

Proposed Corporate Strategy and Plan 2009-2014

Document type: Consultation

Ref: 02a/09

Date of publication: 16 January 2009

Deadline for response: 27 February 2009

Target audience: All stakeholders

Overview:

In August 2008, 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, which has been developed in the light of responses to that letter.

In November 2008 Parliament changed our statutory duties. Revised Government guidance on social and environmental matters will follow in the spring. We have reflected these developments in our strategy, for example by setting out a wide range of activities that we believe will contribute to achieving a more sustainable energy sector.

Parliament has legislated at a time of great financial and economic uncertainty. Ofgem is keenly aware of the need to protect the interests of energy consumers while maintaining a stable regulatory framework in order to continue to attract investment into the gas and electricity sectors. We would welcome views on whether our strategy strikes the right balance.

We will consider the responses to this consultation and finalise our strategy in March. We will publish our strategy at the end of March.

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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 2009-14 initial consultation letter, August 2008 and the responses to the consultation letter, September 2008
<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/Corporate%20Strategy%20open%20letter%202008.pdf>
- Corporate Strategy and Plan 2008-13
<http://www.ofgem.gov.uk/About%20us/CorpPlan/Documents1/CORPORATE%20STRATEGY%20AND%20PLAN%2028%20MARCH%202008.pdf>

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Introduction

In August 2008, 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. This 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 achieve sustainable development
4. Helping to protect the security of Britain's energy supplies
5. A leading voice in Europe
6. Helping to tackle fuel poverty
7. Better regulation

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

Ofgem's principal objective in carrying out its functions is to protect the interests of consumers, existing and future, wherever appropriate by promoting effective competition. We promote competitive solutions wherever appropriate, but direct regulation of network monopolies is essential to protect the interests of consumers.

Ofgem must carry out its functions in the manner best calculated to further the principal objective, having regard to the need to secure that all reasonable demands for electricity and gas are met, the need to secure that licensees can finance their authorised activities, and (when the new Energy Act 2008 duty commences) the need to contribute to achieving sustainable development. In performing that duty, Ofgem must have regard to the needs of vulnerable customers.

Ofgem has other important duties. These include securing diverse and long term supplies and having regard to the principles of best regulatory practice. In addition, we must have regard to guidance issued by the Secretary of State for Energy and Climate Change on social and environmental matters. This guidance is currently being revised. Appendix 5 gives more details of our statutory objectives and duties.

Appendix 2 sets out our deliverables and performance indicators for 2009-10, which provide the practical targeting of activities to achieve the broader objectives of the seven themes. Appendix 3 sets out Ofgem's budget for the period 2009-14.

Appendix 4 contains a draft Simplification Plan setting out the work that we propose to undertake in 2009-10 in support of the better regulation agenda and in particular our new duty in respect of regulatory burdens under the Regulatory Enforcement and Sanctions Act 2008. We would welcome any other suggestions that you might have.

Appendix 6 provides a glossary of technical terms used in the document. Appendix 7 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

Our energy supply probe identified a number of areas where the transition to fully effective competition needs to be accelerated. We are seeking agreement with suppliers on the proposed reforms. If they do not agree, we can make a market investigation reference to the Competition Commission. We will continue to monitor the energy markets to make sure that they are operating in the interests of all energy consumers. We will periodically publish information and analysis to inform the debate on issues such as wholesale market transparency, liquidity and the role of large customers in the market. We will continue to seek to reduce barriers to smart metering and microgeneration.

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

Retail markets

1.1. In February 2008 Ofgem launched its study of the state of the British energy supply markets (the probe). The probe was undertaken against the background of unprecedented increases in world fuel prices, which flowed through into record increases in wholesale and retail gas and electricity prices in Great Britain.

1.2. A typical household's energy bills have more than doubled since early 2004 and many households are now struggling to pay their energy bills. The number of consumers in debt to their energy suppliers, average debt levels and disconnection rates are all rising. These energy price rises have come at a time when household budgets are under pressure from the rising cost of food, petrol, mortgages and other essentials. Vulnerable consumers and those in fuel poverty are particularly affected. As fuel prices, wholesale energy costs and the costs of environmental compliance rise, it becomes even more vital that energy retail markets function properly because the potential adverse impact on energy consumers of any inefficiency is greater.

1.3. In September 2008 we published the findings of our probe. Ten years after British energy markets were opened to full retail competition, and six years after the domestic supply price controls were removed, we concluded that the fundamental structures of a competitive market were in place and that the transition to effective competition was well advanced and continuing. The market shares of the 'Big 6' suppliers in their former monopoly markets continue to fall year-on-year, though these markets remain highly concentrated. There are greater levels of competitive activity and consumer switching than almost every other energy market in the world and most other service markets in the United Kingdom (UK).

1.4. Suppliers compete actively for those consumers who seek out the best deal in the market. Dual fuel, direct debit tariffs offer the lowest prices. Around 8.5 million consumers benefit from these deals, which represents 38 per cent of all consumers with both gas and electricity supplies. Suppliers have also considerably widened the range of tariffs available. They offer fixed, capped or variable prices, green energy deals, social tariffs, energy service packages, and other incentive and reward deals. Around 4 million consumers have benefited from fixed or capped price deals.

1.5. Concerns were expressed that the Big 6 operate as a cartel. We examined very carefully whether this was the case and are satisfied that the suppliers' key pricing decisions are made independently and without unlawful agreements or information exchange between them. Suppliers do consider the pricing policies of their competitors and possible reactions to price changes but this is a normal feature of a competitive market that we would expect to see.

1.6. We did, however, find a number of areas where the transition to competition needed to be accelerated. Many consumers are not yet benefiting fully from the competitive market. Vulnerable consumer groups are disproportionately affected. We therefore consulted on a package of measures designed to tackle these issues. We remain convinced that consumers benefit most from a vibrant competitive market and our proposals are intended to improve the functioning of the market. We have since consulted on specific proposals to address the unfair price differentials that we identified in our initial report.

Wholesale markets

1.7. As part of the probe, we examined the manner in which wholesale price changes have been passed through to consumers by the Big 6. There is clear evidence of a lag between changes in wholesale and retail prices. This is largely the result of suppliers hedging their wholesale market exposures. We have found no evidence that this lag is greater when prices are falling than when they are rising.

1.8. There is evidence that the Big 6 benchmark their hedging strategies against each other in order to minimise the risk of their wholesale costs diverging materially. We are therefore concerned that hedging might not be adequately driven by the risk preferences of consumers. We will monitor price changes over the coming months, during which wholesale prices are likely to remain volatile, and have committed to publish quarterly reports on the relationship between wholesale and retail prices.

1.9. During the probe, small suppliers and potential new entrants highlighted price volatility and a lack of liquidity in the wholesale electricity market. They also raised concerns about the operation of the functioning of the wholesale market itself. We are as a matter of urgency undertaking work to identify both the underlying causes of low market liquidity and any actions that would improve liquidity. We are also exploring the issues raised by the Business and Enterprise Select Committee in its report last summer on energy prices. We need to be certain that the vertically integrated industry structure does not exacerbate liquidity problems or distort long-term investment decisions in wholesale businesses.

The next two years

Retail markets

1.10. As stated above, the probe found that the transition to effective competition was well advanced but that in some areas the transition needed to be accelerated. For example, there is no significant 'competitive fringe' - companies of a markedly different scale and business model offering a material threat to the Big 6. We proposed measures to facilitate efficient market entry. Consistent with our better regulation duties, we are reviewing existing regulatory obligations to gauge whether they deter new entry and growth and, if they do, whether they might be removed or made less onerous.

1.11. The level of consumer participation in British energy supply markets is amongst the highest of any retail energy market in the world. However, we want to build on this by running a sustained customer awareness programme of the benefits of switching and examining the scope for simplifying the switching process. We are also pursuing measures to help more consumers engage actively with the market and to make well informed switching decisions. We are considering requiring suppliers to provide clearer information on bills about a customer's existing tariff and an annual statement. We are also working with consumer groups and suppliers to develop a simple price metric to enable consumers to compare prices quickly and easily. We are also considering whether to require suppliers to provide consumers with a written quotation and comparison with the consumer's current price.

1.12. Encouraging more consumers to participate actively in the market and improving the quality of switching decisions should intensify competitive rivalry among suppliers and erode unfair price differentials. However, we consider that in order to prevent unfair pricing in the short- and medium-term it may be necessary to introduce a new licence requirement on suppliers not to discriminate unduly when setting charges for different payment types. As noted above, we have therefore consulted on specific proposals to tackle unfair price differentials.

1.13. Even after unjustified price differentials are removed, PPM tariffs will remain amongst the most costly. It will be essential to ensure that PPM customers are aware of the price premium and that they can switch to a lower cost option as easily as possible. Improving the direct selling experience for all consumers should benefit PPM customers in particular.

1.14. The probe identified several concerns that particularly affect vulnerable groups. For example, low income groups are disproportionately higher users of PPMs and may also be prevented from switching by their existing suppliers if they are in debt. We are considering restricting the right of suppliers to prevent switching by indebted customers. More broadly, we will review the assistance that suppliers provide to vulnerable customers, including considering whether supplier obligations on debt and disconnection remain appropriate.

1.15. In the small business markets, we will pursue a range of measures to help small customers engage more effectively in the market, including requiring suppliers to inform small business customers in writing of the key terms of their contracts and establishing a code of practice to govern the objections regime.

1.16. In December we considered the responses to the consultation on our probe findings alongside recent pricing announcements by the Big 6. The suppliers agreed with our probe finding that many disadvantaged households have been paying unfair prices. Since the probe began the premiums paid by customers, including PPM users, have been reduced by more than £300 million. The Big 6 have also indicated that further reductions of at least £200 million will apply to more than four million households off the gas grid and others we identified as missing out on the best deals. While a number of companies have already delivered some of these savings, we have not been satisfied with the overall pace of delivery.

1.17. We have therefore consulted on licence changes prohibiting unjustified pricing with a number of options put forward for a six-week consultation starting in January. These proposals will ensure that consumer interests are better protected. The consultation ends in mid-February. If sufficient progress is not made following consultation, we will consider further action, which could involve a full market investigation reference to the Competition Commission.

1.18. The consultation that closed in December confirmed our initial findings. As well as the January consultation on licence changes, Ofgem is moving forward with the full package of remedies identified in the probe report. As noted above, these include tightening rules on sales and marketing activities, helping small businesses and powers to tackle market abuse. We are also vigorously investigating new complaints that have been made in relation to the substantial increases in direct debit payment levels introduced by some suppliers. As stated above, we will seek agreement with suppliers on the proposed reforms so that they can benefit consumers as soon as possible. In the event that suppliers agree to the package, much of our activity in 2009-10 will be directed towards implementing the proposals.

1.19. In October 2008 the Government introduced new arrangements for domestic and small business consumer representation in the energy sector. At the same time Ofgem introduced stringent new complaints-handling standards for energy suppliers. The new arrangements strengthen the incentives on suppliers to establish effective internal procedures for dealing with consumer complaints. We are auditing suppliers' practices and it is open to us to impose financial penalties on suppliers that fail to comply with the standards.

1.20. We will continue to liaise closely with Consumer Direct, Consumer Focus and the Energy Ombudsman as necessary to ensure that the arrangements operate in the interests of consumers. In 2009 we will carry out a review of how the new statutory ombudsman arrangements are working after a year of their operation and will follow up on the findings from our complaint-handling standards audit.

1.21. Theft of electricity and gas increases the cost of energy to honest customers. It can also endanger lives and property. In 2009-10 Ofgem will develop and consult on proposals to strengthen the incentives on industry participants proactively to detect and minimise theft. There are also linkages to existing price control incentives on electricity and gas distribution companies to reduce losses. We will aim to publish final proposals in late 2009 to align with the timetable for DPCR5.

Wholesale markets

1.22. Increases in wholesale energy prices have been by far the most significant driver of the recent unprecedented price increases faced by domestic consumers. Around 65 per cent of retail prices are accounted for by wholesale electricity and gas costs. The vast majority of these costs (more than 50 per cent of the final bill) arise from international energy commodity markets in coal, oil, gas and carbon. These are drivers over which Ofgem has limited influence. Higher wholesale gas prices in part reflect the decline in supplies from the North Sea and the higher costs of importing gas over longer distances. Several major new gas storage and import infrastructure projects will be completed in the next few two years and this is likely to affect the wholesale price.

1.23. Liquidity in the wholesale electricity market is low compared to other traded energy markets, including our own gas wholesale market. As a result, many small suppliers cannot always trade the products they need to hedge the requirements in both the short and longer-term. A closely related issue is the degree of vertical integration in electricity markets. Integrated companies use their generation plant as a hedge for their retail businesses. Non-integrated suppliers should be able to emulate that through trading in accessible and liquid wholesale markets. However, if liquidity is insufficient, the use of generation capacity to hedge retail profitability is likely to exacerbate the hedging difficulties faced by non-integrated suppliers.

1.24. Ofgem intends to focus on improving wholesale market liquidity directly. In 2009 we will develop and consult on proposals to improve wholesale market liquidity. In addition, we will continue to monitor the wholesale electricity market to make sure that there is no evidence of anti-competitive behaviour. We have also stated our desire for new powers to tackle potential abuses in wholesale energy markets.

