

Proposed Corporate Strategy and Plan 2008-2013

Document type: Consultation

Ref: 01/08b

Date of publication: 14 January 2008

Deadline for response: 22 February 2008

Target audience: All stakeholders

Overview:

In August 2007, Ofgem published an open letter seeking views on the key challenges and priorities for the next five years. This document sets out our proposed strategy, developed in the light of the responses to that letter, and provides stakeholders and interested parties with a further opportunity to comment.

The proposed strategy maintains our seven themes but takes into account our developing work on making the gas and electricity sectors more sustainable. This work is essential given the EU's 2020 targets on greenhouse gas emissions and renewable generation.

Significant new energy legislation is being developed at both EU and UK level. We will publish our plans at the end of March 2008 and we will return to the themes later in the year to confirm or change them to take account of legislative 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

- Corporate Strategy and Plan 2007-2012, March 2007 (Ref: 60/07).
http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/19247_2007%20Corp%20Plan.pdf
- Corporate Strategy initial consultation letter, August 2007 (Ref: 204/07).
<http://www.ofgem.gov.uk/About%20us/BetterReg/Documents1/Corporate%20Strategy%202008-2013.pdf>
- Responses to Ofgem's initial consultation letter, September 2007.
<http://www.ofgem.gov.uk/Pages/MoreInformation.aspx?docid=276&refer=About%20us/CorpPlan>.

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Introduction

In August 2007, Ofgem published an open letter seeking views on the key challenges and priorities for the next five years. The responses to this letter are on our website. The present document sets out our strategy, developed in the light of the responses to that letter, and provides stakeholders and interested parties with a further opportunity to comment. Appendix 1 gives details of how to respond.

Respondents to our initial consultation generally took the view that our existing seven themes remained suitable. The themes are as follows:

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
6. Helping to tackle fuel poverty
7. Better regulation

Work under these themes is discussed in the chapters that follow.

Ofgem's principal objective is to protect the interests of consumers wherever appropriate by promoting effective competition. We promote competitive solutions wherever appropriate, but direct regulation of network monopolies remains essential to protect the interests of consumers.

Ofgem has a range of important secondary duties. These include having regard to the needs of vulnerable customers, contributing to the achievement of sustainable development, securing diverse and long term supplies, and having regard to the principles of best regulatory practice.

We must also have regard to guidance issued by the Secretary of State for Business, Enterprise and Regulatory Reform on social and environmental matters. Further details of these statutory objectives and duties are set out in appendix 2.

Appendix 3 sets out our deliverables and performance indicators for 2008-09, which provide the practical targeting of activities to achieve the broader objectives of the seven themes.

Appendix 4 sets out Ofgem's budget.

Appendix 5 contains a draft Simplification Plan setting out the work that we propose to undertake in 2008-09 in support of the better regulation agenda.

Appendix 6 provides details of how to give feedback to us about the way we have carried out this consultation, 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 and we will use our sectoral and competition law powers where necessary. We will periodically publish information and analysis to facilitate and inform the debate on important issues such as the health of retail competition, wholesale market transparency, liquidity and the role of large customers (the demand side) in the market. We will continue to seek to reduce any barriers to the take-up of smart metering, microgeneration and green supply tariffs.

Question box

Question 1: Does this theme remain valid?

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

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

Introduction

1.1. In the period from 2003 to the end of 2006, bills for domestic and business customers rose sharply. The main driver of 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 costs under the EU Emissions Trading Scheme (EU ETS) of beginning to reduce carbon emissions to tackle global warming.

1.2. Since June 2006, however, an increase in gas supplies because of significant private sector investment in new sources of imported gas and a very mild winter led to a fall of approximately 50 per cent in the wholesale price. During 2007, prices for the most competitive domestic electricity tariffs fell by about 3 per cent on average across Britain, or about £11 off the average bill. The most competitive domestic gas tariffs also fell, by around 12 per cent on average across Britain, or £68 off the average bill. However, the second half of 2007 saw increases in wholesale gas prices, and spikes in wholesale energy prices in October and November.

1.3. A range of factors have contributed to the wholesale price increases observed in late 2007 and early 2008. These include high oil prices which have led to higher European gas prices. Structural problems in the European market (such as a lack of transparency in how daily and within gas flows meet demand) mean that British gas prices have been higher than they would have been if European gas markets were fully competitive. In addition the global liquefied natural gas (LNG) market has been tight, leading to more competition in obtaining scarce LNG supplies. While UK gas storage capability is significantly increased on last year, there have been some delays in the further expansion of this capacity, notably to the Aldbrough gas storage facility and the new LNG facilities at Milford Haven.

1.4. Coal prices have also hit record highs driving up British and European electricity prices. Extended outages at a number of British Energy's nuclear power stations are a further factor. Recent cost pressures faced by suppliers come not only from wholesale energy cost increases observed in late 2007, but also from the impact of environmental schemes which affect all suppliers, including the costs associated with the Carbon Emissions Reduction Target, the Renewables Obligation and, most notably, Phase II of the EU ETS, which has added to the carbon component of wholesale prices since its introduction in 2008.

1.5. In response to these price increases, those industrial and commercial (I&C) customers who had not entered into fixed price contracts by October 2007 have already seen their energy costs increase significantly. This again confirms that in volatile commodity markets, the timing of purchase decisions and appropriate risk management strategies play a crucial role. The domestic sector has also seen some price increases, although the pressure on individual suppliers to increase retail prices due to wholesale cost pressures will vary, depending on the hedging strategy that they have adopted. Suppliers who bought a significant proportion of their energy needs on the forward markets while wholesale prices were low will be better positioned to maintain lower retail prices. Those who have not, or who choose to take higher supply margins, risk losing market share.

1.6. Britain's domestic energy market is highly competitive and remains the most competitive in Europe. Energy companies continue to compete vigorously on price, service and the range of products they offer their customers. For example, suppliers have in recent months been competing strongly to offer the cheapest internet tariff. Domestic customer switching levels have continued to increase: some 3.4 million electricity customers and 2.6 million gas customers switched supplier in the first eight months of 2007. These figures show an increase on the same point last year, despite 2006 being a year of historically high switching because of the high prices.

1.8 We constantly undertake market surveillance to ensure the wholesale and retail markets remain competitive. During this period of rising wholesale and retail prices we will be stepping up our activity in this area to make sure that there is no evidence of anti-competitive behaviour. Where we find that there is, or that there are other barriers to effective competition, we will act, drawing on our full range of powers.

1.7. The scope for domestic customers to make savings by switching to the lowest cost supplier remains significant. This includes pre-payment meter (PPM) customers, who can save on average across the 14 regions over £100 by switching away from both incumbents. We will continue to publicise the savings that customers can make by switching and encourage customers to take advantage of the savings available.

1.8. Given the very significant savings available to PPM customers, we undertook a switching campaign for PPM users in June 2007 to encourage these customers to take advantage of the better deals that are on offer. We are now looking at more direct ways of encouraging customers, in particular PPM customers and those that are vulnerable, to switch to cheaper deals, and at the role we can play in helping to make sure that these customers are able to take advantage of the opportunities available to them.

1.9. Suppliers have offered a range of capped and fixed price deals that have assisted customers in dealing with rising and volatile energy prices. In 2007 the most expensive suppliers have continued to be punished by customers who have left them at a rate of half a million a year. The Energy Supply Ombudsman, which can award compensation to domestic customers in the event of an unresolved dispute, has prompted some suppliers to improve their complaints-handling performance. The new arrangements for consumer representation should from October 2008 further sharpen incentives on suppliers to handle consumer disputes effectively and compete on service quality.

1.10. The business market is also competitive. Prices fell substantially in response to wholesale price movements for much of the year. In electricity, roughly 70 per cent of large industrial and commercial customers have spot-indexed contracts that expose them to fluctuations in the wholesale market. As a result, these customers saw their average electricity costs fall by 13 per cent from August 2006 to July 2007 as wholesale prices declined over the period. By the same token, however, the higher prices observed in the wholesale market in late 2007 are likely to lead to price increases for these customers in the coming months, as noted above.

1.11. Higher prices over the past couple of years have stimulated product innovation. Suppliers have tailored contracts to help industrial and commercial customers manage their energy costs through, for example, reducing their energy use during periods of peak demand and high prices. Intermediaries have increased their role in the market brokering flexible purchasing arrangements and other innovative 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 services and tools.

1.12. Following consultation with customers and suppliers, in November 2007 we modified the gas and electricity supply licences to improve the switching process for non-domestic customers. The change means that suppliers cannot use the switching process as an opportunity to re-contract with customers and secure new objection rights to prevent the proposed transfer to a new supplier from going ahead.

1.13. 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.

1.14. 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.

1.15. 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.

1.16. 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 simplified the licences and halved 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.

1.17. 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.

1.18. In 2007 Ofgem worked with the industry to develop new energy ratings to help domestic customers choose between 'green' energy deals. We proposed two sets of guidelines: one about tariffs for renewable energy and the other about tariffs for other low carbon energy sources. Our aim is to improve the information available so that customers can make informed choices when seeking a service that will cut their carbon footprint. In line with better regulation principles, the new guidelines will be voluntary. We envisage that, within six months of our publishing the guidelines, suppliers will develop and fund a certification scheme consistent with the principles set out in them. We will monitor the market to be sure that customers who want to take advantage of green tariffs are confident about what they are buying.

