

## **Additional supplementary memorandum by the Association of Electricity Producers**

### **INTRODUCTION**

1. The Association of Electricity Producers (AEP) represents large, medium and small companies accounting for over 90 per cent of the UK generating capacity, together with a number of businesses that provide equipment and services to the generating industry. Between them, the members embrace all of the generating technologies used commercially in the UK, from coal, gas and nuclear power, to a wide range of renewable forms of energy.
2. We welcome the opportunity for continued engagement with the Committee on the subject of UK economic regulators, particularly the Office of Gas and Electricity Markets (Ofgem). We would like to draw attention to the written and oral evidence which we have already given during the course of this inquiry, much of which supports in detail the points made in this submission.

### **IMPACT OF UK ECONOMIC REGULATORS ON THE UK ECONOMY**

3. The electricity industry is a central part of the UK economy, providing an essential product to society. The industry currently contributes around 1.7% to the Gross Domestic Product and is responsible for some 18% of all industrialised investment in the UK. The impact of Ofgem's actions could therefore be significant for the economy at large. However, it is difficult to disentangle the effect of Ofgem's actions on the economy and the general economic performance of UK power generators from that of government policy as a whole. As we have mentioned in previous evidence to the Committee, the regulator is only part of the broader energy policy framework.
4. What is essential is that this policy framework is long-term, clear and stable. Without this certainty, energy companies will be discouraged from operating in the UK, delaying their investment decisions or opting instead to deploy their resources in countries where the risks of investment are lower. This could obviously have significant consequences for the UK economy, especially since at least £20 billion of investment is needed in new and replacement plant in the UK between now and 2020 simply to meet electricity demand. Furthermore, the government has committed itself to challenging targets for greenhouse gas emissions reductions and an increase in renewable energy, which the electricity generation industry will be instrumental in meeting. Investment in low carbon and carbon abatement technologies to meet these targets should not only benefit the UK economy by putting it at the forefront of development of new and innovative technologies, but may also help avoid some of the large potential costs of dealing with the effects of climate change at a later date (as highlighted in the Stern Report).

## **REGULATORS' SUCCESS IN REALISING THE BENEFITS OF COMPETITION**

5. Great Britain has some of the most competitive energy markets in Europe, as confirmed in recent analysis by the European Commission. Since privatisation began in 1990, the electricity generation market has become progressively less concentrated. The benefits of such high levels of competition are readily apparent. Between 1990 and 2004, electricity prices for typical UK domestic customers fell by 31% in real terms, while the average reduction for industrial customers was 45%. Despite recent price rises (which were mainly the result of higher fuel prices), UK domestic and industrial electricity prices still lie towards the middle and lower end of prices in the EU15 and G7. Furthermore, levels of customer switching are high in the UK. 51% of domestic customers had changed supplier by the end of 2006.
6. The economic regulators in the energy markets have therefore been successful in promoting competition and realising its benefits. It is not entirely clear whether the introduction of the New Electricity Trading Arrangements (NETA) in 2001, which was overseen by Ofgem, increased levels of competition beyond the level reached in the last years of the previous trading mechanism, the Electricity Pool, but it is clear that a high level of competition remains. Analysis suggests that factors other than the trading arrangements may have had a more significant impact on levels of competition.
7. Where competition does not exist in the monopoly network businesses, Ofgem has also been broadly successful in its approach to regulation. Over successive price control periods, Ofgem and its predecessors have applied a ratchet to the charging of monopoly companies and encouraged them to deliver a higher quality of service.

## **IMPACT OF ECONOMIC REGULATORS ON ECONOMIC PERFORMANCE OF FIRMS IN THE UK**

8. Economic regulation is necessary in that it provides for an orderly market, ensuring all companies operate on a level playing field. If the regulatory framework is stable and any changes to it are timely, well-signalled and transparent, companies can have more confidence that their investments will be secure. In highly liberalised markets, such as the UK electricity and gas markets, the emphasis of economic regulation should be on maintaining the existing regulatory framework, which will deliver greater benefits than regular intervention in the market mechanisms.
9. Our experience of Ofgem to date has been that it is too ready to intervene in the competitive market, increasingly regulatory risk. Ofgem's decisions and actions do not always seem to be based on the most pragmatic assessment of what would be of most benefit to consumers or companies operating in the market. In several cases, Ofgem has approved changes

to the market structures or operations which provide little benefit to consumers and in fact increase costs to companies rather than enhancing their economic performance. Ofgem must therefore be certain that its interventions are necessary, appropriate and of actual benefit.

10. One notable example of Ofgem intervening in the market and not adopting the most economically efficient approach is in the Authority's approval of the proposals for reform of the gas NTS offtake arrangements (UNC Modification 116V) against the recommendation of the UNC Panel, which advocated maintaining the current offtake arrangements. Offtake reform has been a long-standing Ofgem policy objective and Ofgem therefore made it a pre-requisite of the sale of four gas distribution networks in 2005, thus forcing this project to be pursued despite a lack of industry support. The proposals contained in Mod 116V impose very substantial costs and increased complexity on the competitive part of the industry for no real benefit. Ofgem's own impact assessment showed that the costs of the proposals outweighed the quantitative benefits by some £27m PV. Ofgem justified its recommendation to implement Mod 116V on the basis that a small number of contestable qualitative benefits outweighed these significant costs. The Authority's decision in respect of Mod 116V is currently being appealed by an industry party.
11. A further example in electricity from 2003 saw Ofgem approve BSC Modification Proposal 98, concerning "Dual Notification of Contract Positions", against the recommendation of the BSC Panel. Dual notification was intended to decrease the trading risks associated with a single notification system, in particular by stopping parties having positions notified against them about which they did not know. The BSC Panel did not consider that the possible benefits of the modification would outweigh the significant costs of implementing the new system, calculated by Ofgem to be £0.75m to £1.3m with ongoing costs in the order of £175,000 to £540,000 per year. Ofgem considered, however, that these costs were proportionate to the benefits of the new system. However, since its introduction the voluntary dual notification process has been little used.

## **IMPACT OF ECONOMIC REGULATORS ON THE INTERNATIONAL COMPETITIVENESS OF UK FIRMS**

12. The international competitiveness of UK power generation companies will be enhanced if European energy markets are opened up and a level playing field created for UK companies wishing to operate and buy assets on the Continent. It is political pressure from the Government which will help to achieve this. However, Ofgem can assist the international competitiveness of UK companies by taking into account in its work the development of the European electricity and gas markets and the growing interdependency between the UK and continental countries. Greater coordination between regulators in different Member States, a duty to consider the interests of customers in other EU countries and more consistent and effective arrangements for regulation at EU level will help remove disparities between the operating environments in different

Member States and aid the development of the internal electricity and gas markets.

### **INCREASING THE BENEFITS AND REDUCING THE COSTS OF ECONOMIC REGULATION**

13. Great Britain has the largest and most costly energy regulator of any European country, despite the fact that the UK's gas and electricity markets are among the most liberalised in Europe. We consider that Ofgem could operate just as effectively with a fraction of this resource. In fact, a lower budget and fewer staff would provide benefits by limiting Ofgem's ability to intervene unnecessarily in the market, thus reducing uncertainty and costs for companies and ultimately consumers. Economic regulation in the energy markets could therefore be improved if Ofgem were to adopt a zero-based business planning approach. Clear filtering criteria should be introduced for any work which Ofgem undertakes and a merit order of projects established on the basis of which the budget for market facilitation could be approved.

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