

## Corporate Strategy and Plan 2006-2011

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### Overview:

In August 2005, Ofgem published an open letter seeking views on the key challenges and priorities for the next five years. In January 2006, we consulted on our proposed strategy, which was developed in the light of the responses to the initial letter, and provided stakeholders and interested parties with a further opportunity to comment. We also held an open meeting with the Authority on 23 February. The deadline for consultation responses was 27 February. Having taken responses into account, we are now publishing the final version of the Corporate Strategy and Plan 2006-2011.

Major reviews of energy policy are now underway in the UK and in Brussels. Ofgem is playing a full part in these reviews and we plan to revisit the strategy later in the year to ensure it reflects emerging conclusions and developments.

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**Target Audience:** All stakeholders and licensees

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## Context

Each year Ofgem publishes a Corporate Strategy setting out our work programme and budget for the next five years.

## Associated Documents

- Responses to Proposed Corporate Strategy and Plan 2006-2011 (Ref. No. 13/06)  
[http://www.ofgem.gov.uk/ofgem/whats-new/archive.jsp?section=whats-new&levelids=,1\\_12618&upper=2007&lower=2006#top12618](http://www.ofgem.gov.uk/ofgem/whats-new/archive.jsp?section=whats-new&levelids=,1_12618&upper=2007&lower=2006#top12618)
- Proposed Corporate Strategy and Plan 2006-2011, January 2006 (Ref. No. 13/06)  
[http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13515\\_1306.pdf?wtfro m=/ofgem/whats-new/archive.jsp](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/13515_1306.pdf?wtfro m=/ofgem/whats-new/archive.jsp)
- Responses to initial consultation letter (Ref. No. 185/05)  
[http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/corporateplanning&levelids=,1\\_11359#top11359](http://www.ofgem.gov.uk/ofgem/work/index.jsp?section=/areasofwork/corporateplanning&levelids=,1_11359#top11359)
- Corporate Strategy initial consultation letter, August 2005 (Ref. No. 185/05)  
[http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12131\\_CSconsultation.pdf](http://www.ofgem.gov.uk/temp/ofgem/cache/cmsattach/12131_CSconsultation.pdf)
- Corporate Strategy and Plan 2005-2010, March 2005 (Ref. No. 106/05)  
[http://www.ofgem.gov.uk/ofgem/documents/corp\\_plan\\_2005\\_2010.pdf](http://www.ofgem.gov.uk/ofgem/documents/corp_plan_2005_2010.pdf)

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## Foreword

2006 is an unusual year. It is pivotal in developing policy at EU and UK level - decisive in carrying through major changes and structural improvements to the way our networks operate and respond to new challenges.

Our corporate strategy sets out how we will work to protect consumers' interests and respond to the regulatory challenges of the 21st century. Government will be reaching many critical decisions in the coming months and the European Council is developing its new energy policy for Europe. What follows, therefore, is our best shot at the strategy which we will return to, as necessary, later this or early next year, to consider whether it properly reflects the emerging political and economic policy conclusions.

The underlying basis of our strategy echoes that of the past two years, including the seven corporate themes. But there are some changes. As last year, we have responded positively to the many thoughtful comments made during the consultation. New initiatives, for example to improve information on European developments, establish a new microgeneration forum and simplify aspects of the industry codes arrangements all build on measures taken last year, such as project paperless and the facilitation role Ofgem has played throughout the winter.

Needless to say the challenges and tensions we ourselves face as a regulator are reflected in the range of responses we have received. Some argue for the regulator significantly to step back and leave markets to deliver. Others urge us to be still more active. On fuel poverty some argue that we should not undertake detailed monitoring while others seek more energetic involvement to help contain rising fuel poverty.

We have said we want to be a listening organisation. We welcome an open debate on all such issues. At this pivotal moment that readiness to listen is even more relevant. We need to keep closely in touch with the concerns of domestic consumers particularly as the Government considers structural changes in consumer representation. We ourselves want, wherever possible, to work in smarter and more efficient ways and eliminate any unnecessary administrative burden we place on industry. In keeping with this commitment, we include for the first time in our corporate strategy a simplification plan (at appendix 4).

Next year we will take forward a number of projects under our seven themes - some of the key areas include:

- working with industry and business customers to ensure that the lessons from this winter are applied to preparations for next winter, and that we do all we can to help at this difficult time of high and volatile prices,
- developing regulatory arrangements which enable timely and efficient network investment to meet future energy needs,
- breaking down regulatory barriers to the development of smart metering and microgeneration, exploring urgently sustainable solutions that could bring real social and environmental benefits,

- crucially in times of high energy prices, scrutinising the operation of the competitive wholesale and retail energy markets and tackling barriers to entry, to ensure these markets are working to the benefit of all consumers,
- in parallel, continuing to press for measures to achieve greater transparency and competition in the EU's energy markets, and
- through the Supply Licence Review, developing regulations that are 'fit for purpose' in protecting consumers and reflecting changing market circumstances.



**Sir John Mogg**  
Chairman, Gas and Electricity Markets Authority



**Alistair Buchanan**  
Chief Executive, Ofgem

## Introduction

In August 2005, Ofgem published an open letter seeking views on the key challenges and priorities for the next five years. The responses to this letter are on our website. In January 2006, we consulted on a Proposed Corporate Strategy and Plan. The present document sets out our strategy, developed in the light of the responses to those documents.

Ofgem's remit is to protect the interests of consumers where appropriate by promoting competition. If competition cannot protect the interests of consumers then regulation may be necessary. Ofgem also has a range of important secondary duties, including promoting security of supply, having regard to the environment and sustainable development, paying particular attention to the needs of vulnerable consumers. We must also have regard to guidance issued by the Secretary of State on social and environmental matters. Further details of these statutory objectives and duties are set out in appendix 5.

The strategy is based around the following seven themes:

1. Creating and sustaining competition,
2. Regulating network monopolies,
3. Helping protect the security of Britain's energy supplies,
4. A leading voice in Europe,
5. Helping protect the environment,
6. Helping to tackle fuel poverty, and
7. Better regulation/improving Ofgem's efficiency and effectiveness.

Respondents to the August 2005 letter and the January 2006 consultation on the Proposed Corporate Strategy and Plan endorsed these themes. Work in these areas is discussed in more detail in the sections that follow.

Appendix 1 lists those who responded to the January 2006 consultation. Appendix 2 sets out Ofgem's deliverables and performance indicators for 2006-2007, which provide the practical targeting of activities to achieve the more broadly stated objectives of the seven themes. Appendix 3 gives budget details for the rest of the RPI-3 cost control period. Appendix 4 contains Ofgem's first Simplification Plan setting out our current and future initiatives in support of the better regulation agenda.

Appendix 6 contains a glossary of terms used in the present document and appendix 7 provides details of how to give feedback to Ofgem on the manner in which this consultation was conducted, should you wish to do so.

## 1. Creating and sustaining competition

1.1. We will continue to monitor wholesale and retail energy markets and we will take the necessary steps to address any problems we identify. Reflecting our commitment to better regulation and our assessment that competition is effective in these markets, we will look to rely on self-regulation or general competition and consumer protection law wherever possible.

### Introduction

1.2. Wholesale energy costs and suppliers' costs make up around 70 per cent of a typical consumer's energy bill. It is therefore essential that competition continues to function effectively and that it provides choice, competitively priced energy and secure supplies to consumers. The importance of competitive wholesale markets to security of supply is discussed in the section on helping protect the security of Britain's energy supplies.

1.3. Ofgem continuously monitors the wholesale and retail markets to make sure they remain competitive and free from abuse. Ofgem also assesses whether market rules are adapting to changing circumstances and are continuing to promote and sustain competition. Market monitoring also informs other areas of Ofgem's work such as that on European affairs, merger advice and environmental policy. Ofgem has enforcement powers under the Competition Act, and other legislation, to tackle anti-competitive behaviour and to protect consumers. We stand ready to use these powers where necessary.

1.4. Effective competition in both wholesale and retail (including metering services) markets is important to protect the interests of consumers. Competitive markets will, over time, provide more innovation, better services and lower prices than prescriptive regulation. This approach is also central to the principles of better regulation.

1.5. Looking ahead, there may be scope to rely even more on competition rather than regulation so that wholesale and retail markets become increasingly like normal commodity and service industry markets. However, in considering the case for doing so, recognition would be given to certain factors that may make energy markets different. For example, in retail markets, suppliers' own behaviour, notably their ability to establish effective self-regulation, will be an important factor in this assessment given ongoing customer concerns about certain aspects of suppliers' performance such as billing.

1.6. This winter, a number of smaller suppliers have exited the energy market. We will continue to focus on identifying and removing any significant barriers preventing new entry to retail energy supply, electricity generation and gas supply and storage.

### The Next Two Years

1.7. As competitive markets continue to evolve, Ofgem will need to react to changing circumstances and so the issues described below will represent only some of our work to create and sustain competition. Other areas of possible work include further



Competition Act investigation or sectoral investigations and advising the Office of Fair Trading, Competition Commission or the European Commission on energy sector mergers.