The next two years

Monitoring energy markets

1.19. Higher wholesale gas prices in part reflect the decline in gas supplies from the North Sea and higher costs associated with importing gas. There are still a number of major new gas import infrastructure projects to be completed. These projects will give us access to imported gas via new pipelines and LNG terminals. There are also plans to double Britain's gas storage capacity; if these projects gain planning permission the extra storage capacity will greatly assist the market in managing peak winter demand as North Sea production continues to decline. These are significant developments that are likely to have an impact on the wholesale price.

1.20. There remains, however, an ongoing need to reassure customers that price movements reflect changes in supply and demand and are not being manipulated either in Britain or by events or arrangements in neighbouring markets in continental Europe. Close monitoring of the wholesale and retail markets will therefore remain an essential part of our work. We will also continue 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.

1.21. We will continue working with the European Commission, and other European regulators and stakeholders to ensure that arrangements in continental Europe do not restrict supplies of LNG and/or piped gas to the UK. We play a key role in a number of regulatory initiatives being taken forward with other European regulators and we will use these processes to continue to work towards greater transparency and liberalisation of the European energy markets. 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

1.22. 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, liquidity, the ability of small new entrants to enter the market 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.

1.23. Ofgem's review of the electricity cash out arrangements, started in early 2007, is ongoing. Two modification proposals are currently under consideration by Ofgem, and a third has recently been raised for industry assessment. In addition, the industry is still considering how to improve the arrangements for the wholesale gas market in the event of a supply emergency.

Retail markets

1.24. In 2007 we completed our review of the standard electricity and gas supply licences and introduced new streamlined licences that we believe are appropriate for energy markets that are fully competitive. We are monitoring suppliers' behaviour carefully to ensure that the new regulatory framework operates in the best interests of customers going forward.

1.25. The Consumers, Estate Agents and Redress Act 2007 changed arrangements for consumer representation by providing for the establishment of the new National Consumer Council (which will be known as Consumer Voice), the abolition of energywatch and the establishment of a statutory ombudsman. We are committed to playing our part in ensuring that the transition is as smooth as possible for consumers.

1.26. The Consumers, Estate Agents and Redress Act also gave Ofgem a duty to prescribe standards for the handling of complaints in the energy sector. In 2007 we consulted on the standards that ought to apply and in 2008 we will implement the new standards. Our intention is that the new obligations will be well targeted and proportionate while ensuring that consumers are adequately protected.

1.27. In 2007 we reviewed the performance of the Energy Supply Ombudsman and concluded that, while the arrangements were largely working well, a number of improvements could be made to enhance its effectiveness. In 2008 we will monitor events carefully. Using the powers set out in the Consumers, Estate Agents and Redress Act, and on the basis of criteria on which we are consulting, we will also consider whether to give statutory approval to redress schemes put forward by industry. Our goal will be to ensure that customers have an effective means of redress when suppliers and customers cannot resolve disputes.

1.28. 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 Business, Enterprise and Regulatory Reform.

Distributed energy

1.29. Distributed energy has the potential to make a large contribution towards reducing carbon emissions from the energy sector. In 2007 we took forward work, with BERR, on addressing the barriers to distributed energy within the current marketing and licensing arrangements. We are currently consulting on a broad range of possible options for introducing greater flexibility to the market, regulatory and licensing arrangements for distributed low carbon electricity. We expect to set out a detailed implementation plan in May 2008. Consistent with our principal statutory objective, we will ensure that consumers are properly protected under any proposals for encouraging distributed energy that are implemented.

Metering

1.30. We will continue our work to establish effective metering competition and to facilitate the introduction of more advanced or smarter forms of metering for domestic and business customers within the framework of a competitive metering market.

1.31. Advanced or 'smart' metering could put an end both to estimated bills and on site meter reading and provide the information to help customers become more energy efficient. This could deliver reduced bills and reduced carbon emissions, thereby helping to tackle global warming and fuel poverty simultaneously.

1.32. 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 the best way of 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 the smart metering debate.

1.33. We have engaged with the industry and the Government in a drive to bring to the domestic energy market widespread use of smart meters. We have formed an industry-wide group to agree minimum standards for smart meters and to look at how industry rules need to be changed to allow for wider use of the technology.

1.34. Ofgem is running a £10 million trial of smart meters with industry on behalf of the Government. Separately we are supporting the independent monitoring and evaluation of a small-scale trial of 200 smart meters. These trials will provide 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

1.35. We do not think that it is appropriate for us to try 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.

1.36. 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.

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

1.38. 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

It remains our view that incentive-based regulation is the best regulatory framework for energy networks. We think that the framework remains fit for purpose, flexible and innovative enough to respond to changing circumstances, such as new patterns of supply and demand in response to the challenges posed by tackling climate change. Ofgem will continue to regulate networks transparently and take decisions that are consistent across sectors wherever appropriate.

Question box

Question 1: Does this theme remain valid?

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

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

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 of network monopolies is therefore necessary to protect the interests of consumers. Regulation of networks covers 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 and incentives to help the network companies play their part in making the energy sector more sustainable.

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 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. For example, we have introduced Innovation Funding Incentives in electricity transmission and electricity and gas distribution.

2.5. We continue to encourage the development of cost-reflective charging methodologies for use of the networks. This is the best means of promoting more sustainable, efficient investment in networks over the longer term and of reducing the carbon and wider environmental footprint of the energy networks.

2.6. 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.

2.7. 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

2.8. Recent events in the water sector and, to a lesser extent, in the energy sector, underline the importance of companies providing accurate information to the regulator. We have strengthened our approach to compliance, through the detailed specifications for annual reporting and the audit checks we require, but we cannot be complacent. We will therefore continue to be vigilant in this area. Meanwhile the annual cost reporting process puts us in a better informed position for future price control reviews.

2.9. A key area where Ofgem takes a consistent approach across sectors is in the financial aspects of price controls. One of the newer ideas in this area is to index allowances for the cost of capital to measures of the market cost of debt, or to provide triggers for such a linkage. As part of the gas distribution price control review we considered adopting this approach but decided not to do so. However, we expect to return to this issue at or alongside the early stages of the next electricity distribution review. If the analysis that we undertake suggests that a change might be appropriate, we will consult fully and make changes only where we can demonstrate benefits to customers from doing so.

2.10. In 2007 we developed the scope of the long term electricity network scenarios (LENS) project and the methodology that Ofgem and our academic partners would use to develop the scenarios. We will shortly publish a draft scenarios report. By June 2008 we intend to publish a final scenarios report, setting out four or five final scenarios for British electricity networks looking out to 2050, as well as our views on key issues for the networks and how they are regulated. The outcome of the LENS project will help set the context for the next electricity distribution price control review and future price control reviews. It will also aid consideration of other strategic issues affecting the networks and the way we regulate them.

2.11. 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 (NWML) but for the time being statutory and financial responsibility for these activities remain with Ofgem. These activities cost about £0.9 million per year and form a significant part of the overall cost of our Technical team. The Government intends to take powers to transfer responsibility to NWML in the Energy Bill.

Electricity and gas transmission

2.12. The new EU 2020 targets to reduce greenhouse gas emissions and increase renewable generation are likely to have a significant impact on our work. We will discuss with the Government how the targets can be met at the lowest cost to consumers.

2.13. Ofgem will continue to work with the Department for Business, Enterprise and Regulatory Reform (BERR) in developing the regulatory and licensing regime for offshore transmission networks. Offshore networks are important as they will transmit electricity from marine renewable plant to the onshore network. They have the potential both to strengthen security of supply and contribute to a lower carbon energy system. We will continue to develop a regulatory regime for offshore transmission which will ensure costs are economic and efficient while also providing certainty about network delivery and ongoing operation to offshore generators. We will publish a final proposals document in 2008.

2.14. Ofgem is currently working with BERR to conduct a joint review of the regime governing connection to electricity transmission access. The objective is to develop proposals for changes necessary to support the connection of renewable generation to the transmission network in the medium and long term. It is intended to publish the final report of the Transmission Access Review in the first quarter of 2008-09.

2.15. We will also continue our work on the new regulatory arrangements that may be necessary to extend the electricity transmission network to the Scottish Islands to enable the development of renewable energy for export to the mainland.

2.16. We will continue to seek better 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.

2.17. We remain committed to assessing the forecasting and network planning regime for gas transmission so as to improve the information available on network performance, and undertake a review of buyback arrangements.

2.18. The current transmission price controls introduced mechanisms that will automatically flex allowances for investment in response to the demand for capacity from users of the networks. To protect customers' interests, demands for capacity from new and existing users will be backed by long term financial commitments. These commitments from users will help the network companies to identify where and when 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.

2.19. We will carry out annual performance monitoring and reporting on the transmission companies' costs and performance. We will publish the report for 2007-08 in early 2009 and we will continue to produce reports annually on the same schedule. During 2008-09, we also will review proposals from transmission companies for the introduction of output measures designed to improve our ability to assess whether the companies are delivering appropriate levels of network performance for the funding they receive.

