

The logo for ofgem, featuring the word "ofgem" in a white, lowercase, sans-serif font inside a yellow rounded rectangle.

Annual Report

2002-2003

Office of Gas and Electricity Markets

Report of the Gas and Electricity Markets Authority for the period 1 April 2002 to 31 March 2003 to the Secretary of State for Trade and Industry.

The document comprises a report made under section 5(6) of the Utilities Act 2000.

Office of Gas and Electricity Markets

Ofgem is the Office of Gas and Electricity Markets, regulating the gas and electricity industries in Great Britain.

Ofgem operates under the direction and governance of the Gas and Electricity Markets Authority which sets all major decisions and policy priorities.

Ofgem's powers and duties are provided for under the Gas Act 1986, the Electricity Act 1989, the Competition Act 1998, the Utilities Act 2000 and other statutes.

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1. Foreword by Chairman and Chief Executive

- 1.1 This report covers the last full year of my time at Ofgem. It is a good opportunity to take a longer term view, extending over the past four years, which makes for a fuller and more personal statement than has been my custom.
- 1.2 In looking back, I am struck both by how much has changed, and also by how consistent are the themes which have informed Ofgem's work. The changes have arisen in Ofgem's organisation, in our approach to the work done, and in the emphasis we attach to the different duties and responsibilities given to Ofgem by statute.
- 1.3 Organisationally, the decision to bring together the responsibilities for gas and electricity, which lay behind the creation of Ofgem, has been clearly shown to be correct. It reflects the increasing convergence between the gas and electricity markets and has enabled a consistent approach to be adopted to liberalisation and market rules. It is the regulatory model now adopted throughout Europe.
- 1.4 The second organisational change has been the creation, in reality, not simply in law, of the Authority, as the body which sets Ofgem's policies, priorities and direction. This is a real advance in establishing greater continuity of purpose and greater regulatory certainty. When I step down in October, there will be one new, and eleven continuing, Authority members. Regime change is not the order of the day. I suspect that many observers have not yet appreciated how deep and full is the involvement of my Authority colleagues in Ofgem's direction – an involvement for which I am grateful.
- 1.5 I am also struck by the changes which Ofgem has made in how we approach our work. Neither of its predecessor organisations produced a strategy. Ofgem now produces a three year strategy which identifies each major work stream, and indicates planned completion dates by quarter. It is widely consulted on before it is finalised and we subsequently report on what we have, and have not, done. This report plays a major part in demonstrating the transparency to which Ofgem is committed. Ofgem has also taken a number of steps to improve the way in which we present and explain significant policy proposals. Since June 2003, this has included regulatory impact assessments for all major initiatives.
- 1.6 Most of all, there have been important changes in the emphasis of Ofgem's work. It is illuminating to look back to the time of Ofgem's creation. Then, there was no effective Social Action Plan and no Environmental Action Plan. The responsibility for direct communication with consumers lay with Ofgem rather than energywatch. And dealing with the Millennium was a preoccupation.
- 1.7 Most recently, two issues have placed an increasing demand on Ofgem resources. These are the environmental implications of energy policy, and growing public concern about a number of issues under the general heading of security of supply. February 2003 saw the first White Paper on energy policy for 35 years. In it, the Government has set new and demanding targets and aspirations for carbon reduction which will, in being realised, have profound implications for the pattern of electricity generation, transmission and distribution in Great Britain. Ofgem has been working hard to anticipate those changes, most significantly in shaping the next price review for electricity distribution network operators.
- 1.8 The next price review will be, in important ways, unlike any previous price review. Ofgem has been preparing for this over the last year. The review has been a major, but only one, component of Ofgem's increasing attention to the environmental agenda.
- 1.9 Although the environmental ambitions of the White Paper attracted most attention, an important theme in it was the importance of security of supply, which is one of Ofgem's statutory duties. The record for Great Britain is good. We have coped with severe tests – the putting into administration of the world's largest energy trader (Enron), the putting into administration of the supplier of gas and electricity to some 10 per cent of British households (TXU Europe) and the problems of British Energy – without any interruption to supply.
- 1.10 Ofgem continues to monitor the position, in both the short and long-term. We have worked with the Department of Trade and Industry through the Joint Energy Security of Supply (JESS) working group to establish a better understanding of market developments. We have introduced arrangements to facilitate long-term contracting both in electricity and in gas, most recently the long-term gas entry

auctions, which for the first time ever have made available to offshore producers firm long-term rights to land gas. We are also working actively to facilitate investment in LNG terminals, which bring geographical diversity of gas supply.

1.11 It is generally believed that the major threat to security of supply within markets is the threat of direct Government intervention. It is, therefore, to be greatly welcomed that the White Paper emphatically endorsed the principle of independent regulation, and set its face against Government intervention in the energy markets.

1.12 Alongside these changes, there have been some continuing themes during the last four years. Everything Ofgem does is designed to protect and advance the interests of consumers. Ofgem promotes effective competition, and regulates only where necessary. These principles have served consumers well.

- A continuing concern for Ofgem has been to ensure that our actions benefit all sectors of society. The most significant example of this has been to reduce the number of households in fuel poverty through lower energy prices, resulting from the combination of competition and regulation. This has been a major contributor to tackling the realities of discomfort, ill health and, in extreme circumstances, death which lie behind the bland title of fuel poverty.
- For the first time in England and Wales, we have a competitive wholesale market for electricity. This is the result of a number of policy initiatives, notably the change from the Electricity Pool to the present trading arrangements. This change has helped to deliver significant price reductions for industrial and commercial customers who buy two thirds of all electricity. Ensuring, with energywatch, that competition thrives in the domestic market remains a major concern for Ofgem.
- The round of price controls completed by Ofgem for the regulated sectors, the pipes and wires businesses, has resulted in some £1.25 billion being transferred annually from the companies to their customers. This has happened at a time of growing

investment by the companies, rising service standards and no shortage of either debt or equity finance for the companies – quite contrary to the all too easy perception that price controls have merely “sweated assets”.

1.13 This has involved much hard work for those at Ofgem who are now significantly fewer – some 300 against 380 four years ago. I like to think they are more skilled, as well as better paid, than before. As always, I am grateful to all my colleagues who are hard working, committed and skilled. It has been – and remains – a pleasure to work with them.

1.14 I am particularly conscious of my most senior colleagues who have worked with me on the Management Committee. They include Eileen Marshall, who over more than a decade at Ofgem, and both of its predecessor organisations, did more than anyone else to bring about the present achievement of liberalised energy markets which serve Britain so well.

1.15 I am also grateful to the non-executive members of the Authority whose commitment, interest, contribution and involvement are all far greater than could be reasonably expected. It is an indication of the qualities shared by all non-executive members that two have been appointed to further Government responsibilities. I congratulate Margaret Ford on her appointment as Chair of English Partnership and James Strachan on his appointment as Chairman of the Audit Commission.

1.16 As before, much remains to be done. Ofgem’s record to date gives me every confidence that it will continue to meet its duties in the future as it has in the past.



Callum McCarthy

Chairman of the Gas and Electricity Markets Authority
Chief Executive of Ofgem

2. The Gas and Electricity Markets Authority



John Belcher



Dr Robin Bidwell



Richard Farrant



Margaret Ford

The Gas and Electricity Markets Authority has the ultimate responsibility for all that Ofgem does. It determines strategy and decides on major policy issues. Its members are:

John Belcher

Non-executive

Dr Robin Bidwell

Non-executive

Joined Feb 2003

Richard Farrant

Non-executive

Margaret Ford

Non-executive

David Gray

Managing Director, Regulation and Financial Affairs

Joined May 2003 -

replacing Richard Ramsay

Dr Eileen Marshall

Managing Director, Competition and Trading Arrangements

Retired March 2003

Callum McCarthy

Chairman



David Gray



Dr Eileen Marshall



Callum McCarthy



Dr Boaz Moselle



John Neilson



Richard Ramsay



James Strachan

Dr Boaz Moselle

Joined March 2003 -
replacing Dr Eileen Marshall

Managing Director, Competition and Trading Arrangements

John Neilson

Managing Director, Customers and Supply

Richard Ramsay

Left May 2003

Managing Director, Regulation and Financial Affairs

James Strachan

Non-executive

Sir Keith Stuart

Non-executive

Professor Len Waverman

Joined May 2002 -
replacing Lord Currie

Non-executive

Gill Whittington

Left March 2003

Chief Operating Officer



Sir Keith Stuart



**Professor Len
Waverman**



Gill Whittington

3. Making markets work effectively

Key achievements for 2002-2003

Wholesale Markets

Electricity

- The first year review was completed of the new electricity trading arrangements which, by March 2003, had contributed to boosting business competitiveness in Britain by £1.8 billion
 - Modifications were made to industry codes to better facilitate competition and to promote efficiency in the electricity trading arrangements
 - Ofgem contributed to the development of legislation and measures to create British-wide electricity trading and transmission arrangements
-

Gas

- New long-term entry capacity auctions were implemented to increase efficiency and improve security of supply
 - The long-term future of the gas balancing regime continued to be examined
 - Ofgem continued to work with the Department of Trade and Industry (DTI) to promote offshore arrangements which encourage a competitive wholesale market in Britain
-

Europe

- Ofgem contributed to developing policy on European gas and electricity liberalisation and on gas and electricity interconnectors

Introduction

- 3.1 Competition in Britain's gas and electricity markets, and effective regulation of those sectors which remain monopolies, have delivered lower prices to domestic and business customers. They have also stimulated the investment needed to secure gas and electricity supplies and to improve quality of service.
- 3.2 In those parts of the gas and electricity markets where competition is established and effective, Ofgem has withdrawn from price regulation and is relying increasingly on its competition powers to monitor companies' behaviour.
- 3.3 A key priority for Ofgem during 2002-2003 has been making markets work effectively. This has been met through a range of activities including:
- extending competition where restricted
 - developing, monitoring and enforcing rules for competitive markets
 - and monitoring and advising on industrial restructuring.

Wholesale markets

- 3.4 The costs of wholesale gas and electricity account for around 40 per cent of domestic customers' bills – more for business customers. A great deal of Ofgem's work is, therefore, focused on ensuring that wholesale gas and electricity markets operate competitively.
- 3.5 During 2002-2003, Ofgem's objectives were to:
- improve the efficiency and competitiveness of the wholesale gas and electricity markets throughout Great Britain
 - monitor the operation of wholesale gas and electricity markets and take appropriate enforcement action where there was evidence of market abuse, and
 - support the Government in its work to develop competition in the offshore gas industry and in energy markets across Europe.

Electricity

England and Wales

- 3.6 During the year, Ofgem published a major review of the first year of the new electricity trading arrangements. The main findings showed that:
- the new arrangements performed well against objectives set by Ofgem and the DTI
 - the reforms, alongside other factors, have brought about a 40 per cent reduction in the costs of wholesale electricity since 1998, and
 - flexible governance arrangements have allowed significant changes to be made to the new balancing and settlement rules to the benefit of all market participants.
- 3.7 The review found that major energy users were already benefiting from the reductions in wholesale prices and lower prices were beginning to feed through to domestic customers.
- 3.8 By the time of their second anniversary in March 2003, the new arrangements, combined with other factors, had delivered more than £1.8 billion in lower electricity prices for large energy users such as businesses, hospitals and schools. Concern was expressed about the fall in wholesale prices not feeding through to domestic customers. Ofgem said that these customers needed to claim their savings by switching supplier. The 38 per cent of customers who had switched electricity supplier had benefited the most, their electricity bills being reduced by up to £50 a year.

3.9 Significant improvements were made to the governance of the balancing mechanism where, during the year, about four per cent of electricity was traded. These were brought about through modifications to the Balancing and Settlement Code (BSC) which governs the electricity balancing mechanism. A key modification took effect in July 2002 which reduced the period between when generators have to notify National Grid Company (NGC) of their output, and when they physically deliver it, from 3.5 hours to 1 hour. This helped all generators balance their positions closer to real time and was particularly helpful to intermittent generators, such as wind generators, whose output is more difficult to predict.

Market developments – 2002-2003

3.10 The new electricity trading arrangements have delivered more competitive, market-based arrangements like those in other commodity markets, while maintaining a secure and reliable electricity system.

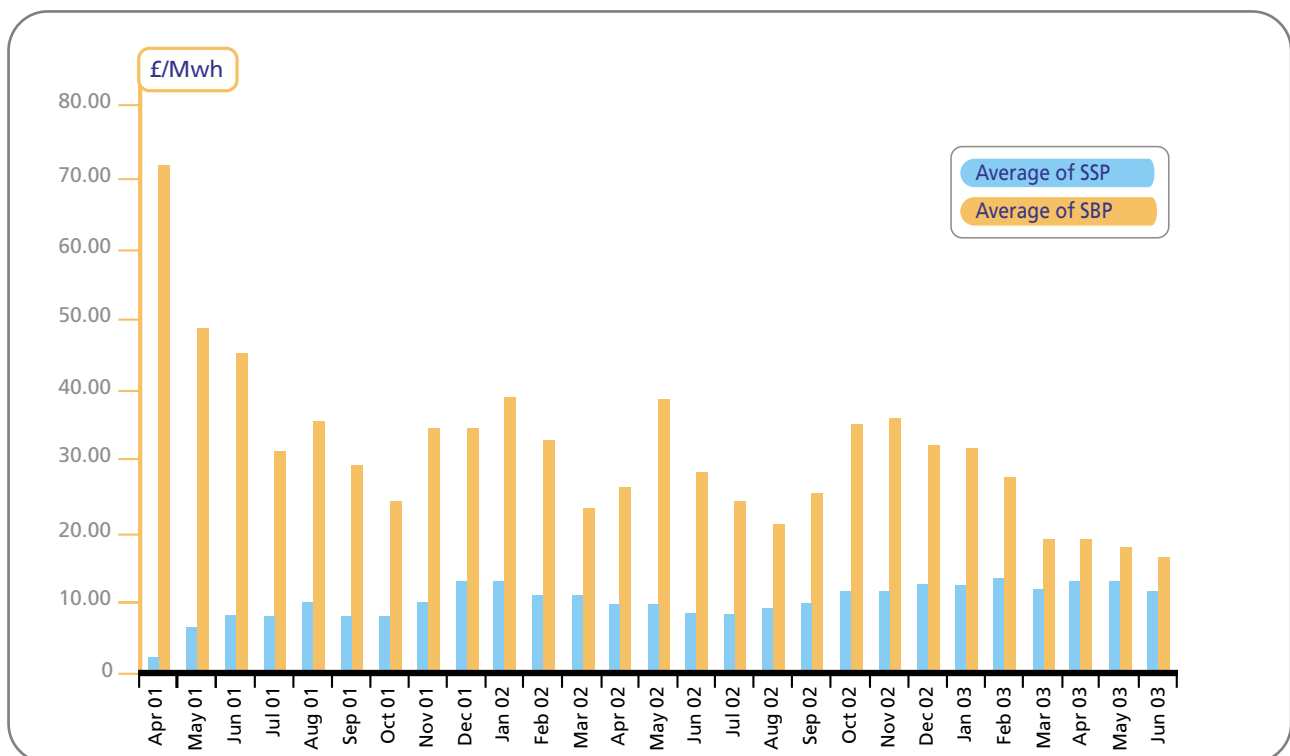
3.11 A more competitive generation market, more demand-side influence in price setting and lower generation input costs have contributed to significant reductions in wholesale prices.

These sustained lower prices have inevitably contributed to the worsening financial position of some generating companies, especially those companies which used mostly debt-financing to acquire high-cost generating plant, those with uneconomic long-term contracts and those with expensive fuel sources.

3.12 Ofgem has clear responsibilities with regard to security of supply and has worked during the year to ensure that energy supplies remained secure, despite the difficulties faced by some companies.

3.13 In September 2002, British Energy announced that it had begun discussions with Government for immediate financial support. In early October 2002, TXU put up for sale its UK retail and generating businesses. Throughout this period, to meet its primary duty to protect customers' interests, Ofgem worked to ensure that measures were taken to secure gas and electricity supplies. This involved contact with the GB transmission companies to ensure steps were taken to secure supplies, as well as making ready the procedures to implement Supplier of Last Resort (SoLR) in case these powers were needed.

Average monthly imbalance prices since April 2001



Scotland

- 3.14** The trading and transmission of electricity in Scotland is subject to time-limited and inefficient arrangements dating from privatisation. These arrangements have not allowed competition to develop as strongly as in England and Wales – to the detriment of Scottish consumers. Similarly, they have created barriers to the development of generation in Scotland, particularly renewables.
- 3.15** Following a Government decision to bring forward legislation to reform the electricity generation market in Scotland and create a fully-competitive British-wide market, Ofgem launched its programme to implement reforms in May 2002.
- 3.16** GB-wide arrangements will bring more competition to the Scottish generation market and help reduce the costs of transmitting electricity to homes and businesses.
- 3.17** A draft Bill to introduce GB-wide arrangements – the Electricity (Trading and Transmission) Bill – was published by the Government in January 2003 and completed pre-legislative scrutiny in April 2003. The original intention to implement the reforms

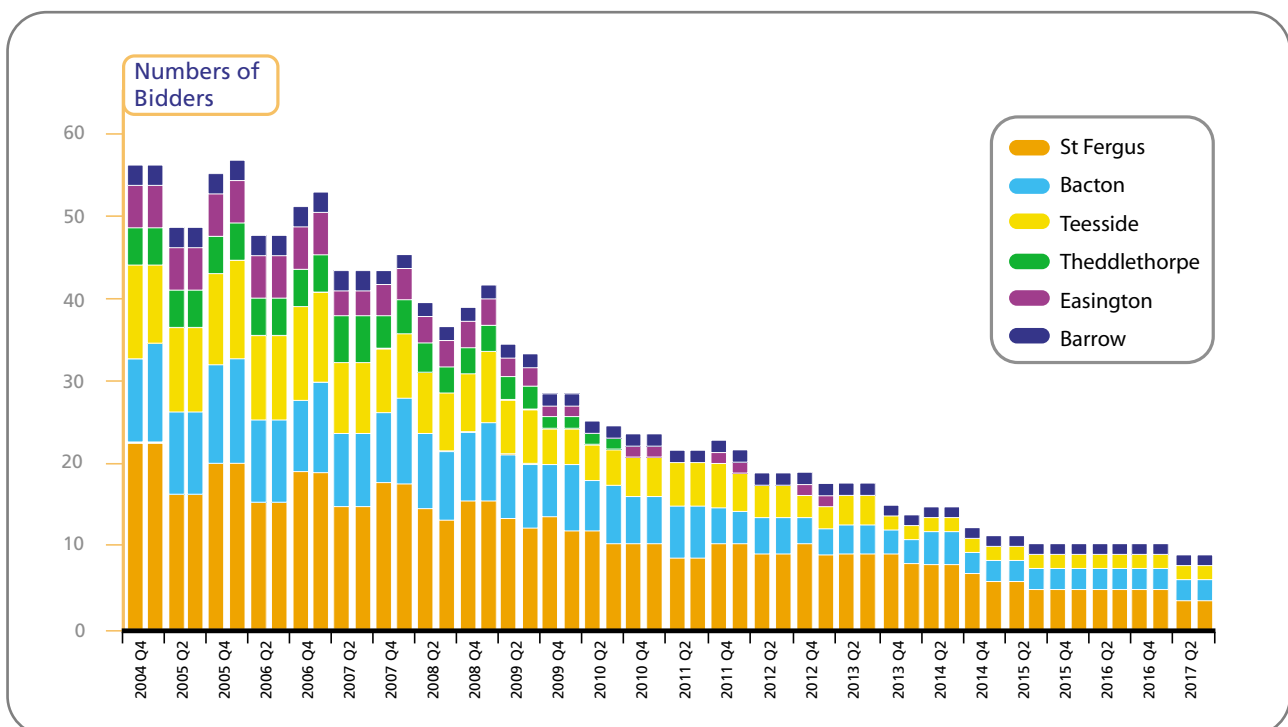
by October 2004 was dependent on legislation being passed. The DTI announced in June 2003 that, due to pressure on the Parliamentary timetable, this would not be possible. Ofgem is working to implement the new arrangements by April 2005. This, again, depends on the Bill's passage through Parliament. Ofgem believes it is strongly in consumers' interests that this happens as soon as possible.

- 3.18** Ofgem has worked with industry during the year to progress and consult on the proposed design of the licences, codes and other arrangements which will be needed to create a single GB-wide market once legislation is in place.

Gas

- 3.19** New entry capacity auctions were approved by Ofgem in September 2002 and began in January 2003. This meant that, for the first time, industry could have certainty about long-term access to the National Transmission System (NTS) to land and ship gas.

