

ofgem

Ofgem Annual Report 2008-2009

Protecting energy consumer interests now and for the future





A full picture of our year

Ofgem London

9 Millbank
London SW1P 3GE
Tel: 020 7901 7000

Ofgem Scotland

Cornerstone
107 West Regent Street
Glasgow G2 2DQ
Tel: 0141 331 2678

www.ofgem.gov.uk

Report of the Gas and Electricity Markets Authority for the period 1 April 2008 to 31 March 2009 to the Secretary of State for Energy and Climate Change presented to Parliament pursuant to Section 5 Utilities Act 2000.



Ordered by the House of Commons to
be printed 20 July 2009
London: The Stationery Office £14.35
HC 824

Office of Gas and Electricity Markets

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

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

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

Contents



1

Foreword by the Chairman

04-05

2

The Gas and Electricity
Markets Authority

06-07

3

Introduction by the
Chief Executive

08-09

4

Creating and sustaining
competition

10-14

5

Regulating network monopolies

15-20

© Crown Copyright 2009

The text in this document (excluding the Royal Arms and other departmental or agency logos) may be reproduced free of charge in any format or medium providing it is reproduced accurately and not used in a misleading context. The material must be acknowledged as Crown copyright and the title of the document specified. Where we have identified any third party copyright material you will need to obtain permission from the copyright holders concerned. For any other use of this material please write to Office of Public Sector Information, Information Policy Team, Kew, Richmond, Surrey TW9 4DU or e-mail: licensing@opsi.gov.uk

ISBN: 9780102960655



6

Helping protect the security of Britain's energy supply

21-23

7

A leading voice in Europe

24-26

8

Helping to protect the environment

27-30

9

Helping to tackle fuel poverty

31-33

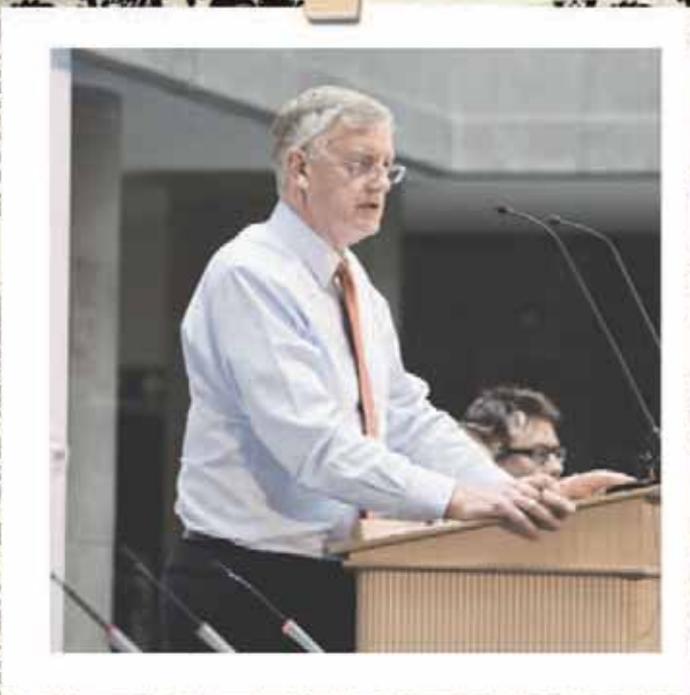
10

Better regulation

34-38

Appendix I	Ofgem's performance against 2008-2009 deliverables	39-42
Appendix II	Impact Assessments undertaken 2008-2009	43-44
Appendix III	Investigations and enforcement action 2008-2009	45-46
Appendix IV	Simplification plan 2009-2010	47-49
Appendix V	Financial statements (extracts) 2008-2009	50-52

The Ofgem Resource Accounts for 2008-2009 are published separately



1

Foreword by the Chairman

Just as most of us have started to learn to live with the cost of beginning to tackle climate change and big rises in commodity fuel prices we have had to watch a global financial crisis add to the risks faced by Britain's energy industry and the pressures felt by Britain's householders and businesses.

The scale and character of the challenges faced by the energy industry and its stakeholders demand innovation and determination in equal measure from the entire sector including the industry regulator. While the implications of these challenges are here and now, they are also global and stretch far into the future.

The pages of this report show how Ofgem has responded to new challenges with an open mind and a clear focus on the consumer. We have been guided too by the distress voiced by consumers and looking ahead, we will continue to follow that guide. Our commitment to understand and act on consumers' concerns is perhaps best exemplified by our appointment under our Consumer First programme, of a panel of domestic consumers to advise our thinking on the issues that most exercise them.

Consumer anxiety grew as prices kept on climbing after last summer. With the need to address that anxiety in mind, we took unprecedented measures in our energy market probe to identify and then to deal with instances of unfair pricing. This focus on the protection of customers will endure in our work for the future.

Ofgem has started up a series of projects that together seek to ensure that it is best positioned to continue protecting consumer interests. The urgency to do this long-term work arises from the mix of inevitabilities and uncertainties that the future holds. Key among these are the impact of the global credit crisis on the British energy sector coupled with Government support for a low-carbon economy by 2050 and the closure, under European environmental legislation, of much of Britain's coal- and oil-fired power stations by 2016.

Ofgem has already begun to respond to these developments. We have launched, in Project Discovery, an analysis of the energy markets to test their capacity to cope with the fallout from the credit crisis and Britain's shifting reliance on imported gas. Its findings will provide a full appraisal of the situation that will be impartial and independent.

Ofgem's two-year review of the 20-year old regime for regulation of the pipes and wires operators (RPI-X@20) will make sure any future regime keeps up the value for money and reliable networks Britain's consumers expect. This work has been informed by our report on long-term electricity network scenarios (LENS) which highlights the challenges anticipated from possible developments in renewable generation out to 2050.

Meanwhile we are advancing the next review of revenue which will introduce a greater focus on consumers and new incentives for innovation to help make the transition to a low-carbon economy.

A huge programme of investment is needed to build the networks that will carry the power from planned onshore and offshore wind farms. We have launched a new regulatory regime for offshore connections developed in partnership with the Department of Energy and Climate Change and in the summer of 2009 we expect to see the significant

interest shown to date translate to commitment to invest.

Our review of the arrangements for connecting renewable generation to the national grid – the Transmission Access Review (TAR) - aims to step up the pace at which green energy comes on line. We have worked hard toward enduring measures to ensure national networks are available to carry the output of new, low-carbon generation needed over the next two decades. The scope for reform has however been frustrated by industry process such that we have now recommended that the Government use its powers to avoid further delay.

Aligned with TAR is our Codes Governance Review - our overhaul of the rule-making process that underpins the entire industry. Benefits to customers of removing red tape in the rules governing many aspects of the industry – including renewable development – will emerge in the coming year.

The 'Third Package' of European energy legislation adopted in spring 2009 could have profound implications for British energy consumers in the future. It lays the ground for a more competitive European energy market. We are considering how we can carry on shaping the European energy scene as the legislation is brought in. Indeed the context for our work in Europe is shifting. Key to this is the need to strengthen security of gas supplies emerging from the stand-off between Russian and Ukraine and the EU Renewables Directive.

As we take on these major responsibilities we are also being asked to do much more in the coming year. The Government has handed us greater responsibilities to administer environmental programmes. This raises naturally an issue over resources as we approach the end of our self-imposed five-year cap on expenditure.

Meanwhile our role was expanded and reinforced during 2008. Parliament has enacted changes to our statutory duties to increase our focus on sustainability. We welcome this. It has been more than a year since our Chief Executive Alistair Buchanan declared that "Sustainability is in Ofgem's DNA." And I believe our launch now of key, long-term strategic reviews is timely and will define our forward-thinking to protect and promote customers' interests today and for the future.



Lord Mogg
Chairman

2

The Gas and Electricity Markets Authority

Ofgem is governed by the Gas and Electricity Markets Authority which determines strategy and decides on major policy issues. The Authority is made up executive and independent non-executive members.



The Authority is supported by a Senior Management Team and committees that have clear terms of reference. There are three main committees: the Audit Committee, the Remuneration Committee and the Enforcement Committee. They create a strong framework of internal control throughout the organisation.

Membership





3

Introduction by the Chief Executive

Over the next twelve months Ofgem will be delivering more than ten major policy and process projects that could influence the shape of the energy sector for a generation. Projects include examinations of whether our methods are fit for the environmental and financial challenges that lie ahead.

These and other large projects dominating Ofgem's calendar are progressing through a period of great interest in energy and climate change. That interest has given us opportunity during the past year to show the flexibility in thinking, diligence, and real willingness to engage with stakeholders that will be key to our future delivery for Britain's consumers.

During this year we have seen evidence of the increasing value to stakeholders of Ofgem's work in a string of highly successful workshops and open meetings. These covered, among other issues, our review of the network regulatory regime, liquefied natural gas, the outlook for winter prices and energy in Scotland.

The quality of our research – for example in our energy retail market probe – has provided an emphatic demonstration of our capacity to deliver judgements for consumers based on detailed analysis, backed by consumer views. And we have demonstrated our openness to testing new ideas in launching a review of the principles that have guided the regulatory regime for two decades.

We have proved that we are able to deliver today's complex policy and administration issues while committing resources to focus on the future. While some of the Ofgem team were focused on vital, forward-looking projects, most were involved in delivering an excellent year for the consumer here and now. Highlights during the past year include:

- National Grid found guilty of abusing competition policy and being penalised with a record fine;
- Npower fined following misselling and moves to address poor practices in direct debit;
- the delivery of a flexible regulatory regime for offshore networks;
- an Ofgem-led win for greater market transparency and openness across Europe – in the Third Package of measures to inject competition into the European energy market; and
- without question, the major win for consumers in 2008/09 was the publication of the retail market Probe.

