

Foreword

In September 2003, Ofgem¹ invited views from industry, customers and customer groups on our 2004-2007 Corporate Strategy. The present document sets out seven more developed themes of the Strategy for a further round of consultation, with a deadline for responses of Wednesday 4th February 2004.

We have listened carefully to the views already expressed. Where we have not taken up suggestions we have, wherever possible, tried briefly to explain why. The final **Strategy** will be published in late March, when we will also launch a consultation on our detailed **Corporate Plan**. That plan will set out in more detail the workstrands, projects and resources required to deliver the Corporate Strategy. The final Corporate Plan will be published in May 2004.

We want the decisions we take to be fully informed by the views of all affected parties. We particularly welcome new evidence and arguments that challenge our policies. We commit to testing our policies in an open and rigorous fashion against the evidence and arguments provided, and to explaining the approach we have chosen.

This draft Strategy builds on Ofgem's reputation for expertise, professionalism, delivery and independence. We are determined to build on the successes of the past and to preserve our independence as a regulator. And we are

convinced of the need to demonstrate a sense of continuity, coherence, and predictability in the way we regulate.

There are, however, major changes that face the businesses we regulate. Government policy, particularly with regard to the environment, brings fresh challenges that will require major investment in our gas and electricity industries, in order to:

- help deliver a low carbon economy
- allow for rising gas imports, and
- deliver sufficient electricity generation to maintain security of supply, particularly as older plant is retired and demand continues to rise.

Significant new European environmental legislation to curb emissions will also have an increasing impact on the markets we regulate. There are already signs of upward pressure on wholesale electricity prices as a result of this legislation. Such pressure is likely to remain.

Against this background, we will continue to develop the incentives on companies to improve their efficiency and to compete effectively. This will help to make sure that customers are able to get good value for money when buying gas and electricity. We will also continue to encourage customers to lower their fuel bills by switching their energy supplier.

¹ Ofgem operates under the direction and governance of the Gas and Electricity Markets Authority, which makes all major decisions and sets policy priorities for Ofgem.

Foreword (continued)

Themes

The draft Strategy has seven themes that represent our priorities for the coming three years. They reflect our strong desire for continuity, coherence and predictability in the way we discharge our statutory responsibilities. They also take full account of the new challenges we face.

Better regulation

Our broad approach will be guided by the key principles of **better regulation**: proportionality, accountability, consistency, transparency and targeting. Specifically, we shall:

- consult widely on the need for, and the nature of, regulatory action, including preparing Regulatory Impact Assessments (RIAs) for all important proposals
- continue to withdraw from regulating the energy industry where we believe this is in the best interests of customers, for example, by removing certain licence conditions and/or by making greater use of industry codes of practice
- ensure that, where regulation is necessary, it is proportionate and effective, for example, by satisfying ourselves of the need for energy-sector specific regulation, and
- make vigorous use, wherever necessary, of the enforcement powers we have under energy and competition legislation.

Our organisation

We must continually strive to become more efficient and to improve the way we work. Following the Government's decision to separate the functions of the Chairman of the Authority and Chief Executive, the new team has the opportunity to take a fresh look at the organisation.

The Chief Executive is now undertaking a review to ensure that we will be able to make the best use of our resources to deliver our strategy and to meet the new challenges we face. We shall also encourage all Ofgem staff to think about how we can improve the way we work and meet our commitment to better regulation.

We look forward to your comments by the deadline of Wednesday 4th February 2004.



Sir John Mogg

**Chairman of the Gas and Electricity
Markets Authority**



Alistair Buchanan

Chief Executive of Ofgem

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1. Introduction

1.1 Even as this consultation is launched, Ofgem is facing a significant workload.

- The new electricity distribution price controls are due for introduction in April 2005 and much detailed analysis and consultation is needed before then.
- We are investigating the blackouts that occurred in August and October 2003.
- We are preparing now for the modernisation of European competition laws in May 2004, and for new European gas and electricity legislation.
- We will undertake much of the detailed work associated with creating a competitive wholesale electricity market across Great Britain, the provisions of which are in the new Energy Bill currently going through Parliament.

1.2 We are now also assessing National Grid Transco (NGT) proposals to sell one or more of its gas distribution network businesses - proposals to which we will agree only if they will bring real benefit to customers.

1.3 These are just some of the issues we face, in addition to our normal activities. Many others will, of course, emerge.

1.4 We are keen to avoid any hint of complacency or unwillingness to embrace fresh ideas and new approaches. Nonetheless, we have clear statutory responsibilities laid down by Parliament,² within which we must operate at all times.