#### *Monitoring Energy Markets*

1.8. Since winter 2004-5, prices in wholesale gas markets have been much higher and much more volatile. Higher prices in part reflect the decline in gas supplies from the North Sea and the higher costs associated with importing gas. While this may provide some explanation for higher price levels, there is still an ongoing need to reassure customers that price movements reflect underlying changes in supply and demand conditions and are not being manipulated either in Britain or by events or arrangements in continental Europe.

1.9. Given that a significant proportion of electricity generation is gas-fired, high wholesale gas prices also feed through into higher wholesale electricity prices. The pressure on gas and electricity prices should ease in the next two to three years as over £6bn is invested in new gas infrastructure that will allow us to import more gas through new pipelines to Norway, the Netherlands and from North Africa, the Caribbean and the Middle East in the form of Liquefied Natural Gas (LNG). There are also plans for investment to double our gas storage capacity that will help to manage peak winter demand and any shocks to gas supplies as peak winter production from the North Sea continues to decline.

1.10. During this difficult period we have focused on providing customers with more information on events in the market and available supplies, increasing transparency, reviewing and changing the market rules and improving awareness among business customers on the possible scenarios and options available, given the difficulties they face in managing higher energy prices. This has helped facilitate any necessary demand side response and build consumer confidence in the effectiveness of the market. Ofgem has also been working with the European Commission to identify and tackle behaviour or arrangements that are distorting the trade of gas and electricity between Member States and causing higher prices in Britain.

1.11. A single British wholesale electricity market was established on 1 April 2005, extending to Scotland the wholesale market arrangements that have applied in England and Wales since 2001. Ofgem will closely monitor the British market to assess whether the arrangements are working properly and the benefits are being passed to customers. In particular, given the nature of the transmission network in Scotland, it will be important that network constraints can be managed efficiently. This should provide signals to encourage timely, economic and efficient investment in transmission network reinforcement.

#### *Incentives for Efficient System Balancing*

1.12. The transmission system operator manages any supply and demand imbalances on a day-to-day basis and deals with any network constraints. We will be reviewing the incentive schemes for the system operator in gas and electricity, which aim to give network operators incentives to invest efficiently and reduce the day-to-day costs of running and balancing the system. For 2007-2008 and beyond the work on system operator incentives will be closely co-ordinated with the work on

the transmission price control review, described in the section on regulating network monopolies.

#### *Transparency*

1.13. In 2005, Ofgem clarified the way in which potential modifications to industry codes in relation to the transparency of gas markets would be assessed. We are now considering a proposal by energywatch to publish more information. In consultation with market participants, Ofgem will review the levels of information provided to the gas market in order to assess the potential benefits of the release of additional information.

#### *Metering*

1.14. Policy on metering competition starts from the assumption that competition is the best form of consumer protection. However, in the light of many concerns about the lack of innovation in this area to date and strong interest in the potential environmental and social benefits, Ofgem has been carrying out a review of the effectiveness of the current arrangements and of the costs and benefits of smarter forms of metering in gas and electricity. 2006 will be an important year for metering as we take forward the conclusions of that review, using consultations and seminars to present our analysis, and consider what role Ofgem should play, if any, in facilitating smarter metering. We will also aim to conclude our two Competition Act investigations into the metering and metering services markets. We will also be reviewing whether competition is sufficiently developed in this market to warrant the lifting of the existing metering price controls.

#### *Customer Disputes*

1.15. Following a 'supercomplaint' by energywatch on billing, Ofgem asked industry to set up an independent dispute resolution body to enable the relatively small proportion of customers who had suffered real harm as a result of billing problems to obtain redress and, where appropriate, compensation. We also told suppliers to stop the process of 'back billing' customers who have not received a bill for over two years. This self-regulatory approach was acknowledged by the Better Regulation Task Force as a good example of better regulation in practice. We are working closely with the industry and energywatch to ensure that these proposals are implemented by July 2006.

#### *Supply Licence Review*

1.16. The review of supply licences will provide an opportunity, consistent with better regulation, to develop a set of clear and simple licence obligations which provide appropriate protection for customers and do not act as a barrier to entry for new suppliers. This is expected to lead to further deregulation in retail markets without weakening the protection offered to vulnerable customers. We have recently published a consultation on the implications of the supply licence review for vulnerable customers and the responses from this exercise will be considered as part of the overall review.

1.17. We intend to publish initial proposals in July 2006 and final proposals in November 2006. We intend that any licence changes will take effect in April 2007.

### **A Five Year View**

1.18. Although it is difficult to predict the evolution of a competitive market, the next five years are likely to bring a number of challenges and opportunities for the further development of wholesale and retail markets. For instance, while capital market competition and mergers can be important drivers of efficiency, it is essential that mergers and acquisitions do not lessen the competitive pressures on energy companies. Ofgem will continue to review the implications of corporate transactions on competitiveness and to advise the relevant competition authorities where necessary.

1.19. In the provision of bulk supplies of gas, electricity generation, wholesale energy markets and retail energy markets, competition will continue to evolve. We will continue to monitor these markets actively but will make sure that the resources we devote to this activity remain appropriate as the market evolves.

1.20. In taking forward work on retail markets, Ofgem will continue to promote competition while at the same time having regard to our duties relating to sustainable development, the environment and protecting vulnerable consumers.

## 2. Regulating networks effectively

2.1. We use incentive regulation to keep the costs of network monopolies down and to encourage improvements in quality of service. We are developing our approach to ensure that regulation is sufficiently flexible to accommodate changing patterns of supply such as renewable generation and new gas import terminals.

### Introduction

2.2. In general it is not practicable to have competition in distribution or transmission activities. Regulation is therefore necessary to protect the interests of consumers. Regulation encompasses price controls on network charges, issues arising from the structure of network charges, quality of service, financial ring-fencing of network businesses and protecting security of supply. Matters relating to security of supply are dealt with in more detail in the section on helping protect the security of Britain's energy supplies.

2.3. Across all network sectors, Ofgem remains committed to incentive regulation as the best way of protecting the interests of consumers. Each network business must meet its statutory and licence targets and obligations. If they do so, they should be able to earn higher returns. Those companies that fail to meet their obligations run the risk of financial penalties, and those that under-perform in relation to their price control targets should earn lower returns. This approach encourages efficiency and over the longer term ensures that prices to consumers are no higher than is necessary.

2.4. Over time the regulatory framework will need to evolve to meet new challenges. Nevertheless, the following basic principles are likely to remain important:

- transparency and predictability,
- consistency in approach across the networks where appropriate,
- applying simple solutions where they are effective,
- improving incentives on network operators to invest efficiently and quickly in response to their customers' needs,
- making network operators more responsive to the changing needs of their customers,
- encouraging the development and adoption of innovative technologies where this will result in more efficient and effective solutions,
- encouraging cost-reflective charging – so that each network user takes into account the wider costs of its decisions, and
- protecting security and reliability of supply.

2.5. Challenges for the future include ensuring that network businesses have incentives to invest in a timely and efficient way to protect security of supply, ensuring that renewable electricity generators are able to connect to distribution and transmission networks, and adopting innovative techniques where appropriate. We have recently issued a discussion paper jointly with Ofwat to review regulatory approaches to financing network investment.

2.6. Ofgem also continues to encourage the development of competition in areas associated with networks where this is an appropriate way to protect customer interests, such as in the provision of new gas and electricity connections.

### **The Next Two Years**

#### *Gas and Electricity Transmission*

2.7. Work will continue on the gas and electricity transmission price control reviews. These controls were last set in 2001 and 2002. In the intervening period, the transmission businesses will have had an opportunity to improve efficiency and earn higher rates of return. The price control reviews provide an opportunity to share these efficiency gains with consumers and take into account new information and developments across these sectors. Particular challenges for the transmission price control reviews include:

- assessing the level of asset replacement required on the electricity transmission system, and
- developing incentives so that transmission companies can respond quickly and flexibly to demands for new capacity to support new gas infrastructure such as storage, LNG terminals and import pipelines and new conventional and renewable electricity generation.

2.8. The intention is to consult further during the first half of 2006 and publish final proposals in autumn 2006. The new controls will take effect from 1 April 2007.

2.9. Alongside this work, there will be important issues to consider in relation to the structure of charges and developing arrangements that allow network users to signal their demand for capacity by making medium and long-term commitments.

2.10. Ofgem is assisting the Department of Trade and Industry (DTI) to develop the regulatory and licensing regime for the underwater cables that will be needed to allow the connection of offshore wind generation in a manner which is cost effective and protects consumers' interests.

#### *Gas Distribution*

2.11. The main priority for the next two years is the gas distribution price control review. This will be the first time that the gas distribution price controls have been set since National Grid (NG) sold four of its gas distribution businesses. We will be publishing more detailed papers in 2006 and early 2007, ahead of final proposals in autumn 2007. This work will encompass:

- extending the existing price control by one year to 31 March 2008,
- resetting the main control from 1 April 2008, and
- establishing a cost reporting framework to operate from 1 April 2008.

2.12. Other important work will involve reforming the arrangements for interruption on gas distribution networks to ensure that capacity is used efficiently across gas distribution and gas transmission networks, and introducing incentives on gas distribution networks to purchase an efficient level of gas transmission capacity.

#### *Electricity Distribution*

2.13. New price control arrangements came into effect in April 2005. There are two particular priorities for the next two years:

- to encourage the development of robust distribution charging arrangements that are appropriately cost-reflective, and
- the annual collection and review of cost data and regulatory asset value calculations. This should make the price control review process more transparent, predictable and effective. Over time this should encourage companies to be more efficient and lead to lower prices for consumers.

