



ofgem

Annual Report
2004-2005

Ofgem Annual
Report 2004-2005

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Ofgem Annual Report 2004-2005

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Report
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Office of Gas and Electricity Markets

Report of the Gas and Electricity Markets Authority for the period 1 April 2004 to 31 March 2005 to the Secretary of State for Trade and Industry.

The document comprises a report made under section 5(1) of the Utilities Act 2000. It also sets out information on Impact Assessments as required by section 5A(9) of the Utilities Act 2000, as introduced by section 6 of the Sustainable Energy Act 2003.

Office of Gas and Electricity Markets

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

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

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

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Contents

Contents

1.	Foreword by the Chairman	3
2.	The Gas and Electricity Markets Authority	4-5
3.	Introduction by the Chief Executive	6-7
4.	Creating and sustaining competition	8-11
5.	Regulating network monopolies	12-15
6.	Helping protect the security of Britain's energy supplies	16-18
7.	A leading voice in Europe	19-21
8.	Helping to protect the environment	22-25
9.	Helping to tackle fuel poverty	26-28
10.	Improving Ofgem's efficiency and effectiveness	29-32
<hr/>		
	Appendix I	33-39
	Ofgem's performance against 2004-2005 deliverables	
	Appendix II	40-41
	Impact Assessments undertaken - 2004-2005	
	Appendix III	42
	Investigations and enforcement action - 2004-2005	
	Appendix IV	43-47
	Financial statements (extracts) 2004-2005	
	The Ofgem Resource Accounts for 2004-2005 are published separately	



1. Foreword by the Chairman

At the heart of our responsibilities is the consumer. We have a statutory duty to protect the interests of consumers – present and future, commercial and domestic – wherever appropriate through effective competition. To that end, in our Corporate Strategy and Plan, we reaffirmed our belief in the coherence and continuity of the seven broad themes that have, to date, guided our work.

There is, however, another side of this broad strategic objective that assumes almost equal importance – the way in which we carry out our regulatory functions. We want to be properly accountable for all we decide. We want to be open and transparent in the way we conduct ourselves.

We want to be a listening, consulting organisation, making regulations and decisions that are both proportionate and as consistent as possible. And we want to make our organisation efficient and cost-effective, thereby enhancing, but certainly not damaging, the high reputation that Ofgem has enjoyed over the years.

We are confident that we have the right regulatory framework in which to operate and that we are making strides in improving all aspects of our work at both a strategic and operational level. The Chief Executive's introduction spells this out in more detail and highlights the wide range of issues we are called upon to tackle. Among these, the high and variable energy prices we have witnessed this year undoubtedly present a challenging environment for all consumers.

Even though our detailed scrutiny of energy markets – particularly gas – found no evidence of market manipulation, major energy consuming companies and domestic consumers, especially those in fuel poverty, have had to manage a difficult situation, notably the double digit price rises.

As to the future, if there are signs of market abuse we shall search them out and take the appropriate action. With Government, energy suppliers and the many voluntary organisations that do such valuable work at ground level, we shall intensify our efforts to bring a more holistic approach in the face of rising fuel poverty. And we shall continue to promote all the benefits a truly competitive market brings, including delivering a secure supply, in the most cost-effective way we can.

Across the energy landscape we are witnessing a period of immense change. The Authority's decision on the electricity distribution price control review last year will deliver greater company efficiency and improved network resilience while each year providing a sound basis to allow the cost-effective adaptation of our electricity networks for renewable energy.

Indeed, it is clear that the Government's agenda for a lower carbon economy presents industry with major challenges. That environmental agenda, together with the higher prominence of EU policies for our markets, will bring new and significant challenges for our future work.

I am most grateful to my fellow Non-executives on the Authority team. They have given generously of their time and expertise. James Strachan and John Belcher have now left us. But Jayne Scott, Miriam Greenwood, Judith Hanratty and John Wybrew all joined the Authority during the course of the year. Two Managing Directors at Ofgem who also served on the Authority, John Neilson and Boaz Moselle, have also moved on and we are now joined by Sarah Harrison as a new Managing Director.

Finally, I should like to record my special thanks to Alistair Buchanan. Under his leadership the Ofgem teams have again demonstrated their loyalty, expertise and dedication. They have responded to an ambitious agenda with true flair and resilience. Their effort and loyalty makes our work, difficult at the best of times, as successful as it can be.

Sir John Mogg
Chairman



2. The Gas and Electricity Markets Authority

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

Membership

Sir John Mogg
Chairman



Dr Robin Bidwell
Non-executive



Alistair Buchanan
Chief Executive



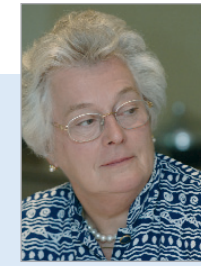
David Gray
Executive



Miriam Greenwood
Non-executive



Judith Hanratty
Non-executive



Sarah Harrison
Executive



Jayne Scott
Non-executive



Steve Smith
Executive

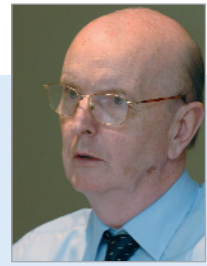


Members who stood down during 2004-2005:

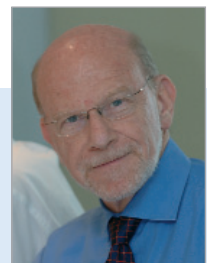
John Belcher
Non-executive (stood down December 2004)

Dr Boaz Moselle
Executive (stood down June 2005)

Sir Keith Stuart
Non-executive
(re-appointed June 2004)



Professor Len Waverman
Non-executive



John Wybrew
Non-executive



John Neilson
Executive (stood down January 2005)

James Strachan
Non-executive (stood down December 2004)



3. Introduction by the Chief Executive

Major projects during the year meant that Ofgem's public profile was high in 2004-2005.

These included the five year price review for the electricity distribution network companies, the probe into high gas prices, National Grid Transco's (NGT's) sale of gas distribution businesses and the achievement, on 1 April 2005, of uniting the Scottish electricity market with that of England and Wales.

These projects alone will deliver major benefits to consumers.

- The electricity distribution price control review allows for investment of £5.7 billion over the next five years, an increase of 48 per cent on current levels. It also provides for improvements in network reliability as well as facilitating the growth in distributed generation. At the same time, charges will be kept to a minimum, averaging 6p a month in real terms.
- We estimate that consumers will benefit by about £225 million, in net present value terms, between 2005 and 2023 from the sale of the gas distribution networks, as we should be better able to compare company performance.
- In Scotland, consumers should benefit from greater competition following the creation of an all-British electricity market. Scottish generating companies, including renewable generators, should also benefit from being able to sell their electricity to a wider market.
- Finally, we provided comfort to domestic and industrial consumers who saw significant increases in gas prices last year, that this was not being caused by manipulation of the GB gas market, deliberate or otherwise.

The successful delivery of these highly complex projects is a testimony to the ability and professionalism of Ofgem staff. I am extremely grateful to

everyone who worked on these projects and they, I am sure, would be the first to recognise the support they received from the rest of the Ofgem team.

Away from these high profile projects, we continued to make important strides in our efficiency. Some examples include the substantial improvement in turnaround time for processing modifications to market rules, the significant reduction in time taken to amend a licence and the organisation hitting 87 per cent of its deliverables, against a target of 75 per cent.

Given the significance of Ofgem's workload in 2004-2005, it will come as no surprise that we spent a lot of time explaining our actions. Among a range of activities, we gave evidence to the Trade and Industry Committee on the gas probe, disconnections and electricity distribution price control. We ensured that, in a price control year, we had open channels to the capital markets, we explained our position on Europe to the European Parliament and Commission and we discussed our social and environmental agenda with the Public Accounts Committee.

This latter meeting was on the back of an endorsement from the National Audit Office Chairman, Sir John Bourn, who said: 'Ofgem's actions are to be applauded both in its attempts to help vulnerable consumers and in its attempts to increase energy efficiency'.

If the first theme of last year was securing benefits for consumers, then the second theme was Ofgem's ability to evolve as an organisation, both in policy development and in the way we operate. The most striking policy evolution was arguably on environmental, social and European issues.

In the 2004 Energy Act, Ofgem was given an additional secondary

duty – that of contributing to sustainability. This duty, together with our enhanced social and environmental guidance from the Secretary of State and the framework of the White Paper, has led Ofgem to ensure that these matters are considered as comprehensively as possible.

We have been fully committed to a wider ranging environmental agenda - from our work on contributing to the launch of the EU Emissions Trading Scheme and the new Energy Efficiency Commitment, to fast-forwarding the regulatory regime to enable an upgrade of the transmission lines in Scotland to bring electricity, primarily wind power, south. On social issues, an Ofgem-brokered commitment saw debt and disconnection levels reduced substantially.

Our commitment to Europe was seen in both our leadership and support of key initiatives and seconding Ofgem personnel to Brussels to be at the heart of European energy issues. Also, Ofgem was a fully committed member of the Commission's gas and electricity regulators' advisory group, ERGEG, which pushed through a voluntary agreement that will enhance substantially information on gas storage.

Our interest in European gas issues is driven by the need to ensure that British consumers' interests are served fully. To that end, we were pleased that our Chairman, Sir John Mogg, was asked to become the Vice-Chair of ERGEG during the year, and Chair of the Gas Working Group. These bodies report to the Council of European Energy Regulators (CEER), where Sir John is also Vice-President. We will continue to exert influence on the development of markets across Europe, and export best practice.

Ofgem is a keen supporter of the inquiries into both electricity and gas markets across Europe by the EU competition directorate which were announced in June 2005. Again, we have had a central role both in promoting the need for a gas review,

but also in providing senior personnel on secondment to assist in this project. We justify such an investment by the need to promote the best interests of British consumers.

Operational evolution and handling management change were key issues. Last year, we announced that, after achieving an 8 per cent cost reduction in 2004-2005, we would operate under an RPI-X efficiency cost control.