Ofgem's statutory responsibilities

- 1.5** Ofgem's principal objective is to protect the interests of consumers present and future, wherever appropriate by promoting effective competition. We must also have regard to:
- the need to ensure that all reasonable demands for electricity and, so far as is economical, gas are met
 - the need to secure that licence holders are able to finance their obligations, and
 - the interests of those people who are disabled or chronically sick, of pensionable age, living on low incomes, or living in rural areas.
- 1.6** We are also required to carry out our functions in the manner which we consider best calculated to:
- promote efficiency and economy
 - protect the public from dangers, and
 - secure a diverse and viable long term energy supply.
- 1.7** Furthermore, we must have regard to the impacts of the gas and electricity industries on the environment and to social and environmental guidance issued by the Government.

Themes

- 1.8** Against this background, the remainder of this consultation paper identifies seven themes for the 2004-2007 Strategy. Some are new, and others are well-established, underlining our desire to combine continuity of regulatory approach with new thinking to meet fresh challenges.
- 1.9** We want to know if we have identified the right themes, and, within them, the best way of achieving our objectives. The deadline for comments on the draft Strategy is Wednesday 4th February 2004. Responses, which will be published on the Ofgem website unless otherwise requested, should be sent to:
- Chris Chapman, Head of Planning
Ofgem, 9 Millbank
London SW1P 3GE
- Email:
chris.chapman@ofgem.gov.uk
- 1.10** At the same time as the final text of the Corporate Strategy is published in March 2004, the first draft of the Corporate Plan will be launched for consultation.

² Ofgem's powers are provided for under the Gas Act 1986 and the Electricity Act 1989, as amended by the Utilities Act 2000. It also has enforcement powers under the Competition Act 1998.

2. Creating and sustaining competition

- 2.1** Where competition is established, we will make sure that it continues to work well for all customers. Where it is not established, we shall work to introduce and sustain it, wherever appropriate.

Wholesale markets

- 2.2** The wholesale electricity market in England and Wales has been highly competitive since the introduction of new electricity trading arrangements in March 2001. Some responses to the preliminary round of consultation called for Ofgem to withdraw further from regulation and monitoring, reduce its role in industry governance, and remove what respondents see as unnecessary licence conditions.
- 2.3** The Energy Bill introduced into Parliament in late 2003 will extend the electricity trading and transmission arrangements in England and Wales to Scotland, creating common arrangements across Great Britain. Ofgem is committed to devoting the resources necessary to implement a single electricity market across the whole of Great Britain in April 2005. Delivering a single market across Great Britain from April 2005 will also require the full co-operation of the energy industry.



2.4 Prices in the wholesale gas market in Great Britain have, for much of this year, been driven by prices in continental Europe, where competition is not yet fully developed. In addition to their impacts on gas customers, gas prices are an increasingly important influence on electricity prices as gas-fired power stations have a significant share of the generation mix. A significant challenge for Ofgem is to encourage reforms necessary to increase competition in European gas markets.

2.5 Ofgem will continue to place strong emphasis on effective wholesale market monitoring. Monitoring acts as a deterrent against forms of behaviour by companies that could harm customers, for example heightening threats to security of supply, or damaging competition. As industry structures and company strategies evolve, and external influences such as environmental legislation change, targeted and effective monitoring of these markets is crucial.

2.6 Our current investigation into recent high wholesale gas prices has highlighted the need for ongoing monitoring. The special features of energy markets, such as the need for supply and demand to be matched over short timescales, together with our established expertise, make Ofgem the most appropriate competition authority to undertake this work.

2.7 If evidence of abuse is found, we shall not hesitate to take vigorous action against companies, by using our competition or regulatory powers as appropriate.

2.8 As markets evolve, companies and customers are able to propose changes to the industry agreements that sit at the heart of the electricity and gas markets. Ofgem will approve or reject these proposals as quickly and efficiently as possible, and explain its decisions clearly.

2.9 Ofgem will also seek to improve access to information relating to the wholesale markets, particularly in relation to offshore gas production, notably through its work with the Department of Trade and Industry (DTI).

Retail markets

2.10 Ofgem took a significant step back from regulating the retail markets in electricity and gas by removing the remaining retail price controls in March 2002. Some respondents to the preliminary consultation suggested that we should withdraw even further from regulating and monitoring retail markets, and remove what they see as unnecessary licence conditions. Others, notably customers and customer groups, did not support such deregulation, and claimed that slowing switching rates and the rising profit margins in supplying domestic customers were evidence of the energy market losing its competitive edge.

(Retail markets continued)

2.11 Our commitment to withdrawing from regulation where appropriate is strong, but retail competition at the domestic level is relatively new and the structure of the industry is still evolving. In line with our commitment to better regulation, we shall continue to identify possible improvements in the way the market works by, for example, improving the process for customers to switch from one supplier to another, particularly by scrutinising the way suppliers exercise their limited power to object to their customers switching. Effective monitoring and evaluation of behaviour in these markets is also likely to remain a key component of our policy. Specific regulation of certain aspects, such as marketing, will probably be necessary, given continuing customer concerns. Nevertheless, we shall ensure that any such monitoring is effective and targeted so that:

- all customers, particularly the most vulnerable, have access to the benefits of competition, and
- all customers are aware of their right to switch supplier, and are able to exercise this right easily and quickly.