This pivotal report highlighted customer groups who had been poorly served by their suppliers – especially electricity consumers who are not on the gas grid and pre-payment customers. Ofgem's actions were swift for these categories in particular and wrongs were righted over the winter months. The Probe delivered much more and key outputs for 2009/10 will include licence conditions banning undue price discrimination and a package of remedies addressing industry shortfalls in serving domestic and small business customers.

Ofgem is acutely aware from its excellent Consumer Panel and from Consumer Focus that confidence in the sector was seriously eroded in the run up to our Probe. Our licence condition proposals show that we are willing to take regulatory action to unlock the benefits of competition.

Understandably, penalties, new retail rules and new Ofgem initiatives get the headlines but a vast amount of work by Ofgem staff receives little fanfare. For example Ofgem administers a range of programmes relating to renewable generation and carbon reduction with new ones on the horizon including the roll-out of smart metering and a levy supporting clean-coal generation. Other unsung heroes of the administration functions of Ofgem are the teams that manage the rules and regulations of the industry. Ofgem has been concerned about whether the rules that govern the energy industry remain right in a world influenced more and more by new considerations such as climate change. So we launched the Codes Governance Review last year, which we expect to lead to improvements in the way the industry runs.

Also below the media's radar screen is the outstanding performance by the members of Ofgem's finance team. Not only have they enabled us to beat our cap on cost increases of 3 per cent below retail price index (RPI) for the fourth year running but they also lead all other public sector bodies in delivery of accounts.

New administrative responsibilities such as the smart meter roll-out mean greater workload. That is reflected in the increase over the past three years, in our headcount. Meanwhile our outstanding graduate recruitment scheme attracted 240 applicants for four places this year.

Most of our work receives direct funding but often related policy work does not. So we will have to work hard to beat our cost target for the fifth and final year of the controls.

The reach of our influence is growing not just in what we do but also where we do it. We have expanded our activity in Glasgow to address the growing importance of issues north of the Border. Our Chairman, Lord Mogg, continues his highly successful stewardship of the European regulators and was a prime mover in the creation of the new European Union regulatory agency. Ofgem is expecting to send staff to assist in running the agency given its potential impact on GB consumers.

And we reach out also to be influenced as well as to influence. We are mindful that good ideas and advice can be found outside Ofgem. I admire the patience of my colleagues who handle misdirected (but understandable) frustrations of many groups of consumers. However I do believe that it is a desire to do well for the consumer that unites the diverse activities of Ofgem. In 2008/09 Ofgem delivered key successes for consumers and we plan to do so again in the year that follows.



Alistair Buchanan
Chief Executive

4

Creating and sustaining competition



Key achievements for 2008-2009

- Completed probe into energy retail markets
- Unveiled tough new complaint handling standards
- Appointed Consumer Panel
- Investigations and enforcement
- Sought new powers to curb abuse in the wholesale energy market
- Published first quarterly report on wholesale and retail energy prices
- Building a competitive metering market

Introduction

Competition in wholesale and retail energy has encountered new and testing challenges to its capacity to keep a check on energy prices and encourage innovation in the market to deliver choice for consumers. Ofgem has looked hard at these challenges and intervened where consumers have needed help to gain the full benefits of competition.

Retail markets

Supply market probe

Ofgem's probe into energy supply markets opened at the start of 2008 and concluded in September with a number of findings on which we based proposed remedies to end the situation where some consumers are missing out on the full benefits of competition.

We proposed wide-ranging reforms to deliver those benefits by putting an end to practices that were failing some customers.

The seven-month probe uncovered behaviour by supply companies that was hitting the 4.3 million customers without a gas supply, and imposing unfair deals on other sectors of the domestic and commercial market.

At the same time, we found that competition has generated a wide range of tariffs and products. And there is strong consumer awareness of – and satisfaction with switching.

The probe report proposed measures to tackle issues identified in a number of areas where the transition to fully effective competition should be accelerated. These proposals were grouped under five action areas:

- promoting more active customer engagement;
- helping consumers make well-informed choices;
- reducing barriers to entry and expansion;
- helping small business consumers; and
- addressing concerns over unfair price differences.

The investigation covered markets serving domestic customers and small businesses. It was conducted using the Authority's formal information gathering powers under the Enterprise Act 2002.

Key examples of proposed actions to help households

- Measures to ban unfair price differences, including differences between payment methods. Suppliers' prices will have to reflect the costs to the companies.

For example, prices charged under different payment methods such as pre-payment meters and direct debit will have to reflect the cost to the supplier of offering those payment methods.

- Tougher rules on doorstep selling requiring written quotations following doorstep sales and other measures to give the consumer confidence.
- New requirements on suppliers to provide clearer information to help consumers to choose between competing deals.
- Proposed actions to help the small business market. Ofgem focused its remedies to protect businesses on micro businesses - companies with fewer than 10 employees or any of several other characteristics. This group makes up 70 per cent of all small and medium-sized businesses.
- Proposals to address poor liquidity in the wholesale electricity market and remove other barriers to new entrants.

If implemented, Ofgem aims to have all the rule changes in place for autumn 2009.

Standards

Suppliers will be expected to deal fairly with domestic customers. This was spelt out in a set of new, overarching standards of conduct that suppliers should meet. The standards will complement the licence conditions that will deliver new retail remedies and will be taken into account by Ofgem as we enforce them.

The probe also looked specifically at the supply market for consumers in Scotland and Wales and Ofgem met with Scottish and Welsh governments and consumer representatives to fully understand the issues.

The Consumer First programme

Consumer First was introduced to improve the way we take consumers' interests into account in decision making. The initiative was sparked by growing public awareness of issues such as smart metering, microgeneration and the rising cost of environmental programmes, all of which complicate the issues that matter most to consumers.

Consumer First aims to increase the scope for getting direct consumer contributions to Ofgem's deliberations over policy on customer issues. Research under the programme showed that low-income groups were unaware of the help available and opportunities to switch supplier. This formed the basis of a national campaign to assist vulnerable consumers to get the best deal from their energy suppliers (see page 33)

Consumer Panel

Tapping into developing consumer attitudes to energy is a key concern for Ofgem, especially as we move into an era of rising energy costs and important climate change priorities. Ofgem strengthened its expertise by recruiting domestic energy consumers to help sharpen its focus on consumer concerns. The regulator engaged its first consumer panel (Consumer First panel) drawn from Britain's household energy consumers in October 2008.

The panel has provided a sounding board for the consumer's take on issues that matter most and on the key challenges such as willingness to pay for security of supply and curbs on environmental damage caused by energy supply.

At the same time we assembled a small group of consumer policy experts to shadow the distribution price control review (see page 19). We are pursuing this initiative to bring a stronger consumer focus to the network companies and to Ofgem's policy thinking.

Complaint handling

New arrangements were put in place by Government to replace energywatch. From 1 October 2008 Consumer Direct took responsibility for providing initial advice to energy consumers, as it does already in other sectors. And Consumer Focus replaced the National Consumer Council to combine its functions with some of those of energywatch and postwatch to create a more powerful and streamlined consumer body.

As part of the new arrangements Ofgem introduced, in spring 2008, tough new complaint handling rules for suppliers and network companies. The new standards apply to all complaints from domestic or small business customers. Ofgem will audit the companies later in the year to ensure they are meeting the new obligations and to promote best practice.

Energy Ombudsman

In March, Ofgem published its criteria for a new statutory redress scheme. The new arrangements formally extended the scope of the scheme to all energy suppliers and network companies. Ofgem appointed the Energy Ombudsman Service in summer 2008. It is available to domestic consumers and small businesses who have unresolved disputes with their energy provider. The Ombudsman can seek redress for consumers and it can award compensation.

Investigations and enforcement

Ofgem imposed financial penalties on a number of supply companies in the year.

Mis-selling

Npower was fined £1.8 million after the supplier was found to have breached its licence by failing to comply with its obligations relating to marketing to domestic consumers. While Npower had procedures in place to follow up complaints, Ofgem judged that its managers had not done enough in applying and improving them.

Gas tariff notification

Following an Ofgem investigation into Npower's changes, in 2007 to its gas tariffs, the company agreed to make payments totalling £1.2 million to some 200,000 customers affected. The regulator was concerned about Npower's approach to notifying its customers of the changes which resulted in financial loss to some households whose consumption was low. A large number of consumers did, however, benefit from the changes.

Direct debit

Concerns were raised at the end of 2008 over suppliers' increases in direct debit payments that were unanticipated by consumers. Ofgem reviewed suppliers' direct debit arrangements and we found neither systematic errors nor evidence of attempts by suppliers to increase cashflow through unjustified increases. We did find a lack of transparency and poor communication by suppliers was at the heart of the problem.

The problems we have seen and the concerns that self-regulation will not deliver led us to consider that a licence condition was necessary to ensure that the interests of existing and future consumers are protected. We have opened a consultation on such a licence condition.

Wholesale/ retail prices

In spring 2009 Ofgem published its first quarterly report on wholesale and retail energy prices. The reports provide clear information for customers who want to understand the relationship between the two ends of the price chain.