During 2004-2005, our Authority Audit Committee decided that RPI-3 per cent a year will be imposed on Ofgem for the next five years. We also announced that we were reinforcing the importance of our Glasgow office. Both of these actions, we felt, left us well-placed to handle the challenges announced in the Gershon and Lyons public sector reviews.

In looking at the better regulation agenda, Ofgem also sought to review the way it operates, as well as the cost base. With this in mind, we announced, in January 2005, 'Project Paperless', a root-and-branch review of our documentation, and our plans to set our own target for reducing the burden of paperwork on our stakeholders, an initiative identified in our Corporate Strategy and Plan.

We are also keen to introduce smarter regulation to our policy decisions. One main project is the review of the supply licence conditions, arguably a set of rules and regulations that creates a barrier to retail market entry which, in their current form, may not offer the best protection to consumers.

Other notable examples of better regulation in the last year have been our decision to roll-over for two more years the Scottish transmission price review, without the need for a full-scale regulatory price control review. Further, we removed the overall standards applying to electricity distribution companies as customers' interests are protected in other ways.

These activities and commitments are well in line with the recently-published Arculus and Hampton Reports on better regulation.

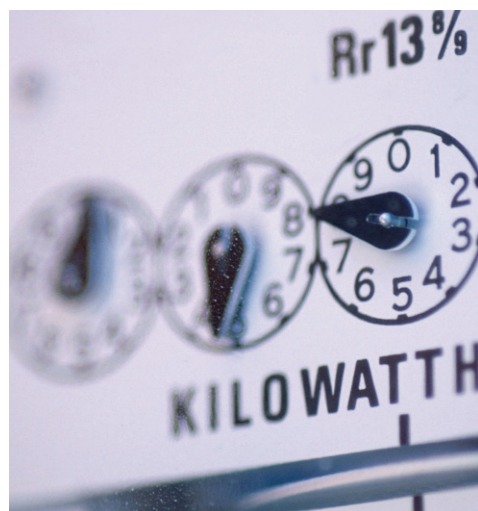
During the last year, we believe that we improved further our reputation as a listening organisation. Formally, this is reflected in the workshops, meetings and consultations which we have on major issues – such as the electricity distribution price control review.

Informally, the organisation is keen to hear consumers' and user groups' views. This has ranged from Sir John visiting Shetland and South Wales, inviting observers of Ofgem to speak their minds at our management Awayday, through to my own 'walk talk' trips to a range of interesting destinations: a call centre in Cardiff, the pumped storage facilities at Dinorwig, a sub-station at Feckenham and a day 'listening to the calls' at Scottish Gas. My colleagues and I try to capture all these experiences to improve the way we regulate the sector.

The regard with which we are held by other parties has also served to enhance our reputation. Two recent examples are worthy of note. Firstly, Ofgem was voted the top European electricity regulator in a survey by EurElectric of 80 European banks and fund managers. This was assessed on the basis of issues such as consistency, transparency, clarity, and neutrality. Closer to home, I was very pleased to note that Ofgem was the first Government department to publish its fully audited accounts.

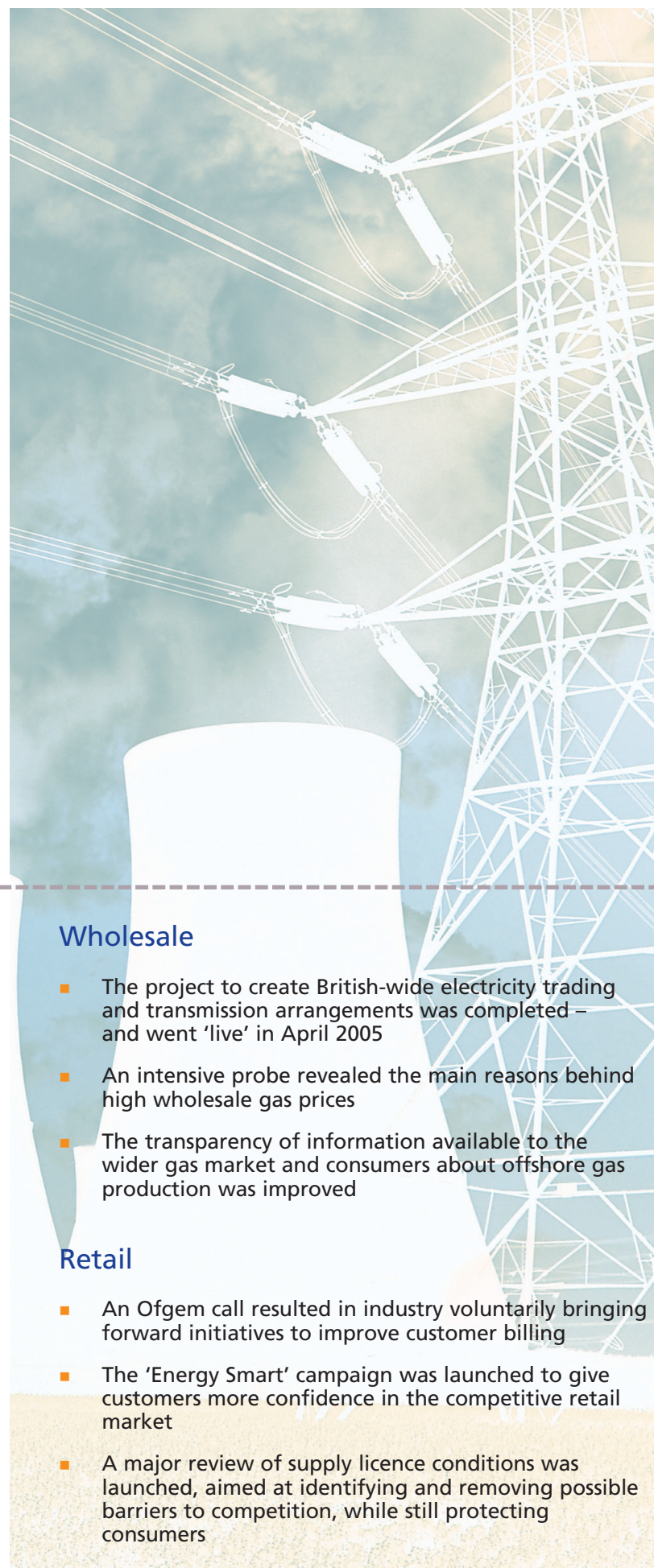
Finally, I would like to thank all the staff for their huge contribution in the last year. Ofgem is a dynamic and vibrant place, and these qualities are apparent in most of what we do.

Alistair Buchanan
Chief Executive



4. Creating and sustaining competition

Key achievements for 2004-2005



Wholesale

- The project to create British-wide electricity trading and transmission arrangements was completed – and went ‘live’ in April 2005
- An intensive probe revealed the main reasons behind high wholesale gas prices
- The transparency of information available to the wider gas market and consumers about offshore gas production was improved

Retail

- An Ofgem call resulted in industry voluntarily bringing forward initiatives to improve customer billing
- The ‘Energy Smart’ campaign was launched to give customers more confidence in the competitive retail market
- A major review of supply licence conditions was launched, aimed at identifying and removing possible barriers to competition, while still protecting consumers

Introduction

Consumers have benefited considerably over the last few years from the competitive markets that have been established in gas and electricity, at both wholesale and retail levels. This is why Ofgem’s approach remains the same – that where competition is established, we will seek to ensure that it continues to work well for customers.

Where it is not established, we help pave the way for its introduction and work to keep it sustained, as long as this is the most appropriate way of meeting our principal statutory objective of protecting consumers’ interests.

The main thrust of our work is to continue to protect consumers by identifying and removing barriers to competition. To achieve this during the year, we continued to monitor market developments, taking enforcement and other necessary action when appropriate.

Wholesale markets

As gas and electricity costs make up most of the energy bills received by households and businesses, 40 per cent and 75 per cent respectively, much of our work is focused on ensuring the wholesale markets remain competitive.

Also, our approach, shared by Government, is that security of supply is delivered best by promoting effective competition in wholesale and retail energy markets, and by network monopolies having the right incentives to invest.

Electricity

Following the move to create a more competitive electricity wholesale market in England and Wales in 2001, a single wholesale electricity market for the whole of Great Britain finally came into being on 1 April 2005.

A single British market will bring more competitive prices and greater choice to electricity consumers across Great Britain, and especially those in Scotland. It will also give generators in Scotland – including renewable generators – access to a wider British market.

We expect this to lead to more energy companies offering better deals to Scottish customers and businesses. Since the British market went live, one company has already

announced a major drive to compete for customers over the border.

The new market requires a common approach to paying for connection to, and use of, the high-voltage transmission system. Previously, there were three separate transmission charging systems – one for England and Wales and two for Scotland. Ofgem approved new GB-wide charging arrangements for generators and customers in February 2005 (see ‘Regulating network monopolies’, page 12).

Gas

Gas probe

Wholesale gas prices rose substantially during winter 2003-2004 – and they remain high. Following an 80 per cent rise in prices in October and November 2003, while demand remained similar to the previous year, Ofgem launched a probe to look into the reasons behind these increases. This probe was extended to consider high spot prices during summer 2004 and forward prices for winter 2004-2005.

In May 2004, we closed enquiries on five of the seven potential causes of high prices in October and November 2003 – but announced we were seeking further information on two outstanding issues relating to some specific contracts for offshore gas in the North Sea and supplies between GB and the continent, through the interconnector.

Final findings published in October 2004 showed that the main reasons behind the winter 2004-2005 forward price rises were record oil prices feeding into the GB gas market and declining UK supplies. There was no evidence overall of market manipulation.

In parallel, Ofgem called on the European Commission to put more resources into making competition work across the European Union. Stronger competition in Europe could have diluted the effect from high oil

prices, to which continental gas prices are linked, and, consequently, their impact on British customers' energy bills.

In March 2005, the European Commission announced its plans for inquiries into the European gas and electricity markets – inquiries which Ofgem encouraged, and in which we continue to play a full part (see 'A leading voice in Europe, page 19).

Ofgem closed its consideration of issues concerning the North Sea gas contracts in June 2005, with no further action being taken at this time.