2.12 We will work effectively with the customer body, energywatch, for example in dealing with customer concerns and providing tools for customers to learn about the benefits of switching - building on such initiatives as the 'Switched On' educational resource for schools.

2.13 Again, as part of our commitment to better regulation, and in order to retain and improve customers' confidence in the competitive market, we intend to examine closely how suppliers market their services. We will do this by focusing on customers' personal experience of dealing with companies. We will also maintain a close dialogue with representatives of industrial, commercial and domestic customers. We welcome views on any aspect of retail market regulation that could be improved. In some areas, for example in respect of protection of vulnerable customers and provision of consumer information, further targeted regulation may be required. In other areas, we may find simplification, or even ending, of Ofgem's involvement to be in customers' best interests.

Industry structures


- 2.14** The structure of the gas and electricity industries continues to evolve through mergers, acquisitions and divestments. Some respondents to our preliminary consultation expressed concern about the introduction of competition in metering and connections, although others stressed its benefits. Some respondents emphasised the need to consider the effects of recent mergers. Vertical integration in electricity, and levels of wholesale prices and market power in the gas market, were also causes for concern.
- 2.15** We continue to assess structural developments in terms of the impacts they have on customers and competition. Where necessary, we have also taken action to develop structures that support competition in areas such as electricity generation and gas storage.
- 2.16** Effective competition is of critical importance. Mergers and acquisitions must not lead to a degree of consolidation that could result in a substantial lessening of competition. Where regulated network businesses are involved, mergers may also reduce, or even eliminate, our ability to use comparative information to improve efficiency when setting price controls.
- 2.17** Nevertheless, it is important that companies and capital markets retain the freedom to seek and adopt innovative and more efficient corporate structures, where this continues to support effective competition. Mergers and other corporate restructurings can also produce synergies and efficiency savings that will directly benefit customers. We shall keep the structure of these markets under review to ensure that competition remains effective.
- 2.18** This will involve:
- assessing merger and acquisition proposals in order to advise the relevant competition authorities
 - examining whether structural changes to introduce competition or to make it more effective would be in customers' best interests, and
 - developing the ways we analyse the incentives that result from consolidation and vertical relationships, and continuing to monitor companies' behaviour in these markets.

Local gas distribution

- 2.19** NGT owns and operates the national gas transmission system in Great Britain and the national electricity transmission system in England and Wales. In addition, the company also owns all eight local gas distribution network (DN) businesses in Great Britain, and has proposed the sale of one or more of them. Any sale would require the Authority's approval.
- 2.20** Ofgem has already identified potentially significant benefits for customers from more diverse ownership of the DNs. However, a number of concerns have been expressed by industry and by some customers about the potential costs and benefits of the proposals. We will work with NGT and other industry participants to develop a better understanding of the customer benefits and costs associated with a sale. Over the next three to four months, we shall also undertake significant work to develop the regulatory, commercial and operational arrangements that would support a DN sale. The Authority intends to reach a decision in April 2004 as to whether approval in principle should be given.

Metering and connections

- 2.21** Competition in providing new connections to gas and electricity networks has only recently been introduced. Competition in the provision of meters and metering services is still in the early stages of development. The industrial and commercial metering market is competitive and competition is beginning to emerge in domestic metering. Nevertheless, we must ensure that the necessary industry processes are in place to support competition. In setting the price controls for electricity metering, as part of the distribution price control review, we shall assess how effective competition is and where controls are still needed. We are also sensitive to the calls for more to be done to encourage innovative metering, given the potential for its social and environmental benefits. We shall work with the industry to identify any barriers that need to be overcome.



3. Regulating network monopolies

- 3.1** Ofgem regulates the level and structure of the prices charged for using the monopoly gas and electricity networks. The price controls on electricity distribution network operators are currently under review, with new five year controls due to start in April 2005. We intend to align the timing of the gas and electricity transmission price controls so that new controls for both networks across the whole of Great Britain will take effect from April 2007. We are introducing separate controls for the individual gas distribution networks and have proposed that the next gas distribution price control should take effect from April 2008.
- 3.2** Across the network sectors, we remain committed to incentive regulation as the best way of protecting the interests of consumers.
- 3.3** We shall, wherever practical, focus on regulating outputs rather than inputs ie on what companies deliver in terms of service to customers, rather than on how they deliver it. Companies must meet their statutory and licence obligations. If they do so while out-performing price control targets, they should earn higher returns. Conversely, companies that do not meet their obligations run the risk of financial penalties, and those which under-perform should earn lower returns.

