



*Bringing choice and value
to customers*

31 March 2003

Dear Consultee,

Ofgem Strategy – 2003-2006

I am writing to thank those who commented on our draft Strategy for the next three years, and to report the result of our consultation. In response to those comments and in the light of events which have occurred since the publication of the draft Corporate Strategy, in particular the Government's Energy White Paper, the Authority has made a number of changes to the original proposals. These include:

- Taking account of the Government's increased commitment to working towards a low carbon economy
- Regulatory Impact Assessments for all new major policy proposals
- New work on security of supply
- A stronger emphasis on monitoring and compliance

The attachment to this letter covers in greater detail the main additions and adjustments which have been incorporated in the final Strategy.

While for the most part the changes cover areas which Ofgem has long been addressing, they represent an overall increase in our work. I am glad, however, that we have been able to accommodate them within our proposed budget which is, in real terms, lower than Ofgem's budget for the 2002-2003 financial year.

The final Strategy document is now available on the Ofgem website and we look forward to getting on with the work.

A handwritten signature in black ink that reads "Callum McCarthy".

Callum McCarthy
Chairman and Chief Executive

Ofgem Corporate Strategy 2003–2006

Responses to consultation

1. Some 120 representatives of organisations concerned with the gas and electricity industries attended the seven consultation meetings hosted in London and Glasgow. Nineteen written responses were also received.
2. For the most part, respondents were broadly supportive of the Strategy whilst at the same time providing detailed comments on specific issues.
3. It is never easy to decide what changes to make to initial proposals in response to representations. Representations are understandably not uniform and sometimes conflict. A particular challenge for Ofgem is to balance the views of sophisticated and well organised interests, of the sort typically represented by major energy producers and major industrial groupings, against interests which are more fragmented and less well represented. This particularly occurs when more complicated questions are under discussion, when the interests of domestic consumers are often not as strongly voiced.

The White Paper: “Our energy future – creating a low carbon economy”

4. The White Paper sets out a clear commitment by Government to the target of a low carbon economy. Ofgem welcomes this clarity. We also welcome the Government’s commitment to competitive markets as a cornerstone of energy policy, and its reaffirmation of the value of independent regulation. We share with Government duties in relation to security of supply.
5. The real challenge now lies ahead in developing the measures to deliver the vision which the White Paper seeks to establish. We believe the difficult task of translating the Government’s long term environmental target into practice will be best achieved by solutions based on market mechanisms, as has been proposed. Ofgem is committed to working with Government to meet its White Paper objectives through the programme of work set out in the Strategy.
6. Much of the Strategy already strongly supports the main themes of the White Paper. For example, on the move to a low carbon economy:
 - Ofgem has already identified as a priority in its work on the next Distribution Price Control, the importance of ensuring the Distribution Network Operations have appropriate incentives to develop their networks to accommodate the expected significant increase in distributed generation
 - work which Ofgem is progressing to reduce losses on both electricity transmission and distribution networks contributes to low carbon objectives
 - our metering work facilitates both energy efficiency and the development of Domestic Combined Heat and Power, and
 - Ofgem’s administration of the Government’s Energy Efficiency Commitment, Renewables Obligation and Climate Change Levy exemptions schemes helps to achieve the Government’s environmental objectives.

7. Similarly, much of Ofgem's work to promote competition and regulate monopolies is expected to improve security of supply, including:
- stronger incentives for efficient investment in the gas and electricity networks
 - long-term auctions for gas entry capacity, and
 - detailed monitoring of, and work on the day-to-day operation of, the gas and electricity markets.

Changes to the Corporate Strategy for 2003–2006

8. In the following paragraphs we set out some of the main issues raised in consultation and by the White Paper, and how Ofgem has reconsidered the Strategy in the light of these.

Regulatory Impact Assessments

9. By the end of the first quarter of the year (June 2003), Ofgem will publish Regulatory Impact Assessments (RIAs) for all major new proposals. We intend these to meet the requirements for RIAs discussed in the Better Regulation Task Force's latest annual report. Like the Better Regulation Task Force, we want to make the facts and assumptions behind any proposal transparent, and therefore easier to challenge when necessary.
10. Regulatory Impact Assessments will consider the benefits, impact and costs of Ofgem's proposals on those affected – consumers and industry. As with all RIAs, it is important to be realistic about quantifying, as distinct from assessing, what is involved. Much of the benefit of the liberalising measures which Ofgem promotes is general rather than specific, and quantification is often problematic. Future RIAs will also consider the impact of proposals on competition, security of supply and the environment.