1.25. The wholesale market rules that determine the imbalance ('cash-out') prices can have a significant impact on wholesale market liquidity and prices. In October 2008 we approved a modification to the Balancing and Settlement Code on the basis that it represented an improvement to those rules. However, that modification did not address all the defects of the current arrangements. While we recognise that some market participants would like to see a period of stability in the cash-out arrangements, we consider that there remains scope for further improvement. Specifically, we believe that issues such as the targeting of reserve costs, the cash-out price spread, the timing of gate closure and contract notifications would warrant consideration in any future modification proposals. In 2009 we will take forward work to reform these arrangements with a view to reducing their complexity and improving the economic signals on market participants to balance their energy positions efficiently.

1.26. Ofgem has for several years expressed concerns about the operation of continental European gas markets and the impact on British wholesale gas prices. The third package of energy market reforms described in chapter 5 will drive significant pro-competitive changes across the European Union (EU). We are working to accelerate implementation of the key reforms, such as improving the transparency of cross-border flows.

1.27. Given the increasing level of interconnection between Britain and continental gas markets, we have stepped up our monitoring of EU (and global) gas markets. Such monitoring is especially important when prices are high and consumers want reassurance that their bills reflect market fundamentals and are not being artificially inflated either in Britain or by companies operating abroad.

1.28. The industry has for some time been considering how to improve the cash-out arrangements in the event of a gas supply emergency. We are considering whether there is a need to strengthen price signals during an emergency.

Metering

1.29. The Energy Act 2008 contains a power for the Secretary of State to mandate a roll-out of smart meters across Britain by 2020. We welcome this development. Ofgem believes smart metering has the potential to bring great benefits to energy consumers. Smart meters could put an end to estimated bills and on-site meter reading. They could also provide consumers with the information that they need to become more energy efficient. This could deliver reduced bills and reduced carbon emissions, thereby helping to tackle climate change and fuel poverty simultaneously.

1.30. We will advise DECC with a view to ensuring that smart meters are introduced in a cost-effective manner that maximises the benefits to consumers. We will also continue our work with industry to agree minimum standards for smart meters and on general interoperability issues.

1.31. On behalf of the Government and industry, Ofgem is managing a three year Energy Demand Research Project to trial better billing and a range of smart meter technologies. The project is assessing customers' long term response to better information on their energy use and the effectiveness of different interventions in delivering energy savings. The trial involves around 50,000 households across Great Britain, including specific customer segments such as the fuel poor.

1.32. We will use the results of this trial to inform our policy advice to the government about the roll-out of smart metering. As has already been recognised, the introduction of smart metering has implications for consumer protection (for example by enabling remote disconnection). Ofgem will take forward work, with DECC, on any changes that may be needed to ensure that consumers are appropriately protected.

Distributed energy

1.33. Distributed energy can make a large contribution towards reducing carbon emissions from the energy sector. Local electricity generation cuts losses of electricity as it is transmitted over long distances from large power stations. In 2008 we introduced proposals to remove barriers to distributed energy within the existing marketing and licensing arrangements. This will make it easier for community electricity generators to supply customers while protecting consumer rights to switch supplier. We will monitor the impact of the changes closely.

1.34. As set out in chapter 2, we have sought to promote changes to the structure of electricity distribution charges that would, inter alia, encourage the growth of distributed energy. We will seek to make further progress in 2009. We will also advise the Government in relation to any proposals that it brings forward for the introduction of feed-in tariffs for small-scale generation using its new powers under the Energy Act 2008. We may in due course have a role in administering feed-in tariffs as part of our growing role of administering Government sustainable development programmes (see chapter 3 for details).

A five year view

1.35. It is not appropriate for Ofgem to try to predict the evolution of a competitive market. Capital market competition and corporate transactions can drive efficiencies but must not be allowed to diminish the competitive pressures on energy companies. We will continue to examine the implications of energy sector mergers and will advise the relevant competition authorities of any concerns that we might have.

1.36. We expect that competition will continue to develop in the provision of bulk supplies of gas, electricity generation, wholesale markets and retail energy markets. We will monitor these markets actively to ensure that participants are acting consistently with competition and sectoral legislation. We will make sure that the resources we devote to this work remain appropriate as the markets evolve.

1.37. We will continue to promote retail market competition as the best means of protecting the interests of consumers and will continue to take full account of our other duties, including those relating to sustainable development, vulnerable consumers and security of supply. We will continue to advise the Government on how to manage the transition to a low carbon energy sector in the most cost-effective way. As part of this, we will work closely with DECC on the efficient introduction of smart metering.

1.38. Looking further ahead, the retail market might change quite radically with a growing focus on energy efficiency and reducing demand. We will consider how the regulatory framework might develop in order to facilitate the emergence of energy service companies.

2. Regulating networks effectively

Chapter Summary

Ofgem considers that incentive-based regulation is the best framework for regulating the energy network companies. However, the *RPI-X at 20* review will objectively evaluate the strengths and weaknesses of our approach to network price controls. The team will report in 2010 on whether that approach remains the best means of incentivising the companies to invest in their networks, maintain security of our energy supplies and tackle climate change. Ofgem will work with the industry to facilitate the connection of new, lower carbon generation to the transmission and distribution networks. We will develop price controls that encourage the electricity distribution companies to play their full part in tackling climate change. We will promote cost-reflective network charges and take decisions 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 transmission and distribution activities because duplication of networks would substantially increase consumers' bills. Regulation of network monopolies is therefore necessary to protect the interests of consumers. Regulation of networks encompasses revenue controls on network businesses; the structure and level of network charges paid by network users; incentives on quality of service; and ring-fencing the licensed network businesses so that they have adequate resources to meet the networks needs and are shielded from any financial difficulties that may be experienced by a parent company. It also means developing policies to help the network companies play their part in making the energy sector more sustainable.

2.2. Incentive-based regulation encourages network companies to deliver a variety of outputs, such as efficiency, reliability and quality of service, that are 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. 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. We have introduced incentives such as the Innovation Funding Incentive to encourage the network companies to innovate where this will result in better outcomes for customers. We also apply simple

solutions where they are likely to be effective and, where appropriate, adopt policies that are consistent across the networks.

2.4. We continue to support 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.

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

The next two years

All networks

Network of last resort arrangements

2.6. The implications of a network company experiencing financial distress and struggling to maintain and develop its network could be serious for consumers in terms of reduced security and/or quality of supply. Therefore, over several years we have developed arrangements to protect consumers from the financial failure of a network company. These arrangements include:

- procedures for collecting and monitoring network data;
- financial ring-fencing conditions which place constraints on the operation of network companies;
- provisions for reopening or disapplying price controls; and
- provisions to place a 'protected energy company' into special administration.

2.7. While we consider that the existing arrangements are sound, they have never been tested. No gas or electricity network company in Britain has been put into administration. We consider it is important to test the robustness of our existing arrangements to ensure that consumers do not face any undue risks associated with financial failure. In addition, in the interests of better regulation, in particular transparency, we propose to develop and publish a procedural manual setting out in detail the arrangements we have in place to respond to deteriorating financial health of a network company.

2.8. This work is not driven by concerns about any specific network company. Nor is it our aim to prevent the financial failure of inefficient network companies. Rather, we aim through these arrangements to ensure that the risks to and impact of deteriorating financial health on consumers are minimised. It remains at all times the responsibility of the network companies' management to ensure that they run businesses that are financially sound.

2.9. We intend to publish a draft procedural manual in February 2009 for consultation. Simultaneously, we intend to run a simulation exercise to test the arrangements place. Our final manual will then be published in early spring 2009. We will also continue to monitor the network companies on an ongoing basis.

RPI-X at 20

2.10. In March 2008, we unveiled our *RPI-X at 20* review. This is a two-year project examining whether the current approach to regulating Britain's energy networks will continue to deliver customers reliable, well-run networks with a good quality of service and at reasonable prices despite the growing investment challenges faced by the energy networks.

2.11. These challenges include meeting the UK's share of the new EU 2020 target for renewables, proposals for greater power network interconnection in Europe, new nuclear connections, a greater emphasis on small-scale distributed generation and growth in gas imports. Ofgem is committed to ensuring that the regulatory regime is up to the task. The review team is now in place and work has started in earnest.

2.12. Ensuring effective stakeholder engagement is vital to the success of this review. We want to engage the full range of stakeholders during the review through a variety of channels. We have already held a number of successful workshops and launched our web forum and our first consultation document will be published in February. We anticipate that the review will be in two phases. The first will be a 'visionary' phase, thinking strategically and exploring new and emerging concepts. The second phase will involve the development and detailed assessment of policy options. The aim is to present a report with recommendations to the Authority in the summer of 2010 and subsequently consult on the recommendations.

Long-term electricity network scenarios (LENS)

2.13. In November 2008 we published the LENS report from our academic partners at the University of Strathclyde and King's College, London. This report and the ongoing LENS initiative will play an important role in helping to inform and shape the development of the regulatory framework to deliver future energy networks that meet climate change and renewables targets.

2.14. We hope that the report will allow Ofgem, Government, the energy industry and other stakeholders to understand better the issues that climate change and our renewables targets raise for the future development of our energy networks. It is important that Ofgem and other policy makers do not inadvertently 'close off' options for developing the networks. We will explore this further as we take forward the LENS project. We will shortly publish our views on the potential implications of the scenarios for the networks and the way we regulate them. This will help inform and guide future (and current) network regulatory price control reviews and our fundamental reappraisal of the regulatory framework for the energy networks through our *RPI-X at 20* project.

Transmission networks

2.15. We have worked closely with DECC to develop the regulatory and licensing regime for offshore electricity transmission networks. Offshore networks are important because they will transmit electricity from marine renewable generation plant to the onshore network and therefore can help increase security of supply and decrease carbon emissions. The regulatory regime for offshore electricity transmission is designed to ensure costs are economic and efficient yet provide certainty about network delivery and operation to offshore generators. We have set up a dedicated team to manage the tenders for offshore electricity transmission licences efficiently so as to keep costs reasonable for participants. We expect to run the first competitive tender process in 2009.

2.16. Access to the onshore electricity transmission network is currently governed by rules that were devised to connect large conventional gas, coal and nuclear power stations. These rules are poorly suited for the rapid connection of a large volume of smaller renewable generators or a significant volume of new, lower carbon conventional plant. Reform of the access rules is critical if Britain is to achieve its 2020 renewable targets and to maintain security of supply as we seek to lower carbon emissions from the electricity sector.

2.17. Last summer Ofgem and DECC published proposals to speed up the connection of new generation projects while protecting consumers from inefficient expenditure. In the meantime, Ofgem and DECC have introduced measures to speed up the connection of renewables. This could hasten the connection of more than 1GW of extra renewables capacity over the next 18 months. Chapter 3 provides more details. More enduring access reform and new investment incentives on transmission companies should allow much faster access in future and make sure that new transmission capacity is built where and when it is needed and see the end to the significant queue of generators waiting to connect. We also will continue to work with DECC on new regulatory arrangements that may be necessary to extend the electricity transmission network to the Scottish Islands.

2.18. We will continue to carry out annual performance monitoring and reporting on the electricity and gas transmission companies' costs and performance; reports will be published early in the succeeding calendar year. We have reviewed proposals from the transmission companies for improved output measures. We will take this work forward with a view to introducing new output measures that will enhance our ability to assess whether the companies have invested enough to sustain network performance and how much they need to invest in future.

2.19. The transmission system operators (SOs) are responsible for balancing supply and demand on the network in real time and for managing short-term network capacity constraints. We set commercial incentives to encourage the SOs to balance the system and manage constraints in an economic and efficient manner. System balancing costs have increased in recent years and we will be considering how the longer-term incentives on the SOs could be improved. We will also consider the interaction of SO incentives with the incentives placed on the transmission owners.

Distribution networks

2.20. In 2009 we will develop proposals for the next electricity distribution price control (DPCR5) that will come into effect on 1 April 2010. As outlined in the policy document that we published in December, we will be seeking to strengthen the incentive on the distribution network operators (DNOs) to play a full role in tackling climate change for instance connecting renewables and microgeneration and reducing losses on their networks.

2.21. We are committed to maintaining the undergrounding scheme in Areas of Outstanding Natural Beauty and will be seeking views on how it might be improved. We are looking for ways to encourage DNOs to address the worst served customers in their areas and are developing a broad measure of customer satisfaction against which to assess the performance of the companies. We will also strengthen and widen the scope of output measures to encourage the DNOs to consider the impact of their decisions on levels of network risk and quality of service to consumers. This will make it clear what customers should expect to receive in return for paying distribution charges.

2.22. As part of DPCR5 we will set out a framework to allow the role of DNOs to evolve in response to changes in network use which might come about as a result of more distributed generation, smart meters, zero carbon homes or electric vehicles for example. Once the next price control has been settled we will build on the LENS work to establish how the DNOs' role might develop into the medium-term in order to tackle climate change and ensure secure energy supplies.

2.23. Regulatory reporting in electricity distribution has enabled us to make better comparisons between companies. With the introduction of regulatory reporting for GDNs as well as DNOs, we will look for ways to streamline our requirements and reduce the burden on companies. We will continue to publish cost, revenue and quality of service data for DNOs and GDNs and explore whether we can widen the range of data that we publish. For example, we will consider publishing more information on the different components of network company pension costs.

2.24. Charging models play an important role in delivering efficient and sustainable network development. In 2008 we began a project on the structure of electricity distribution charges with a view to encouraging efficient network development and helping to tackle climate change by rewarding distributed energy and demand-side management where these bring network benefits.

2.25. As part of the project we sought to introduce a common charging methodology for electricity distribution with a new governance arrangement enabling all affected parties to propose future modifications to the methodology. We are at present consulting on proposals in relation to a common charging methodology, revised governance arrangements and the particular charging model that should apply for extra high voltage consumers. We expect that the Authority will take a decision on these issues in February 2009.

