



Promoting choice and value for all gas and electricity customers

## Corporate Strategy and Plan 2007-2012

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### Overview:

This document sets out our strategy for 2007-2012 as developed in the light of responses to two rounds of consultation with stakeholders.

The strategy maintains and updates our seven themes, in particular to take into account our developing work on making the gas and electricity sectors more sustainable and a greater focus on consumer engagement through our new *Consumer First* project.

This strategy is being prepared at a time when energy policy is under profound review. We intend to return to the themes later in the year to confirm or change them to take account of further developments.

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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 2007-2012, February 2007 (Ref: 6/07b).
- Proposed Corporate Strategy and Plan 2007-2012, January 2007 (Ref: 6/07b).
- Cover letter, Proposed Corporate Strategy and Plan 2007-2012, January 2007 (Ref: 6/07a).
- Responses to initial consultation letter, September 2006 (Ref: 131/06).
- Initial consultation letter, Corporate Strategy and Plan 2007-2012, August 2006 (Ref: 131/06).

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## Foreword

Ofgem's Corporate Strategy is being developed at a time of profound review of energy policy in Britain and across Europe.

The European Commission's Strategic Energy Review and planned legislative package set an important new course for delivering truly competitive energy markets across Europe. The new European Union renewables target and the Government's Energy White Paper and draft Climate Change Bill will ensure that environmental considerations remain at the heart of future energy policy.

There will also be major changes to the way in which consumer interests are represented in the energy sector as well as new opportunities for consumers to engage more actively with the climate change agenda. It is in this area that we will respond to the Chancellor's Budget request for Ofgem to examine how households that generate clean energy can benefit from exporting electricity back into the grid.

These are significant developments and Ofgem will continue both to influence and respond to them in the interests of British energy consumers. Our forward strategy positions us well to do this. Thus, whilst we have retained the seven core themes established in 2004, we shall revisit them later in the year to take account of any relevant developments.

The strategy demonstrates our continued commitment to listen and take on board your views, notably by:

- setting out our plans for *Consumer First* - an initiative which has been widely welcomed, especially given the forthcoming changes to consumer representation;
- giving priority to long term investment and security of supply through our work with DTI on future market monitoring and our plans for new energy scenarios;
- committing to a project on green tariffs and to publishing revised guidelines;
- stepping up our work to prepare the industry for widespread smart metering;
- maintaining our involvement in the development of the EU energy strategy; and
- actively considering, within our statutory remit, our response to the Government's climate change agenda.

We will work to deliver our corporate programme within the RPI-3 cost control regime that we set in 2005 and whose successful application has enabled us to deliver over £5 million of savings to licence fee payers to date.

We invite you to join the Authority at its open meeting on 21 June to debate with us our strategy and wider market developments at this crucial time for energy consumers.



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



**Alistair Buchanan**  
**Chief Executive**  
**Ofgem**

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## Introduction

In August 2006, Ofgem published an open letter seeking views on the key challenges and priorities for the next five years. In January 2007, we consulted on a Proposed Corporate Strategy and Plan. This document sets out our strategy for 2007-2012, which we have finalised in the light of those responses. The responses to both rounds of consultation are on our website.

Ofgem's principal objective is to protect the interests of consumers, wherever appropriate by promoting competition. If competition does not constitute an appropriate means of protecting consumers then regulation may be necessary. In carrying out this objective we must have regard, amongst other things, to the needs of vulnerable consumers. Ofgem also has a range of important secondary duties, such as securing a diverse and viable long term energy supply, contributing to the achievement of sustainable development and having regard to the principles of best regulatory practice. We must also have regard to guidance issued by the Secretary of State for Trade and Industry on social and environmental matters.

The strategy is based around the following seven themes:

1. Creating and sustaining competition
2. Regulating networks effectively
3. Helping to protect the security of Britain's energy supplies
4. A leading voice in Europe
5. Helping to achieve sustainable development (previously 'Helping to protect the environment')
6. Helping to tackle fuel poverty
7. Better regulation

Respondents to the August 2006 letter and the January 2007 consultation endorsed these themes. Work under these themes is discussed in the chapters that follow.

Appendix 1 sets out Ofgem's deliverables and performance indicators for 2007-08. These provide the practical targeting of activities to achieve the broader objectives of the seven themes.

Appendix 2 sets out Ofgem's budget to 2011.

Appendix 3 contains a draft Simplification Plan setting out the work we will undertake in 2007-08 in support of the better regulation agenda.

Appendix 4 provides further details of Ofgem's statutory objectives and duties.

Appendix 5 contains a glossary of terms used in this document.

Appendix 6 lists the questions on which we specifically sought views and the organisations that responded.

Appendix 7 provides details of how to give feedback to Ofgem on the manner in which this consultation has been conducted, should you wish to do so.

## 1. Creating and sustaining competition

### Chapter summary

We will continue to monitor the wholesale and retail energy supply markets to make sure that competition remains effective. We will publish information and analysis to facilitate and inform the debate on important issues such as wholesale market transparency and demand-side response.

### Introduction

1.1. Domestic bills rose on average by 71 per cent in gas and 45 per cent in electricity from 2003 to the end of 2006. Over a similar period bills to industrial and commercial customers rose on average by 109 per cent in gas and 93 per cent in electricity. The main driver behind the increase was the rise in wholesale gas prices, which affected electricity prices because at present around a third of Britain's electricity comes from gas-fired power stations. Electricity prices were also affected by rising oil and coal prices, lower nuclear availability and by the need to cut carbon emissions to tackle global warming.

1.2. Since last June, however, an increase in gas supplies coupled with lower oil prices and a mild winter has led to a fall of approximately 50 per cent in the wholesale price. Most of the major energy suppliers have now announced or implemented plans to reduce bills to their domestic consumers.

1.3. Britain has a highly competitive domestic energy market - the most competitive in Europe. Energy companies compete vigorously on price, service and the range of products they offer their customers. Despite rising prices, customers have been able to save a significant amount by switching to the cheapest supplier. Suppliers have offered a range of capped and fixed price deals that have helped customers deal with volatile energy prices.

1.4. More expensive suppliers were punished by customers who left them at a rate of half a million a year. Some four million customers signed up to capped and fixed price deals and so were not been affected by more recent price rises. The best suppliers also improved the service they offer their customers and the industry put in place an Ombudsman scheme that can award compensation to domestic customers where this service fails. Changes in consumer representation expected at the end of the year should further sharpen incentives on suppliers to handle consumer disputes effectively and compete on service quality.

1.5. The non-domestic market is also competitive. Prices have fallen substantially in response to recent wholesale price movements. This happened relatively rapidly because the majority of large industrial customers index their prices directly to wholesale prices, and fixed price contracts that were renegotiated in October last year now reflect the fall in forward wholesale prices.

1.6. Higher prices over the past couple of years have led to product innovation. Suppliers have tailored contracts to help industrial and commercial customers manage their energy costs through, for example, demand-side response. Innovation has further intensified through the increased role of intermediaries in the market brokering flexible purchasing arrangements and other deals. There has also been greater interest in energy efficiency with suppliers, consultants and intermediaries beginning to offer smart metering (for non half hourly metered businesses) and other energy management tools.

1.7. At the beginning of 2006 we consulted on whether to conduct a full review of the non-domestic energy retail market. We concluded that there was insufficient evidence that a market review was necessary, but agreed that there was a need for Ofgem to work with specific customer groups (particularly small and medium sized businesses) to help them get the most from the retail market. This work continues, as does our regular engagement with the groups representing business customers of all sizes. At present the focus is on exploring with suppliers how energy contracts can be made more user-friendly.

1.8. The background of high prices (which also reflect the costs of reducing greenhouse gas emissions, which are likely to increase over time as the energy sector makes even greater cuts in emissions) makes it essential that competition remains vigorous so that the market delivers secure supplies and a range of competitively-priced services to customers.

1.9. Ofgem will continue to monitor wholesale and retail markets to make sure that they remain competitive and free from abuse. We will continue to deal with any proposed changes to the market rules quickly and effectively. Where necessary we will use our enforcement powers under the Competition Act 1998, and other legislation, to tackle anti-competitive behaviour and protect consumers.

1.10. We have delivered on our better regulation duty by completing our review of the standard conditions of the gas and electricity supply licences. We have developed proposals to simplify the licences and halve their length to make them better suited to the competitive retail market that now exists. However, we have left in place important safeguards, in particular for vulnerable customers.

1.11. Competitive markets will, over time, provide more innovation, better services and lower prices than prescriptive regulation. 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.

## **The next two years**

### **Monitoring energy markets**

1.12. Higher wholesale gas prices in part reflect the decline in peak gas supplies from the North Sea and higher costs associated with importing gas. Pressures on



wholesale prices have eased and are likely to continue to do so as several major infrastructure projects are completed. These projects will give us access to imported gas via new pipelines and liquefied natural gas (LNG) terminals. There are also plans to double Britain's gas storage capacity; if these projects gain planning permission the additional storage capacity will greatly assist the market in managing peak winter demand as North Sea production continues to decline.

1.13. These are significant developments which may be expected to have an impact on the wholesale price. The wholesale price of gas began to fall in the autumn of 2006 because of very mild weather and increased supplies as major new import pipelines came on stream. Suppliers typically had bought their gas in advance so these price reductions did not immediately feed through to lower bills for domestic customers. By contrast, many large industrial customers have indexed contracts, so they began to see relatively quickly the effects of falling wholesale prices on their bills.

1.14. Suppliers continue to compete as prices have gone up and we expect them to compete just as hard as wholesale prices fall. As stated above, most of the major suppliers have recently announced plans to reduce bills to their domestic consumers. As at late March 2007, dual fuel customers paying by direct debit have seen their bills fall by between 9 and 15 per cent, which represents a cut of between £82 and £154. Bills for dual fuel consumers on prepayment meters have fallen by up to 5 per cent, a reduction of up to £54.

1.15. There remains, however, 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. Close monitoring of the wholesale and retail markets will therefore remain an essential part of our work. We will also continue both to carry out analytical work to understand the effectiveness of retail competition and to publish periodic reports on the state of domestic retail market competition.

