



Promoting choice and value for all  
gas and electricity customers

## Ofgem Corporate Strategy and Plan 2005-2010



The Office of Gas and Electricity Markets

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## Foreword

### Introduction

We anticipate that our principal focus over the next 12 months will be on work to review gas prices (both in Britain and the rest of Europe) and finalise arrangements for the sale of gas distribution networks and associated industry restructuring, as well as to press for further action on European liberalisation and pursue an active programme on social matters.

During the year we will also turn our attention increasingly to developing offshore renewables regulation, the forthcoming review of the Renewables Obligation and promoting energy efficiency. Finally, we will be preparing for the major gas and electricity transmission and gas distribution network price reviews due in 2007 and 2008, respectively.

This activity will take place against a wider industry, public policy and regulatory backdrop. As an organisation, we need to be both intellectually challenging, for example in our review of the RPI-X formula for the 2009 distribution price review, and be prepared to challenge ourselves, for example in how we meet the increasing demands of better regulation.

### Our seven themes: consistent and clear

There was a positive response from the consultation to retaining the seven themes, which were seen as providing the right policy focus. Continuity in our work themes also helps promote regulatory consistency and stability. Some consultees doubted, however, that there was a clear link between the themes while others argued that they should be prioritised. This is not our view. We believe there are clear links between the themes and 'joined up' regulation enables us to achieve consistency. A useful example of this is the

project that will merge the Scottish electricity market with that of England and Wales, described in detail within the report.

### Our working environment

In preparing this Corporate Strategy and Plan, we have been very alive to calls for us to operate more smartly, in particular to adhere to 'better regulation' principles in all that we do. The 2005 Budget, and associated Hampton and Arculus Reports, have re-affirmed this approach. As an organisation, we are keen to demonstrate clearly that we have understood the better regulation challenge: our decisions to revisit the large and burdensome supply licence conditions and not to undertake a full process for the Scottish transmission companies' interim price reviews are good examples.

In achieving better regulation, we have to take into account other important considerations such as our new duties in the Energy Act 2004, including sustainability, the requirements of the Freedom of Information Act 2000, which are absorbing considerable resource, and the demands of Impact Assessments. Furthermore, there is a real dichotomy in what many of our respondents have urged us to do. Most argue for more Impact Assessments, generally in areas that affect their interests. At the same time, however, they express concern over the volume of our paperwork. We are confident we can meet these challenges and will strive to strike the right balance between what are sometimes conflicting demands.

We have listened to comments on the quality and quantity of our consultation documents and plan to intensify our efforts to reduce their number and improve their presentation. We have launched 'Project Paperless' as the vehicle for this review. The project team will draw on best practice identified by recent

reports, for example from the NAO on Impact Assessments, and the Better Regulation Task Force, and will take on board the Hampton Report's support for 'burden reduction targets' by setting ourselves an initial target for reducing the volume of documentation.

Some of the demands and pressures of the wider environment have also been recognised in our future plans. For example, the combination of our five year RPI-3 per cent cost control regime and our decision to enhance the importance of our Glasgow office respond to the approaches of the Gershon and Lyons Reports. This will help to improve our '**efficiency and effectiveness**'.

The theme of efficiency is meshed with that of being a '**leading voice in Europe**'. We are encouraged by the widespread approval for Ofgem's work in Europe. British consumers' interests are inextricably linked to the successful development of competition in continental markets but we recognise that such a leadership position carries with it a commitment to time and resource. In response to many requests, we will publish a regular update on European affairs and work to promote the better regulation agenda in Europe.

### The seven themes in the wider working environment

It is crucial that our seven themes remain relevant to the wider environment, notably in the second half of 2005 during the UK's leadership of the G8 and Presidency of the EU when the focus will be on the climate change agenda. Our theme of '**helping to protect the environment**' allows us to contribute to the debate, for example by careful analysis of how best to reduce CO2 emissions in ways which ensure best value for money for energy consumers.

There continues to be great public interest in the security of our fuel supplies and how markets interface with this. '**Helping to protect the security of Britain's energy supplies**' is a core function. Sometimes this has a high profile, such as our review of gas prices. More generally, however, we are keen to provide confidence to consumers that we monitor markets regularly and will act where any party seeks to undermine their effective operation. We continue to place great emphasis on transparency and availability of information which we believe are central to the theme of '**creating and sustaining competition**'.

Security of supply is not only about markets. Our December 2004 decisions in the electricity distribution companies' price review opened the way for a 48 per cent increase in capital expenditure in the local networks over the next five years. In '**regulating network monopolies**' we are involved not only in price reviews but also in facilitating investment, including in renewables. This will be a continuing theme in future price controls.

Much concern continues to be expressed about the recent sharp increases in energy bills. '**Helping to tackle fuel poverty**' is a key theme. We will continue to apply our formal and informal powers to help vulnerable customers and the fuel poor who are most badly affected by such price increases. Formally, we can contribute by promoting well-functioning markets and ensuring that suppliers meet their obligations. Informally, we can encourage suppliers to identify better those in need and to make sure that, once targeted, they get the right help and information.

### Conclusion

We are grateful for the detailed and thoughtful responses made during the consultation - a summary of these and our reactions to them will be published on our website. We have already responded to several suggestions and a number of other comments will be helpful in developing our policy in particular areas going forward. Our most important immediate response, however, is to improve transparency. In the spirit of greater openness, the Authority, while maintaining necessary confidentiality, will publish shortly reports of its monthly meetings and will hold a public session once a year.



**Sir John Mogg**

Chairman of the Gas and Electricity Markets Authority



**Alistair Buchanan**

Chief Executive of Ofgem

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## Ofgem's developing role over the next five years

Ofgem's approach to independent regulation needs to respond to changes in the gas and electricity markets over the next five years. In this section, the seven corporate themes have been used as a basis for considering the challenges that lie ahead.

### Overall remit

Ofgem's principal objective is to protect the interests of present and future consumers, wherever appropriate by promoting effective competition. We will use this as a sound basis for our activities over the next five years. We discharge this objective by creating and sustaining competition, where appropriate, and by regulating network monopolies effectively. In addition to the principal objective, Ofgem has to have regard to a range of other duties reflecting the fact that energy is not 'just another product' but that there are broader considerations for society associated with its use. In particular, Ofgem has duties relating to:

- the needs of vulnerable customers, which particularly at a time of rising prices means helping where we can the Government's efforts to eliminate fuel poverty
- taking account of the effects of our decisions on the environment, and helping the Government deliver its carbon saving target in the most cost-effective way
- helping deliver security of supply which, in Ofgem's view, is best achieved through promotion of competitive wholesale markets and structuring price controls so as to facilitate adequate network investment, and
- taking suitable account of the work of safety regulators (notably the Health and Safety Executive (HSE) and the Department for Trade and Industry (DTI) Engineering Inspectorate) in our own activities.

We will continue to focus on consumers receiving value for money. Competitive prices which are consistent with good quality of service, high levels of security of supply and appropriate protection of vulnerable customers and the environment. This will continue to involve providing a framework which is cost-reflective so far as practical. Above all, the interests of consumers will continue to be best served by independent regulation - with its focus on economic efficiency, and creating a stable and predictable regulatory framework. Influencing the regulatory

framework and helping progress the development of competitive markets at the European level will continue to be of crucial importance.

The new duty to contribute to sustainable development underpins Ofgem's existing suite of duties and reinforces the need to carefully consider the implications of all our policies for future, as well as present, consumers. The new duty also emphasises the need to identify policy options that satisfy our economic, social and environmental duties, simultaneously where possible.

This year energy companies will gain a new opportunity to appeal a greater range of our decisions. This reinforces the need for Ofgem to ensure that its decisions are robust and that it follows due process in an open and transparent manner.

### Creating and sustaining competition

After the step-changes associated with reform of the gas and electricity trading arrangements, and the departure of many of the US energy trading companies, the effects of greater concentration in ownership and declining liquidity look likely to become key issues in the wholesale gas and electricity markets in the second half of the decade. Ofgem will continue to monitor liquidity and discuss with the industry what, if anything, Ofgem should do to promote liquidity and new entry.

In gas, there are very encouraging signs of investment which will increase the extent and diversity of Britain's available supplies. The pressures for greater transparency of information on all market participants look likely to continue. Increased interaction with European gas markets will become of even greater importance. We will work closely with the Government, industry and customer groups to tackle the issues arising from changes to gas quality specifications as we use more imported gas, as historically the quality of North Sea gas has differed from that available on the Continent.

In both gas and electricity wholesale markets, there will continue to be a need for active surveillance and monitoring and, where necessary, enforcement of domestic and European competition law.

In retail markets, there is growing concern about concentration, both in relation to domestic and industrial and commercial markets. Any proposed mergers between the major suppliers would need very careful scrutiny. The extent to which Ofgem is able to move away from detailed sectoral regulation will depend crucially on the industry's ability to improve its performance in the areas consumers regard as important - marketing, smooth operation of the transfer process, billing - and on its success in promoting effective self-regulatory approaches to tackle these issues.

We hope that the second half of the decade will see scope for the removal of the remaining regulation of metering through the metering price controls on the former monopoly providers as competition becomes established. The prospects for establishing more competition in connections markets have been less certain to date and this remains a priority for action.

### Regulating network monopolies

In networks, a major challenge over the next five years will be to ensure that the regulatory regime allows for, and incentivises, increased investment where this is needed for asset replacement, for network resilience and to respond to changing supply and demand patterns such as increased levels of renewable generation and new gas import sources. We expect network operators to develop efficient and innovative solutions to these challenges, including application of new technological approaches. In addition, we expect the commercial and charging arrangements associated with electricity distribution to respond to the needs of new and existing network users.

Following extensive consultation with customers and industry, we announced on 21 January 2005 that the Authority had given conditional approval for the sale of four gas distribution networks by National Grid Transco (NGT). If the sales proceed, the resulting re-organisation of the gas distribution networks should provide an important opportunity for the industry to improve efficiency and for Ofgem to realise benefits for consumers through the operation of the relevant price controls.

In both electricity and gas networks, the regulatory framework would be more effective if users could purchase forward rights to use the networks, thus providing market signals of where and when new investment may be needed, as already exists with gas entry capacity. The use of market indicators rather than reliance on the judgement of regulators is an

important contribution which Ofgem can make to the better regulation agenda. There is also scope to strengthen the incentives network operators face to improve the quality of service they provide.