Market transparency and information

Wholesale markets work best when participants have access to all relevant data. Ofgem, therefore, supports greater transparency in the gas market. More information about available gas supplies and maintenance of major gas fields can reduce uncertainty. Customers, traders and energy suppliers have all argued that this uncertainty is a major cause of price volatility.

Ofgem worked with the Department of Trade and Industry (DTI) during the year to improve access to information about offshore gas production. This led to the DTI/Ofgem/UK Offshore Operators' Association (UKOOA) negotiating a voluntary agreement between offshore producers, terminal operators and National Grid Transco (NGT) to improve the information provided to NGT and to the market on available supplies, and planned and unplanned outages.

The pressure for greater transparency remains. In June 2005, following a full and wide consultation, Ofgem announced a permanent framework to enable transparency of information about operations offshore which can affect arrangements onshore.

Also, the industry considered during the year a modification to network rules from consumer body, energywatch, so that more information can be published. We carried out an Impact Assessment of this proposal and the results of this consultation are due to be announced in July 2005.

Market surveillance and enforcement

In both wholesale gas and electricity markets, Ofgem continued to monitor market developments for any anti-competitive behaviour. The main manifestation of this work during the year was the gas probe into high wholesale gas prices.

Retail markets

Just five years after the energy markets were opened fully to competition, around 50 per cent of all customers have changed their energy suppliers. This compares well with similar markets – in fixed line telecoms, BT still retains 70 per cent market share some 20 years after competition was introduced.

Ofgem continues to believe that competition best protects the interests of consumers. It keeps pressure on costs, service levels and provides a greater choice of tariffs and services for customers.

Priorities during the year included:

- a commitment to ensuring that all consumers – particularly those who are most vulnerable – have the right to choose and change their supplier, and
- to provide confidence to consumers that we monitor markets regularly and will act to remove any barriers to the further development of competition and, where necessary, use our powers to tackle anti-competitive behaviour.

State of competition in the retail market

In April 2004, Ofgem announced the findings of a review into the state of retail competition which showed that customers are getting a good deal from energy competition and are changing suppliers in similar numbers whatever their income or social background. They also showed an encouraging rise in the number of older people switching supplier – a group which previously lagged behind other social groups.

However, there are signs that the energy market has some way to go before it matures. There remain barriers to prepayment meter customers and customers in debt who have less access to the competitive market than other consumers. Ofgem undertook activity during the year to help tackle this issue (see 'Tackling fuel poverty, page 26).

The review also found that competitive pressure on suppliers is increasing as they battle for market share. More than 60 per cent of all switchers are changing supplier for the first time and this means a steady erosion of the former monopoly suppliers' market share. Suppliers also lose customers when they increase prices – a sure sign that competition is working.

Further, the range of tariffs and offers has proliferated during the year, in particular, tariffs for lower income and more vulnerable customers – important at a time of rising energy costs.

Billing

Accurate and timely billing is important for both customers and any service company. This is particularly true for energy companies competing to retain and win new customers in Britain's competitive energy market.

Against a background of concern from customer groups, Ofgem

Chairman, Sir John Mogg, wrote to the major suppliers in December 2004 asking them to set out the work they are doing to improve billing.

In March 2005, energywatch submitted a supercomplaint to Ofgem arguing that the billing processes of major suppliers were harming customers' interests. In July 2005, we published our detailed response to the supercomplaint.

At the same time, we called for industry to stop 'back-billing' customers beyond two years, if no bill is issued and the supplier is at fault. This will fall to one year from 2007. We also called for the industry to set up an independent complaint resolution service that can award compensation for the relatively small number of cases when things go badly wrong.

Customer transfers

Ofgem has identified the customer transfer process as needing improvement, to make retail markets work more effectively.

During the year, the six major suppliers made further progress 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 customer transfers. Ofgem welcomed this initiative and we expect to see significant improvements during 2005-2006.

Energy Smart

In November 2004, the then Energy Minister, Mike O'Brien, launched the joint Ofgem/energywatch 'Energy Smart' campaign which is aimed at giving customers more confidence to exercise their choice in the competitive retail market.

Main messages of this continuing campaign are to encourage people to reduce their energy costs by

switching energy supplier, changing payment method and using energy more efficiently. As the campaign develops, a further quality of service message will be added.

The first media campaign under the Energy Smart banner ran regionally during November, attracted widespread local coverage and saw a marked increase in calls to the energywatch helpline. A leaflet highlighting the special services available to vulnerable customers was also produced and issued to MPs throughout the country to help them advise their constituents. Further activity is planned during 2005-2006.

Market surveillance and enforcement

Ofgem continued market surveillance and took enforcement action where necessary to ensure company compliance.

During the year, we imposed a financial penalty of £700,000 on Powergen after the company unfairly stopped more than 200,000 domestic customers from switching to new gas and electricity suppliers.

Supply licence review

In February 2005, Ofgem announced the start of the first major review of supply licence conditions since they were first introduced.

This review, consistent with the principles of better regulation, will consider how consumer protection can best be provided, given the level of competition, the existence of other consumer protection legislation and the opportunity for self-regulation.

Against this background, the review will determine the future role of the supply licence and its detailed conditions. We will be paying close attention to the particular needs of more vulnerable customers and how best their interests can be protected.

Metering

In July 2004, Ofgem confirmed that standard industry-wide processes to support competition in gas metering services were introduced successfully – a culmination of more than four years' work undertaken across industry.

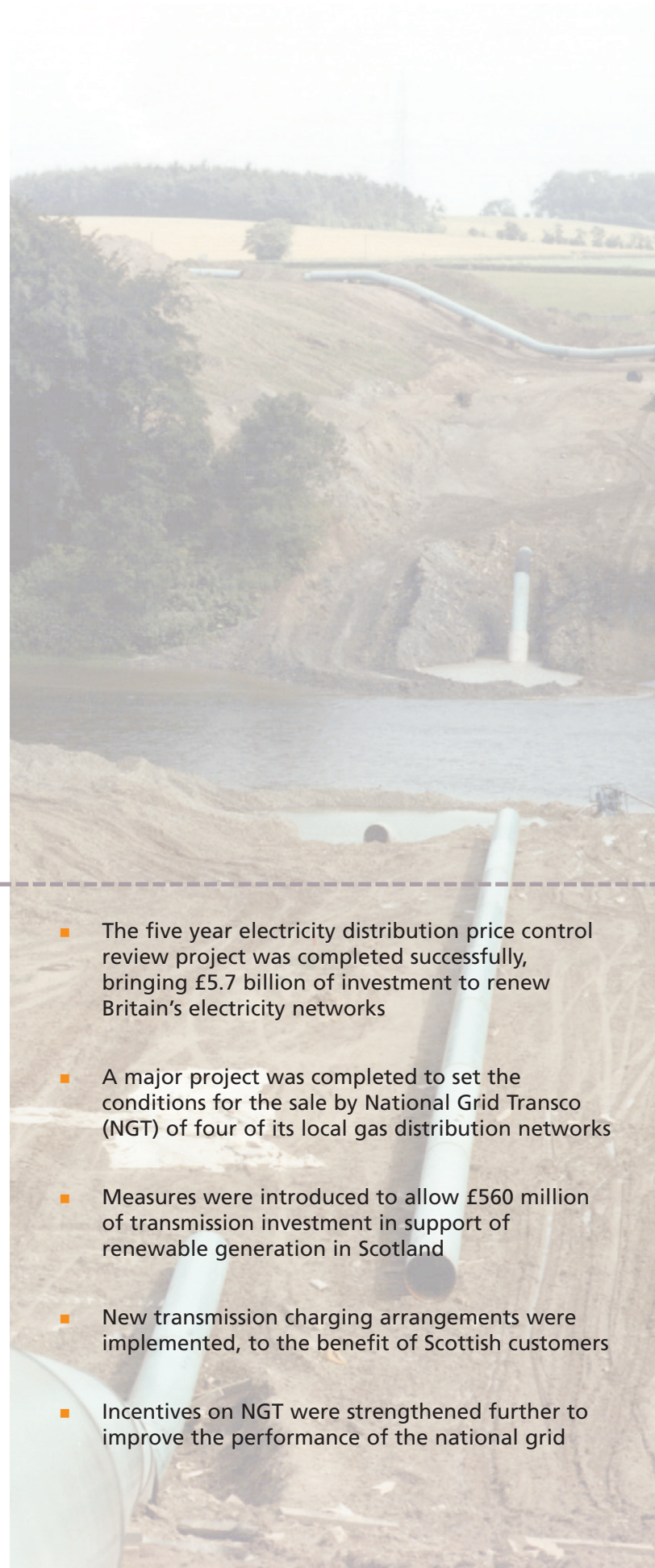
The implementation of these processes was overseen by an industry project team, chaired by Ofgem. We welcomed the implementation of these new processes as it helped promote choice for gas shippers, suppliers and consumers in the provision of gas metering services.



5. Regulating network monopolies

Key achievements for 2004-2005

- The five year electricity distribution price control review project was completed successfully, bringing £5.7 billion of investment to renew Britain's electricity networks
- A major project was completed to set the conditions for the sale by National Grid Transco (NGT) of four of its local gas distribution networks
- Measures were introduced to allow £560 million of transmission investment in support of renewable generation in Scotland
- New transmission charging arrangements were implemented, to the benefit of Scottish customers
- Incentives on NGT were strengthened further to improve the performance of the national grid



Introduction

Where competition is not practicable, or is not sufficiently well developed, Ofgem protects consumers' interests by regulating through price controls and incentive schemes. This helps ensure that consumers receive value for money and a secure and reliable service.

These price controls and incentives apply to the monopoly businesses that run the pipes and wires which bring gas and electricity to homes and businesses.

Under price controls, Ofgem will, wherever possible, focus on outputs – concentrating on what companies actually deliver in terms of quality of service, rather than on how they deliver it.

Companies must meet their statutory and legal obligations. If they do so and, at the same time, out-perform their price control targets, they should earn higher returns.

Companies that do not meet their obligations run the risk of financial penalties. Those that under-perform risk earning lower returns.