2.20. The gas and electricity transmission system operators (SOs) are responsible for keeping supply and demand on the networks in balance in real time and managing short term constraints on the networks. We set commercial incentives to encourage economic and efficient system balancing. The current incentives were designed to last for one year. We are at present consulting on National Grid's proposals for new incentives that will apply for a further year from 1 April 2008. We still think that longer term schemes could provide better value for consumers. However, unless National Grid comes forward with proposals as part of the current consultation process, we may not be in a position to consider implementing longer term arrangements before April 2009 at the earliest.

Gas distribution

2.21. Throughout 2007 Ofgem took forward the gas distribution price control review for the period 2008-2013. In December we published final proposals - now accepted by all gas distribution networks (GDNs) - to allow for increased spending by the companies primarily to make their networks safer by replacing cast iron mains.

2.22. At a time of rising pressure on input costs the ability to compare different companies - made possible by the sale of four of National Grid's distribution networks - was vital in helping us to set challenging targets to improve operating efficiency across the networks and to determine what levels of spending were appropriate.

2.23. In our final proposals we also included a package of incentives for sustainable development of the networks. We proposed to cut the upfront charges that customers in fuel poor communities face if they want connections to the networks. Encouraging network extensions can help to alleviate fuel poverty and can also bring environmental benefits, for example where customers replace fuel oil with mains gas. We also introduced financial incentives for the companies to reduce methane leakage from their networks.

2.24. At the same time we have developed new interruption arrangements and a set of incentives to reward distribution companies for investing efficiently in their networks and for delivering the outputs that matter to customers. More work is planned to implement our final proposals through the modification of the GDNs' licences.

Electricity distribution

2.25. We will shortly publish the initial consultation document for the next electricity distribution price control (known as DPCR5) that will take effect in April 2010. An important element of DPCR5 will be to strengthen the incentives for sustainable development, for example the incentive for distribution companies to connect low carbon forms of generation such as renewables and microgeneration. We expect to publish a policy paper in early 2009 and thereafter to publish initial proposals in summer 2009 and final proposals in November 2009.

2.26. Distribution companies' charging models are an important element in delivering efficient and sustainable network development. One distribution company, Western Power Distribution, has delivered charging models that better reflect its costs, but elsewhere progress has been slower. The distribution companies have told us that they will bring forward further modification proposals in the coming months. We are considering whether a better process would be to move to a common methodology. In the meantime, we are encouraging the companies to develop improved charging models for medium-sized generation and for independent distribution network operators.

2.27. We will carry out our ongoing annual performance monitoring and reporting on the distribution companies' costs and quality of service. We will publish the reports by the end of 2008.

2.28. Following our review of competition in connections we introduced new performance standards for distribution companies. We will monitor companies' performance and publish an update in summer 2008.

A five year view

2.29. The EU 2020 targets on greenhouse gases and renewable generation will play an important part in shaping our activities. However, 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 be the best way of ensuring that network investment is timely, efficient and in the best interests of consumers.

2.30. 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 that investment and encourage innovation where it adds value. We will continue to monitor and, where appropriate, promote the development of new network technologies. We will also extend and develop incentives on network companies to improve the quality of service to their customers.

2.31. By regulating networks in a transparent and consistent manner we will further strengthen confidence in the regulatory regime. For example, we will continue to develop a clear, predictable approach to the conduct of price control reviews so as to reduce uncertainty and provide a stable framework for long term decisions by network companies.

2.32. 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 believe 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, including EU proposals, in terms of their impact on security of supply.

Question box

Question 1: Does this theme remain valid?

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

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

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 or unplanned interruptions to gas and electricity supplies.

3.2. Competitive markets are the best way of promoting security of supply. They encourage companies to contract for 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 shocks or disruptions to supply, which will encourage consumers who can temporarily reduce their energy use to do so.

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 where and when the market wants them to.

3.4. Since privatisation £14 billion has been invested in 31 GW of new gas-fired and renewable electricity generation. This represents more than 40 per cent of total generation capacity in Britain. Coal-fired generators have invested, or intend to invest, £1.2 billion in Flue Gas Desulphurisation to reduce emissions and prolong the life of 11GW of coal-fired generation that would otherwise be prohibited from operating under EU laws limiting sulphur dioxide emissions.

3.5. There is at present 20 per cent more generation capacity than required to meet peak demand. This provides a satisfactory cushion in times of need and is consistent with the planning margins used before the industry was privatised. Looking forward, the closure of some coal plant on environmental grounds and the ageing of our nuclear fleet mean that the generating margin is likely to erode progressively.

3.6. The market is already investing to safeguard our future energy supplies. A number of energy companies have announced plans to invest in new conventional (including new gas plant and 'clean' coal) and renewable generation. Our analysis indicates that if there were no new investment above that currently known this generation surplus would last until at least 2014. Subject to receiving the necessary planning permissions, there is still time to enable the industry to fill any potential supply gap given typical lead times for building power stations. Investors will require a stable political and regulatory environment before making investment in new generation capacity.

3.7. A powerful influence on future investment plans in generation will be the value of carbon dioxide emission allocations under the European Union Emissions Trading Scheme (EU ETS). Higher carbon prices will feed through into wholesale electricity prices and this will encourage greater energy efficiency by domestic and business customers. We have made our view clear that greater certainty is needed about the arrangements for future phases of the EU ETS in order to encourage investment in low and zero carbon technologies. We support the full auctioning of carbon permits for electricity generators. It is also important that, whatever the allocation method, the carbon costs are passed through to customers to encourage energy efficiency. This would clearly be beneficial for both the environment and security of supply. Revenues raised through auctioning could be used to help tackle fuel poverty.

3.8. Britain is moving from being self-sufficient in gas to being more reliant on imports. In response, the market is investing £10 billion in gas import and storage facilities. The planning regime remains the biggest barrier to the completion of these projects. If they are all completed enough import capacity will be ready by 2009 to meet 90 per cent of UK gas demand and gas storage capacity will double by 2010. In addition, our gas supplies will come from a more diverse range of sources than ever before.

3.9. As the sources of electricity generation and gas production change, so the energy networks must evolve to meet the new demands. During the last 20 years, over £30 billion has been invested in the gas and electricity networks. Between 1991 and 2005, £6 billion was invested in the high-voltage transmission network and over £15 billion was invested in the local electricity networks.

3.10. In 2005 Ofgem authorised a further £7.4 billion of investment in the local electricity networks for the period 2005-2010. We also authorised more than £5 billion of investment in the gas and electricity transmission networks from 2007-2012. A further £1 billion of investment might be needed to enable the transmission companies to respond to requests for connection to their networks by developers.

The next two years

3.11. We will seek to remove any barriers preventing the market from delivering security of supply that lie within our remit. We will work with Government to remove others, such as planning. We will continue to work with customers and industry stakeholders, for example by holding seminars, to ensure that market participants are aware of the options that they have to manage the difficulties created by higher prices during periods of tighter supplies. As part of this we will continue to try to facilitate improvements in demand-side management and response.

3.12. In 2007 Ofgem and BERR developed new arrangements for analysing longer term security of supply issues, including publishing the first *Energy Markets Outlook*. This document outlines the prospects for medium- and long-term security of supply to help the industry and consumers make the decisions needed to maintain security of supply. We will publish the next *Energy Markets Outlook* by the end of 2008.

3.13. 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.

3.14. Ofgem will continue to work with BERR, 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 National Grid 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

3.15. 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.

3.16. 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.

3.17. 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.

3.18. 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 promote the development of sustainable energy markets across the EU. We will continue to support the European Commission in its drive to achieve competitive energy markets and effective network regulation. We will focus on advising the Commission on the detailed provisions and subsequently the implementation of planned new energy legislation, including unbundling of EU transmission networks. We will also continue to work with fellow EU energy regulators on the gas and electricity regional market initiatives.

Question box

Question 1: Does this theme remain valid?

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

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

Introduction

4.1. European energy markets, and EU regulatory and competition policy, have a major and increasing influence on Britain's energy markets and consumers. For example, the British gas market is an integral part of the North West European gas market. Wholesale gas prices are likely to converge for much of the year across this region. Britain will shortly become a net importer of gas via new and expanded interconnectors. Gas transported across continental Europe will be increasingly vital for our security of supply. With new electricity interconnectors planned with the Netherlands and the Republic of Ireland, continental electricity flows will also have an increasing influence on our security of supply.

4.2. The overall objective for our European activities remains unchanged. It is to assist in developing genuinely competitive European gas and electricity markets that benefit British consumers in terms of prices and security of supply. Our aim continues to be to drive forward the debate and remove the risk that European markets and regulation might roll back the many benefits that liberalisation has brought to British consumers.

4.3. Environmental Directives and Regulations are having an increasing influence on regulatory and competition policy in Member States. Ofgem has decided to reflect this shift by bringing together its European and environmental work into one team. This will better enable us to respond to the environmental agenda being pursued both in Europe and domestically and ensure that this develops in the interests of British energy markets and consumers.

4.4. Ofgem is already actively involved in the debate. For example, we chair the Sustainable Development taskforce of EU national regulators. A key deliverable for this taskforce over the next year will be a European-wide Sustainable Development report, similar to the one produced annually by Ofgem.

