

Rob Wright  
Head of Unit, White Paper Team  
Department of Trade and  
Industry  
Room 167  
1 Victoria Street  
London SW1H 0ET

Your Ref:  
Our Ref:  
Direct Dial: 020 7901 7273  
Email: Joanna.whittington@ofgem.gov.uk

2 September 2002

Dear Rob,

### **Ofgem's response to the recommendations of the PIU Energy Review**

As you will be aware, Ofgem has recently responded to your consultation document, *Energy Policy: Key Issues for Consultation*, which you issued in advance of publishing a white paper. A significant input to your consultation paper was the PIU's Energy Review, which contained detailed recommendations, some of which were addressed to Ofgem. For the sake of completeness, we thought it would be useful to prepare a separate discussion of each of the detailed recommendations of the PIU review which address Ofgem or relate directly to areas of Ofgem's work. A copy of this is attached as Appendix 1.

This discussion does not address the recommendations relating to NETA. Ofgem's review of the first year of NETA was published in July 2002.<sup>1</sup>

If you have any questions on this document, or would like to discuss further any of the points made, please contact me on the number above, Toby Brown on 020 7901 7114 or Ben Woodside on 020 7901 7047.

---

<sup>1</sup> The review of the first year of NETA, A review document, Ofgem, July 2002.

Yours sincerely,

**Joanna Whittington**  
**Director of Strategy**

## **Appendix 1 – Ofgem’s response to the recommendations of the PIU energy review**

### **Introduction**

In its review of energy policy, published in February 2002, the Performance and Innovation Unit made a number of specific recommendations addressed to Ofgem or relating to areas of Ofgem’s work. Ofgem sets out below its response to these specific points. Ofgem has separately responded to the government consultation paper *Energy Policy: Key Issues for Consultation*, and has also recently published a review of the operation of NETA in the year following its introduction.

For ease of reference, this document follows the structure of the PIU’s report, and the relevant recommendations are numbered as they are at the end of each chapter of that report. Numbers in brackets at the end of each recommendation refer to the relevant paragraph in the main body of the PIU report.

### **Chapter 4 – Security in the energy system**

#### *Recommendation 6*

*WGSS should expand its existing activities to take on responsibility for monitoring all risks to security of the energy system. It will need to:*

- *expand its membership to include representatives from FCO;*
- *build on the Group’s existing monitoring indicators to monitor all risks to security of supply – one completely new area for the Group will be risks to oil supplies; and*

- *conduct ongoing monitoring of all of these indicators in order to establish how the risks alter over time.*

Ofgem agrees that the international and geo-political dimensions to security of supply need to be recognised and incorporated in the work of JESS, and understands that the FCO will be involved in the Joint working group on Energy Supply Security (JESS) as and when necessary.

Oil supply security does not fall within Ofgem's remit, and JESS does not consider it a significant area of its responsibilities due to the relatively small quantities of liquid fuels used for electricity generation (less than 1% of generation inputs).

#### *Recommendation 9*

*There is no case for restricting the share of gas in the power sector at this time. However, WGSS should monitor this situation, in particular to assess the market signals surrounding gas prices. (4.27)*

JESS (WGSS) is monitoring market signals surrounding gas prices, which are discussed in the group's first report. It will be important to continue to monitor changes in forward gas and electricity prices, and the market's response to these price changes, to identify any material barriers or distortions to the full range of fuel sources being developed for generation. Ofgem agrees that at this time there is no case, on supply security grounds, for specific limits to be placed on particular sources.

#### *Recommendation 10*

*Departments should look at the barriers to private sector construction of both gas storage and LNG facilities.*

One major barrier at present is the planning process, which can cause delays in the period between the need for investments being signaled by the market and the realisation of those investments. A faster, or at least less uncertain, decision making process in the planning system would enable investors to react more effectively to market signals; it is important that participants in the planning process are aware of the potential costs of delay and uncertainty.