(Regulating network monopolies continued)

3.4 Incentive regulation works best when the regulator establishes a clear, transparent and predictable framework that is not too rigid in the face of uncertainty. This allows the companies room to manage and innovate without the regulator being too prescriptive or intrusive.

3.5 Within this framework, our approach to network regulation continues to evolve, reflecting the desire to:

- improve incentives to invest while promoting efficiency
- make network operators more responsive to the changing needs of their customers
- maintain security of supply, and
- meet new challenges such as renewables and distributed generation.

Incentives to invest

3.6 Respondents to our preliminary consultation agreed that significant network investment will be needed to accommodate gas imports and renewable generation. We are already working on improved investment incentives on electricity distribution network operators to encourage the growth of distributed generation, for electricity transmission in respect of new renewable generation, and gas transmission to respond to major investments in Liquefied Natural Gas (LNG) import terminals and new interconnectors. We also remain committed to reforming

arrangements for rights to gas network exit capacity to make them more responsive to customer demands.

3.7 In gas transmission, there are stronger financial incentives on NGT to invest in response to signals from customers of demand for new entry capacity. These new arrangements are designed to provide NGT with better information and incentives so that it can respond quickly to customers' changing requirements.

3.8 In electricity transmission, we will seek to improve the information available to NGT on customer demand for additional network capacity, and the incentives on NGT to respond. This will be particularly important in relation to increased renewable generation to meet the Government's environmental objectives. Many renewable generation projects are likely to be in geographically remote areas and may well require significant transmission investment to allow them to transport their power to customers.

3.9 Future price controls on electricity transmission will need to provide incentives for investment to be undertaken efficiently. But some investment is required now and, where this was not taken into consideration in setting the current price controls, we are developing, and already consulting on, mechanisms to deal with this efficiently and effectively.

3.10 In electricity distribution, the new incentive framework we have proposed is intended to encourage electricity distribution companies to invest in the reinforcement of their networks, and to develop and apply innovative solutions to lower the costs of doing this. This is necessary to accommodate new renewable and Combined Heat and Power (CHP) generators. We have also proposed reforms to the arrangements for distribution charges which are primarily intended to provide fairer charges for new generators.

3.12 To inform the electricity distribution price control, we are conducting research into customers' attitudes towards quality of supply, and their willingness to pay for improvements in, for example network reliability and resilience. One specific objective will be to introduce clearer incentives for improved performance in the event of severe weather.

3.13 In gas distribution, we intend to introduce a new quality of service incentive scheme for implementation in April 2005.

Responsive to customers

3.11 We will continue to protect customers' interests through measures in the monopoly network price controls that encourage improvements in efficiency. Since privatisation, such measures have proved extremely effective in reducing the charges paid by customers. We are also considering incentives for the network operators to improve their service to customers. This will be an increasingly important theme of future price controls. In electricity distribution, our approach has focused on the number and duration of interruptions to customers' supply. As part of the current price control review, we are assessing the need for additional measures of output service performance, and how the incentives can be improved.

System Operation

3.14 NGT currently performs the role of system operator for the electricity transmission system in England and Wales and the gas transmission system in Great Britain. Under the proposed arrangements for a single electricity market, NGT will be responsible for operating the system for the whole of Great Britain. The system operator is responsible for balancing supply and demand in the very short term in response to shocks, such as sudden increases in demand or sudden loss of production, and in managing network constraints.

3.15 Successive schemes have been successful in driving down the costs of system operation in gas and electricity while maintaining security of supply. We will continue to review and develop these schemes and seek to put in place longer-term incentive arrangements that provide a stable framework to allow NGT to invest, innovate, and reduce costs.

4. Helping protect security of Britain's energy supplies

4.1 Security of our energy supplies is of central importance to domestic, industrial and commercial customers. Since privatisation, security of supply has been maintained at a high level by historic and international standards, while the quality of supply in electricity has been improved. There have been no interruptions due to insufficient generating capacity or gas supplies, and the reliability of networks remains high. The recent blackouts in the USA, Italy, and here in Great Britain have, however, provided timely reminders against any complacency.

4.2 Security of supply requires:

- sufficient electricity generation and gas production, together with import and storage capacity, to meet peak demands
- sufficient network capacity to transport gas and electricity to customers, and
- effective balancing arrangements to ensure that the system operator can keep the system in balance over the short-term.

Experience in California has also demonstrated that security of supply can be threatened by market abuse.