1.16. We will continue working with the European Commission and other regulators to ensure that arrangements in continental Europe do not restrict supplies of LNG and/or piped gas to the UK. We will continue to apply a light touch regulatory regime for new gas import infrastructure where this will promote competition and protect customers' interests. However, we will impose regulated third party access to these facilities in the absence of effective 'use-it-or-lose it' arrangements.

### **System balancing**

1.17. The wholesale market rules that determine the imbalance ('cash-out') prices are an important part of the arrangements and can have a significant impact on security of supply and wholesale price levels more generally. The existing rules have been subject to a number of changes in electricity that have divided opinion and have led to a very complex set of arrangements. In addition the arrangements for gas in emergency conditions are still under consideration. We will carry out a fresh

look at the rules in 2007 and see whether there is scope to simplify them and make sure they are creating the right incentives on all market participants.

### **Retail markets**

1.18. In 2007 we will complete our review of the standard conditions of the gas and electricity supply licences. We think our proposals to streamline the licences and extend the scope of self-regulation in the energy supply markets are appropriate for energy markets that are fully competitive. However, we will be watching events carefully to make sure that the new regulatory framework operates in the best interests of customers going forward.

1.19. We will continue our work to ensure that customers have an effective means of redress when suppliers and customers are unable to resolve service disputes. As part of this we will review the performance of the Energy Supply Ombudsman and will respond to any legislative measures enacted by Parliament that formalise our role in the approval of ombudsmen in the energy sector.

1.20. We recognise the challenge of ensuring continued support for customers while the Government takes forward its proposals in relation to consumer representation. Ofgem will work closely with the new organisation, Consumer Voice, and with Consumer Direct and the Energy Supply Ombudsman, to ensure that support for customers remains effective. We will also be taking forward our *Consumer First* project, which is described in chapter 7.

1.21. Given the state of competition in retail energy markets and proposed changes to consumer representation, Ofgem intends to conduct a review of whether the guaranteed and overall standards of performance imposed on suppliers should continue in their present form. We will consult on initial proposals, which may include amendments to the statutory framework that ultimately would need the consent of the Secretary of State for Trade and Industry.

### **Metering**

1.22. We will continue our work to establish effective metering competition and to facilitate the introduction of smarter forms of metering for domestic and business customers within the competitive metering market. We will conclude a major Competition Act investigation into the metering and metering services markets.

1.23. Metering innovation is a particularly important strand of work, especially in the context of the UK's implementation of the EU Energy Services Directive. Smart meters could potentially put an end to estimated bills and the need for meter readers to call as well as encouraging customers to be more energy efficient, thereby helping to tackle global warming. This could deliver savings in carbon emissions and on bills.

1.24. We think that suppliers are best placed to understand the costs and benefits to different groups of customers of the various technologies available. Relying on

suppliers' commercial incentives is therefore the best way of adequately protecting consumers and ensuring that new metering investment is cost-effective and meets individual consumers' different needs. We are and will remain fully engaged in that debate.

1.25. We will continue our work to remove regulatory barriers to the development of smarter metering. As part of this we have recently established an industry-wide group to set interoperability standards for smart meters. We have appointed Derek Lickorish, an acknowledged expert in this area, to advise us on what more needs to be done to prepare the industry for widespread smart metering.

1.26. We will also administer the Government-funded smart metering trials in order to gather detailed evidence on how domestic customers change their energy consumption when they have better information on how much energy they use through improved billing or smart metering.

### **A five year view**

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

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

1.29. We will continue to promote retail market competition while having regard to our duties relating to sustainable development, the environment and protecting vulnerable consumers.

1.30. We will continue to advise Government on how to manage the transition to a low carbon energy sector in the most cost-effective way.

## 2. Regulating networks effectively

### Chapter summary

Ofgem considers that incentive-based regulation is the best way of ensuring that the network regulatory framework remains fit for purpose and flexible enough to respond to changing circumstances, such as new patterns of supply and demand. We will regulate networks transparently and take decisions that are consistent across sectors wherever appropriate.

### Introduction

2.1. In general it is not efficient to have competition in most aspects of distribution and transmission activities as duplication of networks would lead to substantially higher costs for consumers. Regulation is therefore necessary to protect the interests of consumers. Regulation encompasses such issues as revenue controls on network businesses, the structure and level of network charges, quality of service incentives, and the financial ring-fencing of network businesses. It also means developing policies that contribute to the achievement of sustainable development, for example by protecting the environment and security of supply.

2.2. Incentive-based regulation encourages network companies to run their businesses in the interests of consumers. If network businesses outperform their statutory and licence targets and obligations, they should earn higher returns. If they do not, they should earn lower returns and run the risk of incurring financial penalties. This approach encourages reliable networks, good customer service and cost efficiency and over the longer term ensures that prices to consumers are no higher than necessary.

2.3. We use incentive regulation of monopoly networks to encourage the delivery of a variety of outputs, such as cost-efficiency, reliability and quality of service, that are in the interests of consumers. Our approach is evolving so that the regulatory framework is flexible enough to accommodate changing patterns of supply such as renewable and other low carbon generation and new gas import terminals.

2.4. We provide incentives for network businesses to use innovative approaches where this will result in better outcomes for customers. We continue to encourage the development of cost-reflective charging methodologies because this is the best means of promoting more sustainable, efficient investment in networks over the longer term.

2.5. Ofgem will continue to encourage the development of competition in areas associated with networks where this is an appropriate way to protect consumer interests, as in the provision of new gas and electricity connections.

2.6. Ofgem will operate in a transparent manner and, where appropriate, will adopt policies that are consistent across the networks. We will also apply simple solutions wherever they are likely to be effective.

## The next two years

### All networks

2.7. The current cycle of network price control reviews will conclude with the setting of the five year control for gas distribution companies to apply from 1 April 2008. To assist future reviews we will continue our project to introduce annual cost reporting requirements for all of the networks.

2.8. It is vital that the information that companies report to Ofgem is accurate. In 2006 we asked each of the network operators to provide written confirmation that their businesses are being conducted in accordance, amongst other things, with the standards prescribed in their licences. We will continue to consider how best to take this forward in the light of the annual reporting processes.

2.9. We will also progress our thinking on indexing allowances for the cost of capital to measures of the market cost of debt and analysing the drivers of company risk, as set out in our conclusions to the Financing Networks project that we conducted with Ofwat. If this work suggests that we should consider changes to our approach, we will consult fully and make changes only where we can demonstrate benefits from doing so. We intend to hold a briefing in the summer of 2007 to update investors and financial analysts on our approach to financial issues and price controls more generally.

2.10. In our response to the Government's Energy Review consultation we offered to provide longer term scenario assessments. We will take forward work on energy scenarios in 2007 with the aim of providing a longer term strategic contribution to the energy sector. This will help set the context for price control reviews in the future and aid consideration of other strategic issues. We expect to publish the first report in 2008.

2.11. Since 2002 Ofgem has undertaken surveys of the network companies' asset risk management practices. In 2006 we encouraged the companies to gain independent certification to the PAS 55 standard recently issued by the British Standards Institute. We are working with stakeholders to develop an assessment methodology that will complement PAS 55 certification. With these elements in place, we intend to withdraw from undertaking a bespoke Ofgem survey. We will continue to monitor developments and publish certification status on our website. We will also continue to contribute as one of the stakeholders to the assessment methodology being developed under the auspices of the Institute of Asset Management.

2.12. We will continue to deliver our statutory obligations for gas and electricity metering and for gas quality. Metrology activities have been transferred to the National Weights and Measures Laboratory as part of the UK response to the EU Measuring Instruments Directive, although statutory and financial responsibility for these remains with Ofgem. These activities, costing about £0.9m per year, form a significant part of the cost of our Technical team.

### **Electricity and gas transmission**

2.13. Ofgem will continue to work with the Department of Trade and Industry (DTI) in developing the regulatory and licensing regime for offshore transmission networks. These networks are important as they will transmit electricity from marine renewable generating stations (such as wind farms and, potentially, technologies that harness wave and tidal resources) to the onshore network. They have the potential therefore to strengthen security of supply and contribute to a lower carbon energy system.

2.14. Offshore networks are potentially expensive, so Ofgem is seeking to ensure that they are developed as efficiently as possible to avoid consumers paying excessive charges.

2.15. Over the next two years we will follow up a number of issues arising during the recent transmission price control review (TPCR). This work will include developing output measures for electricity transmission operators to improve our ability to assess whether they have invested enough to sustain network performance and how much they need to invest in future. We will also develop new regulatory arrangements that may be necessary to extend the electricity transmission network to the Scottish Islands and will assess the forecasting and network planning regime for gas transmission.

2.16. In the TPCR we introduced mechanisms which will automatically flex allowances for investment in response to the demand for capacity from users of the networks. These will work best if demands for capacity, both from new and existing users, are backed by long term financial commitment. The industry has brought forward proposals to introduce such arrangements and we will decide on these during the coming year. Such commitments from users will help the companies to identify where to invest and reduce the risk either that investment is disallowed at future reviews or that consumers have to pay for investment that turns out not to be required.

2.17. The transmission system operators (SOs) in gas and electricity are responsible for co-ordinating the actions of wholesale market participants so that supply and demand balance in real time. The SOs are subject to a package of incentives designed to encourage economic and efficient system balancing. In April 2007 we plan to implement an annual scheme for both the gas and electricity SOs.

2.18. At present the SO incentive regimes for gas and electricity vary considerably. We are also concerned about the efficiency of some of the incentive arrangements.

We therefore plan in 2007 to conduct a full review of the role of the SOs. The aim of the review will be to introduce new longer term incentives from April 2008 onwards.

### **Gas distribution**

2.19. The main priority is the gas distribution price control review (GDPCR) for the five years from 1 April 2008. This is the first five year review since National Grid (NG) sold four of its gas distribution businesses to three new gas distribution network owners in June 2005. It will provide our first opportunity to introduce the techniques of comparative analysis developed in electricity distribution and to ensure that we are able to deliver benefits for customers in future reviews.