Wholesale markets

During its supply market probe Ofgem stressed that competition cannot completely shield consumers from spiralling prices of global commodities such as oil, gas and coal. These drive the wholesale energy prices that make up the bulk of consumer bills and are the main drivers behind the recent energy bill increases.

Liquidity

The probe looked at the issue of poor liquidity – a key measure of market performance – in the electricity market. Ofgem shared a widespread concern that this could be restricting the flow of newcomers to the generation market and curbing competition. The same did not apply to the gas market but a number of characteristics of the GB power market including significant vertical integration whereby — companies generated as well as supplied electricity — were limiting liquidity. We intend to publish a consultation document setting out in more detail a range of proposals to address the issues identified in a discussion document published earlier in the year.

Curbing market abuse

During its probe into the retail market Ofgem announced its intention to seek greater powers in the wholesale market to address the potential for generators to abuse circumstances where they are able to dominate the market. Typically opportunities to dominate might be during periods when generation is constrained through (say) limited access to the networks or shortage of available power plant. Undue exploitation of a dominant position could increase the price of wholesale electricity and the costs of all these effects are likely to be borne by consumers in increased energy bills.

Using our Competition Act 1998 (CA98) powers in April 2008 we opened an investigation into allegations that ScottishPower and Scottish and Southern Energy had abused a dominant position when network access was limited. We closed that investigation in April 2009 on the grounds that the likelihood of finding an infringement under the CA98 was low and more effective actions were available to address the market concerns.

In light of concerns over possible undue exploitation of market power, Ofgem is currently minded to seek to address market power concerns through the introduction of a new licence condition which is broad and applicable to all generators, with guidance on Ofgem's approach to enforcing it. We are seeking to take this forward through consultation with the industry.

System Operator incentives

National Grid Gas (NGG) and National Grid Electricity Transmission (NGET) consented to Ofgem's final proposals for electricity and gas transmission System Operator Incentive Schemes to apply from April 2009. Ofgem's view is that the best way to achieve lowest costs to consumers is to provide the system operators with incentives to share some of the gains from cost reductions as well as any losses arising from increased costs.

We have asked NGET and NGG to look to develop proposals for schemes from April 2010 that will cover a two-year period, as we consider this will enable NGET and NGG to further develop their roles in a more efficient manner.

Competitive metering market

Gas metering

A measure of Ofgem's commitment to promoting competition in metering was our fining of National Grid £41.6 million for a breach of competition law that restricted the development of competition in the domestic gas meter market. The company was judged to have used its dominance in gas metering to prevent suppliers from contracting with other companies for cheaper metering deals. By restricting competition, National Grid deprived gas suppliers and customers of access to lower prices and it curbed innovation in domestic metering.

Smart metering

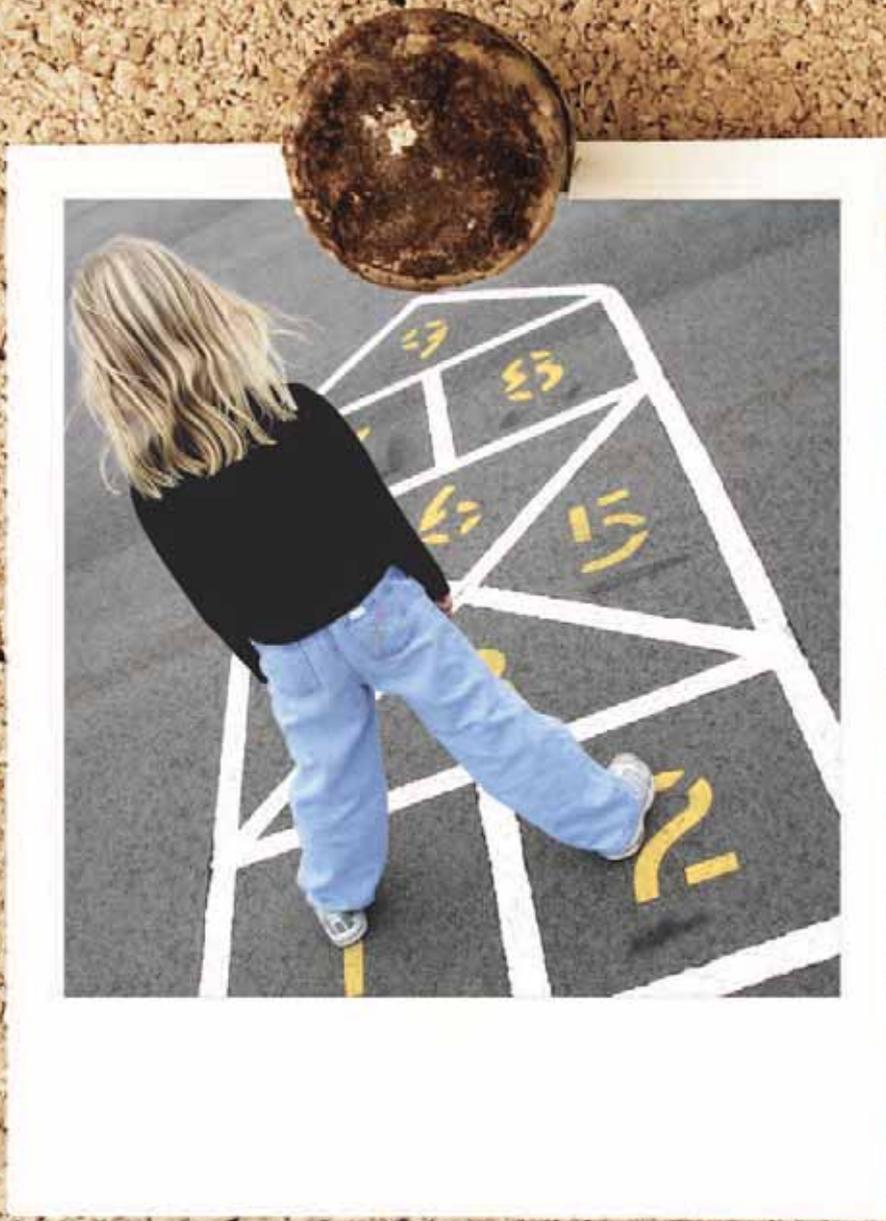
The first trial in Britain of advanced energy meters – smart meters - was launched in July 2007. The two-year trial is administered by Ofgem under a £10 million Government programme match-funded by four energy suppliers.

The trials will test how customers respond to having access to greater information. And to bring down barriers to the use of smart meters Ofgem has formed an industry-wide group to agree minimum standards for smart meters and to revise industry rules to pave the way for their use.

Ofgem has worked throughout with Government to get agreement on a way forward with smart metering. The Government mandated the introduction of smart metering in spring 2009.

Market consolidation

During the period of this report we saw the merger of Electricité de France and British Energy. In this Ofgem acted as advisor to the UK and European competition authorities to ensure consumers' interests were met.



Regulating network monopolies

5

Key achievements for 2008-2009

- Transmission Access Review advances

- New offshore transmission regime

- First year of gas distribution price control

- Progress in next review of electricity distribution price controls

- Competition in connections

Introduction

Regulation of the networks aims to place competitive pressures on natural monopolies. The networks face new demands arising from the need for the energy industry to meet environmental and social challenges. With these new challenges for the networks comes the need to consider if, and how we need to change the way we regulate their businesses.

Review of the regulatory regime for energy networks

Ofgem has progressed its review of the 20-year-old regime governing its regulation of the gas and electricity networks. The two-year review will seek to establish whether the existing approach - based on pegging revenue increases below the retail price increase (RPI) - is still the best way to ensure that networks are well-run, provide good service to customers and innovate to meet the challenges of moving to a low-carbon economy.

RPI-X regime

The current system provides incentives for companies to outperform efficiency targets set in a series of five-yearly Price Control Reviews. These reviews establish allowances for expenditure and income for the companies based on a fundamental formula: Retail Price Index (RPI) minus X per cent where X is worked out at each review for network businesses.

In summer 2009 the review team began publishing a series of working papers beginning with a study of what will be required of the regulatory regime for the future.

The need for the review arises out of the new challenges faced by the energy network companies. Those challenges emerge from the anticipated need to connect large amounts of new gas and power production plant to the networks. This need emerges from:

- ambitious Government targets for wind power and other renewable energy;
- proposals for greater energy network interconnection in Europe;
- greater use of imported gas in Britain; and
- a growing emphasis on small-scale regional energy production.

The review will test the RPI-X regime against the demands these developments will place on the businesses to ensure consumers continue to get the quality and resilience of supply they have grown to expect.

The review will report in 2010 so it will not affect the work on the next price control review for electricity distribution scheduled to come into force in 2010. Recommendations from the review will not be limited and could range from no change to substantial transformation. Where change is recommended there will be full consultation.

Transmission

Transmission is the long-distance transportation of electricity and gas along the national grids for each.

Transmission Access Review

Current and future growth in renewable and other types of low-carbon generation will place new demands on the electricity transmission grids north and south of the Border. A joint review is underway, led by Ofgem and the Department of Energy and Climate Change (DECC) to change the arrangements for giving generators access to the power grid. It will look at ways to deliver the Government's aspiration of 20 per cent of electricity supplied by renewable generation as well as other European targets.

Issues it addresses include:

- new ways of sharing transmission capacity between different types of generator;
- the way grids are built and run; and
- whether the incentives to connect or disconnect are right to maintain security of supply.

Ofgem and DECC have agreed new principles for reforms that will help connect more low-carbon generation. These proposed new arrangements will make it easier and faster for generators - including new nuclear plant - to connect to the high-voltage transmission network (national grid) as existing power stations reach the end of their operating lives.