### Security of supply

Security of supply will continue to be central to Ofgem's work. Historically, Britain has had a very secure supply, both in terms of network reliability and in the availability of gas supplies and electricity generating capacity. No energy supply system can deliver absolute security at all times. The challenge is to maintain a high level of security, at a reasonable cost to consumers.

Current evidence suggests that Britain's market framework for energy supplies is delivering the security of supply we need. For this to continue, it will be important that market participants have continuing confidence that the Government will maintain its Energy White Paper commitment not to intervene in the market except in extreme circumstances, and as a last resort, such as to avert a potentially serious risk to safety. In electricity, in a period when some of the existing nuclear generating capacity is approaching the end of its economic life, there are important public policy issues for the Government to tackle if it considers new nuclear generation may have a contribution to make in terms of the relative value for money of differing low carbon energy sources. As more wind generation comes on stream, the market may need to provide significant back-up generation to cope with the intermittency of wind. This may lead to greater price volatility and the need for higher levels of reserve capacity.

In gas, the more rapid decline than expected in UK Continental Shelf (UKCS) gas supplies in recent years has led to a tightening of the supply position. The market response in terms of new investment has been impressive, with new LNG facilities, new interconnectors and additional capacity on existing ones. However, it appears likely that much of the imported gas, including LNG, will have quality specifications that are not within the UK's current limits. In the light of these developments, DTI, Ofgem, HSE and Department for Environment Food and Rural Affairs (Defra) are carrying out a three-phase joint study on future gas quality issues.

In both gas and electricity, the development of greater demand side response will be an important component of providing security of supply particularly in the event of a significant loss of supply or very severe weather. Ofgem's role will be to facilitate efficient infrastructure investment, monitor

market rules, and to provide timely information, with Government, about future developments and trends, so that market participants are better informed in making their own investment decisions.

## Europe

European Union (EU) regulatory policy will have an increasing impact on energy markets and consumers in Britain over the next five years. This is because European markets are linked physically to Britain by the interconnectors and because European energy prices have a major influence on British energy prices. British wholesale gas prices are directly influenced by European wholesale gas prices and, given that 40 per cent of British electricity generation is gas-fired, there is also a significant indirect impact on British wholesale electricity prices. Ofgem, therefore, has a key role to ensure that liberalisation of European energy markets is carried out fully and effectively, and to ensure more broadly that EU policy develops in ways that are consistent with Britain's existing market-based regulatory arrangements.

There is strong support for Ofgem to commit resources to influence the European agenda where this would be important for British consumers. Our top priority will be to seek a fully-liberalised wholesale gas market in Europe, particularly in terms of facilitating the unfettered transmission of gas across the rest of Europe on a fair and non-discriminatory basis. We are, therefore, pleased that the European Commission has decided to undertake a review of the European gas market.

New EU legislation on environmental issues is also likely to be important to Ofgem's responsibilities, where this relates to carbon or other emissions, or more directly to consumer issues such as energy efficiency or billing. A challenge will be to encourage Europe to follow an approach of better regulation on consumer issues, rather than adopting a more prescriptive regulatory approach.

## Environment

At the heart of the Government's environment policy is a commitment to reduce carbon emissions. Following the ratification of the Kyoto agreement, a substantial challenge over the next five years will be to negotiate a more comprehensive and far-reaching international agreement on carbon reductions stretching further into the future, and to develop more extensive international emissions trading schemes. Such an approach offers consumers the best prospect of achieving value for money in securing significant environmental improvements.

The promotion of renewable energy is an important part of the Government's, programme for addressing climate change. At present the promotion of renewables entails higher costs than other approaches to carbon abatement. Going forward, the challenge will be how best to achieve low carbon emissions as efficiently as possible, balancing future reductions in abatement costs against current costs.

## Fuel poverty

The Government's target to eliminate fuel poverty among vulnerable households is due to be achieved by the end of the five year period, in 2010. However, domestic energy prices are rising, and fuel poverty will increase too unless effective action is taken. For example, there needs to be a substantial improvement in the energy efficiency of the homes involved, which is, in any event, the most sustainable way of lifting households out of fuel poverty. It will also require a sustained effort by the variety of organisations involved - Government, suppliers, installers and community groups - to focus the help available where it is most needed. Further work in the coming months will show whether they are on course to meet this target, or whether more resources will be needed.

Throughout this period, Ofgem will continue to work with suppliers and partner organisations where we can contribute to best practice in this area. Our current initiative to raise the profile and involvement of all parties in the fuel poverty agenda, at a time of rising domestic energy prices, will be followed up with similar initiatives in the coming years, linked to our programme of research in this area.

## Ofgem's own efficiency

Our decision to subject Ofgem to an RPI-3 per cent resource control sets the context for our work. We are committed to prioritising all our normal work programmes within this constraint. A major task for Ofgem through this period will be to follow a better regulation agenda in all that we do. In 2005, the focus will be on taking forward 'Project Paperless', our management tool to reduce the quantity of our written work and make it more accessible to the reader. In addition, we will continue to engage industry and consumers in drawing up Impact Assessments, as these stakeholders are often better placed to provide information on likely implementation costs. While maintaining necessary confidentiality, the Authority will shortly publish reports of its monthly meetings and, once a year, will hold a public session.

# Creating and sustaining competition

Ofgem's principal statutory objective is to protect the interests of consumers, wherever appropriate by promoting effective competition. As a consequence, creating and sustaining competition is a vital part of Ofgem's strategy. Our overall approach remains the same: where competition is established, we will seek to ensure that it works well for all customers. Where it is not established, we will work to introduce and sustain it, where this would be an appropriate way of protecting consumers' interests.

The main thrust of our work will be to identify and remove barriers to entry and to effective competition. We also aim to align the resources we devote to the retail markets with the development of competition in these markets and the need for ongoing oversight. Our major project this year is to review the supply licences to make them shorter and less complex while maintaining basic levels of protection, particularly for vulnerable customers. We will also monitor the industry's project to improve the customer transfer process to make sure it delivers. In wholesale markets, we will again seek to ensure participants have the necessary information and that the market rules support a competitive market. Monitoring compliance with and, where necessary, enforcement of competition legislation, statutory obligations and licence conditions also plays an important role in sustaining competition in all markets.

## Wholesale markets

### Electricity

The new electricity trading arrangements which were introduced in March 2001 created more competition in the wholesale electricity market in England and Wales. The Energy Act 2004 provides the legal powers for extending that framework across the whole of Great Britain, by introducing a single British wholesale electricity market.

The main features of the new market will be:

- a common set of trading rules so that electricity can be freely traded across Britain
- a common set of rules for access to, and charging for the use of, the transmission network, and
- a British system operator, independent of generation and demand interests, so that those seeking to use the system and access the market

can be confident that there will be no undue limitation to access.

These changes will extend to Scotland the same framework that exists in England and Wales, and we expect that this will bring real benefits to Scottish consumers. Ofgem will be closely monitoring the British market, in particular immediately following the introduction of these changes, so that we can be sure that the arrangements are working properly and the benefits are being passed to customers.

## Gas

Wholesale gas prices have risen substantially and remain high, compared with prices over the last five years, for winter 2005-2006. Rising prices do not necessarily indicate that competition is not working - they may, for example, reflect the increased cost of bringing new, more expensive gas supplies into Britain.

Ofgem will conclude its investigation of whether certain contractual arrangements might have limited the flow of gas from UKCS gas fields. We will also support the European Commission in its investigation of the wider European gas market given the concerns highlighted by our probe into the high wholesale gas prices.

## Offshore data availability

Wholesale markets work best when participants have access to all the relevant data. Ofgem, has therefore, worked with the DTI to improve access to information in relation to offshore gas production. In 2004 the DTI negotiated a voluntary agreement between offshore producers, terminal operators and NGT to improve and standardise information provided to NGT on available gas supplies, planned and unplanned outages and for the release of sufficiently detailed information to the market.

In October 2004, NGT began publishing aggregated data on forecast gas deliverability based on planned maintenance and data on ex-post gas daily flows through each sub-terminal (the points at which gas is delivered to NGT's network). This data was previously only available to shippers.

NGT plans to release more information when the necessary IT systems are complete which is planned to

happen in the coming year. In 2005 NGT, will begin to publish data on forecast gas flows and on real time gas flows onto the network on an aggregate basis. Ofgem considers that making this information available will enable market participants to adjust their behaviour efficiently, with benefits in terms of promoting competition and improving security of supply.

As part of the process of releasing further information in 2005 and beyond, certain changes will be necessary to the onshore regulatory arrangements to enable NGT to release, in an appropriate form, information provided to it by offshore producers. The pressure for greater transparency will continue and the industry is currently considering a modification proposed by energywatch to publish more information. In February 2005, Ofgem issued a consultation document about the onshore regulatory framework governing information disclosure. We will be considering carefully any proposed changes to the existing level of disclosure in the coming year.

## Market monitoring, compliance and enforcement

Rising wholesale gas prices have a serious impact on both domestic and industrial and commercial gas customers. In addition, gas is an important input fuel for electricity generation (gas-fired plant accounts for nearly 40 per cent of all generation) and as such gas prices have a significant effect upon wholesale and retail electricity prices.

The special features of energy markets, such as the need to balance supply and demand over short timescales, highlight that market monitoring will be needed to protect consumers for the foreseeable future. Effective wholesale and retail market monitoring in both gas and electricity will, therefore, remain a key part of our work to sustain competition in British energy markets.

## Governance

Companies and customers may propose changes to the industry agreements called codes that underpin the gas and electricity markets. Ofgem's role in the code modification process is limited to the Authority directing any final independent decision. Ofgem does not consider that it would be appropriate for the Authority to move away from this role at present, despite continued developments in energy markets. Ofgem considers it has an important role to ensure that code modifications are pro-competitive, maintain security of supply and are consistent with not only the codes' relevant objectives but also the

statutory duties of the Authority which are designed to protect the interests of consumers. We have always taken the view that areas of the codes that the industry feel are not commercially material could be made the subject of a modification to place them in subsidiary documents that have lesser regulatory oversight. Equally, we have always supported the concept of so-called 'housekeeping' modifications being dealt with efficiently. It is a matter for industry to raise the appropriate modifications to bring about any changes they feel would benefit the arrangements and the relevant objectives.