2.20. Ofgem is developing a set of incentives to reward distribution companies for investing efficiently in their networks and for delivering the outputs that matter to customers. As part of the review we will be developing proposals to encourage extensions to the gas network that are consistent with our responsibilities to all gas consumers, present and future. We will publish initial price control proposals in May 2007 and final proposals in December 2007. We will also establish a new cost reporting framework to operate from 1 April 2008.

2.21. Ofgem will develop proposals to incentivise interruption arrangements for gas distribution networks that strengthen security of supply. Ofgem intends to create a new framework for gas distribution businesses to make informed trade-offs between interruptions, network capacity and storage investments and NTS offtake capacity to meet their security of supply licence obligations. We will develop proposals alongside the GDPCR process.

### **Electricity distribution**

2.22. We expect to launch the first full consultation on the next electricity distribution price control review in early 2008. Since the last price review, we have made substantial progress in developing our approach to cost reporting, in changing aspects of the commercial framework (notably introducing the Distribution Connection and Use of System Agreement) and reviewing various policy areas.

2.23. A key priority for 2007 will be to complete outstanding policy reviews in charging, connections, distributed generation (jointly with the DTI) and losses. Completion of the connections review to promote improved performance and choice will be an early focus.

2.24. The charging review is a key issue in delivering efficient and sustainable network development. Some of the distribution companies have begun to deliver charging models that better reflect their costs, for example by crediting distributed generators where they provide system benefits. We will look to the distributors to take leadership in this area going forward.

2.25. In parallel, we intend to issue a scoping paper on the next electricity distribution price control review in the first quarter of 2007-08. In the light of the progress made through the cost reporting project, we have the opportunity to evolve our overall approach, building on what we have learnt. The scoping paper will include consideration of such issues as how we can move the focus away from five-year allowances set by the regulator; how we can simplify and recast the incentive framework in terms of sustainable development; and what changes are appropriate to the roles and responsibilities of the companies (relative to transmission companies, suppliers, generators and customers).

2.26. The paper will also outline a proposed timetable for the price control review, which we expect to involve fewer consultation documents with longer response periods than in past reviews. As one of the lessons from the previous electricity distribution review, we will prioritise customer research early on in the timetable.

### **A five year view**

2.27. We will remain committed to incentive-based regulation as the best means of ensuring that the network regulatory regime remains fit for purpose and sufficiently flexible to cope with changing circumstances, whether caused by new UK or European legislation or changing supply or demand patterns. Incentive-based regulation, combined with financial commitments from users where relevant, will also be the best way of ensuring that network investment is timely, efficient and in the best interests of consumers.

2.28. Significant network investment will continue to be needed, for instance to accommodate an increase in renewable and other low carbon generation and new sources of gas supply. Our policies will be designed to facilitate new investment and encourage innovation where it adds value. We will also extend and develop incentives to improve the quality of service to network customers and continue to monitor and, where appropriate, promote the development of technology.

2.29. By regulating networks in a transparent and consistent manner we will further strengthen confidence in the regulatory regime. After each price control review we conduct an exercise to learn lessons from the process. On completion of the main gas distribution review in late 2007, we will consider the lessons from the last set of reviews and take these into account in our next cycle of price controls, starting with electricity distribution in 2008. The aim is to continue to develop a clear, 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.

2.30. We intend to publish initial proposals for electricity distribution in summer 2009 and final proposals in November 2009. Licence modifications will take effect on 1 April 2010. We intend to commence the next electricity and gas transmission price control reviews in 2010 and the next gas distribution price control review in 2011.



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

#### Chapter summary

We think that a combination of competitive markets and effective regulation of networks is the best means of protecting the security of Britain's energy supplies. We will continue to assess all policies in terms of their impact on security of supply.

#### Introduction

3.1. Ofgem has important statutory duties relating to security of supply, and we assess all major policies to gauge their impact on security of supply. This reflects the value that customers place on reliable energy supplies, for although some large business consumers choose contracts with suppliers or network operators that allow for interruption, most customers do not want extended interruptions to gas and electricity supplies.

3.2. Competitive markets are the best way of promoting security of supply. They encourage companies to contract and build sources of energy supply to meet their customers' demand. Competing suppliers will also look to secure diverse sources of supply to manage their commercial risks. If supplies become scarce relative to demand, prices will rise and this will encourage investment to provide additional energy supplies. Prices may also go up for short periods in response to short term disruptions to supply, which may prompt those consumers who are able to do so to reduce their demand.

3.3. In order to protect the security of Britain's energy supplies, we also seek to facilitate timely and economic investment in transmission and distribution systems. This is necessary to ensure sufficient network capacity and reliability, so that available supplies of gas and electricity can be transported to consumers. We monitor the reliability of networks and use price control reviews to develop and improve the incentives on network companies to invest in a timely and efficient way.

3.4. Over £14.5 billion has been invested in over 30 gigawatts (GW) 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 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.

3.5. Around 17.2GW of new plant may be constructed by 2010. Of this around 1.5GW is under construction.<sup>1</sup> A number of energy companies have announced plans to invest in new conventional (including new gas plant and 'clean' coal) and

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<sup>1</sup> NGC Seven Year Statement 2006, table 3.7, Changes in Power Station Capacity (TEC (MW)), from 2000/01 to 2012/13.

renewable generation. Investors will expect a stable political and regulatory environment before making investment in new capacity.

3.6. The gas market is responding to our growing import dependency by investing £10 billion in gas import and storage projects. The biggest barrier to the completion of these projects is the planning regime. If all these projects are completed enough import capacity will be ready by 2009 to meet 90 per cent of UK gas demand, and storage capacity will double by 2010. In addition, our gas supplies are set to come from a more diverse range of sources than ever before.

### **The next two years**

3.7. We will make sure that any barriers that prevent the market delivering security of supply are removed. We will assess the impact of the recently introduced measures to improve transparency in the gas market.

3.8. We will continue our facilitation work to make sure that the market, and large customers in particular, are aware of the options they have to manage the difficulties created by higher prices and tighter supplies. As part of this we will continue to try to facilitate improvements in demand-side management and response.

3.9. We will also, with the DTI, develop new arrangements for analysing longer term security of supply issues through a revised Joint Energy Security of Supply working group. Working with the industry and the Energy Emergencies Executive, we will maintain and improve the effectiveness of the contingency arrangements that underpin the gas and electricity markets in the event of an emergency.

3.10. Ofgem will continue to work with the DTI, the 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. We will also continue to encourage NG to develop gas blending services that would enable continental European gas to be imported via the UK-Belgian interconnector. This is vital to ensure that continental gas supplies can reach the British market without compromising the integrity and safety of the network.

### **A five year view**

3.11. We will continue to monitor the evolution of competitive markets and key indicators of security of supply and highlight any emerging issues to the market and to customers. The development of new gas infrastructure should ensure that Britain has secure gas supplies from a diverse range of sources over the next five years and beyond. We will facilitate this by adopting a light-touch approach to the regulation of new infrastructure providers.

3.12. These developments will increase the interaction of the British market with European and global gas markets. Around 30 per cent of electricity is generated

from gas-fired power stations, so there will be important interactions with the electricity market as well. Ofgem will monitor these developments and ensure that competition continues to evolve and security of supply is maintained.

3.13. Incentive-based regulation will be the best means of ensuring that the network regulatory regime remains fit for purpose and flexible enough to cope with changing circumstances. Significant network investment will continue to be needed, for instance to accommodate an increase in renewable and other low carbon generation and new gas imports. Our policies will be designed to facilitate the necessary new investment in a timely and efficient way.

3.14. We will continue to develop a clear and predictable approach to network regulation in order to reduce uncertainty and provide a stable framework for long term decisions by network companies. We will also 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

### Chapter summary

We will continue to promote the development of competitive energy markets and effective network regulation across the EU. We will continue to support and advise the European Commission in its drive to achieve this through new energy legislation and the application of EU competition law, in particular arguing for full structural unbundling of transmission networks across the EU. We will continue to work with EU energy regulators to push through the regional initiatives to make competition more effective.

### Introduction

4.1. European energy markets, and EU regulatory and competition policy, have a major influence on Britain's energy markets and consumers. With the completion of the Balgzand-Bacton pipeline and the enhancement of the Belgian interconnector, the British gas market is now an integral part of the North West European gas market and wholesale gas prices are likely to converge for much of the year. As Britain becomes a net importer of gas through new and expanded interconnectors, European gas will be increasingly important for security of supply. In addition, European Directives and Regulations, including those relating to the environment, have the potential to impact increasingly on competition and regulatory policy in Britain.

4.2. Our overall objective is to develop genuinely competitive European gas and electricity markets that benefit British consumers in terms of prices and security of supply. Our aim is to drive forward the debate and to remove the risk that European markets and regulation might roll back the many benefits that liberalisation has brought to British consumers.

4.3. We work primarily through the Council of European Energy Regulators (CEER) and the European Regulators' Group for Electricity and Gas (ERGEG). CEER and ERGEG advise the European Commission on the development of regulatory and competition policy and are playing an active role in developing the policy framework needed to establish effective energy markets in Europe. Sir John Mogg is currently President of CEER and Chairman of ERGEG.

4.4. We also build direct relations with EU institutions and the Commission in particular. These links will be vital as the Commission takes forward proposals for a common European energy policy including a new package of energy legislation.

4.5. We are actively pursuing the development of regional energy markets through the Gas and Electricity Regional Initiatives. We believe that creating effective regional markets is an important practical step towards the eventual goal of a competitive single European energy market.

4.6. We will continue to support the work of the European Technology Platform ('SmartGrids') that is developing a vision for the electricity networks of the future and a research agenda to make this a reality.

## The next two years

### New EU legislation

4.7. In 2005 the EU agreed in principle on the need to develop a common European energy policy. The Commission published a Green Paper in March 2006 which reflected a wide range of concerns about security of supply, climate change, rising prices and evidence from the sector inquiry by the Directorate General for Competition that competition in energy markets was not developing sufficiently.

