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Ofgem's Five Year Strategy 2011 - 2016

Dear Andy,

We welcome the opportunity to respond to the recent Ofgem letter regarding its five year strategy for 2011-2016.

Please find below our responses to Ofgem's current priorities for its future strategy as detailed in the letter, which we have grouped under the four themes used recently by Ofgem in its latest documents. We have highlighted the key challenges we feel the industry faces and in each case indicated how we think the Authority should respond to these challenges.

We initially provide the following high level comments, but draw your attention to the more detailed observations in the subsequent sections.

- In moving towards a low carbon energy economy within the UK, this will serve towards ensuring Britain's security of energy supply. However, we are seeing increased regulation of the energy companies, but with little encouragement for investment within the UK to fund government's aims of moving to a low carbon energy system.
- Ofgem should take account of cost reflectivity in its review of charging arrangements across industry.
- The move towards smart metering and smart grids should be done in a co-ordinated approach to enable greater interaction between generators, suppliers and customers and to ensure smooth integration with EU policy.
- With regards to price control reviews and charging methodologies in both the gas and electricity sectors, we believe that any potential outputs-based regulatory framework should also be geared towards user commitment when encouraging longer-term planning and investment decisions for both onshore and offshore transmission networks. This would reduce the risk of adverse environmental and financial repercussions that may arise due to incorrect signals being given by market participants.

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- Some form of a national fuel poverty strategy (NFPS) would offer a better service for protecting vulnerable customers.

Theme 1 - Contributing to the achievement of a low carbon energy sector

Transmission Charging

We note that Ofgem intends to review charging arrangements across the industry. We look forward to participating in that review but would like to make the point that cost reflectivity has an important role to play in moving to a low carbon electricity market. It produces a more efficient electricity market at a lower cost to the consumer whilst delivering Government low carbon targets. We believe that the starting point in the review should be cost reflectivity and that there would need to be convincing arguments to move from this position.

Investment

Ofgem has taken a lead with Project Discovery in making public the amount of investment required to meet Government targets, and the scale of investments is huge. Investments are made where best opportunities exist and conditions are most favourable. With little provision in the Energy Bill to encourage inward investment to the UK, and the fact that the UK could be considered quite a challenging environment for investment, we feel Ofgem should consider this when ensuring the needs of future consumers are met.

Smart Metering

We believe that Smart metering will transform the customer experience and enable more direct engagement by consumers with their suppliers in their demand for energy. The transformation period will continue for many years and it is important to view the process as much more than a meter replacement programme. In particular it is important that Smart metering, Smart settlements, and Smart grids are viewed in a coordinated way, as this will enable greater interaction between generators, suppliers and customers, and better management of energy demand.

Theme 2 - Helping to maintain the security of Britain's energy supplies

Consulting on and implementing new market power licence conditions (MPLC)

At some point during the life of this plan we would expect Ofgem to be directed to draft and introduce a licence condition to reflect what is in the Energy Act 2010. We believe that such a licence condition has the potential to undermine investment. There are a number of jurisdictions where regulations designed to limit prices have led to a "Missing Money" (inadequate returns on capital) problem and consequent sub-optimal investment. If this risk is to be contained, it will be vital that the guidance which Ofgem produces regarding its enforcement of the MPLC is completely transparent and, in particular, accurately distinguishes "good spikes" from "bad spikes".

Transmission and Distribution Price Control Reviews

The next transmission price control review (TPCR5) and gas distribution price control review (GDPCR2) are likely to be undertaken under a new outputs-based regulatory framework, designed to deliver Sustainable Network Regulation. These reviews will take place against a background where future network requirements are uncertain, given energy policy and the changing generation mix. While we support the regulator introducing incentives to encourage longer-term thinking, innovation and anticipatory investments, we still strongly believe that these decisions must be guided, at least in part, by user commitment. This will minimise stranding risk, as assets will be constructed where users who are willing to commit, require them. We believe that a proportion of the investment costs should be underwritten by users and that this is equally applicable to the gas and electricity sectors.

With the significant level of onshore network investment identified under Project Discovery, it is crucial that the transmission charging methodology provides strong, cost reflective signals about how siting decisions affect costs on the transmission network. In undertaking its review of transmission charging arrangements, we believe that Ofgem must retain a methodology that gives the correct signal of the cost implications of connecting at a particular location. Where such signals are missing, economically inefficient decisions to locate plant will be taken. These will have an environmental as well as financial effect, where it leads to an increase in transmission losses.

The offshore transmission regime includes competitive tendering arrangements. Ofgem and DECC are considering how the enduring regulatory regime might be developed to provide greater flexibility to offshore generators and ensure that the offshore network develops in a coordinated manner. We agree that it will be appropriate to include both an OFTO build option and a generator build option in the enduring regime. Given the scale of investment required in offshore transmission assets, we also recognise that an integrated offshore network may deliver benefits compared to individual connections provided to wind farm projects located in the same zone. However, the provision of transmission capacity should reflect the requirements of the individual developer and be backed, at least in part, by a financial commitment.