Our approach to network regulation reflects our desire to:

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

Electricity Distribution

The work on the fourth electricity distribution price control review provided the ideal opportunity to put this approach into action. The new five year price control was implemented in April 2005, following intense activity during the year to hit a number of important milestones.

Ofgem faced significant new challenges when undertaking this review. These were:

- general recognition that investment to replace network assets and to improve network performance needed to increase
- a greater focus on quality of service, and
- a need to respond to the growth in renewables connecting to the local electricity networks.

Through open and transparent consultation, Ofgem worked to produce a package of measures that struck the right balance between attracting investment and ensuring that customer prices are no higher than they needed to be.

In total, the final proposals announced in November 2004 are based on investment of £5.7 billion for 2005-2010 – an increase of around 48 per cent on investment in the previous five years.

This increased investment – and additional tax and pension costs faced by companies – will result initially in an average increase of around one per cent on distribution charges, or around 6p a month on the average domestic bill in real terms. After that, distribution charges will, on average, increase by no more than the rate of inflation.

There continues to be scope for distribution companies to achieve further efficiencies in their day-to-day running costs – although not on the same scale as previous years. During the next five years, companies will be expected to reduce their operating expenditure by three per cent on average.

The new price control responded to the growth in renewable generation by providing incentives for distribution companies to connect new forms of generation and to invest more in research, development and innovation to help realise the potential of renewable generation.

All of the 14 companies accepted the price control proposals in December 2004. The onus is now very much on them to deliver on the significant investment which the price control allows so customers can see even better levels of service.

Gas distribution

In April 2004, following an initial cost-benefit analysis, Ofgem announced there was potential for customers to benefit from NGT's proposed sale of one or more of its local gas distribution networks. Following this announcement, NGT signed conditional sale agreements in August 2004 for four of its networks.

Selling off these networks represented a radical change to the way the gas industry is structured – one of the biggest changes since privatisation in 1986. Ofgem had to examine carefully all the issues associated with any sale to ensure that customers' interests are protected.

Throughout the year, we undertook substantial and transparent consultations on the regulatory, commercial and operational arrangements needed to protect customers if, and when, the sales went ahead.

In November 2004, we published a final detailed look at the cost and benefits of the proposed sales. We estimated that the sales could produce future net benefits of around £225 million to customers. These potential benefits are expected to begin to feed through to customers in future price controls as we should be better able to compare the performance of the distribution networks.

On that basis, the Authority gave conditional approval for the sales to proceed on 21 January 2005. After meeting a set of conditions set down by the Authority following this decision, NGT transferred the assets

of its four networks into wholly-owned subsidiary companies in readiness for sale. The Authority gave its final consent for Transco to sell shares in its subsidiary companies to the respective buyers in May 2005.

Transmission

During the year, price controls for the two Scottish electricity transmission companies were extended to 31 March 2007. This allows us to set a new five year price control at the same time as the ones planned for the British-wide gas transmission network, and the electricity transmission network for England and Wales, both of which are owned by NGT.

This is seen as a pragmatic solution and demonstrates Ofgem's commitment to adhering to better regulation principles wherever possible.

In response to the growth of renewable generation in Scotland, Ofgem confirmed in December 2004 a new funding mechanism to bring forward investment totalling £560 million to strengthen the electricity transmission networks in Scotland and the North of England and allow power from new generation, particularly wind, to flow to markets in the rest of Britain.

Ofgem also began work with the Department of Trade and Industry (DTI) to set out the regulatory options for offshore electricity transmission. A joint DTI/Ofgem consultation is due for publication in July 2005.

Charging

The new single electricity market also needed a common approach to paying for connection to, and use of, the high-voltage transmission system. Previously, there were three separate transmission charging systems – one for England and Wales and two for Scotland.

Ofgem approved new GB-wide charging arrangements for generators and customers in February 2005. This approval requires NGT – which runs the network and applies the charges – to monitor and review the regime in the first two years of operation and to propose refinements where necessary.

During the year, the new charges faced much criticism. The facts are that the costs of transmission for Scottish customers will fall under the new arrangements.

For generators, the overall impact of the new charges will be neutral, while the new electricity arrangements will provide access to a wider market for Scotland's generation capacity, helping to realise Scotland's renewables potential and to meet the Scottish Executive's renewables targets.

The Authority's decision on GB-wide transmission charging arrangements is currently subject to challenge in the High Court through judicial review proceedings.

Incentives

In January 2005, in order to maintain and improve on an already high standard of performance, Ofgem strengthened incentives on National Grid Company (NGC), the NGT subsidiary responsible for the electricity transmission network. This scheme means that major power cuts could cost NGC up to a maximum of £12 million a year. However, the scheme also allows the company to earn up to a maximum of £8 million a year for improving performance on the national grid.

This scheme was introduced following the blackouts affecting parts of London and Birmingham in 2003 (see 'Helping protect security of Britain's energy supplies', page 16).

Further to this, Ofgem agreed a new System Operator incentive scheme

for NGC which covered for the first time NGC's role as System Operator for the whole of Great Britain. This scheme set a cost target for NGC of £377.5 million. If it outperforms this target, it will keep a percentage of the savings but if it overspends, it bears a percentage of the costs. This is aimed at ensuring the national transmission system, funded by generators and energy users, is operated as efficiently and effectively as possible.

Quality of service

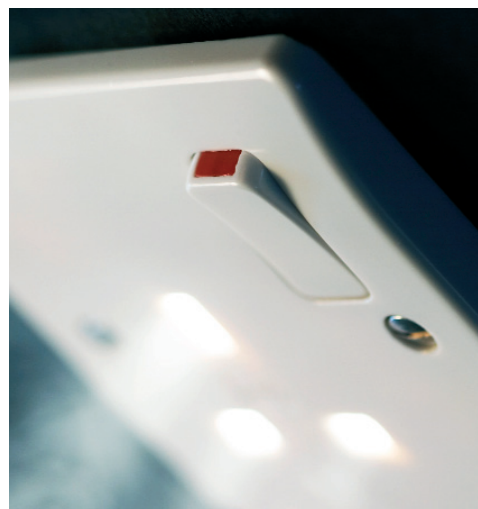
In November 2004, Ofgem published a report on the quality of service performance of the 14 electricity distribution companies between April 2003 and March 2004.

The report highlighted that since we introduced a quality of service incentive scheme in April 2002, the average number of power cuts fell by seven per cent, and the duration of power cuts fell by six per cent.

There was also an improvement in the quality of the companies' customer telephone response service which, on average, is rated highly by customers. However, while overall standards were raised, performance varied across the country, leaving room for further improvement.

Investigations and enforcement

In May 2004, Ofgem confirmed a £1 million financial penalty on national gas pipeline operator, Transco, the NGT subsidiary responsible for gas transmission, for the poor performance of its connections business. A wide range of customers had been affected, including gas suppliers acting on behalf of home owners wanting a new gas connection, competing connections firms and building contractors.



6. Helping protect the security of Britain's energy supplies

Key achievements for 2004-2005

- A regulatory framework was developed to enable the British market's transition to becoming a net importer of gas
- The market responded well to attract significant investment in new gas supplies
- National Grid Transco's (NGT's) winter outlook report was brought forward by six months to give the market adequate time to prepare for exceptional weather conditions
- Impact Assessments on security of supply were considered in all policy proposals
- Ofgem continued to play an integral role in the Joint Energy Security of Supply (JESS) group



Introduction

The security of energy supplies is central to everything that Ofgem does. We continue to believe that security of supply is maintained best by competitive wholesale and retail energy markets, and by network companies having the right incentives to invest efficiently.

Ofgem contributed to the debate on how this challenge can be met. Also, we monitor market rules and, with Government, provide timely information about future developments and trends. This helps better inform market participants when making investment decisions.

This approach has served British consumers well in the past and we have every confidence that it will continue to do so in the future. However, there is a difficult balance to maintain between the costs and benefits of improving security of supply. No energy supply system can guarantee absolute security at all times.

Because of this, Ofgem continues to seek to avoid the risk that consumers pay excessive costs in order to 'gold plate' infrastructure. The challenge is to maintain a high level of security at a reasonable cost to the consumer.

Blackout investigation

June 2004 saw Ofgem's Authority rule on our 10 month intensive investigation into the 2003 blackouts in London and Birmingham. The Authority did not find that National Grid Company (NGC) had breached its legal obligations. However, mistakes were made and the Authority could not give NGC a 'clean bill of health'.

In parallel, the Authority announced a new scheme to complement existing legal obligations on NGC and strengthen the incentives on the company to improve system performance (see 'Regulating network monopolies', page 12).

Winter 2004-2005

In order to give the market plenty of time to respond and consider improvements to cope with any severe, albeit exceptional, weather conditions during winter 2004-2005, Ofgem asked NGT to bring forward its forecasts by almost six months and these were published in May 2004.

NGT forecast that under all credible scenarios, including a severe winter, the market would be capable of maintaining secure supplies. These forecasts were reinforced by NGT's October 2004 winter report. Also, to help ensure future security of supply, the Joint Energy Security of Supply (JESS) working group reported in May 2004 that more than nine gigawatts of power plant had received planning permission.

Ofgem continues to monitor developments carefully. During the year, the market saw renewed activity including transactions and plant acquisitions as well as commitments, in January 2005, for new build and major plant conversion – all of which confirmed that the market is responding well to price signals with necessary investment.

In gas, GB supplies declining at a faster rate than forecast presented its own issues. During the year, the gas market responded well to the challenges posed by declining UK gas production – and continues to do so.

Companies announced plans to invest in new storage facilities, new Liquefied Natural Gas (LNG) terminals and new pipelines to import gas from continental Europe and other countries – and, for the more advanced projects, construction has begun or has been completed. Also, a number of new UK Continental Shelf fields have been brought into production.

If all these projects come to fruition, more than 70 billion cubic metres of gas a year of new gas supplies would be delivered to the market during the next two to four years. This would be equivalent to more than 60 per cent of current GB demand.

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.

Informing the debate

Ofgem continues to contribute to an informed policy debate about how competitive markets and effective network regulation can promote security of supply. We do so in a number of ways.