Long-term gas entry capacity auctions - January 2004



3.20 New auctions have also given Transco important market signals to help inform future investment plans. Improved signals, in combination with enhanced commercial incentives on Transco to respond to demand, will help ensure investment is carried out when and where it is needed, thereby increasing efficiency and enhancing security of supply.

3.21 During the year, Ofgem also worked with Transco, producers, shippers and major energy customers to improve arrangements for keeping the NTS in balance. Continued discussions with the industry throughout the year resulted in Ofgem's decision to keep daily gas balancing arrangements. This decision was the result of a number of developments in the market which meant that the problems in balancing the system were not as acute as was previously thought.

3.25 Ofgem is a founder member of the Committee of European Energy Regulators (CEER) and, through this body, contributed during the year to the debate on the development of the arrangements necessary to promote effective competition in a pan-European energy market.

3.26 In February 2003, CEER set out to the European Commission the principles which would need to be satisfied to achieve efficient liberalised energy markets. It was on the basis of these principles that, in the same month, Ofgem criticised the acquisition of Ruhrgas by German utility E.ON and its implications for the development of competition. Ofgem remains concerned by the anti-competitive arrangements for gas supply and transportation in Germany, which clearly operate to the disadvantage of consumers across Europe.

Monitoring and enforcement

3.22 Ofgem's resources were reorganised to place greater emphasis on its monitoring and compliance work so as to ensure that the gas and electricity trading arrangements remained competitive and free from abuse.

Influencing activity offshore and in Europe

3.23 Ofgem has no regulatory, and limited information gathering, powers offshore. Within this limitation, it continued to work with the DTI and other agencies to ensure offshore arrangements that encourage a competitive gas wholesale market.

3.24 Another key area of work during the year was to continue to influence developments in Europe to ensure that they are pro-competitive and in the best interests of British consumers. Working with the DTI, the European Commission and other European regulators, Ofgem contributed to developing policy on European electricity and gas liberalisation and on gas and electricity interconnectors.

Retail markets

Key achievements for 2002-2003

- With competition established, residual controls on domestic customers' prices were lifted in April 2002
- New enforcement procedures to tackle licence breaches were finalised
- New powers were used to take strong action against misselling (the first financial penalty of £2 million was imposed on London Electricity)
- A review of the Erroneous Customer Transfer (ECT) Charter showed improvements in the customer transfer process

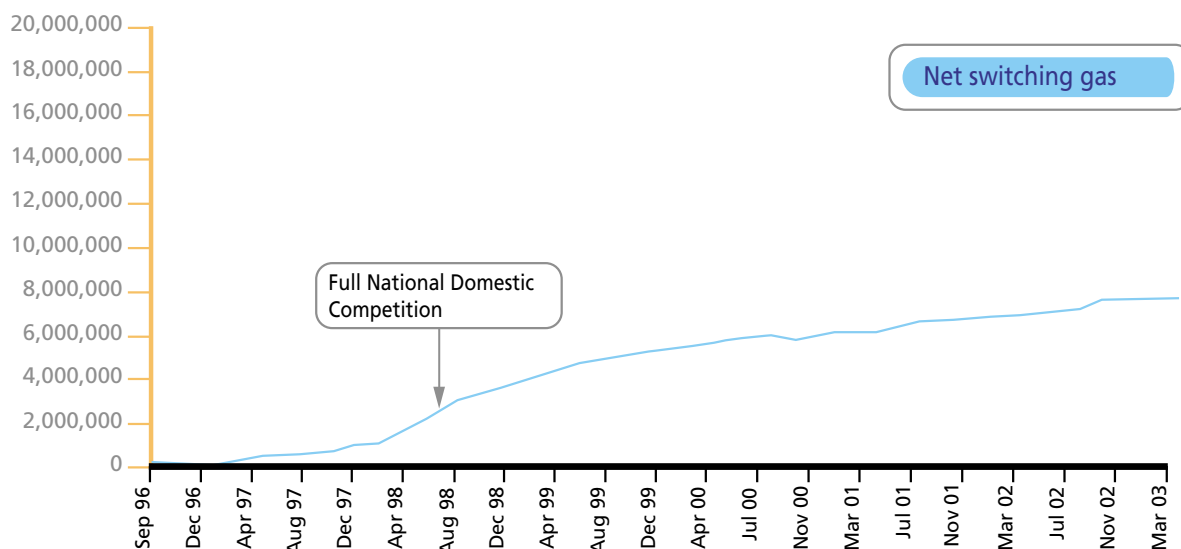
3.27 The gas and electricity retail markets have been fully open to competition since 1999. Eight million domestic gas and 11 million domestic electricity customers have exercised their choice to switch suppliers. With competition established, Ofgem lifted the residual controls on domestic customers' prices in April 2002.

3.28 The key objective for the year was to ensure that competitive retail markets continued to work effectively for domestic and business customers. Ofgem monitored carefully the extent to which the benefits of competition were realised for all customers, large and small, across all income groups and on all

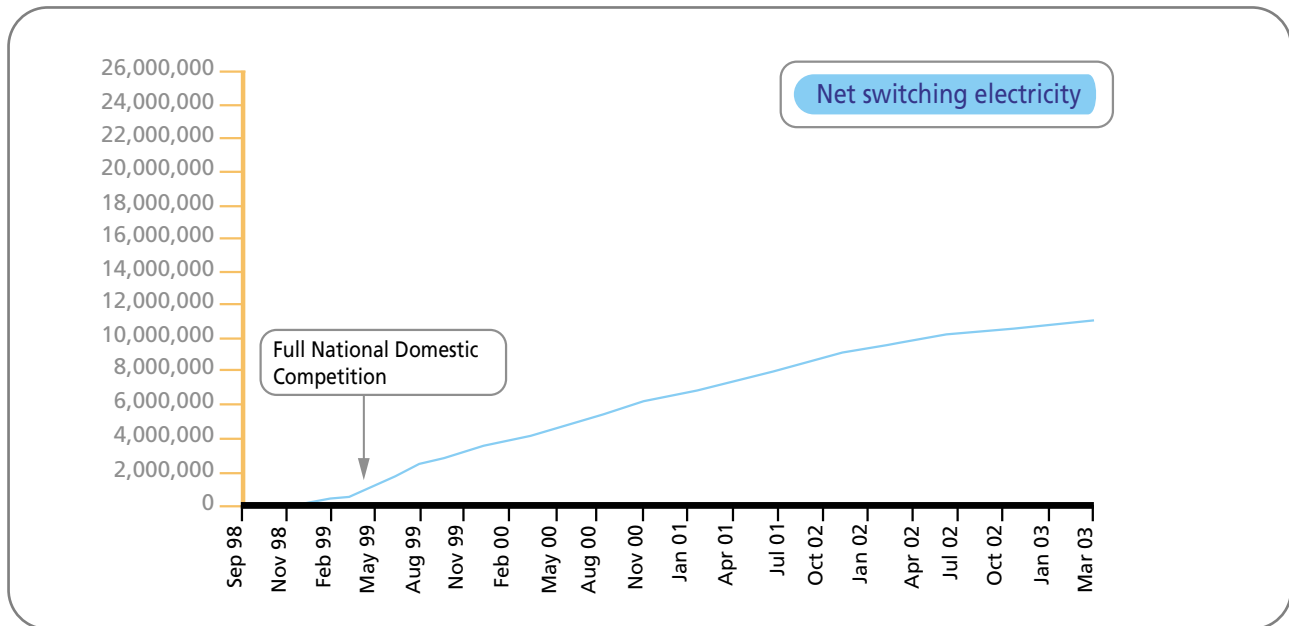
tariffs, and worked to enforce compliance with licence obligations, competition and consumer law. Throughout the year, Ofgem also continued to urge customers to switch energy suppliers to take advantage of the choice and competitive offers available.

3.29 Customers have access to up to 12 suppliers offering discounts in gas (compared to BGT) and up to 11 suppliers offering discounts in electricity (compared to their regional electricity supplier). Customers can save up to £100 a year if they switch both gas and electricity suppliers. Tens of thousands of customers across all payment types and income groups continue to switch supplier each week.

Net switching in domestic gas supply (1996 - 2003)



Net switching in domestic electricity supply (Sept 1998 - March 2003)



Monitoring and enforcement

3.30 In April 2002, Ofgem finally received its powers to impose financial penalties on companies for breaches of licence obligations. In November 2002, Ofgem used these powers for the first time to impose a £2 million financial penalty on London Electricity (LE) for failing to stop its sales force, and its affiliate company, Virgin Energy, misselling gas and electricity to domestic customers. This decision was triggered by an unacceptable level of complaints about how LE and Virgin Energy managed their direct selling. The investigation found LE to be in clear breach of licence conditions.

3.31 Also in April 2002, Ofgem published its assessment of how npower had discharged undertakings agreed in January 2001. Those were agreed after an unacceptably high level of complaints was received about the company's marketing activities. Ofgem recognised that npower had performed well against its undertakings but needed to maintain its improved performance. Its performance continues to be monitored carefully.

3.32 An investigation carried out between May 2002 and March 2003 resulted in Ofgem proposing financial penalties on British Gas Trading of £200,000, after the company incorrectly objected to almost 5,000 customers switching to another gas or electricity supplier. These penalties were confirmed in June 2003.

Misselling

3.33 Concerted efforts to clamp down on misselling were made during the year. In June 2002, Ofgem published proposals for new enforcement procedures for misselling. These were finalised in August 2002.

3.34 At the same time, plans for a new industry code of practice were announced following a misselling summit hosted in June 2002 by consumer body, energywatch. The code of practice, developed jointly by Ofgem, energywatch and the industry, committed all energy suppliers to higher standards in energy sales, and included a commitment to pay compensation to affected customers in defined circumstances. While misselling remains a concern, energywatch statistics for 2002-2003 showed that misselling complaints had fallen by 60 per cent.

Customer transfers

- 3.35** Competition has resulted in more than 18 million transfers in gas and more than 20 million in electricity. For competition to be effective, customers and suppliers must have confidence in the processes that enable customers to switch from one supplier to another.
- 3.36** While most customers are transferred without problems, there is still a small but significant number of customers experiencing problems with the transfer process. Steps towards improving the situation for customers wrongly transferred were taken in February 2002 with the introduction of the Erroneous Transfer Customer Charter.
- 3.37** A review of the Charter in October 2002 revealed a sharp drop in complaints to energywatch about such transfers. Ofgem found this fall encouraging but said that industry needed to do a lot more to get its house in order. It challenged the industry to develop a scheme to provide compensation to customers who were not restored quickly to their original supplier after having been wrongly transferred.
- 3.38** Improving the customer transfer process has been identified as a key priority for Ofgem's work in the retail markets for 2003-2004.

Analysis

- 3.39** The first in-depth analysis of the relationship between electricity prices, supply costs and competitive forces since retail price controls were lifted was published in December 2002. The analysis found that:
- all customers have seen their bills fall in real terms since 1998
 - the market is not yet mature, but developing fast
 - the profitability of suppliers will vary, and
 - the pressures of competition are eroding market share.

- 3.40** Throughout the year, Ofgem dedicated resources to monitoring closely developments in the gas and electricity retail markets to check that competition continues to develop effectively.

Supplier failure procedures

- 3.41** Ofgem continued to test and improve its Supplier of Last Resort (SoLR) arrangements during the year. These arrangements protect customers by securing supplies in the event of a company failure.
- 3.42** SoLR arrangements were ready to be used in October 2002 when parts of TXU Europe went into administration (See Wholesale Electricity, Page 10). In the event, Powergen's subsequent purchase of TXU's supply business, with its five million-strong customer base, meant that they were not needed.

Industrial structures

Key achievements for 2002-2003

- Ofgem's metering strategy helped industry bring forward reforms to gas metering arrangements
- The first supplier (British Gas Trading) switched to a more competitive metering services provider
- First steps were made towards full competition in electricity connections
- Ofgem launched its first Competition Act investigation
- Advice was given to Office of Fair Trading (OFT) and European Commission on proposed mergers and acquisitions
- A new policy to protect consumers following future mergers of electricity distribution businesses was finalised and implemented

3.43 Ofgem plays an important role in encouraging appropriate industrial structures that provide the right environment for competition to flourish and deliver the best deal for both domestic and business customers. Further work in this area was progressed during 2002-2003.

Metering

3.44 Competition in metering services can deliver significant benefits to customers, including lower prices through reductions in the £800 million annual cost of metering. More competitive arrangements can bring improvements in the standards of service and can stimulate the development of 'smart' meters.

3.45 In May 2002, a significant step towards the development of competition in the provision of metering services was taken when British Gas Trading awarded its contract to provide metering services in North Wales and the North of England to United Utilities.

Connections

3.46 The costs of new connections to gas and electricity supplies are about £400 million a year – £300 million for electricity and around £100 million for gas connections. These costs are borne by customers.

3.47 A connections survey carried out in August 2002 showed that, while competition in gas connections had developed well since the market was opened to competition in 1996, competition in electricity connections was minimal.

3.48 In response to this survey, Ofgem made the first step towards full competition in the electricity connections business with the opening up of the market for electricity connections to new housing developments and street lighting.

Monitoring and enforcement

3.49 In May 2002, Ofgem began its first investigation under the Competition Act 1998. This followed complaints to Ofgem about United Utilities' connections activities.

3.50 Concerns over the standards being set by Transco in its metering and connections businesses prompted two Ofgem consultations during the year. In November 2002, Ofgem began a consultation on the gas connections business of Transco following complaints about levels of performance. In December 2002, Ofgem announced a similar consultation on the metering information provided by Transco.

3.53 In May 2002, Ofgem announced a new policy on mergers between electricity distribution companies to ensure customers' interests are protected. This new policy compensates for the fact that mergers reduce the number of individual companies and make it harder to compare company performances when setting their price controls. It was first implemented in November 2002 following the merger of London Electricity and Seeboard.

Corporate transactions

3.51 During the year, Ofgem continued important work on considering proposals for business transactions and new financial models, providing advice to the Office of Fair Trading (OFT) and the DTI, and liaising with the European Commission on how best to protect customers' interests.

3.52 Among the major transactions which required Ofgem's advice were:

- the merger between National Grid Group plc and Lattice Group plc to create the National Grid Transco Group, and
- the acquisition by Centrica of the Rough gas storage field.

4. Regulating monopoly networks intelligently

Key achievements for 2002-2003

- Work was advanced to improve the way in which gas and electricity monopoly companies will be price regulated in the future
 - The first asset risk management survey aimed at promoting industry best practice was completed
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Distribution

- The objectives and structure for the next electricity distribution price control were developed
 - A new incentives scheme to improve quality of supply was implemented for electricity distribution companies
 - Proposals to encourage distribution companies to cut electricity losses on their networks were prepared
 - Proposals for separate price controls for the eight regional gas distribution networks were advanced
 - Proposals for improving the governance of the technical standards applied to electricity networks were put forward
-

Transmission

- A new system operator incentives scheme was implemented to ensure National Grid Company (NGC) operates the electricity system economically and efficiently and, ultimately, reduces costs to customers
- The Transco price control and accompanying system operator incentives scheme were implemented to improve security of supply and reduce costs to customers
- Proposals were put forward to regulate charges imposed by Independent Gas Transporters

Introduction

- 4.1 Where competition is not possible, or is not sufficiently well developed, Ofgem protects consumers' interests by regulating the monopoly companies that operate the national transmission and local distribution networks in England, Scotland and Wales – the 'pipes and wires'.
- 4.2 The traditional form of RPI-X regulation has served Britain's gas and electricity consumers well. It has led to lower prices and improved standards of service, while securing a significant increase in network investment.
- 4.3 This position was supported by a National Audit Office (NAO) report in April 2002 which found that consumers of basic services delivered by pipes and wires have benefited from lower prices and more reliable services as a result of the way these networks have been regulated.
- 4.4 Britain's gas and electricity networks now face a time of considerable change which is why Ofgem has to build on this success so that it can meet the new challenges which it, and the industry, faces.

Distribution

'Rewiring' Britain

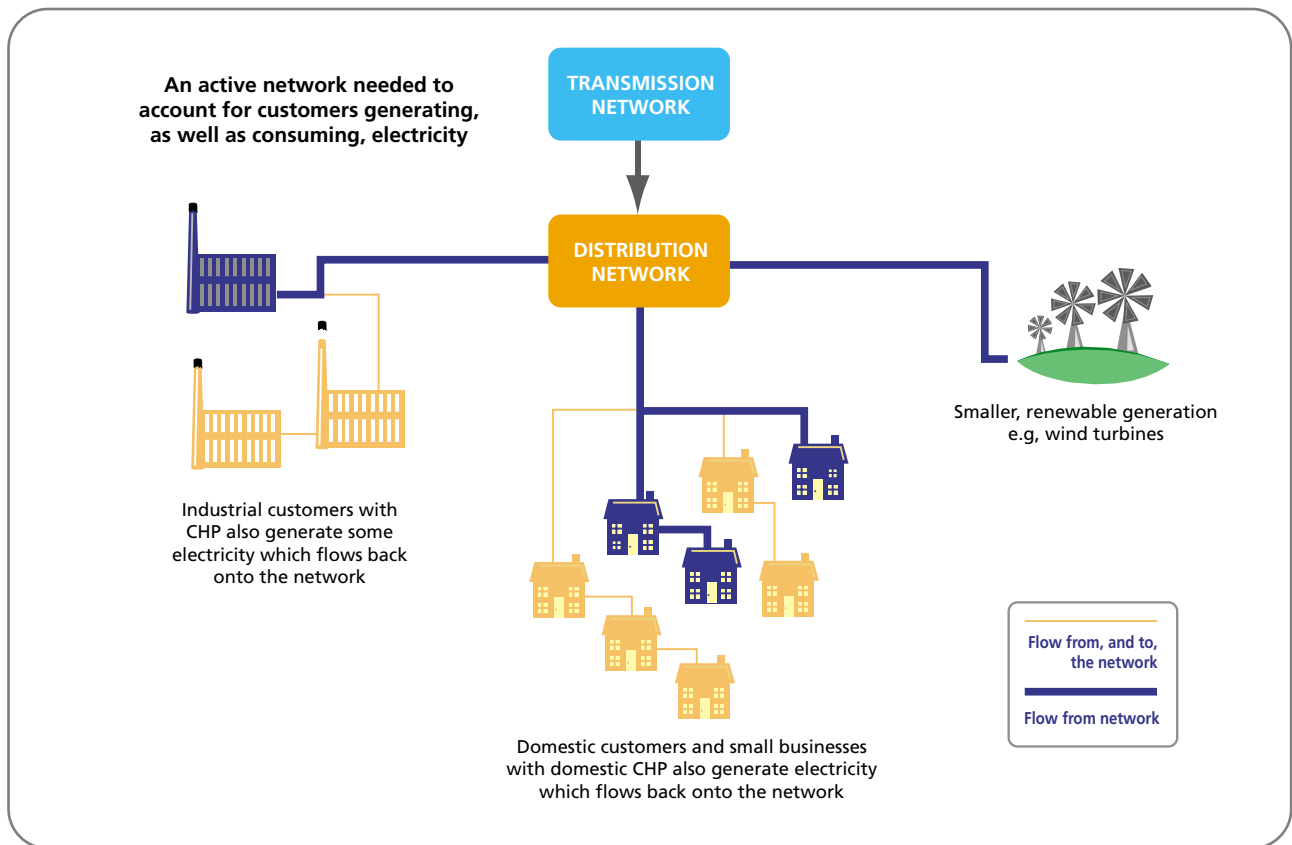
- 4.5 Increased renewable and Combined Heat and Power (CHP) connections will require the electricity distribution companies to address significant technical challenges. It may require many of these networks to be transformed from essentially passive distribution systems to being actively managed. During the year, Ofgem worked to identify, and begin to address, the regulatory issues raised by these challenges, as well as to consider technical and commercial aspects through its work with the Distributed Generation Co-ordinating Group (DGCG).

- 4.6 In September 2002, at a conference hosted with the Institution of Electrical Engineers (IEE), Ofgem called on electricity distribution companies to address the challenge of 'rewiring' Britain.
- 4.7 This event was followed in January 2003 by an open letter to all company chief executives urging them to join Ofgem in addressing the network issues raised by Government targets for power from renewable and CHP generation.
- 4.8 Ofgem's main challenge is to develop a regulatory framework which provides the correct investment incentives and rewards, to enable companies to respond to real demand. Key issues that need to be faced in developing such a framework include how to:
- deal with uncertainty in the type, timing and location of new power generation
 - adapt existing price control arrangements to meet new developments, including innovation where needed, and
 - ensure there are incentives for the economic and efficient management of costs.

Electricity distribution losses

- 4.9 On average, seven per cent of all electricity is lost as heat as it travels along the distribution networks. This accounts for about five per cent of the average domestic customer's annual bill.
- 4.10 In January 2003, Ofgem put forward proposals for improving the current incentives on electricity distribution companies to help reduce the £600 million of electricity that is wasted each year.