In dealing with code modification decisions, Ofgem continually seeks to improve its processes so that decisions are made efficiently and its decisions explained clearly. Ofgem will continue to approve or reject these proposals as quickly and efficiently as possible, taking account of overall organisational priorities, and will try to indicate those modifications that may need a longer consideration. In addition, we will continue to give 'minded to' views when requested. The introduction of a new right of appeal against certain Ofgem decisions, to be introduced in 2005, will provide additional accountability.

## Retail markets

Ofgem considers that the best way to protect customers' interests is to promote competition between suppliers. This is why we removed the last of the retail price controls in 2002. Since then, competition in retail markets has become firmly established with around 50 per cent of domestic customers having changed supplier.

Analysing whether there are any significant barriers to entry, and if there are, then proceeding to tackle them wherever possible, will be a key element of our work in promoting competition. Our supply licence review will be an important part of identifying and removing any barriers preventing companies entering the supply market.

Ofgem will continue to focus its resources on aspects of the competitive market where changes would have the greatest impact on consumers. For example, we will continue to seek improvements to the customer transfer process. We will also continue to take action to remove any barriers preventing the further development of competition. We will also work to ensure that all consumers, including the most vulnerable, have access to the benefits that competition brings. In an era of rising prices, that means communicating to customers that there are no rewards for loyalty and that switching supplier or payment method can bring real savings.

## Market monitoring, compliance and enforcement

Ofgem has carefully analysed the state of competition in supply markets and concluded that competition is continuing to develop and is delivering benefits to customers in all demographic groups. Domestic customers who have not switched from their incumbent supplier have on average six or seven better offers. Ofgem will continue to support energywatch in making sure that customers are aware that they can make substantial savings by changing supplier or payment method. This message is increasingly important against a background of rising energy prices, and we will work hard, in conjunction with energywatch, to promote it.

Ofgem's most recent review of competition in the non-domestic supply sectors considered a range of indicators of competitiveness for different groups of customers. The review found that different supply sectors vary in terms of concentration, with evidence of market entry, a range of prices and substantial switching activity. The review concluded that the sectors appeared broadly competitive but that there was scope for customers to take greater initiatives to address certain issues concerning supplier behaviour. At the time, Ofgem stated that it did not intend to conduct a further review unless evidence was presented that might alter these conclusions. Early in 2005-2006, Ofgem will consult on whether it is appropriate for it to carry out a further review of the non-domestic supply sectors, including the evidence it would require as part of any review.

Although competition is firmly established, retail energy markets are not yet mature. Ofgem has identified aspects of the competitive process which could be improved so as to make retail markets work more effectively. In particular, Ofgem has secured improvements to the process by which customers transfer from one supplier to another. The six major suppliers are co-operating through the Customer Transfer Programme to meet the challenge laid down by Ofgem and energywatch for the industry to improve the performance of suppliers in managing customers' transfers. Ofgem welcomes this initiative and expects that significant improvements will be delivered in 2005.

Ofgem has also demonstrated a readiness to use its powers to protect consumers against abuse by suppliers, whether the abuse is mis selling or unfairly objecting to a customer transfer, and has imposed significant financial penalties on several occasions. We note that following the enforcement action

taken by Ofgem the number of instances of 'debt blocking', and the number of complaints to energywatch about mis selling, have fallen sharply. We are not complacent, however, and are determined that the improvement should be maintained.

During 2005-2006 Ofgem will continue to address other barriers to effective competition. Ofgem has welcomed the industry's commitment to consider how the information on customers' bills could be improved. Ofgem also intends to tackle the issues associated with theft of energy.

Given Ofgem's principal objective to protect the interests of consumers, it is clearly crucial that Ofgem maintains a close dialogue with consumer groups both to ensure that we understand their concerns and to give them a full opportunity to comment on proposals that will affect them. Over the plan period Ofgem will continue to develop its programme of joint work with energywatch and the regular dialogue with a range of domestic and non-domestic consumer groups.

In July 2004, the Government consulted on proposals to develop Consumer Direct into a national first point of contact for consumers, referring consumers to high quality specialist advice and redress services where necessary. The Government also proposed to consolidate the arrangements for consumer representation in the various utility sectors. Ofgem supports both these proposals.

## Review of supply licences

Consistent with the principles of better regulation, Ofgem remains committed to withdrawing from regulation where appropriate. Given that competition is increasingly established in retail markets, Ofgem considers that it is appropriate now to examine the extent to which it is desirable for Ofgem to withdraw from regulating those markets, above and beyond the provision of general consumer protection law. As a first step, Ofgem has begun a review of the supply licences with a view to removing any conditions that represent a barrier to entry or are no longer necessary in a competitive market and ensuring that those which remain are proportionate and enforceable. As part of this review, we are considering carefully the extent to which the existing level of regulatory protection is appropriate for vulnerable customers. Where we consider that it is in the interests of consumers to modify supply licences, we will consult widely on our proposals.

## Metering and connections

Competition in metering and in most aspects of connections is a relatively recent development. Ofgem has established the processes and structures needed to support competition in metering, and has developed separate metering price controls for areas where competition is not yet effective. It is in this context that Ofgem recently consulted on NGT's proposals to restructure its gas metering business by consolidating its two existing metering businesses into a single meter operator organisation. Looking forward, we will examine ways in which the newly competitive metering market is developing and whether there is scope for Ofgem to withdraw from regulation in this area.

Competition in gas connections is well established in the new housing sector and is emerging in the market for larger industrial and commercial connections. However, competition has not developed in the area of one-off domestic connections and Ofgem considers that NGT's proposal to transfer domestic connections work back into the core regulated distribution business will, in the absence of effective competition, be a positive development which should protect better the interests of customers requesting such connections. Alongside these changes, the Authority also intends to introduce, with effect from 1 May 2005, a new guaranteed standards regime covering domestic and commercial connections to any gas transporter's network. In the case of electricity connections, Ofgem continues to encourage the development of a competitive market and will monitor the industry's response to its recent initiatives.

In both metering and connections, Ofgem will be watchful to ensure that the network companies are not able to abuse their monopoly network position to protect their interests. In May 2004, the Authority imposed a financial penalty of £1m on NGT for poor connections performance; Ofgem will not hesitate to take additional enforcement action if it is justified.

## Industry structures

Corporate transactions have the potential to affect Ofgem's ability to sustain competition in the wholesale and retail markets and to regulate networks effectively. We, therefore, assess them carefully in terms of the impacts that they have on customers and competition.

Ofgem considers that companies and capital markets must retain the freedom to seek and adopt innovative and more efficient corporate structures, where these support effective competition. We recognise that mergers and other corporate restructurings can produce synergies and efficiency savings that will benefit consumers. However, mergers can also lead to a degree of consolidation that might result in a substantial lessening of competition, to the detriment of consumers. This has the potential to become a significant concern over the five year plan period, with any proposed merger between the major generators and/or suppliers, for example, requiring careful consideration. In addition, network business mergers could reduce our ability to use comparative information to improve efficiency when setting price controls.

Recent mergers have increased the extent of vertical integration in the wholesale and retail markets. We consider that effective monitoring of wholesale and retail markets, fair and transparent access to monopoly services and Ofgem's powers of enforcement under competition legislation protect consumers against the potential problems associated with vertical integration. We also consider that the absence of barriers to entry is one of the most important contributors to effective competition.

Given the importance of industry structure, Ofgem will continue to examine how the energy markets are evolving and assess the impacts of individual transactions so as to advise the relevant competition authorities (the Office of Fair Trading (OFT) or the European Commission) who are responsible for approving such transactions.

Ofgem has agreed a concordat with the Financial Services Authority (FSA) to enable both agencies to better achieve their statutory objectives by working closely together in areas where there may be a degree of overlap in the agencies' respective functions, for example market abuse, and in other areas where the agencies may benefit from working in parallel. The concordat makes use of gateways established through the Financial Services and Markets Act, the Utilities Act and competition legislation to pass confidential information between specified regulatory bodies.

## Regulating network monopolies

Regulating gas and electricity network monopolies is one of the most important ways in which we fulfil our principal objective of protecting the consumer. Ofgem regulates the level and structure of the prices charged for using the monopoly gas and electricity networks and the quality of service provided by these networks. Network regulation will be important for as long as the networks retain their monopolistic characteristics and certainly throughout the period of the plan.

Network price controls and quality of service standards are typically set for a five year period. In 2004, Ofgem took steps to align the timing of the gas and electricity transmission price controls across the whole of Britain, and developed new five-year price control proposals for the electricity distribution network operators. We also devoted significant resources to analysing NGT's proposals to sell some of its local gas distribution networks.

Work on the latter two projects should cease in the first half of 2005-2006, although the work on the price control review will need to feed into a new system of cost reporting for electricity distribution companies - which Ofgem is committed to progressing in 2005-2006. Work will also begin in 2005 on the new gas and electricity transmission price controls that will come into effect in April 2007. Revised price controls will be introduced for the individual gas distribution networks with effect from April 2008.

### Incentive-based regulation

Our overall approach to regulating network businesses remains unchanged. Across all network sectors, we remain committed to incentive regulation as the best way of protecting the interests of consumers. Wherever practicable, this will involve focusing on regulating outputs rather than inputs. This means concentrating on what network companies deliver in terms of service to their customers, rather than on how they deliver that service. As part of the transmission price controls, we will refine our approach to setting incentives and regulating outputs for both gas and electricity.

Companies must meet their statutory and licence obligations. If they do so, and at the same time, out-

perform their price control targets, they should earn higher returns. Those companies that fail to meet their obligations run the risk of financial penalties, and those that under-perform in relation to their price control targets will earn lower returns. This approach encourages efficiency and over the longer term ensures that prices to consumers are no higher than is necessary.

Incentive regulation works best when the regulator establishes a transparent and predictable framework. Over time, this framework needs to evolve to meet new challenges, such as the need to reconfigure the electricity network so that it can connect substantial amounts of renewable and distributed generation.

Ofgem's approach to network regulation reflects our desire:

- to adopt a consistent approach across the networks where appropriate
- to apply simple solutions where they are effective
- to improve incentives to invest while promoting efficiency
- to make network operators more responsive to the changing needs of their customers, including ensuring that the electricity network is able to connect renewable and distributed generation and so contribute towards a low carbon economy, and
- to maintain adequate network capacity and reliability to protect security of supply.