During the year, we began publishing impact assessments to measure the costs and benefits of our major policy decisions. When preparing these, we paid close attention to the effect that any proposals have on security of supply.

We also continued to play an integral role in the JESS working group which makes an important contribution to providing the market with forward-looking indicators in security of supply. We, alongside the Department of Trade and Industry (DTI), developed and monitored these indicators to enable market participants to have the information they need to make informed decisions.



7. A leading voice in Europe

Key achievements for 2004-2005

- Ofgem continued to work closely with European regulators' groups on developing competitive market arrangements
- Ofgem played a major role in developing the new market rules for adoption under the electricity Regulation
- Through the European regulators, Ofgem led the debate on the development of regional energy markets as the main strategic route towards liberalisation and a single European market
- Ofgem briefed the Commission on the impact that lack of effective competition in the continental gas market has on British consumers, prior to the Commission's announcement of inquiries into Europe's gas and electricity markets

Introduction

Ofgem's broad objective during the year was to help develop genuinely competitive European gas and electricity markets, bringing price and security of supply benefits to consumers, both in Britain and Europe.

During the year, it became even clearer that European energy markets and EU regulatory policy are having an ever-increasing influence on energy markets and consumers in Britain:

- wholesale gas prices in Britain are set by those in neighbouring, less-liberalised markets
- the commercial and physical links between British and other gas markets will be strengthened significantly by plans for new gas pipelines and Liquefied Natural Gas (LNG) import terminals, and
- European rules and regulations will impinge increasingly on Britain's markets.

European gas and electricity markets inquiries

In February 2005, Ofgem welcomed the announcement by the European Commission that it will carry out inquiries into competition in Europe's gas and electricity markets. These inquiries began in June 2005.

Ofgem supports strongly the work of the inquiry teams and we will continue to seek opportunities to make whatever contributions we can.

Our own probe into high wholesale gas prices in Britain (see 'Creating and sustaining competition', page 8) raised a number of questions about the operation of the European gas market. Since then, we have worked with the Commission and other member states to explain what impact the lack of effective competition in continental gas markets has on British consumers.

The 25 EU countries are scheduled to open their gas and electricity markets to full competition by 2007 – but at least 10 member states are lagging behind. By the end of 2005, the Commission will publish a review of the functioning of the gas and electricity markets. This will be an important opportunity to take stock and to examine whether there are

gaps in the current legislative framework.

Powering the energy debate

In March 2005, Ofgem Chairman, Sir John Mogg, kicked off the first of a series of high level seminars, under the banner 'Powering the energy debate', which are aimed at stimulating debate about a range of energy issues.

This first event, 'Europe and energy: a forward look' – at which Energy Commissioner, Andris Piebalgs, was a main speaker – provided an opportunity to highlight how the slow pace of European energy liberalisation is harming British consumers and businesses.

Ofgem believes that the outlook for establishing effective competition in other European markets remains a major worry and risks undermining the benefits of domestic competition to British consumers. The pace of European liberalisation needs to quicken.

The opportunities for both British and European customers from a thriving gas industry within the EU are immense. A failure to liberalise will be costly to all – customers, business and the ambition of the EU to become the most dynamic and competitive global economy.

European regulators' groups

During the year, Ofgem continued to work closely with fellow energy regulators through the Council of European Energy Regulators (CEER) and the European regulators' advisory group for electricity and gas (ERGEG).

Through these bodies, Ofgem continued to provide advice to the European Commission and engaged industry players, particularly at the regular Florence and Madrid fora.

During the year, Ofgem played a major role in influencing rules on tariff harmonisation, congestion management and cross-border

electricity flows which are expected to be adopted under the electricity Regulation, as well as on important rules relating to access to gas storage facilities by third parties.

We also led the debate through the European regulators on the development of regional electricity markets as a means to progress further market liberalisation in Europe and initiated the development of similar proposals in gas.

During the year, Sir John was elected Vice-Chair of ERGEG and he remains Vice-President of CEER. Ofgem staff continue to hold key posts in the main CEER and ERGEG working groups.



8. Helping to protect the environment

Key achievements for 2004-2005



- Ofgem contributed substantially to intergovernmental work on setting up the EU Emissions Trading Scheme (EU-ETS), the cornerstone of the UK's drive to reduce carbon emissions
- Ofgem, with the Department of Trade and Industry (DTI), set up arrangements for companies to meet their obligation to disclose the source of the electricity they are supplying from October 2005
- The final year of the Energy Efficiency Commitment (EEC) saw all suppliers meet their targets and achieve a one per cent reduction in overall household carbon emissions
- Ofgem launched a trial to allow up to a million gas and electricity customers to enter into long-term energy contracts linked to energy efficiency packages
- Ofgem issued more than nine million Renewables Obligation Certificates (ROCs), almost 11 million Renewables Levy Exemption Certificates (LECs), and 22 million Combined Heat and Power (CHP) LECs

Introduction

In addition to its Kyoto commitments, the UK has set itself a domestic target to cut CO₂ emissions by 20 per cent by 2010, and has an aspiration for a 60 per cent cut by 2050. These ambitious targets have set the agenda for Ofgem's work on the environment over the past year.

The cornerstone of the UK's policy to reduce CO₂ emissions is the EU-ETS which came into being on 1 January 2005. Ofgem has consistently supported the introduction of the scheme which has the potential to deliver carbon reductions as cost-effectively as possible. Some 30 per cent of the UK's emissions are caused by electricity generation, and these have been increasing over the past three years.

Ofgem favours the development of this market mechanism which for the first time has provided a value for carbon. This will underpin all future carbon reduction measures, including incentives to promote renewables, increase energy efficiency and reduce energy demand.

As well as our principal objective to protect the interests of consumers, Ofgem has secondary duties to have regard to the impact of the gas and electricity industries on the environment, to promote the efficient use of energy and to secure a diverse and viable long-term energy supply. In March 2004, Social and Environmental Guidance from the Secretary of State was reissued and, in October 2004, we were given a further duty to carry out our functions in a manner best calculated to contribute to sustainable development.

During the year, the Authority reaffirmed that Ofgem's goal in this area is to assist the gas and electricity markets and industry to achieve environmental improvements as efficiently as possible. It also reaffirmed Ofgem's commitment to treating environmental issues coherently across the range of our decision-making, based on systematic and rigorous analysis.

The Authority decided that Ofgem should continue to promote a wider debate on the most efficient ways of delivering a low carbon energy sector. The programme of events under the banner 'Powering the Energy Debate' contributed to this.

Annual review of Ofgem's environmental work

Ofgem published the Environmental Action Plan in 2001 to provide a framework for carrying forward environmental work across all policy areas. An annual review of this work has been issued each year since then, including a set of indicators to quantify as precisely as possible what impact the energy sector has on the environment. The fourth annual review was published in June 2004.

Environmental appraisal

Ofgem is committed to produce Impact Assessments for all major policies, including the impact they have on the environment. During the year, Ofgem's environmental team continued to develop best practice guidelines in the methodology for environmental appraisals and to help with their preparation.

Helping to deliver a low carbon future

Ofgem continued to urge Government to adopt flexible market mechanisms that deliver carbon reductions where they are most appropriate, and at least cost to consumers. That is why Ofgem encouraged the Government, when it reissued the Climate Change Programme at the end of the year, to ensure that the EU-ETS remains clearly at the centre of its carbon reduction strategy.

During the year, Ofgem was closely involved in the setting up of the EU-ETS. We advised policy makers on the impacts of different allocation methodologies on the electricity generating sector and on the economic aspects of trading.

In February 2005, Ofgem hosted a discussion day on the potential cost implications for consumers of the EU-ETS, chaired by Authority member, Dr. Robin Bidwell. It brought together experts from

academia, industry, trading and consultancy and was part of our series of 'Powering the Energy Debate' events.

Further work was carried out during the year on reducing potential barriers to new renewable generation. Ofgem has sought to ensure that there is sufficient investment in both the transmission and distribution networks and that renewable generators have access to a competitive wholesale electricity market. We responded to this through four key projects:

- the distribution price control review which contains new initiatives for network operators to support the growth of renewables and to promote innovative approaches to network design (see 'Regulating network monopolies', page 12)
- transmission investment for renewable generation in Scotland (see 'Regulating network monopolies', page 12)
- British-wide trading and transmission arrangements (see 'Creating and sustaining competition', page 8), and
- offshore transmission regulatory arrangements which are being taken forward jointly with Government to allow efficient and timely investment, while protecting consumers' interests (see 'Regulating network monopolies', page 12).

Ofgem held a discussion day in May 2004 entitled, 'Making sure energy policy delivers', which looked at the latest research into the potential impacts of increased amounts of renewable generation on the transmission and distribution networks, as well as on the trading of electricity and security of supply.

In addition to this programme of work, Ofgem continued to administer the Government's programmes to incentivise increased renewables capacity.

Renewables Obligation

The Renewables Obligation and Renewables Obligation (Scotland), which came into force in April 2002, require licensed electricity suppliers to source at least part of their electricity from renewable generation. The target for companies to reach started at three per cent in 2002-2003 and increases to 15.4 per cent in 2015-2016. The target for 2005-2006 is 5.5 per cent.

In an overview of the second year of the Renewables Obligation, published in February 2005, Ofgem reported that a total of 616 generating stations were accredited, a rise of 111 on the first year. Also, more than nine million Renewables Obligation Certificates (ROCs) were issued during 2004-2005, compared with more than 7.5 million in 2003-2004.

Climate Change Levy

Ofgem also continued to administer the Climate Change Levy (CCL) exemption for renewables. 2004-2005 was the fourth year of the CCL exemption and almost 11 million Levy Exemption Certificates (LECs) were issued.

Since April 2003, the exemption from CCL for direct supplies of Combined Heat and Power (CHP) generated electricity was extended to include indirect supplies, ie those supplies exported to the grid. To date, Ofgem has issued 40 million CHP LECs to complying CHP schemes.

REGOs

In February 2005, Ofgem launched a web-based system to provide evidence of electricity produced from renewable sources. Renewable Energy Guarantees of Origin (REGOs) were introduced as part of a European Union Renewables Directive and are issued in the UK by Ofgem, following applications from generators, to prove their electricity

is being produced from renewable sources.