Distribution network with distributed generation



Connecting to electricity distribution networks

4.11 In October 2002, Ofgem began a review of how customers and smaller generators are charged for connecting to, and using, the 14 electricity distribution networks. It also announced interim charging arrangements for distributed generators connecting to, and using, the distribution networks, prior to the introduction of final arrangements which will come into effect under the distribution price control in April 2005.

Quality of electricity supplies

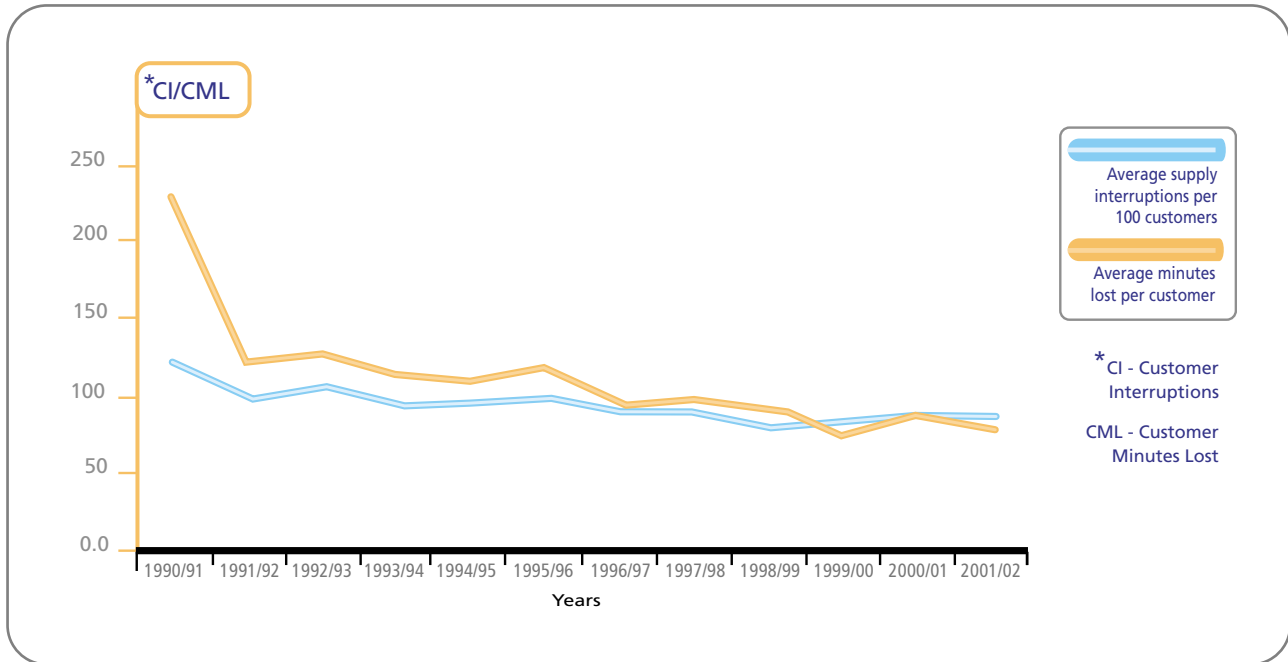
4.12 Quality of supply is an important consideration for Ofgem in setting the regulatory arrangements for electricity distribution companies. A new scheme providing stronger financial incentives for companies to improve levels of service was introduced in April 2002. They focused on the number of interruptions to customers' supplies, length of these interruptions and quality of telephone responses to customers.

4.13 The storms of Sunday 27 October 2002 left almost two million customers throughout the country without electricity. Some customers were cut off for up to nine days.

4.14 Electricity companies are required to pay compensation if supply is not restored within 18 hours. However, companies have a right to claim exemption from paying compensation in exceptional circumstances, such as extreme weather conditions. In the event of a dispute, Ofgem's role is to determine whether any such exemption claims are justified.

4.15 More than 3,000 requests for determination have been received so far. This is the highest number that Ofgem has ever received. Work began in March 2003 on processing these applications and determinations will be reached at the earliest opportunity.

Quality of Supply - average electricity distribution network operator performance since privatisation



4.16 Following the storms, Ofgem contributed to a Government-backed inquiry in November 2002 which analysed the reasons why some companies did not perform as well as others and identified a number of specific recommendations for the companies to address.

Gas distribution

4.17 In December 2002, Ofgem announced draft proposals for separate price controls for each of Transco's eight regional networks. Separate price controls will:

- protect customers in the event that Transco decides to sell off one or more of the networks
- create greater management focus and promote efficiency savings which can be passed on to consumers, and
- provide opportunities to compare the performance of individual networks and enable more effective regulation.

Transmission

Electricity transmission losses

4.18 On average, but with considerable regional variation, about two per cent of all electricity in England and Wales is lost as heat as it is transported on the transmission system. NGC has estimated that generation situated far from demand can result in losses of up to six per cent. This is neither economic nor good for the environment.

4.19 In January 2003, Ofgem approved a modification to the Balancing and Settlement Code (BSC) which introduced zonal transmission losses to England and Wales.

Electricity transmission system costs

4.20 Customers, the electricity industry and NGC are benefiting under enhanced system operator incentive proposals put forward by Ofgem in October 2002, and finalised in March 2003. The incentive scheme encourages NGC to operate the transmission system more efficiently and economically by providing it with an appropriate balance of risk and reward.

Independent Gas Transporters (IGTs)

4.21 During the year, Ofgem began a review of the regulation of IGTs. These local gas network monopolies, which serve about 400,000 customers, are not at present subject to price controls.

Asset risk management

4.22 In January 2003, Ofgem published the results of its first asset risk management survey of the electricity and gas network companies. The survey sought assurance that the companies are addressing longer term asset stewardship effectively. This was not only important for future security of supplies but also provided information to Ofgem, not previously available, which will be valuable in assessing company capital spending plans at price control reviews. The survey formed part of the work carried out by Ofgem during the year to encourage best practice in this area.

5. Securing Britain's gas and electricity supplies

Key achievements for 2002-2003

- New long-term capacity auctions were implemented to increase efficiency and improve security of supply
- Ofgem participated in the Joint Energy Security of Supply (JESS) working group, run with the Department of Trade and Industry (DTI)
- Ofgem's and industry's arrangements for tackling supplier failure were improved

Introduction

- 5.1 Ofgem has statutory duties relating to security and diversity of supply. The need to maintain high levels of security of supply influences many aspects of Ofgem's work and continued to be a priority during 2002-2003.
- 5.2 In February 2003, Ofgem's duties were placed in context with those of Government with the publication of the Energy White Paper. Ofgem will be doing even more in future to promote better understanding of security of supply considerations, including reporting retrospectively every six months on the performance of the electricity and gas industries in delivering a secure supply.

Competitive markets

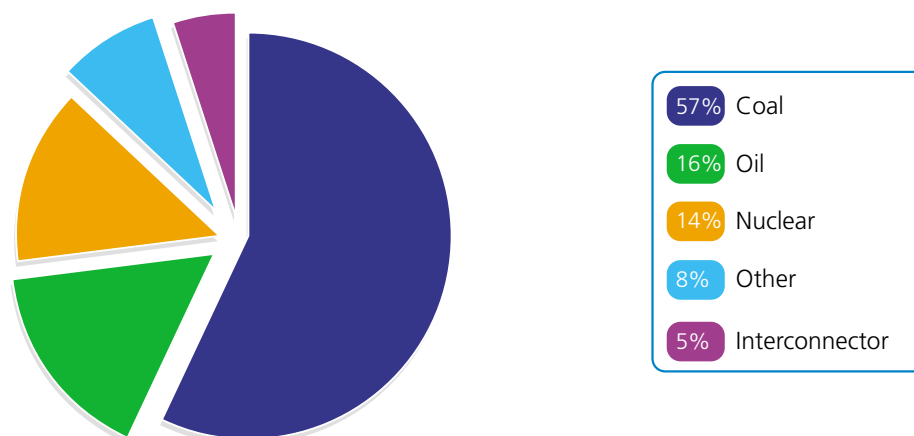
- 5.3 Work during the year was aimed at ensuring that competitive wholesale markets continued to operate effectively to produce timely and appropriate market signals, and that there were no barriers to the development of different sources of generation.
- 5.4 Ofgem coped with severe tests during the year. These included the administration of TXU Europe, which supplied gas and electricity to some 10 per cent of British households, and the problems of British Energy, which generates more than 20 per cent of total electricity needs. None of these events led to any interruptions of energy supply.

- 5.5 Ofgem also worked actively to facilitate efficient investment in Liquefied Natural Gas (LNG) terminals, which bring geographical diversity of gas supply.

Networks

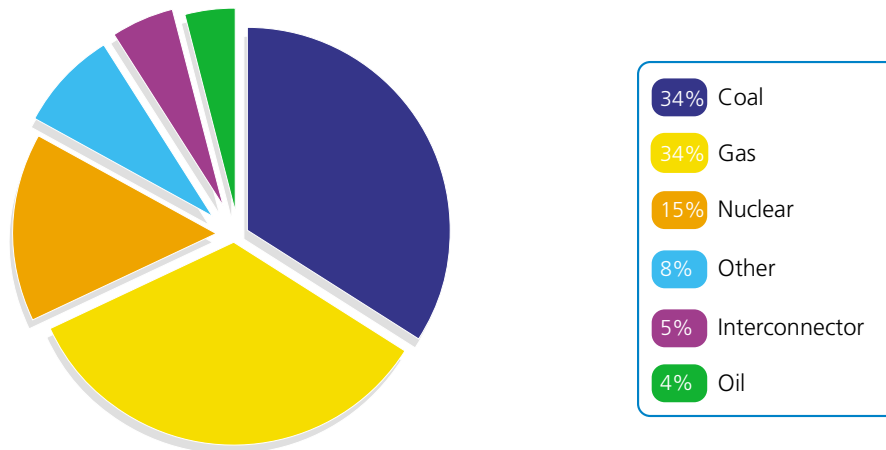
- 5.6 Work was also carried out which was aimed at developing the regulatory framework for national transmission and local distribution networks to improve incentives for efficient investment and system operation.
- 5.7 Under the Transco price control, new system operator incentives gave producers long-term access rights to network capacity to land their gas – and compensation if they were unable to do so (See Making Markets Work Effectively, Page 11). These also provide stronger incentives for Transco to respond efficiently to meet variations in demand.
- 5.8 Similar long-term incentive arrangements are being developed for the National Grid Company (NGC) to provide incentives to invest efficiently and in a timely way in response to demand.

Generation plant diversity - 1989/90



Source: National Grid Company Seven Year Statement

Generation plant diversity - 2002/03



Source: National Grid Company Seven Year Statement

System balancing

- 5.9 In both gas and electricity, Ofgem worked to ensure that the arrangements for system balancing operated effectively and efficiently to ensure that supply continued to meet demand, either on the day, as in gas, or second-by-second, as in electricity.

Joint Energy Security of Supply (JESS) working group

- 5.10 In 2001, the DTI and Ofgem set up the JESS working group to assess risks to Britain's future gas and electricity supplies. The group publishes a series of indicators to inform market participants and other interested parties of trends in the gas and electricity sectors.
- 5.11 During the year, two reports were published in June 2002 and in February 2003. These addressed a range of issues in gas and electricity which affect security of supply.
- 5.12 JESS will continue to contribute to the work which Ofgem undertakes more generally to monitor the impact of competitive and regulatory arrangements in delivering secure gas and electricity supplies.

6. Meeting Ofgem's social and environmental responsibilities

Key achievements for 2002-2003

Social action

- New debt prevention guidelines were developed and introduced
 - A new industry protocol to allow customers in debt to switch was agreed following a successful trial
 - An annual review of progress and priorities under the Social Action Plan was published
 - A joint campaign was undertaken with Age Concern to encourage older people to switch suppliers
-

Environmental action

- Renewables Obligation Certificates (ROCs) were issued for the first time
- The Energy Efficiency Commitment (EEC) saved 17,000 GWh of energy in its first year, just under 30 per cent of its three year target
- The second annual review of Environmental Action Plan was published
- Guidelines on energy efficiency advice were published, following 'mystery shopping' research
- Ofgem's Environmental Advisory Group was established
- Four research studies into areas of energy use affecting the environment were completed
- A Combined Heat and Power (CHP) plant was installed in Ofgem's London office to provide baseload electricity

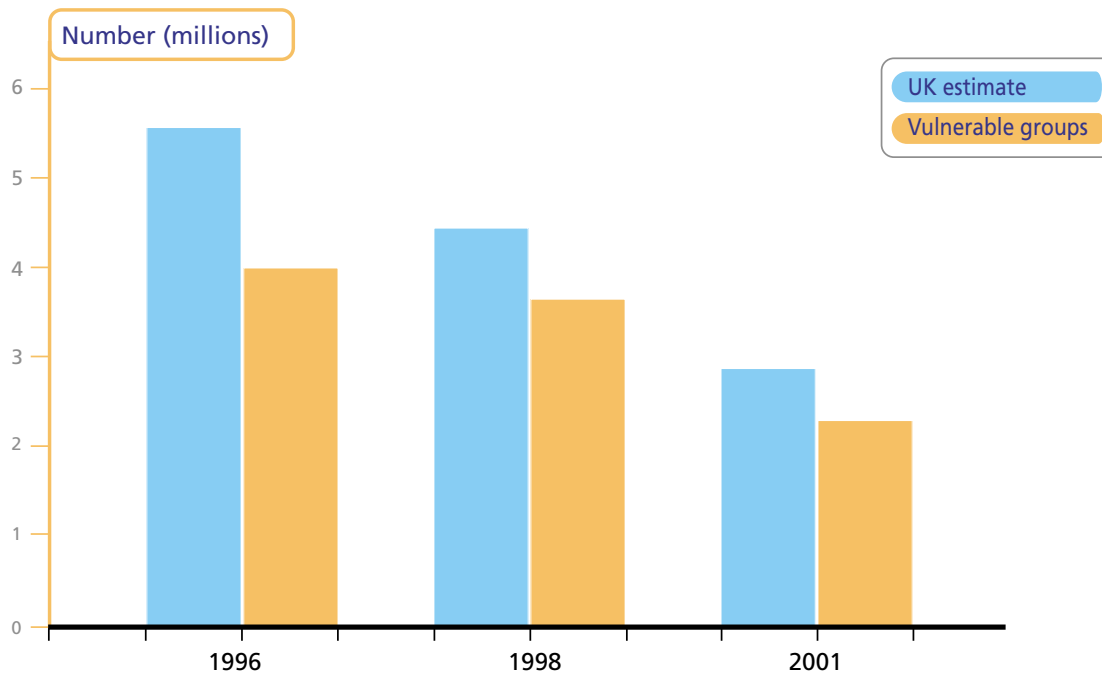
Introduction

- 6.1 In addition to its principal objective to protect the interests of consumers, present and future, Ofgem has important social and environmental duties in relation to energy policy.
- 6.2 Ofgem also has a statutory duty to have regard to the social and environmental guidance issued by the Secretary of State in November 2002. (This guidance is being revised in light of the Energy White Paper and an amended version was put out for consultation in June 2003.) The guidance explains that, where action would have significant financial implications for customers, or for industry, ministers will take the lead on social and environmental policies.
- 6.3 Ofgem is committed to playing a central role to meet the challenge of working towards a low carbon economy, at least cost to the economy, consumers and other environmental impacts.

Social action

- 6.4 The main objectives for Ofgem in this area during 2002-2003 were to:
- ensure that vulnerable customers share fully in the benefits of competition and regulation
 - promote best practice among suppliers for preventing customers from getting into debt, and helping those already in debt
 - improve the quality of energy efficiency advice provided to vulnerable customers by gas and electricity suppliers, and
 - ensure that the Social Action Plan continues to be the framework for taking forward Ofgem's main contribution to tackling fuel poverty.

Number of households in fuel poverty in the UK



Note: Vulnerable groups include older households, families with children, or the sick and disabled

Source: DTI Fuel Poverty Strategy First Annual Report 2003

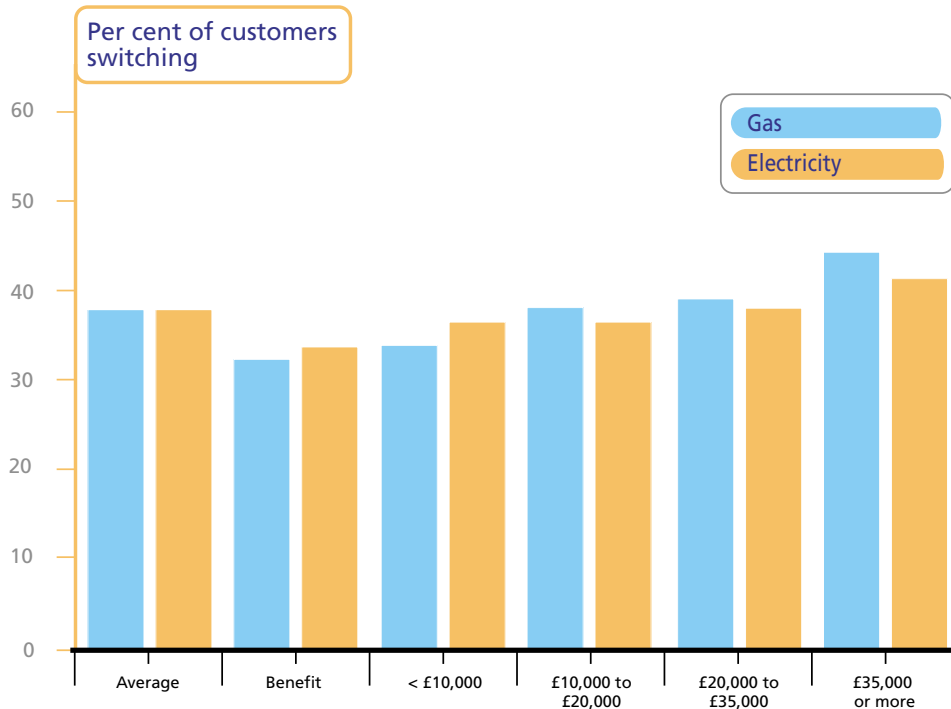
Fuel poverty

- 6.5 The Government has set a target to end the blight of fuel poverty for vulnerable households by 2010 and a Fuel Poverty strategy is in place to meet this target. Since 1996, the number of UK households in fuel poverty, defined as the need to spend more than 10 per cent of household income to keep satisfactorily warm, has fallen from 5.5 million to 3 million. It is estimated that about half this reduction resulted from lower gas and electricity prices.
- 6.6 The biggest contribution Ofgem can make to tackling fuel poverty is to ensure that energy prices are as competitive as possible.
- 6.7 During the year, Ofgem also worked in other ways to help tackle fuel poverty under its Social Action Plan and through its work on energy efficiency. These included encouraging companies to continue to develop innovative services and tariffs for vulnerable customers, as well as monitoring and reporting on how companies were meeting their obligations to improve the services, information and advice provided to vulnerable customers.