4.8. In January 2007 the Commission published its 'Strategic Energy Review'. This sets out measures to address the policy concerns set out in the Green Paper. Drawing on the conclusions emerging from the sector inquiry, it also contains proposals for a third package of legislation to liberalise European energy markets, by providing for:

- an increase in the powers of national regulators in EU Member States;
- an enhanced European regulatory framework;
- an integrated European Grid in electricity and gas; and
- further unbundling of network operators from interests in the competitive parts of the industry.

4.9. The Commission's Strategic Energy Review also includes proposals for strategic gas stocks, a European energy efficiency strategy and extending the EU Emissions Trading Scheme (EU ETS) beyond 2012. We anticipate that the Commission will publish detailed proposals by the autumn of 2007.

4.10. We will play a full part in the discussions and debate and will continue to support the Commission's efforts strongly. We will argue for full structural unbundling of transmission networks across the EU. Full ownership separation offers the potential for Britain's energy suppliers to gain access to continental European transmission and storage capacity on a fair and open basis. It should also provide a boost to investment in additional capacity to handle the growing volumes of imported gas transiting Europe. We will promote policies that facilitate the development of truly competitive energy markets in Europe, and we will seek to minimise the risk of measures being adopted that would adversely affect competition, and consumers, in British energy markets.

### Regional energy markets

4.11. Ofgem, in concert with other ERGEG members, is taking forward work to develop gas and electricity markets in regions of the EU. Creating well-functioning

regional markets is a necessary first step towards the eventual development of a competitive single European energy market. The Regional Initiatives, begun in 2006, will identify and remove barriers to trade between existing national markets.

4.12. In electricity, Ofgem chairs the regional project that covers Britain, France, Northern Ireland and the Republic of Ireland. In gas, we are part of the North/North West Region, chaired by the Dutch regulator, which comprises Britain, France, Northern Ireland, the Republic of Ireland, Belgium, the Netherlands, Germany, Denmark and Sweden.

4.13. The main market integration issues in both gas and electricity include wholesale market design, information transparency and access to cross-border transmission infrastructure. Over the next two years we hope to see significant progress towards regional energy markets characterised, amongst other things, by non-discriminatory access to networks and improved liquidity at gas hubs.

#### **Policy work of CEER/ERGEG**

4.14. Ofgem is heavily engaged in policy development work for CEER and ERGEG. We are in particular pushing for a coherent and effective European regulatory framework and for a successful conclusion to our work on gas interoperability and balancing; electricity network congestion management, balancing and transparency; and developing an EU Grid Code in parallel with any legislative proposals.

4.15. We will continue to communicate developments to interested parties, for instance by publishing information on the dedicated European section of our website. In addition, we will maintain working groups and industry discussion groups to focus on specific reform proposals. We will also continue to encourage the European regulators to consult, via CEER and ERGEG, on all significant regulatory proposals.

#### **A five year view**

4.16. We will continue to work with CEER, ERGEG and the Commission to ensure that European competition and regulatory policy benefits British energy consumers. We will seek in particular to ensure that any third package of liberalising legislation is implemented effectively and consistently across the EU. We will seek to develop effective regional energy markets that not only operate to the benefit of customers but also may readily evolve into a single competitive European market.

4.17. Putting our experience in developing effective markets to good use, we will seek to be a key member of any effective European regulatory body that may be created in the third legislative package.

## 5. Helping to achieve sustainable development

### Chapter summary

Ofgem is committed to playing our part in facilitating the transition to a low carbon energy sector. We will take full account of the impact on the environment across the range of our decision-making. We will continue to contribute to the debate on how to reduce carbon emissions from the energy sector in the most cost-effective manner. We will continue to administer Government environmental programmes efficiently and effectively. Alongside our work to tackle fuel poverty, this work forms a major part of our contribution to the achievement of sustainable development.

### Introduction

5.1. Ofgem's principal statutory objective is to protect the interests of consumers, present and future. We also have important duties relating to the environment and sustainable development, and the Secretary of State for Trade and Industry has provided statutory guidance on social and environmental matters to which we must have regard. Recognising the increasing weight of scientific evidence on climate change and changing attitudes in society, we have done much to take forward the sustainability agenda within the context of our existing statutory duties.

5.2. We have recently published our first report on sustainable development. In the report we have developed a range of indicators that can be used to assess progress in making the energy sector more sustainable. We only have limited powers and influence over many of these indicators. We have highlighted the actions we will take to play our part and have also highlighted where we think the Government or other agencies could do more and where the indicators suggest that existing policy measures are not delivering.

5.3. An important role for Ofgem and the Government is to remove barriers to innovation and to provide regulatory and policy frameworks that support long term investment. This will encourage companies to invest in new, innovative and effective ways of delivering a more sustainable energy system.

5.4. While the Authority has a role to play, many of the actions are not within our direct control. However, we see it as our responsibility to continue to facilitate change by engaging in the debate, trying to persuade the relevant players to make the changes that would ease the transition to a low carbon energy sector in a cost-effective way, and contributing information and expertise where we can. For example, we have:

- thoroughly assessed the case for smarter meters for domestic energy consumers;
- proposed carbon contracts to work alongside the EU ETS;
- provided special incentives on network companies to connect local generation;
- and

- approved funding for over £5 billion of transmission network investment over the next five years, including more than £1 billion for investment in support of renewable generation that cannot choose to locate closer to demand.

### **Sustainable energy markets**

5.5. Across the range of Ofgem's decision-making, and at all stages of the policy process, we carefully consider the environmental impact of our proposals. We have set up a framework for valuing carbon dioxide emissions that takes account of the environmental damage that these emissions cause. We will for instance facilitate lower carbon technologies, such as microgeneration, by identifying and removing regulatory barriers to their development.

5.6. Ofgem strongly supports the Government's commitment to policy measures for tackling greenhouse emissions that are based on, and work with, existing market arrangements. In this respect the introduction of the EU ETS from 1 January 2005 was an important step forward. We think that emissions trading through the EU ETS provides the right framework for delivering lower carbon emissions at the lowest possible cost to consumers. It has already increased the commercial incentives on electricity generators to lower their emissions, and will allow emission reduction targets across the EU to be met at lower cost than alternative arrangements such as technology, sector or country specific targets. But the EU ETS has a number of shortcomings that need to be addressed quickly to maintain the scheme's credibility. Ofgem will continue to advise the Government and European Commission as they consider subsequent phases of the Scheme and review its effectiveness.

5.7. In our response to the Energy Review, we proposed that funded long term carbon contracts could be introduced to work alongside the EU ETS whilst agreement is reached over future phases of the scheme. Such contracts could deliver more sustainable energy supplies and help to resolve some of the uncertainty that could be stalling potential developers of lower carbon generation technologies. Building on this, we also suggested that the Government considers developing longer term renewable contracts to replace the existing scheme for renewable support. These could deliver more renewables and lower carbon emissions at lower cost to energy customers than the current Renewables Obligation.

5.8. Against a background of growing climate change concerns and rising retail prices, Ofgem expects suppliers to be offering their customers products that enable them to manage their consumption and energy costs effectively. Assessing suppliers' quality of service has many dimensions. It can include the quality and accuracy of billing, as well as the availability of energy service products or other services that allow consumers actively to manage their own energy consumption. In line with our commitment to better regulation we will encourage suppliers to deliver improvement through self-regulation.



### **Sustainable energy networks**

5.9. Ofgem is committed to facilitating the development of energy networks that will meet the challenges of the 21st century. One example of this is the network price controls, where there is now a major emphasis on facilitating the investment necessary to connect the new forms of generation that are being encouraged by government policies to reduce carbon emissions.

5.10. We have taken steps to improve the incentives for reducing electrical losses from the networks. We have also strengthened the incentives on distribution companies to connect cleaner forms of generation to their lower voltage distribution networks. Making sure that electricity generators located far away from energy consumers face the full costs of the transmission and distribution system they use helps to promote microgeneration and other technologies that can bring generation closer to demand and smaller, local energy networks. In setting future gas price controls we will also pursue measures that reduce gas losses. Looking ahead, our decisions on the regulation of networks will facilitate the transition to a low carbon economy.

5.11. Beyond the climate change agenda, the gas and electricity industries affect the environment through the emission of other pollutants and through their visual impact on our countryside and communities. We are committed to working with all stakeholders to ensure that we take those wider considerations into account in all of our decisions.

### **The next two years**

#### **Advising Government on environmental policies**

5.12. In 2007-08 Ofgem will advise the Government on the future development of a number of environmental programmes. We will work with Government on the EU ETS, including development of the National Allocation Plan for Phase II. We will undertake research to contribute to discussions on the long term future of the scheme both in the UK and as part of the European Commission's review of the EU ETS Directive. We will monitor the development of the allowance market and any impact it may have on the energy markets and will organise a seminar to discuss the impact of the EU ETS on the electricity generation sector and on consumers.

5.13. We will continue our work with Defra on the implementation of the Large Combustion Plant Directive and will monitor its impact on the energy system. We will support actions by Defra, the Devolved Administrations and the environmental regulators to design and implement economic instruments to meet environmental objectives, including possible schemes for sulphur dioxide and nitrogen oxides.

5.14. In the light of the Government's Energy Review we are conducting a joint review with DTI on distributed energy. The review is looking at the incentives and barriers that currently impact on distributed electricity generation, including

Combined Heat and Power (CHP). The review will build on initiatives we took at the last electricity distribution price control and work already underway in other areas. The Government has stated that it intends to publish a White Paper in the spring.

5.15. The Government's Energy Review report and the Energy End-Use Efficiency and Energy Services Directive include provisions relating to the metering and billing practices of energy companies. We will assist the Government in coming to an informed view of how the Directive should be applied in the UK.

5.16. We believe that any mandatory measures to provide improved metering or increase the accuracy of billing should reflect the principles of better regulation. Implementation should be through self-regulation, if possible, to facilitate flexible solutions that take account of the fact that consumers respond in different ways to information given to them.