2.26. Gas distribution network businesses (GDNs) must also ensure that their charging methodologies remain appropriate and consider the merit of proposals that parties might bring to them.

2.27. We will seek to refine the regulatory framework in response to potential new uses for the gas networks, such as biogas entry into the network. We will continue to work with the GDNs to ensure that the networks extensions scheme is successful in delivering cheaper connections to fuel poor households and communities. We are encouraging the GDNs to partner with other agencies so that network extensions are available to those communities eligible for grants for central heating and gas appliances. We will also consider reviewing the gas distribution licences.

2.28. We intend to review the market and regulatory structure for independent gas transporters (IGTs) and independent electricity distribution network operators (IDNOs). The aim of the review will be to ensure that the rise in activity in both sectors is delivering real benefits to customers in the form of lower prices or better service and to assess whether the regulatory arrangements are standing in the way of the development of competition in electricity network development.

2.29. We will continue our work on monitoring the development of competition in connections and making sure that where competition does not develop, customers are adequately protected through regulation. We are considering as part of DPCR5 whether further measures are needed to improve connections services.

A five year view

2.30. The EU 2020 targets on greenhouse gases and renewable generation will continue to play an important part in shaping our activities. We remain committed to incentive-based regulation as the best means of ensuring that the networks can deal effectively with changing circumstances, whether caused by new UK or European legislation or changing supply or demand patterns. Our policies will be designed to facilitate efficient investment so that customers are protected from the risk of having to pay for network assets that are built but not used.

2.31. Regulating networks transparently and consistently will further strengthen confidence in the regulatory regime. We will continue to develop a clear, predictable and transparent approach to conducting price control reviews as this will reduce uncertainty and provide a stable framework for long term decisions by network companies and investors.

2.32. Our *RPI-X at 20* review will set the regulatory framework for the network companies to meet the challenges ahead. We will of course consult fully on any changes that might be recommended by the review. Any changes that result from this comprehensive process will be implemented in the new price control reviews that we will be commencing in the next five years. We intend to commence the next electricity and gas transmission price control reviews in 2010, the next gas distribution price control review in 2011 and the next electricity distribution price review in 2013.

3. Helping to achieve sustainable development

Chapter summary

Ofgem will play a full part in facilitating the transition to a low carbon energy sector. We will take full account of environmental impacts and use an appropriate cost of carbon across the range of our decision-making. We will strengthen the incentives on the network businesses to connect renewable and other plant, including low carbon generation. 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, which is especially important in a period of persistently high energy prices.

We will continue to administer Government environmental programmes efficiently and effectively. This work forms a major part of our contribution to the achievement of sustainable development. It is also increasing in scale. As well as administering the existing environmental schemes, we will be running tenders for offshore transmission licences. We might also in the future have an administrative role in relation to heat, feed-in tariffs and smart meters. We will advise the Government on the development of these schemes based on our practical experience.

Chapter 6 sets out all the activities that we are undertaking to contribute to the social dimension of sustainable development.

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

3.1. The Energy Act 2008 has changed our statutory duties in two important ways. First, it has amended our principal objective to make it clearer that we must protect the interests of future as well as existing consumers. Second, it has promoted sustainable development within the hierarchy of duties so that in seeking to further our principal objective, we must now have regard to the need to contribute to achieving sustainable development. The Government is also revising the statutory guidance on social and environmental matters to which we must have regard.

3.2. Parliament has also legislated to require the UK by 2050 to reduce its carbon emissions by 80 per cent from 1990 levels. We regard these changes as a clear signal that sustainable development must continue to be an increasingly important factor in all of our policy and decision-making. As the independent regulator of the energy sector, which is responsible for the majority of our greenhouse gas emissions, it is clear that we have an important role to play.

3.3. 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. 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.

3.4. During 2008 we demonstrated our continued commitment to putting environmental considerations at the heart of our work. For example, we:

- incorporated the shadow price of carbon in our impact assessments and brought environmental considerations firmly into the network code modification process;
- published proposals to reform the arrangements governing access to the electricity transmission system to enable faster connection of lower carbon and renewable generation (see paragraphs 3.13-3.17 for more detail);
- published proposals to remove unnecessary regulatory and market barriers to the economic deployment of distributed electricity technologies, while protecting consumers' rights to switch energy supplier;
- published our latest thinking on DPCR5, which sets out our intention to increase sharply the incentives on electricity distribution business for 'green' investment;
- introduced new incentives for the gas distribution networks to cut greenhouse gas emissions from their networks;
- continued to engage with industry and the 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;
- continued to develop new guidelines for green tariffs, focusing on environmental benefits and greater clarity for consumers;
- advised the Government in relation to the EU Renewables Directive and the development of the UK Renewable Energy Strategy; and
- published our third report on sustainable development, which highlights the actions that we will take and notes actions needed elsewhere.

3.5. Sustainable development is at the heart of our 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. We participate actively in a range of industry committees and initiatives that concentrate on sustainability issues.

3.6. 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. In recent years we have introduced incentives for the network businesses to invest in innovative technologies. We will seek opportunities to strengthen these incentives.

3.7. Where matters are not under our direct control we nonetheless see it as our responsibility to facilitate change. We do this by engaging in the debate, trying to persuade the relevant parties to make the changes that would ease the transition to a low carbon energy sector in a cost-effective way, contributing information and expertise where we can.

The next two years

Sustainable energy markets

3.8. Ofgem expects suppliers to offer their customers products that enable them to manage their energy use and energy costs effectively. Suppliers' quality of service 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.

3.9. In November 2008 we began work to analyse the performance of the retail market in stimulating sustained behavioural change and the uptake of energy efficiency measures. We are examining the impact of different tariff structures and products, including rising block tariffs and energy service packages, on the uptake of energy efficient measures. We are also looking at their implications for consumers, including those in fuel poverty. We will also consider the role that can be played by active demand management and so-called 'smart homes'. We will use this work to inform our advice to the Government on energy saving and heat, the Carbon Emissions Reduction Target and the UK Renewable Energy Strategy.

3.10. We have been working closely with industry and interested stakeholders on developing revised guidelines for 'green' supply. We are seeking an increased emphasis on transparency to ensure that green claims are verifiable and to make the environmental benefit of any tariff a central part of the guidelines. Once we have finalised the green supply guidelines we will work with industry to establish a certification scheme, based on the requirements set out in the guidelines, that suppliers sign up to and in so doing give customers greater clarity and ensure that green tariffs deliver environmental benefits. We expect this to occur in 2009.

3.11. As stated in chapter 1, Parliament has given the Secretary of State a power in the Energy Act 2008 to introduce feed-in tariffs for small-scale generation. We will work with DECC on the design of any proposals to implement feed-in tariffs. We will also continue to encourage DNOs to develop charging methodologies that facilitate the connection of microgenerators and will, as part of DPCR5, seek to introduce new measures to encourage DNOs to connect renewable and other low carbon distributed generation. We have worked with the Energy Savings Trust (EST) to ensure that domestic customers can easily compare the export and generation rewards available from suppliers. Export and generation tariff prices will soon be available from the Green Homes advisory service and on the EST website with guidance for customers on how to choose the best tariff for their circumstances.

Sustainable energy networks

3.12. Ofgem will facilitate the development of truly sustainable energy networks. Significantly increasing the amount of renewable and other low carbon generation is a key part of this. In recent years Ofgem has approved unprecedented investment in the electricity networks to enable the connection of low carbon generation. We have also sought radical reform of electricity transmission access arrangements.

Electricity transmission access

3.13. It is important that access to the transmission network is fair. Renewable generators need to compete on a level playing field with existing generators that already have access to network capacity. When demand for network capacity exceeds supply, as is currently the case, National Grid's 'first come, first served' approach to connections favours existing generators over new generators - which are often renewable or lower carbon than existing generators. Existing generators are given preference even though they have made no long term financial or contractual commitment to pay for network access and have the option to stop paying any charges at one year's notice.

3.14. The ultimate solution to the generation queue is to increase the capacity of the transmission network. Given the long lead time to get planning permission and then to build the upgrades, Ofgem and DECC believe that further measures are needed. We have asked the transmission companies to develop detailed investment plans that would deliver the transmission capacity required to hit the 2020 targets. We will publish this report shortly.

3.15. Ofgem is also working with the transmission companies to develop a new financial incentive framework for transmission investment. Under this framework, transmission companies will be able to anticipate demand and build new capacity before securing contractual commitments from generators to fund the links. The risk in doing this is that the companies may not correctly forecast the level or location of new demand and may invest substantial sums of money in unneeded capacity. Ofgem is proposing to allow the companies to earn higher returns than allowed under typical network price controls in return for the companies taking on some of this stranding risk. This mechanism will protect customers from the financial and environmental costs of new transmission lines that are built but not used. We are also looking to advance funding for 'pre-construction' costs such as planning surveys and applications so that this investment can be delivered as quickly as possible.

3.16. Working with the industry, National Grid is developing a range of proposals that could result in radical reform to the access arrangements. These proposals could end the first come, first served approach and deliver quicker and fairer access to the transmission system. They could also allow for much more effective use of existing transmission capacity through sharing, which will be increasingly important given the intermittency of wind generation. National Grid submitted the proposals to us in December and we aim to reach our decision in the summer of 2009. If introduced, the new arrangements would go live progressively in the period up to 1 April 2010.

3.17. As it is likely to take over a year to deliver the full set of new arrangements (and might take longer if there is a legal challenge) we are pursuing measures to accelerate renewable connections during this period. As an interim measure, Ofgem has implemented an approach known as 'connect and manage'. This will allow renewable generators that can connect faster to make an application to National Grid to connect sooner. An extra 1GW of renewables could be connected sooner through this approach, which would represent an increase of around a third in the amount of

UK renewable generation. Parliament has given the Government a power in the Energy Act 2008 to drive through reforms if the industry makes insufficient progress.

Other networks issues

3.18. Offshore renewables can make an important contribution to the UK's share of the EU renewables target. Offshore transmission networks will be required to transfer marine electricity to our onshore networks. Ofgem will carry out competitive tenders for the provision of these networks. The competitive offshore regulatory regime is designed to ensure efficient investment, allow scope for innovation, and to be flexible enough to meet the needs of future offshore generators.

3.19. Making sure that electricity generators located far from energy consumers face the full costs of the networks 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.

3.20. The gas and electricity industries also affect the environment through the emission of 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.

Advising the Government on environmental policies

3.21. Ofgem will continue to advise the Government on environmental policies where they are likely to affect existing and future energy consumers. The EU has recently passed Directives on renewable energy and the EU ETS. The Commission has now determined that 15 per cent of the UK's energy should come from renewable sources by 2020. We will advise the Government on how the UK can achieve this target at the lowest cost to consumers, including mitigating the effects on fuel poverty. We advised the Commission on the long term future of the EU ETS and will monitor the development of the allowance market and its effects on British energy markets.

3.22. The Energy Act 2008 gives the Government a power to introduce a renewable heat incentive. We recognise that the supply of heat by third parties is likely to become a more established part of the competitive market as a result of government policy to encourage combined heat and power (CHP) plant, district heating schemes and heat markets more generally. We will help assess different approaches for providing safeguards for domestic customers connected to district heating schemes. We support the Government's consideration in its Renewable Energy Strategy of additional measures for distributed energy and community energy, including CHP. We will contribute to policy development on renewable and low carbon heat.

3.23. 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 energy consumers to be more energy efficient. We will also work

with 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.

3.24. As stated in chapter 1, we welcome the Government's decision to take powers in the Energy Act 2008 to mandate a roll-out of smart meters across Britain by 2020. We hope that the Government will introduce smart meters in a cost-effective manner that maximises the benefits to consumers. We believe that this will best be achieved by preserving the benefits of competition and 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.

Sustainable Development Reports

3.25. We published our third annual report on sustainable development in December 2008. The report sets out the progress that we have made in facilitating a more sustainable energy industry and the actions we will take in 2009-10. It also looks at the challenges that the industry and government will face in meeting Britain's climate change and sustainability targets.

3.26. 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 fourth annual Sustainable Development Report in late 2009. This will again report on progress made on key indicators and give our latest views on the way forward.

'Greening' Ofgem

3.27. 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. This reflects a sustained drive to reduce our own energy usage and carbon footprint.

3.28. In 2003, for example, we installed a combined heat and power unit that has since saved well over a thousand tonnes of carbon dioxide 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. In 2008 Ofgem established an internal Environmental Champions Team, which organises awareness-raising campaigns to drive down our use of resources such as energy, water and stationary.

3.29. We will continue to seek ways of reducing our impact on the external environment. More detail on the measures we have adopted so far can be found in our Sustainable Development Action Plan.

A five year view

3.30. All Ofgem policies will fully reflect our duties towards future consumers and the need to contribute to the achievement of sustainable development.

3.31. Climate change is one of the most significant challenges facing the world today. In response, the EU has proposed that 15 per cent of the UK's energy should come from renewable sources by 2020. Parliament has introduced statutory targets to reduce UK carbon dioxide emissions by at least 26 per cent below 1990 levels by 2020 and at least 80 per cent below 1990 levels by 2050.

3.32. Meeting these targets may require a transformation of the energy networks and generation technologies used to meet demand. We will continue to work with all stakeholders to identify barriers hindering the shift to a low carbon energy system. We will examine ways to enhance energy efficiency 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. We will also keep under review actions that might be required to reduce the sector's emissions of non-carbon greenhouse gas, such as methane and sulphur hexafluoride.

3.33. We will 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. As part of this, we will continue to engage with policy makers so as to ensure that they recognise and consider any trade-offs that are inherent in their policy proposals. We will also 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.