Debt

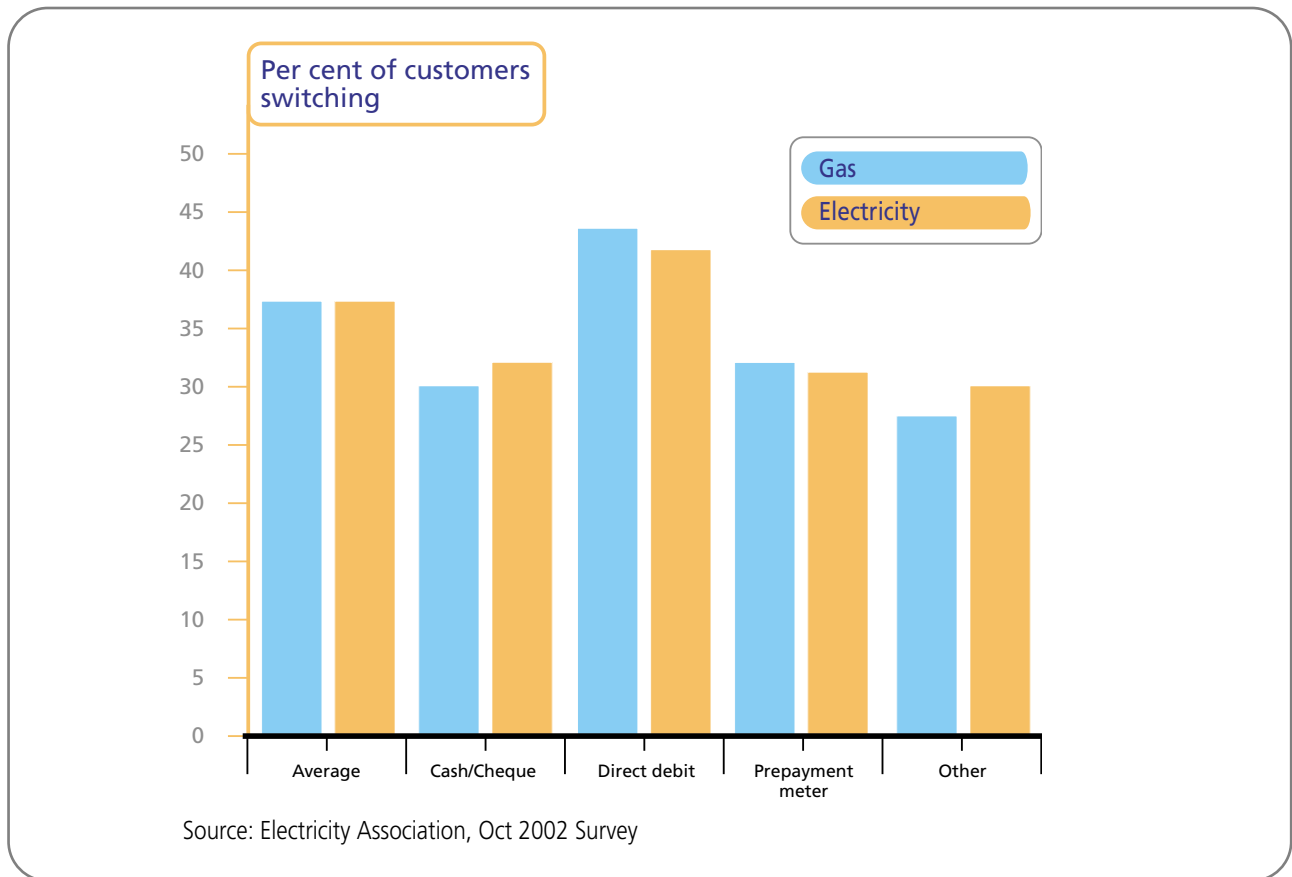
- 6.8 One and a half million gas and electricity customers are affected by debt. A joint Ofgem/energywatch report published in September 2002 called on companies to be more proactive in preventing customers from getting into financial difficulty. It provided a good practice framework for companies to work with customers who are already in debt, as well as highlighting key areas of action for preventing those at risk of falling into debt in the first place.
- 6.9 This report resulted in the publication of new good practice guidelines in January 2003 to encourage companies to improve their debt prevention procedures. They also provided helpful advice to consumer agencies, and to others offering financial advice on paying fuel bills, on how best to prevent customers running up debt.
- 6.10 Proposals were put forward in October 2002 for a new industry protocol which will, for the first time, allow many gas and electricity customers on prepayment meters to transfer to another supplier, taking their debt with them. Under current arrangements, a customer can be prevented from transferring to a new supplier if they have a debt.

Switchers by income



Source: Electricity Association, Oct 2002 Survey

Switchers by payment method



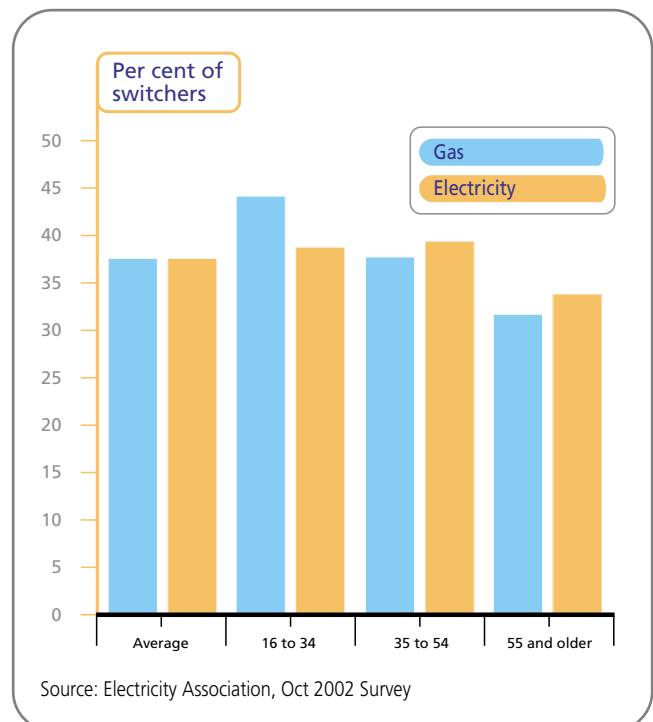
6.11 These proposals followed the completion of a three month trial involving the major energy companies. Ofgem now expects the protocol to come into operation early in 2004.

Switching campaigns

6.12 In October 2002, Ofgem launched a joint campaign with Age Concern, featuring former TV weatherman, Ian McCaskill, encouraging older people to switch their energy supplier. Research had shown that older people do not switch as often as other age groups. Materials were circulated throughout Age Concern's 400 branches nationwide. This campaign is currently being evaluated.

6.13 Ofgem continued, throughout the year, to promote switch and save messages through press releases and other campaign activity. This included a project with schoolchildren which demonstrated how quick and easy it was to identify savings using online price information services.

Switchers by age group



Ofgem and the environment

6.14 Ofgem's main objectives during 2002-2003 were to:

- make an effective contribution to the wider debate on energy policy, in particular about how the Government can work towards a low carbon economy, at least cost to customers
- assess carefully the environmental implications of Ofgem's policies and where possible maximise their benefits, and take action to minimise any adverse effects
- pursue policies where there is synergy between economic, social and environmental objectives
- administer effectively its executive responsibilities in relation to renewables and energy efficiency
- consult on how gas and electricity companies can properly discharge the requirements on them to publish amenity statements, and
- carry out a programme of research to help set future priorities.

Energy White Paper

6.15 The Government's Climate Change Programme was established to ensure the UK meets, and for CO₂ gases exceeds, its commitments under the Kyoto Climate Change Protocol. Ofgem has an important role in helping the Government meet those commitments.

6.16 The Government's Energy White Paper, published in February 2003, set out, for the first time, a clear commitment to achieving a low carbon economy. Ofgem will work with the Government to meet the challenge of moving towards this objective, at least cost to the economy, consumers and other environmental impacts.

6.17 The White Paper set out areas of work to which Ofgem will contribute going forward, for example helping to establish a stronger market in energy services, proposals to expand the Energy Efficiency Commitment from 2005-2008 and a review of the Renewables Obligation in 2005-2006. Ofgem is participating actively in a new cross-departmental environment working group and working to improve consistency in environmental analysis across Government.

6.18 Ofgem has also pledged to assess the environmental implications of all major new policies. These are being included in Regulatory Impact Assessments.

Energy efficiency

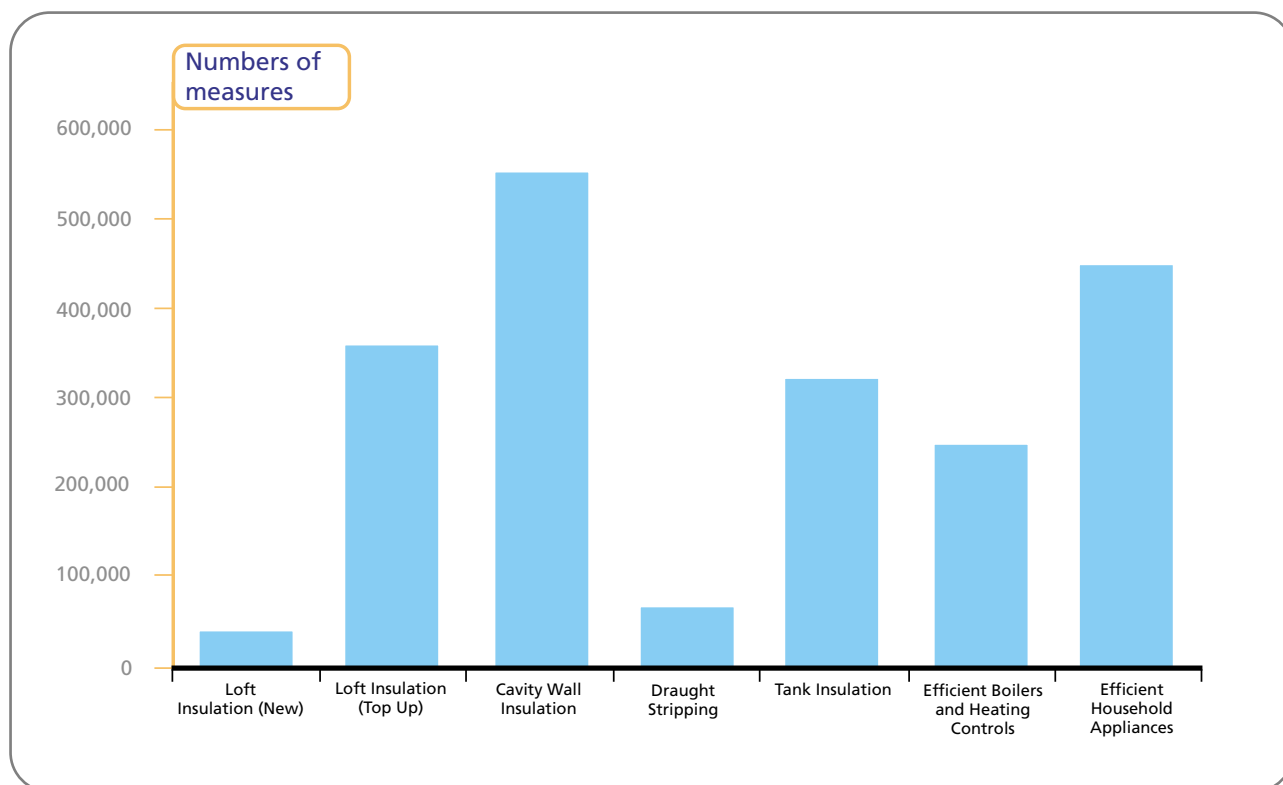
6.19 There are many opportunities for domestic customers to make cost-effective energy efficiency investments in their homes which will both save them money and reduce carbon emissions. Many customers could, in this way, save up to £100 a year.

6.20 To promote greater awareness of these opportunities, Ofgem published 'mystery shopper' research in June 2002. This found significant differences in the way in which energy companies were encouraging their customers to benefit from energy efficiency. It resulted in Ofgem producing good practice guidance on how gas and electricity companies could improve the energy efficiency advice that they give to customers.

Energy Efficiency Commitment (EEC)

6.21 During the year, the EEC delivered more than 17,000 GWh of energy savings. This represents just under 30 per cent of the 62,000 GWh savings target set by the Government over the three year period of the EEC scheme.

Number of measures in the EEC approved during 2002-2003 to be installed in priority group households



6.22 The EEC, which requires all major gas and electricity suppliers to improve the energy efficiency of consumers' homes, began in April 2002. Each company has an energy savings target, which it must achieve between 2002 and 2005, by installing energy efficiency measures in homes.

6.23 Half the energy savings must be achieved from those customers receiving benefits or tax credits. It is estimated that this help will be worth around £300 million over three years. Since 1 April 2002, more than 30 per cent of that £300 million has been allocated. Many households have received 100 per cent grants to improve the energy efficiency of their homes.

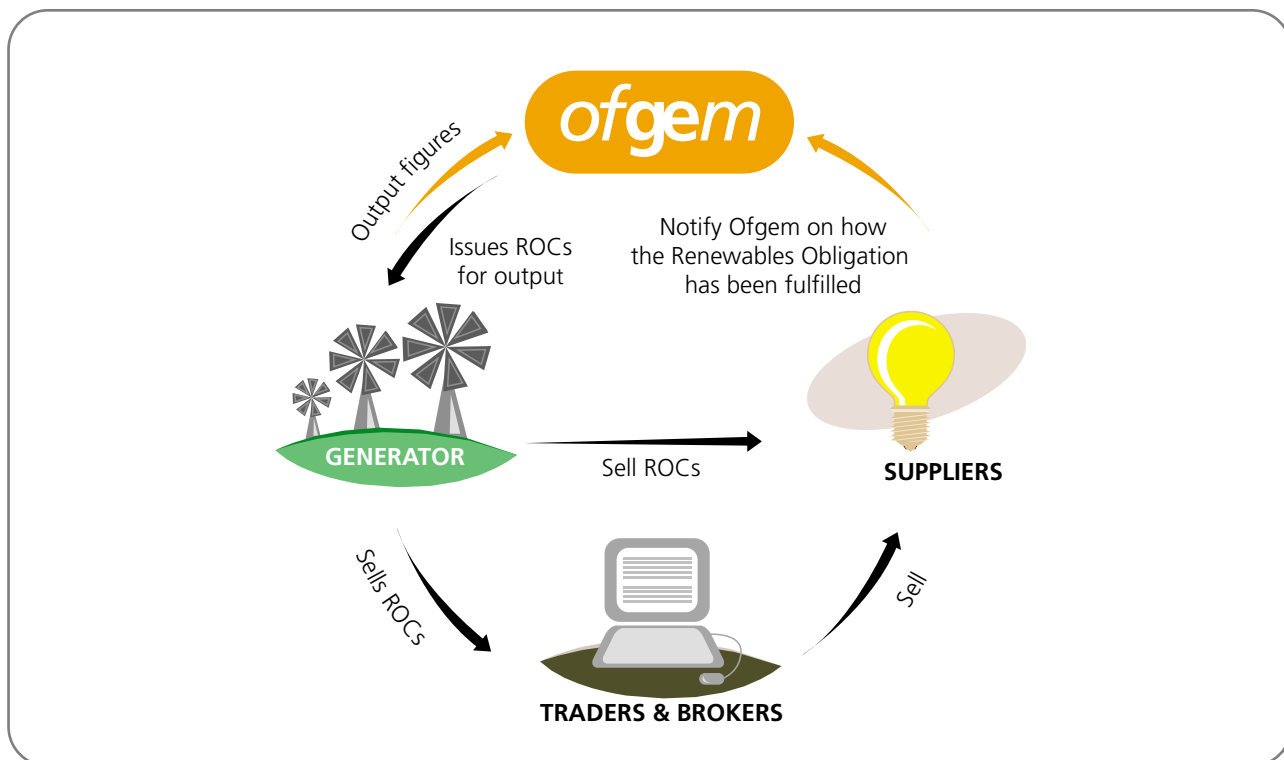
Renewables

6.24 The Renewables Obligation is a key part of the Government's Climate Change Programme, aimed at encouraging the development of renewable capacity and generation in the UK.

6.25 About 2.8 per cent of Britain's electricity is currently sourced from renewable generators. The Government has set a target for electricity suppliers sourcing more of their electricity from renewable sources. To facilitate this, the Government's Renewables Obligation started at three per cent in 2002-2003 and reaches 10.4 per cent in 2010-2011. This is designed to encourage the expansion of the renewable generation sector by offering a steadily increasing market over the next seven years. It should also increase diversity of supply.

6.26 As part of this, in 2002, Renewables Obligation Certificates (ROCs) were issued for the first time. ROCs are issued by Ofgem to renewable generators to prove that their generation comes from eligible renewable sources. Almost five million ROCs have been issued to date, each one representing 1 MWh of generation. During the year, Ofgem set up an online Register to allow suppliers, generators and members of the public to keep track of the movement of ROCs' ownership. The Register shows how many ROCs have been issued and who currently owns them.

Renewables Obligation



Climate Change Levy (CCL)

6.27 Industrial and commercial customers who buy renewable generation are exempted from paying the CCL as this generation does not contribute to global warming. Renewable generators can apply to Ofgem for accreditation. Ofgem continued during the year to ensure that accredited renewable generators' supply met the criteria for exemption and issued it with Levy Exemption Certificates (LECs).

Marketing green tariffs

6.28 Supporting its work on renewable energy, Ofgem issued guidelines in April 2002 to help customers make an informed choice when selecting an environmentally friendly electricity supply.

6.29 The guidelines set out the criteria to which Ofgem recommends that suppliers adhere when they advertise and promote a supply as being green. About 60,000 customers have opted for one of the currently available green tariffs.

Environmental Action Plan

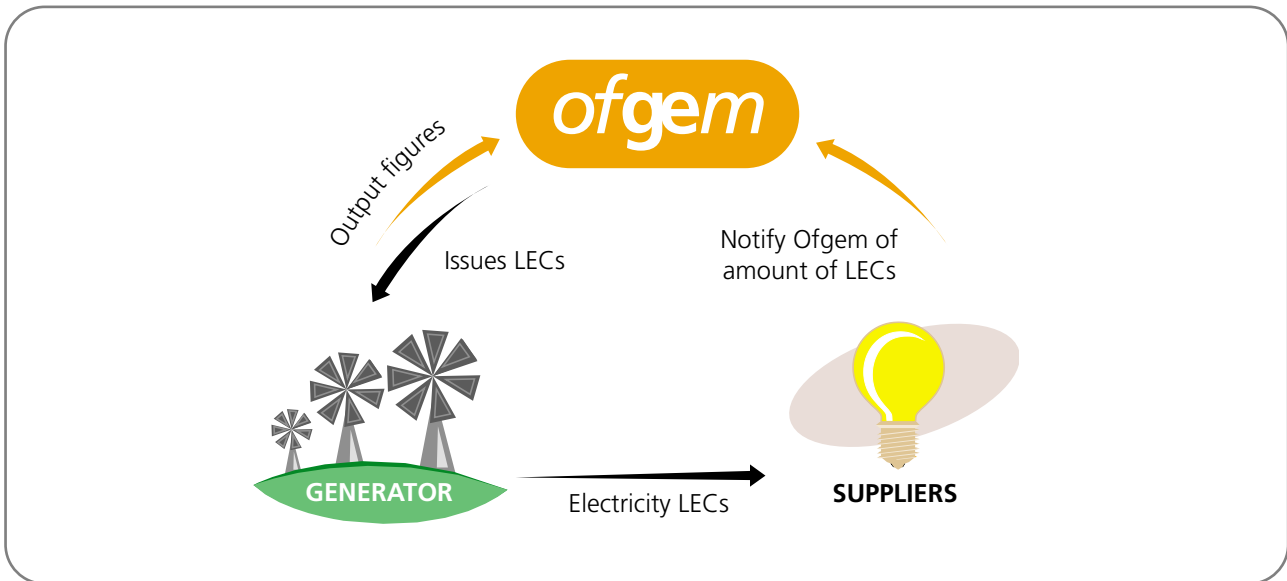
6.30 The Environmental Action Plan is Ofgem's framework for taking forward activities which help the Government meet the challenge of working towards a low carbon economy. Plans to play a fuller and more effective role in informing the environmental debate and decision-making process were announced in the first annual review of Ofgem's Environmental Action Plan in June 2002.

6.31 As part of the Plan, Ofgem also continued its programme of research into environmental issues during the year. This research helps inform Ofgem's work and contributes to broader energy and environmental debates.

6.32 During the year, research studies were completed in:

- the effects on domestic competition from increased awareness of energy use
- consumer attitudes to, and implementation options and associated costs of, the disclosure of fuel sources on electricity bills

Levy Exemption Certificates (LECs)



- energy savings from the installation of insulation in gas-heated homes under the former Energy Efficiency Standards of Performance, and
- the use of sulphur hexafluoride in the electricity industry and its environmental impacts.

Informing Ofgem's work

6.33 During the year, Ofgem established an Environmental Advisory Group. This group is made up of policy experts drawn from Government, industry and the green groups and advises Ofgem on the priorities for its work on the environment. It has met twice to date. Ofgem has also set up a panel of environmental economists.

Electricity distribution issues

6.34 Work is being undertaken as part of the forthcoming electricity distribution price control review (see *Regulating Monopolies Intelligently*, Page 19) to facilitate the growth of distributed generation, typically Combined Heat and Power (CHP) generators or renewable generators such as wind, solar or hydro power.

6.35 To complement this work, Ofgem announced in June 2002 further steps to make it easier for new generators to connect to the electricity system. Distributed generators sometimes find it difficult and expensive to connect to, and operate on, the distribution networks, which were not originally built to accommodate them.

6.36 Ofgem's proposals were aimed at enabling more renewable generators to connect efficiently to the system and at making it easier for new entrants in the market to compete. This work will help meet the challenge of 'rewiring' Britain which will be needed so that electricity distribution networks can cope with the growth in distributed generation. In an event with the Institution of Electrical Engineers (IEE) in September 2002, Ofgem called on the industry to begin gearing up to meet this challenge (see *Regulating Monopolies Intelligently*, Page 19).