5.17. Energy conservation and improved energy efficiency are critical elements in any sustainable development strategy. We recognise the huge range of benefits - environmental, social and economic - that energy saving can bring. We are committed to playing our part to encourage all energy consumers to be more energy efficient. We will work with all agencies across Government to support initiatives to reduce the energy intensity of the economy, ensuring as far as possible that the market rewards investment in energy saving on an equivalent basis to energy consumption.

5.18. We will continue to work with Government on implementing Climate Change Programme measures that affect energy markets, for example in relation to metering and microgeneration. We are taking forward a project on green tariffs and will publish revised guidelines later this year. We will also monitor the first year of fuel mix disclosure compliance.

### **Microgeneration**

5.19. Widespread use of microgeneration could help the Government meet its target of reducing carbon emissions by 60 per cent by 2050. Ofgem's policy is to ensure that there are no significant barriers to the development of microgeneration. We expect that customers should be able to discuss with energy suppliers how they might install and benefit from microgeneration in their homes. If customers encounter difficulties in securing offers, Ofgem will seek to address any market rules that lie behind this.

5.20. We are considering how the mass introduction of microgeneration technologies affects the electricity networks, since greater use of microgeneration units may require changes to their design and operation. We are also looking at the technical issues that arise from the need to develop meters that measure both the import and export of electricity from homes or businesses. In December 2006 we held a high-level seminar in our 'Powering the Energy Debate' series to help move the issues forward. Our Microgeneration Forum will meet regularly to address any remaining obstacles to the development of microgeneration.

5.21. The Government has taken powers to determine how much microgenerators should be paid for their surplus electricity. In March 2007 the Chancellor of the Exchequer also asked Ofgem to examine how homes with microgeneration facilities can benefit from exporting electricity back into the grid.

### **Sustainable Development Report**

5.22. In November 2006 we published our first report on sustainable development. In the report we described what sustainable development means to us and how it influences and shapes our work and the way we exercise our powers. We defined a range of indicators that will help us to assess progress towards a more sustainable energy system. We set out the contribution that Ofgem has made and hopes to make towards achieving that goal given our present powers and duties. We also highlighted the areas where further actions are needed by Government and others.

5.23. We will use this report and the indicators to engage in the wider debate and point out where Government and other organisations can take action to promote a more sustainable energy system. We will publish a revised Sustainable Development Report in late 2007. This will report on progress made on key indicators and give our latest views on the way forward.

### **'Greening' Ofgem**

5.24. We have taken a number of steps to reduce our own energy usage and carbon 'footprint'. In 2003, for example, we installed a CHP unit that has so far saved 934 tonnes of carbon dioxide. In addition, replacing four boilers produced 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). We have introduced area-specific utility meters, which further enhance our ability to measure accurately the effectiveness of any new energy saving steps that we take. We will continue to seek ways of reducing our impact on the external environment.

### **A five year view**

5.25. Climate change is one of the most significant challenges facing the world today. The Government's Climate Change Programme sets out policies and priorities for action in the UK and internationally. It includes a challenging domestic target to reduce carbon dioxide emissions to 20 per cent below 1990 levels by 2010 and a long term goal to reduce carbon dioxide emissions by some 60 per cent by 2050.

5.26. Meeting these targets may require transformation of the energy systems and the generation technologies that are used to meet demand. We are committed to playing our part in facilitating the transition to a low carbon energy sector. We will therefore continue to ensure that all Ofgem policies fully take into account our duties in relation to the environment and sustainable development.

5.27. We will continue to work with all stakeholders to identify the barriers that hinder the transition to a low carbon economy in the sectors for which we have responsibility. In particular, we will examine ways to enhance energy efficiency throughout the system focussing for example on network losses, metering and innovative tariffs. We will seek to reduce barriers to distributed generation, renewable generation and the use of heat.

5.28. We will also keep under review actions that might be required to reduce non-carbon greenhouse gas releases, such as methane and sulphur hexafluoride, from the operations of the gas and electricity sector.

5.29. We will also:

- make 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;
- ensure that 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;
- encourage the Government and the 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; and
- publish annual reports on sustainable development.

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## Environmental programmes

Ofgem administers a number of the schemes and arrangements established by the Government under its Climate Change Programme. The main schemes are the Renewables Obligation (RO), 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 and exemptions from the Climate Change Levy for renewables and CHP generators.

We have extensive knowledge of the environmental programmes based on our experience of their administration. Building on this, we will work with the DTI and the Devolved Administrations on changes to the RO, the RO Scotland, and the Northern Ireland RO, including measures to allow small generators easier access to RO Certificates. We will continue to work with Government on the next phase of the EEC. We will also amend our administrative processes and IT systems to reflect the outcomes of the current reviews of the RO and the EEC.

In 2007-08, we plan to rebuild the IT systems that we use to administer the renewables and CHP programmes, as our existing systems are at their operational limit. By increasing automation, we hope that the new system will reduce the administrative burden on us and the renewable energy industry. We will also continue to keep under review and seek further efficiencies in the administration of the schemes on the Government's behalf and to ensure that these are administered in a customer focused way.

The cost of administering the environmental programmes is projected to be £3.1 million in 2007-08, including overheads and support costs. (For a more detailed breakdown see appendix 2.) There is continuing upward pressure on these costs because of the increase in scale and complexity of the schemes since we started administering them. Further changes are anticipated with the present review of the RO and the EEC.

We are keen to secure adequate funding from the Government to cover our costs of administering these schemes. We do not think it appropriate that these costs should be recovered from network businesses through the licence fee procedure. Attempts in 2006-07 to secure adequate funding from the Government were unsuccessful but we will continue discussions with Government about future funding arrangements.

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## 6. Helping to tackle fuel poverty

### Chapter summary

We will continue to facilitate efforts by the Government and industry to target fuel poverty measures on those most in need. We will also continue our broader programme of work as part of our Social Action Strategy to protect the interests of vulnerable customers. This work is a major part of our contribution to the achievement of sustainable development.

### Introduction

6.1. Fuel poverty is part of a wider problem of poverty and social exclusion and is caused by high energy prices, low incomes and poor housing conditions. There is an important and continuing role for Ofgem, and industry, to help ensure that prices are no higher than necessary and to promote energy efficiency. However, given the wider social causes of fuel poverty there will inevitably be a limit to the role that the industry and the regulator can play in tackling it. The main focus should be on raising incomes and improving housing - which are jobs primarily for the Government.

6.2. Energy suppliers are playing an important role, for instance through their Corporate Social Responsibility (CSR) programmes. The Government should use their information sources to improve the targeting of the available help to vulnerable consumers. We have advocated a 'find and fix' approach and have demonstrated the value in joint working and data sharing in our Winter Initiative pilot scheme, which brought together suppliers, the Pension Service and voluntary agencies to target help to pensioner households. We welcome the additional £7.5 million announced in the 2006 Pre-Budget Report for further co-ordination activity between the EEC and Warm Front.

6.3. The costs of investment needed to meet Britain's evolving energy needs and the cost of measures to reduce carbon emissions will continue to place upward pressure on prices for all consumers. Competitive markets are vital to ensure that costs are truly competitive and lower than they otherwise would be. Ensuring that the market remains competitive will remain a key part of our work to protect all customers, including vulnerable customers and those suffering from fuel poverty.

### The next two years

#### Retail markets

6.4. Higher energy costs mean that fuel poverty will remain a priority and as 2010 approaches there will be an increased focus on the Government's target that no vulnerable households should be in fuel poverty. We will continue to do whatever we

can to facilitate efforts by the Government and industry to target help more effectively.

6.5. The best means of protecting customers in terms of price and service quality is by ensuring that the energy markets remain fully competitive. Mandated social tariffs do not sit well with a competitive market - at least not on the scale that would be needed to eliminate fuel poverty - given the difficulties inherent in targeting such tariffs and the market distortions that would result. However, we welcome and will continue to promote the CSR initiatives that some suppliers have introduced. In particular, we will continue to audit suppliers' efforts in this area and to publicise those schemes that are most effective.

6.6. Significant savings can be made by customers who switch supplier and/or payment method, so we will continue to promote the *energysmart* message informing customers how they can reduce their energy costs. We will monitor switching levels among more disadvantaged groups, such as low income or prepayment meter (PPM) customers, and ensure that there are no barriers unduly affecting their ability to switch supplier.

6.7. We will pursue policies that promote greater energy efficiency and which can help reduce fuel poverty and carbon emissions. We will continue to advise the Government on energy efficiency policy. Our aim will be to try to ensure that resources are well targeted and that the EEC interacts effectively with fuel poverty programmes such as Warm Front.

6.8. Our work described in chapter 1 on establishing effective metering competition and facilitating smart metering is important in helping to bring down the costs of PPMs. Building on the research we will be carrying out shortly on consumer concerns with PPMs we will consider if there are further steps we should be taking in this area.

6.9. We will continue to monitor debt and disconnection levels given the potential for these to rise with higher prices, and will work to promote customer awareness and best practice amongst suppliers. We will drive forward supplier progress in preventing debt accumulation, for example, through support for improved billing via the new supplier Billing Code and Energy Supply Ombudsman, and through smarter metering, including suppliers' plans for the replacement of outdated electricity token meters.

6.10. In monitoring the effects of the supply licence review, we will pay especially close attention to the outcomes for vulnerable customers, for example in relation to gas safety checks and awareness of the Priority Service Register.

## **Networks**

6.11. Extending the gas network to fuel poor communities that are close to but not presently connected to the mains network would help to alleviate fuel poverty. We are considering this carefully in developing the new gas distribution price controls for

2008. Extending the gas network would also help to reduce carbon emissions as gas is less carbon-intensive than other fuels and gas heating systems are more efficient than other heating options such as coal and oil.

6.12. The annual customer service reward scheme that we introduced for electricity distribution network operators encourages them to develop best practice in respect of vulnerable consumers, going beyond the formal requirements of their licences. We will continue to work with the companies to promote best practice in dealing with vulnerable customers when supplies are interrupted and will consider extending a similar incentive to gas distribution network companies as part of the 2008 price control review.