Over the plan period, Ofgem's approach to network regulation will continue to evolve, for example by relying more on market signals as to where investment is needed rather than solely on traditional planning and forecasting processes.

### Incentives to invest

Significant network investment will be required in the coming years to ensure that the networks are robust and can accommodate changes in supply and demand patterns such as the anticipated increase in renewable generation and gas imports, as well as currently unforeseen market changes.



Ofgem has already improved incentives for investment in a number of key areas:

- in gas distribution, new incentives have been put in place to encourage efficiency in the mains replacement programme
- in electricity distribution incentives have been introduced to encourage the distribution companies to respond to the anticipated growth of distributed generation, and
- in gas transmission incentives exist to encourage NGT to respond to major investments in new supply sources such as LNG import terminals, pipeline import projects and new interconnectors.

In gas transmission, NGT already has incentives to invest in response to signals from customers of demand for new entry capacity. These arrangements provide NGT with information and incentives so that it can respond to customers' changing requirements. Over the plan period significant network investment is likely to be required to accommodate a greater diversity of sources of gas to the British market as UK supplies decline. We will review whether the current incentive structure is effective or whether it should be modified and/or simplified.

For new gas network exit capacity, the incentives are less strong. Ofgem has, therefore, pursued changes to the arrangements for exit capacity to make them more responsive to network customer demands. These changes are expected to come into effect in 2005 in respect of the National Transmission System (NTS), and 2006 in respect of the local gas distribution networks.

In electricity transmission, following the introduction of new arrangements in 2005, NGT will be responsible for operating the transmission system across Great Britain under the new single wholesale market. Each of the three transmission owner licensees should also have new incentives to promote the efficient network reinforcement necessary to accommodate the growing level of renewable generation. Creating appropriate incentives for investment will be critical to the transmission price control reviews that will take place during 2005 and 2006.

### Cost-reflective charging

Ensuring that network users pay charges that reflect the costs they impose on the system is an important

principle that underlies Ofgem's approach to network charging arrangements. Only when network charges reflect these costs will users take into account the wider costs of their decisions. Cost-reflective network charges will encourage generators to locate and operate plant efficiently and allow all generators, including conventional and renewable stations across England, Wales and Scotland, to compete fairly for access to the British market, thereby minimising total costs to consumers. Ofgem does not seek to identify 'winning' technologies. Developing cost-reflective network charges is an important element in ensuring that one technology is not unduly favoured over another.

The Authority has approved to new charging arrangements to meet the £1.7 billion cost of running Britain's high-voltage transmission network. The Authority's approval will require NGC to monitor and review certain aspects of the charging regime over its first two years of operation and to propose refinements where necessary. Reviews of both electricity and gas distribution charging structures are currently underway and will continue in 2005.

### Onshore renewables and distributed generation

Much of Britain's potential renewable resource, at least in terms of the options that are currently most economic, is located in geographically remote areas, away from the main centres of demand. The capacity of the electricity networks in these areas is not currently adequate to meet the anticipated future demand which the Government's targets for renewables imply. The drive to increase renewable generation at an acceptable cost to consumers, therefore, presents significant challenges to distribution and transmission networks.

Ofgem has published proposals to allow for investment in addition to that allowed for under the current transmission price controls, set in 2000 and 2001. This means that major investments can be made before the next main price control review. The objective is that this investment should be made in an efficient and effective manner, minimising the risk that customers may have to pay for unused transmission assets. The new transmission price controls from 2007 will have to consider the appropriate incentive structure for the connection of renewable load in future years.

The development of distributed generation, from domestic combined heat and power (CHP) units to small-scale biomass and larger scale gas plants, will potentially have a major impact on the distribution networks. Distribution networks are currently designed to handle the distribution of power in a single direction from large power stations connected to the transmission network. The need now is to integrate larger numbers of smaller generators, connected to the distribution network at many points.

The new incentive framework in electricity distribution is intended to encourage electricity distribution companies to invest efficiently in the reinforcement of their networks, and to develop and apply innovative solutions that reduce the costs of such reinforcement. Ofgem will continue to be closely involved with the electricity industry, equipment manufacturers, academic institutions and other interested parties in identifying innovative solutions to the technical and commercial challenges arising from increasing quantities of renewable generation. The Innovation Funding Incentive and Registered Power Zones are designed to bolster spend on research and development and to foster innovation in relation to distributed generation.

Ofgem has also taken steps to reform the structure of distribution charges in order to provide more cost-reflective charges for new generators. These changes will encourage the efficient connection of new renewable and CHP generators.

### Offshore renewables

There is a major challenge in respect of connecting offshore renewable generators. The Energy Act established a broad legal framework for offshore renewables beyond territorial waters. Ofgem will be the licensing authority for offshore generation, transmission and distribution.

Ofgem is currently working closely with the DTI to develop the regulatory and licensing regime for offshore market participants so that offshore cables may be connected to the onshore transmission and distribution networks and managed in a cost efficient manner. Ofgem will then have the ongoing role of maintaining and enforcing these licences as necessary.

### Quality of service

Consumers' interests are protected by network price controls designed to encourage efficiency improvements. These measures have, since privatisation, secured substantial reductions in the charges paid by consumers.

Consumers' interests are also protected via statutory standards of performance regulating the quality and reliability of supply of all network businesses. In recent years, Ofgem has introduced a package of financial incentives for electricity distribution companies to improve the quality of the service that they provide to their customers. The incentive scheme is focused on the network companies' performance in relation to the number and duration of interruptions to supply and contact with customers following an interruption.

Quality of service and the setting of outputs are likely to become an increasingly important theme of future price controls. Already, as part of the electricity distribution price control review, Ofgem has proposed refinements to the incentive scheme for the electricity distribution network operators. In addition, we are taking steps to extend quality of service incentives to other network businesses. In the light of our investigation into the blackouts affecting parts of London and the Birmingham area in 2003, Ofgem has taken forward a new quality of service incentive scheme for electricity transmission network owners. These arrangements will enhance substantially the protection of consumers' interests. However, there remain areas for further development, including the extension of these new transmission incentive arrangements to Scotland, improved understanding of resilience of electricity distribution networks and the ongoing development of quality of service regulation in gas distribution.

### Local gas distribution

At present NGT owns and operates the national electricity and gas transmission networks and all eight local gas distribution network (DN) businesses in Britain. NGT announced in 2003 that it proposed to sell one or more of the DNs. Ofgem undertook extensive work throughout 2004, involving customers and industry, in order to establish whether consumers' interests could be safeguarded in the event of a sale. A detailed cost benefit analysis identified the potential for savings of around £225 million. These potential benefits are expected to begin to feed through to customers in

future price controls as Ofgem should be better able to compare the performance of the distribution networks. On that basis, Ofgem announced on 21 January 2005 that the Authority had given conditional approval for the sales to proceed.

The conditions attached to the Authority's approval of the sale relate to the implementation of the detailed regulatory, commercial and operational arrangements necessary to protect the interests of consumers'. This includes the introduction of new offtake arrangements at the interface between Transco's NTS and the DNs from September 2005 and the introduction of an agency to carry out the functions that NGT currently carries out centrally, including administering the processes needed to support gas competition. In addition, in order to introduce the arrangements necessary to protect the interests of consumers' in a divested industry structure, there will also be consultation on licence and network code changes which will continue into the 2005-2006 financial year.

Looking beyond this point, there will be an important ongoing role in regulating the gas distribution networks, including setting a new price control from 2008 which, if the sales proceed, will represent the first opportunity to capture for consumers' the potential benefits of comparative regulation of the gas distribution networks.

## Helping protect the security of Britain's energy supplies

Security of our energy supplies is of central importance to domestic, industrial and commercial customers. The regulatory regime properly reflects this. In carrying out our principal objective of protecting consumers', Ofgem must have regard to the need to ensure that all reasonable demands for electricity and, so far as is economical, gas are met and the need to secure that licence holders are able to finance their obligations. Ofgem also has to have regard to the need to secure a diverse and viable long term energy supply. These explicit duties mean that security of supply is central to everything that we do.

There are three main dimensions to security of supply:

- availability of supplies - ensuring that there is sufficient electricity generation, gas production, gas storage and import capacity to meet demands, taking into account the likely demand-side response over time,
- networks - to provide the means of delivering supplies from energy producers to consumers through transmission and distribution infrastructure, and
- system operation - ensuring that given the available network and availability of energy supplies, any transmission constraints are managed, and demand and supply are balanced when required.

Since privatisation, security of supply has been maintained at a high level both by historic and international standards. There have been no interruptions of firm loads due to a lack of generating capacity or gas supplies. The reliability of networks remains high.

Security of supply remains a strategic priority for Ofgem. We have pursued a consistent approach over several years based on the view - which is shared by the Government - that security of supply is best maintained by creating and sustaining competitive wholesale and retail energy markets, and by establishing appropriate incentive arrangements for the network monopolies. That approach has served British consumers' well in the past and we have every confidence that it will continue to do so in the future.

There is an important judgement to be made between the costs and benefits of improving security of supply. No energy supply system can guarantee absolute security at all times. On that basis, Ofgem seeks to avoid the risk that consumers are required to pay excessive costs in order to 'gold plate' infrastructure. The challenge is to maintain a high level of security, at a reasonable cost to consumers.

### Informing the debate

Ofgem will continue to contribute to an informed and reasoned policy debate on how competitive markets and effective network regulation can promote security of supply. We will continue to examine security of supply under a number of different scenarios, and we will inform the market of our findings so that participants can themselves contribute fully to the debate. In addition, when publishing important policy proposals, we will of course also pay close attention in our Impact Assessments to the effect of the proposal on security of supply. The Joint Energy Security of Supply (JESS) working group plays a key role in providing the market with forward-looking indicators on security of supply. We will, with the DTI, continue to develop and monitor these indicators to enable market participants to have accurate information to inform their expectations about future prices and to see whether the markets are responding as expected to deliver required investment.

The Energy Act 2004 introduced, from 2005, a requirement for the Secretary of State to publish and lay before Parliament an annual report, compiled in conjunction with Ofgem, on short- and long-term security of supply. In addition, the UK is required under EU Directives to monitor and report on supply issues.

It will be important to consider these new reporting requirements against the existing reporting, with a view to ensuring that what is provided helps inform markets and delivers the message of how markets and effective network regulation have, and continue to, promote security of supply, whilst minimising duplication of effort and resources.