Sustainable development programmes

Ofgem increasingly has two main 'businesses'. One of these is the core function of an economic regulator to regulate the gas and electricity markets. The other is to administer a range of Government programmes that in various ways contribute to the achievement of sustainable development. Ofgem is well placed to administer these schemes given our knowledge of the industry and its governance.

The number and scope of these programmes is increasing. Already we administer schemes relating to renewables and energy efficiency. From 2009 we will manage tenders for offshore transmission licences. In the course of the next five years we might be asked to take on an administrative role in relation to smart meters. In addition, the Energy Act 2008 leaves open the possibility that we might be asked to administer the Renewable Heat Incentive and the feed-in tariff scheme. Our aim in all cases will be to administer the programmes as efficiently as possible so as to minimise both the burdens on companies and costs to consumers.

The main environmental schemes that we administer are the Renewables Obligation (RO), which creates obligations for electricity suppliers, and the Carbon Emissions Reduction Target (CERT) which replaced the Energy Efficiency Commitment (EEC) in creating 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 published a review of the EEC 2005-08 and we will shortly publish our annual report on the RO.

We have extensive knowledge of the environmental programmes based on our experience of their administration. We advised the Government and the Devolved Administrations on their reforms of the RO, including the introduction of banding, which will be implemented in April 2009. We will advise the Government on any further reforms of the RO and will seek to use our expertise to secure efficient outcomes for British energy consumers. We will also be closely involved in the development of the Government's £1 billion Home Energy Savings Programme. We will ensure that resources are well targeted and that measures interact effectively with fuel poverty programmes such as Warm Front.

In April 2008 we introduced a new IT system to administer the renewables and CHP programmes. We believe that the new system has reduced burdens on the 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.

From 2009 Ofgem will manage the competitive tenders for offshore electricity transmission licences. We anticipate that the cost of administering tenders in 2009-10 will be around £4.8 million.

The cost of administering the other environmental programmes is projected to be £2.9 million in 2009-10, including overheads and support costs. (For a more detailed breakdown see appendix 3.) There is continuing upward pressure on these costs because of the increase in scale and complexity of the schemes since we started administering them.

This work requires different skills to those needed for the economic regulation of the energy markets. Beyond advising the Government on the design of the schemes we have little discretion over the scope and nature of what we do in this part of our business. We would welcome views on our approach to discharging the obligations that we have in this area.

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

Chapter summary

A combination of competitive markets and effectively regulated networks is the best means of protecting the security of Britain's energy supplies. We will continue to assess all policies in terms of their impact on security of supply.

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. Ofgem has important statutory duties that relate to security of supply. In protecting the interests of consumers we must have regard both to the need to secure that all reasonable demand for gas and electricity is met and to secure that licensees can finance the services that they are obliged to provide. We are also required to secure a diverse and viable long-term energy supply. We therefore assess all major policies for their impact on short- and long-term security of supply.

4.2. Competitive markets are the best way of promoting security of supply. They provide strong commercial incentives for companies to contract for and build sources of energy supply to meet customers' demand. Competing suppliers will also seek diverse sources of supply to manage their commercial risks. However, we are reviewing the extent to which the credit crisis might affect our market assumptions.

4.3. 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 sudden, unexpected disruptions to supply. Some customers will respond to short-term price shocks by temporarily reducing their energy use helping to balance supply and demand.

4.4. Since privatisation £14 billion has been invested in 31 GW of new gas-fired and renewable electricity generation. This is 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 unable to operate under EU laws limiting sulphur dioxide emissions from power stations.

4.5. 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.

4.6. As the sources of electricity generation and gas production change, so the energy networks must evolve to meet the new demands. We facilitate the investment necessary in transmission and distribution systems when it is required. This ensures sufficient network capacity and maintains and improves reliability, so that energy supplies can be transported to consumers. We monitor network reliability and seek to improve the incentives on network companies to invest efficiently where and when the market wants network enhancements.

4.7. 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. In 2005 Ofgem authorised a further £7.4 billion of investment in the local electricity networks for the period 2005-10. We also authorised more than £5 billion of investment in the gas and electricity transmission networks from 2007-12. 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 of both conventional and renewable generation.

4.8. Britain is moving from self-sufficiency to being more reliant on gas 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 all the proposed projects are completed there will be enough import capacity to meet 90 per cent of UK gas demand. Gas storage capacity could double by 2012 and our gas will come from a wider range of sources than ever before.

4.9. The value of carbon dioxide emission allocations under the European Union Emissions Trading Scheme (EU ETS) will be a powerful influence on future investment in generation. Higher carbon prices will feed through into wholesale electricity prices which will encourage greater energy efficiency by domestic and business customers. Greater certainty is needed about the arrangements for future phases of the EU ETS 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 greater energy efficiency. As we have suggested previously, revenues raised through auctioning could be used to tackle fuel poverty.

The next two years

4.10. The implications of a network company experiencing financial distress and struggling to maintain and develop its network could be serious for consumers in terms of reduced security and/or quality of supply. As noted in chapter 2, we are testing the robustness of the existing arrangements to ensure that consumers do not face any undue risks associated with financial failure.

4.11. We will seek to remove barriers preventing the market from delivering security of supply that lie within our remit and powers. We will work with Government to remove others, such as planning, and will advise the Government in relation to its forthcoming National Policy Statement for major energy infrastructure projects.

4.12. 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 high and volatile prices during periods of tighter supplies. As part of this we will continue to try to facilitate improvements in demand-side management and response.

4.13. National Grid publishes winter and summer outlook reports looking at the prospects for short-term security of supply in Britain. Given the increasing interdependence of British, European and even global energy markets, we will be working with National Grid to increase the international dimension of these reports. We play a key role in a number of regulatory initiatives being taken forward with other European regulators (see chapter 5 for more details) and we will use these processes to continue to work towards greater transparency and liberalisation of the European energy markets. We will also contribute to the debate over the proposed new EU Directive on gas security of supply.

4.14. We will work with DECC as necessary to refine the arrangements for analysing longer term security of supply issues. At the end of 2009 we will jointly publish our *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. The 2009 document will be the first report to be prepared in the light of the EU Renewables Directive and UK Renewable Strategy.

4.15. 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. Following the floods that took place in Yorkshire and Gloucestershire in 2007, Ofgem has been considering the issue of flood protection for electricity substations. The DNOs are working with Ofgem, DECC, and the Environment Agency to establish levels of flood risk, determine appropriate solutions and prioritise work. We will take this forward as an important part of DPCR5.

4.16. Ofgem, the DNOs and DECC have been considering the resilience of the distribution networks to high impact/low probability events affecting network infrastructure in key central business districts. This has involved assessing the cost of increasing the level of redundancy of the network to mitigate the impact of such events and the potential economic losses in these areas should power be lost for a significant period of time. We will continue to keep under review the resilience of networks to future climate impacts and will pursue such measures as may be necessary to ensure that security of supply is maintained.

4.17. 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 liquefied natural gas and/or piped gas to the UK. We will continue to apply a light touch regulatory regime for new gas import infrastructure where this will promote competition and protect customers' interests. However, we will impose regulated third party access to these facilities in the absence of effective 'use-it-or-lose it' arrangements.

4.18. Ofgem will continue to work with DECC, the Health and Safety Executive and the European Commission to develop new gas quality standards. The aim will be to introduce new standards that allow greater trading with and transportation of gas to and from continental Europe, who currently have different gas quality standards to the UK, but do not lead to customers facing very high costs to convert gas appliances to meet the new standards.

A five year view

4.19. 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. We will for example examine the incentives for investment in new electricity generation plant and will monitor the impact of increasing amounts of intermittent generation on the balancing market.

4.20. 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 maintaining our light-touch approach to the regulation of new infrastructure providers where our analysis shows that the new infrastructure will enhance competition in the gas market and benefit consumers.

4.21. These developments will increase the interaction of the British market with European and global gas markets. Over 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.

4.22. 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. Our policies will be designed to facilitate new investment in a timely and efficient way. As stated in chapter 2, 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 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.

5. A leading voice in Europe

Chapter summary

We will continue to support the European Commission in its drive to achieve competitive and sustainable energy market that operate in the interests of British energy consumers. We will work with fellow EU energy regulators and the UK Government on the detailed implementation of the new energy legislation and 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

5.1. European energy markets, and EU regulatory and competition policy, have a major and increasing influence on Britain's energy markets and consumers. Gas transported across the continent will be increasingly vital for our security of supply as we become a net importer of gas through new and expanded interconnectors. Continental electricity flows will have an increasing influence on the security of our electricity supply with several new interconnectors under development. British energy prices are already increasingly influenced by market arrangements in continental Europe and this is set to continue.

5.2. The overall objective for our European activities is unchanged. It is to develop truly competitive European electricity and gas markets that benefit British consumers in terms of prices and security of supply. We aim to influence the debate and remove the risk that European markets and regulation roll back the benefits that liberalisation has brought to British consumers.

5.3. We work primarily through the Council of European Energy Regulators (CEER) and the European Regulators' Group for Electricity and Gas (ERGEG). They advise the Commission on energy regulation and competition and are playing an active role in developing the policy framework needed to establish effective energy markets in Europe. Lord Mogg has now been confirmed as Chair until 2010.

5.4. We have built direct relations with EU institutions, in particular the Commission. These links have served us well as the Commission has been developing the third package of legislation to liberalise energy markets. The package, which imposes tougher unbundling requirements, creates a new energy agency and requires the regulators and transmission system operators to draw up legally binding cross-border network codes, is due to be adopted in the spring. We are now advising DECC as it negotiates the detail in European Council meetings and we will work closely with DECC to achieve our common aims for European energy policy.

5.5. 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.

5.6. Ofgem's efforts through CEER/ERGEG and the regional initiatives have led to significant progress in improving transparency in European electricity and gas markets. Most countries regularly publish detailed data on the availability of generation plant and maintenance plans. This reduces the volatility and risk premia associated with wholesale markets that lack data transparency, to the benefit of consumers. In gas, progress until recently was patchy but transparency now appears to be improving. We will be keeping up the pressure to ensure that transmission operators publish a full range of information that the market values.

5.7. The Commission has just published a *Strategic Energy Review*, which proposed several measures to increase security of energy supplies, such as a new Directive addressing in particular gas supply shocks and other emergencies. The Commission has also proposed an action plan for LNG and a blueprint for an offshore North Sea electricity grid. We will actively seek to influence the debate on these matters.

5.8. With higher energy prices and the progressive liberalising of retail markets across Europe, consumer issues are rising up the agenda. We will engage closely in that work to ensure that proposals are workable in the context of the competitive British energy markets and to help develop our thinking on consumer issues generally, such as the impact of smart meters. In October 2008 we hosted the *Citizens Energy Forum* where such issues were discussed. We expect this to be an annual event.

5.9. The EU has developed a 'green package' to complement its liberalisation agenda. This includes Directives on carbon emissions trading and renewable generation. These Directives are likely to have significant impacts on national energy markets. Ofgem has for some time been actively involved in the debate, not least in our role as Chair of the EU Sustainable Development Taskforce. In 2009 our focus will shift towards the implementation of these Directives.

5.10. 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

5.11. With the Third Package on energy legislation in place the focus will switch to implementation. As part of this, we will contribute to the work of CEER and ERGEG in preparing for the establishment of the new EU energy agency, for instance by helping to draw up the agency's consultation processes and draft its rules of procedure. The agency is an important part of the new institutional framework for energy regulation in the EU, which also includes strengthened national regulators that are expressly protected from direct political interference.

5.12. We have in recent years argued strongly for full structural unbundling of transmission networks because it would enable British energy suppliers to gain fair access to continental transmission and storage capacity for the first time, which in turn could help secure British energy supplies and reduce pressure on prices. It will now be vital to ensure that transmission unbundling is carried out rigorously across the EU so these benefits can be secured in full. For our part, we will consider, with DECC, how the Directive's unbundling provisions should be implemented in Scotland.

5.13. Ofgem will work proactively with national energy regulators and industry in areas where we think the potential for benefits to British consumers is greatest. In particular, we will prioritise work to improve transparency in the North West regional gas market and seek to ensure that key transmission businesses publish data on gas flows and transmission capacity.

5.14. Ofgem will seek to draw up guidelines for opening up access to European networks including new mechanisms for the non-discriminatory allocation of transmission capacity. We will consider how best to incentivise investment in cross-border interconnection. We will develop proposals to remove barriers to entry from balancing arrangements and explore the potential for new EU-level powers for tackling abusive conduct in the wholesale electricity market.

5.15. We will also step up our involvement as the Commission develops its thinking on security of supply and environmental issues. We will promote policies that are consistent with facilitating genuinely competitive European energy markets that operate in the interest of British energy consumers. Our aim will be to guard against the risk of measures being implemented that adversely affect competition and consumers in British energy markets.

5.16. As noted above, there is growing interest at European level in the consumer agenda and in particular the extent of consumer protection in liberalised energy markets. We will play a central role in the debate, which is focusing on issues such as potential EU-level complaint-handling standards, monitoring the impact of smart meters and monitoring compliance with consumer protection Directives.

5.17. In recent years we have been heavily engaged in policy development for CEER and ERGEG. We expect that this will continue, for example as we tackle issues such as congestion management, gas interoperability and system balancing in the context of developing cross-border industry codes. We will maintain working groups and industry discussion groups to focus on specific reform proposals. We will also continue to encourage the European regulators to consult, via CEER and ERGEG, on all significant regulatory proposals.