4.5. We work primarily through the Council of European Energy Regulators (CEER) and the European Regulators' Group for Electricity and Gas (ERGEG). These bodies 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 will continue as President of CEER and Chairman of ERGEG until later in 2008.

4.6. We have also built direct relations with EU institutions, in particular the Commission. These links have been vital while the Commission has been developing its proposals for a third package of energy legislation. Effective links will remain important as the detailed legislative provisions are debated and thereafter as the focus switches towards consistent and thorough implementation across the EU.

4.7. We will pursue the development of effective regional energy markets through the Gas and Electricity Regional Initiatives. This is an important practical step towards the eventual goal of a competitive single European energy market.

4.8. Ofgem's efforts through CEER/ERGEG and the regional initiatives have led to huge strides in improving transparency in European power and gas markets. We now have access to important information on the levels of gas in store in all the major European markets and can see how much gas is taken out of store each week. We can now see daily gas flows on major pipelines in France, Belgium and the Netherlands. Germany remains a problem and less progress has been made there. There is also limited transparency on production from the Norwegian gas fields. It remains impossible, however, to understand total Norwegian gas supply and this adds uncertainty and volatility in the GB and NW European market. The picture is much better in the power market with most countries, including Germany, now publishing regular and detailed information on the availability of their generating stations, maintenance plans. This benefits customers by reducing the volatility and risk premia associated with wholesale markets that lack transparency of information.

4.9. We will continue to support the work of the European Technology Platform ('SmartGrids') that has brought together stakeholders from across Europe to develop a vision for the electricity networks of the future, together with a strategic research agenda and deployment plan to make this a reality.

The next two years

New EU legislation

4.10. In September 2007 the Commission announced proposals for a third package of legislation to liberalise European energy markets. We are carefully considering all aspects of the proposals to determine their potential impact on British energy markets and how they are regulated. The Commission's package includes:

- unbundling transmission network operators from competitive parts of the industry;

- an integrated European Grid in electricity and gas;
- increased transparency of key system and network information to assist the effective functioning of the market;
- an increase in the powers of national regulators in EU Member States; and
- a new European regulatory framework involving an EU Energy Agency.

4.11. During 2007 we played a full part in the debate on the Commission's proposals and we are now supporting the Commission in considering the detailed provisions. In particular, we argued strongly for full structural unbundling of transmission networks across the EU.

4.12. We will continue to make the case for full unbundling because, if achieved, it could allow Britain's energy suppliers for the first time to gain access to continental transmission and storage capacity on a fair and open basis. The Commission's unbundling proposals could also stimulate investment in new capacity to handle the growing volumes of imported gas transiting Europe. All this would boost security of supplies and put downward pressure on energy prices, both of which would benefit British consumers.

4.13. Ofgem welcomes the Commission's emphasis on ensuring that all EU Member States have strong independent national regulators with the necessary powers to carry out their role effectively. We think the record shows that competition has flourished most strongly in those countries where there is truly independent and well-resourced regulation. We continue to support a strengthening of national energy regulators but will consider carefully the impacts of any proposed new duties on our current remit, for example any duty that requires us to consider impacts on markets or consumers in other Member States.

4.14. We are actively involved in a number of taskforces that are developing the Commission's proposals into detailed provisions. In taking this work forward we will continue to promote policies that facilitate the development of truly competitive European energy markets, since this is in the interest of British consumers. In addition, we will continue to seek to minimise the risk of measures being adopted that would adversely affect competition, and consumers, in British energy markets.

Regional energy markets

4.15. Ofgem, in concert with other ERGEG members, has since 2006 been 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. This is a voluntary process involving other regulators, operators and market participants, seeking to identify and remove barriers to trade between existing national markets.

4.16. In 2007 Ofgem chaired the regional electricity project covering the UK, France and the Republic of Ireland. In gas, we are playing a key role in the North/North West Region. Chaired by the Dutch regulator, this region comprises the UK, France, the Republic of Ireland, Belgium, the Netherlands, Germany, Denmark and Sweden.

We have signed a Memorandum of Understanding with the other gas regulators to commit us to working more closely together on issues of cross border interest. This voluntary measure is a positive step that allows progress to be made while negotiations continue on the third package of energy legislation.

4.17. The main market integration issues in gas and electricity include wholesale market design, information transparency and access to cross-border transmission infrastructure. We have worked with European counterparts and transmission companies to ensure that the market gets much more data on European gas flows and capacity. We will however continue to press for greater transparency because competition will only take hold in Europe when real-time information is made available across the continent.

4.18. In 2007, the transmission companies committed to releasing increased information on both network capacity and gas flows during 2008. This is a key achievement for the gas initiative. We will work with other regulators and the companies to ensure that this is implemented as soon as possible. We will also seek to implement proposals that improve liquidity at gas hubs and enable non-discriminatory access to markets.

Policy work of CEER/ERGEG

4.19. Ofgem continues to be heavily engaged in policy development work for CEER and ERGEG. We have taken forward work on:

- developing a coherent and effective European regulatory framework;
- gas interoperability and balancing;
- electricity network congestion management, balancing and transparency; and
- developing an EU Grid Code in parallel with the legislative proposals.

4.20. 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.

4.21. We will also use our position as chair of the Sustainable Development taskforce to engage more closely with other regulators on issues surrounding the development of EU ETS and the Renewables Directive, and to develop the EU Sustainable Development report over the next year.

A five year view

4.22. We will continue to work with CEER, ERGEG and the Commission to ensure that European competition and regulatory policy benefits British energy consumers.

4.23. Over the next five years the third package of legislation will be implemented. Our aim will be to ensure that it is implemented effectively and consistently across the EU so that European energy markets become truly competitive.

4.24. We will continue our work 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. We expect, over this period, that our work will lead to regional electricity and gas markets that are substantially more pro-competitive than the existing arrangements.

4.25. 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 remains committed to playing its part in facilitating the transition to a low carbon energy sector. A key part of this will be the removal of any barriers to innovation. We will continue to take full account of the impact on the environment across the range of our decision-making. We will also 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. We will also advise the Government on the future development of these schemes based on our practical experience in their administration.

Question box

Question 1: Is this theme valid?

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

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

Introduction

5.1. Whilst 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 to sustainable development. In addition, the Secretary of State has provided statutory guidance on social and environmental matters to which we must have regard. Given our statutory duties, we are keen to ensure, as far as we can, that emissions reductions are made cost-effectively to minimise the burden on consumers, especially those in fuel poverty.

5.2. As the independent regulator of the sector that is responsible for the majority of greenhouse gas emission in Britain, it is clear we have an important role to play. Recognising the increasing weight of scientific evidence on climate change, changing attitudes in society, and the potential costs of inaction highlighted by the Stem Report, we have done much to take forward the sustainability agenda within the context of our existing statutory duties.

5.3. During 2007 we demonstrated on many fronts our commitment to putting sustainable development considerations at the heart of our work. For example, we:

- sought to influence the Commission and UK Government in relation to the EU Emissions Trading scheme and the support mechanism for renewable generation;
- set new incentives for National Grid to reduce greenhouse gas emissions from its transmission networks;

- proposed new incentives for the gas distribution networks to cut greenhouse gas emissions from their networks;
- carried out a joint review with Government of the arrangements for access to the transmission system to enable faster connection of lower carbon and renewable generation;
- carried out a joint review with Government on distributed energy looking at the incentives and barriers that impact on distributed electricity generation;
- fully engaged with industry and Government on smart metering, including running the smart metering trials and developing technical standards that will speed up the roll out of smart meters nationwide;
- reported to the Treasury on the development of microgeneration tariffs; and
- developed with industry new guidelines for renewable and low carbon tariffs that we hope will stimulate much larger take-up of these products.

5.4. We have recently published our second report on sustainable development. The report contains a list of indicators that can be used to assess progress in making the energy sector more sustainable. We have only limited powers and influence over many of these indicators. The report highlights the actions that we will take and highlights where we think the Government or other agencies could do more and where the indicators suggest that existing policy measures are not delivering.

5.5. 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.

5.6. Where matters are not under our direct control we nonetheless see it as our responsibility to facilitate change. This we do 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.

5.7. Sustainable development considerations are at the heart of Ofgem's policy and decision-making processes. The Authority's sustainable development sub-committee, which is chaired by Robin Bidwell, meets regularly to discuss policy proposals. We also organise the high level industry Environmental Advisory Group, which discusses environmental issues and their impact on the energy sector.

Sustainable energy markets

5.8. 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 in line with Government guidance. We will for instance facilitate lower carbon technologies, such as microgeneration, by identifying and removing regulatory barriers to their development.

5.9. Ofgem continues to support the Government in developing climate change policies that are based on, and work with, existing market arrangements. We continue to believe that a reformed EU ETS will provide the best means for reducing carbon emissions at the lowest possible cost to consumers over the long term. EU ETS has increased the commercial incentives on electricity generators to reduce emissions and will allow targets across the EU to be met at lower cost than alternative arrangements such as technology, sector or country specific targets. Ofgem will continue to advise the Government and the European Commission as they consider subsequent phases of the Scheme and seek to improve its effectiveness.

5.10. In our response to the Government's 2006 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. We continue to believe that 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.