## Making markets work effectively

Markets have to date worked well in delivering security of supply. There has been significant investment in Britain's energy sector since privatisation, particularly in recent years.

Ofgem welcomes the Government's commitment to competitive energy markets and is pleased that the Government stated in its Energy White Paper that it would maximise the use of market-based and/or voluntary mechanisms, promoting regulations only where they are clearly necessary and well-designed, or in accordance with the principles of better regulation.

## Electricity generation

The electricity market has a proven ability to react swiftly to short-term price signals. The winter of 2003-2004 showed clearly that the market can respond, with prices rising in response to lower margins, and generators bringing mothballed plant back into operation in response to these prices.

In the long-term too, price signals can deliver a clear message to the market and trigger the appropriate response. Indeed, forward prices are already sending signals to the market that new plant will be required in several years' time. Ofgem is confident that potential investors will respond in a timely way, on the basis of their expectations of future prices, informed by longer term market signals and other available information that might suggest that new plant is needed. Recent developments and announcements concerning plans for new combined cycle gas turbine generation at Langage, Pembroke and Grain suggest that this process is already under way.

## Gas production and storage

A major challenge for Ofgem is to provide a regulatory framework that will maintain security of supplies while Britain makes the transition to being a net importer of gas. To date, the gas market has responded well to the challenges posed by declining UK gas production. Companies have announced plans to invest in new storage facilities, new LNG terminals and new pipelines to import gas from continental Europe and other countries. In addition, a number of new UKCS fields have been brought into production and are due to begin production this winter.

If all these projects come to fruition, over 70 billion cubic metres a year of new, cheaper gas supplies would be delivered to the market over the next two to four years. This additional supply capacity represents more than 60 per cent of current demand. These projects add up to more than £6 billion of private sector investment, which amply demonstrates the ability of the market to respond on a timely basis in developing new supply sources and the confidence that investors have in the British gas market. Part of Ofgem's role is to work with Government to make available relevant information about future developments and trends so that market participants are better informed in making their own investment decisions.

Diversity of supplies is an important factor in ensuring security of supply. The interconnectors and other pipelines, new and existing, will give Britain increased access to gas from Norwegian and Dutch gas fields and the European gas market. LNG terminals will allow Britain to import gas from many different areas of the world, including the Middle East, Central Asia, Africa and South America. Britain will not, therefore, be dependent on gas supplies from any one country or region.

While significant investment is planned, it is nonetheless true that UK gas supplies have declined faster than previously expected. In the short-term, this does not threaten security of supply in either average or extreme winter conditions. It does however, mean that other more expensive alternatives will be required to replace North Sea gas in the winter of 2005-2006. From 2006 onwards, pressure on prices should ease as the major gas infrastructure projects come on stream.

Under extreme weather conditions, the market would be expected to deliver a significant volume of demand-side response. In these circumstances, wholesale gas prices might have to rise significantly, to levels where large customers are willing to sell back their gas to the market and reduce their own demand for gas. Ofgem has carried out some analysis of the ability and willingness of the demand-side to respond to extreme weather conditions. Our assessment is that at a sufficiently high price and with enough notice, there is scope for a large reduction in demand. Looking forward, it will be important to collect and analyse further information on demand responsiveness.

## Gas quality

Historically, the quality of North Sea gas has differed from the gas produced in continental Europe. Gas quality specifications vary across Europe and the UK has a different gas quality specification to most of the rest of continental Europe and, for some gas quality parameters, a narrower range of limits. It appears likely that much of the imported gas, including LNG, will have quality specifications that are not within the UK's limits. In the light of these developments, DTI, Ofgem, HSE and Defra are carrying out a three-phase joint study on future gas quality issues. Ofgem notes that discussions on harmonising EU gas quality standards have been taking place under the auspices of the European Association for Streamlining of Energy Exchange-gas, and that proposals will be submitted to the Madrid Forum in 2005.

Ofgem must be satisfied that gas quality arrangements are consistent with the regulatory framework and the duties and obligations placed on Transco and other licensed companies. In particular, Ofgem must ensure that charges for delivering gas to, or taking it from, the gas transportation network are cost-reflective and do not give rise to any undue discrimination. In this respect, Ofgem has recently held open discussions with industry on issues relating to gas quality with a view to undertaking detailed assessments of Transco's entry and transportation arrangements going forward.

## Network investment

Adequate network capacity is needed to transport available supplies to customers. Ofgem has taken steps to improve the information available to network operators on which to base their assessment of the need for new investment. We have also made proposals to improve the financial incentives on network owners to invest quickly and efficiently to meet those needs, whilst maintaining and improving the quality of supply on their networks.

Ofgem has moved to develop innovative arrangements such as auctioning long term rights to gas network entry capacity. Long term rights send clear signals to NGT about the need for new investment, and about where on the system the investment is most needed. These arrangements enhance security of supply by reducing the risk of network constraints and reducing the time it takes for NGT to deliver the extra capacity required.

Ofgem considers that cost-reflective transmission and distribution network charging is also important in order to send appropriate signals to network customers about the costs of using the networks at peak times. We consider that this will encourage network customers to consider how using the networks at peak times can be avoided, thus easing pressure on security of supply.

For electricity, there is a need for substantial increases in investment to replace ageing assets. This requires adequate allowance for capital expenditure in price controls together with incentives to ensure that the required investment takes place. The challenge of accommodating significant volumes of renewable generation will also require Ofgem to work with all stakeholders, as noted above.

In addition, the Energy Act 2004 gives the Secretary of State the power to appoint a special administrator to keep networks running should one of the monopoly network businesses become insolvent. Under those extreme circumstances, a special administration regime would assist in ensuring continued security of supplies. The detailed arrangements will be finalised during 2005-2006.

## Interconnectors

The Energy Act 2004 provides for the licensing of interconnector operators. Companies operating interconnectors between Britain and other systems will have to obtain a licence from Ofgem. Ofgem and DTI have worked closely to determine what conditions the interconnector licences should contain, and have consulted widely on the proposed licence drafting. Once these licences are in place in 2005, Ofgem will have responsibility as the regulating authority to grant, modify and enforce interconnector licences. These licences have been drafted to meet the requirements of the new European Gas and Electricity Directives and Electricity Regulation, but with a light-touch regulatory approach which Ofgem considers will be attractive to new investors looking to bring new sources of energy to British markets and thus help to protect security of supply.

## A leading voice in Europe

### The importance of Europe

European energy markets and EU regulatory policy have an ever-increasing influence on energy markets and consumers in Britain:

- wholesale gas prices in Britain are affected by those in neighbouring markets which may not be as liberalised as those in Britain
- the commercial and physical links between British and European gas markets will be strengthened significantly by plans for major new gas pipelines and LNG import terminals, and
- European Directives and Regulations will increasingly impinge on Britain's markets. For example, binding guidelines issued under the Electricity Regulation could in the future lead to increased harmonisation of transmission tariffs, requiring changes to Britain's tariff systems.

Policy debate on EU liberalisation and regulation is developing rapidly. Ofgem made Europe one of its seven strategic themes last year so as to drive the debate forward and to minimise the risk that European markets and regulation might damage our own liberalised markets.

This is a major priority for Ofgem. Ofgem will work with the European Commission, national regulators and national competition authorities to promote full and effective liberalisation of the European energy markets and to shape the regulatory agenda going forward.

### European legislation

The EU is becoming increasingly active in developing policy and law that affects European gas and electricity markets. New EU legislation specifically for gas and electricity, for security of supply and also on the environment, is likely to be implemented in the next few years. This legislation, will have a significant impact on the way we regulate British energy markets.

The Second Gas Directive which was adopted in June 2003 established common rules for the transmission, distribution and storage of natural gas and for market access and also set out a timetable leading to full EU gas market liberalisation for existing Member States by July 2007. The Second Electricity Directive which was

also adopted in June 2003 established common rules for transmission and distribution of electricity and a similar timetable for electricity market liberalisation. Both Directives require the establishment in each Member State of regulatory authorities independent of the interests of industry. The electricity regulation, adopted in June 2003, sets out conditions for access to networks for cross-border exchanges of electricity and is aimed at promoting a single EU-wide market for electricity.

Since then the European Parliament and Council have adopted a Regulation on Conditions of Access to the Gas Transmission Networks. The Regulation is intended to establish a mechanism for effective, fair and enforceable rules across the EU for third party access to gas transportation networks. Ofgem considers that the Regulation is vital to reduce barriers to companies entering continental gas markets and is an example of Ofgem working effectively with other regulators in establishing the need for the Regulation. We will work closely with DTI to ensure, as far as possible, that the final text of the Regulation contains sufficiently robust anti-discrimination provisions and provides for fair access to European transmission networks.

The European Parliament and Council have adopted a Directive to Safeguard Security of Gas Supply, which sets out the roles and responsibilities of gas market players, the European Commission and Governments for ensuring security of supply in a liberalised market. The Directive must be implemented by May 2006.

Prompted by the interruptions to supplies in Italy in 2003, the Commission has also proposed a Directive to Safeguard Security of Electricity Supply and Infrastructure Investment. Ofgem considers that it is vital that the Directive does not undermine market-driven investments and measures delivered within the framework of liberalised competitive markets. We will promote strongly the view that centralised direction will be less effective at maintaining security of supply than competitive energy markets in which participants are able to respond to price signals.

### Ofgem's strategic goals

One of Ofgem's primary goals in relation to Europe is to enable Britain to have available secure supplies of piped gas and LNG from within the EU and from outside but transported through it at competitive prices. This means that we need, within the

framework of liberalised markets, regulated third party access to gas pipes, proper investment incentives for the development of gas pipes, LNG import facilities and gas storage and liquid traded gas markets across Europe, including access to gas storage. Other significant issues for the UK are to resolve potential difficulties posed by differences in gas quality, and to address any abuses of market power. We hope that the Commission's review of European gas markets will address some of these important issues.

We are also concerned to check that future EU legislation does not undermine our domestic market arrangements, and that they are based on the development of efficient and competitive markets.

Finally, we aim for electricity markets in Europe to be developed on the basis of a common set of market-based principles with the minimum degree of harmonisation necessary to facilitate cross-border trade. The intention is to integrate national markets progressively, based on the concept of trading regions rather than a single market.