Informing the debate

- 4.3** A major theme emerging from some responses to the preliminary consultation was a concern about the ability of existing arrangements to maintain security of supply. Some respondents expressed the view that competitive markets alone could not be relied upon to deliver sufficient security of supply, particularly in electricity, suggesting that capacity payments should be re-introduced.
- 4.4** The approach Ofgem has pursued for several years is based on the belief that a combination of competitive wholesale and retail energy markets, and appropriate incentive arrangements for network operators, is the best way of delivering security of supply.
- 4.5** An important part of our role is to contribute to an informed and reasoned policy debate. We shall provide reliable information and analysis to show how competitive energy markets and effective network regulation will continue to promote security of supply.
- 4.6** In the Joint Energy Security of Supply (JESS) working group, the DTI and Ofgem assess supply security and, every six months, publish forward-looking indicators, such as the margin of generation capacity over peak demand. We shall also report on security of supply retrospectively twice a year, setting out levels of security achieved, relevant events and any lessons learned.

- 4.7** There are important trade-offs between the costs and benefits of spending more to improve security of supply. No energy supply system can deliver absolute security at all times, and we must avoid the risk that customers are forced to pay excessive costs to 'gold-plate' infrastructure. We shall assess the impact of policy initiatives on security of supply through our Regulatory Impact Assessments (RIAs).

Making markets work

- 4.8** There is clear evidence that markets are working well in delivering security of supply. There has been significant investment in Great Britain's energy sector since privatisation, and particularly in recent years. In late 2003, companies brought significant amounts of mothballed electricity generation back on to the system in response to higher prices because of lower forecast reserve margins during the winter months.
- 4.9** The gas market has also responded to the challenges posed by declining UK gas production. Companies have announced plans to invest in new storage facilities, new LNG import terminals, and new pipelines to import gas from Europe. There can never be any room for complacency, and, in addition to providing reliable information, Ofgem has the following key responsibilities in relation to the wholesale markets.

(Making markets work continued)

- Acting within our statutory responsibilities and other relevant obligations, we must approve appropriate changes to the market rules and industry codes that improve security of supply.
- We must seek to ensure that companies behave in a manner consistent with the market rules, their licence obligations and general competition law.

4.10 With DTI, we shall continue to monitor security of supply indicators to see that markets are delivering the investment required. Potential problems and possible improvements to the existing arrangements, including rule changes that would improve security of supply, will be identified. However, we do not have any new evidence or arguments that suggest that capacity payments are necessary to promote security of supply or would be cost-effective at increasing security of supply.

Network Investment

4.11 Adequate network capacity is needed to transport available supplies to customers, and Ofgem's activities focus on three areas:

- improving the information available to network operators on which they base their assessment of the need for new investment,

- improving the financial incentives on network owners to invest quickly and efficiently to meet these needs, and
- improving the incentives to maintain the quality of supply on their networks.

4.12 Innovative new arrangements are now in place or being actively considered. They include auctioning of long term rights to gas network entry capacity to improve the information available to national pipeline operator, NGT, about the need for new capacity. Arrangements such as these enhance security of supply by reducing the risk of network constraints and reducing the time it takes NGT to deliver extra capacity. It will remain an important aspect of our work to identify other areas where the provision of information can be improved.

4.13 For electricity, the challenges of accommodating significant volumes of renewable generation over the next few years will require us to work with all stakeholders. We shall improve the incentives on the transmission companies and the distribution network operators not only to invest efficiently in extra capacity but also to improve the quality of information on which such investment decisions are based.




5. A leading voice in Europe

Influencing and shaping the debate

- 5.1** European energy markets and EU regulatory policy have an increasing influence on energy markets and customers in Great Britain. Our broad objective remains to assist in developing genuinely competitive European electricity and gas markets as quickly as is feasible, bringing price and security of supply benefits to customers in Great Britain.
- 5.2** Gas prices in Great Britain are already heavily influenced by prices in continental Europe. The England–France interconnector plays a significant role in the electricity market, particularly at peak periods during winter. A number of new gas pipelines and LNG import terminals are planned that will strengthen the commercial and physical links between the gas markets in Great Britain and continental Europe. New electricity interconnectors have also been proposed.
- 5.3** New EU legislation, specifically for gas and electricity but also dealing with environmental policy, will require implementation in the next year or so. Proposals on security of supply have also recently been made. This legislation will have a significant impact on the way we regulate gas and electricity markets in Great Britain. Of even greater long-term significance will be the new regulatory machinery it creates at the European level.

(Influencing and shaping the debate continued)

- 5.4** Many respondents to the preliminary consultation emphasised the need for Ofgem to become more closely involved in shaping and influencing the EU's liberalisation debate and agenda. We have responded to that call. Our clear objective going forward will be to engage more fully with other EU regulators and the European Commission.
- 5.5** Ofgem is already an active member of the Council of European Energy Regulators (CEER) and has worked closely with the DTI to make sure that the rapidly-emerging energy legislation is consistent with Great Britain's needs. The European Commission has very recently established an advisory group of energy regulators. In providing technical assistance, this group will play a fundamentally important role in the exercise of the Commission's regulatory powers. It must have the resources and expertise to provide timely and credible advice, and actively to consult with the market on its work. That in turn will demand a significant investment of resource and expertise from Ofgem in the coming years.
- 5.6** More generally, we shall work to influence key Member States' implementation of European legislation and regulation to ensure that there is effective access to continental gas and electricity networks, given an increasing reliance on them for security of supply. We shall also underline that, for Great Britain, markets deliver security of supply more effectively than centralised arrangements.
- 5.7** Many of the companies active in Great Britain's energy markets have significant interests elsewhere in Europe or beyond. Our monitoring of ownership and market structures will be essential to prevent market liberalisation efforts from being undermined.