*It may be worth considering keeping some coal plant as a strategic reserve to be operated only if there were widespread power cuts. Such plant could be solely contracted to NGC and the costs covered through NGC's regulated charges – this would be in addition to NGC's normal reserve arrangements. (4.25 and 4.26)*

NGC is required, under the terms of its licence, to maintain certain standards of transmission network security.<sup>2</sup> NGC is under regulatory incentives to discharge this duty efficiently, and is free to purchase the balance of reserve and other services that will allow it to achieve system security at least cost. Ofgem considers that incentives are in place to reward market participants that are able to come forward with cost-effective support services to NGC. Ofgem notes that NGC's Seven Year Statements include detailed information on plant margins and generators' plans.

Where investment in supply security is being delivered through the operation of competitive markets, it is important to recognize that government intervention to increase security might have the effect of displacing, rather than adding to, private investment. Hence the intervention could have the effect of subsidizing the cost (either to market participants or final consumers) of supply security, without increasing the level of security provided. The existence of strategic capacity reserves might discourage private companies from investing in other contingency measures. Hence the intervention could simply displace private action, and have no overall net benefit on supply security, and indeed could reduce it by creating an expectation of further government intervention.

Plant mothballing is an example of the market acting to maintain reserves. Plant which has been mothballed can be brought back on line, in response to a rise in demand or a fall in supply (signaled by higher wholesale prices). Ofgem recognises the need to ensure that information about plant mothballing is available and well understood, including information about the time required to return a mothballed plant to service (currently, it is estimated that most plant can come back on to the system within about a month).

---

<sup>2</sup> The details of NGC's transmission system planning criteria are described in NGC Transmission System Security and Quality of Supply Standard, Issue 2, NGC (2000).

### Recommendation 16

*There appear to be no grounds at present to think that there is insufficient interconnector capability or that markets will not provide new capacity as needed. DTI and Ofgem should adopt the following guidelines:*

- *the international regulation of large discrete infrastructure projects should be confined to requirements for open access; and*
- *there should be no major new initiatives for public funding for new projects, given that such proposals would be likely to undermine market-driven proposals and could be costly for consumers.*

Ofgem fully agrees with the principle of open access to gas and electricity networks, and considers that the regime for access to off-shore gas pipelines should be brought into line with that for on-shore networks. Ofgem does not consider that current arrangements for negotiated third-party access to European gas networks offer the same degree of openness as the fully transparent regime in GB, and believes that there are significant benefits from separate ownership of networks and network users.

Ofgem agrees that government intervention to provide infrastructure capacity can crowd out private investment and that there is no case for government to fund additional interconnector capacity. It will be important to identify and remove any barriers to the development of private sector infrastructure projects.

In the text of chapter 4, the PIU comments that:

*It can be argued that a period of RPI-X price control of more than 5 years is needed to provide the right incentives for long-term investment.*

The longer the period between price control reviews, the greater are the rewards for companies that are able to outperform the efficiency targets set by the regulator. However, a longer price control period requires estimates of future costs to be made for more than five years ahead and therefore increases the risk of company performance being significantly different from the projections and assumptions used in setting the price control.

As part of the consultation process for each price control review, Ofgem seeks views on the appropriate period for the duration of the control. In the past Ofgem has always set price controls on electricity network operators for

a period of 5 years.<sup>3</sup> This seems to have provided an appropriate balance between incentives to make efficiency savings and reducing uncertainty in company performance. Respondents to price control consultations have generally supported the choice of a 5 year control.

Ofgem remains committed to improving regulatory frameworks where possible. For example, Ofgem's Information and Incentives Project has been implemented to provide distribution companies with incentives to improve the quality of service for customers. System operation incentives have been placed on NGC to encourage it to operate its system in an economic, efficient and coordinated manner. Ofgem has proposed similar incentives for Transco in relation to the operation of the gas transmission system.<sup>4</sup>

In addition to the existing system operation incentives, Ofgem has also proposed strengthening the incentives on Transco to meet changes in the demand for network capacity in a timely and efficient manner, through a system of auctions for up to fifteen years ahead. Such capacity investment incentive arrangements do not currently apply to NGC in respect of the electricity transmission system, but in September 2002, Ofgem will consult on the form, scope and duration of similar arrangements for NGC, which will take effect from April 2003.<sup>5</sup>

## **Chapter 7 – A programme for a low carbon future**

### *Recommendation 27*

*For network investment for embedded generation, Ofgem should ensure that the recommendations of the EGWG are implemented by 2005:*

- *The EGWG recommendations to be implemented in full, no later than through the 2005 Distribution Price Control Review.*

---

<sup>3</sup> Offer initially set price controls for shorter periods, but since 1990, all electricity network price controls have been for 5 years.