Market Liquidity

Ofgem has recently consulted on GB wholesale electricity market liquidity. We are concerned that Ofgem has not given the market sufficient time to develop the solutions that will increase liquidity. There is no doubt that liquidity is improving and that N2EX is moving the market in the right direction with regards to introducing new products, but to expect this to have matured within a year of it coming into operation is an impossible ask. This raises the prospect of premature and ultimately counterproductive regulatory intervention if Ofgem persists with its presently stated timeline

Theme 3 – Promoting consumer choice and value and protecting vulnerable customers

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 and 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, there are a profusion of recent and prospective new obligations, revisions to obligations, new license conditions and amendments to existing licence conditions. This is not a stable regulatory environment conducive to investment or efficient delivery of obligations.

When it introduces new or extended obligations, we would like to see Ofgem state explicitly how it is applying the one in – one out principle set out in the Coalition Agreement.

In addition, whilst 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.), these must be undertaken in a timely manner.

Notwithstanding DECC's current review of Ofgem's role, we would urge Ofgem to work with other stakeholders to minimise duplication and ensure optimal outcomes.

Europe

With the implementation of the EU Third Energy package in early March 2011 and its single market obligations on national regulators as well as its duties on them to comply with and implement the Agency for the Cooperation of Energy Regulators' (ACER's) and European Commission's (EC's) relevant legally binding decisions, we continue to support Ofgem's participation in European energy regulation.

Liberalisation of the energy market has brought benefits to UK customers and we continue to support both cost-effective implementation of EU policies and market-based mechanisms wherever possible. Furthermore, given that GB gas and electricity wholesale and retail markets are the most competitive and transparent in Europe, we would urge that any implementation of new requirements is not over prescriptive and provides the flexibility to undertake Impact Assessments on the specific markets and to allow for consequent variation before they are imposed.

More generally, we support the aim of safeguarding against the danger that overly prescriptive European proposals might undermine benefits to consumers. Aspects of the implementation of the EU Third energy Package's Consumer Protection measures provide such an example. We look to Ofgem to work with Government to ensure appropriate transposition into UK law.

Dissemination of information to consumers

With regards to information on energy bills, suppliers have recently introduced additional consumption and cost information on bills and annual statements, as required following Ofgem's Energy Supply Probe. The Government has just announced that The Energy Security and Green Economy Bill may contain measures requiring energy companies to provide information on the cheapest tariff and consumption comparisons on energy bills. Other consumer stakeholders hold views regarding bill content and clarity. We would urge the industry and stakeholders to take stock and review the benefit (or otherwise) of the information that customers are already being provided with, before immediately launching into further changes. A holistic approach should then be applied as this will be more cost effective than incremental review and change. We are keen to work with stakeholders to ensure that customers are provided with meaningful information and able to exercise informed choice. It will also be important that suppliers retain sufficient flexibility to differentiate their bills in a competitive market.

Protecting vulnerable customers

Responsibility for tackling poverty including fuel poverty is fragmented and initiatives are insufficiently integrated. A strategic approach via a national fuel poverty strategy (NFPS) would bear more fruit than piecemeal measures. The forthcoming energy bill would appear to be the ideal vehicle by which a NFPS could be developed and promulgated. However, as we have said before, such a strategy must consider the role of other stakeholders and government agencies in dealing with the underlying issues related to poverty in general.

Theme 4 – Ensuring the timely and efficient delivery of Government programmes for a sustainable energy sector.

Renewable Obligation and Feed in Tariffs

Over the years, Ofgem has moved from its traditional narrowly regulatory role to one where its objectives are far more diffuse. These additional objectives for example to help vulnerable customers, ensure security of supply and curbing climate change are often in conflict and require subjective judgement. In addition to this traditional role, Ofgem has over the years also become the administrator of an increasing number of environmental programmes such the Renewables Obligation and Feed-In Tariffs.

While the details of the FITs regime were delayed because of factors outside Ofgem's control, the FITs system still requires further work before it is fully fit-for-purpose. Only manual intervention and the

considerable support from members of Ofgem's staff has enabled the process to meet the expectations of our customers. At the same time, we have experienced a number of minor problems with the system to support the Renewables Obligation process; again these have been resolved with help from Ofgem staff. We are concerned that if Ofgem becomes the administrator of the Renewable Heat Incentive, this will exacerbate the problem especially at a time when public spending is likely to be under greater scrutiny.

Our experience to date suggests that the administration of environmental schemes should be removed from Ofgem's responsibilities allowing them to focus more sharply on the considerable regulatory policy issues that will need to be addressed if the UK is to meet its targets of affordable, secure, low carbon energy.

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

Yours sincerely

Jill Brown
Economic Regulation
(sent by email)