2.14. Ofgem will also:

- continue to develop indicators and incentives for quality of service (recognising that failures on electricity distribution networks cause most supply interruptions),
- consult on the development of competition in connections and options to increase its effectiveness, and
- review progress with the new initiatives introduced in the last price review to promote innovation.

#### **A Five Year View**

2.15. Looking ahead, it is likely that significant network investment will continue to be needed, to ensure that the networks are robust and can accommodate changes in supply and demand patterns, such as that arising from the increase in renewable generation and gas imports, as well as any further market changes. We will also seek to extend and develop incentives to improve the quality of service to network customers and we will continue to monitor and, where appropriate, promote the development of technology.

2.16. On completion of the electricity distribution price control review in 2005, we undertook an assessment of the review process which identified a number of areas in which lessons could be learned for the future. These will be taken into account in the current transmission and gas distribution reviews, following which we will conduct further assessments of our approach. The conclusions of these will feed into our next cycle of price control reviews, commencing with electricity distribution in 2008 and 2009. Our intention is to develop a clear and predictable approach to the conduct of price control reviews in order to reduce uncertainty and provide a stable framework for long-term decisions by network companies.

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

3.1. We will make sure that any barriers that prevent the market delivering security of supply are removed. We will regulate to promote timely and economic investment in networks and help consumers, particularly large users, understand the role they can play in maintaining reliable and secure supplies.

#### Introduction

3.2. Ofgem has important statutory duties relating to security of supply reflecting the value that consumers place on reliable energy supplies. Although some large business consumers choose contracts with suppliers or network operators that allow for interruption, the majority of consumers expect uninterrupted supplies of gas and electricity.

3.3. Competitive wholesale markets promote and best protect security of supply. If supplies become scarce relative to demand, prices should rise, encouraging investment to provide more energy supplies. When there are short term shocks to supply, prices will rise for short periods and, if necessary, will lead to short term reductions in demand.

3.4. In addition to competition in wholesale markets, security of supply requires effective network regulation to maintain and improve reliability of the transmission and distribution networks that transport gas and electricity to homes and businesses.

3.5. All major policies are assessed to see what impact they will have on security of supply.

#### The Next Two Years

3.6. The faster than expected decline in peak winter gas production from the North Sea led to tighter gas supplies last winter. Although some new infrastructure will be in place for winter 2006-7, forward prices suggest that supplies are likely to remain tight next winter. The gas supply situation will ease as significant investment is being made to deliver new sources of gas supply through new pipelines and LNG terminals. There are also plans to double Britain's available gas storage capacity. During the next two years, before these supplies become available, security of supply will be a major area of work for Ofgem.

3.7. Ofgem will continue to make sure that the market and customers are well-informed of the situation and of the options for customers to manage the difficulties created by higher prices. Ofgem will also continue to work with the European Commission and other regulators to make sure that arrangements in continental Europe do not restrict supplies of LNG and/or piped gas to the UK during this difficult period.

#### *System Balancing*

3.8. The transmission system operator has responsibility for co-ordinating the actions of wholesale market participants such that, on a day-to-day basis, the supply and

demand for gas and electricity remains in balance. It is essential that these arrangements complement a competitive energy market and that any market participants that cause imbalances across the system are exposed to any resulting costs. This should create incentives on companies to contract for sufficient supplies to meet their customers' demand and to contract for flexibility with their customers to manage shocks to supplies or very high demand due to very cold weather.

3.9. The cash-out arrangements provide the incentives on companies to balance the amount of energy they supply to their customers with the amount of energy they put onto the transmission system. Ofgem has established a cash-out working group that comprises industry experts in order to discuss and provide analysis on the way in which cash-out prices are determined. The intention is that this group will be able to take a holistic view of developments across both the gas and electricity markets. Nevertheless, it will continue to be for individual market participants to propose changes to the cash-out rules. The analysis provided by the cash-out working group will help Ofgem, the industry and customers to decide whether changes to the cash out requirements are required.

3.10. Going into last winter, we approved a controversial proposal to change the cash out arrangements in the gas market in the event of an emergency to maintain the commercial incentives on suppliers to do all that they can to balance their positions. We have recently approved another controversial proposal in the electricity market to make sure that generators and suppliers have appropriate commercial incentives to balance particularly when the supply/demand balance is tight. This will be implemented for winter 2006/7.

#### *Monitoring Security of Supply*

3.11. The Government and Ofgem have a role to monitor and inform the market about key developments with respect to security of supply. Ofgem is a member of the Joint Energy Security of Supply (JESS) group, which was established to monitor developments across the gas and electricity markets and in particular to provide information to market participants to help them plan investment decisions. JESS publishes annual reports on security of supply. Following the requirements of the Energy Act 2004, Ofgem will work with the DTI to enable the Secretary of State to publish annual reports to Parliament on security of supplies. In addition, the UK is required under EU Directives to monitor and report on security of supplies. Ofgem and the DTI seek to ensure that all these reports are as useful as practicable to market participants.

#### *The Regulation of Infrastructure for Gas Imports*

3.12. As gas production from the North Sea declines, a number of major projects have been commissioned, or are currently under development, that will substantially increase Britain's capacity for the import and storage of gas. Ofgem has developed, and will continue to apply, a light-touch regulatory regime in order to encourage such investment where this approach continues to promote competition and customers' interests. We have, however, made clear that we will impose regulated third party access to these facilities if effective use-it-or-lose-it arrangements are not in place at import terminals. These arrangements allow other companies access to



the facilities if they are not being used by their owners and prevent hoarding of import capacity.

#### *Demand-side Working Group*

3.13. A feature of British energy markets is that gas and electricity energy demand is much higher in winter than in summer and that electricity demand is much higher at certain periods during the day than at night. Companies can either invest in supplies to meet the higher demand or agree with their customers that they will reduce demand during high demand periods. These actions can help protect security of supply and contribute to lower wholesale prices. We established a demand-side working group to identify and tackle any barriers to demand-side participation. Various changes have also been made to improve transparency so that customers and suppliers can anticipate when supply conditions might be tight and large business customers may have to provide a demand-side response. These arrangements have proved successful in the gas market this winter and the demand side has responded well particularly following the unexpected loss of the Rough storage facility in February. We will assess the lessons from this winter and we expect these arrangements to continue and develop throughout 2006.

#### *Gas Quality*

3.14. For reasons of safety and efficiency, gas quality specifications are applied to gas supplies and historically these standards have been geared towards North Sea supplies. As more gas is imported, these standards will need to evolve. Ofgem is working with the DTI, Health and Safety Executive, the Department for Environment, Food and Rural Affairs (Defra) and the European Commission to develop new gas quality standards that are non-discriminatory and cost effective. In the shorter term, we approved several changes to quality specifications to allow more gas to flow from North Sea this winter and next without compromising safety. We have also asked National Grid to look at whether gas blending services could be offered next winter to allow more, lower quality gas to be imported through the UK-Belgian interconnector without reducing safety.

#### *Network Investment*

3.15. Efficient and timely investment in transmission and distribution systems is needed to ensure sufficient network capacity and reliability, so that available supplies of gas and electricity can be transported to consumers. Ofgem continues to monitor the reliability of networks and seeks to use the price control reviews to develop and improve the incentives on network companies to invest in a timely and efficient way.

#### *Emergency arrangements*

3.16. Market arrangements are underpinned by contingency planning designed to ensure that the energy industry is prepared in the event of an emergency. These issues are not unique to energy markets and the Government attaches high importance to emergency preparedness at a national and local level. In response to the requirements to provide a high-level link between government and industry, the Energy Emergencies Executive has been established to oversee the structures and

practices of energy emergency planning. It is chaired by DTI and includes Ofgem and NG. The Energy Emergencies Executive will continue to oversee the development of effective emergency arrangements during 2006.

### **A Five Year View**

3.17. We will continue to monitor the evolution of competitive markets and key indicators of security of supply to ensure that any difficulties are dealt with in a timely way. As gas production from the North Sea declines and market participants commission more infrastructure projects to allow the import of gas, the majority of Britain's gas supplies will eventually be imported. The development of new gas infrastructure – including storage facilities, LNG terminals and new pipelines linking Britain with Norway and the EU – are very encouraging developments that should ensure that Britain has secure gas supplies from a diverse range of sources over the next five years and beyond.

3.18. These developments will further increase the interactions with European and global gas markets (as LNG is traded globally) and impact on prices. There are also important interactions between gas and electricity markets as around 30 per cent of electricity is generated from gas-fired power stations. Ofgem will need to monitor these market developments and ensure that competition continues to evolve and security of supply is maintained.

3.19. Over £14.5 billion has been invested in over 30GW of new gas-fired electricity generation since privatisation. Coal-fired generators have invested, or intend to invest, in Flue Gas Desulphurisation to allow 18GW of coal-fired generation to continue to operate under new EU laws limiting sulphur dioxide emissions. In electricity the margin of generating capacity over demand is about 20 per cent - consistent with the planning margins used before the industry was privatised. Over 11GW of new generation is being developed. A number of energy companies have announced plans to invest in new conventional and renewable generation. Investors will expect a stable political and regulatory environment before making investment in new capacity and Ofgem will continue to work with and advise the Government to provide stability and certainty in the long term regulatory and policy framework to facilitate this investment.