### **A five year view**

6.13. Wholesale gas costs are likely to fall as new gas supplies come on stream. But the costs of future investment to meet energy needs and measures to reduce carbon emissions are likely to continue to put upward pressure on prices.

6.14. As stated in chapter 5 on sustainable development, we have suggested that the Government introduce funded long term carbon contracts to complement the EU ETS. Given that the cost of environmental measures has been and will continue to be a driver of higher energy costs, we believe that there is also a case to recycle some of the funds raised through such contracts, or through auctioning carbon allowances, to help tackle fuel poverty.

6.15. We will continue to ensure that competition works effectively to minimise costs for all consumers and to use our expertise to advise the Government on the development of fuel poverty programmes. We will ensure that companies continue to meet their regulatory obligations to their most vulnerable customers. We will also promote best practice across the industry in dealing with the particular issues facing vulnerable consumers.



## 7. Better regulation

### Chapter summary

We remain committed to policies and processes that are consistent with better regulation principles. We will continue to improve our efficiency and effectiveness and to keep our costs under tight control. We will draw on best practice from other Government Departments and regulators as appropriate.

### Introduction

7.1. Ofgem has a long standing commitment to better regulation in all our activities. We apply better regulation principles not only to the policies we develop but also to the way in which we develop them. This approach is consistent with our duty to have regard to the principles under which regulatory activities should be transparent, accountable, proportionate, consistent and targeted only at cases in which action is needed, and any other principles which appear to us to represent best regulatory practice. The Better Regulation Commission interprets these principles as meaning:

- proportionality - regulators should intervene only when necessary, remedies should reflect the risk posed, and costs should be identified and minimised;
- accountability - regulators must justify their decisions and subject them to public scrutiny;
- consistency - rules and standards should be coherent and fairly implemented;
- transparency - regulators should develop policy in an open manner and keep regulations as simple and user-friendly as possible; and
- targeting – regulation should focus on the problem and minimise side effects.

7.2. We will seek alternatives to conventional regulation where we consider that they will better protect the interests of consumers. These alternatives may include self-regulation, especially in the competitive retail markets. Increasingly we will adopt an initiating or facilitating role in which other parties develop policy solutions.

7.3. Better regulation is not only about policy development. It is also about running our operations as efficiently and effectively as we can. The RPI-3 per cent internal cost control gives us an ongoing incentive to reduce our costs in real terms. In addition, where we are responsible for administering Government environmental programmes, we seek to do so in the most efficient and cost-effective way possible.

7.4. We will continue to monitor closely any better regulation developments that take place within Government and across regulators and, where appropriate, will draw on best practice as it evolves.

## The next two years

### Supply licence review

7.5. In 2007 we will complete our review of gas and electricity supply licences. This has been our flagship better regulation project. We believe our proposals will deliver substantial benefits to suppliers in terms of reduced administrative burdens and lower costs, which should be passed on to consumers. We believe our proposals will also benefit consumers by creating a more proportionate and targeted regulatory framework that will encourage innovation. As stated in chapter 1 on competitive markets and chapter 6 on fuel poverty, we will monitor outcomes closely.

### Consumer First project

7.6. We have now commenced our new *Consumer First* project to help ensure that we are engaging effectively with the priorities of domestic consumers. We are comparing our approach to determining the interests of domestic consumers on energy issues with current best practice. We will use the results to inform our future approach so as to improve our understanding of the consumer's perspective, especially in relation to sustainability considerations. This work is well under way. We will set out early in 2007-08 the actions we will be taking.

7.7. As part of this project we are looking at the scope for increasing direct consumer input on policy proposals by exploring the use of consumer panels and research techniques. We have commissioned an initial pilot exercise exploring consumer attitudes to energy and the environment through a series of workshops. We will publish the results of this research early in 2007-08. Given the Government's plans to restructure the consumer representation bodies, we see this project as a timely and important piece of work which will also enhance our transparency and accountability.

### Impact assessments

7.8. Ofgem has a duty to undertake impact assessments (IAs) for all important policy proposals that we make. We have developed a rigorous approach to IAs in line with best practice, while ensuring that our decisions are consistent with our wider statutory duties. We are looking at the structure of our IAs and how we can best bring together the environmental impacts with social and distributional impacts to provide a fuller picture of the impact of our proposals on sustainable development.

7.9. The Better Regulation Executive (BRE) is currently reviewing its guidance to Government Departments on IAs with a view to publishing revised guidance in 2007. Although not bound by this, Ofgem will carefully consider any revisions that are made. We expect to publish revised guidance on our approach to IAs in 2007.

### **Enforcement review**

7.10. We are reviewing our approach to enforcing sectoral, competition and consumer protection law. Effective enforcement is a key part of making markets work well for consumers. Our review will ensure that we adopt policies and procedures that enable us to act quickly, effectively and proportionately to the risk to consumers from non-compliance. In 2007 we will publish a revised statement of our approach.

### **Industry codes and licensing**

7.11. In 2007-08 we will conclude our review of industry code compliance arrangements. This is a complex area of work, which links to the enforcement review described above. We are considering carefully the views of certain stakeholders that there is scope for Ofgem to reduce its involvement in code governance. We will also draw up detailed governance arrangements for a Uniform Network Code for independent gas transporters. In the light of the supply licence review, we will make changes to streamline the licensing applications regime.

### **Improving accessibility and transparency**

7.12. In early 2006 we successfully redesigned our consultation and decision documents. More recently we took steps to simplify our documents relating to industry code modifications and derogation decisions. In 2007 we will consider what further improvements can be made to our written product. We will finish a project to make our documents fully electronic and easier to navigate and will also complete the redesign of our website making it easier for stakeholders to locate information online. Internally, we will introduce electronic records management across Ofgem. This should enable us to respond more efficiently to requests for information, including those made under the Freedom of Information Act.

### **Costs and efficiency**

7.13. The key driver for efficiency savings is the RPI-3 per cent target for cost reductions between 2005-06 and 2009-10. This commits us to savings of over £1 million per year. We have so far beaten our target and as a result we reduced the licence fees payable in 2006-07 by an additional £2.9 million, or nearly 10 per cent of our allowed budget. We anticipate savings of around £8 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;
- more efficient purchasing via better contract management and negotiation; and
- reducing headcount, in part through more prioritisation and through continuing to improve the organisation of work flows.

7.14. To date we have successfully met our corporate programme, achieving high levels of operational performance and beating our cost control targets. We intend to maintain this discipline and in 2008-09 we will begin to consider what internal cost control arrangements would be appropriate for 2010-11 and beyond.

7.15. As we continue through the remainder of this cost control period it should be noted that some of our work will be in response to unplanned events and requests, such as those made of us by Government, which by their nature cannot be fully accounted for in our forward planning and budgeting and may therefore require us to re-prioritise.

### **Simplification Plan**

7.16. Appendix 3 contains our latest Simplification Plan, which sets out the activities that we will undertake in the next year in support of the better regulation agenda.

### **A five year view**

7.17. We will continue to review our policies and processes with a view to achieving and maintaining best practice in better regulation. We will continue to refine the regulation of the monopoly networks, for example by building on lessons learned from the price control reviews that we have completed. We will consider the scope for conducting reviews of generation, transmission and distribution licences against better regulation principles. We will look for further opportunities to withdraw from regulation of competitive markets, where it would be in the interests of consumers.

7.18. We will ensure that continued cost reductions arising from the RPI-3 internal cost control do not reduce the quality of Ofgem's work. A better targeted and simpler approach to regulation may facilitate further cost savings. In 2009-2010 we will determine new arrangements for cost savings in 2010-2011 and beyond.

## Appendices

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## Appendix 1 - Deliverables & Performance Indicators 2007-08

### Deliverables 2007-08

#### Creating and sustaining competition

Activity	Action	Period
Wholesale Markets	Publish final Winter Outlook report	Q2
Retail Markets	Implement revised standard conditions for gas and electricity supply licences	Q1
Retail Markets	Publish updated domestic retail market report	Q2
Retail Markets	Publish consultation on the criteria for approving ombudsman schemes	Q2
Retail Markets	Review of the Energy Supply Ombudsman	Q3

#### Regulating networks effectively

Activity	Action	Period
All Networks	Publish scoping letter for the development of long term scenarios for electricity networks	Q1
Transmission	Publish conclusions of the review of the transmission price control review process	Q2
Transmission	Publish summary cost information for transmission companies for 2006-07	Q4
Transmission	Publish policy statement on the development of a regulatory regime for offshore electricity transmission	Q2
	Publish detailed arrangements for the offshore electricity transmission regime	Q4
Electricity Distribution	Publish scoping letter for the next price control review	Q1
	Publish initial consultation on the next price control	Q4
Electricity Distribution	Publish electricity distribution quality of service report	Q3
Electricity Distribution	Publish electricity distribution cost review	Q3
Gas Distribution	Publish price control review initial proposals	Q1
	Publish price control review final proposals	Q3
Gas Distribution	Publish gas distribution quality of service report	Q3
Wholesale Markets	Review System Operator (SO) functions in gas and electricity	Q2
Wholesale Markets	Publish initial SO incentives proposals	Q3
Wholesale Markets	Publish final SO incentives proposals	Q4

### A leading voice in Europe

Activity	Action	Period
Gas regional initiative	Prepare report to the Madrid Forum (expected late 2007)	Q3
Gas infrastructure investment (Task Force Chair, TFC)	Finalise Guidelines for LNG Open Season	Q2
	Finalise Guidelines for Article 22 exemptions <sup>2</sup>	Q4
Gas Interoperability (TFC)	Publish final report on interoperability issues	Q2
Electricity regional market initiative - Integration (TFC)	Prepare report to the Florence Forum	Q3
3rd EU legislative package - proposals	Influence ERGEG to achieve a positive agreed position on the main planks of European primary legislation	Q2
3rd EU legislative package	Influence ERGEG to achieve a positive agreed position on the main guidelines	Q4

### Helping to achieve sustainable development

Activity	Action	Period
Sustainable Development	Publish 2nd Ofgem Sustainable Development Report	Q3

### *Environmental programmes*

Ofgem administers a number of environmental programmes on behalf of the Government. The deliverables associated with this work for 2007-08 are as follows:

Renewables and CHP	Publish updated guidance on the administration of the Renewables Obligation to reflect legislative changes	Q1
Energy Efficiency	Publish a review of the second year of the Energy Efficiency Commitment 2005-08	Q2
Renewables and CHP	Publish annual Renewables Obligation report	Q4

### Helping to tackle fuel poverty

Activity	Action	Period
Social Action Strategy	Publish updated Social Action Strategy	Q1
Social Action Strategy	Publish debt and disconnection best practice review	Q3

<sup>2</sup> ERGEG is developing guidelines to ensure consistent regulatory treatment of requests under Article 22 of the Gas Directive (2003/55/EC) for exemption from the requirement for third party access in order to improve regulatory predictability for infrastructure developers.