6.37 Also during the year, the Distributed Generation Working Group (DGCG) which Ofgem chairs jointly with the Department of Trade and Industry (DTI), and its technical steering group, continued to investigate solutions to the technical and regulatory barriers to the development of distributed generation.

6.38 The first annual report of the DGCG was published during the year and covered its work from November 2001 to the end of 2002. Among the key issues examined were incentives for the connection of distributed generation to local networks, as well as the development of distributed generation, and a range of associated network issues.

Losses

6.39 During the year, work continued on developing new incentives to reduce system losses on the distribution and transmission networks. Reducing system losses should not only produce economic savings but also bring environmental benefits through reductions in carbon emissions which need to be recognised and encouraged (see *Regulating Monopolies Intelligently*, Pages 19 and 22).

Amenities

6.40 In September 2002, as part of its work to improve environmental reporting, Ofgem published proposals to promote good practice for electricity companies who are required to report on the effect of their actions on the environment. These procedures recognise companies' obligations to preserve amenities when constructing or operating power stations, installing overhead or underground lines or carrying out other works.

Ofgem's environmental practice

6.41 During the year, Ofgem continued to take on board the recommendations of the Greening Government initiative which encourages good practice in areas such as building management, recycling and resource consumption. It also installed a CHP plant for its London headquarters. It is anticipated that the plant will reduce heating costs, with associated carbon savings of 698 tonnes each year.

7. Developing Ofgem's efficiency and effectiveness

Key achievements for 2002-2003

- A learning and development strategy was implemented to improve retention of staff and build expertise
- Staff turnover fell below the Government average
- Improvements were made to policy presentation and consultation, particularly in the development of the Corporate Strategy
- Ofgem was awarded Investors in People accreditation

Introduction

7.1 Developing Ofgem as an efficient and effective regulator is important in instilling confidence in those on whom its work has an impact. Ofgem will continue to improve the way in which it works, building on the progress that has been made since it was created in 1999.

7.2 During 2002-2003, Ofgem's key priorities were to:

- attract and retain high calibre staff
- explain and communicate proposals in a user-friendly way
- continue to work to de-personalise regulation, and
- give value for money by controlling costs carefully and managing resources efficiently.

7.3 In April 2002, Ofgem published its first three year corporate strategy which set out how Ofgem will continue to foster competition while shifting emphasis, where appropriate, towards greater reliance on competition powers.

Governance

7.4 Ofgem is governed by the Gas and Electricity Markets Authority which sets all major decisions and policy priorities. The Authority is made up of non-executive and executive members, with a majority of non-executives.

7.5 Professor Len Waverman joined the Authority in May 2002 as a non-executive member, replacing Lord Currie. Dr Robin Bidwell joined the Authority as a non-executive member in February 2003.

7.6 Dr Eileen Marshall, Managing Director for Competition and Trading Arrangements, announced her retirement in September 2002 after 13 years with Ofgem and its two predecessor bodies. She was replaced in March 2003 by Dr Boaz Moselle.

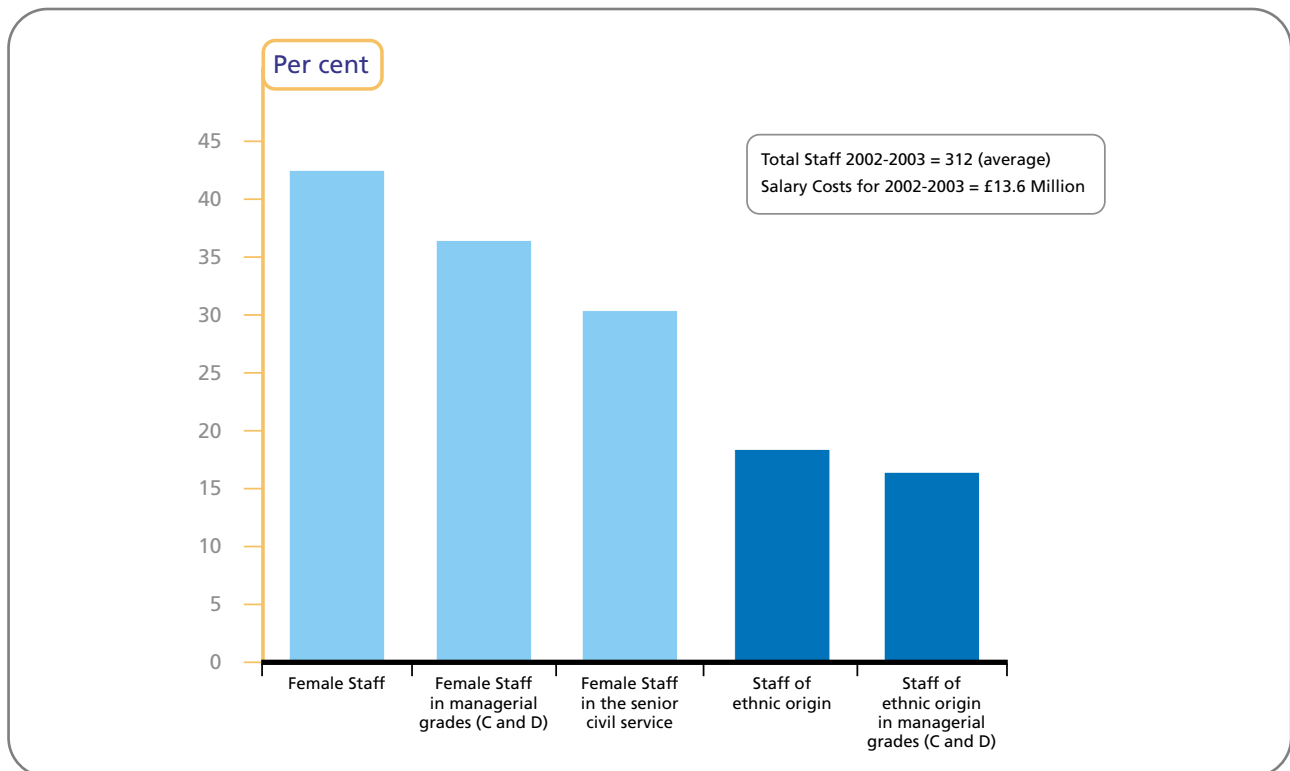
7.7 Gill Whittington, Chief Operating Officer left Ofgem in March 2003. She was replaced by Roy Field. Richard Ramsay, Managing Director, Regulation and Financial Affairs announced that he would leave Ofgem in May 2003. He has been replaced by David Gray.

Explaining and consulting on Ofgem's work

7.8 Ofgem is committed to constant improvements in the way it consults and involves people in its work. During the year, Ofgem worked to explain its plans and proposals in a more user-friendly way – in policy documents, through factsheets, a redesigned website and other vehicles.

7.9 Ofgem continued to report its progress against the deliverables in its Corporate Strategy and to report any changes to priorities and timetables.

Ofgem staff profile



Staff Development

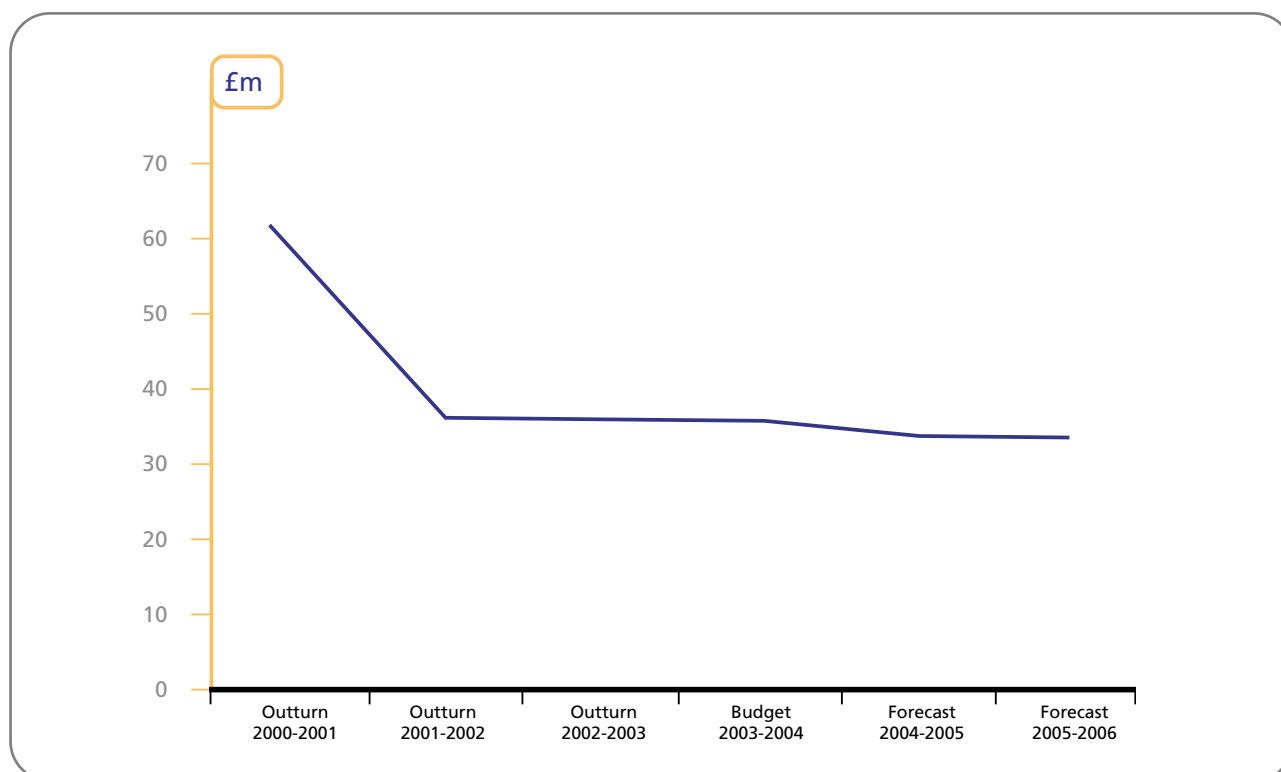
7.10 During 2002-2003 Ofgem continued to work towards Investors in People (IiP) accreditation. This was achieved in April 2003.

7.11 During the year, Ofgem continued to recruit, and worked to retain, good staff. There was continuing emphasis on professionalism and the development of necessary specialist skills, for example, in the legal and regulatory economics fields, especially at senior levels.

7.12 Ofgem recruits on the basis of fair and open competition and selection on merit, in accordance with the Recruitment Code laid down by the Civil Service Commissioners. Between April 2002 and March 2003, Ofgem did not use any of the exceptions to fair and open competition permitted under the Recruitment Code.

7.13 Overall staff numbers, at the time of the merger were around 380 (excluding staff transferred to energywatch). In 2002-2003, they had fallen to an average of 312. Turnover figures were reduced from 28 per cent three years ago to 12 per cent in 2002-2003, below the Government average.

Trend in Ofgem expenditure



Financial review

- 7.14** The costs of Ofgem need to be seen in the context of what it achieves. The range of activities remains as wide as ever. The benefits that Ofgem brings are correspondingly large and outweigh its costs significantly. Ofgem's costs represent around 0.1 per cent of gas and electricity industry turnover, which stands at almost £37 billion a year.
- 7.15** In 2002-2003, Ofgem received income of £50.8 million, of which £46.2 million was received from licence fees. Of this, £13.1 million was collected on behalf of the Department of Trade and Industry (DTI) to meet energywatch and other DTI costs. Other Ofgem income, mainly from property and charges for technical fees, totalled £4.6 million.
- 7.16** Operating costs in 2002-2003 amounted to £38.5 million, compared with £37.8 million in 2001-2002. 2002-2003 operating costs include £3.1m accommodation costs recharged to tenants. Payroll (40 per cent), contractors (19 per cent) and accommodation (24 per cent) accounted for 83 per cent of the total.
- 7.17** Statutory examining and testing services provided by Ofgem laboratories at Leicester were outsourced to SGS (UK) Ltd. Outsourcing has allowed the sale of assets and this process will culminate in the sale of the Leicester site, which should be completed in 2003-2004.
- 7.18** Ofgem's original resource budget, as approved by Parliament following a consultation process with industry and other interested parties, amounted to £39.4 million. More detailed information on costs can be found in Ofgem's Resource Accounts, published in Appendix 1. Ofgem's performance against its deliverables is detailed in Chapter 8.

8. Report against 2002-2003 key deliverables

Making competitive markets work successfully

Wholesale markets

Activity	Action	Delivery Period	Completed
Electricity trading	Publish a review of the new electricity trading arrangements following the first 12 months of operation	Q2	Achieved
	Contribute to development of the Department of Trade and Industry (DTI) drafting instructions to Parliamentary Counsel for British-wide electricity trading and transmission arrangements legislation	Q2	Achieved Q1
	Produce detailed descriptions of system operator and transmission access operator arrangement under British-wide arrangements	Q2	Achieved Q3
	Produce draft documentation for British-wide arrangements	Q4	Achieved
Gas trading arrangements	Continue to participate in the development of the gas balancing regime	Ongoing	N/a
Market governance	Take part in the process for modifications to the Balancing and Settlement Code (BSC), Connection and Use of System Code (CUSC) and Network Code, and take decisions on code modifications	Ongoing	N/a
Market surveillance	Monitor wholesale energy markets and take appropriate enforcement action when there is evidence of licence or competition law infringements	Ongoing	N/a
Security of supply	Participate in DTI/Ofgem's Joint Energy Security of Supply (JESS) Working Group	Ongoing	N/a
Liaise with other European regulators	Support the development of competitive energy markets and promote Ofgem policies across Europe in relation to liberalisation	Ongoing	N/a
	Monitor proposed interconnector projects	Ongoing	N/a
	Provide advice to the DTI on proposals with a negative impact on the UK	Ongoing	N/a
Offshore	Continue work with the DTI and other agencies to promote offshore arrangements that encourage a competitive wholesale market in Britain	Ongoing	N/a

Making competitive markets work successfully (continued)

Retail markets

Activity	Action	Delivery Period	Completed
Monitoring domestic retail	Report on competition in domestic retail supply markets (prepayment meters and where switching activity is low)	Q2 & Q4	Achieved Q2, expected Q1/03
	Report on implications for supply competition of entry of new electricity distribution businesses	Q4	On hold
	Implement improvements to the markets for customer transfer process	Q4	Achieved
	Implement customer contact plan	Ongoing	Achieved
	Publish review of Erroneous Customer Transfer (ECT) Charter	Q3	Achieved Q2
	Publish consultation on marketing licence condition	Q3	Expected Q1/03
	Final proposals for focus of regulation of supply markets	Q4	On hold
Monitoring industrial and commercial retail	Report on competition in industrial and commercial retail supply markets	Q3	Expected Q1/03
Supplier failure	Carry out test of Ofgem's and the industry's arrangements to manage supplier failure	Q2	Achieved

Industry structures

Activity	Action	Delivery Period	Completed
Metering	Update papers on progress under the Metering Strategy	Q2&Q4	Achieved Q2 and Q4
	Support for industry reforms to gas metering arrangements	Q4	Ongoing - achieved
Connections	Undertake dispute resolutions and determinations	Ongoing	N/a
Corporate transactions	Publish consultation documents on proposed mergers and acquisitions and submit reports to the Office of Fair Trading (OFT) as required	Ongoing	N/a
	Implement the decisions of the Secretary of State in relation to mergers and acquisitions	Ongoing	N/a

Regulating monopoly businesses effectively

Activity	Action	Delivery Period	Completed
Development of price regulation generally	Consult on general price control issues to assist in the development of the price control framework and the distribution price control	Q1	Achieved
Transmission, electricity	Implement the NGC system operator incentives scheme, subject to NGC consent	Q1	Achieved
	Continue to participate in the development of new transmission access and losses arrangements for implementation in 2003-2004	Ongoing	N/a
Transmission, gas	Implement the Transco price control and accompanying system operator incentives scheme, subject to Transco consent	Q2	Achieved
Distribution, electricity	Develop objectives and structure for next price control	Q3	Achieved
	Report on quality of supply output measures and medium term performance information	Q2	Expected Q1/03
	Publish final proposals on structure of electricity distribution charges	Q4	Expected Q1/03
	Consult on distribution losses	Q2	Achieved Q4
	Consult on distribution losses	Q4	Expected Q1/03
	Consultation on the regulation of independent electricity distributors	Q2	Achieved
Distribution, Gas	Further consultation on the separation of Local Distribution Zones (LDZ) price controls	Q3	Replaced by initial proposal
	Consult on development of the quality of supply incentive scheme for LDZs	Q4	Expected Q1/04
	Decision document on IGT charging	Q3	Expected Q1/03
Asset risk management	Conduct surveys and publish results	Q3	Achieved Q4
Price control compliance, all industries	Ensure compliance with price controls through monitoring of performance and deal with disputes and determinations	Ongoing	N/a

Helping to tackle fuel poverty and working towards a low carbon economy

Activity	Action	Delivery Period	Completed
Social Action Plan	Publish debt management and prevention guidance	Q2	Achieved
	Publish proposals on reducing debt blocking depending on the outcome of the current industry trial	Q2	Achieved Q3
Energy efficiency	Publish guidelines on energy efficiency advice	Q2	Achieved Q3
Reporting progress	Publish annual review on progress and priorities under the Social Action Plan	Q4	Achieved
Generation	Continue to support the Environment Agency in work to develop emissions trading	Ongoing	N/a
Distributed generation	Review options for domestic and micro-combined heat and power	Q4	Achieved
	Implement interim changes to connection charging regime	Q1	Achieved
Supply	Provide guidance on green supply	Q1	Achieved
Renewables	Issue first Renewables Obligations Certificates (ROCs)	Q2	Achieved
	Implement ROCs' transfer registry	Q2	Achieved
Energy efficiency	Issue procedures manual on administering Energy Efficiency Commitment (EEC)	Q1	Achieved
	Prepare model code of practice on energy efficiency advice for industrial and commercial customers	Q1	Achieved
Reporting progress	Publish report on evaluation of Energy Efficiency Standards of Performance (EESoP) 3 Programme	Q4	Expected Q2/03
	Issue guidance to electricity companies on protection of amenities statements	Q4	Achieved
	Publish annual review on progress and priorities under the Environmental Action Plan	Q1/03*	Achieved

*In last year's Strategy this was mistakenly displayed as Q4/02

Building Ofgem

Activity	Action	Delivery Period	Completed
Attract and retain high calibre staff	Implement Ofgem recruitment and retention strategies	Ongoing	N/a
	Implement learning and development strategy to secure Investors in People accreditation	Ongoing	N/a
Ofgem's proposals	Implement revised Ofgem consultation best practice guidance, including improved rationale	Q1	Target met Implementation September 2002
Strategy	Contribute to the follow-up to the Performance and Innovation Unit report/Government White Paper	Ongoing	N/a

Appendix 1

Resource Accounts 2002–2003

Introduction

These Resource Accounts have been prepared and published by the Office of Gas and Electricity Markets (Ofgem). The Accounts have been prepared under a direction issued by HM Treasury in accordance with section 5(2) of the Government Resources and Accounts Act 2000. The Accounts demonstrate the resources that have been used to deliver Ofgem's objectives. These Resource Accounts have been prepared in accordance with the guidance set out in the HM Treasury's Resource Accounting Manual.

Nature of Ofgem's business and its aim, objectives and activities

This document contains the Accounts of Ofgem for the period 1 April 2002 to 31 March 2003. It should be read in conjunction with the Ofgem Annual Report for 2002–2003, which is published with these Accounts.

Ofgem is a non-ministerial government department. In the parts of the gas and electricity markets where competition is established and effective, Ofgem withdraws from direct price regulation and increasingly relies on competition powers to regulate companies' behaviour and protect domestic and commercial customers' interests. Where competition is not possible or sufficiently well developed, Ofgem protects consumers' interests by regulating the monopoly companies that run the national transmission and local distribution networks in England, Scotland and Wales.

Ofgem is governed by the Gas and Electricity Markets Authority. The Authority's responsibilities are set out in the Gas Act 1986, the Electricity Act 1989, as amended by the Utilities Act 2000 and related legislation.

In fulfilling its obligations Ofgem works closely with the Department of Trade and Industry (DTI) and energywatch.

Aim

Ofgem's primary objectives, duties and functions are set out in statute. From these, Ofgem has distilled its aim as follows:

To protect consumers' interests, wherever possible by promoting effective competition and only where necessary through regulation.

This means working on behalf of consumers to secure gas and electricity supplies which are competitively priced, reliable, safe and, where consistent with these aims, cause as little harm as possible to the environment. The following priority headings were identified in the Plan and Budget for 2002–2003:

- Making markets work effectively
- Regulating monopoly networks intelligently

- Securing Britain's gas and electricity supplies
- Meeting Ofgem's social and environmental responsibilities, and
- Developing Ofgem's effectiveness and efficiency.