Promoting efficiency and limiting demand

Reduced energy demand is potentially the most cost-effective route to carbon reduction and could contribute to reducing fuel poverty. During the year, Ofgem continued its important work to promote energy efficiency and to encourage a reduction in total energy demand which will also bring benefits for security of supply.

We continued with a programme of research to investigate options for improving consumption information provided to consumers. We are working with suppliers on implementing a trial to examine consumer responses to improved feedback on their consumption.

In May 2004, in a bid to encourage domestic energy service offerings, Ofgem launched a trial to allow up to a million gas and electricity customers to enter into long-term energy contracts linked to an energy efficiency package.

Energy savings can be delivered by, for example, installing more efficient boilers or by better insulating lofts and walls. The trial was devised by Ofgem, the Department of Trade and Industry (DTI), Department for Environment, Food and Rural Affairs (Defra), energywatch and the industry, and the results are currently being evaluated. It is closely linked to Ofgem's work on the EEC.

In July 2004, Ofgem consulted on the arrangements under which companies can fulfil their obligation to disclose the source of the electricity they are supplying. The EU Directive on an internal market in electricity requires suppliers to provide details about the mix of fuels used to generate the electricity they supply. A new licence condition – implemented by the DTI – is the basis on which suppliers in the UK will

have to disclose fuel mix to customers from October 2005.

Energy Efficiency Commitment

Ofgem continued to administer, on behalf of Government, the EEC programme. This programme obliges domestic electricity and gas suppliers to deliver energy savings from domestic consumers. Half of the energy savings must come from priority customers who receive benefits or certain tax credits. The second EEC annual report was published in July 2004. This showed that that all solvent gas and electricity suppliers were well on track to meeting the overall three-year energy saving target, having saved 47 TWh of the requisite 62 TWh at the time of publication.

The first phase of the programme ended on 31 March 2005, with a total of 150 individual supplier schemes submitted. A final report reviewing the whole of the first EEC programme will be produced by 31 July 2005. The overall energy savings target achieved is equivalent to one per cent reduction in total household carbon emissions

Environmental Advisory Group

Ofgem's Environmental Advisory Group met throughout the year. The Group was established in 2002, and brings together high level individuals from Government, industry, regulators and green groups who provide advice and act as a valuable sounding board for Ofgem's environmental work.

Topics introduced by members of the Group during the year included: progress towards meeting the UK carbon reduction targets, the implications of increased renewable capacity for transmission, distribution and security of supply, how to foster the UK's biomass industry and an overview of European developments in energy efficiency.

Other consultative and policy groups

Ofgem continued to contribute to the Government's Joint Working Group on Energy and the Environment. The Group was set up under the auspices of the Energy White Paper, and is jointly chaired by DTI, Defra and Ofgem on a rotating basis. The Group meets four times a year, and considers developments in environmental and energy policy.

Ofgem continued to be represented on the Renewables Advisory Board and the Energy Efficiency Partnership for Homes, as well as contributed to numerous ad hoc groups on environment and energy policy, both at UK and EU level. Finally, an internal cross-divisional forum on the environment continued to meet on a monthly basis.



9. Helping to tackle fuel poverty

Key achievements for 2004-2005

- Ofgem brokered a new industry 'safety net' commitment to prevent disconnections
- The Ofgem Chairman called for co-ordinated action across industry, Government and all concerned with tackling fuel poverty to help keep vulnerable customers warm and comfortable
- Independent research published by Ofgem showed that too many vulnerable customers do not know about the free help and support available to them
- A joint Ofgem/energywatch report on debt and disconnection initiatives called on companies to step up their efforts on tackling debt and disconnection

Photograph: www.JohnBirdsall.co.uk



Introduction

Low incomes, poor housing stock and energy costs are the main causes of fuel poverty. The number of fuel poor have reduced in the last decade, largely because fuel prices have fallen.

The number of households in fuel poverty fell from 5 million in 1996 to about 2.3 million in 2002. A significant factor in this reduction was the fall in energy prices during the same period. However, recent energy price rises – driven by high oil prices and lack of competition in Europe - have had an impact on fuel poverty.

By promoting competitive energy markets, regulating network monopolies and promoting more efficient use of energy, Ofgem can help keep up the pressure on energy costs and so help tackle fuel poverty. However, action by Government beyond this will be required if its target of eradicating fuel poverty by 2010 are to be met, particularly given the impact of increased environmental costs on the average household energy bill.

To meet our social obligations, Ofgem will encourage best industry practice, for example on tackling debt and disconnection, development of special tariffs and special services for vulnerable customers, raising awareness of how companies meet their social obligations and informing customers of the choices available.

Social action

In April 2004, Ofgem reported on the progress it made in contributing to helping eradicate fuel poverty. The report looked at what had been achieved through our Social Action Plan during 2003-2004.

Preventing customers getting in debt and being disconnected were among the priorities for Ofgem during the year and we devoted much effort on monitoring company debt prevention strategies as well as how well they promote special services to vulnerable customers.

In December 2004, against a background of rising prices, Ofgem Chairman, Sir John Mogg, announced that he was seeking the support of all energy suppliers for renewed action to help improve the quality of life for vulnerable customers.

Ofgem called for more co-ordinated action across Government, industry and all concerned with tackling fuel poverty to get the most out of the many measures and schemes available to help keep homes warm and comfortable.

This move was prompted by independent research carried out for Ofgem by MORI which exposed how many vulnerable customers are unaware of the free help and support available from energy suppliers.

Rising energy costs and increased competition saw the development of a number of social tariffs in 2005 aimed at cutting bills for vulnerable customers. Ofgem has acted to provide guidance to those wanting to develop new social tariffs and will continue to monitor their impact.

Debt and disconnection

Ofgem issued a challenge to energy suppliers in February 2004 to develop a strategy that would ensure vulnerable customers would not have their supply disconnected. In September 2004, following consultation, the Energy Retail Association (ERA), which represents the largest energy retail companies, put in place a new 'safety net' measure which will ensure that companies take whatever action they can to help vulnerable customers and avoid disconnection. This commitment was secured without needing to resort to formal regulation.

In March 2005, a report jointly-commissioned by Ofgem and energywatch acknowledged company initiatives and improvements to avoid consumer debt. The work identified further activity for companies to undertake. For example,

- to set targets to measure the performance and effectiveness of their debt prevention strategies
- to work hard to improve communications as consumers feel suppliers are difficult to contact and that they do not understand their circumstances, and
- make greater efforts to advise consumers on budgeting and energy efficiency measures.



10. Improving Ofgem's efficiency and effectiveness

Key achievements for 2004-2005

- Ofgem now prioritises all work under the constraint of an RPI-3 per cent cost control regime which is set to cut costs by £5.3 million, in real terms, over five years
- Ofgem committed to 'Project Paperless', a major internal project to reduce the volume of consultation documents and improve their quality
- A review of the way Impact Assessments are carried out was completed



Introduction

At a time when public spending is under the microscope, Ofgem now prioritises all work within the constraint of an RPI-3 per cent cost control over the next five years. This provides downward pressure on Ofgem's cost and will be monitored by the Audit Committee.

This compares well with the efficiency savings targets set for central Government and we believe it strikes the right balance between controlling costs and maintaining our ability to protect customers' interests.

The Gas and Electricity Markets Authority

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

In June 2004, the Secretary of State for Trade and Industry announced the appointments to the Authority of four new Non-executive members. They were Miriam Greenwood OBE DL, Jayne Scott and John Wybrew, who took up their posts immediately, and Judith Hanratty CBE, who took up her post in January 2005. Steve Smith, Managing Director, Markets, also joined the Authority as an Executive member in May 2004.

Two Non-executive members, James Strachan and John Belcher, stood down from the Authority in December 2004 while Sir Keith Stuart was re-appointed to ensure continuity during a time of change.

John Neilson, Managing Director, Corporate Affairs, left Ofgem in January 2005 to become Director of the Science and Engineering Base Group at the Department of Trade and Industry (DTI). He was replaced by new Managing Director, Corporate Affairs, Sarah Harrison, who joined the Authority as an Executive member in June 2005.

Dr Boaz Moselle, Managing Director, Corporate Strategy, left the Authority in May 2005. Ofgem took this opportunity to reallocate the corporate strategy functions within existing divisions to help us meet better the increased focus on European and environmental issues.

Better regulation

The Hampton Report, published in March 2005, focused on the need to reduce the administrative burden imposed by regulators – and the Arculus (Better Regulation Taskforce) Report, published at the same time, recommended that the Government sets targets for reducing the administrative burden on businesses.

Ofgem's initiatives are very much in tune with the objectives of these two key reports and we are committed to operating more smartly and adhering to better regulation principles.

Striking the right balance between meeting the demands placed on us by better regulation and new duties and stakeholder expectations is the major challenge identified in our 2005-2010 Corporate Strategy and Plan published in March 2005.

Ofgem is alive to the fact that there is a delicate balance between adhering to better regulation principles at all times, and meeting the demands placed on us by new duties and our stakeholders. We are confident that we can meet this challenge and continue to provide best value for money for consumers who remain our first priority.

There have been many examples of how we have applied better regulation principles during the year, much of which is highlighted in this report.

The Energy Act 2004 established a right of appeal to the Competition Commission against Ofgem decisions on modifications to gas and electricity industry codes. Following consultation during the year, this appeal process came into effect on 14 July 2005.

Project Paperless

The major internal project for 2005-2006 is 'Project Paperless'. This is in recognition of the fact that Ofgem imposes indirect costs on companies,

such as those associated with contributing to our consultations.

Under 'Project Paperless', we will review the quality, relevance, quantity and timeliness of Ofgem's written product, notably consultation documents. In particular, we will:

- make our publications more concise, clear and better focused
- reduce the number of consultations we undertake
- continue to work openly and transparently, and
- review our practices which relate to gathering information and consider how we might reduce the burden we place on companies.