6. Helping protect the environment

- 6.1** In 2003, the Government issued an Energy White Paper to outline its objectives for energy policy and set the UK on a course to reduce carbon dioxide emissions by 60 per cent by 2050. A key element in delivering this commitment will be the EU's greenhouse gas emissions trading scheme.
- 6.2** Our statutory responsibilities include having regard to the social and environmental guidance from the Secretary of State, and to the broader environmental and social policy context in carrying out our work. That context includes, in particular, the Climate Change Programme, designed to implement the UK's Kyoto commitments, and the Sustainable Development Strategy. We also have an important role to play in administering major Government programmes designed to achieve these targets and to improve domestic energy efficiency.
- 6.3** In August 2002, Ofgem established a senior-level external group to provide advice on Ofgem's environmental work. Its members include senior industry figures, representatives of green groups and academics. The purpose of the Environmental Advisory Group is to advise Ofgem on priorities for its environmental work.

The low-carbon economy

- 6.4** Respondents to the preliminary consultation underlined the importance of Ofgem encouraging the delivery of future environmental policy in a form compatible with competitive energy markets.
- 6.5** Our aim will be to encourage the achievement of environmental improvements in ways which secure good value for money for customers. An important role for Ofgem will be to advise Ministers, on this basis, on the design and implementation of emissions trading schemes - not only the EU-wide greenhouse gas emissions trading scheme, but also schemes for sulphur dioxide and oxides of nitrogen.
- 6.6** There are clearly major challenges for the electricity networks to accommodate and make use of new renewable and CHP generation in an efficient manner. The implications for the electricity transmission and distribution systems of increased renewables in the generation mix will be of major importance in future price controls. Putting appropriate incentives in place to meet these challenges will be a significant element of future reviews for distribution networks and, in the slightly longer term, for transmission networks.
- 6.7** With the DTI, we will also need to develop a licensing scheme for off-shore transmission cables to connect off-shore renewable generation to the on-shore transmission network.

Environmental Action Plan

- 6.8** Ofgem's Environmental Action Plan has been reviewed annually since its publication in 2001. Within that plan we shall take forward several significant initiatives.
- 6.9** We will work to improve customers' awareness of the environmental consequences of their energy use. Here we shall co-operate with DTI in the implementation of EU requirements for disclosing to customers the sources of the electricity they consume. We will also explore with suppliers ways of making customers better informed about their energy use, for example, on bills, meters, websites or by other means, and evaluate whether, and if so how, such information influences customers' decisions.
- 6.10** We intend to pay particular attention to the results of the second survey on the quality of energy efficiency advice provided by energy suppliers to customers. We shall also update our green supply guidelines to take account of recent developments in the renewables market, and seek to have these offerings independently accredited.
- 6.11** More generally, we shall explore the potential for improving the ease with which customers can benefit from responding to prices by, for example reducing their use of electricity during peak periods when prices are high. We shall also study the potential for reducing losses from the electricity transmission and distribution networks.