Operating and financial review

Income generation

In 2002–2003 cash of £50.8m was received in respect of licence fees and other income mainly from property and charges for technical fees. Of this, £13.1m was collected from licence fee payers on behalf of DTI in respect of the costs of energywatch and subsequently transferred to DTI. Ofgem had an operating income of £38.2m as follows:

Cash receipts from licence fees	£45.1m
Cash receipts from deferred licence fees	£1.1m
Cash receipts from property, technical fees and others	£3.6m
Cash receipts from fees charged in prior years	£1.0m
	<hr/>
	£50.8m
Less cash transferred to DTI	£13.1m
Less other payments	£0.7m
Less opening debtors	£3.8m
Add closing debtors	£5.0m
	<hr/>
Operating Income	£38.2m

In addition to operating income of £38.2m, public funds were provided to meet the cost of work undertaken in respect of the Climate Change Levy (£0.22m).

An amount of £1.1m was over-recovered from licence fee payers and this will be offset against licence fee charges in 2003–2004.

Spending

Total operating costs amounted to £38.5m. Three areas of expenditure absorbed 83 per cent of the total, payroll (40 per cent), contractors (19 per cent) and accommodation (24 per cent).

Capital expenditure in the year totalled £0.7m in respect of plant, furniture, office and computer equipment. Ofgem invested in a Combined Heat and Power (CHP) generator to provide power for its Millbank offices (£177k). Security devices are also being enhanced to protect staff from increased terrorist threat.

Output

Ofgem's financial performance in pursuit of its objectives is detailed in Schedule 5 – Resources by Departmental Aim and Objectives. Expenditure against the main projects identified in Ofgem's Plan and Budget 2002–2003 was as follows:

Project	Corporate Plan (£000)	Actual (£000)
BETTA	2,370	2,622
Electricity Trading Arrangements	1,130	936
Gas Trading Arrangements	1,040	962
Market Surveillance	710	542
Renewables	650	643
Quality of Service	540	761

Reviews of these and other projects can be found in the Ofgem Annual Report.

Budgets and liquidity

Ofgem's budget is approved by Parliament following a consultation process with industry and other interested parties. For 2002–2003 Parliament approved a resource budget of £39.422m and a capital budget of £0.654m. In addition, DTI directed that a sum of £13.1m should be collected on behalf of energywatch; this amount was transferred to DTI, in full.

Competition Commission costs of £0.661m in respect of the AES/British Energy market abuse licence condition inquiry were received from generation licence holders, and in November 2002, a financial penalty of £2m was imposed on London Electricity. Both amounts were surrendered to the Exchequer.

In June 2002, £5m was drawn from the Contingency Fund to provide short term liquidity until first receipt of licence fees. This was fully repaid in August.

An amount of £1.9m due to be surrendered to the Exchequer will be retained to fund operations in 2003–2004 until adequate licence fee income is received.

Finance for the future

Substantial provision has been made for liabilities arising from the merger of the Office of Electricity Regulation (OFFER) and Office of Gas Supply (Ofgas). They relate to staff severance and onerous costs of a building lease. Fixed assets are kept to optimal levels and capital expenditure will sustain future Ofgem operations at Corporate Plan levels.

The balance sheet at 31 March 2003 shows negative Taxpayer's Equity of £10.4m. This reflects the inclusion of liabilities falling due in future years which are to be financed mainly by drawings from the UK Consolidated Fund. Such drawings will be from grants of Supply approved annually by Parliament to meet Ofgem's Net Cash Requirement. Further detail is provided in note 1.14 to the financial statements.

Statutory examining and testing services provided by Ofgem laboratories at Leicester were outsourced to SGS UK Ltd. during the year. Note 20 shows the income and costs to the date of transfer, one off costs and details of ongoing costs. Some costs of this change, particularly redundancy and continuing pension liability, have fallen to Ofgem and these have required additional provisions to be made to the value of £1.8m. In addition, a contingent liability for costs that may arise up to 31 January 2004 has also been noted – under the terms of the transfer contract Ofgem has no continuing liability after that date. Outsourcing has allowed sale of assets and this process will culminate in sale of the Leicester site and this should be completed in 2003–2004. Relevant assets have been written down to their realisation value where appropriate.

Business focus for the future

Ofgem will continue to protect consumers' interests, wherever appropriate by promoting effective competition. In particular, Ofgem will seek to:

- Make competitive markets work successfully
- Regulate monopoly businesses effectively
- Secure Britain's gas and electricity supplies
- Help tackle fuel poverty, and
- Work towards a low carbon economy.

The Gas and Electricity Markets Authority

The Authority comprises executive and non-executive members as shown below. The Chairman of the Authority is also currently Chief Executive of Ofgem. The Authority is the ultimate decision making body for all matters dealt with by Ofgem, setting policy and deciding major issues.

Basis of appointment and remuneration

The Chairman of the Authority was appointed by the Secretary of State for Trade and Industry for a period of five years. Initially, this was as Director General for Gas Supply from November 1998 and of Electricity Supply from January 1999 but following enactment of the Utilities Act 2000 he became Chairman of the Authority. His remuneration was set out in his contract and is subject to annual review in line with awards recommended by the Senior Salaries Review Body.

Appointment of the other executive members of the Authority is undertaken in accordance with the Civil Service Management Code. Their remuneration is set out in their contracts and is subject to annual review in line with awards recommended by the Senior Salaries Review Body.

The non-executives are appointed by the Secretary of State for Trade and Industry after consulting the Chairman. Until September 2002 non-executives were remunerated by payment of an honorarium of £12,000 per annum, from October this was revised to £15,000 per annum.

Details of remuneration can be found in Note 2 to the Resource Accounts.

On the 19 December 2002 the Minister for Energy and Construction (Brian Wilson Esq. MP) issued a statement stating that the current Chief Executive and Chairman (Callum McCarthy) planned to step down in October 2003 at the end of his current term. The statement said that thereafter the two roles of Chairman and Chief Executive would be separated. The Department of Trade and Industry announced on 12 May 2003 that John Mogg would take over as Chairman following Callum McCarthy's departure. The new Chief Executive has not been appointed yet.

Management Committee

The Management Committee comprised all the executive members shown in Note 2. Its role is to assist the Chief Executive in the day-to-day running of the business. It meets weekly and decides, subject to the overall direction and control of the Authority, on all matters relating to policy, management and resources.

Two members of the Committee, Eileen Marshall, and Gill Whittington, left Ofgem at the end of March 2003. Gill Whittington was succeeded by Ofgem's Finance Director (Roy Field), Eileen Marshall by Boaz Moselle. Richard Ramsay left Ofgem at the beginning of May 2003 and was succeeded by David Gray.

Governance

Ofgem has introduced a corporate structure with committees that have clear terms of reference. They provide the necessary structure to ensure that there is a strong framework of internal control throughout the organisation.

Audit Committee

The Audit Committee is chaired by Sir Keith Stuart. Other members are Margaret Ford, Richard Farrant and James Strachan, all non-executive members of the Authority. In January 2003 the non-executive members were re-appointed to the Audit Committee for a further year.

The Chief Operating Officer and other staff, the external auditors (National Audit Office) and the internal auditors attend by invitation. The Committee's role is to advise the Accounting Officer and the Authority on anything that affects the financial health, probity or external reputation of the organisation and to ensure the adequacy of the system of internal control. The Committee meets at least three times a year.

Executive Members of the Authority who served during the year

Callum McCarthy, 59, was appointed Chairman in November 2000. He is the Accounting Officer for the Ofgem Resource Accounts.

Dr Eileen Marshall, 60, was appointed Managing Director (Competition & Trading Arrangements) in November 2000. Appointment ceased on 31 March 2003.

Dr Boaz Moselle, 38, was appointed Managing Director (Competition & Trading Arrangements) in March 2003. Prior to joining Ofgem, Dr Moselle was a partner in the Brattle Group. The company provided consultancy services to Ofgem during the year.

John Neilson, 43, was appointed Managing Director (Customer & Supply) in November 2000.

Gill Whittington, 44, was appointed Chief Operating Officer in November 2000. Appointment ceased on 31 March 2003.

Richard Ramsay, 53, was appointed Managing Director (Regulation & Financial Affairs) in March 2001. Appointment ceased on 9 May 2003.

Non-Executive Members of the Authority

John Belcher joined the Authority as a non-executive member in January 2001. His current appointment ends in January 2005.

Lord Currie joined the Authority as a non-executive member in December 2000. He resigned on 30 April 2002.

Richard Farrant joined the Authority as a non-executive member in December 2000. His current appointment ends in December 2003.

Margaret Ford joined the Authority as a non-executive member in December 2000. Her current appointment ends in December 2004.

James Strachan joined the Authority as a non-executive member in December 2000. His current appointment ends in December 2004.

Sir Keith Stuart joined the Authority as a non-executive member in December 2000. His current appointment ends in December 2004.

Professor Leonard Waverman joined the Authority as a non-executive member in May 2002. His current appointment ends in May 2005.

Robin Bidwell joined the Authority as a non-executive member in February 2003. His current appointment ends in February 2006.

Pension liabilities

The main pension scheme for employees is the Principal Civil Service Pension Scheme (PCSPS). The pension liabilities arising from Ofgem's employees' membership of the PCSPS are not provided for in these accounts in accordance with the Treasury instructions and are described in Notes 1.8 and 2 to the financial statements.

Equal Opportunities

Ofgem's Equal Opportunities Policy aims to ensure that no eligible job applicant or employee receives less favourable treatment on grounds of age, disability, sex, race, ethnic or national origin, sexual orientation, religion or religious affiliation or because the employee works part-time.

At the end of the financial year:

- just under 43 per cent of all staff were female
- 30 per cent of senior civil service members in Ofgem were women
- 36 per cent of staff in managerial grades were women
- 18 per cent of staff were known to be of ethnic minority origin, and
- the proportion of staff known to be of ethnic minority origin in the managerial grades was 16 per cent.

The policy statements describing Ofgem's equal opportunity framework are available to provide guidance for all employees.

Training and development

Ofgem's most important investment is in its people and this has been recognised by Ofgem being awarded the status of Investors In People in April 2003. An active policy of recruiting and retaining high calibre staff will also continue. Knowledge management software and processes will be further developed to give staff immediate access to the quality of information they need to work effectively. Ofgem also continues to improve the ways it explains and consults on its work.

During the year Ofgem continued to give a high priority to training and developing all staff to enhance their professionalism in pursuit of Ofgem's objectives. To this end, Ofgem has developed a training plan setting out the themes that link training and development activity across the organisation to meet Ofgem's wide ranging goals and priorities.

This commitment is reflected in expenditure: £489k was spent on training during 2002–2003.

Employee involvement

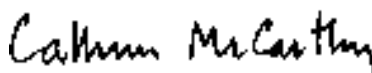
Ofgem attaches great importance to managing, developing and training its staff in accordance with best practice and has a staff consultative committee.

Creditor payment, policy and performance

Ofgem's policy is to comply with the Better Payment Practice Code. Ofgem's standard terms and conditions for the supply of goods or services specify payment within 30 days, or other agreed credit terms, of receipt of goods or services or valid invoice, whichever is the later. During 2002–2003 Ofgem paid 97 per cent of undisputed bills within these deadlines.

Auditors

The Resource Accounts have been audited by the Comptroller and Auditor General.



Callum McCarthy

Accounting Officer and Chairman
5 June 2003

Statement of Accounting Officer's responsibilities

Under the Government Resource and Accounts Act 2000, Ofgem is required to prepare resource accounts for each financial year, in conformity with a Treasury direction, detailing the resources acquired, held, or disposed of during the year and the use of resources by Ofgem during the year.

The resource accounts are prepared on an accruals basis and must give a true and fair view of the state of affairs of Ofgem at the year-end and of the net resource outturn, resources applied to objectives, recognised gains and losses and cash flows for the financial year.

The Treasury has appointed the Chief Executive as Ofgem's Accounting Officer with responsibility for preparing Ofgem's accounts and for transmitting them to the Comptroller and Auditor General.

In preparing the resource accounts, the Accounting Officer is required to comply with the Resource Accounting Manual prepared by the Treasury and, in particular, to:

- observe all relevant accounting and disclosure requirements, and apply suitable accounting policies on a consistent basis
- make judgements and estimates on a reasonable basis
- state whether applicable accounting standards, as set out in the Resource Accounting Manual, have been followed, and disclose and explain any material departures in the accounts, and
- prepare the financial statements on a going concern basis.

The relevant responsibilities of the Accounting Officer (including his responsibility for the propriety and regularity of public finances for which an Accounting Officer is answerable, for the keeping of proper records and for safeguarding Ofgem's assets) are set out in the Accounting Officers' Memorandum, issued by the Treasury and published in Government Accounting.

Statement on internal control

As Accounting Officer I have responsibility for maintaining a sound system of internal control that supports the achievement of departmental policies, aims and objectives set by the Gas and Electricity Markets Authority whilst safeguarding the public funds and departmental assets for which I am personally responsible in accordance with the responsibilities assigned to me in Government Accounting.

The system of internal control is designed to manage rather than eliminate the risk of failure to achieve policies, aims and objectives; it can therefore only provide reasonable and not absolute assurance of effectiveness.

The system of internal control is based on an ongoing process designed to identify the principal risks to the achievement of departmental policies, aims and objectives, to evaluate the nature and extent of those risks and to manage them efficiently, effectively and economically. This process has been in place for the year ended 31 March 2003 and up to the date of approval of the annual report and accounts and accords with Treasury guidance.

As Accounting Officer, I also have responsibility for reviewing the effectiveness of internal control. Ofgem has established the following processes:

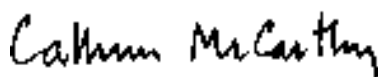
- the Authority which meets at least ten times a year to consider the plans and overall strategic direction of Ofgem and the Management Committee which meets on a weekly basis to manage all policy, resource and operational issues
- a Corporate Strategy and Plan set by the Authority with clear aims, objectives and deliverables which cascade down through Directorate objectives and tasks to project management and then personal job objectives for each staff member
- a detailed annual budget and key performance indicators and outputs which are identified during corporate planning and then monitored through the year in routine management information systems that inform the Authority, Management Committee and Audit Committee

- a formal risk management framework that identifies key risks and their consequences. These are recorded in a risk register and current risk status is reviewed every six months by the Management Committee and annually by the Authority and its Audit Committee, leading to a risk management Action Plan
- Ofgem project managers are trained in risk management and documented project management procedures
- all new projects require a project impact assessment as part of their initiation documentation and this includes a review of all material risks involved in the project and its objectives
- a properly constituted Audit Committee comprising non-executive members of the Authority which reports directly to the Authority
- independent Internal Audit (provided under contract) reports to the Audit Committee to standards defined in the Government Internal Audit Manual and agrees a rolling programme of audit for each forthcoming year according to the Committee's priorities
- the Head of Internal Audit presents a yearly review of the audit programme, including an assessment of general risk, and an opinion on the adequacy and effectiveness of Ofgem's system of internal control together with recommendations for improvement, and
- a process of Internal Control questionnaires requires all Directors to consider and report on all aspects of financial control in their own area.

As part of Ofgem's maintenance and development of risk management, two key changes will come into effect during the next financial year:

- a new panel for economic consultancy advice will be set up to standardise procedures for the selection, management and performance assessment of such consultants, and
- following a tendering process, a new Internal Audit service provider, Chiene and Tait, has been appointed with effect from 1 April 2003.

My review of the effectiveness of the system of internal control is informed by all of the above but particularly the reports of the Audit Committee, internal audit, the internal control questionnaires and the risk framework monitoring reports, as well as by the day-to-day advice of my managers and staff and comments made by the external auditors in their management letter and other reports.



Callum McCarthy

Accounting Officer

5 June 2003

Financial statements

The financial statements on pages 55 to 86, together with the annual report and other statements on pages 45 to 52 and the Certificate and Report of the Comptroller and Auditor General on pages 53 to 54, reproduce in full those included in the resource accounts for OFGEM for 2002–2003 laid before the House of Commons on 16 June 2003 under reference HC789. Pages 1 to 44 of this Annual Report provide additional information, for which I am responsible, that is not included with those accounts. The auditor is required by auditing standards to read other information in documents containing audited financial statements and to consider the implications for his/her audit opinion. A supplementary statement has accordingly been provided by the Comptroller and Auditor General at page 54 in respect of his reading of the additional information.

The Certificate and Report of the Comptroller and Auditor General to the House of Commons

I certify that I have audited the financial statements on pages 55 to 86 under the Government Resources and Accounts Act 2000. These financial statements have been prepared under the historical cost convention as modified by the revaluation of certain fixed assets and the accounting policies set out on pages 64 to 66.

Respective responsibilities of the Accounting Officer and Auditor

As described on page 51, the Accounting Officer is responsible for the preparation of the financial statements in accordance with the Government Resources and Accounts Act 2000 and Treasury directions made there under and for ensuring the regularity of financial transactions. The Accounting Officer is also responsible for the preparation of the other contents of the Annual Report. My responsibilities, as independent auditor, are established by statute and are guided by the Auditing Practices Board and the auditing profession's ethical guidance.

I report my opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Government Resources and Accounts Act 2000 and Treasury directions made there under, and whether in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. I also report if, in my opinion, the Annual Report is not consistent with the financial statements, if the Department has not kept proper accounting records or if I have not received all the information and explanations I require for my audit.

I read the other information contained in the Annual Report at pages 45 to 50, and consider whether it is consistent with the audited financial statements. I consider the implications for my certificate if I become aware of any apparent misstatements or material inconsistencies with the financial statements.

I review whether the statement on pages 51 and 52 reflects the Department's compliance with Treasury's guidance, "Corporate governance: statement on internal control". I report if it does not meet the requirements specified by the Treasury, or if the statement is misleading or inconsistent with other information of which I am aware from my audit of the financial statements.

Basis of audit opinion

I conducted my audit in accordance with United Kingdom Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts, disclosures and regularity of financial transactions included in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Department in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Department's circumstances, consistently applied and adequately disclosed.

I planned and performed my audit so as to obtain all the information and explanations which I considered necessary in order to provide me with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by error, or by fraud or other irregularity and that, in all material respects, the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them. In forming my opinion I have also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In my opinion:

- the financial statements give a true and fair view of the state of affairs of the Office of Gas and Electricity Markets at 31 March 2003 and of the net resource outturn, resources applied to objectives, recognised gains and losses and cash flows for the year then ended, and have been properly prepared in accordance with the Government Resources and Accounts Act 2000 and directions made thereunder by the Treasury, and;
- in all material respects the expenditure and income have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities which govern them.

I have no observations to make on these financial statements.

John Bourn

Comptroller and Auditor General
12 June 2003

National Audit Office,
157–197 Buckingham Palace Road
Victoria, London SW1W 9SP

Supplementary statement by the Comptroller and Auditor General in respect of material included at pages 1 to 44 of this Annual Report, not included with the financial statements to which the audit opinion above relates

In respect alone of my responsibility under United Kingdom auditing standards to read the other information included with financial statements on which I express an audit opinion, I have read the additional information on pages 1 to 44 which was not included with the financial statements on which I reached the audit opinion set out in my Certificate above and considered whether it is consistent with the audited financial statements. I have considered the implications for my audit opinion if I have thereby become aware of any apparent mis-statement or material inconsistencies with the financial statements. I have not considered the effects of any events since the date of my Certificate.

In this regard, my audit opinion on the financial statements is unchanged.

John Bourn

Comptroller and Auditor General
10 July 2003

National Audit Office,
157–197 Buckingham Palace Road,
Victoria, London, SW1W 9SP

Schedule 1

Summary of resource outturn for the year ended 31 March 2003

2002–2003

	Estimate			Outturn				Prior-year outturn
	Gross expen- diture	A-in-A	Net total	Gross expen- diture	A-in-A	Net total	Net total outturn compared to Estimate: saving/ (excess)	
	1	2	3	4	5	6	7	8
	£000	£000	£000	£000	£000	£000	£000	£000
Request for resources 1*	52,302	(52,301)	1	51,349	(51,348)	1	–	2
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry (Note 4, 5, 8)								
Request for resources 2	220	–	220	220	–	220	–	350
Expenditure in connection with the Climate Change Levy (Note 8)								
Total resources	52,522	(52,301)	221	51,569	(51,348)	221	–	352
Non-operating cost A-in-A	–	–	(75)	–	–	(75)	–	(34)
Net cash requirement	–	–	676	–	–	221	455	352

*Request for resources 1 includes an amount of £13,067,000 in respect of energywatch expenditure as per Note 5.