### Influencing and shaping the debate

Ofgem will engage fully with the European Commission, national regulators and National Competition Authorities in addition to continuing our close work with the DTI on European energy issues, in order to take forward this agenda.

Ofgem is a member of the two key bodies for European regulators, the Council of European Energy Regulators (CEER) and the European Regulators Group for Electricity and Gas (ERGEG). Sir John Mogg Vice President of the CEER and Vice Chair of the ERGEG. Ofgem continues to use our membership of both bodies to make the case for full and rapid implementation of the Directives and Regulations. We will promote the view that markets are delivering security of supply and other aspects of consumer protection more effectively and efficiently than centralised arrangements and prescriptive regulation. We will argue for relevant EU legislation to complement, and not hinder, the development of effectively competitive markets.

Ofgem considers that the two regulatory bodies form a potentially powerful voice in shaping EU energy policy and that they will have an increasingly important role to play in regulating European energy markets. We will seek to ensure that they have the necessary resources and expertise to provide credible advice to the European Commission, and will invest a

significant amount of our own resources and expertise. Ofgem needs to play an active role so that their work plans remain consistent with Ofgem's objectives and that they implement their work plans effectively.

As part of the wider move towards the establishment of trading regions in Europe, based on common principles, the Commission has proposed that seven 'mini-fora' be established to examine the way congestion at borders is managed. Britain is part of one of these mini-fora, along with Northern Ireland, the Republic of Ireland and France. This mini-forum will bring together transmission network operators, regulators, the Commission and others to consider the issue of cross-border congestion.

In order to promote debate on key European issues by industry and consumer organisations, Ofgem intends in future to publish regular European updates on our website.

## Helping to protect the environment

### Environmental impacts of energy policy

The electricity generation sector is responsible for 37 per cent of the UK's CO<sub>2</sub> emissions. The Government's energy policy recognises these environmental impacts, with a domestic target to reduce CO<sub>2</sub> emissions by 20 per cent by 2010 in addition to our Kyoto commitments. The publication of the Energy White Paper in 2003 outlined the longer term objectives for energy policy, setting the UK on a course to reduce CO<sub>2</sub> emissions by 60 per cent by 2050. The sector also has important air quality impacts. The result is that energy policy and environmental policy at the UK, EU and wider international levels are becoming more and more closely linked.

Ofgem's statutory responsibilities include several of direct relevance to the environment. The Secretary of State's social and environmental guidance, reissued in March 2004, sets our work in the context of the Government's broader environmental and social policies, such as the Climate Change Programme designed to meet the UK's Kyoto commitments, and the Sustainable Development Strategy.

Ofgem's overall goal in its environmental work is to assist the gas and electricity markets and industry to achieve environmental improvement as efficiently as possible. Ofgem is, therefore, firmly committed to creating the conditions for this, for example by identifying and, wherever possible, removing any market imperfections including regulatory barriers.

Ofgem's work on the environment will continue to be integrated throughout the work of the organisation. This means that Ofgem will treat environmental issues coherently across the range of its decision-making, based on systematic and rigorous analysis. We will also facilitate a wider debate on the most efficient ways of delivering a low carbon energy sector.

The Environmental Advisory Group, whose members include senior industry figures, representatives of environmental groups, and academics, provides advice on Ofgem's environmental priorities. We also have a panel of environmental economists that contributes to the economic analysis that informs our own policy

decisions and the advice that we give to Government on its wider environmental policies.

### Delivering a low carbon future

Ofgem is committed to treating environmental issues coherently across the range of its decision-making, based on systematic and rigorous analysis. In particular, where the decision affects the emission of carbon, this analysis will rely on a social cost of carbon value. For example, the new distribution price controls contain an incentive to reduce losses from distribution networks that incorporates the social cost of carbon. These losses currently account for approximately seven per cent of all electricity generated.

Ofgem is committed to producing Impact Assessments which include environmental appraisals. Ofgem has developed detailed guidelines for these, so that the environmental impacts of the various policy options under consideration are clearly set out, particularly if there appear to be conflicts among our statutory duties. This should ensure that the decisions we make, and the reasons for them, are more transparent and better understood by stakeholders.

Ofgem has consistently urged the Government to adopt flexible, market mechanisms that deliver carbon reductions where they are most appropriate and at least cost to consumers. During the past year, Ofgem has supported the Government's work to implement the EU emissions trading scheme. This should provide a flexible, market mechanism operating across the 25 Member States of the EU. Over the period of the plan, we will examine the extent to which the EU emissions trading scheme is being effective in delivering significant CO<sub>2</sub> emission reductions at least cost to consumer.

Looking forward, Ofgem will continue to support the implementation of the scheme during its first and second phase. We will also contribute to the Government's review of the Renewables Obligation in 2005. Providing advice and analysis on the energy sector to other Government departments in this way is another important part of Ofgem's work on the environment.

Ofgem recognises that it is for Government and environmental regulators to set environmental targets. However, Ofgem has an important role to play in the debate about how targets should be met effectively in ways that minimise the impact on consumers and markets.

### Promoting efficiency and limiting demand

One low-cost way of reducing CO<sub>2</sub> emissions is by reducing demand. This is, therefore, an important element of Ofgem's environmental work, which also contributes to achieving our social and economic objectives, particularly at a time of rising prices. Demand management is also an important element of security of supply.

During the year, Ofgem has advised Defra on the scale and scope of the new Energy Efficiency Commitment (EEC), which aims to reduce CO<sub>2</sub> emissions from domestic household energy consumption and, together with other social programmes, to reduce the numbers in fuel poverty. Ofgem will continue to be involved in inter-governmental discussions on future energy efficiency programmes.

In May 2004, Ofgem launched a two-year trial aimed at allowing customers to make long-term savings on their energy bills. Under the trial, Ofgem is allowing suppliers to offer customers a package of energy efficiency measures in return for signing up to longer term contracts. We hope that suppliers will take advantage of the opportunity the trial provides to offer domestic customers attractive energy service packages. Ofgem is currently evaluating the trial.

During the past year, Ofgem has carried out further research into ways in which domestic customer could benefit from improved information about their consumption, for example on their bills or through advanced meters. Ofgem will be pursuing this work during the coming year, working with suppliers to pilot schemes. We will also be issuing guidelines to suppliers on implementing EU requirements to provide details to their customers of the mix of fuels in the electricity they supply.

Ofgem is working with the Carbon Trust and others to identify opportunities to improve energy efficiency in the industrial and commercial sectors. Ofgem continues to work to reduce its own CO<sub>2</sub> emissions by improving energy efficiency and by purchasing green electricity.

### Administering the Government's environmental programmes

Ofgem, on behalf of Government, is required to administer a range of programmes which are part of the Climate Change Programme. Principal among these are the Renewables Obligation and the EEC, which both take the form of obligations on licensed electricity and gas suppliers, all electricity suppliers in the case of renewables, and all domestic gas and electricity suppliers in the case of energy efficiency. We also administer the exemptions from the Climate Change Levy for renewables and CHP, the Renewables Guarantees of Origin and the CHP database.

Work on all these programmes is complex and involves a combination of technical, legal, IT and administrative skills. As in all our work, Ofgem seeks to administer these programmes as efficiently and cost-effectively as possible. We, therefore, welcomed a report by the National Audit Office (NAO) in July 2004 which concluded that Ofgem had administered the EEC programme effectively.

Looking forward, it will remain important to ensure that we continue to administer the Government's environmental programmes as efficiently and effectively as possible. We have concluded over the past five years that the most effective way to achieve this is by bringing the work in-house, relying on external technical and legal advice where necessary. On this basis, we have also decided to bring in-house the administration of the Fossil Fuel Levy.

## Helping to tackle fuel poverty

Ofgem has a key role to play in helping to tackle fuel poverty. Ofgem has a specific duty to have regard to the interests of vulnerable consumers - those who are disabled or chronically sick, of pensionable age, living on low incomes, or in rural areas. The Secretary of State's social and environmental guidance refers specifically to the Government's fuel poverty strategy, which aims to eliminate fuel poverty among vulnerable households by 2010, and in all households by 2016. The guidance asks Ofgem to do what it can, consistent with its duties, to support that strategy but notes that decisions with significant financial implications are for Government.

### Ofgem's role in an era of rising energy prices

The number of households considered to be in fuel poverty fell from 5 million in 1996 to an estimated 2.3 million in 2002. A significant factor in the decline was the fall in energy prices over the same period. The remainder was largely the result of rising incomes. It follows that rising energy prices, in the absence of other action, will increase the number of households in fuel poverty. Ofgem's broader work on promoting competitive energy markets and regulating network monopolies remains important to help keep any price increases to a minimum.

Over the period covered by this strategy, the Government faces a major challenge if it is to succeed in eliminating fuel poverty in vulnerable households in line with its target. While the broader poverty agenda is an issue for Government, industry has a part to play. We will use our expert knowledge of the sector to help Government, companies and voluntary organisations to target support to where it is most needed and to adopt a more joined up and holistic approach to identifying which households are most in need and providing them with the full range of help they require. Ofgem will continue to be involved in inter-governmental discussions on future energy efficiency programmes.

Recognising the serious impact that rising fuel prices can have on the vulnerable, Ofgem has recently launched a new social initiative calling on industry, Government and voluntary organisations to consider what more they can do in a number of areas. We will also be carrying out an independent review of the companies' approach to corporate social responsibility as it impacts on vulnerable customers. This will allow Ofgem to help spread best practice and to encourage a

responsible attitude by suppliers toward their more vulnerable customers.

The other major challenge for all involved in this area is to increase awareness among vulnerable consumers of the help that is available. Ofgem and energywatch will therefore, work together under the Energy Smart banner to promote the message to customers that there are three things they can do to bring bills down: switch to a cheaper supplier, pay by a cheaper payment method, and install energy efficiency measures. We will also continue to work closely with energywatch to improve the way advice about these options can be targeted to help vulnerable consumers, either directly or through third parties, and to understand in more depth the issues facing these customers.

The areas that we have asked Government and industry to focus on are the targeting and interaction of energy efficiency schemes, the development of special tariffs for vulnerable customers and the provision of benefit health checks, which are all critical to delivering the government's fuel poverty targets, as well as the broader issue of debt and disconnection and the provision of special services to vulnerable customers.