Impact assessments

Ofgem takes very seriously the need to publish Impact Assessments for all important new policy proposals. We believe they are an important tool for improving the quality of our analysis and providing a consistent framework for consultation on important decisions.

During the year, we produced guidelines and how we will go about producing and publishing Impact Assessments. We also undertook a review of the Impact Assessments that we have carried out to date and we will continue to engage industry and all our stakeholders in drawing up Impact Assessments.

Freedom of information

The Freedom of Information (FOI) Act 2000 came into force on 1 January 2005. It gives people the right to request recorded information held by public authorities. Ofgem as a government department qualifies as a public authority.

FOI is designed to help people get a better understanding of how public authorities carry out their duties and make decisions.

Ofgem had received 127 FOI requests between January and March 2005.

Staff development

Continued emphasis was placed during the year on retaining, recruiting and developing staff to ensure the organisation remains well-equipped to deliver the policy priorities set by the Authority.

In 2004-2005, average staff numbers were 291, slightly lower than the previous year. Turnover figures were reduced from 28 per cent four years ago to 13 per cent in 2004-2005, and continue to be held below the 15 per cent target level.

At the end of the year, just under 43 per cent of all staff were female, while 28 per cent of senior civil service members in Ofgem were women and 42 per cent of staff in managerial grades (bands C and D) were women. 15 per cent of staff were known to be of ethnic origin while the figure for those of ethnic origin in managerial grades (bands C and D) was 14 per cent.

Ofgem recruits on the basis of fair and open competition and selection on merit, in accordance with the Recruitment Code laid down by the Civil Service Commissioners. Between April 2004 and March 2005, Ofgem did not use any of the exceptions to fair and open competition permitted under the recruitment code.

Financial review

Ofgem's budget is approved by Parliament following a consultation process with industry and other interested parties. For 2004-2005, Parliament approved a resource budget of £38.1 million. In addition, the Department of Trade and Industry (DTI) directed that a sum of £13.3 million should be collected on behalf of energywatch. This amount was transferred to DTI, in full. Ofgem's performance against its deliverables is detailed in Appendix I.

In 2004-2005, Ofgem received income of £51.1 million, of which £47.3 million was received from licence fees. Of this, £13.3 million was collected on behalf of the DTI to meet energywatch and other DTI costs. Other Ofgem income, mainly from property, totalled £3.8 million.

An over-recovery of £1.1 million from 2004-2005 will be refunded as part of the 2005-2006 licence fee calculation. The carry-forward amount is £3 million.

Operating costs in 2004-2005 amount to £36.5 million, compared with £37.3 million and £38.5 million in 2003-2004 and 2002-2003 respectively. 2004-2005 operating costs include £3.5 million accommodation costs recharged to tenants. Payroll (46 per cent), contractors (18 per cent) and accommodation (23 per cent) accounted for 87 per cent of the total.

In April 2004, £15.0 million was drawn from the Contingency Fund to provide short term liquidity until the first receipt of licence fees. This was fully repaid in August 2004. Financial penalties were imposed on two companies. Transco was fined £1 million and Powergen £700,000. The penalties were received in 2004-2005 and paid over to the Exchequer.

The balance sheet at 31 March 2005 shows Negative Taxpayer's Equity of £5.4 million. This reflects the inclusion of liabilities falling due in future years which are to be financed mainly by drawings from the UK Consolidated Fund. Such drawings will be from Grants of Supply approved annually by Parliament to meet Ofgem's Net Cash Requirement.

Ofgem's financial statements are shown in Appendix IV. More detailed information on costs can be found in Ofgem's Resource Accounts published separately.

Greening Ofgem

Ofgem continues to take account of the Government's Sustainable Development Framework for improving the performance of the UK Government Estate.

Improvements achieved in 2004-2005 and submitted prior to the last environmental management system ISO 14001 assessment included:

- water-saving device fitted and successfully trialled
- installation of a weather station on the roof linked to the Building Management System to help predict likely energy requirements
- installation of PIR office lighting controls, and
- additional cycle parking facilities installed and the promotion of the cycle purchase loan scheme.

Ofgem's own CHP plant, which generates its baseload electricity supply, saved 1,094 tonnes of carbon as well as 3.6 tonnes of nitrous oxide and 2.4 tonnes of sulphur dioxide.

Appendix I

Ofgem's performance against 2004-2005 deliverables

Ofgem's Plan and Budget for 2004-2005 published a number of key deliverables to be achieved in each quarter.

Listed below are details of Ofgem's performance in meeting those deliverables, excluding ongoing deliverables which do not have specific target dates. The deliverables are listed by the quarters in which they were due to be completed. Each deliverable is recorded as either achieved early or on target, achieved late, delayed (will not be achieved in 2004-2005) or no longer applicable.

	Number	Achieved early/ on target	Achieved late	Delayed	n/a
Q1	7	5 (71.4 per cent)	1 (14.3 per cent)	1 (14.3 per cent)	-
Q2	15	14 (93.3 per cent)	-	1 (6.7 per cent)	-
Q3	12	5 (41.7 per cent)	4 (33.3 per cent)	2 (16.7 per cent)	1 (8.3 per cent)
Q4	18	16 (88.9 per cent)	-	1 (5.6 per cent)	1 (5.6 per cent)
Total	52	40 (76.9 per cent)	5 (9.6 per cent)	5 (9.6 per cent)	2 (3.8 per cent)

Creating and sustaining competition

Wholesale markets

Activity	Action	Delivery period	Completed
Energy Policy	Secure release of offshore gas information to the wider market	Q1	Achieved
	Publish conclusion of review of imbalance price rules in electricity and gas markets	Q2	Not Achieved in year
	Obtain European Commission approval to regulated third party access exemptions where Ofgem assesses proposed infrastructure meets exemption requirements	Q3	Achieved Q2
BETTA	Submit core industry documents to Secretary of State for designation	Q2	Achieved
	Start trialling and testing of systems necessary for BETTA 'Go Live'	Q3	Achieved
	Set GB System Operator incentives for NGC under BETTA	Q4	Achieved Q2

Retail markets

Activity	Action	Delivery period	Completed
Retail Competition	Publish proposals on improving information available to customers to help them make the best choice for them in the supply market	Q1	Achieved Q2
	Review the supply licences in the light of Better Regulation principles, with the objective of improving the targeting and effectiveness of regulation, and to reduce barriers to market entry - publish work-plan for review	Q1	Not Achieved In Year
	Complete research on the role of brand independence in securing effective separation of supply and distribution businesses	Q2	Achieved
	Review the supply licences in the light of Better Regulation principles, with the objective of improving the targeting and effectiveness of regulation, and to reduce barriers to market entry - publish initial findings of review	Q3	Not Achieved In Year

Creating and sustaining competition

Retail markets continued

Activity	Action	Delivery period	Completed
Market Infrastructure	Publish assessment of proposed changes in industry processes under the Customer Transfer Project against Ofgem's published criteria	Q4	Not Achieved in Year
	Before consent is granted for any sale by Transco of gas distribution networks, publish agreed plans to ensure disposal does not compromise on-going improvement of supply point administration	Q4	Achieved Q3
Metering	Facilitate industry's adoption of new arrangements to accommodate metering competition under the Review of Gas Metering Arrangements project		
	1. RGMA go-live	Q2	Achieved
	2. Complete "follow up" work of above	Q4	Achieved
	Publish final proposals for any price control of electricity metering from April 2005	Q3	Achieved Q4
Connections	Implement national DNO service level agreement for unmetered customers.	Q3	Achieved Q4
	Introduce GT standards of service licence condition.	Q3	Not Achieved
Gas Modifications	Secure agreement to gas supply licences including Supply Point Administration Agreement	Q1	Achieved

Regulating network monopolies

Transmission

Activity	Action	Delivery period	Completed
Electricity Transmission	Publish statement on transmission investment for Renewable Energy Development	Q1	Achieved
	Publish proposals on transmission investment for Renewable Energy Development	Q2	Achieved
	Initial consultation on interim NGC price control	Q2	Achieved Q1
	Approve appropriate arrangements for GB electricity transmission charging	Q3	No Longer Applies

Distribution

Activity	Action	Delivery period	Completed
DPCR	Publish distribution price control review initial proposals	Q1	Achieved
	Publish distribution price control review final proposals	Q3	Achieved
	Publish distribution price control review licence modifications	Q4	Achieved
Quality of Service	Publish final proposals for Transco incentive scheme	Q4	No Longer Applies
DN Sales	Publish Authority decision on consumer benefits arising from DN sales	Q2	Achieved Q1
Legal Services	Publish consultation document on detailed proposals for credit cover arrangements for network operators	Q2	Achieved
Gas Modifications	Publish consultation document on detail proposal for credit cover arrangements for network operators	Q2	Achieved

Regulating network monopolies

Distribution continued

Activity	Action	Delivery period	Completed
Electricity Modifications	Publish consultation document on detailed proposals for credit cover arrangements for network operators	Q2	Achieved
	Decision on possible reform of connection and use of system agreements relating to electricity distribution	Q4	Achieved
	Introduction of governance in commercial distribution area. Decision on possible reform of connection and use of system agreements relating to electricity distribution	Q4	Achieved

Helping protect security of Britain's energy supplies

Security of Supply

Activity	Action	Delivery period	Completed
Security of Supply	Secure release of offshore gas information to the wider market	Q1	Achieved
	Announce plans for security of supply for winter 2004-2005	Q2	Achieved Q1
	Publish conclusions of cash-out review	Q2	Achieved
	Publish conclusions of top-up review	Q2	Achieved

A leading voice in Europe

Activity	Action	Delivery period	Completed
Europe	Providing advice to relevant govt dept and representing Ofgem's views directly, Gas Regulation (COM(2003)741)	Q3	Achieved
	Working to ensure appropriate implementation of new EU legislation, both directly and in collaboration with relevant Government departments, eg Gas (2003/55/EC) and Electricity (2003/55/EC) Directives and Electricity Regulation (1228/2003)	Q3	Achieved Q4
	Providing advice to relevant govt dept and representing Ofgem's views directly, Electricity security of supply directive	Q4	Achieved
	Providing advice to relevant govt dept and representing Ofgem's views directly, Gas security of supply directive	Q4	Achieved
	Providing advice to relevant govt dept and representing Ofgem's views directly, Energy services directive	Q4	Achieved
	Providing expert support and advice to the DTI, the EU commission and other European Energy regulators including through Ofgem's participation in the Council of European Energy Regulators and the European Regulators Group for Electricity and Gas	Q4	Achieved
	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	Q4	Achieved
	Ensure that unbundling of gas and electricity networks is closely monitored and that reports are prepared by the CEER on the effectiveness of unbundling	Q4	Achieved