5.11. In a similar vein, we also suggested longer term renewable contracts to replace the existing scheme for renewable support, since they could deliver more renewables and lower carbon emissions at lower cost to energy customers than the current Renewables Obligation (RO) and the Government's plans for reform of the RO. We think it will be even more important to consider these and other options as we consider how to comply with new EU targets on renewables and carbon emissions. We will therefore continue to work with the Government to identify improvements to the current scheme, or other alternatives, that will deliver the targets at lower costs to costumers.

5.12. 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 energy use 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

5.13. Ofgem remains committed to facilitating the development of energy networks that will meet the challenges of the 21st century. A major example of this is strong emphasis in the network price controls on facilitating the investment necessary to connect the new forms of generation that are being encouraged by government policies to reduce carbon emissions. Our work on long term electricity network scenarios (the LENS project) will help to set the context for our future price control reviews.

5.14. We have taken steps to improve the incentives for network businesses to reduce the volume of gas and electricity lost from the networks. We have also

strengthened the incentives on distribution companies to connect cleaner forms of generation to their lower voltage distribution networks.

5.15. Making sure that electricity generators located far 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. Locational charging has a key role to play in encouraging more decentralised generation, including microgeneration, and smaller networks.

5.16. Looking ahead, our decisions on the regulation of networks will facilitate the transition to a low carbon economy. For example, over the next year we will be considering industry proposals to prioritise bringing more renewables onto the system. We will shortly publish a detailed impact assessment of the merits of the proposals for consultation.

5.17. The gas and electricity industries also affect the environment through the emission of other pollutants and through their visual impact on our countryside and communities. We remain 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

5.18. In 2008-09 Ofgem will continue to advise the Government on its environmental programmes. The EU has agreed that 20 per cent of the EU's energy should be generated from renewables sources by 2020. We will advise the Government on how the UK could meet this target at the lowest cost to consumers.

5.19. We will continue our work with the Government on the EU ETS, including development of the National Allocation Plan for Phase II. We will continue to provide advice to the European Commission 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.

5.20. We will continue to support actions by Defra, the Devolved Administrations and the environmental regulators to design and implement economic instruments to meet environmental objectives, including schemes for sulphur dioxide and nitrogen oxides. The Large Combustion Plant Directive came into effect on 1 January 2008. We will monitor its impact on electricity prices and the energy system more generally.

5.21. The Energy End-Use Efficiency and Energy Services Directive includes provisions relating to the metering and billing practices of energy companies. We have been assisting the Government in coming to an informed view of how the Directive should be applied in the UK.

5.22. We believe that any mandatory measures to provide improved metering or increase the accuracy of billing should reflect the principles of better regulation. The roll out of smart metering should preserve the benefits of competition by allowing suppliers to offer consumers the products that they want, taking account of the fact that consumers respond in different ways to information given to them. We have recommended to the Government that it require smart meters to be fitted on a new and replacement basis.

5.23. 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 will play our part to encourage all energy consumers to be more energy efficient. Our supply licence review has cleared the path for companies to offer deals that reward consumers for reducing their consumption by using energy more efficiently. This would shift the emphasis of their business from selling kilowatt hours to meeting energy needs.

5.24. 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.

5.25. As noted in chapter 1, in 2007 we worked closely with industry and interested stakeholders on developing revised guidelines for 'green' supply. We will publish revised sets of these guidelines in February 2008 and will be seeking suppliers' commitment to develop an independent verification scheme for summer next year.

5.26. In 2007 we undertook a review of suppliers' compliance with the Fuel Mix Disclosure requirements. We will continue to monitor compliance.

Microgeneration

5.27. Widespread use of microgeneration could help the Government meet its target of reducing carbon emissions by 60 per cent by 2050. Our policy is to remove any significant barriers to the development of microgeneration. 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 barriers that lie behind this.

5.28. For microgeneration to make its mark it needs support in gaining fair access to the networks and to getting a fair price for its output. Ofgem therefore established the Microgeneration Forum, which promotes the industry's efforts to develop charging regimes for use of the distribution networks by microgenerators and monitors the distribution network companies' long-term plans. The microgeneration workstream under the Distribution Working Group (part of the Electricity Networks Strategy Group, the industry group looking at issues involved in the transition to a low carbon electricity network) is now being closed down, having achieved its

objectives, signifying that network issues relating to microgeneration have been successfully addressed.

5.29. In response to a request from the Government, Ofgem has reviewed the microgeneration export market to assess whether consumers can easily understand and compare rival suppliers' offers, and switch between them, and whether those offers fairly reflect the underlying value of the microgeneration. We will be publishing a factsheet on export reward in due course.

Sustainable Development Report

5.30. As stated above, in November 2007 we published our second annual report on sustainable development. The report sets out the progress that we have made in encouraging the development of a more sustainable energy industry and the actions we will take in 2008-09. It also looks at the challenges that the industry and government will face in meeting Britain's climate change and sustainability targets.

5.31. We will continue to use this report as a basis for engaging in the wider debate on climate change and for pointing out where Government and other organisations can take action to promote a more sustainable energy system. We will publish our third annual Sustainable Development Report in late 2008. This will again report on progress made on key indicators and give our latest views on the way forward.

'Greening' Ofgem

5.32. In 2002 Ofgem became the first Government Department to achieve certification to the international standard for Environmental Management Systems (ISO14001). We have retained this certification ever since.

5.33. This reflects a sustained drive to reduce our own energy usage and carbon footprint. In 2003, for example, we installed a combined heat and power unit that has since saved well over a thousand tonnes of carbon dioxide (CO₂) and, since April 2007, all of our electricity has been procured from renewable sources. In 2007 our energy saving achievements were recognised by accreditation to the Energy Efficiency Accreditation Scheme (EEAS). The EEAS is an independent award scheme managed by the National Energy Foundation on behalf of the Carbon Trust.

5.34. More detail on the measures we have introduced so far can be found in our Sustainable Development Action Plan which we published in September 2007. We will continue to seek ways of reducing our impact on the external environment.

A five year view

5.35. Climate change is one of the most significant challenges facing the world today. The EU has mandated that 20 per cent of its energy should come from renewable sources by 2020. 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.

5.36. 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.

5.37. 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.

5.38. 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.

5.39. 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 robust 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.

Environmental programmes

Ofgem administers a number of the schemes and arrangements established by the Government as part of 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. In 2008 we will publish a review of the final year of the EEC 2005-08 and in early 2009 we will publish our annual report on the RO.

We have extensive knowledge of the environmental programmes based on our experience of their administration. We have advised the Government and the Devolved Administrations on their proposed reforms of the RO which include the introduction of banding and are due to be implemented in April 2009. We have also worked with Government on the next phase of the EEC – the Carbon Emissions Reduction Target - and we are taking forward amendments to our administrative processes and IT systems in preparation for its implementation in April 2008.

We have made good progress with the planned rebuilding of the IT systems we use to administer the renewables and CHP programmes. We expect that the new system, when completed in 2008, will reduce the administrative burden both on Ofgem and on the renewable energy industry. We will continue to 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 2008-09, 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. The Government's reforms of the RO and EEC will add to the complexity of the schemes and the costs of administering them.

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. We are continuing discussions with Government about future funding arrangements.

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.

Question box

Question 1: Does this theme remain valid?

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

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

Question 4: Should Ofgem revisit the issue of debt blocking to facilitate the participation in the competitive market of customers who are in debt?

Introduction

6.1. Fuel poverty is part of a wider problem of poverty caused by a combination of high energy prices, low incomes and poor housing conditions. As explained in chapter 1, there continues to be pressure on energy prices as a result of global demand, oil price rises and the impact of environmental schemes. Some suppliers will face more pressure than others but any increases in retail prices will create difficulties for lower income customers and risk further rises in fuel poverty. Against this background it remains Ofgem's priority to help ensure that prices are no higher than necessary and to promote energy efficiency that will help customers reduce their energy demand.

6.2. We will continue our market surveillance work, tackling barriers to the effective operation of the markets for all customers, in particular low income and more vulnerable customers. As part of this we will not hesitate to use our powers to tackle any barriers to the effective operation of the market or anti-competitive practices. Particular targets for the coming year will be to revisit suppliers' practice of blocking switching among customers who are in debt and to explore the barriers to switching among customers on lower incomes and on PPMs, supported by research and the results of our pilot study in partnership with the Citizens Advice Bureau.

6.3. Given the wider causes of fuel poverty - low incomes and poor housing as well as energy costs - there will inevitably be a limit to the role that the industry and the regulator can play in tackling it. The main focus should therefore be on raising incomes and improving housing, which are the responsibilities of Government.

6.4. Our research, guidance and encouragement have helped to steer companies towards developing a range of Corporate Social Responsibility (CSR) schemes including 'social' tariffs for low income and other disadvantaged groups. We have

published analysis of suppliers' social programmes to highlight best practice and promote awareness of the help available for vulnerable customers.

6.5. Suppliers have developed energy efficiency products under the EEC. Significant help is available for fuel poor and vulnerable customers from suppliers and from Government programmes. In many cases the savings available from switching supplier could make a significant contribution to alleviating fuel poverty.