These are expected to remain key issues over the five years of the plan period, and Ofgem will undertake regular surveys and reviews focussing on specific areas in order to promote best practice and to ensure greater awareness of the relative performance of the different companies in this area.

The Social Action Plan remains the framework within which we will take forward our work. The original Social Action Plan set out a five year work programme and we will, therefore, be consulting as part of the next Social Action Plan on an updated work programme in support of the priority areas identified during our current round of consultations. Where consumer research is required to understand consumer attitudes better on particular issues then we will take this forward, where appropriate, jointly with energywatch.

The interests of vulnerable customers will be of particular concern in the supply licence review. Ofgem recognises that special protection for vulnerable customers will continue to be required, but is committed to reviewing the requirements to ensure

they are proportionate and do not distort competition.

Ofgem has recently consulted on how it should use the new powers it has under the Energy Act 2004 to extend the range of payments that can be collected through prepayment meters. This may provide an opportunity to reduce costs for prepayment meter customers. Ofgem will be taking this forward over the coming year.

## Improving Ofgem's efficiency and effectiveness

### Better regulation

Ofgem has a new duty in relation to better regulation. Over the past year, we have made some progress in this area, for example:

- we have secured the ending of disconnections for vulnerable customers through industry commitments, rather than by formal regulation
- we have removed requirements on generators to justify decisions to mothball plant
- we have increased transparency in our enforcement work by committing to publicise formal investigations
- we are saving money by administering the Fossil Fuel Levy in-house from May 2005
- we have resisted calls to regulate the network service agreements between gas distribution networks and the NTS, and
- we have removed overall standards from electricity distribution, given the range of incentives on quality of service now proposed in the new price control.

Nevertheless, we are conscious that there is more to do on this agenda, and we are committed to pursuing it. Our better regulation plans are set out below.

### Controlling Ofgem's costs

Some companies have for some time suggested that Ofgem's direct costs are too high and that we employ too many staff. We recognise that our work imposes costs on the industry and on consumers. During 2004, we introduced a new structure that enabled Ofgem to reduce its running costs without compromising key projects.

We also pledged to implement a RPI-X cost control formula on our own operations similar to that imposed on the regulated network monopoly businesses. During 2004, we conducted a detailed audit of Ofgem's cost base, which was verified by the Authority's Audit Committee. This work formed the basis of the RPI-3 per cent budget cap which will apply for five years from April 2005.

This decision will bring savings of £5.3 million in real terms over the five year period of the control and will strike the right balance in controlling costs, without compromising Ofgem's ability to protect customers' interests. In particular, there is a safety net whereby Ofgem can go to its Audit Committee to seek additional budget should there be significant additional costs relating, for example, to new projects that were not anticipated. The Audit Committee will, in judging whether additional funds are justified, form a view on the scope for delaying previously planned expenditure. If the Audit Committee accepts that further funding is necessary, we will then seek appropriate funding from the Treasury which would, in turn, increase the licence fee.

### Improving Ofgem's policy process

Transparency is one aspect of better regulation to which Ofgem will be paying particular regard over the coming year, given also the new requirements under the Freedom of Information Act. As a part of this, the Authority will shortly publish reports of its monthly meetings and, once a year, will hold a public session.

Ofgem recognises that it imposes indirect costs on companies, including costs associated with engaging with, and responding to, Ofgem consultations. Under 'Project Paperless', Ofgem will strive to improve our consultation, reporting and review processes. In particular, we will

- make our publications more concise, clearer and better focused
- reduce the number of consultations that we undertake
- continue to work openly and transparently, since consultation is a key component of our decision-making process, and
- review our practices in relation to gathering information from licensees, to consider how we might reduce the burden placed on companies by information requests.

During the last year, we made over 150 decisions on modification proposals to the Industry Codes. As a result of better prioritisation we have cleared a backlog

of decisions that had been taking a particularly long time. Ofgem will continue to review its prioritisation of resources so that modification proposals are dealt with as expeditiously as possible.

Ofgem takes very seriously the requirement to publish Impact Assessments for all important new policy proposals. Ofgem believes that Impact Assessments are an important tool for improving the quality of our analysis and for providing a consistent structure for consultation on our important decisions. We have undertaken a review of the Impact Assessments that we have carried out to date. Ofgem will continue to engage industry and consumers in drawing up Impact Assessments, since these stakeholders are often better placed to provide information on likely implementation costs. We recognise that our decisions must continue to be based on the most reliable information, with supporting evidence and objective analysis. High quality decision-making based on sound, well-researched analysis, the firm commitment to our statutory responsibilities, the principles of better regulation, and the attraction and retention of high quality staff are key.

## Appendix 1: Ofgem's Statutory duties

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.

We are also required to carry out our functions in the manner which we consider best calculated

- to promote efficiency and economy including efficient use of energy
- to protect the public from dangers
- to contribute to the achievement of sustainable development
- to secure a diverse and viable long term energy supply, and
- and shall have regard, in carrying out those functions, to the impact on the environment of the gas and electricity industries.

In carrying out our functions we must also have regard to:

- the principles under which regulatory activities should be transparent, accountable proportionate, consistent and targeted only at cases in which action is needed, and
- any other principles that appear to us to represent the best regulatory practice.

Furthermore, we must have regard to social and environmental guidance issued by Ministers. Ofgem also has a duty to consult and take into account any advice given by the Health and Safety Executive about all gas and electricity safety issues that may be relevant to the carrying out of our functions under the Gas Act and the Electricity Act.

## Appendix 2: Corporate Plan Deliverables 2005-2006

The following tables list the key deliverables for 2005-6 by Strategy theme. For each deliverable a delivery date is provided. The delivery dates are listed by quarter (Q1 - Apr-Jun 2005; Q2 - Jul-Sept 2005; Q3 - Oct-Dec 2005; Q4 - Jan-Mar 2006).

### Creating and Sustaining Competition

Activity	Action	Delivery Period
Retail Competition	Domestic monitoring - quarterly website updates of key indicators	Q1,2,3 & 4
	Metering - consult on framework/scope and indicators for a competitive market review	Q2
	Non-domestic markets - consult on carrying out further review of non-domestic supply sectors	Q1
Cash out review	Conclude review of gas and electricity cash out arrangements.	Q2
Retail Competition	Supply licence review - commence review	Q1
Offshore information release	Consult and (implement if appropriate) reform of onshore regulatory arrangements to facilitate information release	Q2
Gas quality	Conclude review of existing gas quality arrangements	Q3
LNG funding	Conclude development of appropriate funding arrangements for LNG.	Q3
Gas SO incentives	Start development of enhanced SO incentives for Transco in its role as GB SO in the gas market to apply from 1 April 2007	Q2
Electricity SO incentives	Start development of enhanced SO incentives for NGC in its role as GB SO in the electricity market to apply from 1 April 2007	Q2
	Develop and implement shallow SO incentives for NGC in its role as GB SO in the electricity market to apply from 1 April 2006 to 31 March 2007	Q4
Gas balancing arrangements	Report on the performance of the gas balancing indicators.	Q2, Q4
Modifications	Publish review of reconciliation by difference in gas	Q4
Connections	Implement, by 1st April 2006, new Standard Special Licence Condition for all gas distribution networks in respect of scope of emergency service to be offered to independent gas transporters	Q4
Market Infrastructure	Liaise and support the work of the Customer Transfer Programme	Q1



## Regulating Monopoly Networks

Activity	Action	Delivery Period
DN Sales	Consent to transfer of licences to gas distribution businesses to be sold by Transco plc and approve revised Network Code	Q1
Networks	Closure of the second Asset Risk Management Survey	Q3
Modifications	Publish procedures for complaints and dispute resolution under Articles 23 & 25 of the Gas and Electricity Directives	Q1
	Publish decision document on Distribution CUSC	Q1
Electricity and gas transmission	Publish initial consultation on electricity and gas transmission price control reviews.	Q1
Electricity distribution policy	Publish initial consultation on longer term electricity distribution charging arrangements	Q1
Electricity and gas transmission	Publish initial consultation on structure of electricity transmission charges	Q2
	Publish, jointly with DTI, initial consultation on the regulatory regime for offshore transmission	Q2
Electricity distribution price control review	Publish conclusions of review of 2004-2005 electricity distribution price control review (DPCR4)	Q2
Gas distribution policy	Publish final proposals for gas distribution structure of charges	Q2
Connections	Publish final proposals for new Standard Licence Condition to prohibit undue discrimination by electricity distribution networks in the provision of non-contestable connections information and services	Q2
Electricity and gas transmission	Publish second consultation on electricity and gas price control reviews	Q3
Electricity distribution price control review	Publish summary cost information for electricity distribution companies for 2004-2005	Q3
Quality of service	Publish annual reports for 2004-2005 on electricity and gas distribution quality of service	Q3

## Protect Security of Energy Supply

Activity	Action	Delivery Period
Security of supply reporting - Winter Outlook	Publication of NGT winter outlook reports	Q2
Security of supply reporting - JESS/Energy Act	Publication of Energy Act and Joint Energy Security of Supply Reports	Q2 Q3
	Publication of conclusions document following consultation on NGT's information release licence condition	Q1

## Leading Voice in Europe

Activity	Action	Delivery Period
Europe	Publish CEER report assessing the factors which inhibit the development of regional markets in Europe and key factors which inhibit interactions between regional markets and make proposals for improvement	Q1
	Ensure that unbundling of gas and electricity networks is closely monitored and that reports are prepared by the CEER on the effectiveness of unbundling, in particular in the benchmarking report	Q3
	Start development of CEER 'Road Map' which will define the necessary interactions between regions for the realisation of a single energy market	Q2
	Complete the initial process for the UK/Ireland/France mini forum as requested in the Florence Forum and report to the next Florence Forum	Q1

## Protecting the Environment

Activity	Action	Delivery Period
Renewables	Publish administration procedures for NI generators	Q1
	Submit response to DTI preliminary consultation on 2006 Renewables Obligation Review	Q2
CHP	Publish administration procedures for non-exporting CHP operators	Q1
Environmental issues	Publish Environmental Action Plan annual report	Q1
Energy efficiency	Produce final report on supplier compliance with the Energy Efficiency Commitment	Q2
Fossil Fuel Levy	Set the Fossil Fuel Levy annually (from time-to-time, in Scotland) and ensure that it is collected	Q3