Helping to protect the environment

Activity	Action	Delivery period	Completed
Environmental Action Plan	Publish update of Ofgem's guidelines on suppliers' green offerings	Q3	Achieved Q4
Energy Efficiency	Publish procedures for suppliers for the second Energy Efficiency Commitment.	Q4	Achieved Q3
Distributed Generation	Publish the Distributed Generation Co-ordinating Group's annual report with its advice to Ministers and the Authority	Q4	Achieved
Fossil Fuel Levy	Set the Fossil Fuel Levy annually (from time to time in Scotland) and ensure that it is collected	Q4	Achieved Q3

Helping to tackle fuel poverty

Activity	Action	Delivery period	Completed
Social Action Plan	Publish a report on supplier's compliance with debt prevention and management guidelines, jointly with energywatch	Q4	Achieved

Improving Ofgem's efficiency and effectiveness

Activity	Action	Delivery period	Completed
Licensing	Finalise revised arrangements for preparing impact assessments	Q2	Achieved
Consumer Affairs	Complete review of the Memorandum of Understanding for working with energywatch	Q3	Achieved
Government Affairs	Publish revised Energy Guidelines following the Authority gaining new powers relating to the EU Modernisation of competition law	Q2	Achieved

Appendix II

Regulatory Impact Assessments undertaken - 2004-2005

32 Impact Assessments published by Ofgem 1 April 2004 – 31 March 2005

83/04	National Grid Transco – Potential sale of network distribution businesses: Agency and governance arrangements, Regulatory Impact Assessment
84/04	National Grid Transco – Potential sale of network distribution businesses: Allocations of roles and responsibilities between transmission and distribution networks - Regulatory Impact Assessment
119/04	National Grid Transco - potential sale of gas distribution network businesses: Allocation of roles and responsibilities between transmission and distribution networks
120/04	National Grid Transco - potential sale of gas distribution network businesses: Agency and Governance arrangements
131/04	National Grid Transco – Potential sale of gas distribution network businesses: Off-take arrangements
146/04	National Grid Transco – Potential sale of gas distribution network businesses: Interruptions arrangements: Regulatory impact assessment
179/04	Making markets work for consumers – the regulation of gas and electricity sales and marketing proposals for the amendment of standard licence condition 48
196/04	Transmission Investment for Renewable Generation - Initial proposals
198/04	Interruptions Arrangements, Conclusions document on framework
199/04	Offtake Arrangements, Conclusions document on framework
201/04	The Review of Top Up Arrangements in Gas - Conclusions Document
211/04	Connection and Use of System Code Proposed Amendment CAP047: "Introduction of a competitive process for the provision of mandatory frequency response" Impact assessment
221/04	Gas Quality Wet Gas Administration Scheme - Initial proposals
222b/04	Electricity Distribution Price Control Review: draft impact assessment
226/04	Recommendations for best practice guidelines for gas and electricity network operator credit cover
240/04	Electricity transmission network reliability incentive schemes Initial proposals
241/04	The proposed transmission charging methodologies of the GB system operator - An Ofgem consultation and Impact Assessment

250/04	Financial ring-fencing for new and existing independent gas transporters - Initial proposals
255/04a	National Grid Transco – Potential sale of gas distribution network businesses: Final Impact Assessment
265/04b	Electricity Distribution Price Control Review - Impact Assessment
279/04	Transmission price controls and BETTA - Final proposals and impact assessment
282/04	BETTA "minded to" statement on the interim discount for small transmission connected generators and impact assessment
288/04	Transmission investment for renewable generation – Final proposals.
289/04	Gas Quality: Wet Gas Administration Scheme - Final proposals
07/05	Grid Code Changes to Incorporate New Generation Technologies and DC Inter-connectors (Generic Provisions) – The Authority's 'Minded To' decision letter and Impact Assessment relating to the National Grid Company's H/04 Report to the Authority
08/05	Consultation on Technical Requirements for Windfarms – The Authority's 'Minded To' decision letter and Impact Assessment relating to the Scottish transmission licensees' SA/2004 Report to the Authority
19/05	Offshore gas production information disclosure - Initial consultation and draft impact assessment
25/05b	The proposed transmission use of system charging methodology of the GB system operator - An Impact Assessment: Appendix 7 The October IA
25/05a	The proposed transmission use of system charging methodology of the GB system operator - An Impact Assessment
51/05	Reviewing the gas and electricity supply standard licence conditions: Consultation document – scope and timescale of the review
57/05	Transmission price controls and BETTA: statutory licence consultation, impact assessment, and consultation on the statements of the basis of transmission owner charges
68/05	The provision of non-contestable connection services by DNOs: Amending licence Condition 4C of the Electricity Distribution Licence

Appendix III

Investigations and enforcement action - 2004-2005

Company	Issue	Decision	Date of decision	Comment
Transco plc	Compliance with section 9(1a) Gas Act in relation to its provision services.	Finding of breach, penalty of £1 million proposed	23 March 2004	Penalty confirmed 19 May 2004
Powergen Retail Ltd	Incorrect objections to the transfer of consumers, on the grounds of debt, gas supply licence	Finding of breach, penalty of £250,000 proposed	14 July 2004	Penalty confirmed 14 July 2004
Powergen Retail Ltd	Incorrect objections to the transfer of consumers, on the grounds of debt, electricity supply licence	Finding of breach, penalty of £450,000 proposed	14 July 2004	Penalty confirmed 24 August 2004

Appendix IV

Ofgem's financial statements (extracts) 2004-2005

Operating cost statement

for the year ended 31 March 2005

	2004-2005 £000	2003-2004 £000
Administration costs		
Request for resources 1:		
Staff costs	16,571	16,292
Non-staff administration costs	19,196	20,285
	35,767	36,547
Request for resources 2:		
Non-staff administration costs	700	680
	700	680
Gross administration costs	36,467	37,227
Operating income	(35,766)	(36,545)
Net administration costs	701	682
Programme costs		
Request for resources 1		
Expenditure	13,363	12,497
Less income	(13,363)	(12,497)
Net programme cost	-	-
Net operating cost	701	682
Net resource outturn	701	682

All income and expenditure are derived from continuing operations.

Statement of total recognised gains and losses

for the year ended 31 March 2005

	2004–2005 £000	2003–2004 £000
Net operating cost	(701)	(682)
Net gain/loss on revaluation of tangible fixed assets	33	(10)
Actuarial loss on revaluation of pension liabilities	(42)	-
Total recognised losses for the financial year	(710)	(692)

Balance sheet

as at 31 March 2005

	31 March 2005 £000	31 March 2004 £000
Fixed assets		
Tangible assets	4,463	4,679
	4,463	4,679
Current assets		
Debtors	3,978	4,137
Cash at bank and in hand	2,632	2,272
	6,610	6,409
Creditors (amounts falling due within one year)	(10,174)	(8,170)
Net current (liabilities)/assets	(3,564)	(1,761)
Total assets less current liabilities	899	2,918
Provisions for liabilities and charges	(5,946)	(12,061)
	(5,946)	(12,061)
Total net liabilities before pension liability	(5,047)	(9,143)
Pension liabilities	(340)	(257)
Total net liabilities	(5,387)	(9,400)
Taxpayers equity		
General fund	(5,422)	(9,425)
Revaluation reserve	35	25
	(5,387)	(9,400)

Cash flow statement

for the year ended 31 March 2005

	2004-2005 £000	2003-2004 £000
Net cash outflow from operating activities (see a below)	(3,728)	(2,182)
Capital expenditure and financial investment (see b below)	(768)	419
Receipts due to the Consolidated Fund	1,982	-
Payments of amounts due to the Consolidated Fund	(2,410)	-
Amounts due to the Consolidated Fund received in a prior year and paid over	(2,272)	(1,277)
Financing (see c overleaf)	7,556	4,035
Increase in cash in the period	360	955
Reconciliation of operating cost to operating cash flows		
Net operating cost	701	682
Adjust for non-cash transactions	(906)	(600)
Adjust for movements in working capital other than cash	(2,141)	(834)
Use of provisions	6,074	2,934
Net cash outflow from operating activities (a)	3,728	2,182
Analysis of capital expenditure and financial investment		
Tangible fixed asset additions	777	481
Proceeds of disposal of fixed assets	(9)	(900)
Net cash outflow/(inflow) from investing activities (b)	768	(419)

	2004-2005 £000	2003-2004 £000
Analysis of financing and reconciliation to net cash requirement		
From the Consolidated Fund (Supply) current year (1)	7,556	3,814
From the Consolidated Fund (Supply) prior year	-	221
Advances from the Contingency Fund	15,000	10,000
Repayment to the Contingency Fund	(15,000)	(10,000)
Net financing (c)	7,556	4,035
Increase in cash	(360)	(995)
Net cash flows other than financing	7,196	3,040
Adjustment for payments and receipts not related to Supply:		
Amounts due to the Consolidated Fund received in prior year and paid over	(2,272)	(1,277)
Amounts due to the Consolidated Fund received and not paid over	-	-
Receipts due to the Consolidated Fund (2)	1,982	400
Amounts collected on behalf of other Government Departments (2)	13,267	12,392
Amounts paid over in year (2)	(15,677)	(12,792)
Net cash Requirement	4,496	1,763

Notes

(1) Amount of grant actually issued to support the net cash requirement = £7,556,000.00

(2) Amounts paid over: Energywatch costs (£13,267m) paid to DTI, fines levied (£1,982m) and an advance surrender of cash (£428k) to remove a CFER receivable balance relating to 2002-03 paid to Consolidated Fund.