Reconciliation of resources to cash requirement

	Note	Estimate Net total £000	Outturn Net total £000	Net total outturn compared to estimate saving/ (excess) £000
Net total resources		221	221	–
Capital:				
Purchase of fixed assets	9,10	654	707	(53)
Investments	–	–	–	
Repayment of deposit	12	–	(100)	100
Non-operating cost A-in-A				
Book value of fixed asset disposals	10	(75)	(75)	–
		579	532	47
Accruals adjustments:				
Non-cash items	3	(1,060)	(490)	(570)
Changes in working capital other than cash	11	–	(437)	437
Changes in creditors falling due after more than one year	–	–	–	
Use of provision	15	936	(1,241)	2,177
Excess cash to be CFERd	14	–	1,636	(1,636)
		(124)	(532)	408
Net cash requirement (Schedule 4)		676	221	455

Explanation of the variation between Estimate net cash requirement and outturn (net cash requirement):

(i) Increase in provisions to cover the costs of outsourcing statutory examining and testing services, which also led to a higher than anticipated excess cash to be CFER'd.

Analysis of income payable to the Consolidated Fund

In addition to appropriations in aid, the following income relates to Ofgem and is payable to the Consolidated Fund (cash receipts being shown in italics):

	2002–2003 Forecast		2002–2003 Outturn	
	Income £000	<i>Receipts</i> £000	Income £000	<i>Receipts</i> £000
Operating income and receipts-excess A-in-A	–	–	–	–
Non-operating income and receipts-excess A-in-A	–	–	290	<i>262</i>
Subtotal	–	–	290	<i>262</i>
Other operating income and receipts not classified as A-in-A	–	–	–	–
Other non-operating income and receipts not classified as A-in-A	–	–	–	–
Other amounts collectable on behalf of the Consolidated Fund	–	–	–	–
Excess cash surrenderable to the Consolidated Fund	–	–	1,636	<i>1,015</i>
Fines levied and CFER'd	–	–	2,000	<i>2,000</i>
Total	–	–	3,926	<i>3,277</i>

Actual outturn – cash

Net cash requirement: Outturn net requirement £221,000.00 which is £455,000.00 less than estimate.

The actual cash surrenderable to the Consolidated Fund is £1,925,531.46

Schedule 2

Operating cost statement for the year ended 31 March 2003

	Note	2002–2003 £000	2001–2002 £000
Administration costs			
Request for resources 1			
Staff costs	2,20	15,480	12,699
Other administration costs	3,20	22,662	24,485
		38,142	
Request for resources 2			
Other administration costs	3,20	220	350
		220	
Gross administration costs		38,362	37,534
Operating income	4,20	(38,141)	(37,182)
Net administration costs		221	352
Programme costs			
Request for resources 1			
Expenditure	5	13,207	22,658
Less income	5	(13,207)	(22,658)
Net Programme Cost		–	–
NET OPERATING COST		221	352
NET RESOURCE OUTTURN		221	352
	7,8		

Statement of recognised gains and losses

for the year ended 31 March 2003

	2002–2003 £000	2001–2002 £000
Net operating cost	(221)	(352)
Net loss on revaluation of tangible fixed assets	(174)	(128)
Total recognised losses for the financial year	(395)	(480)

All activities are continuing.

Schedule 3

Balance sheet

as at 31 March 2003

	Note	31 March 2003 £000	Restated 31 March 2002 £000
Fixed assets			
Tangible assets	9	5,999	6,865
		5,999	6,865
Current assets			
Debtors	12	4,998	3,788
Cash at bank and in hand	13	1,277	7,705
		6,275	11,493
Creditors (due within one year)	14	(7,423)	(12,200)
Net current (liabilities)/assets		(1,148)	(707)
Total assets less current liabilities		4,851	6,158
Provisions for liabilities and charges	15	(15,252)	(13,974)
		(10,401)	(7,816)
Taxpayers equity			
General fund	17	(10,463)	(8,152)
Revaluation reserve	16	62	336
		(10,401)	(7,816)

Callum McCarthy

Callum McCarthy
Accounting Officer

5 June 2003

Schedule 4

Cash flow statement

for the year ended 31 March 2003

	2002-2003 £000	Restated 2001-2002 £000
Net cash inflow from operating activities (see a overleaf)(1,694)	(8,737)	
Capital expenditure and financial investment (see b overleaf)	(11)	691
Payments to the Consolidated Fund	8,398	3,840
Financing from the Consolidated Fund	(265)	–
Decrease/(Increase) in cash in the period	6,428	(4,206)

Reconciliation of operating cost to operating cash flows

	Note	2002–2003 £000	2001-2002 £000
Net operating cost		221	352
Adjust for non-cash transactions	3,4	(252)	(1,233)
Adjust for movements in working capital other than cash	11	(385)	(6,440)
Adjust for transfer to provisions	15	(1,278)	(1,416)
Net cash inflow from operating activities (a)		(1,694)	(8,737)
Analysis of capital expenditure and financial investment			
Fixed asset additions	9	707	884
Proceeds of disposal of fixed assets	10	(618)	(34)
Repayment of deposits	12	(100)	(159)
Net cash (inflow)/outflow from investing activities (b)		(11)	691
Analysis of financing and reconciliation to net cash requirement			
From the Consolidated Fund (Supply) – prior year ¹	17	265	-
Advances from the Contingency Fund		5,000	33,000
Repayment to the Contingency Fund		(5,000)	(33,000)
Net financing		265	-
Decrease/(Increase) in cash	13	6,428	(4,206)
Net cash flows other than financing		6,693	(4,206)
Adjustment for payments and receipts not related to Supply:			
Amounts due to the Consolidated Fund in prior year and paid over	17	(8,398)	(3,840)
Amounts due to the Consolidated Fund and not paid over	14,17	1,926	8,398
Amounts collected in year ²		15,728	22,428
Amounts paid over in year ²		(15,728)	(22,428)
Net Cash Requirement (Schedule 1)		221	352

¹ Amount of grant actually issued to support prior year net cash requirement = £352,000.00

² Amounts collected and paid over relate to energywatch costs (£13.067m), fines levied (£2.0m) and Competition Commission costs (£0.661m)

Schedule 5

Resources by departmental aim and objectives

for the year ended 31 March 2003

AIM: To protect consumers' interests, wherever possible by promoting effective competition and only where necessary through regulation.

Objective ¹	2002–2003			2001–2002		
	Gross	Income	Net total	Restated Gross	Restated Income	Restated Net total
	£000	£000	£000	£000	£000	£000
1. Making markets work effectively	22,031	(22,031)	–	20,970	(20,970)	–
2. Regulating monopoly business intelligently	10,861	(10,861)	–	11,843	(11,843)	–
3. Meeting Ofgem's social and environmental responsibilities	3,511	(3,291)	220	2,991	(2,641)	350
4. Developing Ofgem's effectiveness and efficiency	2,099	(2,098)	1	1,960	(1,958)	2
Net operating cost	38,502	(38,281)	221	37,764	(37,412)	352

¹ See note 26.

Appendix 2

Notes to the Accounts

1. Statement of accounting policies

The financial statements have been prepared in accordance with the 2002–03 Resource Accounting Manual (RAM) issued by HM Treasury. The accounting policies contained in the RAM follow UK generally accepted accounting practice for companies (UK GAAP) to the extent that it is meaningful and appropriate to the public sector. Where the RAM permits a choice of accounting policy, the accounting policy which has been judged to be most appropriate to the particular circumstances of Ofgem for the purpose of giving a true and fair view has been selected. The particular accounting policies adopted by Ofgem are described below. They have been applied consistently in dealing with items considered material in relation to the accounts.

1.1 Accounting conventions

These accounts have been prepared under the historical cost convention, modified to include the revaluation of fixed assets at their value to the business by reference to their current costs.

1.2 Tangible fixed assets and depreciation

Title to freehold land and buildings shown in the accounts is held by the Ministry of Defence (MOD).

Freehold land and buildings are restated at current cost using professional valuations in accordance with Financial Reporting Standard (FRS) 15 every five years and appropriate indices, as published by the Office of National Statistics, in intervening years. Other tangible assets have been stated at current cost using appropriate indices.

Freehold land is not depreciated.

Depreciation is provided at rates calculated to write off the valuation of freehold buildings and other tangible fixed assets by equal instalments over their estimated useful lives, after allowance for residual value. Freehold buildings are now depreciated over 20 to 60 years following an external valuation. Asset lives are within the following ranges:

Freehold buildings	20 to 60 years
Leasehold improvements	Life of the lease
Office equipment, furniture and fittings	5 to 17 years
Specialist laboratory equipment	5 to 10 years
Computers and IT equipment	3 to 5 years
Vehicles	3 years

The minimum level for the capitalisation of tangible fixed assets is £1,000.

1.3 Provisions

Ofgem makes provision for liabilities and charges where, at the balance sheet date, a legal or constructive liability exists (i.e. a present obligation from past events exists), where the transfer of economic benefits is probable and a reasonable estimate can be made.

Where the time value of money is material, Ofgem discounts the provision to its present value using a discount rate of 6 per cent, the Government's standard rate. As directed by HM Treasury this rate will change to 3.5 per cent with effect from 1 April 2003. Each year the financing charges in the Operating Cost Statement include the adjustments to amortise one year's discount and restate liabilities to current price levels.

1.4 Operating income

Operating income is income that relates directly to the operating activities of Ofgem. It comprises principally licence fees and fees and charges for services provided on a full cost basis.

Since all licence costs are recovered via the licence fees, and these are invoiced in two tranches during the year based on estimated costs, any over recovery is treated as deferred income within Creditors and any under recovery as accrued income within Debtors.

Following the introduction of the Utilities Act, monies were collected in respect of energywatch and the Department of Trade and Industry costs. This income and expenditure is shown under programme costs.

1.5 Administration and programme expenditure

The operating cost statement is analysed between administration and programme costs. Administration costs reflect the costs of running Ofgem. These include both administration costs and associated operating income. Income is analysed in the notes between that which, under the administrative cost-control regime, is allowed to be offset against gross administration costs in determining the outturn against the administration cost limit, and that operating income which is not. Programme costs reflect non-administration costs in respect of

energywatch and the Department of Trade and Industry costs.

1.6 Capital charge

A charge, reflecting the cost of capital utilised by Ofgem, is included in the operating costs. The charge is calculated at the Government's standard rate of 6 per cent on all assets less liabilities, except for:

- cash balances with the Office of the Paymaster General (OPG) where the charge is nil, and
- liabilities for amounts to be surrendered to the Consolidated Fund, where the credit is nil.

1.7 Foreign exchange

Transactions which are denominated in a foreign currency are translated into sterling at the rate of exchange ruling on the date of each transaction, except where rates do not fluctuate significantly, in which case an average rate for the period is used.

1.8 Pension costs

Present and past employees are covered by the provisions of the Principal Civil Service Pension Scheme (PCSPS), which is non-contributory and unfunded. Liability for payment of future benefits is a charge to the PCSPS. Departments, agencies and other bodies covered by the PCSPS meet the cost of pension cover provided for the staff they employ by payment of charges calculated on an accruing basis. Liability for payment of future benefits is a charge on the PCSPS. There is a separate scheme statement for the PCSPS as a whole.

Ofgem's Chief Executive and former Directors General have separate pension arrangements that are broadly analogous with the PCSPS. The arrangements provide for a defined benefit, unfunded scheme. However, unlike the PCSPS, a pension provision is included in the accounts.

1.9 Early departure costs

Ofgem is required to meet the additional cost of benefits beyond the normal PCSPS benefits in respect of employees who retire early. Ofgem provides in full for this cost when the early retirement programme has been announced and is binding on Ofgem.

1.10 Taxation

Value Added Tax (VAT) is accounted for in the accounts, in that amounts are shown net of VAT except:

- irrecoverable VAT is charged to the Operating Cost Statement and included under the heading relevant to the type of expenditure, and
- irrecoverable VAT on the purchase of an asset is included in the capitalised purchase cost of the asset.

The amount due to, or from, HM Customs and Excise in respect of VAT is included within Debtors and Creditors within the Balance Sheet.

1.11 Schedules 1 and 5

The information contained in Schedule 1 and associated notes is based on the Request for Resources information that will form part of parliamentary approval processes.

Schedule 5 has been prepared from the underlying books and records. Where possible costs have been directly attributed to each objective. Overhead costs have been attributed based on the appropriate cost driver.

1.12 Operating leases

Rentals due under operating leases are charged to the Operating Cost Statement over the lease term on a straight-line basis, or on the basis of actual rentals payable which fairly reflects the usage. Future payments, disclosed at Note 19, "Commitments under operating leases", are not discounted.

1.13 Comparative amounts

Comparative amounts are restated where necessary to conform to current presentation. Restated amounts in Schedule 3 (Debtors and Creditors now reflect undrawn grant), Schedule 4 (amounts collected and paid over to the Consolidated Fund now shown) and Schedule 5 (to reflect changes to Ofgem corporate objectives) are fully reflected in the corresponding notes.

1.14 Going concern

The balance sheet at 31 March 2003 shows a negative taxpayers equity of £10.4M. This reflects the inclusion of liabilities falling due in future years, which are to be financed mainly by drawings from the UK Consolidated Fund. Such drawings will be from grants of supply approved annually by Parliament, to meet Ofgem's Net Cash Requirement. Under the Government Resources and Accounts Act 2000, no money may be drawn from the Fund other than required for the service of the specified year or retained in excess of that need. All unspent monies, including those derived from Ofgem's income, are surrenderable to the Fund.

In common with other government departments, the future financing of Ofgem's liabilities is accordingly to be met by future grants of Supply and the application of future income, both to be approved annually by Parliament. Such approval for amounts required for 2003–2004 has already been given and there is no reason to believe that future approvals will not be forthcoming. It has accordingly been considered appropriate to adopt a going concern for the preparation of these financial statements.

1.15 Contingent liabilities

In addition to contingent liabilities disclosed in accordance with FRS 12, Ofgem discloses for parliamentary reporting and accountability purposes certain contingent liabilities where the likelihood of a transfer of economic benefit is remote. These comprise all items (whether or not they arise in the normal course of business) over £100,000 (or lower, where required by specific statute or where material in the context of resource accounts) which are required by the Resource Accounting Manual to be noted in the resource accounts.

Where the time value of money is material, contingent liabilities which are required to be disclosed under FRS 12 are stated at discounted amounts and the amount reported to Parliament separately noted. Contingent liabilities that are not required to be disclosed by FRS 12 are stated at the amounts reported to Parliament.

2. Staff numbers and costs

The average number of whole time equivalent staff employed (including senior management), by objective, during the year was as follows:

Objective	2002–2003 No.	Restated 2001–2002 No.
Making markets work effectively	182	175
Regulating monopoly businesses intelligently	88	91
Meeting Ofgem's Social and environmental responsibilities	26	23
Developing Ofgem's effectiveness and efficiency	16	14
	312	303

The aggregate payroll costs of these staff were as follows:

	2002–2003 £000	2001–2002 £000
Wages and salaries	10,980	10,008
Social security costs	911	806
Pension costs	1,552	1,329
Early retirement and severance costs	184	397
Sub Total	13,627	12,540
Inward secondments	–	–
Total	13,627	12,540
Less recoveries in respect of outward secondments	(149)	(64)
Provisions:		
Provided in year	2,002	223
Total Net Costs	15,480	12,699

The Principal Civil Service Pension Scheme (PCSPS) is an unfunded, multi-employer, defined benefit scheme. Ofgem is unable to identify its share of the underlying assets and liabilities. A full actuarial valuation was carried out at 31 March 1999 and details can be found in the separate scheme statement of the PCSPS.

For 2002–2003 employer contributions of £1,552,000 (£1,329,000 in 2001–2002) were payable to the PCSPS at rates in the range 12–18.5 per cent of pensionable pay. Employer contribution rates are reviewed every three years following a scheme valuation by the Government Actuary. The contribution rates reflect benefits as they are accrued, not when the costs are actually incurred, and they reflect past experience of the scheme.

The salary and pension entitlements of the executive and the non-executive members were within the following ranges:

The Gas and Electricity Markets Authority

Name Position	Age	Salary including performance pay £000	Real increase in pension at 60 £000	Total accrued pension at 60 at 31 March 2003 £000	Benefits in kind (rounded to the nearest £100)	Employers contribution to partnership pension account including risk benefit cover- to nearest £100
Callum McCarthy Chairman	59	170 – 175	N/A	N/A	19,800	N/A
Dr Eileen Marshall Managing Director to 31 March 2003	60	140 – 145	0–2.5	15–20	N/A	N/A
Dr Boaz Moselle* Managing Director from 10 March 2003	38	5 – 10	N/A	N/A	N/A	N/A
John Neilson Managing Director	43	105 – 110	2.5–5	30–35	N/A	N/A
Richard Ramsay Managing Director	53	155 – 160	N/A	N/A	N/A	N/A
Gill Whittington Chief Operating Officer to 31 March 2003	44	115 – 120	N/A	N/A	N/A	N/A

*opted to join 'premium'
pension scheme

Non-executive members of the Authority

Name	Honorarium
John Belcher	£13,500
Richard Farrant	£13,500
Margaret Ford	£13,500
James Strachan	£13,500
Sir Keith Stuart	£13,500
Leonard Waverman	£12,000

The following salary and pension details are provided in accordance with the 2002–2003 Resource Accounting Manual (RAM) issued by HM Treasury.

Salary

(i) 'Salary' includes gross salary; performance pay or bonuses; overtime; reserved rights to London weighting or London allowances; recruitment and retention allowances; private office allowances and any other allowance to the extent that it is subject to UK taxation.

Pension

(ii) Pension benefits are provided through the Civil Service pension arrangements. From 1 October 2002, civil servants may be in one of three statutory based "final salary" defined benefit schemes (**classic**, **premium**, and **classic plus**). New entrants after 1 October 2002 may choose between membership of **premium** or joining a good quality "money purchase" stakeholder based arrangement with a significant employer contribution (**partnership pension account**).

(a) Classic Scheme

Benefits accrue at the rate of 1/80th of pensionable salary for each year of service. In addition, a lump sum equivalent to three years' pension is payable on retirement. Members pay contributions of 1.5 per cent of pensionable earnings. On death, pensions are payable to the surviving spouse at a rate of half the member's pension. On death in service, the scheme pays a lump sum benefit of twice pensionable pay and also provides a service enhancement on computing the spouse's pension. The enhancement depends on length of service and cannot exceed 10 years. Medical retirement is possible in the event of serious ill health. In this case, pensions are brought into payment immediately without actuarial reduction and with service enhanced as for widow(er) pensions.

(b) Premium

Benefits accrue at the rate of 1/60th of final pensionable earnings for each year of service. Unlike classic, there is no automatic lump sum, but members may commute some of their pension to provide a lump sum up to a maximum of 3/80ths of final pensionable earnings for each year of service or 2.25 times pension if greater (the commutation rate is £12 of lump sum for each £1 of pension given up). For the purposes of pension disclosure the tables assume maximum commutation. Members pay contributions of 3.5 per cent of pensionable earnings. On death, pensions are payable to the surviving spouse or eligible partner at a rate of 3/8ths the member's pension (before any commutation). On death in service, the scheme pays a lump-sum benefit of three times pensionable earnings and also provides a service enhancement on computing the spouse's pension. The enhancement depends on length of service and cannot exceed 10 years. Medical retirement is possible in the event of serious ill health. In this case, pensions are brought into payment immediately without actuarial reduction. Where the members' ill health is such that it permanently prevents them undertaking any gainful employment, service is enhanced to what they would have accrued at age 60.

(c) Classic Plus Scheme

This is essentially a variation of **premium**, but with benefits in respect of service before 1 October 2002 calculated broadly as per **classic**.

Pensions payable under classic, premium, and classic plus are increased in line with the Retail Prices Index.

(d) Partnership Pension Account

This is a stakeholder-type arrangement where the employer pays a basic contribution of between 3 per cent and 12.5 per cent (depending on the age of the member) into a stakeholder pension product.

Employees do not have to contribute but where they do make contributions, these will be matched by the employer up to a limit of 3 per cent (in addition to the employer's basic contribution). Employers also contribute a further 0.8 per cent of pensionable salary to cover the cost of risk benefit cover (death in service and ill health retirement). The member may retire at any time between the ages of 50 and 75 and use the accumulated fund to purchase a pension. The member may choose to take up 25 per cent of the fund as a lump sum.

The Chief Executive has a separate pension arrangement that is broadly analogous with the PCSPS. The arrangements provide for a defined benefit, unfunded scheme. However, unlike the PCSPS, a pension provision is included in the accounts.

The Managing Director, Regulation and Financial Affairs and the Chief Operating Officer have opted out of the PCSPS and Ofgem make no pension contributions on their behalf but their salaries reflect contributions that would otherwise have been made.