**Better Regulation**

<b>Activity</b>	<b>Action</b>	<b>Period</b>
Customer Contact	Launch new <i>Consumer First</i> arrangements for consumer engagement	Q1
Enforcement	Publish guidelines on Ofgem's approach to enforcement	Q2
Better Regulation	Publish updated guidance on Impact Assessments	Q3
Finance	Set the Fossil Fuel Levy Rate for 2008-09	Q3



### Performance indicators 2007-2008

Activity	Measure	Target	Timing
Wholesale Markets	Consult upon and carry out consultations regarding any applications made for exemption from Regulated Third Party Access (RTPA) by prospective storage and pipeline operators	100%	
	Submit decisions to the European Commission within the prescribed timescales if adequate information has been provided	100%	
	Assess and make decisions in relation to any Income Adjusting Event within three months of it being raised if adequate information is provided	100%	
Licensing	Process competitive market licence applications	90%	40 working days
Industry codes	Process industry code modification decisions	70%	25 working days
Customer contact	Respond substantively to customer contacts	93%	10 working days
Technical Policy	Completion of Meter Asset Manager approvals and authorisations	95%	5 working days
Enforcement	Investigate and take appropriate enforcement action (which may include referring the case to the OFT or the FSA) when there is evidence of licence or competition law infringements within the prescribed timescales	100%	
Better Regulation	Respond to Freedom of Information Act queries	100%	20 calendar days
	Pay undisputed bills	98%	30 calendar days

### Environmental programmes

Renewables and CHP	Follow up with generators on any outstanding issues in their applications for accreditation	100%	10 working days
	Circulate the RO buy-out funds		1 month
	Complete reconciliation of CHP Levy Exemption Certificates within 20 working days after receipt of accurate data from Defra		
Energy Efficiency	Respond to suppliers who have submitted schemes for approval	100%	10 working days after submission deadline

## Appendix 2 - Ofgem budget 2007-2011

<b>BUDGET TABLE</b>							
<b>£ million</b>	<b>2005-06</b>	<b>2006-07</b>	<b>2006-07*</b>	<b>2007-08</b>	<b>2008-09</b>	<b>2009-10</b>	<b>2010-11</b>
<b>Costs By Theme</b>	<b>Outturn</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>5.2</b>	<b>5.1</b>	<b>5.0</b>	<b>4.9</b>	<b>4.9</b>	<b>4.6</b>	<b>4.5</b>
Retail Competition (1)	1.5	1.5	1.4	1.2	1.2	1.0	0.9
Wholesale Markets (1)	1.4	1.2	1.5	1.3	1.3	1.2	1.2
Connections	0.3	0.4	0.3	0.3	0.3	0.3	0.3
Industry Codes & Licensing (2)	1.0	1.1	1.1	1.1	1.1	1.1	1.1
Enforcement & Consumer Affairs(2)	1.0	0.9	0.8	1.0	1.0	1.0	1.0
<b>Regulating Network Monopolies</b>	<b>9.4</b>	<b>10.3</b>	<b>10.7</b>	<b>8.9</b>	<b>9.0</b>	<b>8.4</b>	<b>8.6</b>
Transmission	5.2	3.7	4.3	2.3	2.3	2.0	3.1
Electricity Distribution	1.4	1.6	1.3	2.3	3.0	2.7	1.8
Gas Distribution	0.8	2.8	2.9	2.1	1.4	1.4	1.4
Technical Policy (2)	1.1	1.4	1.2	1.3	1.4	1.4	1.4
Technical Statutory (3)	0.9	0.8	1.0	0.9	0.9	0.9	0.9
<b>Helping protect the security of Britain's energy supplies</b>	<b>1.2</b>	<b>1.2</b>	<b>1.5</b>	<b>1.3</b>	<b>1.3</b>	<b>1.2</b>	<b>1.2</b>
Security of Supply (4)	1.2	1.2	1.5	1.3	1.3	1.2	1.2
<b>A Leading Voice in Europe</b>	<b>1.2</b>	<b>1.5</b>	<b>1.1</b>	<b>1.0</b>	<b>1.0</b>	<b>0.8</b>	<b>0.8</b>
Europe (5)	1.2	1.5	1.1	1.0	1.0	0.8	0.8
<b>Helping to achieve sustainable development</b>	<b>1.8</b>	<b>2.5</b>	<b>1.9</b>	<b>2.5</b>	<b>2.1</b>	<b>2.2</b>	<b>2.6</b>
Environmental Policy	0.4	0.5	0.4	0.4	0.4	0.5	0.5
Environmental Programmes (6)	1.4	2.0	1.5	2.1	1.7	1.7	2.1
<b>Helping to tackle fuel poverty</b>	<b>0.3</b>	<b>0.3</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>	<b>0.4</b>
Social & Consumer Affairs	0.3	0.3	0.4	0.4	0.4	0.4	0.4
<b>Better Regulation</b>	<b>0.3</b>	<b>0.5</b>	<b>0.5</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>
Better Regulation	0.3	0.5	0.5	0.2	0.2	0.2	0.2
<b>Sub Total</b>	<b>19.4</b>	<b>21.4</b>	<b>21.1</b>	<b>19.2</b>	<b>18.9</b>	<b>17.8</b>	<b>18.3</b>

£ million	2005-06	2006-07	2006-07*	2007-08	2008-09	2009-10	2010-11
Other Costs	Outturn	Planned	Provisional outturn	Planned	Planned	Planned	Planned
<b>Executive/Support/Overhead Costs (7)</b>	<b>7.9</b>	<b>6.9</b>	<b>9.1</b>	<b>8.9</b>	<b>8.0</b>	<b>7.7</b>	<b>7.8</b>
Strategy and Direction	1.3	1.0	1.0	1.1	1.1	1.1	1.2
Corporate Communications and Scottish office	1.2	1.3	1.4	1.4	1.4	1.4	1.5
Finance	0.7	0.8	0.7	0.8	0.9	0.7	0.9
Human Resources	2.0	1.0	1.4	1.1	1.1	1.1	1.1
HR Graduate Scheme	0.0	0.0	0.1	0.4	0.4	0.4	0.5
Corporate Services	2.7	2.8	2.9	2.8	2.5	2.4	2.6
Restructuring	0.0	0.0	1.6	1.3	0.6	0.6	0.0
<b>Accommodation</b>	<b>4.5</b>	<b>4.9</b>	<b>5.0</b>	<b>5.1</b>	<b>5.1</b>	<b>5.1</b>	<b>5.1</b>
Gross	8.4	8.3	8.4	8.5	8.5	8.5	8.5
Recharge	(3.9)	(3.4)	(3.4)	(3.4)	(3.4)	(3.4)	(3.4)
<b>Other</b>	<b>0.1</b>	<b>2.1</b>	<b>0.0</b>	<b>2.4</b>	<b>3.1</b>	<b>4.3</b>	<b>4.3</b>
Depreciation	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Anticipated developments (8)	0.0	2.0	0.0	2.3	3.0	4.2	4.2
Other Income	(0.8)	(0.8)	(0.9)	(0.8)	(0.8)	(0.8)	(0.8)
<b>Sub Total</b>	<b>12.5</b>	<b>13.9</b>	<b>14.1</b>	<b>16.4</b>	<b>16.2</b>	<b>17.1</b>	<b>17.2</b>
<b>TOTAL COSTS</b>	<b>31.9</b>	<b>35.3</b>	<b>35.2</b>	<b>35.6</b>	<b>35.1</b>	<b>34.9</b>	<b>35.5</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) This item relates to our statutory obligations in relation to gas and electricity metering and gas quality. The work on metering is now carried out by the NWML but Ofgem retains statutory and financial responsibility for this.
- (4) Security of supply costs indicated are directly attributable to work in this area, but many workstrands under other themes contribute to the work. To avoid duplication, costs included in other themes are excluded from those shown under security of supply. This applies to other cross-cutting workstrands.
- (5) The reduction in spend in Europe is due to two members of staff finishing their secondments at the Commission.
- (6) On behalf of the Government Ofgem administers a number of environmental programmes. Ofgem is in discussion with the Government over the future funding arrangements for such schemes. The allowances for 2007-08 and 2010-11 include £0.4 million extra IT costs associated with database rebuilds.
- (7) Following a reorganisation during 2006-07 these figures have been restated to reflect the new structure.
- (8) This is a contingency provision to meet future developments. See paragraphs 1.3 and 1.4 below for details.

\*See 2006-07 provisional spend analysis below.

### 2006-07 provisional spend analysis

1.1. Provisional figures for 2006-07 suggest that our spending will be within budget. There is likely to be a small underspend of £0.1 million.

#### Budget commentary

1.2. 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 (2005-06 to 2009-10). As with last year, we have extracted central and overhead costs for transparency to enable comparisons to be made.

1.3. Much of Ofgem's work is reactive with constantly changing priorities. To provide for this a contingency for future developments has been included in the budget. In 2006-07, we have fully utilised the £2.0 million contingency. This includes additional costs primarily associated with consultancy support to policy areas and the reorganisation of the Operations Division.

1.4. In 2007-08, Ofgem proposes to set the contingency for future developments at £2.3 million. In later years, the contingency for future developments is set to rise to reflect increased uncertainties. However, we anticipate these will reduce as budgets are finalised.