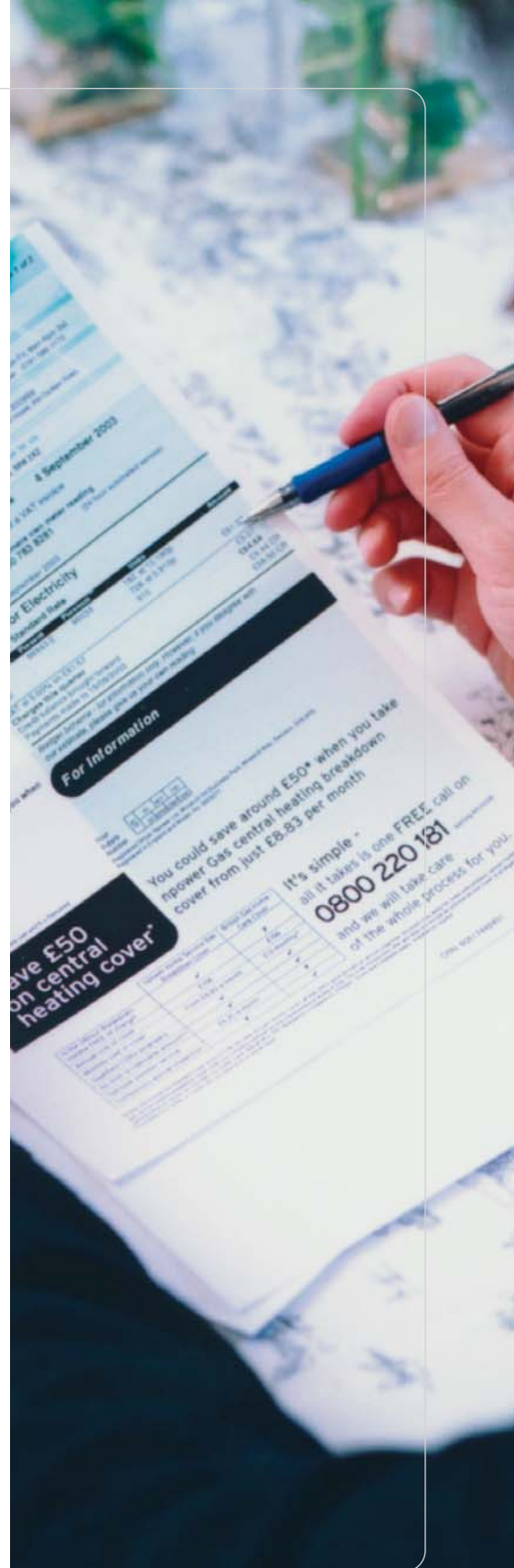
6.12 Ofgem will continue its important work to administer Government environmental programmes as efficiently and effectively as possible. These are the Renewables Obligation, the exemptions from the Climate Change Levy for renewables and CHP, the Renewables Guarantees of Origin, the Energy Efficiency Commitment and the CHP database.

Improving our analysis

6.13 Monitoring environmental outputs as part of the regulatory process is similarly of major importance. Our aim is to improve the environmental analysis that informs our own policy decisions, with the additional benefit of informing the wider environmental debate within Government. In this, our panel of environmental economists will play an important role. We shall also evaluate the recently announced pilot projects in which suppliers are permitted to offer domestic consumers energy service packages linked to longer term supply contracts than are possible under the normal 28-day rule arrangements.

7. Helping tackle fuel poverty

- 7.1** Ofgem has a key role to play in helping to tackle fuel poverty. It has a specific duty to have regard to the interests of vulnerable customers - those who are disabled or chronically sick, of pensionable age, living on low incomes, or living in rural areas. The social and environmental guidance from the Secretary of State for Trade and Industry includes specific reference to the Government's fuel poverty strategy that aims to eliminate fuel poverty among vulnerable households by 2010, and all households by 2016.
- 7.2** Ofgem's Social Action Plan is the framework within which we take forward our work in this area. First published in 2000, the Plan is reviewed annually. Good progress has been made on important issues such as debt and disconnection, payment methods, special services for vulnerable customers and energy efficiency advice. We shall take forward the Social Action Plan by seeking to:
- remove any barriers to innovative metering that could lower the costs to customers with prepayment meters
 - mount a joint initiative with other utilities and consumer groups on payment methods for customers on benefits
 - follow up earlier work with suppliers to reduce the incidence of self disconnection



- improve the provision of energy efficiency advice, particularly to those who would benefit the most, and
- monitor the effectiveness of companies' debt prevention strategies.


Energy prices

- 7.3** The number of households in Great Britain considered to be in fuel poverty has fallen from 5 million to 2.5 million between 1996 and 2001. A significant element of this change has been the fall in energy prices over the same period. The remainder is largely due to changes in incomes.
- 7.4** Even small increases in energy prices - and future increases could well be more significant - could, in the absence of any further action, see a large increase in the number of households in fuel poverty. This was a concern shared by many of the respondents to our preliminary consultation. Anxiety about the impact of rising energy prices on fuel poverty underlines the importance of maintaining our focus on competitive energy markets and efficient network operators.
- 7.5** Still more work with Government and industry will be essential to mitigate the effects of such pressures on the fuel poor, and to do all that we can to ensure that the full benefits of a competitive energy market are available to all customers. In developing new policies, we will pay particular attention, in our RIAs, to assessing their impacts on vulnerable customers.

Working with Government, industry and energywatch

- 7.6** With industry and energywatch, we will examine ways of avoiding customers getting into debt to energy suppliers and, if that is not possible, how such debt can be managed sensibly and efficiently.
- 7.7** We will also work more closely with energywatch to improve the way advice about the benefits of switching can be targeted to help vulnerable groups. We will look at ways of improving vulnerable customers' access to energy efficiency advice and to measures already available at no cost from suppliers that will enable vulnerable customers to have warmer homes.
- 7.8** The role of industry is key. We will look for ways of intensifying our co-operation to stimulate imaginative responses from companies to these challenges, and help them develop and follow best practice in relevant areas, for example in developing new tariffs for vulnerable customer groups. We will complete work already underway with suppliers and distributors on the provision of special services to particularly vulnerable customer groups.