Access to the 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 rapidly connecting a large volume of smaller renewable generators or a significant volume of new conventional, lower carbon generation.

We propose to change the financial incentives on the transmission companies to invest in the new capacity that will be needed to connect more remote renewable generation. This will enable the transmission companies to build future capacity so it is ready when the new generation comes on stream. It will also protect customers from having to pay for unnecessary investment in new capacity. This is vital in an era of rising fuel prices and fuel poverty.

Our progress in reforming transmission access has been thwarted by industry process. This has prevented the inclusion for consultation of a model arrangement that the most recent analysis has shown to address shortcomings in other models under consideration. As a result Ofgem's governing authority has formally recommended that the Secretary of State take up his Energy Act 2008 powers to ensure no further delay in delivering these vital reforms.

Short-term measures

We have introduced interim, short-term measures that will accelerate the connection of at least 450MW of wind plant with planning permission to connect to the transmission system before the additional transmission capacity has been built.

New access arrangements

Ofgem and DECC have proposed a new incentive framework whereby transmission companies will be able to build networks ahead of securing contractual commitments from generators to fund the links.

They can earn higher returns on these investments if there is sufficient demand for the capacity once it is constructed. But they will earn lower returns if the new capacity is not fully used. This will allow the companies to build new capacity sooner while protecting customers from the financial and environmental costs of new transmission lines that are built but not used.

Review of Industry Governance

Ofgem has been developing improvements to the rules that govern the electricity and gas industries as part of its Industry Codes Governance Review (see page 36). The changes in transmission arrangements will feature significantly in this work.

Offshore transmission licensing regime

Following a consultation carried out jointly with Government, Ofgem concluded that Britain's transmission network owners should tender competitively with others to build, own and maintain the links that will connect planned offshore wind farms to the mainland grid.

These offshore transmission networks will be pivotal to the UK's objectives for renewable energy and will add to the security of UK energy supplies. DECC has forecast construction of some 33GW of offshore wind power.

In spring 2009 Ofgem appointed Royal Bank of Canada, Ernst & Young and Wills Group as its financial advisors to assist in running the tender process for transmission licences for the anticipated £15 billion-worth of new network infrastructure.

Consultation carried out jointly with DECC concluded in June 2009. The tendering process was expected to start in late summer. The offshore regulatory regime is expected to go live in summer 2010.

Distribution

Distribution is the transportation of gas or electricity from the transmission grid along regional branch networks to the households other premises where it is used.

Price controls

Ofgem regulates the revenue of the transmission and distribution companies to allow companies to finance their activities and make efficient investment to deliver to customers the service they expect from the companies. The regulatory regime is based on price controls that are reviewed every five years. These reviews set allowances for expenditure and create incentives to outperform and share the benefits with customers. They also include incentives to achieve environmental and social improvements on the networks and in the wider energy sector as well as other sustainable development targets.

Gas

First year of review

Gas distribution networks have completed their first year under price controls since they ceased all to be part of National Grid following the sale of four of the eight networks in 2005.

Ofgem's first full, five-year Gas Distribution Price Controls came into play in April 2008. They allow the network companies to increase their investment by more than a third to an average of more than £1 billion a year. Some £3.6 billion of this £5 billion of investment will be the replacement of distribution mains and service pipes as required by the Health and Safety Executive.

Over the five years of the price controls, average annual operating expenditure, capital expenditure

and replacement expenditure will grow leading to an increase in domestic gas bills of about £2 a year.

The gas distributors were given incentives to decrease the impact they have on the environment in carrying out their operations as well as incentives for sustainable development of their businesses.

In Ofgem's first annual report on the gas distribution networks, under the first Gas Distribution Price Controls, we set out revenue, expenditure and returns on regulatory equity for the eight licensed gas distribution networks for the year to 31 March 2008. And we updated benchmarking information produced for the price control and summarised quality of service information.

Key findings in the report included:

- all networks had achieved efficiencies in operating costs while maintaining levels of service to customers with controllable operating costs down by 1.2 per cent;
- customer satisfaction survey scores improved and gas lost through leakage fell but more interruptions in supply were reported; and
- delivery of the industry's safety driven mains replacement programme progressed with replacement expenditure up 9 per cent on 2006/07 reflecting the amount of pipeline replaced and higher costs.

However, we need to be cautious before reaching firm conclusions on the basis of only one year's data. Additionally, National Grid has drawn to Ofgem's attention that they have potentially misreported data in relation to their mains replacement programme, and we are carrying out an investigation into that.

Electricity

Fifth distribution price control review

Ofgem launched its fifth electricity price control review with the first consultation in March 2008.

The review will run from 2010 to 2015. Distribution charges currently stand at around £3.6 billion a year accounting for around 14 per cent of a typical domestic customer's electricity bill.

Ofgem has outlined proposals to strengthen the incentives on the distribution network operators (DNOs) to help tackle climate change. These are in addition to the more established incentives to

provide a secure and reliable network at an efficient cost and to improve services for customers. And we are aiming to ensure that only those DNOs that innovate and perform well against these objectives will be able to make higher returns.

Under our current proposals, DNOs will need to agree to deliver a set of outputs during 2010-2015. Ofgem will take a tough line with companies that do not come forward with sufficient output measures, adjusting allowed revenues as appropriate.

Environmental incentives

DNOs will be encouraged to make an immediate contribution to the climate change agenda. Examples of such contributors include reducing electricity lost on the distribution networks, and trials of new technology and commercial arrangements that might be required in the future low-carbon economy.

The new price control will need to be flexible because tackling climate change and responding to customers' requirements could lead to profound changes in the way distribution networks are run. Ofgem has been working with the DNOs to revise the structure of their electricity distribution charges. This revision will help in responding to changing network use as we move to a low-carbon economy while ensuring that the networks develop in an economic manner.

Customer focus

Ofgem wants DNOs to be more in touch with the needs of their customers, not least because of the growing customer interest in managing their energy use, for example by installing rooftop wind turbines and other forms of microgeneration. This could lead to significant amounts of generation connecting directly to the distribution network rather than the national grid.

The DNOs are planning significant increases in their capital expenditure to replace ageing assets, upgrade the networks and build more capacity where it is needed. Ofgem is challenging the companies' cost forecasts hard and will assess the opportunities for further efficiencies.

At every price control review, Ofgem aims to challenge robustly but fairly the companies' requests. However, there is also a need to ensure that we allow the companies to continue to invest to maintain the high levels of network reliability that customers enjoy and expect.

Competition in connections

Much of the business of distributing electricity and gas is a natural monopoly because it is cheaper and more efficient to have a single company owning and operating the network than several competing networks. But building, owning and operating connections to existing networks is a potentially competitive activity. Customers benefit from competition in connections through lower prices and better service. Ofgem has worked over a number of years to promote competition in gas and electricity connections.

Competition has grown rapidly in gas, to the extent that more than half of all connections are now installed by independent companies rather than the monopoly network provider. However, competition in electricity connections has developed much less rapidly.

We are working to improve the situation in electricity connections and we have demonstrated in recent years our will to take up enforcement cases where we believe competition is being hindered. In September 2008 we opened an investigation into EDF Energy's distribution network businesses over an apparent breach of its licence condition to offer terms for use and connection to its system.

Helping protect the security of Britain's energy supplies

6



Key achievements for 2008-2009

- Launch of in-depth study of Britain's supply challenges for the future

- Energy Markets Outlook

- Winter outlook

Introduction

As Britain approaches the end of its self-sufficiency in gas and its ageing power stations near the end of their lives, concern about the security of our energy supplies is growing in profile.

Project Discovery

Britain's energy market has delivered secure supplies for some 20 years. But there have been changes in the energy sector in recent years, some of them quite profound, with still more testing challenges to come.

The international credit crisis has hit as the energy industry is seeking investment to address the need for new renewable and other low-carbon generating capacity. At the same time Britain is growing in its dependence on imported gas, increasing its reliance on potentially volatile international gas markets.

Given these challenges to the proper functioning of energy markets in Britain, Ofgem launched, earlier this year, a major review to determine whether or not the current arrangements were sufficient to deliver an adequate level of security of supply. This review, called Project Discovery, is looking at gas and electricity markets.

It will consider a wide range of potential policy options to address any shortcomings. It will look at existing market arrangement for wholesale gas to see whether incentives for suppliers are sufficiently strong to deliver security of supply and whether there is a case for extending existing supplier obligations in gas relating to security of supply.

The issue needs the independent and impartial analysis that Ofgem is uniquely positioned to deliver. Ofgem's work and leadership will ensure the debate is not dominated by vested interests or driven solely by commercial priorities.

Energy Markets Outlook

Ofgem's yearly energy market information and analysis programme, run jointly with Government, produced its second report in 2009. The programme reviews medium- and long-term prospects in security of supply. It looks at infrastructure planning and other constraints as well as the availability of coal, gas and other primary fuels. It provides market scenarios to help industry in its strategic planning.

Winter outlook

Gas

In its Winter Outlook report for 2008-2009, National Grid said that North Sea gas deliveries were likely to be around 10 per cent down from the previous winter, but that this was likely to be offset by higher gas imports from diverse sources.

Outturn

The Russia/Ukraine dispute in early January resulted in higher UK demands as the interconnector with mainland Europe exported gas to the Continent, where demand was high. During this period there was some increase in the UK gas price but compared to previous supply shocks the price movements were relatively small.