Security of supply

11. We will explain more fully, and promote a better understanding of, our work to support reliable supplies of gas and electricity, both in the short and long-term.

In future Ofgem will:

- publish a report twice a year on the performance of the gas and electricity industries in delivering security, detailing any issues which have arisen and considering whether action is necessary to address them. This will complement the work already carried out through the Joint Energy Security of Supply (JESS) working group on forward indicators which highlight security of supply issues, and
- describe explicitly the security of supply impact of any significant Ofgem proposal. (to be included in future Regulatory Impact Assessments).

Social and environmental guidance

12. Consultees welcomed the increasing emphasis Ofgem has placed on its work to help those on low incomes and on environmental issues. Many commented on the scope for Government to improve their social and environmental guidance issued in November 2002. We will work closely with Government to establish further clarity which, to be of

real use to both Government and Ofgem, should establish Ministers' priorities among the matters covered by the guidance.

Other White Paper issues

13. Other issues that will require further input from Ofgem include the need to review arrangements in the case of network operator failure, plans for consultation on the gas and electricity industry Codes, work to create an effective market in energy services, and future joint Ofgem/DTI/defra working on environmental issues.

GB-wide electricity trading and transmission arrangements

14. There was widespread support for Ofgem's work with the DTI to create a single wholesale electricity market for Great Britain. The introduction of new GB-wide trading and transmission arrangements will only be possible after the Electricity Trading and Transmission Bill is passed by Parliament.
15. The Bill was published in draft form in January 2003 but has not been introduced to Parliament. This delay has required a rescheduling of the work programme – the largest that Ofgem is undertaking at present. We are now working with DTI towards an implementation date of October 2004 but this will be achievable only if Government secures Parliamentary time for the necessary legislation early enough.

Transmission issues

16. A number of those who commented argued for 'freezing' the present transmission arrangements, for both gas and electricity, and for a period of stasis after much change. We do not believe in stasis, or change, simply for their own sake but will support either where we are satisfied that these meet our statutory duties and that the case has been fully made. For example on gas balancing, Ofgem has decided that customers' interests are best served by retaining the present daily balancing arrangements. This decision acknowledges developments in the market and follows careful consideration of the merits of initial proposals to shorten the balancing period.
17. Ofgem continues to believe, however, that the current arrangements for electricity transmission access and gas exit are discriminatory and can operate against the interests of either new entrants (such as renewable generators in electricity) or customers (disadvantaged by existing interruptible gas arrangements). Ofgem will carefully evaluate proposals for reforms to address these concerns against all its statutory duties and having taken account of their likely costs and benefits.

Compliance and enforcement

18. Having successfully withdrawn from price regulation of many parts of the gas and electricity industry, the emphasis of Ofgem's work has now shifted towards enforcement and compliance with licence obligations and with competition law. There is strong support for this work and there will, in the coming year, continue to be a strong emphasis on compliance and enforcement.
19. We have increased resources dedicated to this work, partly as a result of recently acquired powers to impose financial penalties under the Electricity Act, and as a result of

competition powers. It has been suggested that this work can be done with much reduced resources. Our experience does not support this contention. The proper need to respect natural justice has particular implications for dealing with cases, in particular where financial sanctions are at issue. Ofgem's experience – and that of the Office of Fair Trading – has shown that competition law cases are often very resource-intensive and determinations need careful and detailed consideration. We are committed to increasing compliance and enforcement work and stand by the belief that this must be accompanied by appropriate resources.

Ofgem costs

20. Despite pressures which have led to an increase in Ofgem's work, we expect to be able to accommodate this work within the original budget figure for 2003-2004 of £36 million. This figure, published a year ago in our first three year Corporate Strategy, represents a reduction in costs in real terms.
21. We cannot predict all demands made on Ofgem as each year events occur to which an Ofgem response is needed, often against tight timetables. These events can be commercial, such as the problems of TXU Europe and of British Energy in 2002-2003. Similarly, they can be legal, such as judicial review or litigation, or derived from corporate transactions.
22. In 2003-2004 we expect to see further examples of "unpredicted" demands on Ofgem's resources. For example, there is speculation as to whether there may be further merger activity in both generation and supply or whether National Grid Transco will seek to dispose of one or more regional gas networks. Responding to any such events, should they occur, would involve substantial work by Ofgem, which could have a bearing on the adequacy of contingency funds and on the timing of some elements of this Strategy.