## 4. A leading voice in Europe

4.1. We will continue to promote the development of an effective EU-wide energy market and to influence the development of EU regulatory and competition policy.

### Introduction

4.2. European energy markets and EU regulatory/competition policy have a major influence on Britain's energy markets and consumers. In particular:

- British wholesale gas prices are heavily influenced by wholesale gas prices in Europe,
- around 30 per cent of electricity in Britain is generated from gas-fired power stations and so wholesale gas prices in Europe can have a direct impact on wholesale electricity prices,
- as Britain becomes a net importer of gas through the development and expansion of interconnectors, European gas will be increasingly important for security of supply, and
- European Directives and Regulations have the potential to have a direct impact on competition and regulatory policy in Britain.

4.3. In the light of this, Ofgem will continue to work with the Government, European Commission, other national regulators and competition authorities to promote the development of an effective, competitive European energy market and promote the principles of better regulation when EU regulations and policy are being developed.

4.4. EU environmental regulation is also increasingly important to the operation of the gas and electricity industries in Britain. These matters are discussed further in the section on helping to protect the environment.

### The Next Two Years

4.5. Ofgem is a member of the group of energy regulators (ERGEG) and of the Council of European Energy Regulators (CEER) that advise the European Commission on the development of regulatory and competition policy. Ofgem's Chairman, Sir John Mogg, is the Chairman of ERGEG and President of CEER. These groups will certainly play an active role in developing and implementing the roadmaps for the gas and electricity sectors that will set out the key policy steps necessary to establish effective energy markets in Europe.

4.6. Ofgem has three members of staff seconded to the DG Competition (the Directorate of the European Commission that has responsibility for competition issues) who are helping the Commission progress its sectoral inquiry into the effectiveness of competition in the gas and electricity industries across Europe. The Directorate's initial conclusion was that there were 'serious malfunctions' in the market. The Commission has since signalled, in its report of 16 February, that it will develop remedies and take action under European competition law to tackle these concerns. Given these developments, Ofgem will continue to focus strongly on this over the coming year.

4.7. In parallel, DG Transport and Energy (the directorate that has responsibility for the gas and electricity industries) is investigating compliance with existing EU directives and regulations to liberalise European energy markets. These reports should help to address the remaining obstacles to liberalisation and effective competition across Europe. The Directorate recently published a Green Paper on European Energy Policy. The Green Paper continues the push for competitive single markets, and contains proposals to improve the regulation of the European Grid and a commitment to effective unbundling of control of, and access to, energy networks from energy supply.

4.8. Responding to comments made in the responses to consultation, we will continue to explore how best to ensure that industry is aware of emerging European issues and has an opportunity to engage in the debate. We will continue to discuss current European developments with industry participants through regular meetings, both bilaterally and in wider groups, and will improve the information provided on the Europe microsite which has been established as a dedicated part of the Ofgem website. We will encourage the European regulators to consult, through CEER and ERGEG on all significant European regulatory proposals.

#### **A Five Year View**

4.9. We will continue to work with ERGEG/CEER, DG Competition and DG Transport and Energy to ensure that competition and regulatory policy in Europe benefits British consumers. Particular challenges will include:

- supporting an approach to competition policy that deals effectively and quickly with any abuse of market power,
- encouraging DG Transport and Energy to enforce existing obligations and if necessary develop new legislation to underpin key components of liberalisation that are presently applied unevenly across Europe (including powers of regulators, separation of transmission activities, and restraints on market power),
- refining parts of the present regulatory framework through the comitology process including congestion management on transmission networks, and
- filling in the gaps in the present framework, such as the regulation of access to gas storage.

## 5. Helping to protect the environment

5.1. We carefully consider the environmental impacts of all our decisions. We will continue to administer various environmental schemes on behalf of the Government.

### Introduction

5.2. Electricity generation and the use of gas by consumers contribute around 50 per cent of the UK's carbon dioxide emissions. In addition to its Kyoto targets, the Government has set a target to reduce carbon dioxide emissions by 20 per cent by 2010 and has an aspiration for a 60 per cent reduction by 2050.

5.3. While Ofgem's principal statutory objective is to protect the interests of consumers, we have important secondary duties relating to the environment and sustainable development, and the Secretary of State has provided statutory guidance on social and environmental matters.

5.4. A framework has been established to ensure that policies which have a significant environmental dimension are consistent with our statutory objectives and duties. This includes valuing carbon dioxide emissions to take account of the environmental damage that they cause. In a number of key policy areas, such as in relation to renewable energy and energy efficiency, the Government (or EU) has already established arrangements that provide substantial funding to schemes that have environmental benefits. In these circumstances, consumers are already funding reductions in carbon dioxide emissions. Nevertheless, we will continue to look at other areas of policy that could have an impact on the environment. These include the obligations on suppliers to promote energy efficiency and the incentives on network businesses to reduce energy losses.

5.5. Significant progress has been made in starting to tackle carbon dioxide emissions through the EU's Emissions Trading Scheme. We strongly support the scheme as it provides an effective means of tackling emissions at the lowest possible cost to customers. The scheme works well with the wholesale energy markets and protects security of supply by providing more flexibility than other forms of emissions controls to allow energy suppliers to deal with supply shocks. Ofgem will continue to advise the Government and European Commission as they consider subsequent phases of the Scheme and review its effectiveness.

5.6. We also administer a number of environmental programmes for the Government, including the Renewables Obligation and the Energy Efficiency Commitment.

### The Next Two Years

5.7. Each year, Ofgem produces a report on our Environmental Action Plan and takes advice from a panel of industry specialists and experts (the Environmental Advisory Group) on environmental matters. The Environmental Action Plan summarises Ofgem's environmental policy programme. We have recently set up a sub-Committee of the Authority to assess and develop our approach to sustainable

development in all of our policy work. We will publish the outcome of the sub-Committee's work later this year.

5.8. Areas of policy that may have significant implications for the environment over the next two years include:

- price control reviews, which will provide an opportunity to consider the treatment of losses and shrinkage, electricity network investment for renewable generation and the impact of electricity network investment on visual amenity (in particular in national parks and areas of outstanding natural beauty),
- advising the DTI on offshore electricity transmission regulation - as decisions on these arrangements will have implications for renewable generation,
- the review of supply licence conditions could provide an opportunity to refine the obligations on suppliers which have implications for energy efficiency,
- work on innovative metering also has the potential to encourage energy efficiency, and
- the conclusions of a review of the regulatory and market issues affecting the development of microgeneration.

5.9. Ofgem has been carrying out an assessment of the policy options in respect of metering innovation and intends to take this work forward throughout 2006. We published a consultation paper at the end of January, which invited views from stakeholders on the most appropriate way forward. Ofgem considers that metering innovation is a particularly important strand of work, especially given the context of the Government's Climate Change Programme Review and the implementation of the EU Energy Services Directive. We will ensure that our future work in this area takes these developments fully into account.

5.10. In terms of influencing the debate on wider environmental policy Ofgem will be:

- organising a seminar on, and assessing the impact of, the EU Emissions Trading Scheme (EU ETS) on the electricity generation sector and consumers,
- inputting in to the process for establishing the EU ETS National Allocation Plan and advising Defra and the DTI on these matters,
- contributing to the European Commission's review of the EU ETS Directive,
- running the CEER work programme on environmental matters,
- advising on the European Commission Energy Efficiency Action Plan, including research on the scope for quantifying energy saving measures and possibly the trading of credits, and research on the effectiveness of energy efficiency measures, and
- contributing to the Government's Joint Working Group on Energy and the Environment and its Sustainable Energy Policy Network.

### **Government policy reviews**

5.11. The Government's review of its Climate Change Programme has now reported. Ofgem will consider carefully the conclusions of this review and, if necessary, work with Government and advise on how best environmental targets can be met in a cost-effective manner.

5.12. We are also contributing as appropriate to the Government's Energy Review, which will be dealing with many of these issues, and to the Stern Review on the economics of climate change, by providing analysis and support on those aspects of the review that affect energy markets.

### **Administering Government schemes**

5.13. Ofgem also administers a number of the schemes and arrangements that have been established by Government as part of its Climate Change Programme. The main schemes include the Renewables Obligation - which creates obligations for electricity suppliers - and the Energy Efficiency Commitment (EEC) - which creates obligations for both gas and electricity suppliers. We also administer the Renewable Energy Guarantees of Origin arrangements, exemptions from the Climate Change Levy for renewables and CHP, and the CHP database. In respect of all these schemes we will continue to provide advice to the Government on how they are functioning and ways in which they might be made more effective.

### **'Greening' Ofgem**

5.14. Ofgem has taken a number of steps to reduce its own energy usage. In 2003, for example, we installed a CHP unit that has meant reduced carbon emissions totalling 750 tonnes of carbon dioxide. In addition, the replacement of four boilers has led to a 35 per cent increase in our energy efficiency. Ofgem was the first Government Department to achieve certification to the international standard on Environmental Management Systems (ISO14001) and continues to seek ways of reducing its impact on the external environment. We are currently introducing area-specific utility meters, which will further enhance our ability to measure accurately the effectiveness of any new energy saving steps that we take.