Benefits in kind

(iii) The monetary value of benefits in kind covers any benefits provided by the employer and treated by the Inland Revenue as a taxable emolument. Callum McCarthy had the use of an allocated car and chauffeur.

In addition to the honoraria paid to the non-executive directors, which are included in other administration costs, they are also entitled to receive expenses.

3. Other administration costs

	2002–2003 £000	2001–2002 £000
Rental under operating leases:		
Hire of office equipment	82	55
Other operating leases	6,400	4,111
	6,482	4,166
Non-cash items (Notes a & b):		
Auditors' remuneration and expenses*	45	42
Depreciation	896	879
Loss on disposal of fixed assets	–	112
Capital charge	(490)	(129)
Diminution in value of fixed assets	54	329
	505	1,233
Other expenditure:		
Contractors	7,182	6,378
Bad debts	–	14
Travel and subsistence	577	571
Hospitality	95	76
Honoraria to non-executive members	80	72
	7,934	7,111
Provisions:		
Provided in year	285	3,441
Unwinding of the discount	534	706
	819	4,147
Other		
	7,142	8,178
	22,882	24,835

Other administration costs comprise Request for resources 1 and Request for resources 2 as per Schedule 2.

*There was no auditor remuneration for non-audit work.

Note a – the total of non-cash transactions included in the Reconciliation of operating costs to operating cashflows in Schedule 4 comprises:

	2002–2003 £000
Other administration costs – non-cash items (as above)	505
Less non-cash income profit on sale of fixed assets	(253)
Total non-cash transactions	252

Note b – the total of non-cash transactions included in the Reconciliation of resources to cash requirement comprises:

	2002–2003 £000
Total non-cash transactions as above	252
Adjust for profits and losses on disposal of fixed assets profits on disposal of tangible fixed assets	253
Non-cash items per reconciliation of resources to cash requirement	505

4. Operating income

Operating income not appropriated in aid (i.e. transferred to the Consolidated Fund) is analysed for resource budget purposes between that which is include in public expenditure and that which is not (see note 7). In 2002–03, all operating income not classified as A in A was within public expenditure.

	2002–2003					Operating
	Resource	Reconciliation to Operating Cost Statement				Cost
	Outturn	Transfer	Netted	Payable	Transactions	Statement
	A-in-A	of	off gross	to	between	Income
	estimate	expenditure	Consolidated	requests for		
	cover	in sub-head	Fund	resources		
	£000	£000	£000	£000	£000	£000
Administrative income:						
Fees and charges to external customers	34,965	–	–	–	–	34,965
Fees and charges to other departments	3,176	–	–	–	–	3,176
	38,141	–	–	–	–	38,141
Programme income:						
Fossil Fuel Levy	140	–	–	–	–	140
Amounts collected for energywatch	13,067	–	–	–	–	13,067
Total	51,348	–	–	–	–	51,348

2001–2002

	Resource	Reconciliation to Operating Cost Statement				Operating
	Outturn					Cost
	A-in-A	Transfer of estimate cover	Netted off gross expenditure in sub-head	Payable to Consolidated Fund	Transactions between requests for resources	Income
	£000	£000	£000	£000	£000	£000
Administrative income:						
Fees and charges to external customers	37,180	–	–	–	–	37,180
Fees and charges to other departments	2	–	–	–	–	2
	37,182	–	–	–	–	37,182
Programme income:						
Fossil Fuel Levy	230	–	–	–	–	230
Amounts collected for energywatch	22,428	–	–	–	–	22,428
Total	59,840	–	–	–	–	59,840

An analysis of income from services provided to external and public sector customers is as follows:

	2002–2003			2001–2002		
	Income	Costs	Surplus/deficit	Income	Costs	Surplus/deficit
	£000	£000	£000	£000	£000	£000
Administrative income:						
Gas and Electricity:						
Licence fees (external)	33,197	33,418	221	32,865	33,217	352
Attributable to other government departments	122	122	–	2	2	–
Other	4,822	4,822	–	4,315	4,315	–
Subtotal	38,141	38,362	221	37,182	37,534	352
Programme income						
Other	140	140	–	230	230	–
Total	38,281	38,502	221	37,412	37,764	352

All of the opposite operating income was appropriated in aid. Appropriations-in-Aid represent income due to Ofgem that can be retained for offset against other public expenditure. This contrasts with CFERs, which are remitted by Ofgem to the Consolidated Fund.

Other income includes:	2002–2003 £000	2001–2002 £000
Rent received:		
Department for Environment, Food and Rural Affairs (Defra)	3,054	–
External tenants	20	2,148
Profit on disposal of fixed assets	253	–
Miscellaneous	1,495	2,167
	4,822	4,315

Miscellaneous income includes fees for technical services (meter approval and testing and gas quality audit, etc.), licence application fees, and other minor items.

5. Net programme costs (fees collected on behalf of the DTI for costs of energywatch)

	2002–2003 £000	2001–2002 £000
Total income from licence fees	46,264	55,293
Less: Ofgem licence fee income	(33,197)	(32,865)
Amount collected and paid to the DTI for the costs of energywatch	13,067	22,428
Add: Fossil Fuel Levy income (see note 4)	140	230
Programme income	13,207	22,658

In accordance with the income accounting policy (note 1.4), licence fees collected on behalf of the DTI and remitted directly to them, to meet the cost of energywatch and DTI, are shown under programme costs in the Operating Cost Statement.

Total programme income and expenditure is reflected in Schedule 2 at £13,207,000.

6. Administration cost limits

The outturn within the administration costs control regime shown against individual administration cost limits is as follows:

	2002–2003 £000		2001–2002 £000	
	Outturn	Limits	Outturn	Limits
Request for resources 1				
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry	37,682	38,001	36,105	37,000
Request for resources 2				
Expenditure in connection with the Climate Change Levy	220	220	350	350
	37,902	38,221	36,455	37,350

7. Reconciliation of net operating cost to control total and net resource outturn

	2002–2003 £000	2001–2002 £000
Net operating cost	221	352
Remove non – supply expenditure and income, including income scored as CFER	–	–
Net resource outturn (subject to Supply procedures)	221	352

Net operating cost is the total of expenditure and income appearing in the operating cost statement (Schedule 2). Net resource outturn is the total of those elements of expenditure and income that are subject to parliamentary approval and included in the Department's Supply Estimates. The outturn against the Estimate is shown in the summary of resource outturn (Schedule 1).

For Ofgem, all Supply expenditure is within the control total (resource budget) and no expenditure is financed other than by requests for resources.

8. Analysis of net resource outturn and net operating cost by function

	2002–2003 £000				Estimate	Net total outturn compared with Estimate
	Admin	Other current	A-in-A	Net total		
Request for resources 1						
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry	38,142	140	38,281	1	1	–
Request for resources 2						
Expenditure in connection with the Climate Change Levy	220	–	–	220	220	–
Resource outturn	38,362	140	38,281	221	221	–
Non supply expenditure				–	–	
Non A-in-A operating income				–	–	–
Net operating cost				221	221	–

	2001–2002 £000				Estimate	Net total outturn compared with Estimate
	Admin	Other current	A-in-A	Net total		
Request for resources 1						
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry	37,184	230	37,412	2	2	–
Request for resources 2						
Expenditure in connection with the Climate Change Levy	350	–	–	350	350	–
Resource outturn	37,534	230	37,412	352	352	–
Non supply expenditure				–	–	
Non A-in-A operating income				–	–	
Net operating cost				352	352	

9. Tangible fixed assets

	Land and buildings	Office equipment & furniture	Computer equipment	Laboratory equipment	Leasehold works	Motor vehicles	Total
	£000	£000	£000	£000	£000	£000	£000
Cost or valuation							
At 1 April 2002	1,410	2,222	1,090	492	4,106	87	9,407
Additions	–	228	479	–	–	–	707
Disposals	(410)	(509)	(64)	(485)	–	(40)	(1,508)
Revaluation	(200)	37	(53)	(1)	–	–	(217)
At 31 March 2003	800	1,978	1,452	6	4,106	47	8,389
Depreciation							
At 1 April 2002	8	1,216	522	453	294	49	2,542
Charged in year	6	303	316	10	261	–	896
Disposals	(7)	(505)	(62)	(459)	–	(24)	(1,057)
Revaluations	(5)	15	(1)	–	–	–	9
At 31 March 2003	2	1,029	775	4	555	25	2,390
Net book value							
at 31 March 2003	798	949	677	2	3,551	22	5,999
at 31 March 2002	1,402	1,006	568	39	3,812	38	6,865

Freehold land and buildings were revalued at £800,000 on 20 January 2003 by DTZ Debenham Tie Leung (International Property Advisors), on the basis of open market value of freehold interest. The valuation has been made in accordance with the appropriate sections of the current Practice Statements and Guidance Notes contained within the Appraisal and Valuation Manual issued by the Royal Institute of Chartered Surveyors. In accordance with asset policy, the assets will be revalued in the intervening years using the appropriate indices.

Outsourcing of the statutory examining and testing services has allowed the sale of Ofgem's assets at Leicester. Three of the four buildings, specialist laboratory equipment, and general office equipment with a total net book value of £356k (Cost £1,463k depreciation £1,107k) have now been sold. It is planned to sell the remaining building in 2003–2004.

Other tangible assets have been revalued using appropriate indices.

Ofgem normally depreciates capitalised leasehold improvement costs over the life of the lease or to the point at which the leasehold ends, whichever is the sooner.

10. Analysis of capital expenditure and associated A-in-A

	Capital expenditure	2002–2003 £000 A-in-A	Net total
Request for resources 1			
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry	707	(75)	632
Request for resources 2			
Expenditure in connection with the Climate Change Levy	–	–	–
Total	707	(75)	632

Sale proceeds authorised by parliament to be used as A-in-A totalled £75,000, whereas income from fixed asset disposals totalled £618,000.

	Capital expenditure	2001–2002 £000 A-in-A	Net total
Request for resources 1			
Protecting consumers by regulating monopolies and promoting competition in the electricity and gas industry	884	(34)	850
Request for resources 2			
Expenditure in connection with the Climate Change Levy	–	–	–
Total	884	(34)	850

11. Movements in working capital other than cash

	2002–2003 £000	2001–2002 £000
Increase/(decrease) in debtors (see note 12)	1,354	(7,783)
(Increase)/decrease in creditors (see note 14)	(1,739)	1,343
Net decrease in working capital other than cash	(385)	(6,440)
Less: capital creditors	–	–
	(385)	(6,440)

Debtors shown under note 12 as other debtors and the undrawn grant are excluded from the movement in working capital.

12. Debtors

	2002–2003 £000	Restated 2001–2002 £000
Amounts falling due within one year		
Trade debtors	1,058	266
Accrued fees	894	168
Undrawn grant	221	265
Other debtors	–	100
Prepayments	2,017	2,051
HM Customs and Excise (VAT)	590	756
Staff debtors	218	182
	4,998	3,788

Other debtors 2001–2002 represented a deposit on account with Ofgem’s solicitors. The deposit was utilised during the the year to settle Ofgem’s liability in a legal matter.

Staff debtors represent loans outstanding, of which £87,000 relates to season ticket loans for 106 employees; and £131,000 relates to housing advances in respect of 8 employees.

Trade debtors of £1,058k includes a bad debt provision of £51k

The 2001–02 comparator figures have been restated to include undrawn grant.

13. Cash at bank and in hand

	2002–2003 £000	2001–2002 £000
Balance at 1 April	7,705	3,499
Net cash (outflow)/inflow	(6,428)	4,206
Balance at 31 March	1,277	7,705
The Office of HM Paymaster General provides a current account banking service. The following balances were held:		
Paymaster General	1,248	7,683
Overdraft at commercial banks	–	–
Cash at commercial banks and cash in hand	29	22
	1,277	7,705

Included in cash at bank and in hand on Schedule 3 is £1,277,000 (£1,248,000 at the Paymaster General and £29,000 at commercial banks).

The balance at 31 March comprises:

Cash due to be paid to the Consolidated Fund £1,277,000.

14. Creditors

	2002–2003 £000	Restated 2001–2002 £000
Amounts falling due within one year:		
Trade creditors	1,488	2,014
Staff creditors	7	15
Deferred licence fees	1,071	1,105
Accruals	2,710	403
	5,276	3,537
Cash balance payable to the Consolidated Fund:		
Surplus A-in-A	1,926	8,398
Actual Surplus to be surrendered	221	265
	7,423	12,200

The 2001–02 comparator figures have been restated to include actual surplus to be surrendered.

15. Provisions for liabilities and charges

	Early Retirement £000	Severance £000	Pensions £000	Other £000	Total £000
Balance at 1 April 2002	1,194	–	246	12,534	13,974
Provided in the year	612	1,328	62	285	2,287
Provision utilised in the year	(287)	–	–	(1,256)	(1,543)
Unwinding of discount	71	–	–	463	534
Net movement in year	396	1,328	62	(508)	1,278
Balance at 31 March 2003	1,590	1,328	308	12,026	15,252
Of which:					
Payable within one year	330	1,328	–	1,372	2,835

The Early Retirement provision relates to the costs of pensions for individuals who have retired early. Ofgem meets the cost of pension payments from its resources until the individual reaches normal retirement age. The provision has been discounted, with the undiscounted amount being £2,373,000. Additional provision has been made for staff who were made redundant at Ofgem laboratories at Leicester, see note 20.

The Severance cost provision relates to the redundancy costs incurred in restructuring Ofgem. All of these costs are expected to be incurred within 12 months of the balance sheet date and have therefore not been discounted.

The Pensions provision is in respect of the unfunded pension liabilities which fall to Ofgem for the previous Directors General and current Chief Executive.

Other provisions include the onerous costs of a building lease. The provision will be utilised over the remaining 12 years of the lease term. Included in Other provisions is the reverse premium received on acquiring the lease for Ofgem's new headquarters in London. The remainder of the reverse premium of £4,505,128 will be utilised on a straight-line basis over the lease term up to the first break in the lease, being 23 June 2017. Also included is an amount of £189,000 which relates to other estimated costs of outsourcing the Leicester services.

16. Revaluation reserve

	2002–2003 £000
Balance at 1 April 2002	336
Arising on revaluation during the year (net)	(174)
Realisation on disposal of fixed assets	(84)
Transferred to General fund in respect of realised element of the Revaluation reserve	(16)
Balance at 31 March 2003	62

The Revaluation reserve reflects the unrealised element of the cumulative balance of indexation and the revaluation adjustments of tangible fixed assets.

17. Reconciliation of net operating cost to changes in General fund

	2002–2003 £000	2001–2002 £000
Net operating cost for the year (Schedule 2)	(221)	(352)
Income not appropriated-in-aid paid to the Consolidated Fund	–	–
	(221)	(352)
Parliamentary Funding:		
Supply for 2001–2002	265	–
CFER yet to be surrendered:		(8,398)
Excess A-in-A	290	
Excess cash to be CFER'd	1,636	
Surplus written off the grant for 2001–2002	–	87
Transfer to General fund in respect of realised element of Revaluation reserve	16	7
Non-cash charges:		
Cost of capital	(490)	(129)
Auditor's remuneration	45	42
	(2,090)	(8,391)
Net decrease in General fund	(2,311)	(8,743)
General fund at 1 April	(8,152)	591
General fund at 31 March (Schedule 3)	(10,463)	(8,152)

18. Capital commitments

	2002–2003 £000	2001–2002 £000
Contracted capital commitment (excluding VAT) for which no provision has been made	–	–

19. Commitments under operating leases

At 31 March 2003 Ofgem was committed to making the following payments during the next year in respect of operating leases expiring:

	2002–2003			2001–2002		
	Land & buildings £000	Other £000	Total £000	Land & buildings £000	Other £000	Total £000
Within one year	–	7	7	–	–	–
Between 2 to 5 years	–	70	70	–	59	59
After 5 years	6,400	–	6,400	4,525	–	4,525
	6,400	77	6,477	4,525	59	4,584

20. Outsourced technical services

Leicester technical services were outsourced to SGS (UK) Ltd. in January 2003. Ofgem still retains the liability for the statutory services where costs cannot be recovered. SGS (UK) Ltd. will charge Ofgem to recover their costs of delivering these services. The financial effects of outsourcing the technical services directorate in Leicester are as follows:

(a) Effects on the Operating Cost Statement

	Note	2002–2003 £000	2001–2002 £000
Administration costs			
Staff costs	2	15,480	12,699
Staff costs outsourced		(791)	(971)
		14,689	11,728
Other administration costs	3	22,882	24,835
Other administration costs outsourced		(144)	(235)
		22,738	24,600
Operating income	4	38,281	37,412
Operating income outsourced		(1,345)	(1,519)
		36,936	35,893

(b) One off costs

2002–2003
£000

Initial salary contributions	47
Severance costs	1,185
Contracted retention fee	135
	<hr/>
	1,367
	<hr/>

One off costs are not included in the costs outsourced shown in section (a) above.

(c) Ongoing income and costs for Ofgem

SGS (UK) Ltd. will be charged rent for the use of Ofgem's premises up to a maximum of seven months from the commencement of full operations.

The costs associated with the site in Leicester will continue to be met by Ofgem until it is sold. This is planned to be completed in 2003–2004.

Ofgem retains the pension liability costs for transferred individuals who retire before 31 January 2004. A provision has been made for pensions where staff have been made redundant (see note 15) and a contingent liability has been identified for remaining staff (see note 22).

Ofgem will continue to reimburse SGS (UK) Ltd for work performed on gas meter disputes and electricity meter disputes as costs for these services cannot be recovered by SGS (UK) Ltd.

Ongoing costs described above are not included in the costs outsourced, shown in section (a), above.

21. Other commitments

Ofgem had not entered into any non-cancellable contracts (which are not operating leases) as at 31 March 2003.

22. Contingent liabilities

Statutory examining and testing services provided by Ofgem laboratories in Leicester were outsourced to SGS (UK) Ltd. during the year.

Some costs of this change, particularly redundancy and continuing pension liability, have fallen to Ofgem and a provision has been made for these amounts. However, in addition, Ofgem is liable for costs that may arise up to 31 January 2004. Ofgem has no continuing liability after that date. An amount of £0.7million has been identified as a potential liability.

23. Losses and special payments

2002-2003
£000

Losses Statement

Special Payments

Total cases 2

102

Ofgem made two payments defined as special payments under Government Accounting to the total value of £102,000.

24. Related party transactions

Ofgem collected £13.067m from licence fee payers, on behalf of the DTI, in respect of the costs of energywatch. These were transferred in full to the DTI. A contribution of £50,000 was also made by DTI towards a court case.

Ofgem has had a small number of transactions with other government departments and central government bodies.

None of the Authority members, key managerial staff or other related parties has undertaken any material transactions with Ofgem during the year.

25. Post balance sheet events

There were no reportable post balance sheet events at 31 March 2003.

26. Notes to Schedule 5

Ofgem's capital is employed exclusively for administrative purposes and its attribution to objectives is in the same proportion as the related gross administrative cost. Where costs cannot be directly attributed to each objective, they have been classed as overhead and attributed based on the underlying cost driver, in accordance with the Department's normal management accounting practices.

Ofgem's objective of Securing Britain's gas and electricity supplies has no staffing or resource separately attributed to it and is achieved via either effective regulation of monopolies or competition in the market place. Consequently, no costs or income have been allocated to it.

The 2001–2002 comparator figures have been re-stated to the (corporate plan) objectives for 2002–2003.

27. Derivatives and other financial instruments

Ofgem's activities are largely non-trading, Ofgem is therefore not exposed to the degree of financial risk faced by business entities. Ofgem has no independent powers to borrow or invest surplus funds. Except for insignificant forward purchases of foreign currency, financial assets and liabilities are generated by day to day operational activities and are not held to change the risks facing Ofgem in undertaking its activities.

Liquidity risk

Ofgem operates on a full cost recovery basis and is financed primarily by licence fee income. Specific and limited areas of operation are, for reasons of public policy, directly funded by grants of supply approved annually by Parliament. The extent to which licence fee and other income may be raised and retained for use in operations (Appropriated in Aid) is also approved by annual vote of Parliament, along with further grants of supply needed to meet Ofgem's Net Cash Requirement. Ofgem is not exposed to significant liquidity risks.

Interest rates and foreign currency risks

Ofgem is not exposed to any significant interest rate or foreign currency risks.

Fair values

Set out below is a comparison by category of book and fair values of Ofgem's financial assets and liabilities:

	Book value £000	Fair value £000	Basis of valuation
Primary financial instruments			
Financial assets			
Cash at bank	1,277	1,277	–
Financial liabilities			
Provisions	15,252	15,252	see note (a)

Notes:

- a) As at 31 March 2003 the fair value was the same as the book value since, in the recent calculation of book value, the expected cash flows were discounted by the HM Treasury discount rate of 6 per cent in real terms.

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