A five year view

5.18. Ofgem will work with CEER, ERGEG, the Commission and the new Agency for Co-operation of Energy Regulators (ACER) to ensure that European competition and regulatory policy benefits British energy consumers.

5.19. We will continue to develop effective regional energy markets that benefit consumers and can evolve into a single competitive European market. We expect that our work will lead to regional electricity and gas markets that are substantially more pro-competitive than the existing arrangements.

5.20. Within the next five years ACER will become fully operational and new, binding cross-border network codes will be in effect. These changes are likely to have far-reaching implications. Ofgem will seek to ensure that the changes operate in the interests of British energy consumers.

5.21. We will also aim to ensure that any new Directives contain proposals that are in the interests of British energy consumers and that they are implemented effectively and consistently across the EU.

6. Helping to tackle fuel poverty

Chapter summary

With increasing numbers of households struggling to pay their fuel bills, we will continue to facilitate efforts by the Government and industry to target fuel poverty measures on those most in need. The package of remedies being developed as a result of our probe will help ensure that vulnerable consumers receive more benefit from the competitive market. We will also continue our broader programme of work as part of our Social Action Strategy to protect the interests of vulnerable customers. We will look at suppliers' measures to protect vulnerable customers, including their approach to debt and disconnection in the current economic climate. 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?

Introduction

6.1. The Government defines fuel poverty as existing where a household needs to spend more than 10 per cent of its income on energy to maintain a satisfactorily warm home. Fuel poverty is part of a wider problem of poverty caused by a combination of high energy prices, low incomes and poor housing conditions. A lack of affordable energy can have a significant impact upon the lives of individuals, raising health issues and having implications for general wellbeing and economic prosperity. The Government and the Devolved Administrations have committed to eliminating fuel poverty and have separate targets, the overall aim being that no household in the UK should live in fuel poverty by 2018.

6.2. Official fuel poverty figures for 2006 estimate that 3.5 million households in the UK were in fuel poverty, of which 2.5 million were vulnerable households (which in this context means a household containing children or those who are elderly, sick or disabled). Since 2006 pressure on energy prices has intensified as a result of global demand, oil price rises and the impact of environmental schemes. Substantial increases in retail prices have created difficulties for lower income customers and pushed more consumers into fuel poverty. As a result, the number of households in England experiencing fuel poverty is expected to have increased by another 0.7 million in 2007 and a further 0.5 million in 2008.

6.3. Ofgem is required to have regard to the needs of vulnerable customers in carrying out our duties. We must also have regard to social and environmental guidance issued by the Secretary of State, which will shortly be revised. Our aim is to improve the ability of all households to adequately heat their homes; to ensure that more vulnerable customers can and do access the lower prices and better energy services and products that are available to them; and to ensure that

customers who are having difficulty paying their bills are given help to manage their debt and prevent their energy supply being disconnected. In doing this we can make an important contribution towards achieving the Government's fuel poverty targets.

6.4. Ofgem has been very active in contributing to and influencing the debate about measures to help tackle fuel poverty. In particular, Ofgem has highlighted the need to target help to those who need it most and improve the effectiveness of individual measures. In April 2008 we convened a Fuel Poverty summit bringing together Ministers, Government officials, energy suppliers and consumer organisations to agree a programme of practical action to improve the targeting of existing help to those in fuel poverty and to help more vulnerable consumers participate more effectively in the energy market. The key outcomes from the Summit included:

- the Government committed to legislate to allow the Department of Work and Pensions and energy suppliers to share data so that help could be targeted at vulnerable pensioner customers and subsequently introduced amendments into what became the Pensions Act 2008;
- energy suppliers committed to improving the targeting of their social measures to fuel poor customers and to keep consumer advice groups better informed of the wide range of help available to customers struggling to afford their energy bills;
- leading switching site providers agreed to promote their telephone switching service for customers without internet access;
- Defra, eaga and suppliers agreed to establish a pilot programme to check that 3,000 vulnerable customers were on their supplier's best tariff. This has now been completed and plans for a roll out are being explored.

6.5. In 2008 the Government secured an agreement with suppliers to increase their collective expenditure on their social programmes by £225 million for 2008-11. We published a monitoring framework and guidance document in July 2008 and our first report of suppliers spend against this framework in December 2008. This confirmed a baseline annual spend of £57 million. We also made clear that a supplier's social tariff would be eligible only if it was at least equal to the lowest tariff they offered to customers in that area, including online deals, regardless of the payment method. The challenge remains getting the message 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 will continue to require a joined up approach from Government, industry and other agencies.

6.6. 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 therefore remain a key part of our work. Environmental measures have increased energy costs and there is a case for recycling some of the funds raised by auctioning carbon allowances to tackle fuel poverty. In developing its approach to climate change, it is essential that the Government adopts a truly sustainable approach that takes full account of the social implications of environmental issues. We will contribute fully to these important debates.

The next two years

Retail markets

6.7. Ofgem will focus on ensuring that prices are no higher than necessary. One of the key findings of the probe described in chapter 1 was that many consumers were not yet benefiting fully from the competitive market and that vulnerable consumer groups are disproportionately affected. Lack of internet access, poor levels of literacy and numeracy, reliance on cash and tight budgets all create barriers to participation in the market.

6.8. Ofgem will in 2009 seek to implement a range of measures that will assist vulnerable consumers in participating fully in the benefits of a competitive market. This may include restricting suppliers' ability to prevent switching among customers who are in debt, improving the information available to consumers about tariffs and switching, strengthening direct selling rules. In monitoring switching by vulnerable customers we will consider how to assess the quality of switching decisions as well as the rate of switching. We are also looking at introducing licence conditions that require cost-reflective tariff differentials for different payment methods and are consulting on other potential licence changes to tackle unfair price differentials.

6.9. There is scope for significant further increases in domestic energy efficiency. Energy demand could be reduced by improving the efficiency of products and processes and through changes in consumers' consumption or behaviour. Increased energy efficiency contributes to the achievement of Government fuel poverty and climate change targets. Ofgem is already undertaking analysis of how to promote greater take-up of energy efficiency measures. This work will inform our policy advice to the Government.

6.10. 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 CERT scheme. Our aim will be to try to ensure that resources are well targeted and that the CERT and the new Community Energy Saving Programme announced by the government in September interact effectively with fuel poverty programmes such as Warm Front. We will also use the result of the smart metering trial to inform our view of the potential for smarter metering to help tackle fuel poverty through increased energy efficiency and lower cost prepayment meters.

6.11. At a time of rising bills and mounting economic uncertainty, Ofgem has pressed suppliers to increase their efforts to help customers manage their bills, resolve debt early and avoid disconnections. It is essential that suppliers do all they can to assist their customers, particularly those who are vulnerable, to manage their energy bills and to prevent the build up of debt. We will keep up the pressure on suppliers by reviewing debt management practices and by promoting best practice. We will not hesitate to take further action, including naming and shaming suppliers, if necessary.

6.12. In 2009 we will continue to monitor suppliers' social spend and continue our work to ensure that the actions from our Fuel Poverty Summit are implemented.

Given that there are now around 5 million consumers in fuel poverty, we need to ensure that we understand where assistance is most required so we can advise on targeting support effectively. We will consider this issue further in 2009. We will also work with the Government's Financial Inclusion Taskforce to encourage appropriate take-up of direct debit as a payment method. We will take part in ERGEG's Consumer Working Group and Consumer Empowerment Taskforce as they develop proposals to harmonise arrangements for consumer representation and redress. We also expect to host the Citizens Energy Forum in 2009. We will seek to ensure that any EU-wide proposals are consistent with the new arrangements for consumer representation and redress that were introduced in Britain in 2008.

Energy networks

6.13. Last year, as part of the gas distribution price control review, Ofgem introduced new incentives for GDNs to extend the gas network. The incentives could help to reduce energy charges for fuel poor households who currently use other more expensive heating fuels. We also introduced a Discretionary Reward Scheme for GDNs, which includes incentives to cut the upfront charges of network extensions and in-house works that customers in fuel poor communities face if they want to be connected to the gas network. 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 will monitor the impact of these incentives on the extent to which the GDNs do connect fuel poor communities to the gas networks.

6.14. The new arrangements for handling consumers' complaints apply to network-related complaints as well as complaints about suppliers. We will work with *Consumer Focus* to ensure that any emerging trends are monitored so that action can be taken if necessary. 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

6.15. 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. Consumer and social issues will therefore remain high on the agenda. We will

- monitor the effects of the measures that we implement in 2009 to improve the market for vulnerable consumers and take further action if necessary;
- seek to ensure that vulnerable consumers can engage effectively in the market and make informed switching decisions;
- seek to ensure that competition minimises costs for all consumers;
- keep the companies' regulatory obligations to their most vulnerable customers under review and ensure that the companies comply with them;
- promote best practice across the industry in dealing with the particular issues facing vulnerable consumers;
- monitor suppliers' spend on social programmes;
- play a leading role in developing EU-wide measures on consumer issues; and
- continue to advise the Government on developing fuel poverty programmes.

7. Better regulation

Chapter summary

We remain committed to policies and processes that are consistent with better regulation principles. We will continue to seek opportunities to remove unnecessary burdens on businesses. We will seek continuous improvement to our operational efficiency and effectiveness and thereby keep our costs under tight control. We will continue to develop our approach to consumer engagement so that consumers' views are properly reflected in our decision-making. We will draw on best practice from 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 areas of regulation that you consider to be an unnecessary burden that should be removed?

Question 5: Are there any other activities that we should include in the Simplification Plan that we intend to publish in March?

Introduction

7.1. Ofgem has a long standing commitment to better regulation in all our activities. We apply better regulation principles to the policies that we develop and 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 are adopting an initiating or facilitating role in which other parties develop policy solutions. We will continue to consider whether any regulations impose burdens on licensees that, in the context of our broader statutory duties, are unnecessary and could be removed. This is consistent with our duty under the Regulatory Enforcement and Sanctions (RES) Act 2008 to keep our functions under review and secure that we do not impose or maintain regulatory burdens that we consider unnecessary.

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, now entering its last year, gives us an incentive to reduce our costs in real terms. In addition, we seek to administer sustainable development programmes in the most efficient and cost-effective way possible. 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

The industry codes governance review

7.4. In June 2008, we issued our decision on the scope of the industry codes governance review. The review is one of Ofgem's key better regulation initiatives over the coming year. Whilst the industry codes arrangements have worked well to deliver incremental reform across a wide range of areas, in setting the scope for the review we have identified a number of concerns with the governance arrangements.

7.5. The arrangements can hinder progress on strategic reforms that could provide significant benefits to consumers. Key reforms are often delayed by piecemeal development of multiple modifications processes as well as by divergences in the interests of commercial players. Two such examples are electricity transmission access reform and electricity cash-out reform.

7.6. The codes arrangements have also become too complex or fragmented and as a result impose unnecessary burdens on market participants, particularly smaller participants and consumers. This is particularly concerning given the changing nature of the market landscape and the entry of smaller suppliers as well as smaller renewable and distributed generation based participants.

7.7. The Authority therefore initiated a major programme of work on codes and charging methodology governance arrangements to ensure that they remain fit for purpose and preserve competition in a changing market landscape. A key focus of this work programme is the introduction of a framework which would enable Ofgem to lead and manage major policy reform programmes under the codes framework.

7.8. In parallel the review is considering proposals that would enable Ofgem to withdraw from making decisions on modifications that have little material consumer or competition impacts. These decisions could be taken by industry. We consider that it is possible that an industry based self-governance process for low consumer impact proposals could produce significant efficiency and better regulation benefits.

7.9. The review is also looking at the scope for simplifying the code modification arrangements. We consider that reduced complexity should benefit all parties, including new entrants, small market participants and consumers in participating in codes processes and influencing policy outcomes. As part of this work we have established an Ofgem-chaired industry working group that is considering improvements to the modification process. This group is due to report early in 2009.

7.10. We are also examining whether the analysis of proposals by the code panels is of sufficient quality, transparency and accessibility to market participants. We are considering measures for improving the performance of the code administrators who manage the process and prepare modification reports. We are also considering whether the codes' objectives should more closely reflect the Authority's statutory duties, relating to sustainable development, and whether market participants should

be able to propose modifications to network charging methodologies. We will publish initial proposals in the summer and final proposals by the end of 2009.

Consumer First initiative

7.11. Ofgem's principal objective is to protect the interests of consumers. In order to do this effectively, we need to have a clear understanding of what consumers think about the major policy issues we face so that their views can inform our decisions. To that end we are committed to establishing an effective working relationship with consumer representation organisations such as *Consumer Focus*. However, Ofgem believes it is also important to have a direct relationship with consumers so we can gain the benefit of their insight. This is why we launched our *Consumer First* initiative in January 2007, which has contributed to many of our key policy decisions.

7.12. We have sought to learn more about customers' views on electricity distribution issues, including the extent of their willingness to pay for network improvements. This research is informing our approach to DPCR5. We have also taken a close look at the different issues facing vulnerable customers in order to understand how we might reduce or remove barriers to different groups engaging with the energy market and improve the effectiveness of the advice that they get on switching energy supplier. As part of the work for our energy markets probe we carried out behavioural segmentation work to elevate our understanding of how different consumers behave in relation to the energy market and we carried out research with small businesses to explore their views on energy suppliers. In addition, we have improved our understanding of how consumers' attitudes to energy and environmental issues are changing. We will bring this together in a report on *Future Consumers* in early 2009, which will provide the basis for further work in this area.