Gas supplies were broadly in line with our forecasts. Though declining by nearly 10 per cent, North Sea supplies made up 55 per cent of demand. Due to lower deliveries to the Continent, Norwegian supplies to the UK were above our pre-winter forecast and made up nearly 30 per cent of demand.

While BBL interconnector imports were in line with forecasts, Interconnector UK imports were limited to just a few short periods and the link was in export mode for most of the winter, notably during the Russia/Ukraine dispute.

Electricity

National Grid said electricity supplies will be sufficient to meet demand for the winter. But at the time of the report it was unclear when certain nuclear power stations were to return from maintenance. The spare generating capacity margin for the winter was expected to be 25.4 per cent above demand.

Outturn

Overall electricity demand was reduced because of falling industrial demand. As a result, we found that weekly peak demand over the winter was 2GW lower on a weather-corrected basis.

At times of peak demand the availability of nuclear power stations was less than we expected but the market responded by, for example, making other forms of generation available.



7

Leading voice in Europe

Key achievements for 2008-2009

- Central influence on European energy policy to open up the energy markets by separating supply and transmission businesses in vertically integrated groups

- Improve transparency in gas networks through European Union Regional Initiative

- Key player in developing a Europe-wide sustainability report

- Security of supply initiative

Introduction

Ofgem has provided the European Union with a strong steer in its bid to inject competition into its energy markets and its moves to consolidate the regulatory framework.

European policy

Ofgem has continued to press for the separation of supply and transmission businesses in the vertically integrated pan-European energy companies.

We welcomed the formal adoption by European member states of the third package of legislation to make the European energy market more competitive.

The package, which each member state must now transpose into law, establishes that member states could order energy companies to separate fully ownership of transmission and generation or supply businesses. They may also choose from two other options allowing utilities to retain ownership with an independent company running transmission networks to ensure fair access to them.

Many regulators across the European Union (EU) do not have the same enforcement powers or same levels of independence as Ofgem and the package will enhance their powers. A pan-European regulatory agency will be established to administer a set of legally-binding codes governing access to and use of European networks. Ofgem will play a key role in setting up the agency through its chairman, Lord Mogg, who is also president of the Council of European Energy Regulators (CEER) and chairman of the European Regulators Group for Electricity and Gas.

Sustainable development

Ofgem suggested and approved work to develop a Europe-wide Sustainable Development Report to provide an indication of the progress that is being made in the environmental, social and other areas that constitute sustainability. Work on this project is underway and is scheduled for publication later in 2009.

Ofgem has continued to chair the Sustainable Development Taskforce within the CEER. Ofgem has led the contribution of CEER to discussions regarding the future of the European Union cap-and-trade scheme for emission permits (the EU Emissions Trading Scheme) and the Renewables Directive to bring on the achievement of the 2020 targets.

Regional initiative

The seven EU Regional Initiatives were set up in 2006 to bring on the development of gas and electricity markets in discreet areas of the EU. They seek to identify and remove the main barriers to trade and competition.

Ofgem played a key part in a project to provide network users with greater transparency of information on north west Europe's gas networks. Transmission network operators made sound progress in their commitment to publish all the information required.

Security of supply initiative

The European Commission's proposed regulation for European security of gas supply is likely to introduce revised standards for member states to ensure the supplies of gas to protected customers. The draft new standards are more stringent than those currently in force, in terms of the requirements they impose on member states.

One such a standard relating to a one in 20-year period of high demand could have a significant impact on GB market arrangements and consumers. For example, it may lead to new obligations on shippers to contract longer in advance for sufficient supplies or to hold physical gas in storage. Similar policies are also being considered domestically however, by DECC, Ofgem and National Grid, in their ongoing work on security of gas supply.

Helping to protect the environment

8



Key achievements

for 2008-2009

- Pave way for low-carbon generation through Transmission Access Review
- Clear up green tariff confusion
- Sustainable development report
- Removing barriers to local generation schemes
- Offshore transmission regulatory regime
- Administration of the Government's environmental programme

Introduction

Ofgem aims to assist and guide the energy industry to ensure it fulfils its vital role in the challenge of tackling climate change. The Energy Act 2008 contains provisions that will change the Authority's duties. The change will highlight that its principle objective relates to future, as well as existing customers and will elevate the Authority's duty relating to sustainable development to place it as equal to its duties to meet reasonable demand for gas and electricity and ensure the financing of authorised activities.

Transmission Access Review

Ofgem is driving forward reform of the arrangements governing connection to the national electricity grid to speed up the connection of renewable and low-carbon generators. It has however been frustrated by industry process in our bid to establish enduring reforms (see page 17).

We have put in place measures that will remove immediate barriers to investments and we have proposed new financial incentives.

Overall we are looking to a transmission network that will enable Britain to connect even more renewable generation to meet the EU's 2020 renewables targets while potentially connecting new nuclear and conventional power stations over the next ten to 15 years.

Green tariffs

Ofgem has published final guidelines on how suppliers should market so-called green electricity tariffs to tackle the difficulties consumers faced in working out how much environmental gain came with a given tariff. Our guidelines make it clear to customers whether these tariffs are truly green and form the basis for an independent accreditation scheme for green tariffs for householders and small business customers. The scheme will be run by an independent body.

Under the accreditation scheme, a tariff will only be regarded as green if it brings environmental benefits that go beyond the suppliers' existing Government environmental obligations. The big six energy suppliers and Good Energy signed up to the guidelines immediately.

Sustainable Development Report

The report reviews Ofgem's activities in the past year, in relation to the delivery of a low-carbon energy system, protecting vulnerable customers and tackling fuel poverty. As well as our direct activities, Ofgem has been working with Government and other stakeholders to influence wider developments.

Local generation

Ofgem and Government introduced new measures to make it easier for community electricity generators to supply customers. While protecting consumers' rights to switch supplier, the proposals will help local generators operate in the competitive market, and provide more choice.

Local electricity generation schemes – sometimes called distributed generation — are increasingly becoming part of new housing developments and more than 12GW of such schemes are already installed in, for example, factories and schools.

Ofgem eliminated the need for local generators to comply with costly, complex and time consuming rules by formalising arrangements whereby major electricity suppliers can take on the administrative side of this requirement.

Currently, to avoid the costs associated with operating on public networks, local generators build their own private ones. However, customers connected to them find it very difficult to switch supplier. The proposals will address this by retaining the rights of customers to switch supplier if they wish. Ofgem will monitor progress of the new arrangements.

Key to this is the work Ofgem has been doing with the electricity distribution networks to introduce cost-reflective charges that signal the costs and benefits that distributed generation can bring to the networks.

Offshore transmission regulatory regime

The Government anticipates that offshore wind power will provide some 25GW of generating capacity for the UK, making it a vital contribution to the nation's response to the climate change challenge. The offshore transmission regime being run by Ofgem is a crucial element in ensuring the networks needed to carry the power to the mainland are built swiftly and provide value for money to consumers (see page 18).

Environmental programmes

Ofgem administers, on behalf of Government, a number of crucial components of its Climate Change Programme.

Renewables Obligation

The Renewables Obligation and Renewables Obligation (Scotland), require electricity suppliers to buy at least part of their electricity from renewable generation.

The obligation was designed so the target increases each year from an initial 3 per cent at its instigation in 2002, increasing to 9.1 per cent in 2008-2009. This target is the same under the Renewables Obligation (RO) for England and Wales and the Renewables Obligation (Scotland) (ROS).

From 1 April 2009 the obligation changed from a percentage to an obligation to present a number of Renewable Obligation Certificates (ROCs). In 2009-10 this will be 9.7 ROCs per 100MWh in England, Wales and Scotland, rising to 15.4 ROCs per 100MWh in 2015-2016 and staying at this level until 2027 (one MWh equals 1,000 kWh). However, if the amount of renewable generation is likely to be close to (or exceed) these targets then the targets are increased to provide sufficient headroom. The maximum the target can be under the orders is 20 ROCs per 100 MWh. The Government plans to issue a consultation on the RO in July.

Ofgem also administers the Renewables Obligation in Northern Ireland (NIRO), via an Agency Services Agreement. This came into force in 2005 and the target for electricity supply companies in Northern Ireland was 2.6 per cent in 2006-2007 and 3.0 per cent in 2008-2009.

From 1 April 2009 the NIRO also changed from a percentage to an obligation to present a number of ROCs. In 2009-10 this will be 3.5 ROCs per 100 MWh rising to 6.3 ROCs per 100 MWh in 2015-2016 and staying at this level again until 2027.

Over 18.5 million ROCs were issued during 2008-2009, across the three schemes for England and Wales, Scotland, and Northern Ireland, compared with just under 16.2 million in 2007-2008.

In April 2008 Ofgem streamlined its management of the Renewables Obligation, Climate Change Levy Exemption Certificates and REGO schemes with its introduction of a single IT platform to replace four existing ones. The new platform – the Renewables and CHP Register – handles transactions worth some £4 billion a year.

Climate Change Levy

Ofgem continued to administer the Climate Change Levy (CCL) exemption for renewables. 2008-2009 was the eighth year of the CCL exemption and almost 24.7 million Renewables Levy Exemption Certificates (LECs) were issued – up from 22.8 million in the previous year.

Since April 2003, the exemption from CCL for direct supplies of Combined Heat and Power (CHP)-generated electricity, from sources designated as good quality, was extended to include indirect supplies — those supplies exported to the grid. We issued just over 22.5 million CHP LECs in 2008-09 to complying CHP schemes compared with 24.3 million in 2007-08.