## Tackle fuel poverty

Activity	Action	Delivery Period
Social Action Plan	Publish social action plan for 2005-2010	Q1
	Publish review of the effectiveness of the priority service register, based on joint research with energywatch	Q3
	Supply licence review - consult on issues relating to vulnerable customers	Q4

## Improving Ofgem's efficiency and effectiveness

Activity	Action	Delivery Period
Licensing	Launch Electronic public register	Q2
Scotland office	Establish Scottish Energy Regulation Forum, for discussion of gas and electricity issues between all parts of Government in Scotland	Q1
Consultation	Report on the preparation of consultation documents	Q2

## Appendix 3: Performance indicators 2005-2006

Activity	Measure
Europe	Outputs of the CEER Regional Energy Market Task Force and Gas Working Group to be delivered within the prescribed timescales in 100 per cent of cases  Maintain a clear understanding of Northern Irish issues, so that the interests of UK electricity and gas consumers can be effectively represented at the European Regulators Group for Gas and Electricity, by meeting twice a year with OFREG
Renewables	Process 100 per cent of application forms within 10 working days or ask for further information
CHP	Carry out reconciliation of CHP LECs within 20 working days of receipt of information from Defra, in 100 per cent of cases
Energy efficiency	Respond within 10 working days to the schemes submitted by suppliers, in 100 per cent of cases
Technical Policy	Energywatch technical advice will be provided within 10 business days following receipt of all relevant information - Pass +90 per cent
Consumer Affairs	Respond to 90 per cent of customer contacts requiring a substantive response from Ofgem within 10 working days of receipt
Enforcement	Investigate possible non-compliance with sectoral legislation and the Competition Act, in accordance with statutory timescales in all cases
Licensing	90 per cent of competitive market licence applications to be processed within 12 weeks of receipt
Modifications	Follow published procedures for all modifications
Ofgem's efficiency	Respond to Freedom of Information queries within 20 days of receipt of request
Income Adjusting Events	Assess and make decision in relation to any IAE within three months of it being raised, in 100 per cent of cases
Ofgem's efficiency	Pay 98 per cent of undisputed bills within 30 days
Connections	Completion of 95 per cent of electricity/gas determinations within 16 weeks
Quality of Service	Single standards of performance determinations are resolved or an alternative course of action is recommended within 16 weeks in 95 per cent of cases
Modifications	70 per cent of decisions relating to modifications to industry codes and charging arrangements to be issued within five weeks

## Appendix 4: Budget 2005-2006

### 2005-2006 budget by theme

<b>Creating and sustaining markets</b>	<b>13,807</b>	<b>Protecting the environment</b>	<b>4,333</b>
Consumer & Wholesale Markets	6,011	Energy Efficiency	1,214
BETTA	133	Renewables	1,651
Market Surveillance	1,455	CHP	480
Connections	1,054	Environmental Issues	865
Gas Modifications	873	Fossil Fuel Levy	125
Electricity Modifications	1,032	<b>Tackle fuel poverty</b>	<b>864</b>
Licensing	748	Social Action Plan	864
Consumer Affairs	887	<b>Other costs</b>	<b>3,200</b>
Enforcement	1,615	Depreciation	1,200
<b>Regulating Network Monopolies</b>	<b>13,930</b>	Contingency	2,000
Technical Policy	567	<b>Sub total</b>	<b>39,029</b>
Technical Statutory	1,050	<b>Non Licence Fee income</b>	<b>(4,194)</b>
Transmission Price Control Review	4,750	Millbank Recharge	(3,346)
Financial Issues	808	Renewables / CHP	(700)
Costs & Outputs	1,983	Fossil Fuel Levy	(88)
Incentives & Structure Of Charges	1,959	Postcomm Recharge	(60)
Transmission Policy Development & Special Projects	1,455	<b>Net costs to licence payers</b>	<b>34,835</b>
Electricity Distribution Policy	1,017		
Electricity Distribution Price Control Review (follow up)	1,164	Note 1 - Accommodation and indirect costs associated with support functions within Ofgem are apportioned to the individual workstrands listed above.	
Quality of Service	1,590	Note 2 - Security of Supply costs indicated are directly attributable to work in this area. However, many workstrands under other themes contribute to the work in this area. In order to avoid duplication costs included in other themes are excluded from those shown in Security of Supply	
DN Sales	496		
Gas Distribution Policy & Gas Price Control	1,842		
<b>Protecting security of supply</b>	<b>697</b>		
Security of Supply	697		
<b>Leading Voice in Europe</b>	<b>2,198</b>		
Developing European Gas Regulation	795		
Developing European Electricity Regulation	590		
Promoting Competition in Europe	813		

### Additional commentary on the Ofgem budget

The above table provides an estimated breakdown of Ofgem's costs by activity and theme for the financial year 2005-2006. The budget has not been extrapolated over a five-year period commensurate with the RPI-X cost control regime since so much of Ofgem's work is undertaken on a reactive basis with constantly changing priorities.

The breakdown of costs is different to that provided in last year's corporate plan in that it shows the gross cost by theme (rather than the net cost). This means

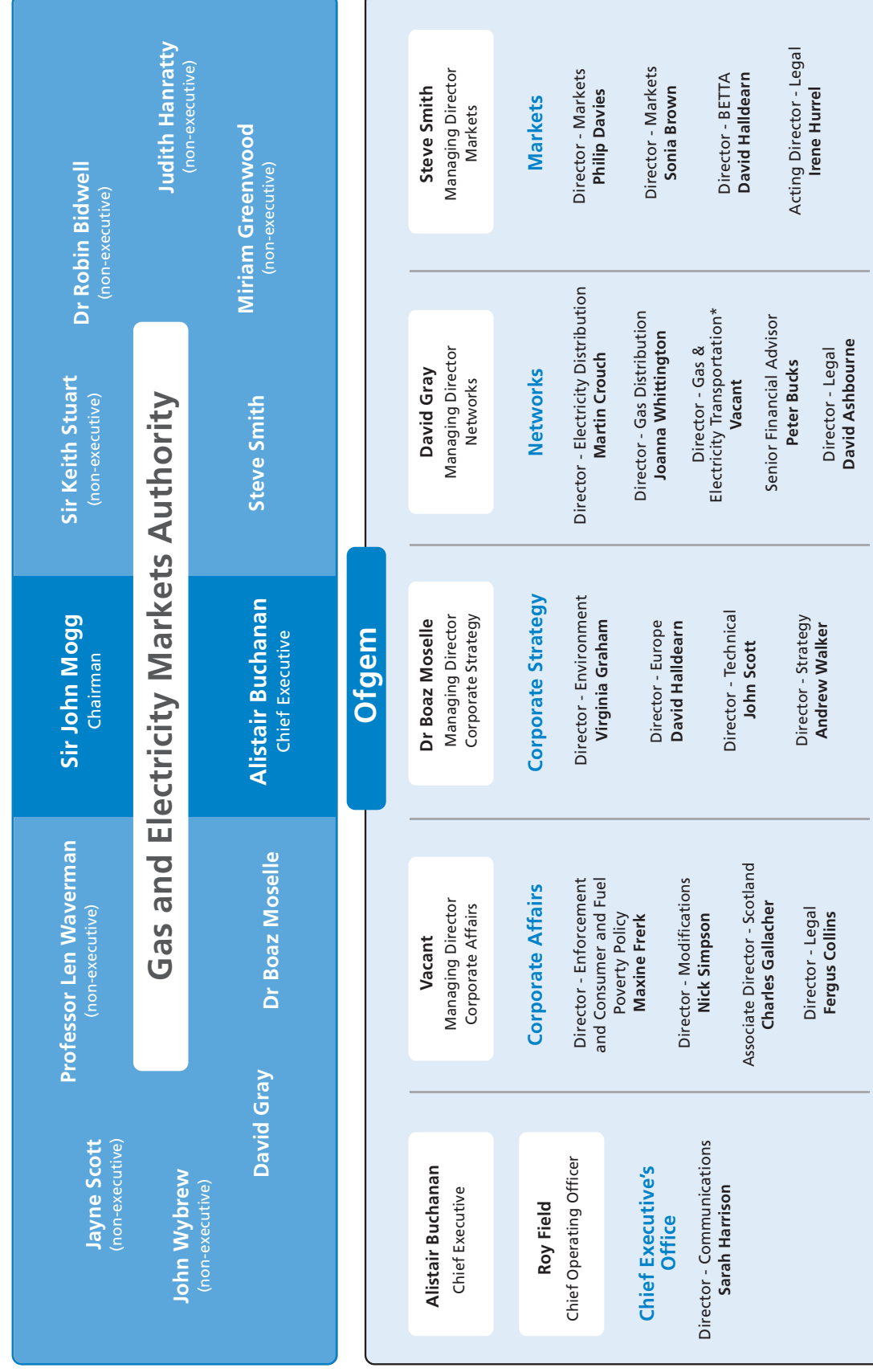
that central costs and overheads have been allocated to individual workstrands within themes on a gross rather than net basis making comparison with previous years difficult.

The main cost changes to the 2005-2006 budget from the previous year reflect the fact that work on DCPR4, BETTA and DN Sales has largely been completed while there is increased spending activity on Renewables, Europe (including seconding staff to the Commission and CEER) and preparatory work on the transmission price controls.

### Costs falling within RPI-X cost control regime

<b>Prior Year Budget (Baseline)</b>	<b>34,700</b>
<b>Adjustments Included in regime</b>	
OGD Recovery	700
Capital	1,000
<b>Excluded from regime</b>	
Work for OGDs	(1,100)
Depreciation	(1,200)
<b>Revised Baseline</b>	<b>34,100</b>
RPI (3.5 per cent as at December 2004)	1,194
Baseline + RPI	<b>35,294</b>
Less X (3 per cent)	(1,059)
<b>RPI-X Budget Ceiling</b>	<b>34,235</b>
<b>Adjustments Included in regime</b>	
Work for OGDs	1,100
Depreciation	1,200
<b>Excluded from regime</b>	
OGD Recovery	(700)
Capital	(1,000)
<b>Net cost to licence payers</b>	<b>34,835</b>

## Appendix 5: Organisational structure



**Authority advisors:** Michael Brocklehurst (Legal), Dr Tony Burne (Secretary), Sarah Harrison (Communications) and John Scott (Technical)

\*Sonia Brown retains the position of Director, Gas Transportation which she will hold on a part-time basis until completion of the DN sales process