### **A Five Year View**

5.15. We will continue to develop our contribution to environmental policy consistent with our statutory duties. In particular:

- making a positive contribution to the debate about the role of the gas and electricity markets in tackling environmental issues by providing the Government with constructive and creative advice on designing and developing policy instruments for the energy sector,
- ensuring a robust framework is in place, allowing policy to be developed in a way that is consistent with our statutory objectives and duties, taking full account of any environmental impact of our decisions, and
- encouraging the Government and EU to carry out cost benefit analysis in developing policy and to look for cost-effective solutions and, wherever possible, market-based policy instruments to meet environmental targets.

## 6. Helping to tackle fuel poverty

6.1. We will promote a holistic and targeted approach to fuel poverty and will take account of the particular needs of vulnerable customers in all our decisions.

### Introduction

6.2. The Government has a target that by 2010 no vulnerable household should be in fuel poverty. This target has become increasingly difficult to meet over the last few years as energy prices have started to increase in real terms.

6.3. Although the broad issues of poverty and social exclusion are for Government, there is a role for Ofgem in protecting consumers, by promoting competitive energy markets and regulating monopoly companies, such that prices are as low as practicable. Consistent with our statutory duties to have regard to sustainable development, the needs of the sick, elderly, those on low incomes and those living in rural areas, we seek to integrate social issues and considerations throughout our work.

6.4. Ofgem has published a Social Action Strategy describing how we will take forward this work under four broad themes:

- developing the regulatory framework and ensuring all suppliers comply with the regulatory obligations designed to protect vulnerable consumers,
- encouraging best practice among energy suppliers,
- influencing the debate about measures to help tackle fuel poverty, and
- considering how best to inform consumers about ways to lower energy bills.

### The Next Two Years

6.5. Over the next two years, with prices likely to remain high relative to historic levels, the issue of fuel poverty will continue to be a priority. A holistic approach that brings together help on energy efficiency, social security benefits and money advice, is likely to be the most effective way to combat fuel poverty. Improved working between Government, industry and consumer agencies is therefore important to identify and target help to where it is most needed.

6.6. Examples of initiatives that Ofgem will be taking forward under the Social Action Strategy include:

- the review of supply licence conditions where we are consulting specifically on how best to provide protection for vulnerable customers,
- looking at the potential for lower cost innovative prepayment meters as part of our consideration of smart metering,
- exploring the barriers to further expansion of the gas network as a part of the gas distribution price control review,
- encouraging network operators to develop best practice in respect of vulnerable consumers, going beyond the formal requirements of their licences, through initiatives such as the electricity distribution discretionary reward scheme,



- putting in place a new reporting system for social obligations to enable stakeholders to track progress in the spread of best practice among suppliers,
- continuing mystery shopping exercises and benchmarking surveys to track performance and help identify best practice, for example in relation to debt and disconnection and provision of front line advice to vulnerable customers,
- following up on the corporate social responsibility audit conducted in 2004-2005,
- working with Government and other stakeholders on the next phase of the EEC and issues concerned with its integration with other Government schemes such as Warm Front together with the proposal from suppliers that EEC should be split into separate environment and social obligations,
- helping to get the message across to consumers about the options for reducing bills, through the Energysmart campaign and the new fuel poverty helpline launched by the major suppliers to provide a one-stop shop for consumers on measures to address fuel poverty.

### **A Five Year View**

6.7. Looking ahead, the Government's 2010 target to eliminate fuel poverty in vulnerable households looks extremely challenging. Tackling climate change through reducing carbon dioxide emissions is likely to continue to put upward pressure on energy prices even after new sources of gas supply come on stream. Meeting the fuel poverty target is therefore likely to require significant additional resources and we will work with Government, industry and consumer groups to ensure that any new schemes that are developed are targeted and effective and are consistent with the operation of competitive retail markets.

6.8. Issues around the protection of vulnerable consumers are likely to remain even as competition in the supply market matures. Nevertheless, if suppliers continue to take a proactive role there is the potential for self-regulation to be increasingly important.

## 7. Better regulation

7.1. We are committed to better regulation and are continually seeking to improve our efficiency and effectiveness. We keep our costs under tight control.

### Introduction

7.2. Ofgem is committed to the principles of better regulation and to running our operations as efficiently and effectively as we can. Across the range of our activities Ofgem seeks to adhere to the principles of good regulation as developed by the Better Regulation Task Force (now the Better Regulation Commission). These are:

- proportionality - regulators should only intervene when necessary, remedies should be appropriate to the risk posed, and costs identified and minimised,
- accountability - regulators must be able to justify decisions, and be subject to public scrutiny,
- consistency - government rules and standards must be joined up and implemented fairly,
- transparency - regulators should be open, and keep regulations simple and user friendly, and
- targeting - regulation should be focused on the problem, and minimise side effects.

7.3. In terms of cost efficiency, Ofgem has adopted an RPI-3 per cent control for the period 2005-2006 to 2009-2010. This will see sustained real reductions in the costs of regulation for the first time since the privatisation of the gas and electricity industries.

### The Next Two Years

#### *Championing best practice*

7.4. The Hampton and Arculus reports published last year articulated the challenge of reducing the administrative costs of regulation on businesses as an aspect of better regulation which the Government is now taking forward. Project Paperless was an immediate response to this and to concerns raised as part of the consultation on the Corporate Strategy last year. Ofgem has continued to consider how best to take forward the recommendations from these reports. As part of this we are producing for the first time a Simplification Plan, which is at appendix 4. This brings together our initiatives to simplify regulation. The plan will evolve over time.

7.5. We sought views in the January consultation on whether there were particular licence conditions or other obligations that imposed an undue or unnecessary administrative burden, for instance because the protection provided by them could be better provided through alternative means. We received a number of suggestions from respondents and we are considering them carefully. The majority of them are already being considered as part of the ongoing review of supply licences.

7.6. In recognition of the growing importance of the better regulation agenda, we have established a small better regulation unit to champion the issues within Ofgem

and to co-ordinate our contribution to wider Government initiatives in this area. Also, as part of future annual budget discussions, we will explicitly consider the extent to which our plans are consistent with better regulation.

### *Policy*

7.7. Our commitment to better regulation initiatives is reflected in our approach to key policy areas:

- in the Supply Licence Review (see the section on creating and sustaining competition) where we are looking to remove licence conditions that are no longer required and to ensure that where conditions remain they are targeted and proportionate,
- in the transmission and gas distribution price control reviews (discussed in the section on regulating network monopolies) where we are considering carefully the lessons from previous reviews in terms of the process to be followed and the burdens that our information-gathering exercises can impose. Bringing together the gas and electricity transmission controls will also help in ensuring consistency of approach, and
- in developing further our approach to impact assessments.

### *Industry Codes*

7.8. Ofgem has a role in approving or rejecting modifications to a range of industry agreements (some of which are known as codes). Over the coming year we will be taking a number of steps to review and, where appropriate, simplify these arrangements.

7.9. We will be undertaking a range of initiatives in relation to certain industry codes. For example, rationalising the Network Codes for Independent Gas Transporters and looking at improving the effectiveness of the Supply Point Administration Agreement.

7.10. We will also begin a major review of the requirements for compliance with the industry codes. This is a significant new project which will involve examining all the codes and their requirements and determining the appropriate role for licence regulation and for self-regulation in securing compliance with these codes in future.

### *Improving accessibility and transparency*

7.11. Responding to concerns raised as part of last year's Corporate Strategy consultation, we launched Project Paperless aimed at reducing the number and complexity of the consultation documents we produce. One conclusion of the project was to redesign our published documents. We have now published several documents in the new template and the initial feedback has been favourable. In the coming year, we will also be looking to apply the Project Paperless principles to industry code modifications and derogation decisions.

7.12. We will also be working to make our documents fully electronic and easier to navigate. Linked to this, we will be redesigning our website to improve transparency and make it easier for stakeholders to locate information they are looking for, picking up on concerns raised through the discussions we held as part of Project Paperless.

We will also be looking to introduce electronic records management across the organisation. This should allow Ofgem to respond more quickly and efficiently to requests for information, including those made under the Freedom of Information Act, again improving transparency.

#### *Consumer input*

7.13. We will also seek to ensure that we get effective consumer input to our policy decisions in the light of DTI's proposals for changes to the structure of consumer bodies. As part of this we will be seeking to strengthen our links with a broader range of consumer organisations and will look at the scope for employing more innovative approaches to consultation on issues which directly impact on domestic consumers.

#### *Costs and efficiency*

7.14. The key driver in terms of our efficiency is the adoption of an RPI-3 per cent target for cost reduction for each of the five years between 2005-2006 and 2009-2010. This will result in savings of around £5 million by the end of the five-year period, mainly achieved through:

- continuing to reduce our dependence on external consultants,
- seeking greater efficiencies in the use of office space,
- exploring further the idea of shared services with other government departments,
- increasing the energy efficiency of our offices,
- seeking to achieve greater efficiency in our purchasing through better contract management and negotiation, and
- reducing headcount, in part through more prioritisation and ensuring work flows are better organised.

7.15. We will also keep under review and seek further efficiencies in the work Ofgem carries out for Government on administering environmental programmes.