<sup>4</sup> Ofgem issued a notice under section 23 of the Gas Act 1986 in respect of proposed modifications to Transco's gas transporter licence to introduce, with effect from 1 April 2002, new price controls and system operator incentives for Transco. Having considered the responses to this consultation Ofgem identified a number of changes to the proposed modifications and on 1 August 2002 issued a further section 23 notice. Ofgem is currently awaiting responses to this further consultation.

<sup>5</sup> The proposed SO incentive schemes on Transco and NGC are described in more detail in chapter 2 of Ofgem's response to the Government's consultation on energy policy, Ofgem, August 2002.

- *While it will be difficult to implement the EGWG recommendations before 2005, in the interim, alternative policies should be prepared so that they would be ready for implementation in 2007, if it became clear that the changes laid out by the EGWG were not coming into effect.*

The Distributed Generation Co-ordinating Group (DGCG) is jointly chaired by the DTI and Ofgem. The DGCG is concerned with a wide range of issues related to the connection and operation of distributed electricity generation in GB, and is following up consideration of the Embedded Generation Working Group's recommendations. Ofgem has made interim recommendations, and projects are in progress to review DNO incentives and charging structures, to provide a fair and transparent regulatory regime for distributed generation.

Should it become evident that any changes made to incentives and charging structures are not effective, Ofgem would consider alternative possibilities. Ofgem will keep the effectiveness of the proposed changes under review following their implementation. It would not seem a sensible use of resources to prepare contingency plans before the effectiveness of the current approach has been tested. Furthermore, 2007 would be too early to see all the effects of measures implemented in 2005.

### Recommendation 28

*Ofgem should ensure that future changes to electricity trading and grid access arrangements do not discriminate unfairly against renewable and CHP generation.*

Any modifications made to the Balancing and Settlement Code (BSC) or the Connection and Use of System Code (CUSC) are assessed against defined criteria and in line with non-discrimination conditions NGC's licence,<sup>6</sup> in Ofgem's statutory duties and in the codes. For example, the BSC panel has an objective that the BSC is given effect without undue discrimination between parties or classes of party.<sup>7</sup>

Ofgem seeks to promote competition and minimise distortions in the markets for gas and electricity. As such, Ofgem is committed to ensuring that the rules and arrangements for gas and electricity trading and access to networks do not discriminate unduly against or in favour of any market participants, and that, for example, access and connection charges should reflect costs.

Ofgem also has powers, for example through licence conditions and under the Competition Act 1998, to investigate and take action against discriminatory behaviour if required.

Ofgem's review of the first year's operation of the New Electricity Trading Arrangements (NETA)<sup>8</sup> considers the impact of NETA on a sample of small generators (including renewable and CHP generation).

### Recommendation 37

*For contracts that include longer-term energy efficiency financing (but only for those contracts) Ofgem should modify the 28-day rule, with other approaches used to protect customers against excessive charging.*

---

<sup>6</sup> Condition 7, Licensee's Grid Code and Condition C7C, Non-discrimination, Electricity Transmission Licence: Standard Conditions, DTI, September 2001.

<sup>7</sup> 1.2.1(c), Section B, Balancing and Settlement Code, NGC, March 2002.

<sup>8</sup> The review of the first year of NETA, A review document, Ofgem, July 2002.

Ofgem holds the view that Standard Condition 46 of the electricity and gas suppliers' licences ("Termination of contracts on notice") is an important means of protection for consumers. The condition allows consumers to change supplier with a notice period of 28 days, and without paying a termination fee (where the contract is a typical domestic supply contract of indefinite length, for example). This facilitates switching of suppliers, which is an important factor in the effective functioning of competition.

The Condition allows for fixed-term contracts to include provision for a reasonable termination fee, providing flexibility for suppliers to offer this option if it is demanded.

Ofgem will shortly be updating its guidance on the flexibility that exists in the regulatory regime as a means of facilitating the promotion of energy efficiency.