6.6. The challenge remains getting the message across to those who most need the help and ensuring that once identified they can benefit from the full range of help available – the 'find and fix' approach. This requires a joined up approach from Government, industry and other agencies. It is also dependent on the Government using its sources of information to improve the targeting of the help available.

6.7. 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 energy prices are truly competitive and as low as they can 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.

6.8. We have previously recommended that the Government introduce funded long term carbon contracts to complement the EU ETS. As set out in chapter 1, environmental measures such as the Carbon Emissions Reduction Target, the RO and Phase II of the EU ETS have resulted in increased energy costs. Given that the cost of these environmental measures has been, and will continue to be, a driver of higher energy costs, we believe that there is also a case for recycling some of the funds raised through the further auctioning of carbon allowances, for example under EU ETS or long term carbon contracts, to help tackle fuel poverty, as well as to invest in further environmental improvement programmes.

6.9. More generally, in developing its approach to climate change, it is essential that Government adopts a truly sustainable approach integrating its thinking on the social implications as it looks at environmental issues. We expect to contribute fully to these important debates.

The next two years

Retail markets

6.10. Higher energy costs and increased retail energy prices 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 what we can to facilitate efforts by the Government and industry to target help more effectively.

6.11. 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 on the scale that would be needed to eliminate fuel poverty are not consistent with a competitive market. The inherent difficulties in targeting such tariffs would lead to significant market distortions. However, we welcome and will continue to promote the CSR initiatives that suppliers have introduced to help their most vulnerable customers. In particular, we will continue to publish annual reviews of suppliers' initiatives in this area to help inform debate, promote best practice and aid consumer advisers in helping consumers understand the offers that exist.

6.12. 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 over the next year and beyond explore the barriers to disadvantaged groups (such as those on low incomes or PPM customers) engaging in the market and what help and advice is most effective in promoting switching among these groups.

6.13. We will continue to monitor switching levels among these groups, seeking to address any barriers we can. In the meantime our work on establishing effective metering competition and facilitating smart metering is important in helping to bring down the costs of servicing PPM customers. As set out in chapter 1, we will continue to monitor the effectiveness of competition in the retail energy market and the impacts on vulnerable and fuel poor customers.

6.14. Our *Consumer First* initiative remains a key programme looking at customer perceptions and giving us greater insight into the views of energy users. In 2008 we will look to build our understanding of the different facets of vulnerability and the issues facing vulnerable customers.

6.15. We will pursue policies that promote greater energy efficiency, which can both help reduce fuel poverty and carbon emissions. We will continue to advise the Government on the evolution of the energy efficiency programmes, including the Supplier Obligation, building on our experience of administering the EEC scheme. Our aim will be to try to ensure that resources are well targeted and that EEC/CERT interacts effectively with fuel poverty programmes such as Warm Front.

6.16. 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. In the supply licence review we considered the potential to remove the facility for suppliers to block switching by customers in debt. This was not pursued in part because of concerns that it could lead to increased levels of security deposits or harsher debt recovery practices. However, we would welcome views on whether we should revisit this issue to facilitate participation of these customers in the competitive market.

6.17. 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.

6.18. With the changes to consumer representation set out in chapter 1 we will pay particular attention to ensuring that the needs of vulnerable consumers are met under the new arrangements.

Networks

6.19. In 2005 we introduced an annual customer service reward scheme for electricity distribution network operators that encourages them to develop best practice in respect of vulnerable consumers, going beyond the formal requirements of their licences. We are introducing a similar scheme for gas distribution network operators as part of the 2008-2013 price control to incentivise initiatives which facilitate network extensions, particularly those which increase the affordability of network extensions for fuel poor consumers.

6.20. We will continue to work with the companies to promote best practice in dealing with vulnerable customers when supplies are interrupted.

A five year view

6.21. The costs of future investment to meet energy needs and measures to reduce carbon emissions are likely to continue to put upward pressure on energy prices.

6.22. 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.

Question box

Question 1: Does this theme remain valid?

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

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

Question 4: Are there any other activities that we should include in the Simplification Plan that we intend to publish in March?

Question 5: Are there any areas of regulation that we should review to ensure that our approach is proportionate to the risk?

Question 6: Are there any areas of regulation that you consider to be an unnecessary burden that should be removed?

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.

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. Across the range of our activities we will consider whether any regulations for which we are responsible impose burdens on licensees that, in the context of our broader statutory duties, are unnecessary and could be removed.

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

Industry codes and licensing

7.5. In November 2007 we published a letter signalling our intention to conduct a review of the various industry code governance procedures. We consider that a governance regime should:

- promote inclusive, accessible and effective consultation;
- be governed by rules and processes that are transparent and easily understood;
- be administrated in an independent and objective fashion;
- provide rigorous and high quality analysis of the case for and against proposed changes;
- be cost effective;
- contain rules and processes that are sufficiently flexible to circumstances that they will always allow for efficient change management; and
- be delivered in a manner that results in a proportionate regulatory burden.

7.6. The review will consider what changes are required in order to deliver these characteristics. We will publish a document setting out the proposed scope of the review in the first half of 2008.

Consumer First initiative

7.7. We will continue our *Consumer First* initiative to help ensure that we are engaging effectively with the priorities of domestic consumers. As stated in chapter 6, we will take forward work on the different issues facing vulnerable customers and seek to understand what methods of giving advice on switching and energy efficiency work best for them. We will also continue to build our understanding of consumers' attitudes to environmental issues and how these attitudes are changing. We will bring this together in a report on 'Future Consumers' in 2008.

7.8. We are also undertaking research on customers' views about electricity distribution companies to inform our decisions on the forthcoming price control review (DPCR5). We recently published the first phase report, based on deliberative groups and in-depth interviews. The second phase, involving quantitative assessment of willingness to pay, will shortly commence and the results will be published in the spring of 2008.

7.9. We continue to see the *Consumer First* project as a timely and important initiative given the restructuring of consumer representation and the rising importance of sustainable development.

Impact assessments

7.10. Ofgem must undertake impact assessments (IAs) for all the important policy proposals that we make. We have developed a rigorous approach in line with best practice, while ensuring that our decisions are consistent with our wider statutory duties. Throughout 2007 Ofgem has been 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. We have consulted on revised guidance and, subject to responses, intend to implement revised guidance in spring 2008.

7.11. As part of this process we have made a new commitment on post-implementation review. Each IA that we publish will state whether we intend to conduct a major post-implementation review after a particular length of time or rely on routine monitoring. Ofgem may undertake a major review exercise where the policy area in question involves major structural changes or changes to the wholesale trading arrangements, or where the outcomes are more difficult to predict through our normal monitoring processes.

Supply licence review

7.12. In 2007 we completed our review of gas and electricity supply licences. The review delivered major benefits to suppliers through reduced administrative burdens and lower costs, which should be passed on to consumers. The new licences benefit consumers by creating a more proportionate and targeted regulatory framework that will encourage suppliers to innovate. We are monitoring outcomes closely and in 2008 will carry out a post-implementation review of the changes to the gas safety checks regime.

Distribution licence review

7.13. We have recently published proposals to streamline the electricity distribution licence. The proposals were developed through an industry working group over the spring and summer of 2007. The intention of this review is not to change the obligations of the licence but to improve its structure and drafting so that it is shorter and easier to use. We expect to complete the review and implement the new licence with effect from April 2008.

Enforcement review

7.14. In 2007 we reviewed our approach to enforcing sectoral, competition and consumer protection law and published a revised statement of our approach. We believe the new approach will allow us to act quickly, effectively and proportionately to the risk to consumers from non-compliance. In 2008 we will review how it is working in practice.

Improving accessibility and transparency

7.15. Over the last couple of years we have redesigned our consultation and decision documents, simplified our industry code modification decision documents and completed the redesign of our website. Internally, we have introduced electronic records management across Ofgem. In 2008 we will review the effectiveness of these changes and consider what more we can do to improve the accessibility of our written product.

Costs and efficiency

7.16. 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 both 2006-07 and 2007-08 by an additional £2.9 million and £0.6 million respectively.

7.17. The RPI-3 cost control regime has led to improved financial discipline in the period to date and we expect to improve considerably on the expected savings of £5 million that the regime was designed to achieve over the full five year period.

7.18. 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. 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 our work.

Simplification Plan

7.19. Appendix 5 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. We welcome views on whether there are other better regulation projects that could be included in the Simplification Plan, especially where this would involve removing unnecessary regulatory burdens.

A five year view

7.20. 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 electricity generation and transmission licences and the gas transporter 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.

7.21. 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 2009-10 we will determine new arrangements for cost savings in 2010-11 and beyond.

Appendices

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Appendix 1 - Consultation questions and how to respond

1.1. Ofgem would like to hear the views of interested parties in relation to any of the issues set out in this document. We would especially welcome responses to the specific questions which we have set out at the beginning of each chapter heading and which are replicated 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 Ofgem include any other activities in its Simplification Plan?

Question 5: 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 6: Are there any areas of regulation that constitute an unnecessary burden that should be removed?

1.2. Responses should be received by 22 February 2008 and should be sent to:

Andy MacFaul
Head of Better Regulation
Ofgem
9 Millbank
London SW1P 3GE

Email: andrew.macfaul@ofgem.gov.uk.