Renewable Energy Guarantees of Origin

Ofgem continues to administer the Renewable Energy Guarantees of Origin (REGOs) scheme on behalf of the Government. This scheme was introduced as part of a European Union directive and REGOs are issued by Ofgem to generators to prove that their electricity is being produced from renewable sources.

Carbon Emission Reduction Target

Ofgem continued to administer the Carbon Emissions Reduction Target (CERT), on behalf of the Department of Energy and Climate Change (DECC). The CERT places an obligation on certain gas and electricity suppliers to meet a carbon emissions reduction target from domestic properties. The overall target is set by DECC with at least 40 per cent of the target having to be met from the priority group (those on certain benefits or over 70 years of age).

More recently, as part of the Heat and Energy Saving Strategy consultation, DECC consulted on amendments to the CERT, which included increasing the target by 20 per cent. Ofgem will continue to administer the CERT, in light of those amendments, accordingly.



Helping to tackle fuel poverty

9



Key achievements for 2008-2009

- Social programmes and social tariffs
- Market probe
- Fuel Poverty Action Programme
- Completed first Energy Best Deal campaign
- Fall in disconnections

Introduction

Escalating energy prices combined with the fallout from the credit crisis have added to the burdens of low-incomes and poor housing stock to carry greater numbers of households into fuel poverty – where energy bills account for more than a tenth of their income. Ofgem has a duty to have regard to the interests of vulnerable customers and we have put pressure on industry to reduce the impact of energy prices on vulnerable consumers including those who are disabled or chronically sick, elderly, on low incomes or living in rural areas.

Social programmes and social tariffs

Ofgem in July 2008 moved to clear away confusion surrounding social tariffs – energy deals for vulnerable and fuel poor customers. A subsequent awareness drive by Ofgem doubled uptake of social and other discounted tariffs to 800,000 homes. Savings to customers from social tariffs increased by 36 per cent to £33.9 million

Following the 2008 Budget, suppliers agreed to increase their collective expenditure on social programmes by £225 million between 2008 and 2011. Under our guidelines on which measures suppliers can count towards this increase, we ruled that any deal described by its supplier as a social tariff must be equal to that supplier's cheapest deal. Now all suppliers have adopted the Ofgem standard.

The move gave consumers and consumer advisors confidence on the value of social tariffs. But in allowing a range of measures, as well as social tariffs, the guidelines will help suppliers to identify and target support to consumers most in need.

Ofgem has maintained its approach in allowing a range of initiatives to be counted, ensuring that suppliers have flexibility in how they structure their social programmes and promoting innovation. This is particularly important given the difficulty in identifying vulnerable consumers.

Market probe

Our probe into the retail market (see page 12) focused on vulnerable customers. It identified customers who were among the most fuel poor. Some 30 per cent of the of the 4.3 million who did not have access to the gas mains and who were paying unduly high prices for electricity were in fuel poverty. And many of the customers paying undue premiums for pre payment meters were on low incomes. This group will benefit from the undue price discrimination licence condition that will be under consultation following the probe findings.

In its remedies emerging from the probe Ofgem looked at debt blocking – where customers in debt are prevented from switching supplier – as this particularly affected low-income and other vulnerable households.

Fuel Poverty Action Programme

Ofgem led a summit of energy sector stakeholders in April 2008. It agreed a package of measures to improve the targeting of help on customers facing growing hardship exacerbated by rising energy bills. The summit included Government ministers, energy industry chief executives as well as consumer and

voluntary agencies and a representative from the European Commission.

The summit produced an action programme to:

- improve the way the fuel poor are identified and targeted to ensure available help gets to them;
- ramp up the level of help available;
- support vulnerable customers to enable them to get the best deals in the market; and
- ensure that tariff differentials for different payment methods are justified.

The Fuel Poverty Action Programme that emerged includes practical proposals from the Government, industry and Ofgem to help low-income customers with better-targeted measures.

Department for Work and Pensions (DWP), DECC, Department for the Environment, Food and Rural Affairs and suppliers have ramped up discussions on data sharing, with a view to enabling suppliers to provide better-targeted help in reducing fuel costs for pensioners most likely to be in fuel poverty. DWP is exploring the use of legislation to enable this to happen.

The market-leading switching site providers agreed to promote their telephone advice services to help customers who do not have internet access to shop for a better energy tariff.

Energy Best Deal

In a national campaign Ofgem teamed up with Citizens' Advice to help the people identified as needing guidance to get the best out of the competitive energy market. Through the campaign - Energy Best Deal – Ofgem provided materials to enable Citizens' Advice and other help agencies to advise their clients.

Disconnection rates fall

Overall disconnection rates remain historically low despite a substantial increase in 2007. Ofgem's report in spring 2009 showed the rate of disconnections fell more than 16 per cent year on year in the first quarter of 2008. The downturn followed publication of an Ofgem review in January which identified best practice across the industry and set debt and disconnection benchmarks for suppliers.

Npower responded well to Ofgem's January 2008 review which highlighted the firm as having the most improvement to make. It responded with lower disconnection rates. Ofgem will continue to monitor and assess suppliers' performance and will look to take further action, including 'naming and shaming', where it is needed.



10

Better regulation

Key achievements for 2008-2009

- Launched overhaul of industry rule-making process
- People development
- Operational performance
- Continued to outperform our self-imposed cost reduction regime

Introduction

The principles that define Better Regulation are that it should be transparent, accountable, proportionate, consistent and targeted at cases only where action is needed. We adhere to these principles in all of our operations and we set out the costs and benefits, and the social and environmental impacts, of everything that we do.

Energy industry rules

In our Industry Codes Governance Review we are proposing to overhaul the governance of gas and electricity industry codes the rules for industry players to participate in the market and connect to the energy networks. This review reflects an increasing emphasis on sustainability and security of supply and the way that is changing the nature of market participation as, for example, more renewable generation is introduced.

We have proposed a reform package to speed up delivery of major policies and reduce our role in routine changes. The review will tackle current complexities in the processes for changing market rules and seek to strengthen competition by making it easier for small industry players to get involved and support changes.

Under current arrangements, major code changes such as the electricity transmission access reforms frequently hit delays. Progress can be hindered by conflicting interests of players in the market.

Existing processes for amending the codes have worked well to implement incremental change but have been severely tested in delivering major policy reforms.

Under the proposed new approach, Ofgem could initiate changes in major policy issues while in parallel, more routine changes, with low impact on customers, could be agreed by industry in a form of self-governance with little or no involvement from Ofgem. Such reforms could provide important better regulation benefits.

The Industry Codes Governance Review launched six work streams. We have published consultation documents on each of these and will be issuing initial proposals in the summer of 2009.

Work stream consultations

Major policy reform and self governance

A framework under which Ofgem would initiate and lead high-level policy reviews where the conclusions of the review would be legally binding and proposals to enable it to step out of the codes decision-making process on proposals that have low impact on customers.

Role of code administrators

Measures to improve the quality of analysis by code administrators and panels on code modification reports and measures to improve the efficiency and accountability of code administrators.

Initiatives to support smaller players

Whether requirements should be placed on code administrators and panels to consider the needs of small players.

Addressing complexity and fragmentation

An exploration of simplification and convergence of code modification processes.

Charging methodologies

Options that would make process of changing charging methodology more accessible to market participants.

Code objectives

Amending the industry's decision-making criteria on code modifications to take into account environmental issues.

Impact assessments

Drawing up Impact Assessments for all important new policy proposals contributes greatly to the quality of our analysis and helps us to be consistent in our consultations on major decisions. We have continued to evolve our Impact Assessment processes this year to ensure that outcomes remain fit for purpose.

Freedom of information

During the period 2007-2008 we received 159 questions under the Freedom of Information Act, of which 142 (92.5 per cent) were answered within the prescribed time limit (20 days in most cases).

People Development

Recruitment and Retention

Retaining, recruiting and developing staff to maintain high standards of performance is vital to Ofgem's success.

In 2008-2009 average staff numbers were 310. We have a 15 per cent target level for turnover. Staff turnover, in 2008-2009 was 12 per cent for permanent staff and 15 per cent for all staff (permanent and casual). This is significantly lower than the 2007/8 all-staff figure of 20 per cent and in line with our target level.

Diversity

Ofgem continues to encourage diversity through its employment practices and at the end of the financial year:

- 44 per cent of all staff were women;
- 41 per cent of staff in managerial grades were women;
- 29 per cent of Senior Civil Service members in Ofgem were women;
- 17 per cent of staff were known to be of ethnic minority origin;
- 11 per cent of staff known to be of ethnic minority origin were in managerial grades; and
- 0.6 per cent of staff were known to be disabled.

Days lost due to absence

Ofgem encourages a culture where good attendance is expected and valued. However, it recognises that from time to time absences for medical reasons may be unavoidable. In 2008-09, the percentage of working days lost was 1.8 per cent or five days a year per employee. This compares favourably to the public sector average of nine days a year per employee.

Operational performance

Financial review

In 2008-2009, Ofgem received fees of £41.3 million, of which £36.2 million was received from licence fees. In addition, £15.1 million was collected on behalf of the Department of Energy and Climate Change in respect of the energy sector-related costs of Consumer Focus, Consumer Direct and the closure costs of energywatch. £6.4 million was transferred to the Department for Business Enterprise and Regulatory Reform (DBERR) to meet energywatch costs prior to closure. Other income, mainly from property totalled £5.1 million.