7.13. We have established two panels to assist us in our work. The *Consumer First Panel* is a representative sample of 100 energy consumers in five locations across Britain. Through regular meetings where issues can be debated in depth and ad hoc surveys between meetings, this panel will provide us with feedback on key energy topics and regulatory issues. We have also set up a *Consumer Challenge Group* comprising six consumer experts, four domestic and two from business, who have in depth knowledge of the energy sector from the consumers' perspective. This group will help Ofgem in complex, high-level decision-making by discussing issues with the relevant sub-Committee of the Authority. We envisage that the group's input will complement the representations made by the industry and other stakeholders on key policies. We are piloting this approach in DPCR5.

7.14. Our *Consumer First* initiative will continue to ensure that we engage effectively with the developing priorities of consumers and result in better informed decisions.

Retail markets

7.15. As noted in chapter 1, the probe found that there was no significant 'competitive fringe' to challenge the established suppliers. We will be taking forward work to identify and remove barriers to new entry as a priority in 2009.

Reporting requirements for distribution network businesses

7.16. Regulatory reporting in electricity distribution has facilitated proper company comparisons and publication has aided transparency. We have spent much time ironing out inconsistencies in interpretation. With the introduction of regulatory reporting for GDNs we will look for ways to streamline the reporting arrangements.

7.17. We remain committed to publishing cost, revenue and quality of service data for DNOs and GDNs. We will explore whether we can widen the range of data that is put in the public domain, exploring for example whether we could publish more on the different components of network company pension costs. We will also seek to publish GDN performance against a balanced score card and DNO performance against new output measures agreed as part of DPCR5. We believe that these measures will enhance transparency and facilitate effective regulation of the networks in the interests of network users and ultimately consumers.

Improving Ofgem's accessibility and transparency

7.18. In recent years we have redesigned our consultation and decision documents, simplified our code modification decision documents and redesigned our website. Internally, we have introduced electronic records management across Ofgem. We are currently reviewing our Publication Scheme under the Freedom of Information Act and expect to publish a wider range of operational information as a result.

Costs and efficiency

7.19. Internal efficiency savings are primarily driven by the RPI-3 per cent target, which commits us to savings of over £1 million per year from 2005 to 2010. We have beaten this target in each of the first three years of the cost control. As a result we have been able to reduce the licence fees by an additional £2.9 million in 2006-07; £0.6 million in 2007-08; and £0.9 million in 2008-09.

7.20. The RPI-3 cost control regime has led to improved financial discipline, which has enabled us to carry out our corporate programme and achieve high levels of operational performance while beating our cost control targets. We expect this to continue in the final year of the cost control period despite the increasing pressures on our resources and costs. 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 the Government. By their nature these cannot be fully accounted for in our forward planning and budgeting and they may require us to revise our work.

7.21. Where we are asked to take on the administration of new sustainable development programmes we will always seek to ensure that explicit provision is made for funding as part of these arrangements. The Government has proposed that Ofgem should administer on DECC's behalf new programmes relating to renewable heat, feed-in tariffs and community energy saving. No budgetary provision is currently included for these programmes.

7.22. We are also experiencing upward pressure on our budget in other areas of our work. For example, our probe into the retail markets will lead to additional work to ensure that the industry delivers the full benefits of competition to the entire market and changing market conditions mean that we need to monitor market activity more closely. We intend to maintain a strong cost control discipline and have begun to consider what arrangements would be appropriate in 2010 and beyond.

Simplification Plan

7.23. Appendix 4 contains our latest annual Simplification Plan. It sets out the activities that we propose to undertake in 2009-10 in support of the better regulation agenda. Consistent with our new duty under the RES Act 2008, we have considered whether there are any regulations that impose burdens that could, in the context of our duties generally, be considered unnecessary. The Simplification Plan reflects our current view of the work we should undertake to reduce or remove those burdens.

7.24. We would welcome views on whether the proposals that we have identified are appropriate and would be likely to reduce or remove unnecessary burdens. We would also very much welcome views on whether there are other regulations that impose unnecessary burdens and which should be simplified or removed in order to comply with the duty. We will carefully consider any suggestions that we receive and they may be included in the final Simplification Plan that will be published in March. We will set out the progress that we make on these projects in our Annual Report.

A five year view

7.25. We will continue to review our policies and processes with a view to achieving and maintaining best practice in better regulation. We will keep our functions under review to secure that we do not impose or maintain unnecessary burdens on businesses. We will consult on, and publish, annual Simplification Plans and subsequently report progress on removing burdens in our Annual Reports.

7.26. We will seek to ensure that any EU or UK regulation of the competitive generation and supply markets is targeted and proportionate. We will look for further opportunities to withdraw from regulation of competitive markets, but will do so only where it would be in the interests of consumers. We will continue to refine the regulation of the monopoly networks. Our *RPI-X at 20* review will enable us to build on lessons learned from previous price control reviews. We will consider the scope for reviewing electricity generation, electricity transmission and gas transporter licences against better regulation principles. We will continue our work to ensure that we are clear about consumer views to enable us to protect their interests effectively and those of future consumers.

7.27. In 2009-10 we will determine new arrangements for internal cost control in 2010-11 and beyond. Over the next five years we will ensure that the RPI-X cost control regime enables us to strike an appropriate balance between continued cost reductions and maintaining the quality of our work.

Appendices

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Appendix 1 - Consultation responses and questions

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.

1.2. Responses should be received by 27 February 2009 and should be sent to:

Andy MacFaul
Head of Better Regulation
Ofgem
9 Millbank
London SW1 3GE.

1.3. It would be helpful if responses were also submitted electronically to andrew.macfaul@ofgem.gov.uk.

1.4. Unless marked confidential, all responses will be published by placing them in our library and on our 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.

1.5. Respondents who wish their responses to remain confidential should clearly mark the document/s to that effect and include the reasons for confidentiality. It would be helpful if any confidential material is put in the appendices to responses.

1.6. Having considered the responses to this consultation, we intend to publish the final version of our Corporate Strategy by the end of March. Any questions about this document should, in the first instance, be directed to Andy MacFaul using the contact details given above or by phone on 020 7901 7083.

CHAPTERS 1-7

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?

CHAPTER 7 (BETTER REGULATION)

Question 4: Are there any areas of regulation that you consider to be an unnecessary burden that should be removed?

Question 5: Are there any other activities that we should include in the Simplification Plan that we intend to publish in March?

Summary of responses to the initial consultation letter

1.7. In August 2008 we conducted an initial consultation with interested parties. We received 13 responses¹, which are summarised below and available on our website.

1.8. Some respondents said it was vital for Ofgem to take actions that maintain consumers' faith in competitive markets. Those respondents stated that we should not accede to demands for intervention that would distort the market because such interventions would increase uncertainty and dampen investment incentives. Some respondents welcomed the work we had done on smart metering but hoped we would avoid introducing new complexity during the roll out.

1.9. Respondents stated that Ofgem should have a long-term focus for network regulation and should promote an investor-friendly, stable regulatory framework. This framework would avoid unnecessary complexity and retain sufficient flexibility to respond to future events. Respondents welcomed the *RPI-X at 20* project but stressed the need for full consultation before making any changes to our approach.

1.10. Several respondents stated that sustainable development and security of supply were of paramount importance. Some respondents argued that we should do more to promote Government climate change goals. One respondent believed that much more could be done under the existing statutory remit.

1.11. There continued to be widespread support for our proactive stance in Europe to promote competitive EU energy markets and to minimise the risk that the EU adopts policies that could have an adverse effect on British energy markets. There was recognition that 2009 would be crucial in terms of finalising the Third Package and that many parts of Ofgem would need to be involved.

1.12. Some respondents noted that, while they would do all they could to tackle fuel poverty, the issue was primarily a matter for Government. One respondent noted that imposing 'one size fits all' solutions risked deterring innovation that could benefit all consumers, while another wanted a period of stability and certainty in terms of what was wanted from suppliers.

1.13. Those who commented on the matter urged Ofgem to retain a focus on better regulation. Several respondents commented on the industry code governance review. Some said the current regime generally worked well while others noted that any significant changes could increase regulatory risk if not accompanied with appropriate checks and balances. There were also calls for more licence reviews.

¹ We received responses from Centrica, CE Electric, Coalpro, EDF Energy, Electricity North West, EON UK, Friends of the Lake District, the Lighting Association, Northern Gas Networks, RWE npower, SSE, Utility Customer Service Management and Wales and West Utilities.

Appendix 2 - Ofgem's deliverables and performance indicators 2009-10

Deliverables 2009-10

Creating and sustaining competition

| Activity | Action | Period |
|--|---|--------|
| GB Markets - Market monitoring and development | Probe - remedies | Q1 |
| GB Markets - Market monitoring and development | Publish 2009 Energy Markets Outlook report | Q3 |
| GB Markets - Market monitoring and development | Publish final Winter Outlook Report | Q3 |
| GB Markets - Market monitoring and development | Publish proposals for System Operator incentives to apply from 1 April 2010 | Q4 |

Regulating networks effectively

| Activity | Action | Period |
|---------------------|---|--------|
| Distribution | DPCR5 - methodology and initial cost assessment update | Q1 |
| Distribution | DPCR5 - publish initial proposals | Q2 |
| Transmission | Implement longer-term enhanced Transmission Operator (TO) incentives | Q2 |
| Regulatory Services | Publish financial distress process manual | Q2 |
| Distribution | DPCR5 - publish final proposals | Q3 |
| Distribution | Publish Connections industry Review | Q3 |
| Transmission | Publish Regulatory Reporting Pack for the Transmission Operators | Q3 |
| Transmission | Make decisions Connection and Use of System Code modifications relating to the Transmission Access Review | Q3 |
| Transmission | Implement short-term enhanced TO incentives | Q3 |
| Distribution | Publish DNO costs and outputs report | Q4 |
| Distribution | Publish GDN costs and outputs report | Q4 |
| Transmission | Approve gas entry substitution arrangements | Q4 |

Helping to achieve sustainable development

| Activity | Action | Period |
|----------------------|--|--------|
| Environmental Policy | Publish report on incentives for energy saving | Q1 |
| Environmental Policy | Publish Sustainable Development report 2009 | Q3 |

Sustainable development programmes

Ofgem administers several environmental programmes on behalf of the Government. The deliverables associated with this work for 2009-10 are as follows:

| Activity | Action | Period |
|---|---|---------------|
| Energy Efficiency | Publish a review of the Energy Efficiency Commitment 2005-08 | Q2 |
| Community Energy Savings Programme (CESP) | Following the Government's consultation, publish the procedures for the administration of the CESP scheme | Q3 |
| Renewables & Combined Heat and Power | Publish annual report on Renewables Obligation | Q4 |

A leading voice in Europe

| Activity | Action | Period |
|-------------------|---|---------------|
| European Strategy | Agree plans for phase 2 of gas transparency in the North West Gas Regional Initiative | Q1 |
| European Strategy | Submit National Report to European Commission | Q2 |

Helping tackle fuel poverty

| Activity | Action | Period |
|---------------------------|--|---------------|
| Social & Consumer Affairs | Update on Social Action Strategy | Q1 |
| Social & Consumer Affairs | Review of suppliers' debt practices | Q2 |
| Social & Consumer Affairs | Publish a review of the new ombudsman arrangements | Q4 |
| Social & Consumer Affairs | Update on vulnerable customer engagement with the market | Q4 |

Better regulation

| Activity | Action | Period |
|----------------------------|--|---------------|
| Industry Codes & Licensing | Industry Codes Governance Review - publish initial proposals relating to major policy reviews/self-governance and the role of industry code administrators | Q1 |
| Corporate Communications | Publish annual report | Q2 |
| Industry Codes & Licensing | Industry Codes Governance Review - publish final proposals relating to major policy reviews/self-governance and the role of industry code administrators | Q3 |
| Finance - Fossil Fuel Levy | Set the Fossil Fuel Levy Rate for 2008-09 | Q3 |

Performance Indicators 2009-10

| Activity | Measure | Target | Timing |
|---------------------------------|--|--------|-----------------|
| GB Markets | 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 in relation to any Income Adjusting Event within three months of it being raised if adequate information is provided | 100% | |
| Industry Codes & Licensing | Publish decision letters for industry code modification proposals within 25 working days | 70% | Annual |
| | Grant competitive licence applications within 8 weeks of receipt | 90% | Annual |
| Social & Consumer Affairs | Respond to complaints on enforcement matters confirming whether we will investigate | 90% | 4 weeks |
| | Respond substantively to customer contacts | 93% | 10 working days |
| Finance - Accounting Operations | Pay undisputed bills within 30 calendar days | 98% | 30 days |
| | Pay undisputed 'small business' bills within 10 days | 98 % | 10 days |

Sustainable development programmes

| Activity | Measure | Target | Timing |
|-------------------|--|--------|--|
| Energy efficiency | Respond to suppliers that have submitted schemes | 100% | Within 10 days of submission deadline |
| Renewables & CHP | Follow up with generators outstanding issues in their applications for accreditation | 100% | Within 10 days of submission deadline |
| | Complete reconciliation of CHP LECs | 100% | Within 20 working days after receipt of accurate data from Defra |
| | Recycle the RO buy-out funds | 100% | Within one month |