1.5. Headline costs to licence payers are set to increase by £0.4 million from 2006-07 to 2007-08. This is largely because of the completion of the transmission price control and expected completion of the gas distribution price control review in Q1 2007-08 (see paragraph 1.9 below).

#### *Environmental programmes*

1.6. As set out in chapter 5, Ofgem administers a range of environmental programmes on behalf of other Government Departments. Our projected costs of administering these programmes in 2007-08 are shown in the table below.

#### **Projected costs of administering environmental programmes, 2007-08**

Renewables Obligation	£1.0 million
Energy Efficiency Commitment	£0.5 million
Non-Fossil Fuel Obligation	£0.1 million
Climate Change Levy Exemption for Renewables and CHP	£0.4 million
Renewable Energy Guarantees of Origin	£0.1 million
Overhead & support costs	£1.0 million
<b>Total</b>	<b>£3.1 million</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 2006-07. For 2007-08, RPI has been determined, based on the prevailing RPI at December 2006, as 4.4 per cent. For 2008-09 and 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 % budget ceiling</b>	<b>34.2</b>	<b>33.9</b>	<b>34.3</b>	<b>34.1</b>	<b>34.0</b>

1.8. The table below sets out the cost control ceiling and, after 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. The budget ceilings give rise to anticipated savings of approximately £1.1 million per year over the period of the RPI-3 regime. For 2005-06 and 2006-07, the planned saving of £1.1 million for each year was achieved. In addition, an extra saving of £2.9 million was achieved in 2005-06 and returned to licence fee payers in 2006-07. The total savings to date are therefore over £5m.

<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>31.9</b>	<b>35.3</b>	<b>35.6</b>	<b>35.1</b>	<b>34.9</b>
<b>Costs excluded (funded by licensees)</b>					
Administering Environmental Programmes (net)	(0.4)	(1.3)	(1.3)	(0.9)	(0.8)
Depreciation	(1.2)	(0.9)	(0.9)	(0.9)	(0.9)
<b>Costs included (funded by HM Treasury)</b>					
Capital	1.0	0.8	0.8	0.8	0.8
<b>Total adjusted costs</b>	<b>31.3</b>	<b>33.9</b>	<b>34.2</b>	<b>34.1</b>	<b>34.0</b>
<b>RPI-3 % budget ceiling</b>	<b>34.2</b>	<b>33.9</b>	<b>34.2</b>	<b>34.1</b>	<b>34.0</b>
<b>Variance</b>	<b>(2.9)</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>

1.9. The table indicates that Ofgem is maintaining costs within the RPI-3 per cent cost control regime.

## Appendix 3 - Ofgem Simplification Plan

1.1. Ofgem is committed to the principles of better regulation and we are continually seeking to improve our efficiency and effectiveness. 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 published our first Simplification Plan in March 2006.

1.2. We set out below our latest Simplification Plan that outlines the work that we will undertake in 2007-08 under the banner of better regulation.

### Process initiatives

Initiative	Outcome	Current status/ milestone
<i>Consumer First</i> project: to improve our engagement with the priorities of domestic consumers	Improve our understanding of the domestic consumer's perspective, especially on sustainability issues	Commenced January 2007. Will publish next steps early in 2007-08. Commissioned pilot research on consumer attitudes to energy and the environment. Will publish the results early in 2007-08
Review Ofgem's approach to enforcement	Ensure that our approach is proportionate to the risk to consumers from non-compliance	Under way. Will publish revised guidance on enforcement policy and procedure in Q2 2007-08
Review Ofgem's approach to Impact Assessments in the light of the Better Regulation Executive's consultation exercise	Ensure that the costs and benefits of our proposals continue to be adequately considered, that solutions remain fit-for-purpose and alternatives are given sufficient consideration	Will consult on revised guidance in 2007 and publish revised Ofgem guidance in Q3 2007-08
Ofgem RPI-3 cost control: to improve Ofgem's internal efficiency	Savings of around £8m by the end of the 5-year period. The savings will directly benefit licensees as their licence fees will reduce accordingly	Implemented. Savings to be made from 2005-06 to 2009-10. For 2005-06, we achieved the planned saving of £1.1 million plus an extra £2.9 million. Licence fees for 2006-07 were reduced accordingly

Project Paperless:		
1. Revised document templates and guidance to make consultation and decision documents shorter and more accessible, responding to industry concerns about the burden imposed by dealing with long, complex documents	20 per cent fewer documents published in 2005-06 than in 2004-05. Benefits all stakeholders who will need to spend less time working through Ofgem documents	Implemented from January 2006. Audit of stakeholders' views conducted in Q4 2006-07. We are considering the results
2. Applying Project Paperless principles to all other Ofgem documents including code modification and derogation decisions	Benefits all stakeholders who need to engage with Ofgem's code modification decisions	New arrangements took effect in autumn 2006
3. Website to be redesigned to aid 'navigation'	Benefits all stakeholders who need to engage with Ofgem's work	Electronic document navigation and website redesign to be implemented April 2007

### Policy initiatives

Initiative	Outcome	Current status/ milestone
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 by reducing the cost of compliance and administrative burden in existing suppliers and through reviewing barriers to more effective competition	Consulted on initial proposals in July 2006 and final proposals in December 2006. These would more than halve the length of the supply licence from 160 to 80 pages. Licence changes likely to take effect in June 2007. Will closely monitor the outcome of the changes. Will also streamline the licence applications process
Review of the guaranteed and overall standards on suppliers	Subject to the consent of the Secretary of State, implement proposals that are consistent with better regulation principles	We will consult on whether the standards should be removed given that competition in retail markets is effective
Advise the Government on implementing the Energy Services Directive	Seek to influence the Government so that implementation is consistent with better regulation principles	Discussions ongoing

Industry Codes:		
1. Streamlining codes and governance arrangements		
- Creating a Uniform Network Code for independent Gas Transporters	Reduce the burden imposed by the need for stakeholders to deal with multiple documents	Conducted two rounds of consultation. Published licence modification notice and conclusions document in March 2007. New arrangements should be in place in summer 2007
- Distribution Connection Use of System Agreement	Single code replaced around 400 separate bilateral agreements	New arrangements took effect in October 2006
2. Review of industry code compliance arrangements	Ensure arrangements are 'fit for purpose'	Consulted in 2006. Conclusions in 2007
Revised and streamlined approach to developing the 2010-15 electricity distribution price control	Reduced administrative burden for electricity distribution businesses	Take forward in 2008
Undertake scoping exercise on reviewing the electricity distribution licence	Ensure that distribution licences remain fit for purpose	Take forward in 2007
Replace Ofgem-led electricity distribution charging implementation steering group with sector-led charging forum	Promote self-regulation where appropriate	Commence in April 2007
New, simplified reporting regime for gas distribution quality of service	Reduced administrative burden for gas distribution businesses	Take forward as part of the gas distribution price control review
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. We consulted on how it affects our need for assurance on longer term asset risk management processes	Four network companies have PAS55 certification. Several more expect to later this year. We will track PAS55 status for other network companies and ultimately stop doing our own surveys
Engineering standard P2/6: introducing simpler compliance arrangements	Distribution licensees will self-regulate their compliance for demand groups up to 60MW	New arrangements implemented March 2007. Derogation from licence condition to enable two-year trial and subsequent Ofgem review. If trial is successful, we will seek to make this permanent



## Appendix 4 - 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 statutory provisions (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. The Authority also has other statutory duties in respect of the environment, as set out in various other Acts<sup>3</sup>. References to the Gas Act and the Electricity Act in this appendix are to Part 1 of each of those Acts.<sup>4</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>5</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>6</sup>; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.<sup>7</sup>

<sup>3</sup> For example, the Environment Act 1995 and the Countryside and Rights of Way Act 2000.

<sup>4</sup> Entitled 'Gas Supply' and 'Electricity Supply' respectively.

<sup>5</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>6</sup> Under the Gas Act and the Utilities Act, in the case of Gas Act functions. Under the Electricity Act, the Utilities Act and certain parts of the Energy Act, in the case of Electricity Act functions.

<sup>7</sup> The Authority may have regard to other descriptions of consumers.

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:

- promote efficiency and economy on the part of those licensed<sup>8</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 above functions 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 for Trade and Industry.

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. The Authority is a designated National Competition Authority under the EC Modernisation Regulation<sup>9</sup> and is 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.

1.9. The Authority has regard to all of its duties when carrying out its functions.

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<sup>8</sup> Or persons authorised by exemptions to carry on any activity.

<sup>9</sup> Council Regulation (EC) 1/2003.

## Appendix 5 - 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).

### 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 ascertain accurately 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.

## Appendix 6 - Consultation questions and respondents

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

### Question box

**Question 1:** Are the proposed themes suitable?

**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:** Should we review any other aspects of our regulation to ensure that our approach is proportionate to the risk posed to consumers by non-compliance?

**Question 5:** Should Ofgem include any other activities in its Simplification Plan?

### List of Respondents

List	Name
1	Airtricity
2	British Energy
3	Centrica
4	Chemical Industries' Association
5	EDF Energy
6	Energy Action Scotland
7	Energy Networks Association
8	Energy Retail Association
9	energywatch
10	E.ON UK
11	Friends of the Lake District
12	Fuel Poverty Advisory Group
13	Gas Forum
14	National Grid
15	Northern Gas Networks
16	PLACE
17	RWE
18	Scottish Power
19	SSE
20	Statoil
21	Sussex Energy Group
22	United Utilities
23	Welsh Language Board

1.2. The responses are available from our website [www.ofgem.gov.uk](http://www.ofgem.gov.uk) and library.

## 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:

- Do you have comments about the overall process adopted for this consultation?
- Do you have comments about the overall tone and content of this document?
- Is this document easy to read and understand?

1.2. Please send comments either by email to [andrew.macfaul@ofgem.gov.uk](mailto:andrew.macfaul@ofgem.gov.uk) or in writing to:

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Consultation Co-ordinator  
Ofgem  
9 Millbank  
London SW1P 3GE.