### **A Five Year View**

7.16. We will continue to review our policy and processes with a view to achieving best practice in relation to better regulation. For instance we will consider the scope for conducting reviews of other licences against the better regulation framework and will continue to improve the approach to setting price controls.

7.17. In 2008-2009 it will be necessary to review the RPI-3 per cent cost target and consider what arrangements would be appropriate for 2010-2011 and beyond. It will be important that further cost reduction does not reduce the quality of Ofgem's work, but a better targeted and simpler approach to regulation may facilitate further cost savings.

**Appendices****Index**

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## Appendix 1 - Consultation Questions

1.1. In our consultation document on the Proposed Corporate Strategy we sought the views of respondents on the questions set out below.

**Question 1: Do the Corporate Strategy themes remain valid?**

**Question 2: Have we identified all the relevant issues within each theme?**

**Question 3: Is Ofgem's approach to the challenges ahead the right one?**

**Question 4: Are there any licence conditions or other obligations that impose an unnecessary administrative burden?**

### List of Respondents

List	Name
1	Centrica
2	Coalpro
3	EDF Energy
4	Energy Networks Association
5	Energy Retail Association
6	Energy Saving Trust
7	energywatch
8	EON UK
9	Friends of the Lake District
10	Fuel Poverty Advisory Group
11	The Gas Forum
12	Northern Gas Networks
13	RWE npower
14	Scottish Power
15	Scottish and Southern Energy
16	Shell Gas Direct
17	Sentec
18	Siemens Energy
19	United Utilities
20	Wales and West Utilities

1.2. All responses received by Ofgem were not marked as being confidential and have been placed on Ofgem's website. We will publish a summary of the responses giving reasons where we have not taken up a suggestion made by a respondent.

## Appendix 2 - Deliverables/Performance Indicators 2006-7

### Deliverables 2006-2007

#### Creating & Sustaining Competition

Activity	Action	Period
Retail Competition	Publish findings on whether a full review of non-domestic supply markets is required	Q1
	Publish a consultation document setting proposals for new electricity and gas supply licences	Q2
	Publish initial proposals on development of metering competition and metering price controls	Q2
	Publish final proposals on metering price controls	Q3
	Implement, through collective licence modification processes, new electricity and gas supply licences	Q4
Wholesale Markets	Implement SO incentives for National Grid Electricity Transmission in its role as GB SO in the electricity market for one year from April 2006	Q1
	Publish the Energy Act report on Security of Supply in conjunction with the DTI	Q1
	Publish initial consultation document for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission in their roles as GB gas and electricity market GB System Operators	Q2
	Publish Final Proposals for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission	Q3
	Implement licence modifications for the enduring SO incentives schemes for National Grid Gas and National Grid Electricity Transmission	Q4
Connections	Consult on review of progress in competition in connections	Q2

**Regulating Network Monopolies**

Activity	Action	Period
Transmission	Publish Transmission Price Control Review (TPCR) Initial Proposals	Q1
	Publish TPCR Final Proposals	Q3
	Publish proposals for cost reporting by transmission companies	Q4
	Publish proposals for offshore regulation	Q4
Electricity distribution	Award rewards under quality of service discretionary reward scheme	Q2
	Implement the Distribution Connection and Use of System Agreement	Q2
	Publish electricity distribution quality of service report	Q3
	Publish summary cost information for electricity distribution companies for 2005-2006	Q4
Gas Distribution	Publish initial proposals on Distribution Network interruption reform	Q2
	Publish extension review Initial Proposals	Q2
	Publish extension review Final Proposals	Q3
	Publish gas distribution quality of service report	Q3
	Final proposals for DN interruption reform	Q4



**A Leading Voice in Europe**

Activity	Action	Period
Europe	Obtain approval from ERGEG for Gas Balancing Good Practice Guidelines	Q1
	Ensure ERGEG consults on Guidelines for Good Practice on Information Management and Transparency in EU electricity markets	Q2
	Obtain a commitment from the other regulators to the regional gas initiatives work under the gas roadmap	Q3
	Ensure that monitoring of the Gas Balancing guidelines is carried out	Q4
	Work to ensure compensation mechanism between European Transmission System Operators is agreed and enters into force in 2007	Q4
	Ensure that the regional initiatives on gas hubs incorporate hubs relevant to the GB market	Q4
	Assist DG Competition in coming forward with effective proposals from the sectoral review	Q4

**Helping to Protect the Environment**

Activity	Action	Period
Energy Efficiency	Publish a review of the first year of the Energy Efficiency Commitment 2005-2008	Q2
Renewables & CHP	Publish guidance for generators on fuel measurement and sampling requirements under the Renewables Obligation	Q1
	Publish updated guidance on the administration of the Renewables Obligation to reflect changes resulting from the RO Review	Q1
	Publish annual report on Renewables Obligation	Q4
Fossil Fuel Levy	Set the Fossil Fuel Levy Rate for 2007-2008	Q3
Environmental Policy	Publish Environmental Action Plan Annual Report	Q1

**Helping to Tackle Fuel Poverty**

Activity	Action	Period
Social Action Plan	Proposals on new licence framework for protecting vulnerable customers as part of supply licence review	Q2
	Benchmarking work on the front line customer experience for vulnerable customers	Q2
	Publish follow-up on Corporate Social Responsibility Audit	Q4

**Better Regulation**

Activity	Action	Period
Better Regulation	Publish scope and programme for Industry Codes Compliance Review	Q1
	Apply 'Project Paperless' principles to industry code modification and derogation decisions	Q2
	Introduce electronic document navigation and website redesign	Q4
	Conduct audit of stakeholders' views on Ofgem communications, including impact of Project Paperless	Q4

### Performance Indicators 2006-2007

Activity	Measure	Target	Timeframe
Wholesale Markets	Investigate and take appropriate enforcement action (which may include referring the case to the FSA) when there is evidence of licence or competition law infringements within the prescribed timescales	100%	
	Consult upon and carry out consultations regarding any applications made from Regulated Third Party Access (RTPA) by prospective storage facility and pipeline operators	100%	
	Submit decisions to the European Commission within the prescribed timescales if adequate information has been provided	100%	
	Assess and make decision in relation to any IAE within three months of it being raised if adequate information is provided	100%	
Connections	Completion of electricity/gas determinations	95%	16 Weeks
Modifications	Follow published procedures for all modifications		
	Decisions relating to modifications to industry codes, agreements and charging arrangements to be issued	70%	5 Weeks
Licensing	Competitive market licence applications to be processed	90%	10 Weeks
Customer contact	Respond substantively to 93 per cent of customer contacts within 10 working days		
Enforcement	Investigate possible non-compliance with sectoral legislation and the Competition Act, in accordance with statutory timescales in all cases		
Technical Policy	Completion of Meter Asset Manager approvals and authorisations	95%	5 Working Days
Quality of Service	Resolve standards of performance determinations	95%	16 Weeks
Energy Efficiency	Respond to suppliers who have submitted schemes for approval	100%	10 Working Days of submission deadline

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Renewables & CHP	Carry out reconciliation of CHP LECs	100%	20 Working Days after receipt of accurate data from Defra
	Follow up with generators any outstanding issues in their applications for accreditation	95%	5 Working Days
	Circulate the buy-out funds	100%	1 Month
	No complaints are raised under Ofgem's complaints procedure about its administration of the Renewables and CHP schemes		
Better Regulation	Respond to Freedom of Information Act queries	100%	20 Calendar Days
	Pay undisputed bills	98%	30 Calendar Days

## Appendix 3 - Ofgem budget 2006-2010

<b>BUDGET TABLE</b>						
<b>£m</b>	<b>2005-06</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>
<b>Costs By Theme</b>	<b>Planned</b>	<b>Provisional outturn</b>	<b>Planned</b>	<b>Planned</b>	<b>Planned</b>	<b>Planned</b>
<b>Creating &amp; Sustaining Competition</b>	<b>5.6</b>	<b>5.3</b>	<b>5.1</b>	<b>5.2</b>	<b>5.4</b>	<b>5.4</b>
Retail Markets (1)	1.7	1.4	1.5	1.5	1.5	1.4
Wholesale Markets (1)	1.3	1.5	1.2	1.2	1.3	1.3
Connections	0.4	0.3	0.4	0.4	0.4	0.4
Industry Codes & Licensing (2)	1.1	1.1	1.1	1.2	1.2	1.2
Enforcement & Consumer Affairs (2)	1.1	1.0	0.9	0.9	1.0	1.1
<b>Regulating Network Monopolies</b>	<b>8.7</b>	<b>9.6</b>	<b>10.3</b>	<b>8.2</b>	<b>8.5</b>	<b>7.8</b>
Transmission	3.9	5.3	3.7	1.8	1.8	1.8
Electricity Distribution	2.0	1.5	1.6	2.3	3.3	2.8
Gas Distribution	0.8	0.8	2.8	1.8	1.1	0.9
Technical (2)	2.0	2.0	2.2	2.3	2.3	2.3
<b>Helping Protect the Security of Britain's Energy Supplies</b>	<b>1.0</b>	<b>1.2</b>	<b>1.2</b>	<b>1.1</b>	<b>1.3</b>	<b>1.3</b>
Security of Supply (3)	1.0	1.2	1.2	1.1	1.3	1.3
<b>A Leading Voice in Europe</b>	<b>1.4</b>	<b>1.2</b>	<b>1.5</b>	<b>1.3</b>	<b>1.0</b>	<b>1.1</b>
Europe (4)	1.4	1.2	1.5	1.3	1.0	1.1
<b>Helping to Protect the Environment</b>	<b>1.9</b>	<b>1.7</b>	<b>2.5</b>	<b>2.7</b>	<b>2.3</b>	<b>2.6</b>
Environmental Programmes (5)	1.5	1.3	2.0	2.2	1.8	2.0
Environmental Policy	0.4	0.4	0.5	0.5	0.5	0.6
<b>Helping to Tackle Fuel Poverty</b>	<b>0.4</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.3</b>	<b>0.4</b>
Social Affairs	0.4	0.3	0.3	0.3	0.3	0.4
<b>Better Regulation</b>	<b>0.0</b>	<b>0.2</b>	<b>0.5</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>
Better Regulation	0.0	0.2	0.5	0.2	0.2	0.2
<b>Sub Total</b>	<b>19.0</b>	<b>19.5</b>	<b>21.4</b>	<b>19.0</b>	<b>19.0</b>	<b>18.8</b>