1.3. Unless marked confidential, all responses will be published by placing them in Ofgem's library and on its website www.ofgem.gov.uk. Respondents may request that their response is kept confidential. Ofgem shall respect this request, subject to any obligations to disclose information, for example, under the Freedom of Information Act 2000 or the Environmental Information Regulations 2004.

1.4. Respondents who wish to have their responses remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if responses could be submitted both electronically and in writing. Respondents are asked to put any confidential material in the appendices to their responses.

1.5. Having considered the responses to this consultation, the Authority will publish its Corporate Strategy and Plan by the end of March 2008. Any questions on this document should, in the first instance, be directed to Andy MacFaul using the contact details set out above or by phoning him on 020 7901 7083.

Appendix 2 - The Authority's powers and duties

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

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

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.²

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;³ and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁴

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 licensed⁵ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;

¹ Entitled "Gas Supply" and "Electricity Supply" respectively.

² 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.

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

⁴ The Authority may have regard to other descriptions of consumers.

⁵ Or persons authorised by exemptions to carry on any activity.

- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity;
- contribute to the achievement of sustainable development; and
- secure a diverse and viable long-term energy supply.

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

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

1.8. The Authority has powers under the Competition Act to investigate suspected anti-competitive activity and take action for breaches of the prohibitions in the legislation in respect of the gas and electricity sectors in Great Britain and is a designated National Competition Authority under the EC Modernisation Regulation (Council Regulation (EC) 1/2003) and therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

Appendix 3 - Deliverables and performance indicators 2008-2009

Deliverables 2008-2009

Creating and sustaining competition

Activity	Action	Period
GB Markets – Market monitoring and development	Publish 2008 Energy Markets Outlook report	Q3
GB Markets – Market monitoring and development	Publish final Winter Outlook	Q3
GB Markets – Market monitoring and development	Publish proposals for SO incentives to apply from 1 April 2009	Q4

Regulating networks effectively

Activity	Action	Period
Transmission	Transmission Access Review final report	Q1
Transmission	LENS - final report	Q1
Transmission	Offshore Final Proposals document	Q2
Transmission	Transmission Licensee Regulatory Report	Q4
Gas Distribution	Cost reporting - publication of first year of data	Q3
Electricity Distribution	Publish Customer survey phase 2 report	Q2
Electricity Distribution	Publish cost review report	Q3
Electricity Distribution	Publish Quality of Supply report	Q3
Electricity Distribution	Publish DPCR5 policy paper	Q4
Connections	Publish update on connections review implementation	Q2
Gas Distribution	Quality of supply report	Q3

A leading voice in Europe

Activity	Action	Period
European Strategy and Sustainable Markets	Contribution to GRI - Internal and External Reporting	Q1
European Strategy and Sustainable Markets	Contribution to ERI - Internal and External Reporting	Q2
European Strategy and Sustainable Markets	Implement GRI transparency proposals	Q3
European Strategy and Sustainable Markets	Implement ERI Balancing proposals either through CODE Modifications or Procurement guidelines	Q3
European Strategy and Sustainable Markets	Ensuring the Implementation of the Inter TSO charging mechanism	Q3

Helping to achieve sustainable development

Activity	Action	Period
Sustainable Development	Publish 3rd Sustainable Development Report	Q3
European Strategy and Sustainable Markets	Decision on measures for Distributed Energy	Q1
European Strategy and Sustainable Markets	Implementation of final Distributed Energy proposal	Q3

Environment programmes

Ofgem administers a number of environmental programmes on behalf of the Government. The deliverables associated with this work for 2008-09 are as follows:

Activity	Action	Period
Renewables and CHP	Publish a review of the final year of the Energy Efficiency Commitment 2005-08	Q2
Renewables and CHP	Publish annual report on Renewables Obligation	Q4

Helping to tackle fuel poverty

Activity	Action	Period
Social and Consumer Affairs	Update on Vulnerable Customer Switching	Q4

Better regulation

Activity	Action	Period
Fossil Fuel Levy	Set the Fossil Fuel Levy Rate for 2009-2010	Q3
Better Regulation	Post-implementation review on gas safety check licence changes	Q2
Better Regulation	Publish a review of the final year of the Energy Efficiency Commitment 2005-08	Q2
Industry Codes and Licensing	Publish Way Forward on Governance Review	Q1
Social and Consumer Affairs	Set complaint handling standards	Q1
Social and Consumer Affairs	Report on Future Consumers	Q3

Performance indicators 2008-2009

Activity	Measure	Target	Timing
GB Markets - Market monitoring and development	Consult on applications made for exemption from Regulated Third Party Access 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 relating to any Income Adjusting Event within three months of it being raised if adequate information is provided	100%	
European Strategy and Sustainable Markets	Representing Ofgem at regular meetings of RCC		Ongoing
	Facilitate and manage quarterly meetings of the Sustainable Development Sub Committee ensuring that the relevant sustainability issues are brought to the attention of the group for consideration		Quarterly
	Chairing the CEER sustainability taskforce		Bi-monthly
	Representing Ofgem at numerous public speaking engagements on a range of European and sustainability engagements		Ongoing
Industry Codes and Licensing	Industry codes decisions made within 25 working days	70%	
	Grant 90% of competitive licence applications within 8 weeks of receipt	90%	
Social and Consumer Affairs	Respond substantively to customer contacts	93%	10 Working Days
Enforcement	Respond to complaints on enforcement matters confirming whether we will investigate	90%	4 Weeks
Better Regulation	Pay undisputed bills	98%	
	Respond to Freedom of Information queries	90%	10 Working Days

Environment programmes

Activity	Measure	Target	Timing
Renewables and CHP	Respond to suppliers who have submitted schemes for approval	100%	
	Follow up with generators outstanding issues in their accreditation applications	100%	
	Complete reconciliation of CHP LECs	100%	
	Recycle the RO buy-out funds	100%	

Appendix 4 - Ofgem budget 2008-2013

BUDGET TABLE £m	RPI-X Five Year Cost Control Period								
	2005-06 Outturn	2006-07 Outturn	2007-08 Planned	2007-08 Provisional Outturn (1)	2008-09 Planned	2009-10 Planned	2010-11 Planned	2011-12 Planned	2012-13 Planned
Costs By Theme									
Creating & sustaining competition	5.2	5.6	4.9	0.0	4.5	4.1	4.0	4.2	4.2
GB Markets – monitoring/development	2.9	3.2	2.5		2.4	2.0	2.0	2.0	2.1
Connections	0.3	0.4	0.3		0.3	0.3	0.3	0.4	0.4
Industry Codes and Licensing (2)	1.0	1.1	1.1		0.9	0.8	0.8	0.8	0.8
Enforcement and Consumer Affairs (2)	1.0	0.9	1.0		0.9	1.0	0.9	1.0	0.9
Regulating network monopolies	9.4	10.7	8.9	0.0	9.6	8.9	9.2	9.7	8.7
Transmission	5.2	4.0	2.3		3.1	2.7	3.7	3.8	2.7
Electricity Distribution	1.4	1.6	2.3		2.8	2.6	1.9	1.7	1.7
Gas Distribution	0.8	2.8	2.1		1.6	1.5	1.5	2.1	2.2
Technical Policy(2)	1.1	1.4	1.3		1.2	1.2	1.2	1.2	1.2
Technical Statutory(3)	0.9	0.9	0.9		0.9	0.9	0.9	0.9	0.9
Offshore Tender Team	0.0	0.0	0.0		3.1	5.4	3.5	2.7	2.7
Offshore Tender Team Recharge	0.0	0.0	0.0		(3.1)	(5.4)	(3.5)	(2.7)	(2.7)
Security of Britain's energy supplies	1.2	1.3	1.3	0.0	1.2	1.0	1.0	1.0	1.0
Security of Supply (4)	1.2	1.3	1.3		1.2	1.0	1.0	1.0	1.0
A leading voice in Europe	1.2	1.5	1.0	0.0	1.0	1.2	1.2	1.0	1.1
Europe (5)	1.2	1.5	1.0		1.0	1.2	1.2	1.0	1.1
Helping to achieve SD	1.8	2.5	2.5	0.0	2.6	2.3	2.3	2.4	2.4
Environmental Programmes (6)	1.4	2.0	2.1		2.1	1.8	1.8	1.9	1.9
Environmental Policy	0.4	0.5	0.4		0.5	0.5	0.5	0.5	0.5
Helping to tackle fuel poverty	0.3	0.3	0.4	0.0	0.4	0.4	0.4	0.4	0.4
Social & Consumer Affairs	0.3	0.3	0.4		0.4	0.4	0.4	0.4	0.4
Better regulation	0.3	0.5	0.2	0.0	0.2	0.2	0.2	0.2	0.2
Better Regulation	0.3	0.5	0.2		0.2	0.2	0.2	0.2	0.2
Sub Total	19.4	22.4	19.2	0.0	19.5	18.1	18.3	18.9	18.0