Appendix 3 - Ofgem's budget 2009-14

| BUDGET TABLE | RPI-3 per cent five-year cost control period | | | | | | | | | |
|--|---|-----------------|-----------------|----------------|--------------------------------|----------------|----------------|----------------|----------------|----------------|
| £m | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2008-09 | 2009-10 | 2010-11 | 2011-12 | 2012-13 | 2013-14 |
| Costs by theme | Out-turn | Out-turn | Out-turn | Planned | Provisional Outturn (1) | Planned | Planned | Planned | Planned | Planned |
| Creating & sustaining competition | 5.2 | 5.6 | 5.5 | 4.5 | 6.1 | 5.6 | 6.0 | 6.0 | 6.1 | 6.3 |
| GB Markets monitoring/development | 2.9 | 3.2 | 2.8 | 2.4 | 3.6 | 3.2 | 3.6 | 3.8 | 3.8 | 4.0 |
| Connections | 0.3 | 0.4 | 0.3 | 0.3 | 0.4 | 0.3 | 0.3 | 0.3 | 0.4 | 0.4 |
| Industry Codes and Licensing (2) | 1.0 | 1.1 | 1.4 | 0.9 | 0.9 | 0.9 | 0.9 | 0.7 | 0.7 | 0.7 |
| Enforcement & Consumer Affairs (2) | 1.0 | 0.9 | 1.0 | 0.9 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 |
| Regulating network monopolies | 9.4 | 10.7 | 8.7 | 9.6 | 10.1 | 8.1 | 8.0 | 7.7 | 7.6 | 7.8 |
| Transmission | 5.2 | 4.0 | 2.5 | 2.5 | 2.7 | 3.0 | 4.0 | 3.5 | 3.3 | 2.7 |
| Distribution (3) | 3.3 | 5.8 | 3.9 | 4.4 | 4.4 | 3.6 | 2.5 | 3.3 | 3.4 | 4.1 |
| RPI-X at 20 and regulatory finance | 0.0 | 0.0 | 0.0 | 0.6 | 0.7 | 1.5 | 1.5 | 0.9 | 0.9 | 1.0 |
| Technical (4) | 0.9 | 0.9 | 2.3 | 2.1 | 1.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Offshore Tender Team | 0.0 | 0.0 | 0.0 | 0.5 | 1.8 | 4.8 | 5.2 | 4.3 | 4.4 | 4.5 |
| Offshore Tender Team Recharge | 0.0 | 0.0 | 0.0 | (0.5) | (0.5) | (4.8) | (5.2) | (4.3) | (4.4) | (4.5) |
| Helping to achieve SD | 1.8 | 2.5 | 2.4 | 2.6 | 2.6 | 2.6 | 2.7 | 2.8 | 2.9 | 2.9 |
| Environmental Programmes (5) | 1.4 | 2.0 | 2.0 | 2.1 | 2.1 | 1.9 | 2.0 | 2.0 | 2.1 | 2.1 |
| Environmental Policy | 0.4 | 0.5 | 0.4 | 0.5 | 0.5 | 0.7 | 0.7 | 0.8 | 0.8 | 0.8 |
| Security of energy supplies | 1.2 | 1.3 | 1.3 | 1.2 | 1.3 | 1.4 | 1.6 | 1.6 | 1.6 | 1.7 |
| Security of Supply (6) | 1.2 | 1.3 | 1.3 | 1.2 | 1.3 | 1.4 | 1.6 | 1.6 | 1.6 | 1.7 |
| A leading voice in Europe | 1.2 | 1.5 | 1.0 | 1.0 | 1.1 | 1.3 | 1.5 | 1.5 | 1.6 | 1.7 |
| Europe | 1.2 | 1.5 | 1.0 | 1.0 | 1.1 | 1.3 | 1.5 | 1.5 | 1.6 | 1.7 |
| Helping to tackle fuel poverty | 0.3 | 0.3 | 0.4 | 0.4 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Social & Consumer Affairs (7) | 0.3 | 0.3 | 0.4 | 0.4 | 0.6 | 0.7 | 0.7 | 0.7 | 0.7 | 0.7 |
| Better regulation | 0.3 | 0.5 | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| Better Regulation | 0.3 | 0.5 | 0.2 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| Sub Total | 19.4 | 22.4 | 19.5 | 19.5 | 22.0 | 19.9 | 20.8 | 20.6 | 20.8 | 21.3 |

| £m | RPI-3 per cent five-year cost control period | | | | | | 2010-11 | 2011-12 | 2012-13 | 2013-14 |
|------------------------------------|--|--------------|-------------|-------------|-------------------------|-------------|-------------|-------------|-------------|-------------|
| | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2008-09 | 2009-10 | | | | |
| Other Costs | Out-turn | Out-turn | Out-turn | Planned | Provisional Outturn (1) | Planned | Planned | Planned | Planned | Planned |
| Executive/Support/Overheads | 7.9 | 7.9 | 9.8 | 8.8 | 9.9 | 9.5 | 10.1 | 10.1 | 10.4 | 10.6 |
| Strategy and Direction | 1.3 | 1.0 | 1.0 | 1.1 | 1.2 | 1.3 | 1.4 | 1.4 | 1.5 | 1.6 |
| Corporate Comms & Scottish office | 1.2 | 1.3 | 1.5 | 1.6 | 1.6 | 1.6 | 1.7 | 1.7 | 1.8 | 1.8 |
| Finance | 0.7 | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 | 1.0 | 1.1 | 1.2 | 1.2 |
| Human Resources | 2.0 | 1.0 | 2.0 | 1.2 | 2.1 | 1.2 | 1.4 | 1.4 | 1.4 | 1.5 |
| HR Graduate Scheme | 0.0 | 0.0 | 0.4 | 0.4 | 0.4 | 0.4 | 0.5 | 0.5 | 0.5 | 0.5 |
| Corporate Services | 2.7 | 2.8 | 2.8 | 3.0 | 3.6 | 3.5 | 4.1 | 4.0 | 4.0 | 4.0 |
| Restructuring | 0.0 | 1.0 | 1.3 | 0.6 | 0.1 | 0.6 | 0.0 | 0.0 | 0.0 | 0.0 |
| Accommodation | 4.5 | 4.6 | 5.2 | 5.1 | 5.0 | 4.8 | 5.3 | 5.3 | 5.5 | 5.6 |
| Gross | 8.4 | 8.3 | 8.7 | 8.7 | 8.6 | 8.5 | 9.0 | 8.9 | 9.5 | 9.8 |
| Recharge | (3.9) | (3.7) | (3.5) | (3.6) | (3.6) | (3.7) | (3.7) | (3.6) | (4.0) | (4.2) |
| Other | 0.1 | (0.2) | 0.2 | 2.1 | 0.1 | 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 | 0.9 | 0.9 |
| Anticipated developments | 0.0 | 0.0 | 0.5 | 2.0 | 0.0 | 2.0 | 3.0 | 3.5 | 3.5 | 3.5 |
| Other Income | (0.8) | (1.1) | (1.2) | (0.8) | (0.8) | (0.8) | (0.8) | (0.8) | (0.8) | (0.8) |
| Sub Total | 12.5 | 12.3 | 15.2 | 16.0 | 15.0 | 16.4 | 18.5 | 19.0 | 19.5 | 19.8 |
| TOTAL COSTS | 31.9 | 34.7 | 34.7 | 35.5 | 37.0 | 36.3 | 39.3 | 39.6 | 40.3 | 41.1 |

Notes: (1) See 2008-09 provisional spend analysis below. (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) Gas distribution and electricity distribution have been merged. (4) This item relates to our statutory obligations in relation to gas and electricity metering and gas quality. The metering work is carried out by the National Weights and Measures Laboratory (NWML) and a full transfer of statutory and financial responsibility to NWML under the Energy Act 2008 is due to occur on 1 April 2009. (5) On behalf of the Government Ofgem administers several environmental programmes. (6) 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. (7) Work that contributes to the theme 'helping to tackle fuel poverty' is also undertaken across other work strands.

2008-09 provisional spend analysis

1.1. This column provides the current estimated outturn figures. The final version of the Corporate Strategy will provide an explanation of any major variances between planned and actual expenditure. We fully expect to meet our RPI-3 per cent cost control target of £34.7 million for 2008-09.

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 for a further four years (from 2010-11 to 2013-14). As with the last four budgets, we have extracted central and overhead costs for transparency to enable comparisons to be made.

1.3. Much of our work is reactive with constantly changing priorities. To provide for this a contingency for future developments has been included in the budget. In 2008-09 we expect to utilise all of the £2.0 million contingency. We have also obtained approval from HM Treasury to use £1.5 million of our £3 million reserves to fund additional activities, such as offshore transmission and the retail market probe.

1.4. In 2009-10 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 that these will reduce as budgets are finalised.

Offshore electricity transmission

1.5. Under the Energy Act 2008, the Government has set out that Ofgem will be responsible for administering on behalf of DECC the tender process for the award of transmission licences to offshore transmission owners. Costs associated with the offshore tender administration are shown in the above budget table. It is planned that costs relating to the tender process will be recovered through fees associated with the tender rather than by Ofgem's normal licence fee payers.

Environmental programmes

1.6. As set out in chapter 3, Ofgem administers a range of environmental programmes on behalf of other Government departments. Our projected costs of administering these programmes in 2009-10 are shown in the table below.

| | |
|--|--------------|
| Renewable Obligation | £1.0m |
| Energy Efficiency Commitment | £0.4m |
| Non-Fossil Fuel Obligation | £0.1m |
| Climate Change Levy Exemption for Renewables & CHP | £0.3m |
| Renewable Energy Guarantees of Origin | <u>£0.1m</u> |

| | |
|--------------------------|--------------|
| Sub-total | £1.9m |
| Overhead & support costs | <u>£1.0m</u> |
| Total | £2.9m |

1.7. Government plans currently propose that Ofgem may be responsible for administering on behalf of DECC additional programmes, such as a renewable heat incentive, feed-in tariffs and a community energy saving programme. No budgetary provision is currently included for these programmes.

RPI-3 per cent cost control programme

1.8. RPI was determined as 3.5 per cent for 2005-06, as 2.2 per cent for 2006-07, as 4.4 per cent for 2007-08 and as 4.0 per cent for 2008-09. For 2009-10 RPI has been estimated as 2.5 per cent but will be adjusted to the rate prevailing at December 2008. This gives rise to the following cost ceiling:

| £m | 2005-06 | 2006-07 | 2007-08 | 2008-09 | 2009-10 |
|--------------------------------------|----------------|----------------|----------------|----------------|----------------|
| RPI-3 per cent budget ceiling | 34.2 | 33.9 | 34.3 | 34.7 | 33.6* |

*The budget ceiling has been reduced by £0.8 million as a result of the transfer of metrology responsibilities to the NWML in 2009-10.

1.9. 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.

1.10. 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, 2006-07 and 2007-08, the planned savings of £1.1 million were achieved. In addition, extra savings of £2.9 million, £0.6 million and £0.9 million were achieved and returned to licence fee payers in 2006-07, 2007-08 and 2008-09 respectively.

| BUDGET/RPI-3 PER CENT COST CONTROL RECONCILIATION | | | | | |
|--|----------------------------|----------------------------|----------------------------|--------------------------------|----------------------------|
| (£ million) | 2005-06 Outturn | 2006-07 Outturn | 2007-08 Outturn | 2008-09 Provisional | 2009-10 Planned |
| Total costs as per budget table | 31.9 | 34.7 | 34.7 | 37.0 | 36.3 |
| Costs excluded (funded by licensees) | | | | | |
| Administering Environmental Programmes (net) | (0.4) | (1.3) | (1.2) | (0.8) | (1.1) |
| Depreciation | (1.2) | (0.9) | (0.9) | (0.9) | (0.9) |
| Reserve drawn down | | | | (1.5) | (1.5) |
| Costs excluded (funded by non-licensees) | | | | | |
| Administering offshore tender process – gross costs | 0.0 | 0.0 | 0.0 | 0.5 | 4.8 |
| Administering offshore tender process – recharge income | 0.0 | 0.0 | 0.0 | (0.5) | (4.8) |
| Costs included (funded by HM Treasury) | | | | | |
| Capital | 1.0 | 0.8 | 0.8 | 0.8 | 0.8 |
| Total adjusted costs | 31.3 | 33.3 | 33.4 | 34.7 | 33.6 |
| RPI-3 per cent budget ceiling | 34.2 | 33.9 | 34.3 | 34.7 | 33.6 |
| Variance | (2.9) | (0.6) | (0.9) | 0.0 | 0.0 |

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

Appendix 4 - Ofgem's draft Simplification Plan 2009-10

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 draft Simplification Plan that outlines the work that we will propose to undertake in 2009-10 under the banner of better regulation.

1.3. Consistent with our duty under the RES Act 2008, we have considered whether there are any regulations that impose burdens that could, in the context of our duties generally, be considered unnecessary. The Simplification Plan reflects our current view of the work we should undertake to reduce or remove those burdens pursuant to the new duty.

1.4. We would welcome views on whether the activities that we have identified are appropriate and would be likely to reduce or remove unnecessary burdens. We would also very much welcome views on whether there are other regulations that impose unnecessary burdens and which should be simplified or removed in order to comply with the RES Act duty. We will carefully consider any suggestions that we receive and they may be included in the final Simplification Plan published in March.