Operating costs in 2008-2009 amounted to £42.0 million and included £3.9 million accommodation costs recharged to tenants. Payroll (49 per cent), contractors (15 per cent) and accommodation (21 per cent) accounted for 85 per cent of the total.

A saving of £0.8 million from licence fees was made in 2008-2009. This, and the carry-forward amount of £2.3 million, is planned to be utilised by Ofgem in 2009-10 as determined under Ofgem's RPI-X cost control regime.

Ofgem's budget is approved by Parliament following a consultation process with industry and other interested parties. For 2008-2009 Parliament approved a resource budget of £42.2 million. Our performance against deliverables is detailed in Appendix 1.

Ofgem's financial statements are shown in Appendix 4. More detailed information on costs can be found in our Resource Accounts published separately (HC 423).

Sustainability

Ofgem is committed to reducing its impact on the environment. In 2003 we installed a combined heat and power generator to provide onsite electricity, heating and hot water and in 2002 we became the first government Department to be certified to the ISO14001 Environmental Management System Standard.

In the year covered by this report we completed two years of our Sustainable Development Action Plan and have achieved the targets set by Government and most of those that we have set ourselves.

These targets address climate change and energy efficiency, waste management and recycling, procurement, and travel. Examples of some of our achievements included:

- increased recycling of waste to 58 per cent from 38 per cent last year following a combination of education and a new waste contractor;
- 93 per cent of business travel between London and Brussels in 2008/9 was by train, compared with 67 per cent in 2005-06;
- the number of videoconferencing calls has increased by over 50 per cent, compared with the previous year; and
- energy consumption has fallen for the fourth consecutive year.

Cost control

Ofgem has continued to reduce its costs in the fourth year of its self-imposed, five-year, retail price index (RPI)-linked cost control regime which has now made savings of £9.5 million. This has been achieved at the same time as meeting all our corporate targets set out in the corporate plan. The regime limits cost increases to 3 per cent below RPI.

While we met our cost control obligations, our resources and costs came under increasing pressure during the year. Ofgem is being asked to do more, including taking on greater responsibilities to administer the Government's environmental programme. To fulfil our responsibilities, we have begun to consider what arrangements would be appropriate in 2010 and beyond to maintain a strong cost-control discipline.

Appendix I

Ofgem's performance against 2008-2009 deliverables

Ofgem's Plan and Budget for 2008-2009 included a number of key deliverables to be achieved in each quarter.

Listed below are details of Ofgem's performance in meeting those deliverables, excluding ongoing deliverables which do not have specific target dates.

	Total in Corporate Plan	Total Achieved			Met in 2009/10	Not Applicable
		In target Qtr	In Later Qtr	Total		
Year Total	32	26	3	29	3	0
Quarter 1	6	6	0	6	0	0
Quarter 2	9	5	3	8	1	0
Quarter 3	10	10	0	10	0	0
Quarter 4	7	5	2	7	2	0

Creating and sustaining competition

Activity	Action	Delivery period	Achieved
GB Markets – Market monitoring and development	Publish initial findings from the energy supply market probe	Q2	Q3
	Publish 2008 Energy Markets Outlook report	Q3	Q3
	Publish final Winter Outlook	Q3	Q3
	Publish proposals for SO incentives to apply from 1 April 2009	Q4	Q4

Regulating networks effectively

Activity	Action	Delivery period	Achieved
Transmission	Transmission Access Review final report	Q1	Q1
	LENS - final report	Q2	Q3
	Offshore Final Proposals document	Q2	Miss *1
	Offshore 'go-live'	Q4	Miss *2
	Transmission Licensee Regulatory Report	Q4	Q4
Gas Distribution	Cost reporting - publication of first year of data	Q3	Q3
Electricity Distribution	Publish consultation on common charging methodology	Q1	Q1
	Publish Customer survey phase 2 report	Q2	Q2
	Publish cost review report	Q3	Q3
	Publish Quality of Service report	Q3	Q3
	Publish DPCR5 policy paper	Q4	Miss*1
Connections	Publish update on connections review implementation	Q2	Q3
Gas Distribution	Quality of supply report	Q3	Q3

*1 - Met in 1st quarter 2009/10

*2 - Met in 2nd quarter 2009/10

A leading voice in Europe

Activity	Action	Delivery period	Achieved
European Strategy and Sustainable Markets	Submit National Report to European Commission	Q2	Q2
	Ensure implementation of Gas regional Initiative transparency proposal	Q3	Q3

Helping to achieve sustainable development

Activity	Action	Delivery period	Achieved
Sustainable Development	Publish third Sustainable Development Report	Q3	Q3
	Publish green supply guidelines	Q2	Q2
European Strategy and Sustainable Markets	Decision on measures for Distributed Energy	Q1	Q1
	Implementation of final Distributed Energy proposal	Q3	Q3

Environment programmes

On behalf of the Government Ofgem administers a number of environmental programmes.

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

Helping tackle fuel poverty

Activity	Action	Delivery period	Achieved
Social and Consumer Affairs	Update on Vulnerable Customer Switching	Q4	Q4
	Hold fuel poverty summit	Q1	Q1

Better regulation

Activity	Action	Delivery period	Achieved
Fossil Fuel Levy	Set the Fossil Fuel Levy Rate for 2009-2010	Q3	Q3
Better Regulation	Post Implementation review on Gas Safety check licence changes	Q2	Q2
Industry Codes and Licensing	Publish Way Forward on Governance Review	Q1	Q1
Social and Consumer Affairs	Report on Future Consumers	Q4	Q4
	Set complaint handling standards	Q1	Q1

Appendix II

Impact Assessments undertaken 2008-2009

Ofgem published 12 impact assessments (IAs) between 1 April 2008 and 31 March 2009.

For further information on the following documents visit www.ofgem.gov.uk and search using the appropriate reference number.

- | | |
|----------|--|
| (81/08) | CAP 131 User commitment for new and existing generators

On 6 June 2008 Ofgem published an IA assessing a number of proposals to amend the Connection and Use of System Code to change the arrangements for connecting to and using the electricity transmission system. |
| (95/08) | Consultation and IA on EDF Energy's charging methodology proposals

On 2 July 2008 Ofgem published a consultation letter on EDF Energy's proposed modifications to its use of system charging methodology. |
| (98/08) | CAP 148 Deemed access rights to the GB transmission system for renewable generation

On 16 July 2008 Ofgem published an IA assessing a proposal to amend the Connection and Use of System Code to change the arrangements for certain classes of new generators (renewable or low-carbon) to connect to and use the GB transmission system. |
| (103/08) | Gas National Transmission System offtake arrangements

On 21 July 2008 Ofgem published an initial IA analysing the potential impact of a series of proposals to modify the offtake arrangements for National Grid Gas' National Transmission System. |
| (104/08) | Electricity distribution structure of charges project

On 22 July 2008 Ofgem published a letter consulting on how a common structure of charges could be implemented and setting out our view of the impacts of various charging methodologies. |
| (122/08) | P217 Electricity imbalance cash-out prices

On 11 August 2008 Ofgem published an IA assessing the impact of a proposal (and an Alternative Modification P217A) to modify the Balancing and Settlement Code in relation to electricity imbalance cash-out prices. |

(125/08) Consultation on Electricity North West's charging methodology proposals

On 22 August 2008 Ofgem published a consultation and IA on ENW's proposals to modify use of system charges for independent distribution network operators and high voltage/low voltage generators.

(147/08) Charging arrangements for generator local assets

On 24 October 2008 Ofgem published an IA on National Grid Electricity Transmission's Use of System Charging Methodology Proposal GB ECM-11 on the charging arrangements for transmission infrastructure assets that are local to generation connections.

**(172/08) Industry codes governance review
(173/08)**

On 19 December 2009 Ofgem published two consultation documents and initial IAs in relation to proposals for major policy reviews and self-governance and on the role of the code administrators. These proposals form part of our work on the industry codes governance review.

(01/09) Unfair price differentials

On 8 January 2009 Ofgem published a consultation and an initial IA on proposals to modify the supplier licence to tackle unfair pricing practices.

(07/09) Charging arrangements in relation to offshore transmission

On 4 February 2009 Ofgem published an IA assessing National Grid's proposed modification to introduce charging arrangements to recover the costs of transmission infrastructure assets that facilitate the connection of a generating site in offshore waters to the onshore network.

Summary of actions taken to which IAs relate

The following sets out the decisions taken in relation to proposals for which an IA was carried out.

(90/08) Transmission Price Control Review gas entry baselines

On 30 June 2008 Price modified National Grid Gas's gas transporter licence to enable the licensee to offer revised baselines and have a higher operational buy-back target cost following a decision made on 30 May 2008 (see document 72/08).

(145/08) Electricity cash-out

On 16 October 2008 Price approved Alternative Modification Proposal P217A and rejected P217 and P211.