£m	RPI-X Five Year Cost Control Period						2010-11	2011-12	2012-13
	2005-06	2006-07	2007/08	2007-08	2008-09	2009-10			
Other Costs	Outturn	Outturn	Planned	Provisional outturn (1)	Planned	Planned	Planned	Planned	Planned
Executive/Support/Overheads	7.9	7.9	8.9	0.0	8.4	8.7	8.4	8.7	8.7
Strategy and Direction	1.3	1.0	1.1		1.1	1.1	1.2	1.2	1.2
Corporate Comms and Scottish office	1.2	1.3	1.4		1.6	1.6	1.7	1.7	1.7
Finance	0.7	0.8	0.8		0.8	0.9	0.9	1.0	1.0
Human Resources	2.0	1.0	1.1		1.1	1.1	1.1	1.3	1.3
HR Graduate Scheme	0.0	0.0	0.4		0.4	0.4	0.5	0.5	0.5
Corporate Services	2.7	2.8	2.8		2.8	3.0	3.0	3.0	3.0
Restructuring	0.0	1.0	1.3		0.6	0.6	0.0	0.0	0.0
Accommodation	4.5	4.6	5.1	0.0	5.0	5.0	5.0	5.0	5.0
Gross	8.4	8.3	8.5		8.7	8.7	8.7	8.7	8.7
Recharge	(3.9)	(3.7)	(3.4)		(3.7)	(3.7)	(3.7)	(3.7)	(3.7)
Other	0.1	(0.2)	2.4	0.0	2.1	3.1	3.6	3.6	3.6
Depreciation	0.9	0.9	0.9		0.9	0.9	0.9	0.9	0.9
Anticipated developments	0.0	0.0	2.3		2.0	3.0	3.5	3.5	3.5
Other Income	(0.8)	(1.1)	(0.8)		(0.8)	(0.8)	(0.8)	(0.8)	(0.8)
Sub Total	12.5	12.3	16.4	0.0	15.5	16.8	17.0	17.3	17.3
TOTAL COSTS	31.9	34.7	35.6	0.0	35.0	34.9	35.3	36.2	35.3

(1) Provisional outturn will be completed for the March final publication.

(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 National Weights and Measures Laboratory (NWML) but Ofgem currently retains statutory and financial responsibility for this activity. A full transfer of responsibility to NWML is planned under the Energy Bill currently going through Parliament.

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

(5) The reduction in spend in Europe was due to two members of staff finishing secondments at the European 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.

2007-08 Provisional spend analysis

1.1. This column will be completed in March when provisional outturn figures are known, and will be included in the final version of the Corporate Plan along with an explanation of any major variances between planned and actual expenditure. We fully expect to meet our RPI-3 per cent cost control regime target of £34.3 million for 2007-08.

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, and three further years 2010-11 to 2012-13. As with the last two budgets, 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 2007-08, we expect to fully utilise the £2.3 million contingency. This includes additional costs primarily associated with the Competition Commission legal challenge and consultancy support to policy areas.

1.4. In 2008-09, Ofgem proposes to set the contingency for future developments at £2.0 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 decrease by £0.6 million from 2007-08 to 2008-09. This is largely due to the completion of the gas distribution price control in 2007-08 and a budget reduction of restructuring costs

Offshore electricity transmission

1.6. Government plans currently propose that Ofgem will be responsible for administering on behalf of BERR the tender process for the award of transmission licences to offshore transmission owners.

1.7. Costs associated with the offshore tender administration are shown in the above budget table. It is planned that these costs will be recovered through fees associated with the tender process rather than by Ofgem's normal licence fee payers.

Environmental programmes

1.8. As set out in chapter 5, Ofgem also administers a range of environmental programmes on behalf of other government departments. Our projected costs of administering these programmes in 2008-09 are shown in the table below.

Renewable Obligation	£1.0
Energy Efficiency Commitment	£0.5
Non-Fossil Fuel Obligation	£0.1
Climate Change Levy Exemption for Renewables & CHP	£0.4
Renewable Energy Guarantees of Origin	<u>£0.1</u>
Sub-total	£2.1
Overhead & support costs	<u>£1.0</u>
Total	£3.1

RPI-3 per cent cost control regime

1.9. RPI was determined as 3.5 per cent for 2005-06, 2.2 per cent for 2006-07 and 4.4 per cent for 2007-08. 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
RPI-3 % budget ceiling	34.2	33.9	34.3	34.1	34.0

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

1.11. The budget ceilings give rise to anticipated savings of approximately £1.0 million per year, and approximately £5.3 million over the period of the RPI-3 per cent regime. For 2005-06 and 2006-07, the planned savings of £1.1 million were achieved. In addition, extra savings of £2.9 million and £0.6 million were achieved and returned to licence fee payers in 2006-07 and 2007-08 respectively.

BUDGET/RPI-3 PER CENT COST CONTROL RECONCILIATION					
(£ million)	2005-06 Outturn	2006-07 Outturn	2007-08 Planned	2008-09 Planned	2009-10 Planned
Total costs as per budget table	31.9	34.7	35.6	35.0	34.9
Costs excluded (funded by licensees)					
Administering Environmental Programmes (net)	(0.4)	(1.3)	(1.2)	(0.8)	(0.8)
Depreciation	(1.2)	(0.9)	(0.9)	(0.9)	(0.9)
Costs excluded (funded by non-licensees)					
Administering offshore tender process – gross costs	0	0	0	3.1	5.4
Administering offshore tender process – recharge income	0	0	0	(3.1)	(5.4)
Costs included (funded by HM Treasury)					
Capital	1.0	0.8	0.8	0.8	0.8
Total adjusted costs	31.3	33.3	34.3	34.1	34.0
RPI-3 per cent budget ceiling	34.2	33.9	34.3	34.1	34.0
Variance	(2.9)	(0.6)	0.0	0.0	0.0

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

Appendix 5 - Proposed 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 drive to reduce regulatory burdens while ensuring consumer protection, we published our first Simplification Plan in March 2006.

1.2. We set out below our latest Proposed Simplification Plan that outlines the work that we will undertake in 2008-09 under the banner of better regulation.

Process initiatives

Initiative	Outcome	Current status/ milestone
Review Ofgem's approach to Impact Assessments	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	Consulting on revised guidance. We are aiming to introduced the revised guidance in spring 2008
Review Ofgem's approach to enforcement	Ensure that our approach is proportionate to the risk to consumers from non-compliance	We published our revised guidance in September 2007. We will review how the new approach is working in 2008
Ofgem RPI-3 cost control for the period 2005-10	Improve Ofgem's internal efficiency. Savings will benefit licensees via reduced fees	We have so far beaten our target and as a result reduced the licence fees payable in 2006-07 and 2007-08 by an additional £2.9 million and £0.6 million respectively
<i>Consumer First</i> project: to improve our engagement with the priorities of domestic consumers	Better understanding of the domestic consumer's perspective, especially on sustainability issues	Ongoing. The focus in 2008 will be on vulnerable customers and attitudes to the environment. We have commissioned research on electricity distribution issues and green tariffs
Memorandum of Understanding with other EU Member State gas regulators	Promote closer working by national regulators on cross-border issues, to the benefit of customers	We have signed the Memorandum and it took effect in October 2007

<p>Project Paperless:</p> <p>Establishment of an Editorial Board to with remit to include:</p> <ul style="list-style-type: none"> - a review of the quality and quantity of print and electronic publications; and - a review of the success of Project Paperless and to consider options for a second phase to the project 	<p>Benefits all stakeholders who will need to spend less time and effort working through Ofgem documents</p>	<p>Implemented from December 2007</p>
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Policy initiatives

Initiative	Outcome	Current status/ milestone
<p>Industry Code governance review: to consider whether improvements can and should be made to the existing code arrangements in electricity and gas</p>	<p>We will examine whether the code arrangements can be improved and whether there are any unnecessary regulatory burdens that can be removed</p>	<p>In November 2007 we published a letter seeking views on the scope of the review. In due course, if the review prompts the development of proposals for altering the code governance regime, we will consult on them</p>
<p>Creating a Uniform Network Code for independent Gas Transporters</p>	<p>Reduced the burden imposed by the need for stakeholders to deal with multiple documents</p>	<p>Implemented on 1 May 2007</p>
<p>Supply licence review</p>	<p>Significantly reduced administrative burden and compliance costs for suppliers. Reduced entry barriers. Benefits suppliers and customers</p>	<p>Implemented. The supply licence is half the length it was. We are monitoring the effects of the changes and will conduct a post-implementation review in relation to gas safety</p>
<p>Review of the guaranteed and overall standards on suppliers</p>	<p>Subject to the consent of the Secretary of State, implement proposals that are consistent with better regulation principles</p>	<p>We will consult on whether the standards should be removed given that competition in retail markets is effective</p>

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
Streamlined approach to the 2010-15 electricity distribution price control	Reduced administrative burden for electricity distribution businesses	Take forward in 2008
Review the electricity distribution licences	Ensure that they remain fit for purpose	Consulted on proposals in October 2007. Workshop held in late November. Expected to complete in March 2008
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
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 6 - 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:

1. Do you have any comments about the overall process, which was adopted for this consultation?
2. Do you have any comments about the overall tone and content of the report?
3. Was the report easy to read and understand? Could it have been better written?
4. To what extent did the report's conclusions provide a balanced view?
5. To what extent did the report make reasoned recommendations for improvement?

1.2. Please send your comments to:

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