1.5. We will set out the progress that make on these projects in our Annual Report.

Process initiatives

| Initiative | Outcome | Current status |
|---|--|--|
| Ofgem RPI-3 per cent cost control for 2005-10. Commits Ofgem to save at least £5 million in 5 years. | The internal cost control has stimulated greater internal efficiency. Licensees have benefited from reduced fees. | We are approaching the final year of the existing cost control period. In each of the first three years of the control we beat our cost reduction target. We returned an extra £4.4 million of savings to licence fee payers in 2006-08. In the light of increasing cost and other resource pressures we are considering how best to incentivise internal efficiencies after 2010. |

| Initiative | Outcome | Current status |
|--|--|---|
| <p>Industry codes governance review.</p> <p>The review is considering whether existing code and can be improved, for example by introducing:</p> <ul style="list-style-type: none"> ▪ a framework enabling Ofgem to lead and manage major policy reform via the codes; and ▪ self-governance where proposals have little impact on consumers or competition. <p>We are also aiming to make the modification process more transparent and accessible, for example to smaller code participants.</p> | <p>The reformed governance regime should:</p> <ul style="list-style-type: none"> ▪ deliver change in a manner that results in a proportionate regulatory burden; ▪ promote inclusive, accessible and effective consultation; ▪ are transparent and easily understood; ▪ are administered in an independent and objective fashion; ▪ provide rigorous and high quality analysis of proposed changes; ▪ are cost-effective; and ▪ are sufficiently flexible to circumstances that they will always allow for efficient change management. | <p>We set out the scope of the review in June 2008.</p> <p>We will publish initial proposals in spring of 2009 and final proposals by the end of 2009.</p> |
| <p><i>Consumer First</i> project to improve our understanding of the priorities of domestic consumers, for example on sustainability issues</p> | <p>Improved decision-making that takes proper account of consumers' views. We will publish research and other data to facilitate debate.</p> | <p>Ongoing. We have focused on vulnerable customers and attitudes to the environment. We have established new consumer panels (see chapter 7 above).</p> |
| <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> <p>The Editorial Board will produce revised internal guidance to Ofgem staff on writing 'plain English' documents in early 2009.</p> |

Policy initiatives

| Initiative | Outcome | Current status |
|--|--|---|
| <p>Probe follow-up work:</p> <p>Retail markets barriers to new entry</p> <p>Increased transparency (eg separate accounts, more accessible bills)</p> | <p>Reduced barriers to entry thereby strengthening competitive pressures on existing suppliers</p> <p>Better informed switching decisions by consumers</p> | <p>We are currently considering how to take this forward</p> |
| <p>Removing barriers to distributed energy (DE) within the existing marketing and licensing arrangements.</p> | <p>Reduced administrative burden for DE providers.</p> <p>The changes will make it easier for DE providers to supply customers while at the same time protecting consumer rights to switch supplier.</p> | <p>In 2008 we introduced proposals to remove regulatory barriers, which took effect in late 2008. DE companies can contract with larger suppliers to manage the administrative requirements of industry codes. We will monitor the impact of the changes closely in 2009.</p> |
| <p>Streamlined approach to the 2010-15 electricity distribution price control</p> | <p>Reduced administrative burden for electricity distribution businesses</p> | <p>We have recently published an updated policy paper for consultation. We will develop and consult on detailed proposals throughout 2009.</p> |
| <p>RPI-X at 20 review.</p> <p>This is examining whether the current RPI-X approach to network regulation will continue to deliver reliable, well-run networks with a good quality of service at reasonable prices despite growing investment challenges.</p> | <p>The review team will report to the Authority in the summer of 2010.</p> <p>We will subsequently consult on the recommendations.</p> <p>The eventual conclusions will inform our approach to new price control reviews after 2010.</p> | <p>We are still in the information-gathering phase of this review. We have held workshops, launched our web forum and published our first consultation document.</p> |
| <p>New, simplified reporting regime for distribution companies</p> <p>We remain committed to publishing cost, revenue and quality of service data for GDNs.</p> | <p>Reduced administrative burden for distribution businesses and greater data transparency for network users.</p> | <p>We are looking for ways to simplify the reporting requirements. We will explore whether we can widen the range of data that is put in the public domain. We will also seek to publish GDN performance against a</p> |

| | | |
|--|---|---|
| | | balanced score card and DNO performance against new output measures agreed as part of DPCR5 |
| Distribution licence reviews | <p>Ensure that the licences remain fit for purpose and that they do not impose unnecessary burdens on licensees.</p> <p>Simplify the text to make them more accessible to those using them.</p> | <p>We completed the electricity distribution licence review and published revised licences in May 2008. The changes improved the style, format and ease of use of the licences.</p> <p>We will consider taking forward a review of gas distribution licences in the next year or two.</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 |
| Engineering standard P2/6: introducing simpler compliance arrangements | Distribution licensees have since March 2007 been self-regulating their compliance with this engineering standard for demand up to 60MW | We will review the operation of the new regime. If we conclude that the trial has been successful, we will seek to make this permanent |

Appendix 5 - The Authority's duties and powers

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 UK statute (such as the Gas Act 1986, the Electricity Act 1989, the Utilities Act 2000, the Competition Act 1998, the Enterprise Act 2002 and the Energy Acts of 2004 and 2008) 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 Acts². 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.³

1.3. 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, existing 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.

1.4. 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 them⁴;
- the need to contribute to the achievement of sustainable development⁵; and
- the interests of individuals who are disabled or chronically sick, of pensionable age, with low incomes, or residing in rural areas.⁶

² Entitled "Gas Supply" and "Electricity Supply" respectively.

³ 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.

⁴ 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.

⁵ This obligation has been introduced by the Energy Act 2008 but has yet to be commenced. See below for more details.

⁶ The Authority may have regard to other descriptions of consumers.

1.5. 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 licensed⁷ under the relevant Act and the efficient use of gas conveyed through pipes and electricity conveyed by distribution systems or transmission systems;
- protect the public from dangers arising from the conveyance of gas through pipes or the use of gas conveyed through pipes and from the generation, transmission, distribution or supply of electricity; and
- secure a diverse and viable long-term energy supply.

1.6. In carrying out these functions, the Authority must also have regard to:

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

1.7. 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 Britain. The Authority is a designated National Competition Authority under the EC Modernisation Regulation⁸ and is therefore part of the European Competition Network. The Authority also has concurrent powers with the Office of Fair Trading in respect of market investigation references to the Competition Commission.

The Energy Act 2008

1.8. The Energy Act 2008 contains provisions which, once commenced, will modify the general duties of the Authority in carrying out its functions under the Gas Act and the Electricity Act. In particular, those changes will mean that, when carrying out its functions in the manner which it considers is best calculated to further its principal objective, the Authority must do so by having regard to the need to contribute to the achievement of sustainable development equally with the need to have regard to the need to secure that all reasonable demands for electricity and gas are met and that licensees are able to finance their regulated activities.

⁷ Or persons authorised by exemptions to carry on any activity.

⁸ Council Regulation (EC) 1/2003.

7.28. It has also been highlighted within the text of the principal objective that the Authority's consideration of the interests of consumers includes both future as well as existing consumers.

7.29. The Energy Act 2008 received Royal Assent on 26 November 2008 but these provisions do not have legal force until they are commenced. We do not yet have a commencement date for the new provisions but it is likely to be early in 2009.

1.9. During the period between the Energy Act 2008 having received Royal Assent and commencement of the provisions which affect its duties, the Authority must continue to apply the principal objective and its statutory duties in accordance with the Gas Act and the Electricity Act as they currently stand (i.e. prior to the Energy Act 2008 amendments taking effect), although it will be mindful of the changes that are forthcoming. The Authority already takes account of sustainable development in its decisions but with the change in duties the weight that is attached to such considerations will be increased.

Appendix 6 - Glossary

A

Area of Outstanding Natural Beauty

An Area of Outstanding Natural Beauty (AONB) is an area of countryside with significant landscape value that has been designated by the Countryside Agency. The purpose of the designation is to conserve and enhance the natural beauty of the landscape. AONBs rely on planning controls and practical countryside management.

C

Community Energy Savings Programme

The Government in late 2008 announced its intention to establish a new programme, the Community Energy Savings Programme, to achieve CO2 savings and reduce fuel bills in targeted dwellings. DECC is consulting on the details of the programme.

Climate Change Levy

The climate change levy is a tax on the use of energy in industry, commerce and the public sector, with offsetting cuts in employers' National Insurance Contributions and additional support for energy efficiency schemes and renewable sources of energy. The aim of the levy is to encourage users to improve energy efficiency and reduce emissions of greenhouse gases.

Combined Heat and Power

The simultaneous generation of useful heat and power in a single process.

Council of European Energy Regulators

The Council of European Energy Regulators (CEER) comprises the independent national energy regulators from EU Member States and the European Economic Area. CEER acts as a focal point for contacts between national energy regulators and is their main interface at European level. Its aim is to facilitate the creation of a single, competitive and sustainable internal European market for gas and electricity.

D

Distribution Network Operators

Distribution network operators (DNOs) are the ex-Public Electricity Suppliers who came into existence on 1 October 2001. There are 14 DNOs each covering a discrete geographical region of Great Britain. They take electricity from the high voltage transmission system and distribute this over low voltage networks to industrial complexes, offices and homes. DNOs must hold a licence and comply with licence conditions for the networks they own and operate in their distribution services area.

E**EU Emissions Trading Scheme**

A cap and trade scheme in which EU Member State Governments are required to set emissions limits for all installations in their country covered by the scheme. It is an administrative approach used to reduce the cost of pollution control by providing economic incentives for achieving reductions in the emissions of greenhouse gases.

F**Feed-in tariff**

A fixed price paid for electricity produced from renewable energy sources, usually with different (above market) price levels set for different technologies.

Fossil Fuel Levy

The Fossil Fuel Levy is a tax charged on domestic and industrial bills. The levy effectively funds the difference between the contract prices payable to the renewable generators and the market price of electricity.

Fuel Mix Disclosure

On 18 March 2005 a new standard licence condition was introduced into electricity supply licences by The Electricity (Fuel Mix Disclosure) Regulations 2005 (SI No. 391). The condition obliges electricity suppliers to provide customers with details of the mix of fuels used to produce the electricity supplied to them along with certain environmental information on or with their bills.

G**Gas Distribution Networks**

Gas is piped from the gas transmission network into each of the eight regional gas distribution networks, which in turn distribute gas to customers. The eight gas distribution networks are owned by four companies - National Grid Gas, Northern Gas Networks, Scotia Gas Networks, and Wales and West Utilities.

I**Impact Assessments**

Impact assessments are studies of the potential effects of policies on economic, social and/or environmental conditions. Ofgem has a statutory duty to carry out and publish impact assessments for major policy proposals. Ofgem has published guidance on its approach to carrying out impact assessments.

ISO 14001

ISO 14001 is an internationally recognised standard for Environmental Management Systems. An Environmental Management System provides a framework for managing environmental responsibilities so they become more efficient and more integrated into overall business operations.

L

Large Combustion Plant Directive

The Large Combustion Plant Directive aims to reduce acidification, ground level ozone and particles throughout Europe by controlling emissions of sulphur dioxide, nitrogen oxides and dust particulate matter from large combustion plants. These include plants in power stations, petroleum refineries, steelworks and other industrial processes running on solid, liquid or gaseous fuel.

Liquefied Natural Gas

Liquefied natural gas (LNG) is natural gas that has been condensed into a liquid at atmospheric pressure by cooling it to approximately -163 degrees Celsius. LNG is transported by specifically designed vessels and stored in specially designed tanks. LNG is about 1/600th the volume of natural gas, making it much more cost-efficient to transport over long distances where pipelines do not exist.

M

Microgeneration

The small-scale generation of heat and/or electricity from a low carbon source, for example solar panels, micro-wind, micro combined heat and power and heat pumps.

N

National Grid Electricity Transmission and National Grid Gas

National Grid Electricity Transmission owns and maintains the high-voltage electricity transmission system in England and Wales. It also operates the system across Great Britain, balancing supply with demand on a minute-by-minute basis. National Grid Gas is the licensed gas transporter responsible for the gas transmission system and for four of the regional gas distribution companies.

P

Prepayment meters

Meter designed to enable consumers to pay for electricity and gas as they use it. The customer needs to be provided with a network of outlets where tokens can be purchased, or cards or keys can be charged up. This network of outlets needs to be linked to a payment settlement system for suppliers.

R**Registered Power Zones**

Registered Power Zones (RPZs) are focused specifically on the connection of generation to distribution systems. RPZs are intended to encourage DNOs to develop and demonstrate new, more cost-effective ways of connecting and operating generation that will deliver specific benefits to new distributed generators and broader benefits to consumers generally.

Renewables Obligation and Renewables Obligation Scotland

The Renewables Obligation (RO) obliges licensed electricity suppliers in the United Kingdom to source an increasing proportion of electricity from renewable sources. Suppliers meet their obligations by presenting Renewables Obligation Certificates (ROCs) or by payment into the buy-out fund.

Renewables Obligation Certificate

A Renewables Obligation Certificate is a transferable certificate received by eligible renewable generators for each MWh of electricity generated. ROCs are traded separately from power and are used by suppliers to fulfil their Renewables Obligations under the Utilities Act 2000.

S**Self-disconnection**

Self-disconnection occurs where a prepayment customer does not have sufficient credit on their meter which results in their energy supply being discontinued.

Smart Metering

Advanced gas and electricity metering technology that offers customers more information about, and control over, their energy use (such as providing information on total energy consumption in terms of value, not only volume). Smart meters can also allow automated and remote measurement.

Sulphur hexafluoride (SF6)

One of the most potent greenhouse gases and is widely used in transmission and distribution equipment.

System Operator

National Grid is the electricity and gas system operator, responsible for managing the operation of the electricity transmission system and the gas transmission network. They balance supply and demand, in gas maintaining satisfactory system pressures and ensuring gas quality standards are met, and for electricity ensuring the stability and security of the power system and the maintenance of satisfactory voltage and frequency.

Appendix 7 - Feedback questionnaire

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

1. Do you have any comments on the overall process 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 or could it have been better written?
4. To what extent does this document provide a balanced view?
5. To what extent does this document make reasoned recommendations for improvement?

1.2. Please send any comments to:

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