£m	2005-06	2005-06	2006-07	2007-08	2008-09	2009-10
Other Costs	Planned	Provisional outturn	Planned	Planned	Planned	Planned
<b>Executive/Support/ Overhead Costs</b>	<b>7.9</b>	<b>7.8</b>	<b>6.9</b>	<b>7.3</b>	<b>7.3</b>	<b>7.4</b>
Board	1.1	1.0	1.0	1.1	1.1	1.1
Strategy (6)	0.4	0.2	0.0	0.0	0.0	0.0
Corporate Communications (inc. Scotland)	1.4	1.3	1.3	1.4	1.4	1.4
Finance	0.9	0.8	0.8	0.9	0.9	0.9
Human Resources	1.2	1.6	1.0	1.0	1.0	1.0
Office Services	1.0	1.0	1.0	1.1	1.1	1.1
Information Management	1.9	1.9	1.8	1.8	1.8	1.9
<b>Accommodation</b>	<b>5.0</b>	<b>4.7</b>	<b>4.9</b>	<b>5.4</b>	<b>5.2</b>	<b>5.2</b>
Gross (7)	8.3	8.4	8.3	8.9	8.7	8.8
Recharge	(3.3)	(3.7)	(3.4)	(3.5)	(3.5)	(3.6)
<b>Other</b>	<b>2.9</b>	<b>0.1</b>	<b>2.1</b>	<b>3.1</b>	<b>3.6</b>	<b>3.6</b>
Depreciation	1.2	0.9	0.9	0.9	0.9	0.9
Contingency (8)	2.5	N/A	2.0	3.0	3.5	3.5
Other Income	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)	(0.8)
<b>Sub Total</b>	<b>15.8</b>	<b>12.6</b>	<b>13.9</b>	<b>15.8</b>	<b>16.1</b>	<b>16.2</b>
<b>TOTAL COSTS</b>	<b>34.8</b>	<b>32.1</b>	<b>35.3</b>	<b>34.8</b>	<b>35.1</b>	<b>35.0</b>

1 On average about 50 per cent of Wholesale Markets' time and 20 per cent of Retail Markets' time is spent dealing with modifications to industry codes.

2 Work in these areas cuts across most of the Ofgem themes. They are listed here for transparency. It is not possible to predict how these costs will be apportioned as work in these areas is mainly demand-led.

3 Security of supply costs indicated are directly attributable to work in this area, but many workstrands under other themes contribute to the work in this area. To avoid duplication, costs included in other themes are excluded from those shown under security of supply. This also applies to a number of other cross-cutting workstrands.

4 The reduction in spend in Europe from 2008-2009 is because four members of staff will finish their secondments at the Commission.

5 Costs are projected to increase due to increased volume of activity and a planned new IT System.

6 Strategy work is being reallocated across policy divisions from 2006-2007.

7 2007-08 costs include provision for external renovation and 2008-2009 costs factor in a rent review.

8 Provisional spend on the contingency for 2005-6 is £1.7m. This has not been reflected here as the money has been allocated out to the relevant workstrands. The main transfers were to Transmission (NTS Offtake £0.7m and work relating to network access issues £0.4m), HR (recruitment £0.3m) and Better Regulation (Project Paperless £0.2m). See also 2005-6 provisional spend analysis below.

## 2005-6 Provisional spend analysis

1.1. Provisional expenditure for 2005-6 shows that Ofgem is forecast to underspend by £2.7m. It is likely that the majority of this underspend will be returned to licence payers in 2006-7. The main two factors explaining the underspend are:

- Headcount - Ofgem has been running at over 10 per cent below the budgeted headcount for much of the year. This has resulted in an underspend of £1.5m in staff costs; and
- Contingency - we have an unutilised contingency of £0.8m.

1.2. The four main areas of overspend are:

- Transmission - there are three key reasons for the overspend in this area. First, unplanned policy work relating to major new projects connecting to the networks. Second, additional work required to put in place transitional regulatory arrangements after DN sales and also to establish an enduring regulatory framework as part of the network overall as well as part of the transmission price control review (TPCR). Third, additional work undertaken for the TPCR such as a cost of capital study, plus certain TPCR analysis advanced due to the enhanced scope of the project and the need to identify critical issues as early as possible;
- Security of Supply - the reason for the overspend was the very heavy workload (including Winter Outlook Project) requiring the use of additional consultants;
- Better Regulation - the costs of Project Paperless are indicated here. This was an unbudgeted project at the start of the year; and
- Human Resources - additional recruitment costs are the primary reason for the overspend in this area.

## Budget commentary

1.3. The above table provides an estimated breakdown of Ofgem's costs by activity and theme for the years covered by the RPI-3 per cent cost control regime (2005-2006 to 2009-2010).

1.4. We have extracted central and overhead costs this year for transparency to enable comparisons to be made.

1.5. Much of Ofgem's work is of a reactive nature with constantly changing priorities. To cover such eventualities a contingency has been included in the budget. Over the past two years the contingency was set at £2.5m; in 2004/5 £2.4m was utilised whilst in 2005/6 it is anticipated that £1.7m will be spent as explained above. For 2006/7 Ofgem proposes to set the Contingency at £2.0m. In later years, to reflect increased uncertainties a higher contingency has been set, but when these budgets are finalised it is anticipated that the contingency will be reduced accordingly.

1.6. The headline costs to licence payers go up by £0.5m from 2005-2006 to 2006-2007 largely because of increased costs associated with administering environmental programmes which are outside the RPI-3 cost control regime. The breakdown of the projected costs for administering Environmental Programmes in 2006-7 is as follows:

Renewables Obligation	£0.7m
Energy Efficiency Commitment	£0.4m
Climate Change Levy Exemption for Renewables & CHP	£0.8m
Other	£0.1m
<b>Total</b>	<b>£2.0m</b>

### RPI-3 per cent cost control regime

1.7. RPI was determined as 3.5 per cent for 2005-06 and 2.2 per cent for 2006-7. For future years RPI has been estimated as 2.5 per cent but will be adjusted to the rate prevailing at December of the relevant year. This gives rise to the following cost ceiling:

£m	2005-06	2006-07	2007-08	2008-09	2009-10
<b>RPI-3 per cent budget ceiling</b>	<b>34.2</b>	<b>33.9</b>	<b>33.7</b>	<b>33.5</b>	<b>33.4</b>

1.8. The table below sets out the cost control ceiling and, following various adjustments to reflect those costs incurred by Ofgem that do not form part of the cost control regime, the net cost to licence fee payers.

<b>BUDGET/RPI-3 PER CENT COST CONTROL RECONCILIATION</b>					
(£m)	2005-06	2006-07	2007-08	2008-09	2009-10
<b>Total Costs as per Budget Table</b>	<b>34.8</b>	<b>35.3</b>	<b>34.8</b>	<b>35.1</b>	<b>35.0</b>
<b>Costs Excluded from Regime (funded by licence payers)</b>					
Administering Environmental Programmes (net)	(0.4)	(1.3)	(1.5)	(1.1)	(1.2)
Depreciation	(1.2)	(0.9)	(0.9)	(0.9)	(0.9)
<b>Costs Included in Regime (funded by HMT)</b>					
Capital	1.0	0.8	0.8	0.8	0.8
<b>Total Adjusted Costs</b>	<b>34.2</b>	<b>33.9</b>	<b>33.2</b>	<b>33.9</b>	<b>33.7</b>
<b>RPI-3 per cent Budget Ceiling</b>	<b>34.2</b>	<b>33.9</b>	<b>33.7</b>	<b>33.5</b>	<b>33.4</b>
<b>Variance</b>	<b>0</b>	<b>0</b>	<b>0.5</b>	<b>(0.2)</b>	<b>(0.3)</b>

1.9. The table above indicates that Ofgem is maintaining costs within the RPI-3 per cent cost control regime. Indications are that while there is a forecast underspend of £0.5 million in 2007-2008, this will be offset in 2008-2009 and 2009-2010.



## Appendix 4 - Simplification Plan

1.1. Ofgem is committed to the principles of better regulation and we are continually seeking to improve our efficiency and effectiveness.