### Recommendation 49

*Ofgem should ensure for micro-CHP, that there are simple and standardised connection terms, that settlement profiles avoid recourse to expensive metering and in the medium term, that advanced metering technology should be introduced.*

Ofgem regards the separate measurement of imports and exports as a minimum for all distributed generation, including domestic CHP. This does not need to be sophisticated (eg half-hourly) metering. However, profiling based on the average of customer groups would seem to be insufficiently precise to allow for robust pricing, since domestic CHP and micro-generation customers are expected to display diverse behaviours and characteristics. Metered data on import and export volumes will be essential to taking proper account of these differences.

Development of distribution networks to allow the connection and operation of distributed generation is both facilitated and impeded by technical standards written or adopted by electricity companies. Small companies are concerned that they find it difficult to influence the content of the standards. Ofgem recently consulted on revising the governance processes relating to the production and revision of standards utilised by the licensed electricity transmission and distribution companies. A follow-up document will be published shortly.

The Technical Steering Group (TSG) of the DGCG is pursuing a workstream on micro-generation solutions. Its work includes addressing all the issues surrounding connection terms for micro-CHP, such as technical, practical and pricing terms.

### **Appendix to Chapter 7**

*Given Scotland's rapidly increasing wind energy deployment and large resource of other renewable energy technologies, there are three issues:*

- *is the investment in transmission necessary;*
- *if so, how should it be paid for; and*
- *who should pay for it?*

Ofgem is in favour of providing incentives to transmission companies to invest efficiently in their networks by reacting to market signals.

Incentives are placed on Scottish Power and Scottish Hydro-Electric to make efficient investment in their respective transmission networks. Ofgem expects efficient incentive arrangements to be in place when a single GB system operator has been established under the British Electricity Transmission and Trading Arrangements (BETTA) project.

In England and Wales, Ofgem currently incentivises NGC, through its price control, to invest efficiently in maintaining and expanding the transmission network. Ofgem is continually looking at ways to improve these incentives and will be consulting next month on extending the current incentive scheme to provide enhanced incentives to respond efficiently and in a timely manner to signals of the need for expansions in capacity. The BETTA project should extend these new arrangements to Scotland where appropriate.

## **Chapter 8 – Institutions**

### *Recommendation 56*

*DTI to sharpen Ministerial guidance to Ofgem on environmental issues.*

Ofgem welcomes the decision to put guidance before Parliament. The guidance is a matter for the Government, but Ofgem will work with DTI if it wishes to consider developments to the guidance.

### *Recommendation 57*

*Ofgem to produce comprehensive analyses of significant regulatory proposals, taking full account of the costs falling on the energy industry and consumers.*

Ofgem stated in its most recent Corporate plan, published in April 2002, that Ofgem consultation and decision documents will usually include a rationale section which seeks to explain why Ofgem is putting forward a particular policy. The rationale section of the document will describe the objective and desired effect of the policy that Ofgem is proposing. It will look at different options and will also consider the implications of not going ahead.

The rationale, where appropriate, will consider the benefits, impact and costs of Ofgem's proposals on those affected (for example on industry, customers, the environment and competition).

Recommendation 69

*There is a continuing need for consultation between the DTI, Ofgem and the industry to ensure that actions affecting onshore and offshore investments are coordinated appropriately.*

Ofgem is not responsible for regulating or licensing the offshore parts of the gas sector, and has limited responsibilities and influence over gas and electricity interconnectors and gas terminals. Nevertheless, Ofgem has an interest in the operation of the offshore parts of the industry as it affects operations onshore, which would include security of supply concerns. As discussed above, open third-party access to offshore pipelines and interconnectors can bring significant benefits, both in terms of price and supply security.

Ofgem does not consider that the existing regime of negotiated access offshore and regulated access onshore is the most efficient way of ensuring security of supply. In particular, the way in which interruptions in the flow of gas through the Bacton interconnector influence prices in the UK gas market may merit further investigation. In this respect, we also suggest that the DTI, together with Ofgem, meet on a regular basis with their Belgian counterparts better to understand the interaction of the UK and Continental markets. Ofgem already has such an arrangement with the Irish regulator.