Appendix III

Investigations and enforcement action 2008-2009

Company	Issue	Decision	Date of decision
Npower	Investigation into compliance by companies in the Npower group with Standard Condition 25 of their Gas Supply and Electricity Supply Licences (Marketing Gas and Electricity to Domestic Customers)	Finding of breach and penalty of £1.8m imposed	30 Jan 2009
Scottish and Southern Energy, Scottish Power	Investigation into SSE and SP under Competition Act 1998 – alleged abuse of dominance in the electricity generation sector contrary to section 18 of the Competition Act 1998 (the Chapter II prohibition) and Article 82 of the EC Treaty	Decision to close the investigation on administrative priority grounds as the likelihood of making an infringement finding under CA98 was considered to be low	19 Jan 2009
Npower	Investigation into compliance by companies in the Npower group with Standard Condition 44 of their Gas Supply Licences (Notification of terms)	Decision to close the investigation on administrative priority grounds	13 Feb 2009
National Grid	Investigation into National Grid under Competition Act 1998 – abuse of dominant position, contrary to section 18 of the Competition Act 1998 (the Chapter II prohibition) and Article 82 of the EC Treaty, by entering into long-term contracts for the provision of domestic gas meters with energy suppliers	The Competition Appeal Tribunal, on 29 April 2009, upheld Ofgem's decision of finding a breach but reduced the penalty to £30m. Decision under appeal to the Court of Appeal	Ongoing

Company	Issue	Decision	Date of decision
National Grid Gas	Investigation into reporting by NGG of regulatory information	Ongoing	n/a
EDF Energy Networks, EDF Energy Networks, EDF Energy Networks	Investigation into compliance by companies in the EDF group with Standard Condition 4D (Requirement to Offer Terms for Use of System and Connection) of their electricity distribution licence	Ongoing	n/a
Electricity North West Limited	Investigation into ENW under Competition Act 1998 – alleged abuse of dominant position, contrary to section 18 of the Competition Act 1998 (the Chapter II prohibition), by foreclosing the market to competitors	Ongoing	n/a

Appendix IV

Simplification plan 2009-2010

Earlier this year, during the corporate planning process, Ofgem considered whether there were any regulations that imposed burdens that could, in the context of our duties generally, be considered unnecessary. In March 2009 we published our Simplification Plan, which set out the activities that we would undertake to reduce or remove those burdens.

The Regulatory Enforcement and Sanctions Act 2008 requires the Authority to report on the progress we have made in removing burdens that we consider unnecessary. The updated Simplification Plan below sets out the progress that we have made on our activities to remove unnecessary burdens since March.

Process initiatives

Initiative	Outcome	Current status
The RPI-3 per cent cost control committed Ofgem to save at least £5m during 2005-10.	Has stimulated greater internal efficiency. We outperformed our target and over 2006-8 licence fees were reduced by an extra £4.4m.	We are in the final year of the existing cost control. Given rising costs and other resource pressures we are considering how to incentivise internal efficiencies after 2010.
The Industry Codes Governance Review seeks to improve governance, for example by creating a framework for Ofgem to examine the case for major policy reform via the codes and by introducing self-governance where proposals have little impact on consumers or competition. The modification process should be more accessible to smaller code participants.	The reformed governance regime should: <ul style="list-style-type: none">• deliver change that leads to a proportionate regulatory burden;• promote inclusive, accessible and effective consultation;• be transparent and easily understood;• be independently and objectively administered;• provide rigorous analysis of proposed changes;• be cost-effective; and• be sufficiently flexible as to enable efficient change management.	<p>We set out the scope of the review in June 2008 and published a consultation in December 2008. We have just launched a consultation on our initial proposals for major policy reform, self-governance and the role of code administrators. Final proposals will follow in Q4 of 2009/10.</p> <p>We have also consulted on proposed licence changes to make clear that where appropriate, industry should assess the greenhouse gas impacts of a proposed code modification.</p>

Process initiatives

Initiative	Outcome	Current status
The Consumer First project aims to improve our understanding of the priorities of domestic consumers.	The project has led to improved decision-making that takes proper account of consumers' views. We have published research and other data to facilitate debate.	We have focused on vulnerable customers and attitudes to the environment. We have also established new consumer panels which are an integral part of our policy-making.
Under Project Paperless we set up an Editorial Board to keep under review the quality and quantity of our print and electronic publications.	Making our documents more accessible will reduce the time needed to read Ofgem documents, with benefits for all stakeholders.	The Editorial Board is drafting revised internal guidance to Ofgem staff on writing plain English documents in 2009.

Policy initiatives

Initiative	Outcome	Current status
Our Probe follow-up work includes proposals to increase transparency, for example on billing	Better-informed switching decisions by consumers.	We will shortly publish a statutory consultation on a package of retail market measures which we propose to be implemented before the winter of 2009.
Removing barriers to Distributed Energy (DE) in existing marketing and licensing arrangements	This work will reduce the administrative burden for DE providers. It will be easier for DE providers to supply customers while upholding the consumer's right to switch supplier.	The changes took effect in late 2008. DE companies can contract with larger suppliers to manage the administrative requirements of industry codes. We are monitoring the impact of the changes closely.
The RPI-X at 20 review is examining whether the current approach to network regulation will continue to deliver reliable, well-run networks with good-quality service at reasonable prices despite growing investment challenges.	The review team will report to the Authority in the summer of 2010. We will subsequently consult on the recommendations. The eventual conclusions will inform our approach to new price control reviews after 2010.	We have hosted workshops with industry, investors, customers and academics. We consulted in February 2009 on whether we were looking at the right issues during the 'visionary' phase of the project. In June 2009 we published the first of what will be a series of working papers. It set out our current view of what energy networks should deliver in the future and the characteristics of an effective future regulatory framework.

Policy initiatives

Initiative	Outcome	Current status
Electricity Distribution Price Control Review (DPCR5)	We will seek a streamlined approach that will reduce Distribution Network Operators' (DNOs') administrative burden.	Initial proposals will be published in July 2009 and final proposals in December.
New, simplified reporting regime for Gas Distribution Networks (GDNs). We remain committed to publishing cost, revenue and quality of service data for GDNs.	We believe this work could reduce the administrative burden for distribution businesses and increase data transparency for network users.	We are looking for ways to simplify reporting requirements. We are exploring 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 balanced score card and DNO performance against new output measures agreed under DPCR5.
Distribution licence reviews	This work would ensure that the licences remain fit for purpose and that they do not impose unnecessary burdens on licensees. It would also simplify the text to make the licences more accessible to those using them.	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. We are considering reviewing gas distribution licences in the next year or two.

Appendix V

Ofgem's financial statements (extracts) 2008-2009

More detailed information on costs can be found in our Resource Accounts published on 29 April 2009 (HC423)

Balance sheet

as at 31 March 2009 (£000s)

	31 March 2009	31 March 2008
Fixed assets		
Tangible assets	3,939	4,012
	<u>3,939</u>	<u>4,012</u>
Current assets		
Debtors	4,604	4,220
Cash at bank and in hand	133	1,471
	<u>4,737</u>	<u>5,691</u>
Creditors (amounts falling due within one year)	(6,249)	(9,207)
Net current liabilities	<u>(1,512)</u>	<u>(3,516)</u>
Total assets less current liabilities	2,427	496
Creditors (amounts falling due after more than one year)	(2,290)	(2,606)
Provisions for liabilities and charges	(1,216)	(1,657)
Total net liabilities before pension liability	<u>(1,079)</u>	<u>(3,767)</u>
Pension liabilities	(562)	(578)
Total net liabilities	<u>(1,641)</u>	<u>(4,345)</u>
Taxpayers' equity		
General fund	(1,641)	(4,349)
Revaluation reserve	-	4
	<u>(1,641)</u>	<u>(4,345)</u>

Operating cost statement for the year ended 31 March 2009 (£000s)

	2008-2009		2007-2008
	Staff Costs	Other Costs	Income
Administration costs			
Request for resources 1:			
Staff costs	20,625		19,198
Other administration costs		21,386	20,709
Operating income			(41,316)
			(39,212)
Totals	20,625	21,386	(41,316)
Net operating cost			695
			695

All income and expenditure are derived from continuing operations.

Statement of recognised gains and losses for the year ended 31 March 2009 (£000s)

	2008-2009	2007-2008
Actuarial gains/(loss) on revaluation of pension liabilities	31	(97)
Recognised gains/(losses) for the financial year	31	(97)

Cash flow statement for the year ended 31 March 2009 (£000s)

	2008-2009	2007-2008
Net cash outflow from operating activities	(2,567)	(12)
Capital expenditure and financial investment	(857)	(364)
Receipts due to the Consolidated Fund which are outside the scope of the Department's activities	224,800	120,025
Payments of amounts due to the Consolidated Fund	(224,800)	(120,873)
Financing	2,086	-
Decrease in cash in the period	(1,338)	(1,224)





Published by TSO (The Stationery Office) and available from:

Online

www.tsoshop.co.uk

Mail, Telephone Fax & E-Mail

TSO

PO Box 29, Norwich, NR3 1GN

Telephone orders/General enquiries 0870 600 5522

Order through the Parliamentary Hotline Lo-Call 0845 7 023474

Fax orders: 0870 600 5533

E-mail: customer.services@tso.co.uk

Textphone: 0870 240 3701

The Parliamentary Bookshop

12 Bridge Street, Parliament Square,

London SW1A 2JX

Telephone orders/ General enquiries: 020 7219 3890

Fax orders: 020 7219 3866

Email: bookshop@parliament.uk

Internet: <http://www.bookshop.parliament.uk>

TSO@Blackwell and other Accredited Agents

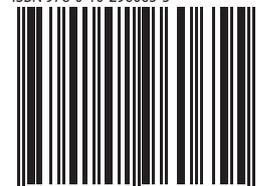
Customers can also order publications from

TSO Ireland

16 Arthur Street, Belfast BT1 4GD

028 9023 8451 Fax 028 9023 5401

ISBN 978-0-10-296065-5



9 780102 960655