1.2. As a part of this, and in response to the Government's broader drive to reduce the administrative burden of regulation while ensuring consumer protection, we have summarised the range of initiatives that we are undertaking in this Simplification Plan. This is Ofgem's first Simplification Plan and it will evolve over time.

### Process Initiatives

Initiative	Outcome	Current status/milestone
Ofgem RPI-3 cost control: to improve Ofgem's internal efficiency	Savings of around £5m by the end of the 5-year period. The savings will directly benefit licensees as their licence fees will reduce accordingly	Implemented. The savings will be made over the period 2005-6 to 2009-10
Project Paperless: revised document templates and guidance to make consultation and decision documents shorter and more accessible, responding to industry concerns about the burden imposed by having to deal with long and complex documents	20 per cent fewer documents published in 2005-6 than in 2004-5. Benefits all stakeholders who will need to spend less time working through Ofgem documents	Implemented from January 2006. Audit of stakeholders' views scheduled for Q4 2006-7
Follow up to Project Paperless: principles to be applied to all other Ofgem documents including code modification and derogation decisions  Website to be redesigned to aid 'navigation'	Benefits all stakeholders who need to engage with Ofgem's work	Applying Project Paperless principles to code modification and derogation decisions is scheduled for Q2 2006-7  Electronic document navigation and website redesign is scheduled for Q4 2006-7

**Policy Initiatives**

<b>Initiative</b>	<b>Outcome</b>	<b>Current status/ milestone</b>
Supply Licence Review: to consider whether each licence condition remains the best means of protecting consumers, given that supply competition is well established	Benefits gas and electricity consumers and suppliers through reducing the cost of compliance and administrative burden in existing suppliers and through reviewing barriers to more effective competition	Ongoing. Being progressed through an overall steering group and several separate industry work groups looking at, for example, vulnerable customers, metering, industry codes and contractual issues (such as supply of last resort). Aim to publish initial proposals in July 2006 and final proposals in November 2006. Any licence changes take effect in April 2007
New reporting system for social obligations	50 per cent reduction in the data required from suppliers. Estimated savings of £100k	New reporting requirements take effect from April 2006
Industry Codes:  1. Streamlining codes and governance arrangements  - Creation of a Uniform Network Code for Independent Gas Transporters  - Distribution Connection Use of System Agreement  2. Review of Code compliance arrangements	Reducing the burden imposed by the need for stakeholders to deal with multiple documents  Single code replaces around 400 separate bilateral agreements  Ensuring code compliance arrangements are 'fit for purpose'	Way forward and timescales to be agreed by Q1 2006-7  New arrangements take effect from September 2006  Publication of scope and programme in Q1 2006-7.
Publicly Available Specification for the management of physical assets (PAS55): a standard setting out the key elements of good physical asset management	Removes need for Asset Risk Management Surveys. Ofgem has consulted on how it affects our need for assurance on licensees' longer term asset risk management processes	Ofgem is encouraging network licensees to seek PAS55 certification. Details are to be taken forward via a stakeholder working group

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Engineering standard P2/5: introducing simpler compliance arrangements as regards the need for distribution licensees to apply for derogations in the case of non-compliance	Distribution licensees should self-regulate their compliance for demand groups up to 60MW. This has advantages to both licensees and Ofgem and is consistent with better regulation principles	Consultation ongoing on conducting a two-year trial from early 2007. Ofgem will review any trial that takes place and, if successful, will seek licence changes to make the change permanent
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## Appendix 5 - The Authority's Powers and Duties

1.1. Ofgem is the Office of Gas and Electricity Markets which supports the Gas and Electricity Markets Authority ('the Authority'), the regulator of the gas and electricity industries in Great Britain. This Appendix summarises the primary powers and duties of the Authority. It is not comprehensive and is not a substitute to reference to the relevant legal instruments (including, but not limited to, those referred to below).

1.2. The Authority's powers and duties are largely provided for in statute, principally the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Act 2004, as well as arising from directly effective European Community legislation. References to the Gas Act and the Electricity Act in this Appendix are to Part 1 of each of those Acts.<sup>1</sup>

1.3. Duties and functions relating to gas are set out in the Gas Act and those relating to electricity are set out in the Electricity Act. This Appendix must be read accordingly.<sup>2</sup>

1.4. The Authority's principal objective when carrying out certain of its functions under each of the Gas Act and the Electricity Act is to protect the interests of consumers, present and future, wherever appropriate by promoting effective competition between persons engaged in, or in commercial activities connected with, the shipping, transportation or supply of gas conveyed through pipes, and the generation, transmission, distribution or supply of electricity or the provision or use of electricity interconnectors.

1.5. The Authority must when carrying out those functions have regard to:

- the need to secure that, so far as it is economical to meet them, all reasonable demands in Great Britain for gas conveyed through pipes are met;
- the need to secure that all reasonable demands for electricity are met;
- the need to secure that licence holders are able to finance the activities which are the subject of obligations on them<sup>3</sup>; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>4</sup>

1.6. Subject to the above, the Authority is required to carry out the functions referred to in the manner which it considers is best calculated to:

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<sup>1</sup> Entitled 'Gas Supply' and 'Electricity Supply' respectively.

<sup>2</sup> However, in exercising a function under the Electricity Act the Authority may have regard to the interests of consumers in relation to gas conveyed through pipes and vice versa in the case of it exercising a function under the Gas Act.

<sup>3</sup> Under the Gas Act and the Utilities Act, in the case of Gas Act functions, or the Electricity Act, the Utilities Act and certain parts of the Energy Act in the case of Electricity Act functions.

<sup>4</sup> The Authority may have regard to other descriptions of consumers.

- promote efficiency and economy on the part of those licensed<sup>5</sup> under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- contribute to the achievement of sustainable development; and
- secure a diverse and viable long-term energy supply.

1.7. In carrying out the functions referred to, the Authority must also have regard, to:

- the effect on the environment of activities connected with the conveyance of gas through pipes or with the generation, transmission, distribution or supply of electricity;
- the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed and any other principles that appear to it to represent the best regulatory practice; and
- certain statutory guidance on social and environmental matters issued by the Secretary of State.

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation<sup>6</sup> and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

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<sup>5</sup> or persons authorised by exemptions to carry on any activity.

<sup>6</sup> Council Regulation (EC) 1/2003

## Appendix 6 - Glossary

### C

#### [Council of European Energy Regulators \(CEER\)](#)

CEER brings together the independent national energy regulators from EU Member States and the European Economic Area (EEA). CEER acts as a focal point for contacts between national energy regulators and is their primary interface at a European level. Its overall aim is to facilitate the creation of a single competitive, efficient and sustainable internal market for gas and electricity in Europe. In December 2005, Sir John Mogg was appointed President of CEER and Chairman of the European Regulators' Group for Electricity and Gas (ERGEG - see below).

#### [Climate Change Programme Review \(CCPR\)](#)

In September 2004, Defra launched a review of the UK Climate Change Programme looking at how existing policies were performing and the range of policies that might be put in place in the future. Defra expects that a revised CCP will be published in early 2006, taking into account the December 2005 Pre-Budget Report.

### E

#### [European Regulators' Group for Gas and Electricity \(ERGEG\)](#)

ERGEG is the means by which European energy regulators provide formal advice to the European Commission, both on the rules that regulators see as necessary for the effective implementation of the legislative framework and reporting on the actual state of implementation of the relevant rules and guidelines and on the level of competition in each of the Member States. Membership of ERGEG is limited to the EU regulators but those from candidate countries and the EEA hold Observer Status.

### L

#### [Liquefied Natural Gas \(LNG\)](#)

LNG consists of mainly methane gas liquified at around -260 degrees Fahrenheit. Cooling and liquifying the gas reduces its volume by 600 times such that a tonne of LNG corresponds to about 1,400 cubic metres of methane in its gaseous state. LNG may be stored or transported by special tanker.

### S

#### ['Smart' metering](#)

The primary function of a basic gas or electricity meter is to accurately ascertain the quantity of energy supplied to a consumer. Beyond ensuring that the meter meets performance requirements, is safe and that a secure display is available, no other functionality is required. Smart metering can therefore be defined as metering that

provides facilities over and above this. Technological innovation in this area is continuing at a rapid pace and there already exists a range of possible advances in metering technology, incorporating both different technologies and functionality. For example, the simplest smart meters would enable consumers to monitor energy consumption in money terms rather than kWh, while others would obviate the need for manual meter reading by communicating energy consumption and/or usage data to the energy supplier.

#### Supercomplaint

Section 11 of the Enterprise Act 2002 enables designated consumer bodies such as energywatch to make a complaint to the Office of Fair Trading or a relevant economic regulator that any feature, or combination of features, of a market in the UK for goods or services is or appears to be significantly harming the interests of consumers. These complaints are called 'supercomplaints'.

## Appendix 7 - Feedback Questionnaire

1.1. Ofgem considers that consultation is at the heart of good policy development. We are keen to consider any comments or complaints about the manner in which this consultation has been conducted. In any case we would be keen to get your answers to the following questions:

- Does the report adequately reflect your views? If not, why not?
- Does the report offer a clear explanation as to why not all the views offered had been taken forward?
- Did the report offer a clear explanation and justification for the decision? If not, how could this information have been better presented?
- Do you have any comments about the overall tone and content of the report?
- Was the report easy to read and understand, could it have been better written?

Please add any further comments and send them to:

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