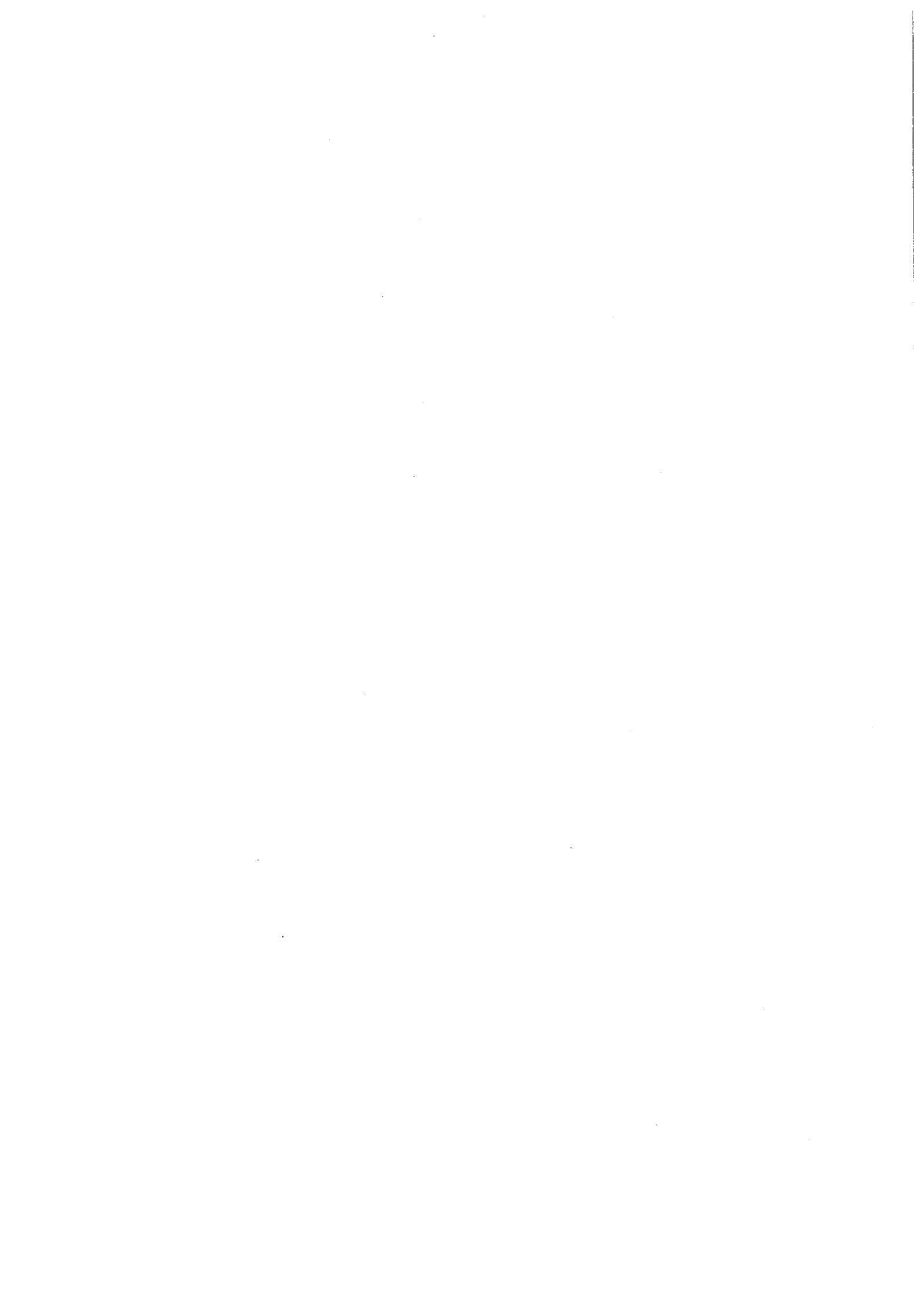
In short, we believe now is the time for Ofgem to clear the decks, lay the old issues of the past to rest, and move on.

Incentive regulation

We welcome the approach Ofgem has taken in the RPI-X@20 review and recognise the progress being made. We look forward to the publication of the next set of documents towards the end of this year. We are concerned however, that the current distribution price control might pre-empt the results of that review with some radical changes to incentive regulation that in effect threatens the stability of the investment environment. For example changing the regulatory treatment of (the so-called equalisation of incentives) investment impacts our decisions to invest in innovation. This shift in the regulatory framework could be seen as making an assumption that the potential for greater efficiencies has come to the end of the road. We agree that the UK's electricity networks are at a mature stage in terms of the potential for cost savings and the feature of a mature market is that further efficiencies will be gained from innovation. The Low Carbon Networks fund is a welcome and radical step to encourage greater innovation. However, reducing the incentives and rewards for greater efficiency will cut across efforts to deliver these benefits. Incentive regulation has served customers well and we are disappointed by the move away from it in the current price review. We would therefore urge Ofgem to re-think its proposals to "equalise" incentives.

Customers

We recognise the dilemmas of security of supply and climate change, but we are also mindful of the challenge of ensuring that energy is affordable to UK consumers too. The results of the Probe into the competitive market are largely to be welcomed. We are concerned however, that any further interventionist steps into the supply market will bring the UK dangerously close to an end of competitive supply offerings. It is a competitive market where, as SSE has demonstrated, suppliers are rewarded by larger



market share on the basis of high quality customer service, competitive pricing policies and innovative products. This market strength is in the best interests of the UK consumer and is a feature that should be guarded by Ofgem in the next five years.

While the process of decision making regarding the need to ensure suppliers fulfil their obligations to their fuel poor customers was perhaps less than ideal, SSE believes the structures Ofgem has put in place for the voluntary arrangements are transparent and generally fair. Ofgem's role within the mandated arrangement will change and new systems will need to be constructed to monitor suppliers' spend. We are concerned to ensure that the maximum benefit reaches the customers who need it the most and we look forward to working with Ofgem in helping to construct that framework.

Conclusion

Finally and in summary, SSE believes the key issues for Ofgem in the period 2010-2015 are:

- Solving the legacy issues on transmission charging, in order for the industry to move on;
- Protecting the competitive market, with no further intervention in the supply market;
- Strengthening incentive regulation in networks.

This is a watershed moment for both the energy industry and its competitive market. There must be change in the UK's energy industry. Change that recognises and responds to public perceptions regarding the cost of energy, change that ensures energy supply makes a dramatic reduction in its carbon emissions and change from new technology. But to lose the strengths of the competitive market at this time would be a backward step and we look to Ofgem within the period to 2015 to strike the right balance: respond to change and tailor the regulatory regime in response, but maintain the best of the competitive and incentives based environment, which is in the best interests of customers.

I welcome this opportunity to comment on the strategic plan and given the scale of the challenges facing the UK's energy industry in the period 2010-2015, SSE looks forward to contributing further to these discussions.

Yours sincerely



Rob McDonald
Director of Regulation