7.9 The Government funds energy efficiency schemes to help reduce fuel poverty. We will encourage the Government to develop this support and, where relevant, use our expert knowledge of the sector to help support to be targeted to where it is most needed and can be most effectively used. We will also encourage Government to adopt cost-effective policies, particularly in relation to the delivery of its environmental objectives, so that costs may be mitigated in respect of vulnerable households.



8. Improving Ofgem's efficiency and effectiveness

8.1 A number of themes emerged from the preliminary consultation about the way that Ofgem works. Some respondents suggested that Ofgem's direct costs are too high and that it employs too many staff. It was also suggested that Ofgem should be more transparent in the way that it sets its priorities. Many respondents welcomed the introduction of RIAs but also suggested that more detail was needed on underlying assumptions, greater emphasis required on safety and environmental impacts, and that the industry should be more involved in identifying implementation costs.

8.2 Although Ofgem's direct costs remain relatively small - £36 million in 2003-2004 - in relation to the responsibilities we discharge, and the size of the companies and industries we regulate, we recognise that our work imposes costs on the industry and on customers. We are now reviewing the way we work and the way we organise ourselves in order to identify new ways to lower the costs of running Ofgem. But this must be achieved without reducing the quality of our work. We also impose indirect costs on companies, including those associated with engaging with, and responding to, Ofgem consultations. We will examine how to improve the consultation, reporting, and review processes.

(Improving Ofgem's efficiency and effectiveness continued)

- 8.3** The level of our costs needs to be seen in the context of our duties and workload. New areas of work, such as greater engagement in Europe and NGT's proposed sale of some gas DNs, will immediately place new pressures on available resources.
- 8.4** However, we recognise that it is the decisions that we take that have the most significant financial implications for the industry, rather than our direct or indirect costs. High quality decision-making based on sound, well-researched analysis, and the firm commitment to our statutory responsibilities and the principles of better regulation are therefore key. To do this, we shall need to attract and retain high quality staff, and bring best practice to all our functions.
- 8.5** We remain committed to delivering value for money and we shall regularly review the way we prioritise our work. As part of that commitment, we intend to spend no more in 2004-2005 than the £34 million proposed for that year in our March 2003 Corporate Plan, an eight per cent reduction from 2003-2004 in real terms.
- 8.6** We shall also continue to work openly and transparently, with consultation a key component of our decision-making process, and one that we will seek to improve, notably by making our publications more concise, clearer, and better focused. We shall seek to engage industry and customers in our RIA process, which is still under development, since industry and customers are often better placed to provide information on likely implementation costs. We want to base our decisions on the most reliable information, with supporting evidence and objective analysis.
- 8.7** The draft Corporate Plan that will accompany the final Strategic Plan in March will contain detailed deliverables and targets against which future performance can be assessed. The draft will also include a fresh look at the priorities we set ourselves within our statutory responsibilities. Where work is not essential, or is less time-sensitive, we will consider whether it can be abandoned or delayed.



9. Responses to the preliminary consultation

- 9.1** Respondents were asked to consider the following four questions:
- what are the key challenges that the industry will face over the medium term
 - how should the Authority deal with them
 - are there any new areas of work that the Authority should pursue
 - and are there any existing areas of work that should be given a higher priority, or stopped?
- 9.2** There were 43 responses from a range of companies, Government departments, customer bodies and think tanks. Responses, together with a summary, are available on the Ofgem website.³ A number of key points emerged.
- Security of supply is a priority, and some respondents called for capacity payments for electricity generators.
 - Greater Ofgem involvement in influencing and steering the European debate would be welcomed.
 - There was general agreement that significant network investment would be necessary to accommodate more gas imports and renewables generation. Investment incentives were seen as key with positive feedback on Ofgem's approach, for example, new LNG terminals and our work on distribution and embedded generation issues.

³ <http://www.ofgem.gov.uk>

(Responses to the preliminary consultation continued)

- Ofgem needs to think about the impact of rising prices on fuel poverty and do more to help the fuel poor benefit for example by allowing customers in debt to switch supplier.
- The introduction of RIAs was universally applauded but more details of underlying assumptions were requested, more industry involvement sought in the early stages to identify costs to industry, and more emphasis placed on safety and environmental impacts.
- Ofgem needs to prioritise better, allocate resources accordingly, and be more transparent in how it prioritises. Some respondents think that Ofgem's costs and staff levels are too high.
- Ofgem should step back from detailed regulation of competitive markets by removing redundant licence conditions and reducing its role in industry governance and monitoring.
- Ofgem needs to be vigilant about the effects of mergers and concerns about vertical integration in electricity and wholesale prices and market power in gas.
- Ofgem's work on metering competition needs to be reviewed with some companies calling for a re-think while others stressed the benefits of competition and the need to do more to support innovation.